INVESTIGATION OF BUREAU OF INTERNAL REVENUE

HEARINGS

BEFORE THE

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

SIXTY-EIGHTH CONGRESS

SECOND SESSION

PURSUANT TO

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SELECT COMMITTEE ON INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

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INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

FRIDAY, MARCH 20, 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), Ernst, and King.

Present also: Mr. L. C. Manson, of counsel for the committee; Mr. Raleigh C. Thomas, investigating engineer for the committee; and A. H. Fay and Mr. Hugh Archbald, investigating engineers for the committee.

Present on behalf of the Bureau of Internal Bureau: Mr. A. W. Gregg, special assistant to the Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. James M. Williamson, attorney, office of Solicitor, Bureau of Internal Revenue; and Mr. A. R. Marr, attorney, office of Solicitor, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. GREGG. Before Mr. Manson proceeds, Mr. Nash wishes to make a brief statement.

The CHAIRMAN. Very well.

Mr. NASH. I want to refer to two statements with reference to the procedure which has been criticized in the case of William Boyce Thompson. Counsel for the committee in opening his case made this statement:

> This case is an important case, not only from the amount of tax involved, but because it discloses a laxness which we believe to be symptomatic in checking losses claimed as deductions.

The Thompson case for 1918 apparently was handled in the bureau without being referred to the revenue agents in the field for a field audit and for checking those losses. Under our present procedure, as described in what we call income tax order No. 13, dated November 28, 1924, and which has been in effect since December 1, 1924, one of the first provisions reads as follows:

> All cases shall be referred for field audit except those which can be closed on the basis of the information at hand without additional correspondence with the taxpayer.

In the Thompson case a letter was written to the taxpayer asking for some information as to the losses and the case was apparently closed on the basis of the reply. Such a case, coming before the bureau to-day, would not be handled in that manner. The case

would be immediately referred to the field for investigation. I just wanted to bring out that point to show that the present practice in the bureau is not the practice which was followed in the Thompson case.

The CHAIRMAN. However, the practice followed in that case was the practice being followed at that time?

Mr. NASH. I can find nothing in any written order that would substantiate that statement. I have talked to the present head of the personal audit division, who was not in charge at that time, I believe, although I am not sure of that. He has been unable to find any written order that would substantiate the procedure in this case. There seems to have been at that time a sort of reorganization in process. There used to be an old field audit control section, through which all field investigations were handled. About that time the old field audit control section had been abolished and the field work was spread out through the other audit divisions. Any instructions on this point are apparently not available now. If there were any definite instructions we are not able to find them at this time.

The other point I wated to bring out was in connection with a statement made by Mr. Manson. Mr. Manson made the following statement:

> Mr. Box interviewed the chief of the subsection where this case was handled, a Miss Powers, as to whether it was customary where the schedule did not contain the information called for and where the information supplied by the taxpayer was not sufficient to make the basis of an effective audit, to allow the deductions under those conditions. She stated to Mr. Box that they not only made no check except on the totals, but there was no information on file in that section from which a check could be made.

In September, 1923, an information section was established in the personal audit division for the purpose of keeping such information was needed in these cases and also a great deal of other information. I find that that information section has the following basis of information in their files: Moody's and Poor's Manuals with respect to stock dividends, reorganizations, receiverships, bond issues, etc.; an index of distribution of estates; index of liquidations, Standard Statistics Co. book showing March 1, 1913, values of stocks and bonds; Financial Chronicle showing the New York Exchange transactions from 1896 down; also curves for each month of New York Stock Exchange, Chicago Exchange, Philadelphia Exchange, Baltimore Exchange, and Boston Exchange; list of stock transactions outside of those traded in on the exchange since March, 1917, from the Standard Statistics; and copies of Bradstreet for each year.

The information section, I am informed, can also give information on the folloing subjects:

> Allocation of dividends showing percentage taxable and nontaxable; allocation of liquidating dividends showing percentage return of capital, taxable for surtax, and taxable for both normal and surtax.
>
> In the case of sale of stocks of corporations having natural resources subject to depletion, the information unit has recorded tax-free distributions received since March 1, 1913, by stockholders of such corporations.
>
> March 1, 1913, value of securities shown by market quotations or determined under A. R. M. 34.
>
> Market quotations of securities for all years subsequent to 1896.
>
> Dates, and percentages of payments of stock dividends and stock rights.
>
> Taxable status of stockholders in reorganization, merger and consolidation transactions.

Status of contributions, showing those deductible and not deductible.
Information on refunds of estate taxes made to various estates.
Matters pertaining to cases coming under the office of the Alien Property Custodian.

There are also other details that are not enumerated here. I just wanted to bring out the above to show that there is such an information section at present in the bureau and that there was one in existence at the time this case was settled.

The CHAIRMAN. I do not get the application of your statement because I do not recall anything in the testimony that indicated even the securities on which losses were claimed.

Mr. NASH. The schedule that was submitted in respect to the letter in this case did give the names of some securities. It did not list them all. For instance, I remember one item of foreign exchange that appeared to be a big sum that was not analyzed.

The CHAIRMAN. Of course you could not tell what foreign exchange that was, could you?

Mr. NASH. No, sir. What I wanted to bring out was the fact that this auditor apparently told Mr. Box that there was no place in the bureau where she could get any information.

Mr. MANSON. I do not think that is what she said. That is not my statement.

Mr. NASH. I will read your statement again.

The CHAIRMAN. I think the Chair understands. I think my understanding of the statement of counsel was with reference to the information concerning this particular case and not the general information.

Mr. MANSON. I made two statements in regard to that matter. I made the statement that counsel for the bureau has just quoted. That statement was that this woman told Mr. Box that there was no information on file in her section. The statement just read by the representative of the bureau does not controvert that.

I wish to say that we have just begun a general survey of the bureau for the purpose of developing just such facts as are now being brought out, a study of its organization, of its facilities, and how cases are routed through the bureau. In other words, we have just begun a general survey for the purpose of ascertaining the general practices and organization of the bureau.

I quoted the statement made to me by Mr. Box and I do not see that the statement that has been made here controverts the statement that was made.

Mr. NASH. It may be true that this information was not immediately at this auditor's elbow. It is in the division in which this auditor belongs. There were instructions in the division that any auditor who wanted that sort of information should fill out a blank such as this which I hold in my hand and forward it or take it to the information division and get such information. Every auditor was furnished with these blanks and with such instructions. We could not keep a copy of Moody's Manual, for instance, on every auditor's desk.

The CHAIRMAN. I understand that. I am still of the impression, or at least I got the impression that the matter related to particular securities on which this taxpayer claimed losses.

Mr. MANSON. The schedule of the taxpayer, even the supplemental information furnished, did not identify 5 per cent of the securities upon which losses were claimed.

Mr. NASH. If I am out of order with this statement I will withdraw it. My understanding was that counsel was criticizing the general procedure in the handling or checking of losses.

The CHAIRMAN. If he was, I did not get that particular point of it. I got the particular point, or at least it was impressed upon me, that information was lacking with respect to this particular case. If the circumstances and conditions are as you state we will let it go at that.

Mr. NASH. The first statement of counsel was that it was "because it discloses a laxness which we believe to be symptomatic."

The CHAIRMAN. I think the laxness was in passing the matter without having information with reference to the securities on which the losses were claimed. I do not desire to controvert your statement if the conditions are as you state, so we will let it go at that.

Mr. MANSON. Surely.

Mr. GREGG. Now, I would like to put something in the record with reference to the oil situation. As will be remembered, counsel for the committee first presented, through Mr. Fay, a general criticism of the procedure of the bureau with reference to discovery depletion, which I want now to answer. I do not want to take up the specific cases which several days later were referred to by counsel. We will come to those at a later time. I merely want to take up now the general criticism made by Mr. Fay of the general procedure of the bureau with reference to discovery depletion.

Mr. Fay's criticism of the handling of this subject by the bureau was divided into three parts: First, the criticism of the definition of the discovery or proven area; second, a criticism of the use of the market price of oil in determining the value; and third, a criticism of the discount rates used by the bureau. I would like to take up those points separately and not in the same order as they were taken up by Mr. Fay.

The first point I want to take up is the question of the market price of the oil. Mr. Fay's criticism and the criticism of the counsel for the committee on that point is divided, I think, into two parts. First, Mr. Fay said that most of the drilling was done during high oil prices and consequently when the discovery wells were brought in, the prices or values were boom values and the depletion deduction was excessive. That criticism is a criticism of the act itself and not of bureau procedure, because the act provides for the valution in the case of discovery on the basis of the fair market value at the date of discovery or within 30 days thereafter.

The CHAIRMAN. In that connection, is it your opinion that the act itself might properly be changed?

Mr. GREGG. I think the whole matter of discovery needs consideration.

The second point in that criticism of the use of the market value of oil was one made by counsel for the committee and later restated by the chairman. It was to the effect that the posted price of oil at the date of discovery might be high, that it might be higher than the average of the preceding three years, and that this would give a fictitiously high value. The chairman restated that criticism in a

different way, both here and before the Finance Committee, when he asked me why we used in valuing mines an average price, and in valuing oil properties the posted price at the date of discovery This criticism, I think, is the more important one.

The CHAIRMAN. That is the one with reference to which you say the law is responsible and not the bureau?

Mr. GREGG. No, sir; that one the law is not responsible for.

The CHAIRMAN. I thought it was the posted value at the date of discovery?

Mr. GREGG. I said that the first criticism that the value at the date of discovery is usually a boom value and high is a criticism of the law, which provides that we must take the value at the date of discovery or within 30 days thereafter. The second criticism and the one you emphasized is that in valuing as of that date we used the posted price of oil on that date, rather than the average, as we do in valuing other mineral properties.

The CHAIRMAN. But you are required by law, you say, to use that valuation?

Mr. GREGG. No, sir; we are not.

Mr. MANSON. You are drawing a distinction there that I did not draw. The point I made is that while you are required to take the value as of the date of discovery, or within 30 days thereafter by law, yet the value you are to take is the value of the well, which depends entirely upon what the operator or purchaser expects to get out of it, and that nobody buying an oil well at the time when oil is at a peak would buy it upon the theory that oil would continue at that price until he had recovered all the oil out of his well. That was my criticism.

Mr. GREGG. That is exactly what I said. Perhaps I did not make myself clear. That is the criticism which counsel made and the criticism which the chairman made. The point is this: The law itself forces us to value as of the date of discovery, to value the oil in the ground as of the date of discovery. The criticism of counsel for the committee, which was later restated by the chairman, was that in valuing the oil in the ground we use the posted price of oil as of that date when it might be that the price of oil would decrease in the future. In other words, a purchaser at the date of discovery, if the price of oil was high, in valuing the property would not use the posted price of oil on that date, but would anticipate a subsequent decrease in the price of oil. You criticized us for using the posted price of oil on the date of discovery, instead of considering the fact that it might decrease in the future before the oil was produced, and that such an element would be considered by the purchaser.

The CHAIRMAN. I must be very dense, because I do not get the difference now between what you say the law requires you to do and what you say I criticized you for doing.

Mr. GREGG. Let me restate it. I evidently have not stated it clearly. The law requires us to value the property, to get the fair market value of the property at the date of discovery.

The CHAIRMAN. Does that include the oil or the land, or just what does it include? In arriving at the value, do you use the oil or the ground, or just what do you include in the term "property"?

Mr. GREGG. The act says "property," and that involves the valuation of the oil in the ground.

Mr. MANSON. What I was criticizing was the use of the posted price of oil as of that time and applying that posted price to all the oil in the ground.

The CHAIRMAN. Is not that what you are required to do by law?

Mr. GREGG. No, sir. We are only required to get the market value of the property. The criticism made by counsel for the committee is that a purchaser would not estimate that for the four years it would take to produce that oil to get it in a marketable condition that the price of oil would remain at that peak price.

Mr. MANSON. That is my criticism.

The CHAIRMAN. I think I understand it now.

Mr. GREGG. In criticizing us for doing that, counsel compared the oil industry with the copper industry, and said we took the posted price of oil at the date of discovery, but in the case of copper we take the average price over the 10 preceding years, and asked why we made the distinction. I did not know at the time, so I did not answer.

The CHAIRMAN. Then I was as well informed as you were at that time.

Mr. MANSON. I made that same criticism, and in making it I assumed the same thing the chairman assumed, namely, that it was your decision that the law required you to take the posted price at the date of discovery or within 30 days thereafter.

Mr. GREGG. I am glad that is brought out, because I want to make our position clear on that matter. We do not make that contention. We contend that all we have to determine at the date of discovery is the market value of the property. The matter of the price of oil which we should use in an analytical appraisal method to determine the value of the oil in the ground is a different question and a matter of judgment, and one on which the act does not require any specific action by the bureau.

Mr. MANSON. I think we can agree that the fact to be determined at that time is what the purchaser would expect to get out of that property.

Mr. GREGG. Certainly. I think we understand the question and the difference.

In the copper industry and in all metal mines the life of the property is usually very long. Some copper mines have a life of 20 to 40 years. Valuation of such property by an analytical appraisal method necessitates an estimate of what the price of the copper will be over the life of the mine. In the case of oil, however, in the majority of cases the property is short lived—two to four or five years. We do not have the long lapse of time over which we have to estimate the price of oil.

The CHAIRMAN. It is a condition well known, is it not? That condition which you have stated is a condition known?

Mr. GREGG. Yes, sir. In the copper industry it has been the practice to estimate the future selling price of copper based upon the past selling price. That is what was done in valuing the copper mines under Mr. Grimes's method, although it differed somewhat from the method used by Mr. Gratton. They both have considered the price of copper for a long period in the past in estimating the future selling price of copper. In the oil industry that has never been the practice. The practice has been in the oil industry, I

believe largely because of the short life of the property, to value the oil on the basis of the present posted price of oil. I would like to give a few authorities on that.

The CHAIRMAN. Do you mean that is the practice in buying?

Mr. GREGG. That is the practice in buying. For example, when the first oil well was brought in in this country around Civil War time in Pennsylvania, oil wells were sold on the basis of a valuation arrived at in the following manner——

Senator ERNST. This was when?

Mr. GREGG. Away back at the time of the Civil War, when oil was first brought in up in Pennsylvania. The value was determined to be the daily posted value of each barrel of oil production multiplied by 1,000. It was an arbitrary method. I will read some other authorities with reference to that.

Senator ERNST. Why did they use the 1,000 unit?

Mr. GREGG. That was the method used at the time. I do not know why 1,000 was determined, but it was based entirely on the posted price of oil at the date of valuation. The authorities I have for that are as follows: "Valuation of oil and gas lands," by Robert Wesley Brown, page 153.

Mr. MANSON. That rule-of-thumb method to which you have just referred was never applied except in the East, was it?

Mr. GREGG. Yes. It has been applied with modifications in other fields, usually with some modifications due principally to the fact that in the Pennsylvania field the production was settled. They could estimate fairly well the life of the property and the yearly production. Of course, some modification was necessary in the case of flush production.

Mr. MANSON. Those were the long-lived wells?

Mr. GREGG. Yes. I am not saying that the formula can be applied to other properties, but as far back as the Civil War in determining the price or the value of oil properties they used as a determining factor the posted price of the oil at the date of valuation.

I am going to quote now on the same subject from a book entitled, "Appraisal of Oil and Gas Properties," published by Roswell H. Johnson, professor of oil and gas production industry of Pittsburgh, and Paul Ruedemann, appraisal engineer and geologist:

> An old and up to the present time most commonly used method for calculating values is the barrel-day rule. This rule of thumb originated in the Pennsylvania field and was stated thus: The value of settled production per barrel is 1,000 times the posted price of the crude.

The following is a quotation from Oil Land Development and Valuation, by R. P. McLaughlin, page 171:

> Settled production has long been the basis for establishing the market value of oil properties. It is applied, as the name implies, after the initial or flush production has settled down to somewhat uniform rates. The price per barrel of oil produced daily by a property is quoted as its value. The price per barrel for settled production in any locality naturallly varies with the market value of oil.

These quotations I am putting in the record, and I have two more which I will turn over to counsel for the committee, for the purpose of showing that as far back as the Civil War properties changed hands on the basis of a valuation based upon the posted price of oil at the time of valuation.

The CHAIRMAN. Then nothing has happened since that time which suggests a better method?

Mr. GREGG. No, sir; evidently not, from the authorities I have read.

Mr. FAY. That applies to settled production, does it not?

Mr. GREGG. It is not my contention that the rule is a rule on which wells should be valued prior to settled production. It is merely to show that in any valuation, and it does not make any difference in this case whether it is flush or settled production, it is the market price of oil at the date of valuation that is used as the basis.

Mr. FAY. It must be at the date of discovery, according to the law.

Mr. GREGG. That is the first point I was attempting to make. The next point is the matter of discount rates.

Mr. MANSON. Before you leave the first point, is it not conceivable that a factor which is proper to be applied as the basis of one formula may not be proper to be applied as the basis of another?

Mr. GREGG. No, sir; I do not think so; not in this particular instance. If oil properties have changed hands since the Civil War on the basis of the valuation of the properties, a factor in the determination of which is the price of oil, and the price of oil which has been used in such cases is the posted price at the date of valuation, then I think if you use the price of oil in any formula the same rule should apply.

I am glad you brought me back to that point, because there is another point I want to make in connection with it. There have been cases where at the date of valuation the price of oil was unusually low or unusually high. I checked that over with the natural resources section, and the only cases they could give me where the price of oil was unusually low at the time of valuation were some of the valuations in the California field, where the price was known to be at an amount much below the level. In those cases they did anticipate an increase in the price of oil over the life of the property.

The CHAIRMAN. Was that justified at the time under the rule?

Mr. GREGG. Not under the ironclad rule. I am making the point myself that it is subject to exception. They made an exception to it in that case. There have been cases where they valued property at a time when the price of oil was unusually high and it was known that it was unusually high.

Senator KING. Sort of a boom price?

Mr. GREGG. A boom price it was. It could be anticipated that over the life of the property that price of oil would decrease. In those cases where that was clearly shown they have taken care of the factor through an increase in the hazard factor.

The CHAIRMAN. And with the consent of the taxpayer?

Mr. GREGG. Not necessarily; that is not material. It is immaterial whether he consents to what we do or not. If he does not, he may take the matter to court.

The CHAIRMAN. If the law and the practice of the department does not permit you to use a flexible rule of raising the price when the price is low and lowering the price when the price is high, how does the taxpayer know there is no ruling to the contrary?

Senator KING. I think Mr. Gregg is right. I do not think the law compels them absolutely to take the posted price as the exclusive method of determining the valuation or the chief factor in deter-

mining the valuation of that date. They may use the posted price, and they usually do use the posted price, but if conditions are such as to indicate quite conclusively that it is a fictitious condition, an abnormal condition which may not be continued, then, as I read the statute, or as I remember the statute, they would be justified in making a departure. The law does not say they must take the posted price as a method of determining value. They may use that as one of the factors. Let me illustrate. Suppose you and I, Mr. Chairman, were to go to buy an oil well that had just come in. On the particular day oil was selling at 50 cents a barrel. I do not know anything about the price of oil, but that would be unusually low, I fancy. We knew that fact and the seller knew it. He would not offer to sell on the basis of 50 cents a barrel, because the current report, the newspaper reports and the oil reports, indicated that within the next year or possibly the next month they would go back to a normal basis of $1 or $1.50 a barrel, and he would not sell to us on that low basis. If it happened at that particular moment that the price was $3 or $4 a barrel, we would not pay that, and he would be glad to sell at that basis, because we would know of the unusual conditions. They only use the posted price as one of the means of determining the value. Am I not right?

Mr. GREGG. That is the point exactly. The posted price represents the general rule, but like most broad general rules it is subject to exceptions, and one of the exceptions is that if the price at the time of valuation is exceptionally low and it is known that it is going to rise, that fact can be taken into consideration.

The CHAIRMAN. When those exceptions are made, you must arrive at the basis being used of the average price?

Mr. GREGG. No, sir. It is based on an estimate of what it is going to be in the future.

The CHAIRMAN. How do you arrive at your estimate except upon the basis of past prices?

Mr. GREGG. The price of oil varies. There is no indication of what it will be in the future. It is just a matter of judgment as to what it is going to be in the future.

The CHAIRMAN. Tell me what factors you use in arriving at the price of oil in the future.

Mr. GREGG. I can not. It is a matter of judgment on the part of the engineers, who are familiar with conditions, having to exercise their judgment. There are plenty of other places in the matter of the valuation of oil properties where they do have to exercise their judgment, but the point is that the exceptions to the rule are rare and they are made both ways.

The next point is the matter of discount rates——

Mr. MANSON. While on this matter of price, would you say that a case where they use the peak price when oil was high in value, but averaged between peaks when oil was low and no hazard factor, conformed to a proper practice?

Mr. GREGG. I should say that if at the time the discovery is brought in the evidence is from past discoveries that there is going to be a slump thereafter, that factor should be taken into consideration either through the hazard factor or in some other manner.

Mr. MANSON. Is it not a fact that the principal factor outside of war which influences the price of oil is the discovery of new fields,

and that it is almost universal, unless we have a war, to have a slump following the discovery of a new field?

Mr. GREGG. I could not express an opinion on that at all one way or the other. I would have to look up the history with reference to oil.

Senator KING. Are you sufficiently familiar with the method of determining values to say that they do not take into account in making the value the fact that the overwhelming majority of the wells, I suppose most of them, shrink in value very quickly?

Mr. GREGG. That is taken into consideration, yes, sir; absolutely.

Senator KING. For instance, if a well comes in which is a 10,000-barrel well, they do not estimate that it is going to continue at 10,000 barrels?

Mr. GREGG. No, sir. If they bring in a well of that capacity, they do not assume that it will be a 10,000-barrel well next year.

Senator KING. I mean as soon as one is brought in at 10,000 barrels——

Mr. GREGG. It is not estimated that it is going to continue at that output.

Senator KING. And so they do not put their basis upon the ground that it is a 10,000-barrel well?

Mr. GREGG. No, sir. They sometimes estimate that as much as 80 or 90 per cent of the oil in that well will come out in the first year.

Mr. MANSON. Is it not a fact that when once the characteristics of a certain sand in a certain field have been ascertained you can anticipate with a fair degree of certainty the rate of recovery of the oil in that sand in that field?

Mr. GREGG. I think so; yes, sir.

Mr. MANSON. That has been reduced to a fairly definite basis, has it not?

Mr. GREGG. They have curves showing that fairly accurately.

Senator ERNST. In reference to your question, Mr. Manson, I happen to know of wide fluctuations in the price of oil when new fields have not been discovered.

Mr. MANSON. Oh, yes; but I think it is generally recognized that the discovery of a new field usually results in a slump.

Mr. GREGG. That represents the opinion of counsel for the committee. I am not qualified to express an opinion on it.

The matter of discount rates is the next point I want to discuss. With reference to this matter the bureau was criticized, the statement being that they used discount rates of from 5 to 10 per cent in the valuation of oil properties. I have here the instructions issued to the engineers in the oil and gas section under date of July 1, 1923, in which it is provided that the 10 per cent discount rate shall be used in all cases, with no exception.

The CHAIRMAN. What was the date of those instructions?

Mr. GREGG. July 1, 1923. That is to take care of the discount for deferment only. In addition to that allowance is made for hazard. I am told by the head of the section that the combined rate for both hazard and deferment—the deferment discount rate is 10 per cent in all cases—ranges from 25 to 55 per cent in all cases.

In this connection I would like to explain something about the work of that section. It was new to me, and I think it will be of interest to the committee. They have the oil and gas section divided

into subsections along geographical lines. The men in a given section have been trained and are familiar with conditions in the section of the country from which the cases they consider come. Texas cases go to one section, for example, and engineers there are familiar with conditions in Texas. They take into consideration from their knowledge the hazard factor, the possibility in the first place of salt water, the hazard for dry wells, etc.

The combined hazard, as the result of these considerations, varies from 25 to 55 per cent, which seems to me to be adequate, certainly. They have a check which is not an accurate one at all, but which seems to me a very wise plan on this valuation. They have taken in each section of the country actual sales of oil property and have determined its relation to the posted price of oil on the day of the sale. For example, as it was told me, they determine in Texas from actual sales that the property is sold for an amount which, reduced to terms of barrels, is between 40 and 50 per cent of the posted price of oil on that day. When the valuation comes up for approval it is immediately determined if it is within this range of between 40 and 50 per cent of the posted price at the date of discovery. If it is not, it is then gone into very carefully by the chief of the section to see why it is out of line that they have based on actual sales. It seems to me it is a very good check and that gross errors should be caught there. I think it particularly valuable when this fact is considered. As I said a moment ago, in the valuation of these oil properties the judgment of the engineer plays a very important part in the matter of the hazards, the dry-well hazards, hazards for salt water, etc. He has to determine the hazards from those things from his own knowledge and from the data he can get, but very largely from his own knowledge, so that in order to keep from giving too great discretion to him they have this check. I think that covers the matter of the discounts.

Mr. MANSON. On that point I would like to say that I have not the slightest doubt that Mr. Gregg honestly believes the practice he just stated here to be the practice of the bureau, and that if that were the practice of the bureau it would meet with my full approval.

Mr. GREGG. May I ask upon what counsel bases his statement which contradicts directly the statement of the men who are handling these questions?

The CHAIRMAN. Yes; Mr. Manson should answer that question.

Mr. MANSON. I have already filled the record with evidence of valuations made on the basis of 5 per cent discount factor with no hazard and where the discount factor was not applied at all to the first year. I will present any number of additional cases. For instance, Mr. Gregg just stated that it is the practice to test the valuations by actual sales. That is a practice which I know prevails in the metal section and which I had commended. I have a case before me, the next one I intend to present to the committee, where two parties owned an interest in the same property in the same well. The interest of one of those parties was actually sold, and although the interest of the other party was less than the interest of the party whose interest was sold, it was valued at about twice what the sold interest actually was sold for. There was a case where a comparison of sales could be made because it was the identical property that was sold.

Mr. GREGG. Counsel for the committee has made a speech in my time without answering my question.

The CHAIRMAN. I thought he did answer your question—that they do not have the uniform policy which you stated.

Mr. GREGG. The only case which has been taken up of oil valuation so far is the Gulf case. I said when I started that I did not intend now to answer the Gulf case. I will answer it later.

The CHAIRMAN. Did not counsel for the committee just refer to a specific case?

Senator ERNST. He did not name the case. He said there was a case, but he did not name the case. I understand that Mr. Gregg wants that case named.

Mr. MANSON. I am going to present it.

Mr. GREGG. They have in that section charts with which every valuation is checked. On the matter of the sales of course there are times when there is a sale involved about which we do not know. I have some here that I am going to read into the record where we undervalued materially as compared with the adjoining sales. The point is, however, that the men in charge of this section have proven to me that they check on the basis of the posted price of oil. That is a check which is made in every case. Where they have sales and know of them, they take those sales into consideration.

The discount rate which I have stated is shown by the order which I have read and which is very specifically 10 per cent—that 10 per cent of the deferment rate is to be used. With reference to the hazard rate, the men in charge of the cases have told me that it ranges, as they say, from 25 to 55 per cent. That is the most I can say at this time. Specific cases have to be answered when brought up.

The CHAIRMAN. The order which you have just read was dated only in 1923 and some of these criticisms, I understand, apply to times prior to that.

Mr. GREGG. Yes, sir. I am merely justifying present practices in the bureau rather than what has been done at some remote time in the past.

Senator KING. You mean prior to 1923?

Mr. GREGG. Yes.

The CHAIRMAN. I want to get your point a little more clearly. You said there were cases where you had undervalued. In that connection, so far as the chairman may speak, the committee is not criticizing only those cases which are overvalued, but if there are cases of undervaluation, the criticism is equally applicable. So far as I am concerned we are trying to get at a uniform policy rather than a variable one.

Mr. GREGG. The point I want to emphasize in that respect is this. Counsel for the committee will bring out the cases where we have overvalued, but I would like to put in cases where we have undervalued. That will show what I think the committee appreciates, that this matter of valuing oil properties is a tremendously difficult one. There are questions of judgment in every step of the procedure and they are not going to work out very accurately. We have done and have to do the best we can. We can not get mathematical accuracy in our results.

The CHAIRMAN. I want to say that I comprehend that fully. The only thing we are interested in doing, so far as I may say so, is to bring out as nearly as possible a uniform system of applying to all taxpayers.

Mr. GREGG. I may answer this by saying that on the matter of principle in this matter we have adopted in general an ideal that has not been realized, but we have done the best we could. There are individual errors. I was answering first at this time Mr. Fay's criticism which was a criticism generally of the procedure of the department involving these cases. Then we will take up later the specific cases.

The CHAIRMAN. What was the order of the bureau prior to the one you have just read?

Mr. GREGG. That is the only one I have discovered.

The CHAIRMAN. So far as the order of July, 1923, is concerned, would the engineers use such discount rates only as they thought best?

Mr. GREGG. I would imagine from the wording of this order that prior to the date of this order different discount rates had been used in different cases.

The CHAIRMAN. And were they based on the judgment of the engineers?

Mr. GREGG. I imagine they were. Here is the wording of the order:

Since the regulations provide for a discount and since Hoskold's 10 per cent discount table modified to indicate the present worth of the unit realized at the middle of the first fractional year and at the middle of each calendar year thereafter, is reasonable and conforms with the current practice, this table should be used in all valuations established by appraisal methods.

I would judge from the wording of that order that something else might have been done prior to that time.

Senator KING. May I ask Mr. Manson a question? You expressed the view, as I understand it, that the interpretation which Mr. Gregg placed upon the law was the correct one, but you stated that the practice from your observation had not measured up to the interpretation he places on the law, and you said you would put in a number of cases. Have you finished upon that matter?

Mr. MANSON. We have just made a start on the subject of oil.

Mr. GREGG. I want to repeat what I said to the chairman just a minute ago, and the reason I am putting this in the record is this, that Mr. Fay's first criticism was a general criticism of our procedure in handling these cases, and I merely wanted to show that our general procedure was proper and justifiable.

As to the matter of the treatment of individual cases, I will take that up later.

The CHAIRMAN. I am glad to have that, because we will get a better conception of these cases as we go along with this in advance.

Mr. GREGG. Yes, sir.

The CHAIRMAN. I approve of that.

Mr. GREGG. The next matter was a criticism of our definition of discovery. I may have to repeat a little of what I said at the time in answering that.

In the first place, Mr. Fay said that our regulation to the effect that one well proved an area of 160 acres, with the well at the center, reached absurd results.

The first example which he gave of that was a case where A and B own adjoining 160-acre tracts. There is no oil on either. A brings in a well on his tract. B drills an offset well on his tract. The criticism was made there that we would allow both discovery value for depletion.

As I pointed out at the time, that is, in my opinion, purely a criticism of the law, which says that in the case of a discovery on property not acquired as the result of the proven tract or lease, this discovery value can be set up.

My construction of that and the construction which has been uniformly adopted by the department since the enactment of the law first in 1918 is that the limitation of a proven tract or lease applies only to the case where the tract was proven at the time the purchase was made. I think the law so states. In other words, if the example that I gave, that limitation has no application, because at the time both A and B purchased there was no oil well around and neither tract was proven.

I think that answers the example that he gave.

But the criticism does apply to another case.

Suppose that A owns a 160-acre tract on which he brings in a well. Suppose, then, after the well was brought in B purchased the adjoining 160-acre tract. Under the regulation B would be allowed discovery on his 160-acre tract on the theory that the discovery of the adjoining tract proved only that 160 acres.

In the first place, in that connection that bring us to a consideration of what area is proven by a single well; and I want to bring out in that connection that the regulations do not say that only 160 acres are proven by a given well. They say that at least 160 acres are proven by a given well, but if geological conditions so indicate more may be proven.

Mr. MANSON. You will recall that Mr. Greenidge stated here at the time you were making that statement, or immediately after you made that statement, Mr. Gregg, that it was the practice of the bureau to arbitrarily accept the 160 acres as the definition of the proven area.

Mr. GREGG. Yes, sir; he said that was his information.

Mr. MANSON. Yes.

Mr. GREGG. But let us come from the point of the definition that we have to the possible definitions which have been suggested; but before going into that I think you will have to admit that you have to lay down some more or less arbitrary rule on the subject. You keep getting into too great a discussion about the handling of particular cases. You have to establish some rule of thumb.

Mr. Fay suggested that no well should be considered as discovery if it were within 3 or 4 or 5—he did not say which—miles of a producing well. I think the arbitrariness of that definition is apparent on its face.

The CHAIRMAN. The chairman got the impression that he meant, or at least he said, that if it was in the same sand or geological formation.

Mr. GREGG. No, sir; I think that was the statement of counsel for the committee, which I would like to come to later. That was not the statement of Mr. Fay, as I remember it. I think Mr. Fay said it would be on the arbitrary rule that no discovery can be claimed if the well is within 3 or 4 or 5 miles of a producing well. Is not that right?

Mr. FAY. I did not give a specific limit. The point I wanted to make is this: That a discovery should apply to the man who discovered it, and that a definition should be so applied that you can not blanket 95 per cent of seven or eight townships.

Mr. GREGG. That does not answer my question. You mentioned, I remember quite distinctly, 3 or 4 or 5 miles.

Mr. FAY. I did say "miles," yes—2 or 3 or 4. It makes no difference what the distance is. I am willing to accept 1 mile.

Mr. GREGG. From a producing well?

Mr. FAY. From a producing well.

Mr. GREGG. Irrespective of the geological conditions?

Mr. FAY. Because geological conditions can not always be determined and the limit of your pool is defined by a series of dry holes around the pool.

Mr. GREGG. I think that answers my question.

The CHAIRMAN. Yes.

Mr. GREGG. It shows what I originally stated, that the arbitrariness of 1 or 2 or 3 or 4 or 5 miles appears on the face of it, I think.

Mr. FAY. The point is to prevent blanketing an entire oil pool.

Mr. GREGG. I get the point.

In order that there may be no misunderstanding about it, I will read the statement of counsel for the committee in this connection. He says, on page 1918 of the proceedings, on February 11:

> But I do know that when you get a combination of a well and certain geological conditions, you can define with a reasonable degree of certainty the extent of that oil body.

I would imagine from that that counsel would say that the extent of a discovery should be determined in the individual case by the geological conditions.

The first objection that I would make to that is that it would do exactly the thing that the committee is criticizing us for. It would be putting too much discretion in the hands of the individual handling the case. You would be bound to get conflicting decisions from your different engineers handling the case as to the extent of the oil body. It is a matter which is so difficult to determine that I do not think you could get uniformity.

With reference to his statement that you can define it with a reasonable degree of accuracy, I would like to read some statements of experts on the subject.

Mr. Carl Beal, Bulletin 177, Bureau of Mines, page 82, states:

> All of some quarter sections (160 acres) on which only one well has been drilled may be called proved oil lands. * * * Other tracts, on the contrary, before they could be considered proved would require many tests.

That, fortunately, was put into the record by Mr. Fay, from the Bureau of Mines, as a quotation from their publication.

Messrs. Cox, Muhlenberg, and Dake, professors of geology in the Missouri School of Mines, on page 2 of their book, Field Methods in Petroleum Geology, state:

> In an area that is partly drilled up, it may be possible to determine certain general conditions of sand change, but frequently it is quite impossible in strictly wildcat (unproved) territory.

Of course, our discoveries have to be determined in unproved territory. There is no discovery unless it is.

Mr. MANSON. That is the very thing that we have criticised, that mostly the discovery is allowed in proved territory.

Mr. GREGG. That is absolutely foreign, I think, Mr. Chairman, to the point that I am discussing.

The CHAIRMAN. That may be true, but you are criticizing the contentions of counsel. However, counsel had better, perhaps, wait until you finish.

Mr. GREGG. Let me put it this way. I will restate it.

Regardless of the definition of proven territory, when a well is brought in, we have to determine the extent of the oil body. The quotation which I have just read says in new territory, and that is the case where we should have to determine it, in new territory it is impossible to do that.

Sir Boverton Redwood, another prominent English petroleum geologist, states in his Treatise on petroleum, page 167:

> Whilst every developed oil field has a more or less clearly defined margin * * * it can not be too emphatically declared that the location of wells should in all cases depend upon local structural conditions and not upon any theoretical considerations of those conditions, even at short distances.

I have one other quotation here.

Mr. E. H. Cunningham Craig, member of His Majesty's geological survey and one of England's foremost oil geologists, in his book, Oil finding, page 247, states:

> In locating wells to prove the extent of the field, in which oil has already been struck, the geologist must use his common sense. * * * In any case, he will find it expedient to feel the way cautiously toward the limits of an oil pool, rather than to locate wells rashly in the hope of proving a wide field at once.

I have read all of these quotations to bring out this point: When you bring in one well, the extent of the oil body is a very questionable matter. It can not be accurately determined. Our definition of 160 acres carries on its face the fact that it is arbitrary. I think it is necessary to have some arbitrary rule of thumb in determining these questions, for the reasons which I have stated, and the only thing that comes close to this in the authorities which we have been able to look up is what Mr. Beal, of the Bureau of Mines, says in that bulletin, that—

> All of some quarter sections (160 acres) on which only one well has been drilled, may be called proved oil lands. Other tracts, on the contrary, before they could be considered proved, would require many tests.

The indication from that is that our rule is too strict, rather than too lenient. It is a very difficult matter, as I say, to justify our definition; but it seems to me, from what the authorities say on the subject, that it is a very fair rule of thumb to apply. It is con-

venient, because on any map you can outline the extent of the proven area. It is not far off, either in favor of the taxpayer or in favor of the Government. I think, from the quotations, if it errs at all it is in favor of the Government; and, in addition, it does give us some rule of thumb. It takes away the great discretion from the engineers that would have to be placed in them if they had to determine in each case whether the given well was brought in upon a pool which was proved by a prior well.

In that connection, Mr. Fay said in his discussion of it—and I want to find it, so as to get it accurate—on page 3036, that the man who drills a well adjoining a well brought in by a wildcatter is 90 per cent sure of bringing in a well. He then says, in answer to the direct question which I asked him, that even in proven territory a 20 per cent risk should be allowed for dry holes.

If it is necessary to allow a 20 per cent risk for dry holes in proven territory, I think it shows very conclusively that the man who drills, even in proven territory, is not sure of bringing in a well.

While we were discussing the matter counsel for the committee put in cases, so he stated, showing where our analytical appraisal method has given too high values. I would like to put in a few cases to show where it has given too low values, which will show that, although we erred, we erred both ways, and probably the average has been fair.

The CHAIRMAN. That is the point I want to make, that the averaging of taxpayers is not a fair way of doing it.

Mr. GREGG. That is perfectly true. I did not mean to give that impression, that we overvalue in one case and undervalue in another, so that it averages between the two. I do not mean to say that that justifies our procedure, but it shows that in this tremendously difficult subject we are bound to make errors, that we can not get an absolutely accurate result; but we are coming somewhere near it, and we are doing the best we possibly can do.

Senator KING. You do not err all on one side.

Mr. GREGG. We are not off all one way.

The CHAIRMAN. I have never contended that.

Senator ERNST. I would like to have those two cases.

Mr. GREGG. I will read the first one, and I will put the others in the record. There are about five of them.

Senator ERNST. Give the names of them.

Mr. GREGG. The first one is the case of W. J. Grisham et al., Wichita Falls, Tex.

Early in 1919 the taxpayer purchased a lease on a portion of block 86 in Burkburnett northwest extension for $5,000.

On May 1, 1919, a discovery was made by the taxpayer. The value as determined by this section in memorandum dated May 9, 1923, was $175,729, with a depletion unit of $1.18977.

On June 20, 1919, the taxpayer sold the lease for $570,000 after having produced 19,222.09 gross barrels. Depletion unit to the purchaser on cost $4.35513.

The reserves as claimed by the taxpayer were accepted.

The price of oil remained at $2.25 for entire period of the three transactions.

The following is a copy of pages 1, 24, 25, and 26, omitting the letterhead on page 1:

IT: En: OG.
JC.
W. J. Grisham et al.

April 14, 1921.

CERTIFICATE

Messrs. W. J. Grisham et al.,
Wichita Falls, Tex.

Gentlemen: We have carefully considered the records pertaining to your property in block 86, Burkburnett northwest extension, and have reached the following conclusions:

Estimated gross recoverable oil ... barrels	168, 800
Estimated net seven-eighths recoverable oil ... do	147, 700
Revaluation as of date of discovery by the present value method	$206, 000
Depletion unit rate per net barrel based on above revaluation	1. 395
Discovery value as established by actual sale of property	570, 000
Depletion unit rate per net barrel based on above value	3. 859

Following are the data and computations upon which the above conclusions are based.

REVALUATION AS OF DATE OF DISCOVERY

The value of the property at the time of discovery will be determined by the present value method, using 15 per cent compound interest and basing the gross income on the posted price of oil at the time of discovery, which was $2.25 per barrel. The computations are as follows:

Computation of discovery value

Year	Net seven-eighths production	Gross returns	Estimated total expense [1]	Net returns	Present value
1919	$68, 000	$153, 000	$63, 000	$90, 000	$90, 000
1920	41, 200	92, 700	8, 000	84, 700	73, 700
1921	18, 500	41, 625	6, 000	35, 625	26, 000
1922	8, 000	18, 000	5, 000	13, 000	8, 600
1923	4, 400	9, 900	4, 000	5, 900	3, 400
1924	2, 700	6, 075	3, 500	2, 575	1, 300
1925	1, 800	4, 050	3, 000	1, 050	500
1926	1, 300	2, 925	2, 500	425	200
1927	1, 000	2, 250	2, 000	250	100
1928	800	1, 800	1, 800		
	147, 700	332, 325	98, 800	233, 525	204, 700
Present worth of salvage, say					1, 300
Total					206, 000

[1] Included depreciable equipment.

The above amount, $206,000, is the appraised fair market value of the entire seven-eighths working interest as of the date of discovery or within 30 days thereafter.

VALUATION BASED ON SALE

The actual sale of the property about 50 days after the date of discovery may under the regulations be considered as indicating the fair market value as of the date of discovery or within 30 days thereafter. Well No. 2 came in within 30 days after No. 1, and there were no changes in conditions in the 20-day interval. It is fair to assume that the property would have sold for as much or more within 30 days as at the end of 50 days.

The sale price appears excessive as compared with the appraised revaluation. Even assuming a considerable rise in price of oil, it would have been

necessary to produce at least twice as much oil as now appears likely, or 67,000 barrels gross per acre. The discrepancy between the appraised value and the sale price appears to be due in part to the fact that the wells did not hold up well or produce as much as might have been expected, and in part to the overestimation of the value of the property.

It is very difficult to estimate the value of a property within 30 days of the completion of the first well. We have come across numerous cases in which properties in a flush or partially developed stage actually sold for much more or less than they were really worth. We believe that in order to minimize the iniquities resulting from such situations the department will be inclined to favor the use of the appraised value as being the fairest method both to the Government and to the taxpayer.

DEPLETION

The depletion rate per net barrel if based on the appraised value, will be $\frac{206,000}{147,700}=\$1.395$. If based on the actual sale, it will be $\frac{570,000}{147,700}=\$3.859$.

Senator KING. I am interested to know what tax this man paid who had the lease and who sold it for $500,000?

Mr. GREGG. I have not the figures, but he paid the difference between the $5,000 cost to him and the $570,000 for which he sold. Discovery value does not apply to sales, you see, Senator.

Mr. MANSON. What did you say was the depletion unit resulting from it?

Mr. GREGG. In which case?

Mr. MANSON. In the one that you just mentioned.

Mr. GREGG. I have two—discovery depletion and cost depletion paid to the purchaser.

Mr. MANSON. The cost depletion unit.

Mr. GREGG. It was 4.35513.

Mr. MANSON. Inasmuch as that is more than oil has ever sold for, would you say that your valuation was too low?

Mr. GREGG. I would say that he made a bad buy.

Mr. MANSON. He just made a bad buy, did he not?

Mr. GREGG. He made a bad buy, very decidedly.

Mr. MANSON. That does not mean, then, that you undervalued the property?

Mr. GREGG. I should say that the best evidence of market value is the purchase between a willing buyer and a willing seller, which we had in this case.

The CHAIRMAN. The market value of the land or of the oil?

Mr. GREGG. The market value of the property; so I should say, on that basis, we undervalued.

The next case is that of the Buttram Petroleum Corporation, Oklahoma City, Okla.

Early in 1923 the taxpayer purchased interests in four tracts in the Powell district of Texas. Several trades were made during the year prior to production on these leases. At the date of discovery the taxpayer owned thirteen-fortieths interest in the properties.

Within the 30-day period the taxpayer purchased for cash an additional five-fortieths interest in these properties and 60 days later sold for cash the entire interest owned.

An appraisal of the property at date of discovery shows a unit of 0.4133, a value of $501,312.50, with 1,112,938 barrels reserve.

A value based on the actual cash cost of a fractional interest within the 30-day period, using the same reserves, shows a unit of

0.54. (This unit was agreed upon as a basis for depletion due to the discovery.) A value of $654,986.47 with the same reserves.

The depletion to the purchaser 60 days later is based on a unit cost of $1.18. Depletable sum of $395,351.06 and a remaining reserve of 335,058 barrels. The reserves are reduced due to production during the period of ownership.

The next case is that of Owen M. Thompson, Fullerton, Calif.

The taxpayer owned a fee land in California which was operated by the General Petroleum Co.

A discovery was made on November 20, 1919, and on March 1, 1920, the taxpayer sold one-fourth of the interest owned for $50,000.

The discovery value determined by an appraisal shows a depletion unit of 0.861, with a value of $88,797.51 and a reserve of 103,133 barrels.

The depletion unit to the purchaser, based on the $50,000 cost, is $2.002, the remaining reserves for the portion sold being 24,970 barrels, the reduction being due to depletion during the period of ownership.

The next case is that of the Peabody Petroleum Co., Eldorado, Kans.

The taxpayer was organized on October 21, 1919. Just prior to the incorporation one of the incorporators sold fractional interests in a lease on which a well was being drilled. The sale price was $70,000 for a one-seventh of the seven-eighths working interests. Two of these sales were made, and immediately after the well came in the corporation was organized. The entire working interest was turned into the corporation for stock, the stock being distributed in proportion to the several interests owned.

These sales indicate a value at date of incorporation of $490,000, a reserve of $275,000 having been determined, with a unit of 1.78182.

An appraisal of the property as of date of incorporation would show a value of $200,000 and a depletion unit of 0.7273.

The next case is that of W. G. Strange Oil & Refining Co., Shreveport, La.

The W. G. Strange Oil & Refining Co. was organized April 1, 1919, and stock was issued for leases previously owned by the stockholders or purchased by the stockholders with the object of turning them into the company.

On July 1, 1919, the taxpayer completed a discovery well on the R. B. Nelson lease, Bull Bayou Field, La.

An appraisal of the property within 30 days after the date of discovery shows a value of $500,000. The reserves have been estimated at 600,000 barrels, giving a unit of 0.8333.

Taxpayer claims that a bona fide offer to purchase was made by the Simms Petroleum Co. within the 30-day period. The consideration named in the offer is claimed to have been $3,000,000. This value would show a depletion of $5 per barrel.

On October 1, 1919, taxpayer entered into a contract to sell the properties for $3,000,000 on an installment basis, $500,000 down, seven payments of $250,000 each at stipulated times, and $750,000 out of 40 per cent of proceeds of the sale of seven-eighths of the oil. Contract and instruments of conveyance were placed in escrow in a bank and possession passed to the purchaser.

On April 15. 1920, the purchaser defaulted and the property was repossessed by the taxpayer.

I asked Mr. Thayer one afternoon to get me a few cases of this sort. I told him what kind I wanted and he had only about half a day to look, and these are the cases that I got.

Senator KING. That really duplicates, then, what Mr. Manson has just said of an undervaluation or overvaluation, or, rather, would it not indicate that the purchasers in those cases did not anticipate the lack of value of the property?

Mr. GREGG. As I said——

Senator KING. They thought its life was going to be longer or that its productivity was going to be greater?

Mr. GREGG. As I said in answer to a similar question of the Senator a few minutes ago, that is very true. Very often, at the time of discovery, the extent of the oil is overestimated. In the example I gave of discoveries brought in in Texas it was overestimated quite decidedly. The transactions at the time indicated the market value then on a basis much in excess of the actual value of the property; but that did indicate the market value at that time. It is impossible to get sufficient data in the cases with reference to the extent of the oil, to determine the actual intrinsic value, so that the market value, the basis on which the property changes hands, is often in excess of the intrinsic value of the property.

Senator KING. I have heard of a case of a friend of mine in Utah who bought a piece of property for some $200,000 as a producing well, but through bad management and bad operation, it being a well 4,000 to 5,000 feet deep, and you know the difficulty in valuing those wells——

Mr. GREGG. Yes, sir.

Senator KING (continuing). The hole became plugged; they lost their pipe, or what not, so that it ceased to produce, and he was offering it for $16,000. Now, it was intrinsically of the same value when he was offering it for $16,000 as it was when he bought it for $200,000. It was simply a case of mismanagement in running in that deep pipe line to a depth of 4,000 or 5,000 feet into the ground.

Mr. MANSON. I could call Mr. Gregg's attention to a case where a well was actually sold at a price which would give the oil a value of $6 per barrel, but that is not market value by any means.

Mr. GREGG. On that point, I think, as strongly as the bureau has argued for the analytical appraisal at various times if we had used the analytical appraisal method when we had actual sales we would be subject to very strong criticism. I think counsel for the committee has criticized us for doing that in some instances.

The CHAIRMAN. I think if this was the actual sales price, that was market value.

Mr. GREGG. Yes, sir; it seems to me conclusive. The difficulty we have had in those cases, as shown in these quotations from these same authorities which I referred to a moment ago.

The bureau has had difficulty with these high values based upon comparative sales in boom times, but we have done what we could to keep from giving those high values.

Senator KING. Mr. Gregg, has the department—and I presume you will answer no, because I do not see how you can answer otherwise, and I have no criticism of it—but I was just wondering whether

the department has kept any account of the number of wells which had been assessed for income taxes and the amount received by the Government in taxes from those——

Mr. GREGG. From the oil industry?

Senator KING. From the oil industry; yes.

Mr. GREGG. We have general statistics——

Senator KING. Pardon me; I do not mean from the sale of gasoline or the finished product, but from the sale of the crude oil.

Mr. GREGG. From the sale of the crude oil?

Senator KING. Yes.

Mr. GREGG. We have general statistics on that in our statistics of income. That is all we have.

Senator KING. I wish we could have that, for the reason that I see frequently in the newspapers that so many hundreds of millions and billions of dollars have been made from oil transactions, or from the sale of the crude oil, and I was just wondering what amount of taxes was paid by these men that have sold the crude oil from their wells.

Mr. GREGG. I looked up the data that we had with reference to the producing oil companies. I think I looked it up in 1923. The last years for which we had the figures at that time, as I remember it, were 1920 and 1921. The excess-profits tax paid for those years by the oil producers, as I remember it, ranged between 22 and 23 per cent, which was low, due principally to the discovery.

Senator KING. You will appreciate from your connection with the work of the Finance Committee that if we take up the question of taxation again in December, we will want—the committee will doubtless want pretty full statistics on oil production, oil income, etc., and it would seem to me that the Income Tax Unit will have to have that information available, and if you could get it ready so that the committee could have it, I would be very glad to have you do so.

Mr. GREGG. The order has gone to the statistical unit to get all the data possible together with reference to depletion, particularly discovery depletion.

There is another thing that I would like to say now on the whole matter of depletion.

It is not the position of the department that the situation is perfect with respect to depletion. We recognize, as I feel the committee does, that errors have been made, that we have lost taxes in some cases, and we have gotten excessive taxes in others, due, usually, I think, to the law; but the point that causes the trouble is this: The Income Tax Law puts on the bureau the task of valuing all of the mineral properties of this country as of March 1, 1913, and in the case of oil principally, at the date of discovery, every time a discovery is brought in. It is an impossible task to do it accurately. It can not be done accurately. We do the best we can. I have argued here this morning to show that it was the best that could be done, but we do not claim it is perfect.

If something could be done in the law to do away with the necessity for valuing mineral properties for the purpose of determining depletion, it would be the biggest help of anything that has ever been done to the Bureau of Internal Revenue.

Senator KING. There is no doubt about it.

Mr. GREGG. If that could be done, it would take a tremendous burden off of us. It would help the administration of the bureau tremendously, and would certainly be more accurate than the present system. If Congress intends to continue to recognize depletion, I have never been able to work out anything that would do away with the necessity of making these valuations.

Mr. MANSON. Have you ever considered the matter of percentage depletion?

Mr. GREGG. Yes, sir; I considered it, and it never impressed me as being sound, and I could never see that it removed to any great extent the administrative burden, for this reason: Percentage depletion still requires the determination of value, and that is the task. What we need is something that will take that burden off of us, the necessity of determining these values. I have never seen any suggestion on depletion that was worth while that did not necessitate the making of these values. Doctor Adams and I went into it once, and we tried to devise some arbitrary percentage of depletion, to make it, for example, in the case of coal, 8 per cent, say, of the gross income. If you do that, you have to have a different percentage in each industry. Coal would be different from oil, and timber would be different from either, and there would be no possible correct method of determining that percentage. The case that finally convinced us that it was too arbitrary, and not to be considered, was this: Suppose you and I own adjoining coal lands. You own yours for ten years, and bought them for $50,000. I bought mine for $1,000,000. They are exactly the same. I am obviously entitled, before I pay a tax, to more of a return of capital than you are, and any scheme that puts us in exactly the same position with reference to depletion is inequitable.

That is where we gave up our attempt to work out a percentage of gross income or net income, something that would do away with the necessity of valuing the properties.

The CHAIRMAN. You do not think a percentage of the sales of these coal companies would help it any?

Mr. GREGG. That is open to the same objection. You mean the sale of the oil?

The CHAIRMAN. The oil or the other mineral products.

Mr. GREGG. That is open to the same objection. In the case I gave, my coal cost me $1,000,000 and Senator King's cost him $50,000. We are selling at the same price. I am entitled to more of a return of capital, because I put out more than he did. The inequality is the big objection. Of course, in England, they just let those inequalities and inequities go and give no allowance for depletion. I can not conceive of that being done here.

Senator KING. That is the plan which I have recommended from time to time.

Mr. GREGG. That is so arbitrary, and it works such a hardship——

The CHAIRMAN. If the tax were low enough, it would not.

Mr. GREGG. If you made the tax low enough, it would not be, possibly.

Senator KING. May I say that one of the principal criticisms that I have made of the department, and it was not based on the department's conduct at all, but it was based on the law, rather, grew out of these oil cases. I have heard of such enormous profits being

made by the producers of oil and the small taxes which they confess to having paid, that I felt the Government was being—I do not want to use a harsh term—the Government was not receiving the tax which should be paid. I talked with Mr. Gregg a great many times when we were framing the last bill to see if we could not devise some way of reaching this problem, and I was unable to do so, except by abolishing depletion.

Mr. GREGG. I have never been able to devise any scheme of doing away with the necessity of these valuations. In 1921 some of us tried this: In depreciation you have the same problem, but not to such a great extent. Depreciation is based on the March 1 value of depreciable property. That necessitates, of course, the valuing of the depreciable property as of March 1, 1913. When that was under consideration in the Senate in the 1921 act an amendment was offered—I drafted it myself—putting that depreciation on cost. Well, it was not even seriously considered by the Senate. That would, of course, have taken a great administrative difficulty off of us, the necessity of valuing for depreciation.

The CHAIRMAN. And would it have resulted in that same conclusion that your coal example a while ago did? In other words, if a man came along and bought it at a higher price?

Mr. GREGG. To a certain extent it would—not on the matter of cost, but it would penalize the man who owned it before March 1, 1913, who purchased it before that for a compartively small amount, and who is now operating in competition with the man who purchased in 1914, or somewhere around there, for a higher amount.

The CHAIRMAN. It would also operate against the man who came along in 1915 and paid a high price for the property, would it not?

Mr. GREGG. Yes, sir. It seemed so desirable to some of us at that time that we though it should be considered. However, Congress has always stood perfectly solid on the proposition of March 1, 1913, value on capital, and would not be budged.

Senator KING. England has abandoned that theory of valuation.

Mr. GREGG. Yes, sir; entirely.

Senator KING. And does not that work more satisfactorily than the arbitrary and confused and almost impossible situation created by our view of it?

Mr. GREGG. It works out just as arbitrarily as it can be, the English system, but they just seem to be used to it, or something.

The CHAIRMAN. Are you going to put in another case now, Mr. Manson?

Senator KING. Are you through, Mr. Gregg?

Mr. GREGG. Yes, sir; I am all through.

Senator ERNST. Mr. Chairman, I desire to have it noted in the record that I was out of town yesterday, and it was impossible for me to be here.

Mr. MANSON. The matter which I desire to call attention to at this time is the discovery value allowed on an oil property in Oklahoma, in which E. R. Black and George A. Simons were jointly interested. Black owned forty-nine one-hundred-and-forty-fourths of this property. Simons owned thirty-five one-hundred-and-forty-fourths of it.

Senator King. Who owned the remainder?

Mr. MANSON. I do not know. The valuation given Black's forty-nine one-hundred-and-forty-fourths is $270,059. The valuation given Simon's thirty-five one-hundred-and-forty-fourths is $533,887. Bear in mind that this is the same property; it is the same well.

Senator KING. They are tenants in common?

Mr. MANSON. They owned undivided interests.

Senator KING. Yes.

Mr. MANSON. The price of oil used as the basis for the Black valuation is $2.25 per barrel. The price of oil used as a basis for Simons's valuation is $2.50 per barrel.

Senator ERNST. How far apart were the valuations made?

Mr. MANSON. About a month apart. The valuation of Black's interest was on the 3d of July, 1919, and the valuation of Simons's interest was on August 5, 1919. That is the date of discovery.

Senator KING. It was just one well?

Mr. MANSON. It was just one well.

Mr. PARKER. It was determined on one discovery well, and there-fore they should have been on the same date.

Mr. MANSON. Lifting cost deducted in the Black case was 50 cents a barrel, and the lifting cost deducted in the Simons's case was 10 cents per barrel.

The details of this case are set forth in a report prepared by Mr. Fay.

There is one other factor that I would call attention to, and that is that Black received his depletion unit of 79.7 cents plus per barrel, while Simons received a depletion unit of $1.76 plus per barrel.

The CHAIRMAN. In that report is there anything that indicates what difference in tax was made by these relative valuations.

Mr. MANSON. I am coming to that.

The CHAIRMAN. All right.

Mr. MANSON. The valuation given Black, which was the lower valuation, is verified by an actual sale of the property, an actual sale of Black's interest, at about the date of discovery, for $300,000, which verifies approximately the valuation given Black. If Simons's interest were valued on the same basis as the actual sale of Black's interest his value would be $379,000 instead of $892,000, and his depletion unit would be the same as the depletion unit on the Black property. This would result in a difference of about $200,000 in tax.

The CHAIRMAN. Is there anything in the records which shows how that happened?

Mr. MANSON. The only conclusion——

The CHAIRMAN. Never mind the conclusion. I want to know what the records show.

Mr. MANSON. No; there is nothing in the record to show how it happened, except that each of these interests was valued separately at separate times, and I believe by separate engineers. Were they not, Mr. Fay?

Mr. FAY. Yes.

Mr. MANSON. I call attention to this case——

Senator KING. Were settlements of taxes made upon those?

Mr. MANSON. They are still pending.

Senator KING. Oh, they are still pending?

Mr. MANSON. Yes. The discovery value was determined but the case has gone to audit based on these discovery values.

Senator KING. Were not the taxes paid for that year?

Mr. FAY. Not yet.

Senator KING. Have they not been paid since 1919?

Mr. FAY. They paid a small amount when they first returned their income tax returns, but there is still $139,000 due, at least in one case yet, and the other has not been settled.

Mr. NASH. Mr. Manson, may I ask when this valuation was made?

Senator KING. One was in July and one in August, 1919?

Mr. MANSON. That is the date as of which they were made. When was this valuation made?

Mr. FAY. The valuations were made, one in 1923 and the other in January, 1925.

Senator ERNST. What time in 1923? That is what I was trying to get at a moment ago.

Senator KING. The valuations were then made as of the date of discovery.

Mr. MANSON. Yes; they were.

Mr. FAY. The date that the computations were made in the department is what they have reference to.

Senator ERNST. Yes.

Mr. GREGG. If we can, I would like also to know whether the man for whom the last valuation was made on one interest knew of the valuation placed on the other interest previously?

Mr. MANSON. I would like to be heard on that point.

Senator ERNST. Let him get this information first, and then you can be heard.

Mr. MANSON. Yes.

Senator KING. And give the names of the two engineers who decided it.

The CHAIRMAN. If you do not know where that is, Mr. Fay, let us proceed and put it in at some other time.

Mr. FAY. Here is one, February 2, 1924. That is E. R. Black.

The CHAIRMAN. Who was the engineer in that case?

Mr. FAY. The engineer on the one for Black was H. H. Power, February 2, 1924. The other one was J. W. Dyche. His valuation was made as a result of a conference of November 12, 1924, but his valuation data was turned in, as I recall it, on January 5, 1925.

Senator ERNST. You say as you recall it. Have you got the records before you?

Mr. FAY. The valuation is——

Senator ERNST. Have you a record, and are you speaking from the record, or are you speaking from your own recollection?

Mr. FAY. The valuation is here, but I do not find the date on the valuation. This is on the sheet:

The valuation set up in that conference is indicated by engineers' conference memorandum November 12, 1924.

Senator KING. November 12, 1924. Then, both of them were in 1924?

Mr. FAY. Yes.

The CHAIRMAN. I think that is sufficient.

Mr. MANSON. The comment that I wish to make on the difference between those valuations is that under any adequate system of check-

ing there would be no excuse for two different valuations being placed upon identically the same property, and if the system of checking valuations made in accordance with the analytical appraisal was checked with the sales of property, as has been described by Mr. Gregg, the result obtained in this case would not have happened.

Senator KING. What would you do in a case like this: Suppose Mr. Black sold his forty-nine one hundred and forty-fourths interest for $500,000 and that Mr. Simons sold his thirty-five one hundred and forty-fourths interest for $600,000, a few weeks or a few months intervening, and those factors were brought to the attention of the Government engineers in making the assessment, and one engineer took care of Black's case and the other took care of Simons' case. How would you reconcile those differences, and what kind of an assessment would you make in that case for the purpose of getting the taxes for the Government?

Mr. MANSON. Of course, the actual sales of the property would govern the values thereafter. There is not any question about that, no matter how inconsistent it might be.

The CHAIRMAN. As a matter of fact, there was not any sale in the one case here, was there?

Mr. MANSON. No.

The CHAIRMAN. The Senator's question was based on an assumption.

Senator KING. Yes; but I am asking for it for my own information.

The CHAIRMAN. Yes.

Mr. MANSON. Yes.

Senator KING. With respect to the general rule. That is all I had in mind, not with respect to this case.

The CHAIRMAN. Yes.

Mr. MANSON. Of course, the actual sale would fix the amount that the purchaser would be entitled to deplete. The matter of valuation would no longer be a question in such a case.

Senator KING. Suppose a case like this, that Mr. Black sold his forty-nine-one hundred and forty-fourths interest for a sum so concededly disproportionate to its value, getting disgusted with the oil business, and losing his health or what not, and in a fit of pessimism he sold his property for a sum far less than what it was worth in the market; and the other man held onto his property, and it was recognized to be of very much greater value, relatively and proportionately, than that for which Mr. Black sold his property. How would the Government take care of that situation when it came to levy an assessment against both? Would it be governed in the levying of the tax upon Black by the injudicious and unwise sale which he made, which was for far less than he recognized to be the value of his property?

Mr. MANSON. I think a sale of that sort falls in the class of a forced sale. In other words, it is not evidence of market value. I do not believe that a sale to someone who is what is popularly called a "sucker," who is willing to pay an enormous price, one that is away out of line as compared with what ordinarily intelligent men in that business would pay for the property, is evidence of market value.

Senator KING. Then, sale price is not conclusive upon the Government?

Mr. MANSON. I do not think so.

Senator KING. Do you recognize that, Mr. Gregg, that that is not conclusive?

Mr. GREGG. Yes, sir.

Senator KING. Then, in the hypothetical case that I have just suggested, if a man, through pessimism, or for other reasons, got far less than the property was worth, that would not be the basis on which the tax was levied?

Mr. GREGG. I think that would probably fall in the class of a forced sale.

Senator KING. I see. All right.

Mr. MANSON. At the same time, I still insist that sales generally fall in neither of those classes, and any intelligent use of the analytical system of appraisal necessarily involves a constant checking of the valuations arrived at by the analytical system with actual sales transactions, in order to test the reliability of the factors that are being used and which are being accepted by the bureau for valuation purposes where comparative sales data is not available. I understood from Mr. Gregg's statement that that is the policy, that that is what is being done.

I now call attention to this particular case as indicating that if this is the policy there is some laxness in the application of the policy or in the enforcement of the policy, and that there is considerable laxness in the administration of the valuation work so far as it applies to oil valuations, because if a proper system were in force that system would necessarily reflect a valuation that had been made upon an identical piece of property, and that the mere fact that such a result as has been arrived at in this case is possible goes to show that there is a laxness either in the system or in the enforcement of the system.

Mr. GREGG. Are you through, Mr. Manson?

Mr. MANSON. Yes.

Mr. GREGG. In reply to that statement, the criticism that Mr. Manson makes is this, as I understand it: That in valuing the interests of two different individuals in the same piece of property as of the same date we used different factors and got different results. Of course, we would want to look into the case to see if there is some explanation of it, but before doing that I would like to explain what attempts we make to avoid such results.

The CHAIRMAN. Why do you not do that when you answer the case completely, so that you will have it all together, or do you prefer to put it in in this other way?

Mr. GREGG. There may not be any answer to the case. That is one reason.

The CHAIRMAN. You may go ahead, then.

Mr. GREGG. The section is divided, as I have said, into subdivisions in which there are engineers who are familiar with the different fields. When they make a valuation, it goes through the chief of their little subsection. It then goes to a reviewer, where it is reviewed. It then goes over the desk of the chief of the section, and it is there that it is checked, not with the sale prices of other prop-

erties, because he has not all of that data there. That is supposed to be done by the engineer, but it is there that it is checked with the sale prices in the field to determine the relation of this value to the posted price of oil as compared with the sale prices in this field. That is just a rough check. In other words, that case is handled by the original engineer, and goes through three different reviews. Now, it is possible, even with that system, that two valuations will slip through, using different factors when they should use the same factors.

From the statement of the last case that counsel just gave it looks as if that is one of the cases, but I think we have taken every step we can in three reviews to eliminate such occurrences, and if this one slipped through it seems to me that it again is an isolated case, and it is very unfortunate that it happened. It may constitute a criticism of one of the reviewers, who may have been inefficient in his review, but I do not think it constitutes a criticism of the system.

Mr. MANSON. In this case it went to a special conferee, and was supposed to have been given special consideration.

Furthermore, I want to say in connection with this case that nobody called our attention to it, but it was just hit on at random and without any idea of what it was going to disclose. The papers were photostated and sent up here, without any examination being made of them at all. It was just a hit-or-miss proposition.

The CHAIRMAN. They were photostated and sent up here because of the statistical work that you are doing; is that right?

Mr. MANSON. No, no; for examination by Mr. Fay.

The CHAIRMAN. Why were they photostated and sent up here?

Mr. MANSON. So that Mr. Fay could have access to them.

The CHAIRMAN. Who asked to have them photostated?

Mr. MANSON. We did.

The CHAIRMAN. Why did you ask for that particular case?

Mr. MANSON. As I say, we just pulled the case at random.

The CHAIRMAN. How many cases did you pull at random?

Mr. PARKER. We pulled only about three or four small cases, just to get away from the very large cases, which are so difficult to handle. This made a case that could be easily photostated, without any great expense, and other cases would be rather expensive to photostat.

The CHAIRMAN. I see.

Senator KING. I think you had better hit or miss a few more small cases and let us see what the result would be.

Mr. FAY. The principles, I think, are more easily brought out in the small cases than they are in the big ones.

Senator KING. I suppose in all of these matters we had better examine some of the small cases, not only in oil but in other matters. I would like to have some cases in real estate, covering depletion, obsolescence, and what not, and some in railroads. I would like to know something about the railroads, not only the steam railroads but the electric railroads, including some of these railroads in New York City and possibly in Washington.

Mr. MANSON. The principal elements there are reductions on depreciation. I will say for the Senator's benefit that we are fast getting our work of investigation of depreciation organized.

The CHAIRMAN. I think it would be quite important to get some of the big newspapers of the country.

Senator KING. I would think so, too, to see what tax they pay.

The CHAIRMAN. Yes.

Senator KING. And it seems to me, Mr. Chairman, we ought to make a little review of the railroads, both the steam and electric, and some of those New York City railroads about which there is so much talk. Some say that they are making no profits and others insist that the people are being robbed. I have no opinion about it. I know nothing about the matter.

The CHAIRMAN. Have you any other case to present to-day Mr. Manson? I did not mean to shut you off, Senator King. I thought you were through.

Senator KING. Yes; I was through.

Mr. MANSON. I want to offer Mr. Fay's report in this case for the record. I have a copy of it here for the bureau.

The report of Mr. Fay is as follows:

This discussion is based on the tax returns and valuation data submitted by George A. Simons and E. R. Black, Okmulgee, Okla., each as individuals and not as a partnership. E. R. Black owns a seven-sixteenths of seven-eighths working interest, or forty-nine one-hundred-and-forty-fourths. George A. Simons owns a five-sixteenths of seven-eighths working interest, or thirty-five one-hundred-and-forty-fourths.

The interests of these two individuals being in the same lease and both having the status of a lessee should receive discovery valuations based upon the same factors as to wells, dates, reserves, market price of oil, operating costs, etc.

This case is presented to show:

(1) Excessive valuation claimed by the taxpayer (George A. Simons) when a bona fide sale within the property set the value at discovery date.

(2) Dissatisfaction on the part of the taxpayer (Simons) regarding an extremely liberal valuation allowed by the bureau. The case was appealed to the special conferees, whereupon a second valuation was ordered, resulting in a higher valuation and higher depletion unit. The taxpayer states that when the revised A-2 letter is received the case will be appealed.

(3) Desire on the part of taxpayer (Simons) to avoid all taxes by claiming excessive depletion.

(4) The comparative results obtained by the bureau in making independent valuations of the holdings of these two taxpayers.

(5) Inability on the part of the bureau to close the case without granting all the demands of the taxpayer, even when stretching points in regulations; and that a condition exists whereby tax advisers, by being persistent and withholding information, can get excessive valuations, and hence substantial reduction in taxes. Each concession in audit or valuation sections is accepted as a basis for appeal to the next higher authority, where often other questions are raised and additional concessions obtained.

GEORGE A. SIMONS—VALUATIONS

The taxpayer in presenting his valuation data has stated the price of oil as \$2.25 plus a 25 cents premium, which he claims to have received. An investigation of the market price of oil in Oklahoma in 1919, as published in the Oil and Gas Journal, does not reveal any premiums being paid for Oklahoma oil. It is barely possible, however, that this being a discovery well in a new field a pipe-line company may have offered to pay a little more for the oil in order to secure contracts for handling oil as soon as the lines were laid. However, these premium prices are ephemeral and should not be taken into consideration in valuing a property whose production is expected to continue over a period of 10 or 12 years. The maximum price that should be taken in this case is \$2.25.

The taxpayer estimates and the bureau has accepted production costs of 10 cents per barrel. This is extraordinarily low for a well that will be pumped

from 2,800 feet, and in view of the fact that such companies as the Carter, Gypsy, and others estimate their lifting costs at from 35 to 60 cents per barrel during 1919 at depths of 2,500 feet. There is also a State tax of 7 cents a barrel which should be taken into consideration in valuing this property.

The well to be valued came in on June 2, 1919, at about 700 barrels per day. Early in August it was drilled a few feet deeper and production increased to about 1,600 barrels, as of August 5, the day the taxpayer states the well was completed. This is the date on which he sets up his discovery valuation. The taxpayer claims this to be a 2,000-barrel well, but reports published in the Oil and Gas Journal do not so indicate. On this point the following excerpts are of interest and show conditions as seen by disinterested observers:

"Black & Simons No. 1 Kimble in the southwest corner of the northeast quarter of section 12-14-11, which was a 500-barrel well when it came in on Monday, June 2, was holding up at 400 barrels after a week, according to a report from the field." (Oil and Gas Journal, June 13, 1918.)

"Black & Simons big well in the southwest corner of the northeast quarter section 12-14-11 is flowing better this week than it has been since it came in, and is reported to be doing 700 barrels on Monday." (Oil and Gas Journal, July 4, 1919.)

"Grouped around the center of section 12-14-11, Okmulgee County, offsetting one another are four wells of a combined production of nearly 4,000 barrels. The first is Black & Simons big well in the southwest corner of the northeast quarter, reported some time ago, which has been holding up remarkably and which was drilled a little deeper last week, bringing the production back to 1,000 barrels per day." (Oil and Gas Journal, August 1, 1919.)

"Deepening and agitating of the first four wells in section 12-14-11 resulted in their production being raised to a total of 5,500 barrels, the discovery well of Simons and the Cosmos Oil Co. leading with a production of 1,600 barrels. The Simons and the Cosmos Oil Co. No. 2, in the northeast quarter section 12-14-11, is making 600 barrels at a few feet in the sand." (Oil and Gas Journal, August 15, 1919.)

"The Indiahoma Refining Co. and Simons's No. 3, in the center of the south line of the southeast quarter of section 12-14-11, has been drilled to sand at 2,820 feet, and the well filled up 400 feet with oil in a very short time. It will be drilled in this week. This is the former Black & Simons lease. The Indiahoma Refining Co. paid over $300,000 to E. R. Black for his half interest after the first well was completed. Black got his pay in currency. It looked like a good trade for him at that time, but events have shown that the Indiahoma Refining Co. made a very wise purchase. The other partner in this concern is a former glycerine shooter who quit that precarious trade while the getting was good and got into the oil game in Okmulgee County at a time and place where more experienced operators showed a very pronounced hesitancy. He is on easy street." (Oil and Gas Journal, September 5, 1919.)

In making the original valuation of these leases in 1922, the bureau accepted the taxpayer's estimate of reserve which checks closely with actual production during two years succeeding discovery.

The analytical appraisal method which was employed by the bureau in May, 1922, for determining the value of this particular discovery, was based on $2.25 oil (no premium) and gave $696,290 for which the taxpayer claims more than a million dollars as the proper valuation. While the taxpayer sets up August 5 as his date of discovery, it is interesting to note that his partner, E. S. Black, sold on August 2, 1919, a seven-sixteenths interest in this particular lease (a five-sixteenths fraction is held by George A. Simons) for a consideration of $300,000 to the Indiahoma Refining Co. This actual sale at this date should have considerable weight as to the market value of the other five-sixteenths working interest held by George A. Simons. Mr. Simons submits affidavits (Exhibits 1, 2, and 3) to the effect that he was offered in excess of a million dollars for his interest in this lease but the affidavits are not sufficiently specific in stating the exact leases for which this offer was made, nor the terms and character of payments. The records show that Mr. Simons owns interests in five or six leases. One of the affidavits does set forth that the amount of this offer which was allocated to the Kimble-Perryman lease was $1,406,250. The Incombe Tax Unit has properly rejected these affidavits.

The valuation report of May 20, 1922, was based upon the following:
Taxpayer's estimated reserves, Perryman lease, 47,487 barrels.
Kimble lease, 432,000 barrels.
Taxpayer's estimate of lifting costs, 10 cents per barrel.
Posted price per barrel, $2.25.
State tax, 7 cents per barrel.
A straight discount of 15 per cent.

This gave a valuation of $33,257 for the Perryman lease, and a depletion unit of 70 cents per barrel. For the Kimble lease a valuation of $696,290 was given, resulting in a depletion unit of $1,61178. The depletion allowable on this basis is given in Exhibit 4. The taxpayer's returns were audited upon the basis of this valuation, resulting in an A-2 letter under date of October 17, 1924, Exhibit 5, assessing an additional tax of $139,464.85.

Prior to this the taxpayer had filed a claim for a refund of $1,381.87 which was rejected (Exhibit 6) and followed by the assessment letter of October 17, 1924. Upon receipt of this assessment letter, the taxpayer protested (Exhibit 7) returning a statement (Exhibit 8) showing no tax due, based upon his excessive claims for depletion. Upon presentation of this protest, the taxpayer was accorded oral hearings (Exhibits 9, 10, and 11). The taxpayer was requested to sign a waiver for the year 1919 which he returned to the department under date of January 9, 1925 (Exhibits 12, 13, and 14). In accordance with the hearings held in the department November 13 (Exhibits 9 and 11), the taxpayer was given a valuation of $892,571.93, with oil reserves as 505,851 barrels as compared with 479,487 barrels in the former valuation. The resulting depletion unit in this second valuation was $1.7647.

This valuation, the depletion schedule of which is shown in Exhibit 15, was based upon $2.25, the posted price of oil, plus a premium of 25 cents per barrel. Also, the bureau's 10 per cent discount factor applied to the middle of the year in place of the flat 15 per cent as used in the valuation of May 20, 1922. The reserves have been slightly increased, which has a tendency to increase the total valuation desired by the taxpayer. The increase in the market price of oil by reason of the 25 per cent premium and the use of a lower discount rate increases the depletion unit in accordance with the taxpayer's request, but does not give him all that he claims, viz, $2.29 for $2.25 oil.

Basing the ultimate reserves on the first three years' actual production there should be approximately 524,000 barrels. An analytical valuation based on these reserves, with oil selling at $2.25 per barrel, less lifting costs of 40 cents per barrel, State tax 7 cents per barrel, and not taking into consideration the 25 cents premium claimed, gives a net value of $1.78 per barrel, or $931,527, which discounted at 15 per cent per year over a 10-year life gives a present worth of $686,742. From this must be deducted the cost of development and equipment, which according to taxpayer's statement is approximately $120,000, leaving a net value of $566,742, as compared with $729,547 as per valuation allowed in May, 1922, and $892,571 allowed as per conference November 13, 1924.

The apparent trouble seems to arise from the fact that the market price of oil in 1920 was $3.50 per barrel, resulting in a substantial profit ($3.50–$1.61) of about $1.90 per barrel for the year 1920. The 1920 production was approximately 150,000 barrels.

Referring to a conference report (Exhibit 9) in the engineering division, November 12, 1924, wherein the taxpayer had appealed from an assessment of additional taxes, this report indicates that the oil reserves did not come up to the estimates originally made. As a matter of fact, the department, in making its original valuation in 1922, accepted the taxpayer's statement as to the reserves on this property (432,000 barrels for the Kimble lease and 47,487 for the Perryman lease). The production on the Perryman lease to the close of 1922, according to information submitted in the Form O, was 47,627 barrels, 140 barrels in excess of the taxpayer's first estimate. The production on the Kimble lease to the close of 1922 was 409,243 barrels, or only 21,000 barrels short of the original estimates. On the basis of the production for 1922 the future production of these wells should be approximately 50,000 barrels, so that the actual barrels recoverable will be in excess of the original estimate. No evidence has been presented to show that the wells have ceased to produce or that the lease has been abandoned.

The conference memorandum (Exhibit 9) of November 12, 1924, further intimates that the value arrived at in 1922 was based on the sale of a fractional interest of the royalty in this particular lease. Information concerning this

sale was submitted, but the valuation was based upon an analytical appraisal. The taxpayer endeavored to use this sale of fractional interest to set up his values, although this sale took place six months after the discovery well came in and could not, according to regulations, be used.

Sale of Kimble royalty

Gross barrels	Reserves at discovery	Production to Jan. 1, 1920	Reserves Jan. 1, 1920
Kimble lease	1,579,836	711,332	868,504
One-eighth of royalty	197,479	88,916	108,563
Five-sixths of royalty	164,565	74,818	89,747
Five-sixteenths working interest	431,987	194,506	237,481
Full working interest	1,382,357	622,416	759,941

The five-sixths Kimble royalty was sold January 2, 1920, for $555,000, as per affidavit, Exhibit 16. The production during the last six months of 1919 was large; in fact, nearly 50 per cent of the ultimate reserves has been exhausted as of January 1, 1920. The remaining oil representing the five-sixths royalty interest on January 1, 1920, was only 89,747 barrels, making the unit cost $6.17 per barrel, when oil was selling at approximately $3 per barrel.

The affidavit is not specific as to the amounts of the various payments, whether they were in cash, oil, or other property.

E. R. BLACK—VALUATION AND SALE OF SEVEN-SIXTEENTHS OF SEVEN-EIGHTHS (FORTY-NINE ONE-HUNDRED-AND-FORTY-FOURTHS) WORKING INTEREST

E. R. Black states that he acquired his interest in the property April 12, 1919, from W. B. Pine, Okmulgee, Okla., for the consideration of drilling a well immediately. This well, including physical equipment, according to the taxpayer, cost $33,397. Black's interests in these two leases (the Perryman 30 acres and the Kimble 80 acres) were sold August 1, 1919, to the Indiahoma Refining Co. for $300,000; deducting the cost of the well would leave for the value of the oil in the ground, $266,603.

The discovery value of oil reserves determined by the Income Tax Unit, oil and gas section, was $270,059, this amount being for seven-sixteenths of seven-eighths working interest in 33 acres which came within the discovery limits of well No. 1. The taxpayer has not set up any value on the remaining 17 acres in the Kimble lease, nor on the 30 acres in the Perryman lease, but he sold his entire forty-nine one-hundred-and-forty-fourths interest in the 80 acres for $300,000 with one good well on the property.

It is noted that in the unit's calculations of profits to Black on this deal, cost of equipment to the extent of $114,791 was allowed. The cost of this equipment however—at least two-thirds of it—resulted from drilling two dry holes on another lease in the immediate vicinity. The profits resulting from the sale (Exhibit 17), even allowing the cost of this equipment, amounted to $223,248.99. Under date of October 13, 1924, the oil and gas section recomputed the profit on the Black sale and revised the cost from $114,791 to $33,397 (the cost of well No. 1) and showed a profit of $277,039.

COMPARISON OF BLACK AND SIMONS VALUATIONS AS DETERMINED BY THE UNIT

A comparison of the various factors used is shown in Exhibit 18. The dates of discovery do not agree. The price of oil for Black valuation is $2.25, while for the last valuation for Simons, it is $2.50. Black's lifting and overhead expenses are taken as 50 cents per barrel, and for Simons 10 cents per barrel. The reserves do not agree. The common unit of interest in this property is 144. The value of this fraction to Black is $5,511, based on 6,914 barrels of oil, while that allowed Simons is $15,218, based on 8,624 barrels of oil. Black owns 49 of these fractional units and Simons 35. The unit allows Black $270,059 for his part and Simons $533,887 for the smaller fraction. Reducing Simons to Black's basis, the $533,887 should be reduced to $192,885. The depletion unit allowed Black is $0.797, while Simons is given $1.764. Considering the valuation placed upon Black's interest by the unit, and the sale of Black's interest, what is the value of Simons's interest?

The question of valuing the Simons interest in this particular property should resolve itself into a very simple matter. The value was fixed by the sale of Black's interest in the property at the date of discovery, and no other valuation basis should be used, for the regulations specifically state that the value to be obtained is that which would induce a willing buyer to buy and a willing seller to sell. These conditions prevailed at the date of discovery. A willing buyer was found; there is a willing seller, and the deal was closed.

On the basis of Black's sale the value of the Simons interest in the 80 acres, allowing for one additional discovery area, should be approximately $400,000 instead of $892,671, allowed by the unit, and $1,250,000 claimed by the taxpayer. The Simons valuation is based on the actual production of succeeding years, while the basis of the valuation of the Black property is the selling price under conditions existing at date of discovery and sale and which is in accordance with regulations.

These cases are now in audit, the taxpayer's attorney awaiting the revised A-2 letters as a basis for another appeal, six years after the transactions in question took place and more than $250,000 additional taxes involved.

(The exhibits accompanying Mr. Fay's report in E. R. Black's and George A. Simons's cases are as follows:)

EXHIBIT 1

STATE OF MISSOURI,
Clay County, ss:

I, W. R. Alexander, of Kansas City, Mo., of lawful age, being first duly sworn, depose and say that I was a resident of Okmulgee, Okla., in 1919, and at that time was negotiating for oil properties for the Gladys Belle Oil Co., of Tulsa, Okla.; that I was familiar with the oil properties and production owned by George A. Simons, of Okmulgee, Okla., and as agent for the said Gladys Belle Oil Co. did make the said George A. Simons an offer for certain oil properties, among said properties being the lease and leasehold covering 80 acres known as the Kimble-Perryman farm in section 12-14-11, Okmulgee County, Okla.; that this offer was as follows: $2,000,000 for an undivided one-half working interest in the Kimble-Perryman lease, five-sixteenths of which was owned outright by the said George A. Simons, with agreement to take in additional properties to the extent of $1,000,000; that said offer to purchase was made in August, 1919, directly after well No. 1 was completed on August 5 and before any other well was drilled in on the said Kimble-Perryman lease; that it was a bona fide offer authorized by the said Gladys Belle Oil Co., by Grant C. Stebbins, president, a willing purchaser; that the said George A. Simons refused to accept said offer. I further state that I was authorized to make a down payment at the time of $500,000 to the said George A. Simons to close.

(Signed) W. R. ALEXANDER.

Subscribed and sworn to before me this 5th day of November, 1924.

(Signed) F. S. KIMBER,
Notary Public.

My commission expires August 6, 1927.

EXHIBIT 2

AFFIDAVIT

STATE OF OKLAHOMA,
County of Tulsa, ss:

I, G. C. Stebbins, of the City of Tulsa, Okla., of lawful age, being first duly sworn, depose and say that I am the president of the Gladys Belle Oil Co. and have been since February, 1919, said corporation being organized under the laws of Delaware, engaged in the oil business in the mid-continent field; that we own and operate leases and wells in the State of Oklahoma and are familiar with the values of properties in the various fields.

In August, 1919, I negotiated with one George A. Simons for the purchase of properties owned and controlled by him in Okmulgee and other counties, which included, among other properties, 80 acres known as the Kimble Perryman farm,

located in 12-14-11, Okmulgee County, Okla. The price offered by me for all of the properties was $3,000,000 and was declined by the said G. A. Simons. The values arrived upon by me were based upon $2,000,000 for one-half interest in the Kimble-Perryman lease, of which Mr. Simons owned five-sixteenths. Our negotiations took place in August, 1919, soon after the completion of well No. 1 and was a bona fide offer made by me for our company as a willing purchaser.

Further affiant saith not.

(Signed) G. C. STEBBINS.

Subscribed and sworn to before me this 3rd day of November, 1924.

(Signed) HAL. G. SIEHR,
Notary Public.

My commission expires March 8, 1926.

EXHIBIT 3

STATE OF OKLAHOMA,
Okmulgee County, ss:

I, E. E. Schock, of Okmulgee County, Okla., of lawful age, being first duly sworn, depose and say that during the year 1919 I was president of the Indiahoma Refining Co., a corporation incorporated under the laws of the State of Oklahoma and engaged in the business of producing and refining crude oil, owning large acreage and producing oil properties in Oklahoma and the midcontinent oil fields and owned and operated refineries in Okmulgee, Okla., and East St. Louis, Ill.; that at that time the said Indiahoma Refining Co. was the owner, and still is the owner, of an undivided one-half interest in the oil and gas lease and leasehold estate covering the 80 acres known as the Kimble-Perryman farm, in section 12, township 14 north, range 11 east, Okmulgee County, Okla.; that as president of the said Indiahoma Refining Co. I was a willing purchaser of the remaining undivided one-half interest in the said property not owned by the Indiahoma Refining Co., and on August 5, 1919, did make a bona fide offer to purchase, through G. A. Simons, of Okmulgee, the said remaining undivided one-half interest for $2,250,000, which said offer was equal to $1,406,250 for the five-sixteenths interest owned by the said G. A. Simons, which said offer was formally declined by the said G. A. Simons; that this offer was made as aforesaid in good faith and immediately after the completion of well No. 1 on the property hereinbefore mentioned, and did not include the cost of any equipment or development expense, undertaken or incurred, except the cost of well No. 1 completed.

(Signed) E. E. SCHOCK.

Subscribed and sworn to before me this 30th day of October, 1924.

(Signed) FRED D. TIFFANY,
Notary Public.

My commission expires May 26, 1927.

EXHIBIT 4

Oil and gas valuation section

[George A. Simons, Okmulgee, Okla.]

1918—Depletion claimed	$4,270.00
Depletion allowable	3,111.59
1919—Depletion and depreciation claimed	553,759.26
Depletion allowable	341,810.91
1920—Depletion and depreciation claimed	437,833.98
Depletion allowable	234,070.42

Taxpayer operates five leases in Okmulgee and claims discovery on two of them in the Beggs Wilcox pool. The values claimed are excessive and supported by incomplete data; the taxpayer's estimate of reserves is accepted and the value reduced to a reasonable figure.

Depletion is allowable as follows:

George A. Simons—Depletion allowable

Lease	1918	1919	1920
Sone	$1,905.00	$7,338.10	$9,796.02
Caram	1,206.59	3,958.57	2,450.91
Jefferson			749.60
Kirable		313,500.88	207,008.96
Perryman		17,013.36	14,064.93
Total	3,111.59	341,810.91	234,070.42

Schedules of depreciation are in Form O.
Recommended by S. G. S. engineer.
Approved by Russell Beall, chief of section.
MAY 20, 1922.

EXHIBIT 5

OCTOBER 17, 1924.

Mr. GEORGE A. SIMONS,
Okmulgee, Okla.

SIR: An examination of your income-tax returns for the years 1919 and 1920, in connection with an investigation made of your books of account and records discloses a deficiency in tax aggregating $139,464.85. The adjustments made are explained in the attached statement.

You are granted 30 days from the date of this letter within which to present a protest, supported by additional evidence or brief, against this determination of a deficiency. Upon request submitted within the period mentioned, you will also be granted a hearing in the bureau with reference to the matter. A request for a hearing should contain (*a*) the name and address of the taxpayer; (*b*) in the case of a corporation, the name of the State of incorporation; (*c*) a designation by date and symbol of the notice or notices with respect to which the hearing is desired; (*d*) a designation of the year or years involved and a statement of the amount of tax in dispute for each year; (*e*) an itemized schedule of the findings of the unit to which the taxpayer takes exception; and (*f*) a summary statement of the grounds upon which the taxpayer relies in connection with each exception.

If, after consideration of any additional evidence submitted and any arguments advanced by you, a deficiency is finally determined by the bureau to be due from you, you will, in accordance with the provisions of section 274 of the revenue act of 1924, be advised by registered mail of the final determination of the commissioner as to the amount of the deficiency and allowed 60 days from the mailing of the letter in which to file an appeal to the Board of Tax Appeals in the event you do not acquiesce in such final determination.

If you acquiesce in the determination of a deficiency as disclosed in this letter and the accompanying statements, you are requested to sign the inclosed agreement consenting to the assessment of such deficiency and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT; PA:2, HLM-203. In the event that you acquiesce in a part of the determination, the agreement should be executed with respect to the items agreed to.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.

STATEMENT

OCTOBER 17, 1924.

In re Mr. George A. Simons, Okmulgee, Okla.

Deficiency in tax

1919	$102,789.97
1920	36,674.88
Total	139,464.85

This deficiency is the result of certain adjustments which were explained to you by the internal revenue agent in charge at Oklahoma, Okla., whose report, dated May 15, 1923, has been reviewed and approved by this office with the exception of the following revisions:

1919

Net income as disclosed by report		$35, 440. 71
Depletion allowed on report	$520, 487. 81	
Depletion as computed by this office	341, 810. 91	
		178, 676. 90
Corrected net income		214, 117. 61
Exemption		2, 000. 00
Subject to normal tax		212, 117. 61
$4,000 at 4 per cent	$160. 00	
$208,117.61 at 8 per cent	16, 649. 41	
		16, 809. 41
Surtax		85, 980. 56
Total tax due		102, 789. 97
Previously assessed		None.
Deficiency		102, 789. 97

1920

Net loss as disclosed by examiner's report		22, 287. 69
Net income as corrected		111, 486. 47
Net additions		133, 774. 16
Additions:		
Depletion allowed by examiner	$365, 591. 49	
Depletion as computed by the engineering division of this office	234, 070. 42	
Disallowed	131, 521. 07	
Error in computation of other expenses on schedule 8-3 of report	1, 256. 31	
Excise tax of furs and auto disallowed	996. 78	
Net addition as above		133, 774. 16

Computation of tax due

Corrected net income		111, 486. 47
Exemption	$2, 000. 00	
Dividends	375. 00	
		2, 375. 00
Subject to normal tax		109, 111. 47
$4,000 at 4 per cent	$160. 00	
$105,111.47 at 8 per cent	8, 408. 92	
		8, 568. 92
Surtax		29, 482. 96
Total tax due		38, 049. 88
Previously assessed		1, 375. 00
Deficiency		36, 674. 88

This assessment is in addition to all other outstanding and unpaid assessments appearing on the collector's lists.

EXHIBIT 6

TREASURY DEPARTMENT, *Washington.*

Mr. GEORGE A. SIMONS,
Okmulgee, Okla.

SIR: Your claim for the refund of $1,381.87 income tax assessed on your 1920 return has been examined and will be rejected for the following reason:

Your 1920 return has been reaudited in connection with a report by the internal revenue agent in charge at Oklahoma, Okla., dated May 15, 1923, and resulted in a tax liability in excess of the amount previously assessed. The adjustments made resulting in the deficiency are explained to you in a separate communication from this office.

Your claim will therefore be rejected.

The rejection of your claim will officially appear on the next schedule to be approved by the commissioner and forwarded to the collector of internal revenue for your district.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.
By A. LEWIS,
Head of Division.

EXHIBIT 7

OKMULGEE, OKLA., *November 13, 1924.*

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

SIR: Protest is hereby filed against the determination of a deficiency in income tax for the years 1919 and 1920 against George A. Simons of Okmulgee, Okla., as set out in your letter of October 17, 1924, under the above file number.

Exception is taken to the "fair market value" of certain oil and gas leases as applied by the Income Tax Unit for depletion purposes. The property is described as the Kimble-Perryman lease in section 12, township 14 north, range 11 east, Okmulgee County, Okla. The discovery well was drilled by the taxpayer in 1919 and was the first producing oil well in Okmulgee County from what is now known as the Wilcox sand; the discovery right being thus clearly established by this taxpayer. This taxpayer claims the fair market value of the property at the basic date was $1,250,000 and submits affidavits and other evidence showing an actual sale in November, 1919, of five-sixths of one-eighth R. I. of the identical property, and bona fide offers by willing purchasers made to this taxpayer for his five-sixteenths interest within 30 days after the completion of the discovery well, equal to and above the capital sum claimed by this taxpayer for depletion. This taxpayer claims that the actual sale and bona fide offers by willing purchasers established the fair market value of the property, and the engineer's estimates of reserves now proven by actual production recovered from the property when applied to this valuation should determine the unit value for depletion.

This taxpayer transmits herewith schedule marked "Exhibit A," supporting the depletion claimed in the schedule of taxes next attached.

The revenue agent in his report of May 15, 1923, has added to income for the year 1919 the sum of $60,000 as the selling price of an interest in the Stella Kelly lease. This addition is protested on the following grounds: The statement made on page 15 of the revenue agent's report to the effect that a sale was completed during the year 1919 is not correct in the following respect: The exploration of the lease was a failure as to the Sewell interest in 1919 and consequently under the terms of the taxpayer's agreement with Sewell the $60,000 was returnable to Sewell in that year and would have been returned to him by the taxpayer but for the fact that Sewell, a British subject, was in England and was unable to come to the United States because of restrictions placed on trans-Atlantic travel following the armistice, a condition beyond his control. Accordingly, the $60,000 was virtually in escrow at all times, and at no time was the sale consummated.

Power of attorney for Mr. Simons to the undersigned has been filed with the department.

Respectfully,

H. W. METZGER,
Attorney or Agent.

In re Mr. George A. Simons, Okmulgee, Okla.
Net result, 1919 and 1920, no additional tax.

This schedule is the result of certain adjustments made by the internal revenue agent in charge in his report of May 15, 1923, revised in accordance with depletion exhibit and protest attached.

1919

Net income disclosed by agent's report			$35,440.71
Depletion allowed on report	$520,487.81		
Depletion per exhibit attached	553,915.71		
		$33,427.90	
"Sale of lease" added in error		60,000.00	
			93,427.90
Net income corrected, loss			57,987.19
Amount of tax			None.

1920

Net loss disclosed by agent's report		$22,287.69
Depletion allowed on report	$365,591.49	
Depletion per exhibit attached	385,776.21	
		20,184.72
		42,472.41
Error in computation schedule 8B of report	1,256.31	
Excise taxes disallowed	996.78	
		2,253.09
Net income corrected, loss		40,219.32
Amount of tax		None.

ENGINEERING DIVISION,
INCOME TAX UNIT,
November 12, 1924.

Memorandum to Mr. S. N. Greenidge, Head, Engineering Division.
In re G. A. Simons, Okmulgee, Okla.

Represented by U. C. Beck, C. P. A.; H. W. Metzger, secretary to Mr. Simon, Okmulgee, Okla.

Representing the Government C. C. Griggs, assistant head of division; A. R. Shepherd, Division Conferee; H. A. Campbell, assistant chief, oil and gas section; J. W. Dyche, valuation engineer.

These representatives had been in conference the forenoon of November 11, 1924, and not coming to an agreement, the conference was transferred to the office of the assistant head of division.

It appears that Mr. Simons had been given a discovery valuation by the unit which was acceptable to the taxpayer but subsequent operations developed the fact that the oil reserves were actually much less than the reserves accepted by the unit. The reserves which the unit stated would have had to be there to reflect the valuation given, resulted in a depletion unit value of $1.61 per barrel, while the actual reserves would indicate a depletion unit value of $2 plus. A discovery value was determined during 1922 on a basis not recognized by the oil and gas section at the present time but the taxpayer having had an offer to sell at the date of discovery reflecting the value previously allowed, a five-sixths interest in the well having been sold at this value (the taxpayer retaining his one-sixth interest), the unit had permitted the valuation to stand.

The taxpayer's contention was that inasmuch as the valuation of the oil well was established as at date of discovery by comparative sales, that that value should govern and in the case of the oil well proving a disappointment and not producing the reserves that were estimated at date of discovery, they should be permitted to readjust the unit rate of depletion in accordance with the actual oil reserves.

Taxpayer was advised that the unit could not concede a higher valuation for discovery in any case than would be reflected by analytical methods, that the engineer would be instructed to compute his discovery valuation by this method and if it resulted in a higher unit rate of depletion than had been allowed him in the previous audit, that he would be allowed that rate. He was

also advised that since Mr. Campbell, assistant chief of this section, had stated that there were cases before the review section of the solicitor's office at the present time and one case before the Court of Claims upon this same question as to the reallocation of the oil reserves after the unit has accepted a valuation that the ruling of the unit would be sustained by this office and that his case would be forwarded in due time to the Board of Tax Appeals through channels.

No doubt by the time his case is considered by the Board of Tax Appeals rulings will have been made upon the cases now pending so that the decision can be made without difficulty.

On November 12, 1924, Valuation Engineer J. W. Dyche reported to the tax payer's representatives and to this office that the unit rate of depletion computed by analytical methods was $1.7647. Taxpayer was then advised by this office that a new valuation memorandum would be prepared reflecting this amount, forwarded to audit and the case would be reaudited reflecting this condition.

Taxpayer expressed himself as being dissatisfied with this rate and stated that he would protest his case when he received his A-2 letter from the reaudit.

C. C. GRIGGS,
Assistant Head of Division.
A. R. SHEPHERD,
Division Conferee.

EXHIBIT 10

TAXPAYERS' CONFERENCE

Conference date: November 13, 1924.
Taxpayer: George A. Simons, Okmulgee, Okla.
Represented by W. C. Beck, jr., and H. W. Metzger, Okmulgee, Okla.
Credentials properly enrolled.
Power of attorney: Recorded November 11, 1924.
Years involved: 1919 and 1920.

Matter presented: There were two questions involved in the adjustment of this case, namely, (1) depletion for the years 1919 and 1920, (2) additional income erroneously included by revenue agent for 1919.

Mr. Dyche of the oil and gas valuation section sat in conference and will submit revised schedule of depletion for the years 1919 and 1920 based on additional information submitted, and it should be used as a basis for closing the case.

The taxpayer objects to erroneously including income of $60,000 in 1919 as the result of the sale of a lease.

The revenue agent treated the transaction as closed in 1919, and when the money was refunded in 1920, two months later, he states it was in the nature of a gift.

The facts as related by the taxpayer and so stated in his brief indicates that the taxpayer entered into an agreement in 1919 with one Sewell, whereby Sewell was to take a certain lease for $60,000, the delivery of the money, held in escrow,: conditional upon striking oil.

No oil was found after drilling in 1919, and the lease was canceled and the money was refunded in 1920 because Sewell was in England at the time.

It is contended that the money was not constructively received by the taxpayer since he was on a cash receipts basis, neither could it be regarded as a cash transaction since the money was held in escrow and not available to the taxpayer, and the transaction was not finally consummated in 1919.

The lease was finally abandoned in 1920.

It is recommended that no income from this transaction be included for 1919.

Interviewed by—

R. H. JOHNSON,
Conferee.

Approved.

WILLIAM BLUM,
Supervising Conferee.

WILLIAM B. RISTIG,
Assistant Head, Personal Audit Division.

EXHIBIT 11

TAXPAYER'S CONFERENCE

ENGINEERING DIVISION,
OIL AND GAS SECTION,
November 13, 1924.

Taxpayer: George A. Simons.
Address: Okmulgee, Okla.
Represented by Mr. Metzger and Mr. Beck, jr.
Credentials: Pamer attorney—Enrolled.
Taxable years: 1919–20.
Matter presented: Valuation data.
Issues discussed: Valuation on account of discovery.
Conclusions: Valuation of $892,671.93, reserves 505,851 barrels, and unit $1.7647 was given the taxpayer. The taxpayer's representative stated that the valuation would be submitted to the taxpayer and acceptance of same would be referred to him. Reference is made to audit conference this date.
Interviewed by: J. W. Dyche, H. A. Campbell, Mr. Thayer, Mr. Griggs.

EXHIBIT 12

Mr. GEORGE A. SIMONS,
Okmulgee, Okla.

SIR: Reference is made to your protest dated November 13, 1924.
In order that the interests of the Government may not be jeopardized and that careful consideration may be given to your contentions, it is necessary that the inclosed waiver be properly signed and executed for the year 1919.
You are requested to return the waiver within 10 days of the receipt of this letter, direct to the Commissioner of Internal Revenue, Washington, D. C., referring to the symbols IT: En: OG: JWD.
Respectfully,

J. G. BRIGHT,
Deputy Commissioner,
By S. M. GREENIDGE,
Head of Division.

EXHIBIT 13

JANUARY 9, 1925.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

DEAR SIR: Reference is made to your esteemed favor of December 3, 1924, under your file symbols IT: En: OG, JWD, which reached my hands through the mails on the 4th day of January, 1925, and which said letters contained a waiver to be signed and executed for the year 1919, with the request that the same be returned within 10 days of the receipt of same.
I am returning herewith the waiver properly signed and executed as requested.
Yours very truly,

GEO. A. SIMONS.

EXHIBIT 14

INCOME AND PROFITS TAX WAIVER

[For taxable years ended prior to March 1, 1921]

OKMULGEE, OKLA., *January 10, 1925.*

In pursuance of the provisions of existing internal revenue laws, George A. Simons, a taxpayer of Okmulgee, Okla., and the Commissioner of Internal Revenue hereby waive the time prescribed by law for making any assessment of the amount of income, excess-profits, or war-profits taxes due under any return made by or on behalf of said taxpayer for the year 1919 under existing revenue acts or under prior revenue acts. This waiver of the time for making

any assessment as aforesaid shall remain in effect until December 31, 1925, and shall then expire, except that if a notice of a deficiency in tax is sent to said taxpayer by registered mail before said date and (1) no appeal is filed therefrom with the United States Board of Tax Appeals, then said date shall be extended 60 days, or (2) the number of days between the date of mailing of said notice of deficiency and the date of final decision by said board.

GEORGE A. SIMONS, *Taxpayer.*
By D. H. BLAIR, *Commissioner, S. M. G.*

If this waiver is executed on behalf of a corporation, it must be signed by such officer or officers of the corporation as are empowered under the laws of the State in which the corporation is located to sign for the corporation, in addition to which the seal, if any, of the corporation must be affixed.

EXHIBIT 15

Individual: George A. Simons, Okmulgee, Okla.
Taxable year: 1919–20.
Protest: 1919–20.
Allowed in part, as indicated below.
Claims in case: 1919–20.

Depletion

Taxable year	Gross income reported, oil	Depletion claimed	Depletion allowable
1919	$555,748.17	$553,915.71	$397,410.12
1920	537,228.07	385,776.71	272,925.15

SALE CAPITAL ASSETS

Reference is made to audit conference memorandum, dated November 13, 1924.

DEPRECIATION, ETC.

Items previously determined, as indicated by A–2 letter with the case.

DISCUSSION

Revaluation on the Kimble-Perryman lease was allowed on the basis of data submitted in conference. Value set up in that conference is indicated by engineering conference memorandum, November 12, 1924.

Memorandum by Engineer S. C. Slusher, dated May 20, 1922, is superseded for the years 1919 and 1920.

Recommended by J. W. Dyche, Engineer.

Approved by chief of section.

EXHIBIT 16

STATE OF OKLAHOMA,
County of Tulsa, ss:

John G. Ellinghausen, of lawful age, being first duly sworn, on oath states: That he is a resident of the city of Sapulpa, Creek County, Okla.; that during the month of November, 1919, this affiant, as trustee, made a contract to purchase the west half of the northwest quarter of the northeast quarter, and the west half of the southwest quarter of the northeast quarter and the southeast quarter of the southwest quarter of the northeast quarer of section 12, township 14 north, range 11 east, the same carrying with it an undivided five-sixths (of a one-eighth royalty of the oil and gas produced from the above-described land. That the purchase price for said land and said five-sixths of the one-eighth royalty was $550,000; that in addition thereto this affiant, as trustee, paid a commission of $5,000; that the total cost of said property was $555,000.

Affiant further states that a deed to said property was made by C. C. Kimble and wife, Wm. H. Reading and wife, and Sylvester Biggerstaff, on the 2nd of

January, 1920; that part of said consideration was paid on or about the 15th of November, 1919, and the balance of the consideration was paid during the year 1920 in installments.

That an oil and gas lease was operated on said property at the time of said purchase by George Simons and the Indiahoma Refining Co.

Further affiant saith not.

JOHN C. ELLINGHAUSEN.

Subscribed and sworn to before me this 31st day of October, 1924.

LUCILE DANNECK,
Notary Public.

My commission expires March 10, 1927.

In re E. R. Black, Okmulgee, Okla.
Taxable years, 1919 and 1920.
Appeal dated October 31, 1923.
R. A. R., 1919 and 1920.
Depletion based on discovery value.
Development charged to expense.

Taxable year	Gross income from oil and gas R. A. R.	Depletion claimed, Form O	Depletion allowable		
			On cost	Appreciation over cost discovery	Total
1919	$36,827.70	$15,884.22	$381.02	$12,082.11	$12,463.13
1920	13,521.33	None.	None.	None.	None.

DEPRECIATION

In his report of April 13, 1923, the revenue agent recommends a depreciation rate of 16 per cent on lease equipment in lieu of 40 per cent as claimed by the taxpayer. In his appeal taxpayer states his reasons for claiming such a high rate of depreciation. In his letter of November 20, 1923, Revenue Agent G. C. Holt recommends that the taxpayer be granted relief in the premises, and it is thought equitable to sustain the claims as set forth in the protest. It appears that the dry-hole loss account would have been larger had not such a large amount of depreciation been claimed.

Profit on sale of assets, 1919

Lease sold to Indiahoma Refining Co.

Value of all considerations received		$300,000.00
Depletion sustained		381.02
Depreciation sustained		45,916.63
Cost of lease	$8,257.10	
Cost of equipment	114,791.57	
Profit	223,248.99	
	346,297.65	346,297.65

It will be noted that the profit shown above is set up differently than that shown in the revenue agent's report, and the depletion sustained is as shown on cost in Form O, the depreciation sustained is as claimed by taxpayer on the investment in lease equipment ($114,791.57), the cost of lease is as shown in Form O.

EXHIBIT 17

In re E. R. Black.

Profit on sale of other leases is in accordance with revenue agent's report.

LEASE EXPENSES

Lease expenses as reported by revenue agent are sustained.

AMORTIZATION OF LEASES

In his protest taxpayer claims "amortization" of leases amounting to $2,411.30. This amount is sustained.

DISCUSSION

A discovery value has been claimed on the Kimble lease in section 12, township 14 north, range 11 east, Okmulgee County, Okla. The value as arrived at by taxpayer has been reduced due to a reappraisement, based on $2.25 oil in lieu of $2.50 oil.

Case may be audited and closed.

Recommended by H. H. P., engineer.

Approved by W. N. Thayer, chief of section.

Work sheet of engineer

H. H. Power oil and gas (net barrels per well)	Price oil $2.25		E. R. Black Kimble lease (10 per cent C. D. F.)
	Profit per net barrel	Operating profit ($0.9524)	
38,281	$1.75	$66,991.75	$63,801.60
11,484	1.25	14,355.00	12,428.56
7,656	1.00	7,656.00	6,025.96
4,977	.75	3,732.75	2,670.93
3,063	.75	2,297.25	1,494.34
1,531	.75	1,148.25	679.02
766	.75	574.50	308.85
67,758	Present worth No. 1		87,409.26
271,032	4 additional such wells		349,637.04
338,790			437,046.30
	Less development 5 wells		166,987.00
	Value of oil reserves discovered		270,059.30

EXHIBIT 18

Comparison of data used and results obtained by oil and gas section in valuing fractional working interests in same

	E. R. Black (allowed)	G. A. Simons (allowed)	G. A. Simons (revised)
Date of discovery for valuation	July 3, 1919	Aug. 5, 1919	July 3, 1919.
Initial production	2,000 barrels per day.	2,000 barrels per day.	2,000 barrels per day.
Price of oil per barrel	$2.25	$2.50	$2.25.
Lifting and overhead costs per barrel	$0.50	$0.10	$0.50
Taxes (7 cents per barrel)	Included in lifting cost.	Included in lifting cost.	Included in lifting cost
Ownership	7/18 of 7/8	5/18 of 7/8	5/18 of 7/8.
Ownership to common denominator	49/144	35/144	35/144.
Area of leases	80 acres	80 acres	80 acres.
Discovery valuation area	33 acres	33 acres	33 acres.
Gross reserves per acre	30,170 barrels	37,713 barrels	30,170 barrels.
Gross reserves, 33 acres	995,616 barrels	1,244,529 barrels	995,616 barrels.
Taxpayer's reserves	338,790	302,511	241,990.
Taxpayer's barrels per acre	10,266	9,167	7,333.
Taxpayer's value per acre	$8,183	$16,178	$5,845.
1/144 interest, barrels per 33 acres	6,914	8,624	6,914.
Value 1/144 interest in 33 acres	$5,511	$15,218	$5,511.
Taxpayer's total interest, 33 acres	$270,059	$533,887	$192,885.
Taxpayer's total interest, 17 acres		$275,017	$99,365.
Taxpayer's total interest, 30 acres		$83,767	$87,675.[1]
Value	$270,059	$892,671	$379,925.
Depletion unit	$0.79713	$1.7647	$0.7970.

[1] Reduced 50 per cent by reason of expected decreased production for future wells and dry-hole hazard.

Value based on Black valuation and Simons production (505.858×0.79713)=$403,234.

Value allowed May 20, 1922, $729,547.

Value claimed by taxpayer ($344,189), $1,250,000.

Mr. MANSON. I will ask you to take up the conclusion of the Gulf case now, Mr. Fay.

Mr. FAY. Before giving the summary in the case of the Gulf Oil Corporation, I have two pages of notes on the Mexican Gulf Oil Co., a subsidiary of the Gulf Oil Corporation.

The two points to be brought out in this statement are (1) excessive reserves due to lack of hazard factors and (2) low discount rate to determine present worth.

This subsidiary corporation acquired leases in Mexico in 1912, 1913, 1917, and 1919. The majority of the leases were purchased for a nominal sum although the records show that two leases were purchased, one for $1,500,000 and one for $373,000 plus contingent payment out of production in future years to the amount of about $600,000. The Mexican Gulf Oil Co. sets up a valuation for its Zuniga lease purchased December 12, 1912, for 500 pesos, plus a small incidental cost of $3,478.48. The annual rental until production was obtained was $617.16 United States currency; royalty rate 10 per cent. On December 12, 1913, the taxpayer set up a discovery valuation on well No. 1, which is estimated as 2,000 barrels daily potential production, with a discovery area of about 60 acres. The taxpayer assumes that two other wells will be drilled on this property, each of which will produce as much as well No. 1. A large number of the wells completed in Mexico prior to this had been producing oil for three or four years with practically no reduction in flow from what was obtained originally. It is on this basis, therefore, that the taxpayer assumes that this discovery well and the two additional wells will produce 2,000 barrels each daily for at least 39 months.

The taxpayer states:

> That at the time Zuniga No. 1 a discovery well on lease was completed little or nothing was known of the extent of the productive area in the Panuco field inasmuch as only 27 wells had been completed in that general region and those were well scattered, except for 15 wells which had been drilled in a localized area then known as the Maza-Willis pool. Of the wells which had been drilled none had encountered salt water and all had been completed as oil wells ranging from a daily potential production of 6 barrels to 5,200 barrels. The depths of these wells varied from a minimum of 1,640 to 2,701 feet from the surface. The oil horizon was known to be a hard, dense limestone, and because of the fact that some wells of only a few barrels capacity were found offsetting wells of daily potential capacity of thousands of barrels, it was thought entirely possible and practically accepted that the oil was contained in fractures and joint planes.

In view of this statement, the company is not justified in assuming that the two additional wells to be drilled on this 60-acre tract would produce as much as well No. 1. The taxpayer uses no production hazard, dry-hole hazard, or any other hazard in estimating his reserves. A purchaser of property in Mexico would undoubtedly consider the above quotation very carefully before assuming that future wells would be as large as the first one. It therefore appears that the taxpayer's estimated reserves are unduly large.

On December 7, 1914, Zuniga well No. 3 was brought in at a depth of 2,370 feet with an estimated daily potential production of 10,000 barrels. The taxpayer assumes that this well will continue producing on this basis without diminishing for approximately 48 months, which would give gross reserves of 14,400,000 barrels, all of which it is expected would be recovered through this one well.

The taxpayer was aware that wells in Mexico go to salt water very suddenly, and yet he assumes that these wells will flow as long as certain other wells have been flowing, and it is on this basis that he estimates the life of these wells.

The reserves of Zuniga lease (19,278,000 barrels) should have been exhausted by the close of 1917. The production to close of 1917 was 4,173,180 barrels, which indicates one of two possibilities, namely, that the estimation of the reserves was erroneous or there was no market for so much oil, both of which should have been taken into consideration for depletion purposes.

The taxpayer has set up four discovery valuations at a net value of $10,858,793, as indicated on the accompanying table.

Discovery valuation on Mexican leases (Mexican Gulf Oil Co.)

	Life of well	Price of oil	Discount factor	Reserve	Depletion unit
			Per cent	*Barrels*	
Lopez No. 1—Mar. 31, 1917	7½ months	$0.16	12.9336	37,537,500	13.49
Zuniga No. 1—Dec. 12, 1913	39 months	.40	12.9336	6,318,000	30.0
Zuniga No. 2—Dec. 7, 1914	46 months	.20	12.9336	12,960,000	16.9
Cobos—Jan. 2, 1919	10.8 months	.25	12.9336	570,375	20.5
Total				57,385,875	16.3

Taxpayer's set-up

	Net value	Present worth	Composite discount, 12.9336 per cent	10 per cent regular discount	25 per cent regular discount
Lopez No. 1	$5,786,000	$5,037,661	$748,338	$1,041,203	$3,348,041
Zuniga No. 1	2,425,200	2,111,534	313,665	617,983	1,183,740
Zuniga No. 2	2,512,000	2,187,107	324,892	640,308	1,226,107
Cobos	135,593	118,056	17,537	12,354	27,119
Total	10,858,793	9,454,358	1,404,432	3,211,848	5,875,007

In order to determine the present worth of these various discovery valuations the taxpayer used a composite discount factor of 12.9336 per cent. This factor is used on the net value, regardless of the life of the property. One of the wells has a life of six years, to which he applies this same composite discount factor, while another has a life of 10.8 months, to which he applies this same composite discount factor.

The CHAIRMAN. Just at that point let me ask you when that 12 per cent factor was applied—as of what date?

Mr. FAY. As of date of discovery.

The CHAIRMAN. No; I do not mean that, but when was it——

Mr. FAY. In the set-up?

The CHAIRMAN. When the claim was made for discovery value. What was the date of the claim?

Mr. GREGG. If I may answer that, it was in 1921, Mr. Chairman. That is what I understand.

Mr. FAY. One of these was on December 7, 1914, and the other was a little earlier than that, December 12——

The CHAIRMAN. No; I am not talking about that. I am talking about the date when they made their claim.

Mr. FAY. This came in, Mr. Chairman, with the Gulf Oil Corporation's returns, in February, 1921. Does that answer it?

The CHAIRMAN. Yes.

Mr. FAY. The taxpayer's present worth of the net value is $9,454,358, which would leave a prospective purchaser a possible profit of $1,404,432. This, of course, is on the assumption that as much oil is recovered within the life of the wells as estimated by the taxpayer. The production figures from 1913 to 1919 amount to 11,620,590 barrels as against reserves 57,385,875 barrels. The discount due to the use of regular 10 per cent and 25 per cent is shown in the above table.

The 10 per cent discount table——

The CHAIRMAN. Are you going to put those tables in the record?

Mr. FAY. The tables will be placed in the record, Mr. Chairman.

It must be remembered that at the time of setting up these various discovery valuations the political situation of Mexico was anything but satisfactory, with revolutions and turmoil on all sides. There was no stability of government and confiscation or destruction of property was possible at any time. The Mexican export taxes on oil amounted to from 4 to 8 cents per barrel, with no certainty that that would be the limit. The World War was in progress, which would also add to uncertainty as regarding investments. Markets were liable to be cut off at any time, and the amount that could be marketed was limited by pipe-line facilities. The taxpayer sets up a value that could not possibly net the investor to exceed 12 or 13 per cent over the entire life of the property in a country without a stable government.

Some authorities on mining recommend a discount of 50 per cent on the net value of a mining property located in a foreign country. It is questionable whether 50 per cent would be sufficient to interest an investor in Mexico during the years 1913 to 1919, inclusive.

The production by years is given in the accompanying table:

Production in barrels—Gulf Oil Corporation—Mexican Oil Co.

	1913	1914	1915	1916	1917	1918	1919
Hernandez (12½ per cent)							41,711.71
Lopez (12½ per cent)							197,144.63
Zuniga (10 per cent)	31,400	921,660	967,831	919,989	1,332,300	556,169.29	653,705.42
Lopez (head royalty purchase)							9,857.23
Lot 251 (12½ per cent)							267,934.85
Cobos (17½ per cent)							436,728.84
Lot 8 (5 cents per barrel)						1,193,906.00	4,090,252.00
Total	31,400	921,660	967,831	919,989	1,332,300	1,750,075.29	5,697,334.68

Grand total, gross oil produced (1913-1919), 11,620,590 barrels.

That is all I have on that subsidiary of the Gulf Oil Corporation. Do you want the summary?

Mr. MANSON. Yes.

Mr. FAY. Summary, the Gulf Oil Corporation——

Senator KING. That includes the subsidiaries and all?

Mr. FAY. That includes the Gypsy Oil Co., Gulf Production Co., Gulf Refining Co., Mexican Oil Co., and Eastern Gulf Oil Co.

Senator KING. And those are all the subsidiaries, are they?

Mr. FAY. Those are all the subsidiaries that are producing oil. There are subsidiaries that handle pipe lines and refinery works that do not come in.

Mr. MANSON. And this summary refers to the discovery values allowed to those corporations?

Mr. FAY. That is all.

The Gulf Oil Corporation and its various subsidiaries filed their income and excess profits tax returns up to and including the year 1919 in regular form. On January 22, 1920, the auditing firm of Ernst & Ernst advised the commissioner that they had been retained by the corporation to handle its tax matters. On July 9, 1920, the corporation's engineers advised the commissioner that valuation reports for the producing properties were being prepared as a basis for depletion deductions. On November 6 two auditors from the department began a field audit of the corporation's books and worked simultaneously with Ernst & Ernst. On November 20, 1920, the valuation and depletion reports (supporting the amended returns in preparation by Ernst & Ernst) were received by the natural resources subdivision. On December 13, 1920, Mr. C. F. Powell, chief of the oil and gas section, recommended the acceptance of the corporation's valuation report subject to check and verification. The mathematical accuracy of the computations in the report was checked by the audit section. The valuation and depletion reports which were filed on November 20, 1920, claiming discovery valuation to the extent of $93,717,927 from 1913 to the close of 1919, are as follows:

Gypsy Oil Co.	$27,658,183
Gulf Production Co.	34,821,424
Gulf Refining Co.	21,413,401
Mexican Oil Co.	9,434,760
Eastern Gulf Oil Co.	390,159
Total	93,717,927

These figures are taken from volume No. 1 of the corporation's schedule (year 1919) for invested capital. This valuation report was recommended for acceptance on December 13, 1919, after a period of about 20 working days in which to determine the correctness of the valuations of hundreds of leases to the extent of more than $93,000,000. In the ordinary course of procedure, in the valuation sections, a proper check on a report of this magnitude would have taken from 10 to 12 months, yet in this particular case it was passed in less than 20 days. On February 7, 1921, representations were made to the Income Tax Unit that inasmuch as Mr. Mellon was to be the next Secretary of the Treasury——

Senator KING. What is that date?

Mr. FAY. February 7, 1921. He—Mr. Mellon—desired to have the cases of all outside interests with which he might be connected closed prior to March 4, 1921. The amended returns were filed on February 19 and the taxpayer was advised of his tax liability on February 28, 1921. The case was closed within seven working days when many other cases of this magnitude required from one to two years, and even now some are still pending.

It will thus be seen that this case was rushed through the department with no adequate check, and that the valuation reports were accepted as prepared by the taxpayer.

The valuation data submitted by the taxpayer has been given a thorough examination by the committee's engineers and as brought out in the hearings of February 27, 1925, excessive valuations were set up by the taxpayer and allowed by the department. The bases for these excessive valuations are as follows:

1. Failure on the part of the taxpayer to use hazard factors in estimating the reserves. Such hazard factors to cover items as to the percentage of total oil recovered, the number of dry holes to be encountered, and the decreased production of future wells in drilled areas. The use of proper hazard factors alone would have reduced the valuations approximately $18,000,000.

The CHAIRMAN. At this point let me ask you whether this case has not been reviewed by the bureau since that date?

Mr. FAY. I do not think so. I would rather you would ask the department about that.

Mr. GREGG. Not that I know of, sir.

The CHAIRMAN. It is not too late to reopen it, is it—February, 1921?

Mr. GREGG. I do not know whether this case is a 1312 settlement or not.

Mr. PARKER. The 1312 is signed in this case.

The CHAIRMAN. Yes; I think it appears from the previous evidence that it was closed under that agreement.

Mr. FAY. 2. Utilization of a price of oil in excess of the market price of oil at date of discovery valuations. Out of 70 leases examined it was revealed that 30 were based on a price of oil far in excess of the market price of oil. The taxpayer consistently used peak oil prices for making valuations when the price of oil was high and an expected or anticipated higher price when oil was low, based on a short-period average that had preceded the low period. The use of a price of oil in excess of the market price at date of discovery results in an excess valuation of approximately $7,000,000.

3. In the matter of discount the taxpayer used a so-called composite discount with 5 per cent as the basis. In discounting the anticipated net receipts to present worth the taxpayer consistently set up the first year's returns at face value without any discount whatever. The anticipated returns for future years were discounted on the basis of a 5 per cent discount factor applied to the middle of the year. The composite discount factor derived from the application of the 5 per cent discount often resulted in discounts of anticipated income of less than 1 per cent over the entire life of the property to determine the present worth of expected income. The regulations provide that a valuation for depletion purposes shall be one on which a deal would be made as between a willing seller and a willing buyer. Purchasers of oil properties usually anticipate that the total capital invested shall be returned within three or four years and that the discount rate be commensurate with the risk. Many authorities place this risk rate at from 15 per cent to as much as 40 per cent per year. The taxpayer's risk rate resulting from the application of the 5 per cent discount was from less than 1 per cent to possibly 15 per cent over the entire life of the property. This

low discount factor alone indicates an excess valuation of at least $20,000,000 to $25,000,000.

4. The Income Tax Unit accepted without change the taxpayer's statements as to valuation for depletion purposes.

5. A former employee of the Income Tax Unit was engaged as consulting engineer in this case before he had been out of Government service two years. (Treasury Circular 230.)

Senator KING. Who was the employee?

Mr. FAY. Mr. James L. Darnell.

The CHAIRMAN. I think this case was discussed at one of our earlier hearings, and I am not sure that fraud might not be discovered in connection with the setting up of this case by Ernst & Ernst. I mention that not to charge the Gulf Oil Corporation or any of its personnel with any responsibility, but the way the books were rewritten, as I remember the evidence, indicated to me that there was fraud; and if it was fraud, the case might be reopened and studied. I think it is a questionable case.

Senator KING. Is it closed irrevocably?

Mr. MANSON. It is closed under agreement.

The CHAIRMAN. Unless fraud can be shown it is closed.

Mr. MANSON. Yes; unless fraud can be shown, it is closed.

Senator KING. Who closed it?

Mr. MANSON. When was the agreement signed?

Mr. PARKER. It was closed about August or September——

Mr. FAY. August 11, 1923.

Senator KING. I thought it was closed before Mr. Mellon came into the Treasury.

Mr. PARKER. No, sir; it was closed after he came in under 1312.

Mr. GREGG. The case was settled before he came in. The 1312 agreement was not entered into until 1923, I think.

Senator KING. From the time that Secretary Mellon came in on March 4, 1921, until the 1312 agreement was signed in August of 1923 was there nothing done on the case?

Mr. GREGG. No, sir; the case had been closed.

The CHAIRMAN. Why was there such a lapse of time from March, 1921, until 1923 in the signing of that agreement?

Mr. GREGG. I do not know.

Mr. NASH. I presume, Mr. Chairman, that no application was made for the 1312 agreement in the meantime. We are constantly getting requests for the 1312 agreement in cases that were closed two or three years ago.

The CHAIRMAN. Then the bureau does not make the original suggestion——

Mr. NASH. No, sir; that is optional with the taxpayer. The taxpayer makes the request.

The CHAIRMAN. The bureau never makes the suggestion that it comes under Form 1312?

Mr. NASH. No, sir.

Mr. PARKER. I understand that when the bureau gets an application to have the 1312 executed they make an examination of the taxpayer's case, and it goes through the different department heads for initialling as to whether it is all right to sign that 1312 agreement. Is not that true?

Mr. NASH. No review is made of the details of the case. A check is made in the bureau to see if the case has been properly closed, and if all the taxes disclosed under those returns had been paid.

Senator KING. It is clear that the taxpayer here, if he computed the tax and the valuation of his experts, Ernst & Ernst, was accepted, it would not ask to have the case reopened, but it would be glad to have the case settled at the earliest possible moment and get the statute of limitations behind it.

Mr. NASH. Nevertheless, the taxpayer did not in this case ask for the 1312 agreement until a year and a half after the case had been closed in the bureau, and, as I say, that is true in a great many cases. You will probably find in the bureau to-day that we have requests for half a dozen 1312 agreements on cases that may have been closed within the last three or four years.

The CHAIRMAN. Have you completed your statement, Mr. Fay?

Mr. FAY. Not quite, Mr. Chairman.

As brought out in the hearings on February 27, 1925, the department set up valuations for lessors of Gypsy leases. While on a basis not entirely approved by the engineers of the committee, they have been accepted as within the law and regulations for the purpose of determining the value of the Gulf Oil Corporation's properties. A check of the discovery valuations allowed for the Gypsy and Mexican companies shows that the valuations claimed and allowed were at least for 116 per cent in excess of what they should have been. This figure applied to the total $94,000,000 shows an excess valuation of approximately $50,000,000 was allowed on discovery alone. This $94,000,000 is being written off the company's books through depletion at the rate of $10,000,000 to $12,000,000 per year, and income to that extent will be tax free. Had the case been placed on the same basis as other taxpayer's cases, the depletion would be reduced to approximately $4,600,000 to $5,000,000 per year.

Since the department allowed the Gulf Oil Corporation excessive valuation to the extent of at least 116 per cent, the depletion allowances both for March 1 valuation and discovery valuation are excessive for the years 1917, 1918, and 1919 to the extent of $13,677,454. (Exhibit 1.) The revision of the taxpayer's A-2 letter of February 28, 1921, as per Exhibit 2, shows that the additional tax for 1917 based on the revised depletion is $519,184.32; for 1918 (Exhibit 3), $3,106,073.99; and for 1919 (Exhibit 4), $965,127.30, or a total additional tax of $4,590,385.61.

The taxpayer had paid for the years 1915 to 1919, inclusive, $10,320,444.36. Additional taxes prior to 1915 amounted to $31,277.52, making the net overassessment $3,996,080.18 for which credit and refund claims were allowed, while the principal owner was the Secretary of the Treasury. Settlements were agreed to under section 1312, 1921 act (art. 1141, Reg. 62) on August 11, 1923, by Acting Secretary of the Treasury Gilbert.

It therefore appears that a careful checking of the taxpayer's valuation reports and placing them on the same basis as other taxpayers with reference to hazard factors, price of oil and discount rates, this taxpayer should have paid over his original payments at least $594,305.43 instead of being given a refund of $3,996,080.18 as shown above.

(The exhibits submitted in connection with this case are as follows:)

Gulf Oil Corporation—Depletion

	Claimed	Allowed	Revised amount [1]	Excess
1917, Mar. 1—1913 valuation	$1,895,602	$1,895,602	$877,593.52	$1,018,008.48
Discovery valuation	(2)	(2)		
1918, Mar. 1—1913 valuation	1,599,388	1,599,388	740,457.41	858,930.59
Discovery valuation	10,173,769	10,173,769	4,710,078.00	5,463,690.00
1919, Mar. 1—1913 valuation	1,398,435	1,398,435	647,423.61	751,011.39
Discovery valuation	10,401,256	10,401,256	4,815,412.00	5,585,844.00
Total	25,468,450	25,468,450	11,790,994.54	13,677,451.46

[1] Based on allowances being 116 per cent excessive.
[2] None.

The additional tax for 1917 if above depletion figure had been used	$519,184.32
The additional tax for 1918 if above depletion figure had been used	3,106,073.99
The additional tax for 1919 if above depletion figure had been used	965,127.30
Total additional tax	4,590,385.61

Summary, 1915 to 1919, inclusive

Payments made	$10,320,444.06
Tax determined by bureau	6,293,086.36
Overpayments	4,027,357.70
Less additional taxes prior to 1915	31,277.52
Net overassessments	3,996,080.18
Amount refunded and credit claims allowed	3,839,635.27
Additional amount refundable	156,444.91

Exhibit 2

Gulf Oil Corporation 1917

Net income (A-2 letter of Feb. 28, 1921)	$15,495,782.26
Invested capital (A-2 letter of Feb. 28, 1921)	58,802,000.04

Invested capital not adjusted for excess depletion allowed in prior years. Deduction—9 per cent of invested capital plus $3,000 equal $5,295,180.

Subject to 20 per cent of $3,525,120	$705,024.00
Subject to 25 per cent of $2,940,100	735,025.00
Subject to 35 per cent of $2,940,100	1,029,035.00
Subject to 45 per cent of $1,813,290.74	815,980.83
Excess profits taxes	3,285,064.83
Original excess profit taxes	2,826,961.02
Additional excess profits taxes	458,103.81
2 and 4 per cent on $1,018,008.48	61,080.51
Additional tax for 1917 if $1,018,008.48 depletion were added to income	519,184.32

Note.—Invested capital and excess-profits tax credit as shown in A-2 letter February 28, 1921, are used in the computation of the above taxes.

Normal tax has been computed on the excess amount of depletion, not allocated to each corporation and figured by the method used by the unit.

Exhibit 3

Gulf Oil Corporation, 1918

Consolidated net income (A-2 letter of Feb. 28, 1921)		$8,835,775.16
Plus excess depletion:		
Mar. 1, 1913, valuation	$858,930.59	
Discovery valuation	5,463,690.00	
		6,322,620.59
Adjusted consolidated net income		15,258,395.75
Consolidated invested capital (A-2 letter of Feb. 28, 1921)		71,939,338.30
Plus depletion disallowed as deduction from net income, 1917		1,018,008.48
		72,957,346.78
Less 1917 income tax prorated ($519,184.32× [illegible])		284,484.55
Adjusted consolidated invested capital		72,662,862.23
Excess-profits credit		15,816,028.98
War-profits credit		10,224,885.32
Profits tax		4,026,808.34
Income tax at 10 per cent		1,347,550.49
Total adjusted tax		5,374,358.83
Original tax		3,334,957.40
Additional tax		2,039,401.43
Overassessment (A-2 letter of Feb. 28, 1921)		1,066,672.56
Total amount of additional tax which could be assessed if the correct amount of depletion had been used		3,106,073.99

Note.—No changes are made in the net income and invested capital figures except on account of excess depletion.

Exhibit 4

Gulf Oil Corporation, 1919

Consolidated net income (A-2 letter of Feb. 28, 1921)		$3,218,818.04
Plus excess depletion:		
Mar. 1, 1913, valuation	$751,011.39	
Discovery valuation	5,585,814.00	
		6,336,825.39
Adjusted consolidated net income		9,555,643.43
Consolidated invested capital		88,430,279.88
Plus depletion disallowed:		
1917	$1,018,008.48	
1918	6,322,620.59	
		7,340,629.07
		95,770,908.95
Less:		
1917 income tax prorated ($519,184.32 × $\frac{200}{365}$)	284,484.55	
1918 income tax prorated ($5,374,358.83 × 0.422602)	2,271,214.79	
		2,555,699.34
Adjusted invested capital		93,215,209.61

Excess-profits tax credit		$7,460,216.77
Net income	$9,555,643.43	
Excess-profits tax credit	7,460,216.77	
Taxable at 20 per cent		2,095,426.66
Excess-profits tax	$419,085.33	
Net income		9,555,643.43
Less:		
Excess-profits tax	$419,085.33	
Exemption	2,000.00	
		421,085.33
Taxable at 10 per cent		9,134,558.10
Excess-profits taxes		419,085.33
Amount of tax at 10 per cent		914,455.81
Total tax assessable		1,333,541.14
Tax assessed A-2 letter of Feb. 28, 1921, is figured at 12 per cent instead of 10 per cent		368,413.84
Total additional tax which could be assessed if correct depletion figure were used		965,127.30

Senator KING. The loss to the Government would be a little over $4,000,000?

Mr. FAY. Yes; under my computations.

Senator KING. It seems to me that those allowances—and I am assuming your figures to be correct—are some fifty-odd million dollars for depletion above what should have been allowed, and the other factors which would increase the tax, would make a difference of more than $4,000,000.

Mr. MANSON. That is a continuing allowance.

Mr. FAY. This is continuing.

Senator KING. Oh, I see.

Mr. FAY. This makes an excess depletion of $13,000,000, which is added to the income distributed over those three years in question, and that would be the tax on that income over that period of three years.

Senator KING. Now, they are allowing that depletion basis as a credit for each of the years since?

Mr. FAY. That will continue.

Mr. MANSON. Until that oil is exhausted.

Mr. FAY. Until that oil is exhausted.

Senator KING. So that if your premises are correct the Government each year is being deprived of taxes because of the improper allowance.

Mr. FAY. To a large extent, yes. In other words, the taxes have been materially reduced.

Senator KING. Have you figured the reduction every day on that settlement, until they got that refund down to the present time?

Mr. FAY. No.

Senator KING. How much would that make, approximately?

Mr. FAY. Let us see.

Senator KING. Several million dollars, would it not?

Mr. FAY. Oh, yes. The depletion amounts to about $10,000,000 a year. There are four years in there.

Senator KING. Do you know whether the bureau is allowing that depletion right along on that basis for each of the succeeding years in the settlement?

Mr. FAY. I do not see any way how it can be otherwise than to allow it on the present basis.

Senator ERNST. But you have not answered the question. You do not really know; you have not examined the records, have you?

Mr. FAY. No; I have not.

Senator ERNST. Then why do you not say so?

Mr. FAY. The point I wanted to make is this: A depletion unit, once determined, is continuous until the property is exhausted.

The CHAIRMAN. That probably is a correct assumption, but is it a fact that they do it in all cases? In other words, if they discover that they made a wrong application or a wrong figure, or used the wrong basis, you do not mean to say they would continue that wrong basis in perpetuity? You may think they do it, but you do not know?

Mr. FAY. I do not know for a certainty, but I would say they ought to correct it.

Senator KING. Do you know, Mr. Nash, whether there has been any change in that respect in the unit?

Mr. NASH. I do not know, Senator King, but unless there has been a revaluation in this case I should say that the original valuations would continue.

Senator KING. Will you have somebody in your office look that up for us?

Mr. NASH. Yes, sir; I shall be very glad to.

Mr. GREGG. I think it was stated before the committee in the prior hearings that for years no audit was made of the company's returns since the closing, which was made in February, 1921; so that question has not arisen yet as to what the bureau is going to do on those subsequent returns.

The CHAIRMAN. Do you mean to say that 1920, 1921, 1922, and 1923 have not been closed?

Mr. GREGG. I think that is correct, from the statement I remember that was made before the committee.

The CHAIRMAN. Why should a case drag so long as that?

Mr. GREGG. Senator, there are plenty of 1920 cases that are not yet closed—plenty of them, I am sorry to say. You see, we have been working almost entirely on the 1919 returns to get them out of the way before the statute ran on March 15, and were neglecting, of course, returns for later years.

Mr. MANSON. Mr. Gregg, let me ask you this: Where the value has been fixed and the resulting depletion unit has been fixed, the mere auditing of future returns in which that depletion unit is claimed as a deduction on production would not result in any change in the valuation? In other words, when the discovery value is fixed and the depletion unit is fixed that depletion unit would be applied by the auditors in the future, unless there was a revaluation, would it not?

Mr. GREGG. Unless there was a revaluation.

Mr. MANSON. Yes.

Senator KING. You admit that, assuming these premises to be correct and this unit depletion continued, there would be a great loss for each of those years?

Mr. GREGG. Well, I do not like to admit anything on the assumption that Mr. Fay's figures are correct, Senator.

Senator KING. All right.

Mr. PARKER. I have looked at some of the years, on what they call the Form O data of the taxpayer which has been submitted since 1919, and on inquiry in the unit I find that the unit has not made any valuations. I do know that the taxpayer has continued practically his same methods of presenting his case, but what action the unit is going to take on it I would not be able to tell, because they have not made that valuation.

Mr. GREGG. Let me say this: If an excessive valuation is made for one year, Senator, its effect continues until the capital is wiped out entirely.

Senator KING. I think this case is one which ought to be reexamined.

Mr. GREGG. I would like to ask that the committee withhold judgment on it until we can put in our answer.

Senator KING. Oh, of course.

The CHAIRMAN. Regardless of Mr. Fay's report and regardless of its correctness, it seems to me that when a case of such magnitude is closed in seven days it ought to be reviewed anyway.

Mr. GREGG. Well, I think we are prepared to show that the case was not closed in seven days, but I would like to postpone that until I have some more facts on it.

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

Mr. MANSON. No, sir; that is all.

Senator KING. Have you anything for this afternoon?

Mr. MANSON. I have some conferences with the engineers for this afternoon.

The CHAIRMAN. Have you anything further to put in now, Mr. Gregg?

Mr. GREGG. No, sir.

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

(Whereupon, at 12.25 o'clock p. m., the committee adjourned until to-morrow, Saturday, March 21, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, MARCH 23, 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 the adjournment of Saturday.

Present: Senators Couzens (presiding), Ernst, and King.

Present also: Mr. George G. Box, chief auditor for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. A. W. Gregg, special assistant to the Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. A. H. Marr, attorney, office of Solicitor, Bureau of Internal Revenue.

Mr. GREGG. I would like to refer to the Black & Simons case which was raised here before the committee last week. In looking into it I find that my theory at the time that there was no answer was not quite justified. As you remember the case, it was disclosed that Black & Simons owned an undivided interest in the lease; that the discovery was brought in by them; that the property was valued by the bureau at the same date at different amounts in determining the depletion of the two taxpayers.

What happened in the case was this: The case of Mr. Black, who was given the lower valuation, arose first in the bureau or was settled first. The engineer who had that case took it up with the engineer who had the Simons case, and they checked Mr. Black's claim just enough to see that he was entitled at least to what he claimed, and it was disclosed that he was obviously entitled to what he claimed. The engineer handling that case sent it on, allowing exactly what he claimed. The Simons case was not settled until later. The taxpayer claimed a much higher value. He was finally given by the engineering division a higher value than the value given to Black, whose case, as I said, was settled when it disclosed that he was entitled at least to what he had asked. Simons did not accept the valuation given him by the engineering division and is now going to appeal to the Board of Tax Appeals on the question, so his case is still pending and is not disposed of and will not be disposed of until the Board of Tax Appeals has passed on his claim. After decision by the Board of Tax Appeals in his case, the Black case will then be reopened—that will be after the final decision in the Simons case—and the same valuation will be given to Black that is found to be due Simons by the Board of Tax Appeals.

The CHAIRMAN. Then as the matter stands now the Black case is closed. Is that correct?

Mr. GREGG. Yes, sir. His valuation claim has been allowed.

The CHAIRMAN. And the case has been closed?

Mr. GREGG. I do not think it has been finally closed.

The CHAIRMAN. Has he not paid his tax?

Mr. GREGG. There was no question of additional tax because his claim for valuation was allowed.

The CHAIRMAN. He paid his tax when he made his claim?

Mr. GREGG. Of course he paid his original tax when he made his return, as Simons did and as everyone else does, but the case has not been finally closed and it will be finally settled only when a decision has been rendered by the Board of Tax Appeals in the Simons case passing upon the valuation of this property.

The CHAIRMAN. Is that all that the bureau wants to present in that connection?

Mr. GREGG. Yes, sir; that is all.

(At 11.50 o'clock a. m. the committee adjourned.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, MAY 11, 1925

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

The committee met at 10 o'clock a. m., pursuant to adjournment of Friday, May 8, 1925.

Present: Senators Couzens (presiding), Watson, Ernst, and Jones of New Mexico.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. L. H. Parker, chief engineer for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue, and Mr. A. W. Gregg, solicitor, Bureau of Internal Revenue.

The CHAIRMAN. If you are ready now, Mr. Manson, you may proceed.

Mr. MANSON. I desire to call the committee's attention this morning to the matter of the Standard Oil Co. of California.

This is still an open case, but it presents several rather remarkable situations, and, therefore, in my opinion, merits the committee's attention.

This case really involves an overassessment or refund for the year 1918 of $3,378,000. If the case is settled in accordance with the principles which have been applied by Mr. Greenidge, the head of the engineering division, and by the head of the oil section, the case will result in a refund of that amount of money. It will establish a precedent which will result in the loss of about $25,000,000 in taxes, but really the most important point in connection with this case is whether or not the Commissioner of Internal Revenue really runs the Income Tax Unit, whether or not his orders must be obeyed, and whether or not the opinions of the solicitor of the Bureau of Internal Revenue, as legal advisor of the bureau, are binding upon the bureau on matters of law.

The question involved is this: From the time of its organization up to and including——

Senator ERNST. Are you going into the case of the Standard Oil Co. of California now?

Mr. MANSON. Yes. From the time of its organization up to and including the year 1921, it was the practice of the Standard Oil Co. of California to capitalize the development costs.

Article 223 of Regulations 45 provides:

Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling wells, building of

pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property, it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years.

Prior to the time that any action was taken on this case that regulation had been passed on by several rulings made by the bureau. It had been construed to mean this, that where a taxpayer charged his development cost to expenses upon his books, such action constituted an election upon his part to carry those as expenses, and that such action was binding upon the bureau, whereas on the other hand, where he capitalized these development costs such action constitutes election.

In each of these cases in which rulings are made the question arose the same as it did in this case. The taxpayer, after having elected how he would carry these charges on his books, found that it would affect his taxes by changing the method, and in every case the bureau ruled that having elected he could not change under this regulation, and that the action of the taxpayer in making his charges upon his books is what constituted the election.

In this case, as I have stated, the Standard Oil Co. of California had from the time of its organization followed a uniform practice of capitalizing its development costs. In the determination of its depletion a question was raised as to whether it was entitled to certain items that had nothing to do with the matter at issue here.

It is claimed that an oral agreement was made between the oil engineers of the bureau and the taxpayer. Under this oral agreement the taxpayer agreed to accept the depletion as determined by the bureau and agreed not to press these other claims.

Senator WATSON. When was that oral agreement entered into, Mr. Manson?

Mr. MANSON. That was made in May, 1922.

It was claimed that as a consideration for that agreement the taxpayer was to be permitted to file amended returns, in which he charged to expense the development costs which appeared upon his books and upon his original returns as capital items.

As in other cases where these oral agreements had been set up, there is nothing in the file which shows what this other claim was that the taxpayer might have asserted. There are no data from which it can be determined whether this other claim that was waived was a valid claim or not. There is not even a sufficient description of it any place in the files to ascertain what it was about.

Senator ERNST. Is this an oral agreement or a written agreement?

Mr. MANSON. The oral agreement, I am talking about.

The agreement under which the taxpayer sought to file amended returns was never reduced to writing. There was a conference, and the conference report shows that the depletion was agreed to. The collateral oral agreement that the taxpayer was to be permitted to file amended returns changing the basis for setting up development costs is not referred to at all.

The CHAIRMAN. Where does it first appear in the records about this oral agreement?

Mr. MANSON. There is a letter from Deputy Commissioner Chatterton in September. The conference at which this agreement purports to have been made was in May. In September, there is a letter stating that the taxpayer shall be permitted to file these amended returns.

The CHAIRMAN. By whom is that letter signed, Mr. Manson?

Mr. MANSON. Deputy Commissioner Chatterton.

Mr. NASH. May I ask the date of the letter, please?

Mr. MANSON. September 1, 1922.

Mr. NASH. Mr. Chatterton was not a deputy commissioner in September, 1922.

Mr. MANSON. Well, it is signed by Mr. Chatterton.

The CHAIRMAN. Can you refer to it there?

Mr. NASH. He might have been acting on that date, but Mr. Chatterton was made a deputy commissioner, I think, in January, 1923.

Mr. MANSON. Well, this was the 1st of September, 1922. The amended returns were filed. They were not signed——

The CHAIRMAN. Not signed by the Standard Oil Co. of California?

Mr. MANSON. Not signed by the Standard Oil Co. of California. The depletion was determined by the oil and gas section on the basis of the amended returns. Mr. Greenidge sought an opinion from the rules and regulations committee as to whether these amended returns could be received. The rules and regulations committee determined that they could not be received.

The matter then went to the solicitor for an opinion, and the solicitor, in an opinion, the whole of which I will file, but only a part of which I have here, ruled that the amended returns could not be received.

I quote from the solicitor's opinion:

> It is the opinion of this office that article 223 of regulations 45 merely recognizes the accounting practice in the oil industry—

That is the article that I have just mentioned—

> And is not intended as granting a special privilege to the industry, for which there is no warrant of law. What effect the exercise of the option by the taxpayer may have on the amount of tax he has to pay is immaterial, and the question is to be decided irrespective of whether the election exercised by the taxpayer serves either to lower or increase his tax liability to the Government. Viewed in this light, it is the opinion of this office that the option recognized by article 223 is exercised by the taxpayer, if not concurrently with the transaction, at least not later than the time when his original returns are filed. It follows that the amended returns of the Standard Oil Co. whereby they seek to now change intangible development costs to expense must be rejected.
>
> It is not the function of this office to decide questions of policy and, therefore, in reaching the conclusion herein no consideration has been given to the fact, if it be a fact, as stated by the taxpayer, that it was induced to agree to the bureau's valuation in consideration of being granted the right to file amended returns on the basis herein discussed. It is well to state, however, that there is no provision of law which makes such an agreement binding on the commissioner, and it may well be that a dangerous precedent would be set if an agreement made by subordinates in the bureau is to be considered as binding when that agreement grants to a taxpayer a privilege that has no warrant in the law. In this connection it should be borne in mind that a number of other big oil companies have indicated their intention of filing amended returns so as to charge to expense items heretofore capitalized, though in the cases of the other companies, so far as this office is aware,

there was no agreement entered into granting them the right to file amended returns in consideration of their acceptance of the bureau's valuation of their properties. It would be difficult, however, to deny to them a right to file amended returns in consideration of their acceptance of the bureau's valuation of their properties. It would be difficult, however, to deny to them a right to file amended returns if that privilege is granted to the taxpayer herein, for it can not be presumed that the bureau may even by way of compromise grant to a taxpayer a privilege which has no legal warrant.

If the valuation as set by the bureau were accepted by the Standard Co., with the understanding that amended returns could be filed, it would seem that the company should have a further opportunity of presenting additional evidence as to values if it desires to do so.

The papers are herewith returned with the suggestion that the tax liability of this company be adjusted on the basis herein set forth.

That is signed by Nelson T. Hartson, Solicitor of Internal Revenue.

After that receipt of that opinion, the taxpayer was notified of the import of the opinion——

Senator WATSON. Do you agree with that opinion, Mr. Manson?

Mr. MANSON. I do. The taxpayer was notified of the purport of that opinion, and that the amended returns changing this accounting basis could not be received. A protest was made——

Senator WATSON. What was the date of that opinion that you have just read?

Mr. MANSON. It is dated July 9, 1923.

A protest was made by the taxpayer, and several conferences were had.

The CHAIRMAN. What was the basis of the protest? Was that oral agreement part of the basis of the protest?

Mr. MANSON. The protest was based on the oral agreement.

The CHAIRMAN. And it was so stated in the protest?

Mr. MANSON. It was so stated in the protest.

Several conferences were had, and on September 10, 1923, there appears the following memorandum in the files, signed by Mr. W. N. Thayer, chief of the oil and gas section. This memorandum is addressed to Mr. Greenridge:

The taxpayer filed original returns and Form O schedules in which development costs for all years were capitalized.

This office made some changes and eliminated the capitalized development, and in a letter of September 1, 1922, wrote the taxpayer, as follows:

"The understanding of this office by verbal statement from your Mr. Tuttle is that amended returns for 1918 and subsequent years are to be filed, in which returns the intangible cost of development is to be charged off as an expense.

"In accordance with this understanding depletion schedules for the years 1913 to 1920, inclusive, as compiled by this office, do not include in the capital sum returnable through depletion any additions to capital on account of development costs after the year 1917."

As a result, the taxpayer filed unsigned amended returns on May 7, 1923, in which development costs formerly capitalized were charged to expense. The matter was referred to the solicitor and as a result of his ruling of July 9, 1923, this office wrote the taxpayer on July 25, 1923, declining to accept the amended returns, and insisting that the development costs after 1917 should be capitalized.

Regardless of the solicitor's opinion as to the legality of the action taken by this office in the letter of September 1, 1922, it appears to be a matter of good principle to adhere to an agreement that was made in good faith by both parties. The Government would not permit the taxpayer to break such an agreement, and by the same token the Government should not seek to break the agreement.

The practical result of permitting the taxpayer to charge to expense items previously capitalized will mean in 1918 a deduction from gross income of approximately $3,000,000.

That is signed by W. N. Thayer, chief of section.

At this point——

Senator WATSON. Was an appeal ever taken?

Senator ERNST. It has not yet been determined.

Senator WATSON. I know; but has an appeal been taken?

Mr. MANSON. In order that you may have the high spots before you I will briefly state them before I go into any further detail.

After the solicitor ruled that these amended returns could not be received, for the reason that the taxpayer had elected to carry his development costs as capitalized items, there are memoranda by the oil and gas section and by Mr. Greenidge urging upon the deputy commissioner, Mr. Bright, the advisability of adhering to the action in accepting the returns and in ignoring the solicitor's ruling. Finally Mr. Bright issued an order that the case be audited on the amended returns, in violation of the solicitor's ruling. The case is so audited, resulting in a refund or credit of subsequent taxes of $3,378,000.

Senator ERNST. Who passed on that?

Mr. MANSON. Mr. Bright.

Senator WATSON. Simply because the development costs were not capitalized?

Mr. MANSON. If they are capitalized, they get back a portion of them each year.

Senator WATSON. Yes.

Mr. MANSON. Through depletion.

Senator WATSON. Certainly.

Mr. MANSON. If they are charged to expense, they get back the whole of it during the year in which they occur.

Senator WATSON. Certainly.

Mr. MANSON. That made a difference of $3,378,000 in taxes in this case.

Senator WATSON. In other words, Mr. Bright did not agree in the conclusions reached by the solicitor?

Mr. MANSON. By the solicitor. All certificates of overassessment are required to go to the solicitor; so that after this case had been audited on the amended returns the certificate of overassessment went to the solicitor, who refused to approve the certificate, on the grounds stated in his former opinion. Mr. Bright then called upon Mr. Greenidge to prepare a memorandum showing why the commissioner should overrule the solicitor. This was done, and the commissioner, after a thorough consideration of the matter——

Senator WATSON. That is, Commissioner Blair?

Mr. MANSON. Commissioner Blair, after having Mr. Greenidge's memorandum, declined to overrule the solicitor. The commissioner set aside, by an order as positive and direct and clear as the English language could make it, this whole transaction, this whole oral agreement. He pointed out that no oral agreements and, in fact, no written agreements with a taxpayer not approved by him would be considered as binding upon the Government.

Senator WATSON. And he upheld his solicitor?

Mr. MANSON. He upheld the solicitor. That set the case back to be reconsidered on the basis of the original returns. The depletion having been determined upon the basis of the amended returns, it was necessary to redetermine depletion.

The case hung on in the engineering division for a while. Mr. Greenidge refused to accept either the solicitor's opinion or the commissioner's order as decisive in the matter. Finally Mr. Bright issued an order, a copy of which he sent to the consolidated audit section, for a further audit of the case upon the basis of the original returns. The case was taken up in the consolidated audit section. It was found that an engineer's report determining depletion upon the basis of capitalizing these development costs was necessary and the case went back to the engineering section, where it is resting.

We called upon the engineering division for a report as to what they intended to do in the case, and they informed us that they intend to stand pat and to stand on this oral agreement, which had been set aside by the commissioner, and that they do not regard the solicitor's opinion as binding upon them.

Senator WATSON. Or the order of the commissioner?

Mr. MANSON. Well, they do not say that. They do not say that they do not regard the order of the commissioner as binding upon them; but the fact that they do not intend to so amend their report as to permit the auditing of the case in accordance with the commissioner's order is a tacit refusal to abide by the order of the commissioner.

That, in brief outline, constitutes the material facts here.

Senator WATSON. Has that case been closed?

Mr. MANSON. It has not; but, as I say, one of the principal things that your counsel has seen fit to criticise in connection with the engineering division has been the tendency to make an oral agreement waiving a mythical claim and allowing a claim which was concededly illegal.

Senator ERNST. Has that been a common practice?

Mr. MANSON. I think it has been a common practice; yes. I have called attention to it here in many instances. The real issue that seems to be raised in this case is as to whether or not they intend to pursue that practice here, notwithstanding the fact that the commissioner himself has set this whole procedure aside.

I would call especial attention to the commissioner's order——

The CHAIRMAN. Just at that point, Mr. Manson, I would like to know if there is any way that these engineers' views could be carried out. As I understand it, no matter if the engineers did insist upon their interpretation and upon recognizing the oral agreement, there is no way of getting it by either the commissioner or the solicitor; is there?

Mr. MANSON. Another reason why I presented this case is brought out by the chairman's question. There is no branch of the work which is so far behind as the oil and gas section, and I claim that this case is a clear illustration of why there are no terminal facilities in the oil and gas section. In other words, if the head of the engineering division and the chief of the oil and gas section want to get a taxpayer to get something, there appears to be no way to wind up

that case and get it to a conclusion until the taxpayer gets what he wants, regardless of whether the solicitor thinks he is entitled to it or whether the commissioner thinks he should get it.

Senator ERNST. Is there not some way of discharging those men and putting somebody in their places who will do what they are told?

Mr. MANSON. I believe an examination of the record in this case will show that is the thing that should be done, and you are never going to get action through the engineering division until the present head of the engineering division is removed.

Senator JONES of New Mexico. Who is the head of the engineering division?

Mr. MANSON. Mr. S. M. Greenidge.

I call attention to the clear and specific language of the commissioner's order in this matter, dated February 20, 1924:

Memorandum for Mr. Bright:

My attention has been called to your letter of September 29, 1923, in regard to the Standard Oil Co. of California, wherein you advise the company that its amended returns for 1918 and subsequent years in which intangible development items previously capitalized or charged off to expenses will be accepted, and notifying them that their case will be audited on that basis.

I think your letter is in error. It appears that you based your letter on some verbal understanding had between the conferees of the natural resources division and the representatives of the company. Any verbal understanding of an important matter like this is most unfortunate, and I do not feel that the bureau can be bound by it. In the first place, a matter of so much importance should be reduced to writing; in the second place, while great weight is given to agreements on the part of conferees, their agreements are not binding and no agreement can be binding unless it is approved by the commissioner.

This matter was called to my attention some months ago and the facts as presented indicated that perhaps the understanding between the taxpayer and the conferees should be carried out, but a thorough investigation of the file convinces me that this would establish a dangerous precedent and should not be done. You will therefore please notify the taxpayer.

That appears to me to be as clear and conclusive a thing as language can make it.

Now I wish to call attention——

The CHAIRMAN. Before you go into that, Mr. Manson, I raised the question a while ago as to whether or not, in this particular case, after the engineers insisted upon their oral agreement, it could not have gotten by the solicitor or the commissioner and, by the same token, had the question not been raised and the matter never been presented to the commissioner or the solicitor, it could have gotten by.

Mr. MANSON. Oh, yes; the matter never would have reached the solicitor had it not been for the rules and regulations section. They advised that this could not be done, and took the matter to the solicitor.

The CHAIRMAN. But had the question never been raised with the rules and regulations section, no one would have known about it.

Mr. MANSON. No one would ever have known about it. Of course, all refunds must go to the solicitor; that is, if they involve over $50,000. The matter might have been caught, and I have no doubt would have been caught by the solicitor.

Senator WATSON. Is there any doubt that final authority in all of those matters is lodged with the Commissioner of Internal Revenue?

Mr. MANSON. Certainly; the Commissioner of Internal Revenue is presumed to be, under the law, the last word. In fact, all of the authority under the act is vested in the commissioner. I think it is only in the case of compromises and in the making of rules and regulations that even the Secretary of the Treasury has any say as to the discretion that is vested in the commissioner under this act. In other words, outside of the case of compromises and the making of regulations, the commissioner is absolutely supreme.

Senator WATSON. You agree to that, do you, Mr. Gregg?

Mr. GREGG. Yes, sir. It is his conclusion on a claim; he is the one who acts.

Senator WATSON. Yes.

Mr. MANSON. I have called attention to the fact, in the first place, that the language of this regulation, which is as clear as the English language can express anything, had been construed before this case ever arose, and I call attention to the fact that there are two solicitor's opinions in this case and this order of the commissioner, and notwithstanding all of that, we have here a memorandum of November 26, 1924, from Mr. S. M. Greenidge, head of the engineering division, to Mr. J. G. Bright, deputy commissioner, which reads:

In re: Standard Oil Co. (Cal.), San Francisco, Calif.

With reference to the still undecided question of whether or not this company should be permitted to file amended returns in which development costs previously capitalized are charged to expenses, your attention is invited to the attached copy of a recent recommendation from the solicitor's office, particularly to issue No. 4.

In the case of the Standard Oil Co., a certain part of its income is impounded each year from 1914 to 1920. It appears, therefore, under the solicitor's recommendation referred to, that this company might file amended returns reporting these impounded funds as income for the year in which they accrued. The adjustment necessary to file these amended returns would be relatively small, as the amount of funds impounded is not large, but once the right to file amended returns on any basis is conceded, a precedent would be established for accepting amended returns for 1918 and subsequent years in which adjustment would be made not only for impounded funds but also for the change from capitalized development costs to expended development cost.

It is suggested that this matter might be discussed informally with the solicitor.

Senator WATSON. You say there were two solicitors who passed on this matter. Who was the other one?

Mr. MANSON. No; the same solicitor passed on the matter twice.

Senator WATSON. Oh, one solicitor passed on it twice?

Mr. MANSON. Yes. I wish to call particular attention to this memorandum which I have just read, for the reason that it shows a devious course of reasoning that no intellectually honest man can concur in. That idea is that while you can not amend your returns for the purpose of changing capitalized development, to charge that development to expense, yet, if you can file an amended return for the purpose of reporting a small amount of impounded income, as income, that would open the door then to making this change in the method of handling the development costs of these tremendous sums.

I now call attention to the fact that that idea is expressly put on paper by the head of the engineering division, and directed to the Deputy Commissioner of Internal Revenue as the reason why these two rulings of the solicitor and the positive order of the commissioner should be ignored.

The CHAIRMAN. When I was down in the bureau the other day, and I spent nearly a day down there in the different sections, someone made the statement to me that there was one organization who handled most of these oil cases. What organization was that, or is that a correct statement? Do you remember, Mr. Parker?

Mr. PARKER. I think you refer to the Petroleum Institute, which institute seems to have retained the firm of Mattison & Davey for doing most of their work. They have a great many cases in the department.

Mr. MANSON. They are the attorneys in this case.

The CHAIRMAN. Do you understand that the Petroleum Institute watches and guards and works in the interest of the oil companies? Is that correct?

Mr. PARKER. That is the way I understand it; yes, sir.

Mr. MANSON. As I stated at the beginning, the oil section, and the head of the engineering division, notwithstanding all that has been done in this case by their superiors, are still standing pat that the Standard Oil Co. of California shall get this $3,378,000, and that affords a good illustration of the reason why business does not move through the oil section, and why it is not cleaned up.

The CHAIRMAN. Would that, in part, account for the delay in the Sinclair Oil Co. case, which I took up with the committee the other day in your absence?

Mr. MANSON. Well, the Sinclair Oil Co. and many other oil companies represent another situation. The bureau has adopted certain regulations and what is known as Form O, which form calls for information necessary for the purpose of making an appraisal. It seems that the bureau sends out these forms and requests this information, and fixes 30 days' and then 60 days' time in which the taxpayer is to present this information.

In the Sinclair case the matter has dragged along indefinitely; in many other cases it has dragged along indefinitely, and there appears to be no disposition on the part of the oil and gas section to take any summary action in the case of a taxpayer who refuses to furnish information which the bureau requires in order to check the valuations upon which he claims depletion. In some instances it has just dragged along for years.

I will submit the following data in connection with this case:

STANDARD OIL CO. OF CALIFORNIA

This is one of the large oil companies whose income-tax liabilities have not yet been adjusted or settled for any year, although the case has been before the department for eight years. The original valuation data was filed in 1919. There have been a number of conferences in connection with the valuation and audit of this case. The last valuation as agreed upon by the department and the taxpayer was May 10, 1923.

The principal point at issue in this case is a disagreement between departmental officials as to the taxpayer's right to file the amended returns for 1918 and succeeding years, the basis for which is a change in accounting methods whereby development expenses shall be charged to expense instead of being capitalized as in former years. There seems to have been an oral understanding between members of the oil and gas section and the taxpayer that the company could file amended returns, and the taxpayer accordingly filed amended returns and the case was audited on this basis, showing an overassessment in excess of $3,000,000 for the year 1918. A complete history of this case from 1922 to 1924 is given in the following memorandum to the deputy commissioner by Mr. Greenidge, under date of February 14, 1924.

A conference (Exhibit 1) was held in the office of the oil and gas section May 7, 1923, and an agreement was reached as to depletion claimed, allowed, etc., May 10, 1923. (Exhibit 2.)

On June 9, 1923, the question of whether or not the company could file amended returns was referred to the rules and regulations section (Exhibit 3), and this section denied the right to file amended returns (Exhibit 4).

The question was then referred to the solicitor, and under date of July 9, 1923, Solicitor Hartson denied the taxpayer the right to file amended returns. (Exhibit 5.)

On July 10, 1923, the deputy commissioner (Exhibit 6) requested the head of the natural resources division to notify the taxpayer of the solicitor's ruling, which was done on July 25, 1923 (Exhibit 7). The effect of this letter was that the taxpayer took the question up with M. W. Mattison of the tax division of the American Petroleum Institute, and on July 27, 1923, Mr. Mattison addressed a letter to the commissioner asking for an extension of time (Exhibit 8), so that he could have a conference with the taxpayer at the San Francisco office.

On July 28, 1923 (Exhibit 9), the taxpayer was notified that no further action would be taken until September 1, which was in accordance with Mr. Mattison's request.

Mr. Mattison filed his power of attorney in this case dated August 21, 1923 (Exhibit 10).

On September 10, Mr. Thayer, chief of the oil and gas section, addressed a memorandum (Exhibit 11) to Mr. Greenidge, head of division, suggesting that—

"Regardless of the solicitor's opinion as to the legality of the action taken by this office in the letter of September 1, 1922, it appears to be a matter of good principle to adhere to an agreement as made in good faith to both parties. * * * The practical result of permitting the taxpayer to charge to expense items previously capitalized will mean, in 1918, a deduction in gross income of approximately $3,000,000."

On September 11 Mr. Greenidge addressed a memorandum to Mr. Bright, deputy commissioner (Exhibit 12), discussing the solicitor's memorandum of July 9.

On September 20, 1923, the deputy commissioner addressed a letter to the taxpayer stating that the amended returns for 1918 and subsequent years (Exhibit 13) would be accepted and that the audit would be made on the basis of these amended returns. The amended returns, however, were unsigned, as per memorandum by Mr. Thayer, under date of September 10, 1923. The deputy commissioner's decision was in effect an overruling of the solicitor.

On September 29, 1923, Mr. Greenidge was instructed by Deputy Commissioner Bright (Exhibit 14) as follows:

"You are therefore instructed to close his case on the basis of accepting the amended returns for 1918 and subsequent years and the conference agreement of June 23, 1922."

The amended returns were audited and resulted in a certificate of overassessment for the year 1918 of $3,378,921.35. In the regular course of procedure, this overassessment would necessarily require the approval of the solicitor.

The solicitor, Nelson T. Hartson, in a memorandum to the deputy commissioner, under date of January 29, 1924 (Exhibit 15), in regard to the overassessment certificate, states that—

"This office, in a memorandum to you, under date of July 9, 1923, held that as a matter of law this could not be done and for that reason the certificate is returned to you without approval.

"It is understood, however, that the proposed adjustment has been discussed with the commissioner and you should dispose of the case as directed by him. File is herewith returned."

On February 8, 1924, Mr. J. G. Bright, deputy commissioner, asked Mr. Greenidge (Exhibit 16) for a complete résumé in the Standard Oil case that he may present the case more fully to the commissioner. This résumé is included in the early pages of this report.

On February 20, 1924, the commissioner addressed a letter to the deputy commissioner (Exhibit 17), stating that he did not think that these agreements and conferences were binding unless approved by the commissioner and instructed the deputy commissioner to so advise the taxpayer.

On March 1, 1924, deputy commissioner advised Mr. Mattison of the American Petroleum Institute (Exhibit 18), of a conference to be held Tuesday, March 4, in the office of the Commissioner of Internal Revenue. There is no memorandum of this conference in the files and under date of April 18, 1925, the deputy commissioner stated that, "No memorandum was made of the conference held in the commissioner's office, March 4, 1924." This was in response to the committee's request for a copy of the memorandum.

On April 4, 1924, the deputy commissioner addressed a memorandum (Exhibit 19) to the commissioner in which he refers to the conference with Mr. Mattison as follows:

"At which time you informed me no further action should be taken in connection with this case for at least 30 days."

The deputy commissioner asked for further instructions.

The records of the case do not show any further action until November 26, 1924 (Exhibit 20), when Mr. Greenidge addressed a memorandum (prepared by W. N. T.) to the deputy commissioner in which he suggests the possibility of allowing the taxpayer to file amended returns based upon a memoranda, No. 488, of the solicitor's office, regarding the appeal of the West End Consolidated Mining Co. to file amended returns, "Reporting these impounded funds as income for the year in which they accrued." This memorandum would indicate that there is a disposition on the part of the oil and gas section and the head of the engineering division to allow the taxpayer to file amended returns on this basis regardless of the solicitor's ruling and "it is suggested that this matter might be discussed informally with the solicitor."

If amended returns are filed as per Solicitor's Memoranda No. 488, the taxpayer would then win his point and rewrite his books by changing his method of accounting and charge all development to expense as incurred in place of capitalizing these expenses which he chose to do in the low tax years.

Regarding this memorandum there is apparently no other correspondence in the case but on January 19, 1925, the deputy commissioner instructed Mr. Greenidge to assess (Exhibit 21) the tax in case waivers are not procured.

On April 18, 1925, the case still remained unclosed (Exhibit 22), pending another report from the valuation engineers.

April 30, 1925, oil and gas section still standing on verbal agreement and insisting on closing case on amended returns.

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

Senator ERNST. Pardon me just a moment. What is the date of that last communication from the solicitor?

The CHAIRMAN. The last communication was not from the solicitor.

Senator ERNST. It was from the commissioner?

The CHAIRMAN. No; from Mr. Greenidge.

Senator ERNST. It was dated November 26, 1924, but I want to know the date of the communication from the commissioner which ought to have determined it.

Mr. NASH. February 24, apparently, was the date of the commissioner's order.

Senator WATSON. Are you gentlemen prepared to discuss this particular case?

Mr. NASH. This is the first time that I ever heard the details of it, Senator.

Senator ERNST. That was dated in February, was it?

Mr. NASH. That is my note on it, Senator.

Senator WATSON. Are there any other cases where either of these sections overruled the express orders of the commissioner or disregarded the opinion of the solicitor where backed by the commissioner?

Mr. MANSON. This is the first one which has been called to my attention in which a positive order of the commissioner has been ignored.

Mr. NASH. There are many cases in regard to which the income tax unit and the solicitor disagree. In those cases, a conference is usually held in the commissioner's office, and he decides one way or the other.

Senator WATSON. Oh, surely. I am well aware of that but, as far as I can gather the facts here, and unless there is some dispute as to the facts, an express ruling of the commissioner was ignored by the oil and gas section. Of course, there may be other facts that will throw a sidelight on the main proposition.

Senator JONES of New Mexico. May I ask right here whether interest is accruing on this amount of money that appears to be due, and which has not been paid?

Mr. MANSON. No, Senator.

Senator WATSON. Because there has been no final assessment.

Mr. MANSON. This is a case where the money has been paid by the taxpayer and it is a question whether a refund should be made, or whether a credit should be given on subsequent years' taxes, I do not know which. In this case there is a certificate of overassessment, which would operate either as a refund or a credit on subsequent years' taxes.

Senator WATSON. As I understand it, interest never runs until after the final assessment is made.

Mr. GREGG. Yes; of course, in this case the question never arose because there was no additional assessment.

Senator WATSON. Yes.

Mr. NASH. If it is determined that a refund is due, then interest will run from the date of payment until the date that the refund is approved.

The CHAIRMAN. Are subsequent years being held up pending a decision of this case?

Mr. MANSON. I understand that there is a deficiency in 1920 of about $87,000.

The CHAIRMAN. I was trying to draw out if there are subsequent years unsettled in which taxes are due but are not being paid awaiting for a determination of this case, which results the same, Senator Watson, as though there was interest running.

Senator WATSON. Yes; that is right.

Mr. MANSON. In making inquiry from the oil and gas section, I assumed that this was a refund case, which it would be if subsequent years' taxes had been paid. I was told that it was not a refund case but a credit case. If that is true, then the subsequent years' taxes are being held up pending a determination of this case.

Senator JONES of Mexico. Would it not necessarily follow that this question as to whether those developments should be charged to capital development or to expense development would affect subsequent years?

Mr. MANSON. Yes; and not only that, but Mr. Greenidge has included, in a memorandum which I will put in the record here, a statement of the amount of taxes affected by considering this case as a precedent amounts to $25,000,000.

The CHAIRMAN. I still want to bring out this point, and I would like to have the bureau answer this at a subsequent hearing: Whether or not the subsequent years have been settled, and what effect the delay in settling this particular case has had upon the settlement of subsequent years.

Mr. GREGG. I think it is impossible for subsequent years to have been settled. I am perfectly certain that they were not. I do not see how it would be possible without having this question determined.

Senator JONES of New Mexico. If they were settled, they were settled on one basis or the other involved in this case.

Mr. GREGG. Well, they could not possibly have been settled.

The CHAIRMAN. I would like to have a statement from the bureau as to whether the subsequent years have been settled, the amounts involved, and the effect that this question has upon the settlement of subsequent years, because it is evident from the record that there have been great delays. There was even a delay of from February 24 to November 24, in spite of a direct order of the commissioner to proceed under a certain theory.

Senator JONES of New Mexico. And it would be enlightening also if we could have some more detailed statement regarding the point that Mr. Manson just made, that in other cases there is probably $25,000,000 involved in this question.

Mr. MANSON. Yes. That arises in this way, that if this rule is applied in this case, that if a taxpayer, after having capitalized development costs, is to be permitted to deduct them from capital and charge them to the expense of a high-tax year like 1918, and if that rule becomes a precedent so that other taxpayers can take advantage of it, it will result in refunds or credits to other taxpayers, and the total of that amount is estimated by Mr. Greenidge as being $25,000,000.

The CHAIRMAN. Reference was made—I think while Mr. Gregg was out of the room—to the fact that if the engineering division decides these cases in accordance with oral agreements, no such case as has been discussed, like the Standard Oil case, could get by the Solicitor of Internal Revenue if the amount exceeded $50,000. I would like to ask if the bureau can let us know if the J. I. Case case did not get through the bureau in spite of rulings of the bureau?

Mr. GREGG. We are having the J. I. Case case matter looked into. There is a direct order that cases involving $50,000 or more must come to the solicitor for approval before going out.

Mr. MANSON. That is where refunds are involved.

Mr. GREGG. Where certificates of overassessment or refunds are involved.

Mr. MANSON. But in cases of claims for abatement?

Mr. GREGG. Yes; claims in abatement.

Mr. MANSON. Are claims in abatement also covered?

Mr. GREGG. Yes.

The CHAIRMAN. Is there any method by which a case might be settled by giving credit on subsequent years that would not have to go to the solicitor's office?

Mr. GREGG. That involves the same thing, Senator.

The CHAIRMAN. That involves the same thing?

Mr. GREGG. Yes, sir.

The CHAIRMAN. Mr. Manson, do you know what steps, if any, have been taken by the engineering department to carry out the directions of the commissioner?

Mr. MANSON. They not only have taken no steps, but they have notified me that they do not intend to.

The CHAIRMAN. Have you got the Gulf Oil case ready, Mr. Gregg?

Mr. GREGG. No, sir. I thought that Mr. Manson was going to take up the entire morning. I can have that ready to-morrow morning.

The CHAIRMAN. Will it take long to present it?

Mr. GREGG. Thirty or forty minutes.

The CHAIRMAN. Then we will adjourn here until to-morrow morning at 10 o'clock.

(Exhibits A to C, inclusive, and 1 to 26, inclusive, in the Standard Oil Co. of California case, are as follows:)

EXHIBIT A

REGULATIONS 45, ARTICLE 223, PAGES 92-93

ART. 233. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years.

EXHIBIT B

CUMULATIVE BULLETIN NO. 4, JANUARY-JUNE, 1921, PAGE 190

6-21-1434
O. D. 796

Section 214 (a) 10, article 223: Charges to capital and to expense in the case of oil and gas wells

A corporation, beginning with the year 1918, deducted such incidental expenses as wages, fuel, repairs, hauling, etc., in connection with the exploration of property, drilling of wells, etc., as operating expenses. From June 1, 1916, to December 31, 1917, inclusive, such expenditures were charged to the capital account. The question is presented as to whether such expenditures for the period stated may now be charged as operating expenses.

Held, that since the corporation in 1916 and 1917 exercised its option of charging such expenditures to capital account, it may not now amend its returns covering such period by transferring such items to operating expenses.

10-21-1498
A. R. M. 110

Section 214 (a) 10, article 223: Charges to capital and to expense in the case of oil and gas wells

"Held, that under article 223, regulations 45, the exercise by a taxpayer of his option to charge cost of drilling wells to operation precludes a revision of the accounts to treat such items as capital expenditures."

The committee has had under consideration a request from the Income Tax Unit for an opinion as to whether the labor cost of drilling gas wells charged to expenses prior to January 1, 1920, by the M Company, may now be charged to capital in accordance with the requirements of the Public Service Commission of Pennsylvania, effective January 1, 1920.

Under article 841, regulations 45, additions to surplus may be made where additions to plant and equipment or other capital charges have, in error, been charged off in prior years as an expense. Amended returns are required.

The action of the Public Service Commission of Pennsylvania in prescribing accounting regulations as of January 1, 1920, does not affect the option exercised by taxpayer in prior years. These regulations outlined a definite accounting policy thereafter to be adopted and which, accordingly, will thereafter be recognized by the Internal Revenue Bureau. These regulations are not conclusive that the practice of the company theretofore was in error.

Article 223 of regulations 45 provides that—

"Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as an operating expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years."

This regulation disposes of the question for years prior to January 1, 1920, because it recognizes the two methods of accounting and determines that the option exercised must control the taxpayer's returns for all subsequent years.

The committee, accordingly, is of the opinion that where the labor cost for drilling wells has been charged to operating expenses under the taxpayer's option, article 223 of regulations 45 precludes a revision of the accounts to treat such items as capital expenditures.

EXHIBIT C

CUMULATIVE BULLETIN NO. II–1, JANUARY-JUNE, 1923, PAGES 117–118

II–11–943
I. T. 1698

Article 223: Charges to capital and to expense in the case of oil and gas wells

REVENUE ACTS OF 1918 AND 1921

"A taxpayer is held to have exercised an option of deducting incidental drilling expenses as a development expense when in its books of account they were treated as current expenses even though in its first return such expenses were capitalized.

"In the case of the first nonproductive well drilled, an option may be exercised of either capitalizing the cost or deducting it as an expense, even though the treatment of such cost should differ from the treatment of similar expense in the case of productive wells."

The taxpayer, a corporation, in its books of account, treated as current expenses incidental drilling expenses, but in its return for 1920, its first year of operation, incidental drilling expenses were treated as capital expenditures. Subsequently, an amended return was filed for the year 1920 in which drilling expenses, in accordance with the corporation's books of account, were treated as current expenses. In the taxpayer's 1921 return, drilling expenses were similarly treated. Inquiry is made whether for the years mentioned amended returns may be filed in which drilling expenses are capitalized.

Held, inasmuch as in its books of account the taxpayer elected to treat drilling expenses as current expenses, it is deemed to have exercised the

option provided in article 223 of regulations 45, and will be bound by the option so exercised. Amended returns may, therefore, not be filed for the purpose of treating drilling expenses as capital expenditures.

Also held, that under the provisions of article 223 of regulations 62, as regards the first nonproductive well drilled by the taxpayer, the option may be exercised of either capitalizing or treating as current expenses the incidental drilling expenses connected with such well, even though the treatment of such expenses may differ from the treatment of similar expenses with respect to productive wells. The treatment of drilling costs incident to nonproductive wells must, however, be uniform as regards all such wells, and an option once exercised will be binding with respect to subsequent returns.

Exhibit 1

TAXPAYER'S CONFERENCE

NATURAL RESOURCES SUBDIVISION,
OIL AND GAS SECTION,
May 7, 1924.

Taxpayer: Standard Oil Co. (Calif.).
Address: 225 Bush Street, San Francisco, Calif.
Represented by: J. H. Tuttle, secretary; C. G. Gester, chief geologist; H. B. Webster, engineer.

Matter presented: Form O data to establish basis of depletion for properties acquired for cost and others upon which discovery values are claimed in years 1921 and 1922.

Issues discussed: Elements entering into engineering appraisals, reserves, and discovery values.

Conclusions: The estimates of reserves, values, and depletion units as claimed, allowed and agreed upon are listed on the attached Tables 1-3. Accepted for taxpayer.

J. H. TUTTLE.
C. G. GESTER.
H. B. WEBSTER.

Interviewed by L. H. Evans, H. G. Pelton, F. K. Baxter.

S. M. GREENIDGE,
Acting Chief of Section.

Exhibit 2

OIL AND GAS VALUATION SECTION

Standard Oil Co. of California, Standard Oil Building, San Francisco, Calif.

Taxable year 1914:	
Depletion claimed	$2,666,566.99
Depletion allowed (original memorandum)	712,002.92
Less depletion (impounded)	1,499.79
Total depletion allowed	710,503.13
Gross income from oil sales	43,141,387.57
Taxable year 1915:	
Depletion claimed	770,112.83
Depletion allowed (original memorandum)	892,314.65
Less depletion (impounded)	6,159.38
Total depletion allowed	886,155.27
Gross income from oil sales	38,155,920.70
Taxable year 1916:	
Depletion claimed	550,027.39
Depletion allowed (original memorandum)	3,610,474.03
Less depletion (TD-3386 and LO-1110)	94,377.22
Total depletion allowed	3,704,851.25
Gross income from oil sales	28,969,311.51

Taxable year 1917:
- Depletion claimed $5,758,133.74
- Depletion allowed (original memorandum) 4,721,640.73
- Less depletion (TD-3386 and LO-1110) 85,312.96
- Total depletion allowed 4,806,953.69
- Gross income from oil sales 81,881,008.03

Taxable year 1918:
- Depletion claimed 12,283,562.80
- Depletion allowed (original memorandum) 9,643,585.71
- Plus depletion (TD-3386 and LO-1110) 16,251.65
- Total depletion allowed 9,659,837.36
- Gross income from oil sales 109,333,049.53

Taxable year 1919:
- Depletion claimed 13,027,310.44
- Depletion allowed (original memorandum) 11,543,000.32
- Less depletion (TD 3386, LO 1110 and impounded) 10,801.73
- Total depletion allowed 11,532,198.59
- Gross income from oil sales 126,046,211.33

Taxable year 1920:
- Depletion claimed 18,748,397.61
- Depletion allowed (original memorandum) 15,766,272.81
- Less depletion (TD-3386, LO-1110 and impounded) 30,205.35
- Total depletion allowed 15,736,067.46
- Gross income from oil sales 163,469,733.89

Résumé of depletion changes

Year	To be subtracted	To be added	Impounded
1914	$1,199.79		$1,199.79
1915	6,159.38		6,179.38
1916		$94,377.22	50,262.00
1917		85,312.96	55,770.17
1918		16,251.65	99,117.80
1919	10,801.73		109,916.04
1920	30,205.35		117,071.29
Total			439,802.47

Discussion: Supplemental to memorandum IT:NR:OG,LHE, of November 21, 1922, and in conformity with TD-3386 and LO-1110 and to adjust for impounded funds, the allowable depletion has been revised for the taxpayer.

The attached schedule details adjustments of allowable depletion upon each lease for the taxable years 1914 to 1920, inclusive.

Additional discovery has been claimed and allowed for dry and wet gas in the Huntington Beach field in the year 1920; additional depletion has been allowed as indicated on the attached schedule.

It is recommended that these adjustments be made.

Recommended by—

F. K. Baxter,
Engineer.

Approved by—

S. M. Greenidge,
Acting Chief of Section.

May 10, 1923.

Exhibit 3

Memorandum

June 9, 1923.

Chief, Rules and Regulations Section.
In re: Standard Oil Co. (California).

Attached is the file in the above case, which is transferred to you for consideration of matters relative to the income and invested capital for the years 1918, 1919, 1920, and 1921.

Opinion is desired as to whether the unit may accept amended income and profits tax returns for the years 1918, 1919, 1920, and 1921, which the Standard Oil Co. (California) seeks to file, in which returns intangible development costs formerly capitalized have been charged to expense.

* * * * * * *

Upon determination of the issues involved please return this file, together with a copy of your findings to Section G, Natural Resources Division, Income Tax Unit.

S. M. Greenidge,
Head of Division.

Exhibit 4

In re: Standard Oil Co., San Francisco, Calif.

With reference to attached memorandum to the rules and regulations section, it is the opinion of the review section that the point in question on which an opinion has been requested is one that a number of decisions have supported article 223, of regulations 45, and the past practice of the unit is holding that in charging development costs to expense on books and claiming same on income-tax returns as a reduction a taxpayer exercises the option granted herein, and "An election once made under this option will control the taxpayer's returns for all subsequent years."

Several decisions pertaining to this point are listed below for reference (A. R. M. 110—O. D. 1002—O. D. 796):

This particular point has also been covered by the rules and regulations section—W. B. H., in letter to Southern Pacific Co., dated November 17, 1920, signed by W. H. Williams, commissioner, copy hereto attached.

Therefore the review section considers the request of this company to amend its returns for the years 1918, 1919, 1920, and 1921 as being unallowable under article 223 of regulations 45, and as further defined by the foregoing decisions mentioned.

The record indicates that the taxpayer has been advised by office letter dated September 1, 1922, signed by chief of oil and gas section, that valuation of properties and depletion allowances would be made on the basis of treating such development costs as expense items. If the department is bound in the audit of this case by the findings set forth in the above-mentioned letter, it is the judgment of the review section that such action should not be taken as establishing a precedent in the audit of future cases wherein the same question arises.

John J. Clancy,
Reviewer.
Robert C. Smith,
Chief of Review Section.

Exhibit 5

July 9, 1923.

In re: Standard Oil Co. of California.

Acting Deputy Commissioner Bright:

Reference is made to your memorandum of June 9, 1923 (IT: NR: G: WCT), which was transmitted through the rules and regulations section relative to the income and invested capital for the years 1918 to 1921, inclusive, of the Standard Oil Co. of California. You request the opinion of this office on the question whether the unit may accept amended income and profits tax returns for the above-named years, in which returns the taxpayer seeks to charge intangible developments theretofore capitalized to expense.

This corporation has since organization followed the policy of charging intangible development costs and drilling expenses to capital, and its original returns for the four years mentioned were filed on that basis. On April 18, 1921, and May 16, 1921, amended returns were filed for the years 1918 and 1919, respectively, in which these costs were still treated as capital charges. This corporation now seeks by filing unsigned amended returns dated May 7, 1923, to reverse its policy from January 1, 1918, and charge the development costs, which were formerly capitalized, to expense, maintaining that although

these costs represent an optional charge, such option was not exercised until the year 1922, when valuation date was submitted to the unit and accepted by the valuation engineers of the natural resources division. The corporation further maintains that its treatment of development costs as capital charges in its returns was tentative and subject to change.

In connection with the filing of amended returns the taxpayer states in a letter addressed to the commissioner under date of June 1, 1923, that it was induced to assent to the depletion valuation fixed by the bureau in consideration of the agreement by representatives of the natural resources division that it might file amended returns in which intangible development expenses theretofore capitalized might be charged off to expense. The conference memorandum failed to embody any mention of this alleged agreement, but in support of the taxpayer's position he quotes from a letter dated September 1, 1922, signed "E. H. Batson, deputy commissioner, by Russell Beall, chief of section," and addressed to the company, which letter in part states as follows:

"The understanding of this office by verbal statement from your Mr. Tuttle is that amended returns for 1918 and subsequent years are to be filed, in which returns the intangible cost of development is to be charged off as an expense.

"In accordance with this understanding depletion schedules for the years 1913 to 1920, inclusive, as compiled by this order, do not include in the capital sum returnable through depletion any additions to capital on account of development costs after the year 1917."

Article 223 of regulations 45 in so far as material here reads as follows:

"Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of well, building of pipe lines, and development of the property may at expense or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as an operating expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years." * * *

A similar provision appears in the Oil and Gas Manual issued by the bureau.

It is the contention of the taxpayer, first, that it has the right under the above-quoted regulations at any time up to the final audit of the returns to exercise the option granted and, second, that the agreement made by the company with representatives of the bureau is binding on the bureau and can not now be changed.

It may be stated as a general rule that under ordinary accounting practice all expenditures which benefit the future should be set up as referred assets and allocated to the succeeding periods which realize the benefits. Montgomery in his work on Auditing Theory and Practice, volume 2, pages 208, 209, and 212, states that although under the regulations issued under the revenue act of 1921 oil concerns may deduct from income the development costs in the year in which they are paid, the correct accounting procedure is to capitalize such costs and to charge them off over the estimated life of the property by way of depletion. This statement is undoubtedly correct as a general proposition and items such as are here sought to be charged to expense in the amended returns would in the average business under good accounting practice be capitalized. The permission granted in article 223 to the taxpayer to charge such items to either capital or expense is merely a recognition of the hazardous character of the oil industry. It is claimed by many competent mining engineers that good practice in the mining industry permits the charging to maintenance of expenditures for improvements, the benefits and advantages of which extend over a period of years, and what the regulations recognize is the fact that in the oil industry there is a difference in the manner of treating the items here under consideration. There is no provision in the statute itself which grants an option to the taxpayer as to the manner in which certain expenditures made by him are to be treated, and article 223 is in no sense of the word a relief provision. It does not contemplate that a taxpayer may change his treatment of such items as are here being considered in a manner so as to produce the lowest tax. All it recognizes is that in the oil industry there is a difference of opinion as to the treatment of

the charges in question and the bureau will accept the treatment accorded the items by the taxpayer.

Throughout the regulations there appears to be a distinction drawn between the final settlement of amounts allowable as deductions and methods of treatment of certain items which as a matter of good accounting are to some extent optional. In the first case the amounts allowable as deductions may be changed upon the presentation of new information, whereas in the second case the taxpayer is bound by the option exercised at the time of filing his original return. In this connection it will be noted that article 841 of regulations 45 provides that amended returns filed for the purpose of reinstating any deductions from income which is as a matter of good accounting to some extent optional, can not be permitted, as in such cases it is considered that the corporation has exercised a binding option in deducting such expenses from income, and an election of this sort which was made concurrently with the transaction can not be revised. On the other hand, amended returns will be permitted in cases where actual errors have been made, as, for example, where excessive depreciation has been deducted, additions to plant or equipment or other capital charges have been charged off to expense, inventories have been taken upon wrong basis of valuation, etc.

In this connection it may be well to consider the holdings of the bureau on the point at issue. In office decision 706, reported in Cumulative Bulletin No. 4, page 199, it was held that a corporation which in 1916 and 1917 exercised its option and charged to capital account such expenditures as wages, fuel, repairs, hauling, etc., in connection with the exploration of property, drilling of wells, etc., may not subsequently amend its returns covering such period so as to transfer such items to operating expenses to agree with their treatment in its 1918 return. In A. R. M. 110, Cumulative Bulletin No. 4, pages 199, 200, the following appears:

"The M Company charged cost of drilling certain gas wells to expense prior to January 1, 1920. The Public Service Commission of Pennsylvania, effective January 1, 1920, prescribed that such expenses be capitalized. Held that under article 223 of regulations 45, the option heretofore exercised by the taxpayer must control its returns for subsequent years and that the accounts can not be revised to treat such items as capital expenditures."

In office decision 1002, reported in Bulletin 34, 1921 series, it was held where a parent company, which owned the stock of a subsidiary company, elected under article 223, regulation 45, to charge as operating expenses, the expense incurred by it during the period in which it operated oil leases, the subsidiary company to which the oil leases were sold was bound by the election of the parent organization and must charge development and exploration expenses made by it in connection with such oil leases and properties to operating expenses.

In the Internal Revenue Bulletin for June 18, 1923, Volume II, No. 11, there appears a ruling directly in point on the question involved herein. In that ruling it is stated that a taxpayer is held to have exercised the option mentioned in article 223 of deducting incidental drilling expenses as a development expense when in its books of account they are treated as current expenses, even though in its first return such expenses were capitalized. This ruling in effect treats the option as having been exercised concurrently with the expenditure and the entry of the item on the books. In the instant case the Standard Oil Co. of California not only charged the items under consideration to capital account at the time the expenditures were made, but in its original returns treated these items as capital expenditures.

It is the opinion of this office that article 223 of regulations 45 merely recognizes the accounting practice in the oil industry, and is not intended as granting a special privilege to that industry, for which there is no warrant of law. What effect the exercise of the option by the taxpayer may have on the amount of tax he has to pay is immaterial, and the question is to be decided irrespective of whether the election exercised by the taxpayer serves either to lower or increase his tax liability to the Government. Viewed in this light it is the opinion of this office that the option recognized by article 223 is exercised by the taxpayer, if not concurrently with the transaction, at least not later than the time when his original returns are filed. It follows that the amended returns of the Standard Oil Co. whereby they seek to not charge intangible development costs to expense must be rejected.

It is not the function of this office to decide questions of policy and, therefore, in reaching the conclusion herein no consideration has been given to the fact, if it be a fact, as stated by the taxpayer, that it was induced to agree to the bureau's valuation in consideration of being granted the right to file amended returns on the basis herein discussed. It is well to state, however, that there is no provision of law which makes such an agreement binding on the commissioner, and it may well be that a dangerous precedent would be set if an agreement made by subordinates in the bureau is to be considered as binding when that agreement grants to a taxpayer a privilege that has no warrant in the law. In this connection it should be borne in mind that a number of other big oil companies have indicated their intention of filing amended returns so as to charge to expense items heretofore capitalized, though in the cases of the other companies, so far as this office is aware, there was no agreement entered into granting them the right to file amended returns in consideration of their acceptance of the bureau's valuation of their properties. It would be difficult, however, to deny to them a right to file amended returns if that privilege is granted to the taxpayer herein, for it can not be presumed that the bureau may even by way of compromise grant to a taxpayer a privilege which has no legal warrant.

If the valuations as set by the bureau were accepted by the Standard Co. with the understanding that amended returns could be filed, it would seem that the company should have a further opportunity of presenting additional evidence as to values if it desires to do so.

The papers are herewith returned with the suggestion that the tax liability of this company be adjusted on the basis herein set forth.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT 6

BUREAU OF INTERNAL REVENUE,
OFFICE OF DEPUTY COMMISSIONER INCOME TAX UNIT,
July 10, 1923.

Mr. GREENIDGE: The suggestion of the solicitor contained in next to the last paragraph on page 5 of his memorandum relative to the case of the Standard Oil Co. of California should be conveyed to the taxpayer.

J. G. BRIGHT,
Deputy Commissioner.

EXHIBIT 7

TREASURY DEPARTMENT,
INTERNAL REVENUE BUREAU, INCOME TAX UNIT,
July 25, 1923.

STANDARD OIL CO. OF CALIFORNIA,
Standard Oil Building, San Francisco, Calif.

SIRS: Reference is made to your letter of June 1, 1923, wherein you state that as a result of several conferences this office, in June, 1922, made a final determination of your depletion values and allowances, and that you agreed to assent without further contention to these valuations, and that this office agreed to accept amended returns for 1918 and subsequent years in which intangible development expenses, previously capitalized, were to be charged off to expense.

You are advised that under the law and regulations this office can not accept these amended returns; but if you desire to present additional evidences of depletion values, such evidences will be considered before the case is finally audited.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.
By W. N. THAYER,
Chief of Section.

EXHIBIT 8

AMERICAN PETROLEUM INSTITUTE,
New York, July 27, 1923.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

SIR: Reference is made to your letter of July 25 addressed to the Standard Oil Co. of California, your file IT: NR: OG: WNT. The undersigned has, as you know, been associated with representatives of the Standard Oil Co. of California in the determination of their tax liabilities and is leaving New York Monday for San Francisco for the purpose of having further conferences with this company regarding its course in the matter.

It is therefore respectfully requested that any further action in this case be deferred pending my return, which will be on or about the 25th day of August, and I will promptly confer with the department on my return.

Respectfully submitted.

M. W. MATTISON,
Agent, Standard Oil Co. of California.

EXHIBIT 9

JULY 28, 1923.

STANDARD OIL CO. OF CALIFORNIA,
Standard Oil Building, San Francisco, Calif.

SIRS: Reference is made to a letter dated July 27, 1923, from Mr. M. W. Mattison, requesting that further action on your case be deferred pending his return to Washington, D. C., about August 25, 1923.

You are advised that no further action will be taken prior to September 1, 1923.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.
By W. N. THAYER,
Chief of Section.

EXHIBIT 10

AUGUST 21, 1923.

Know all men by these presents:

That M. W. Mattison is hereby constituted the attorney of the undersigned corporation to represent it before the Department of Internal Revenue, United States of America, in all matters relating to the income and excess-profits tax returns of the undersigned company now pending and undetermined.

Witness the corporate name and seal of the undersigned corporation hereunto signed and affixed pursuant to resolution of its board of directors.

STANDARD OIL CO.,
By K. R. KINGSBURY, *President.*
By J. H. TUTTLE, *Secretary.*

EXHIBIT 11

OIL AND GAS VALUATION SECTION,
September 10, 1923.

Memorandum to Mr. Greenidge.
In re: Standard Oil Co. of California.

The taxpayer filed original returns and Form O schedules in which development costs for all years were capitalized.

This office made some changes and eliminated the capitalized development, and in a letter of September 1, 1922, wrote the taxpayer as follows:

"The understanding of this office by verbal statement from your Mr. Tuttle is that amended returns for 1918 and subsequent years are to be filed, in which returns the intangible cost of development is to be charged off as an expense.

"In accordance with this understanding, depletion schedules for the years 1913 to 1920, inclusive, as compiled by this office, do not include in the capital sum returnable through depletion any additions to capital on account of development costs after the year 1917."

As a result the taxpayer filed unsigned amended returns on May 7, 1923, in which development costs formerly capitalized were charged to expense. The matter was referred to the solicitor, and as a result of his ruling of July 9, 1923, this office wrote the taxpayer on July 25, 1923, declining to accept the amended returns and insisting that the development costs after 1917 should be capitalized.

Regardless of the solicitor's opinion as to the legality of the action taken by this office in the letter of September 1, 1922, it appears to be a matter of good principle to adhere to an agreement that was made in good faith by both parties. The Government would not permit the taxpayer to break such an agreement, and by the same token the Government should not seek to break the agreement.

The practical result of permitting the taxpayer to charge to expense items previously capitalized will mean in 1918 a deduction from gross income of approximately $3,000,000.

W. N. THAYER,
Chief of Section.

EXHIBIT 12

SEPTEMBER 11, 1923.

Memorandum for Mr. J. G. Bright, Deputy Commissioner.
In re: Standard Oil Co. of California.

The four principal points in this case set out in detail by solicitor's memorandum dated July 9, 1923, are:

(1) Taxpayer capitalized development costs during all years on its original tax returns.

(2) Subsequently valuation data were prepared and filed with the oil and gas section and a considerable reduction in these values was made by the oil and gas section.

(3) During the time the valuation work was in progress conferences were held by the valuation engineers with the solicitor's office, and as a result of these conferences taxpayer was told a change from their method of capitalizing development costs to the charging of development costs to expense in the year in which incurred would be permitted, and amended returns should be filed in conformity therewith.

(4) The solicitor's opinion states that, having capitalized development in its original returns, taxpayer exercised the option which is given to oil companies by Article 223 of Regulations 45 and that this bureau can not now accept amended returns in which development costs are charged to expense in the year in which incurred.

The result of permitting taxpayer to charge to expense items previously capitalized will result, in 1918, of a deduction from gross income of approximately $3,000,000. In accordance with your instructions an estimate of the approximate amounts which may be treated likewise by other taxpayers has been attempted, and while the limited time available for making this estimate has not permitted this division to arrive at any definite figures it is considered safe to say that twenty-five millions would not be a high figure.

Without attempting to take issue with the solicitor's department and its decision, it should be considered that taxpayers conducted their conferences with this division in a spirit of fairness, and if an error in the strict interpretation of the law or regulations occurred it could not be properly chargeable to the engineering section, since this section frequently conferred with the solicitor's office on this subject before an agreement was made with the taxpayer.

If this taxpayer, being permitted to charge development to expense in the year in which incurred, is going to establish a precedent which all other taxpayers may follow, a very considerable amount of development heretofore capitalized will now be charged to expense and taxable income will be reduced during the years 1917 and 1918, but taxable income in subsequent years will be increased, since by permitting development to be charged to expense the depletion allowable is reduced.

S. M. GREENIDGE,
Head of Division.

EXHIBIT 13

SEPTEMBER 29, 1923.

STANDARD OIL CO. OF CALIFORNIA,
Standard Oil Building,
San Francisco, Calif.

SIRS: Upon further consideration of your case, and particularly your letter of June 1, 1923, this office has decided that your amended returns for 1918 and subsequent years, in which intangible development expenses previously capitalized are charged off to expense, will be accepted; and your case will be audited upon the basis of these amended returns and the conference agreement of June 22, 1922.

The letter from this office dated July 25, 1923, therefor may be disregarded.

Respectfully,

J. G. BRIGHT.
Deputy Commissioner.

EXHIBIT 14

BUREAU OF INTERNAL REVENUE,
OFFICE OF THE DEPUTY COMMISSIONER, INCOME TAX UNIT,
September 29, 1923.

MR. GREENIDGE: There is returned herewith the entire file in the case of the Standard Oil Co. of California.

The question raised by audit section G as to the right of this taxpayer to file amended returns, charging the cost of development to expense for the year in which incurred instead of capitalizing these items as it had done in its original returns, has been given careful consideration. The memorandum of the solicitor dated July 9, 1923, on this question, based on the evidence at hand at that time, covers a complete interpretation of article 223, regulations 45, but from the facts now presented does not apply to this particular case, as there is no doubt the original returns filed by the taxpayer were considered only as tentative by the bureau; therefore the taxpayer could not exercise its opinion.

You are, therefore, instructed to close this case on the basis of accepting the amended returns for 1918 and subsequent years and the conference agreement of June 22, 1923.

J. G. BRIGHT.
Deputy Commissioner.

EXHIBIT 15

JANUARY 29, 1924.

In re: Standard Oil Co. (California).

DEPUTY COMMISSIONER BRIGHT: Reference is made to certificate of overassessment for the year 1918 in the amount of $3,378,921.35 in the case of the Standard Oil Co. of California, sent to this office for approval. This certificate results from permitting the company to file amended returns in which there is charged to expense various items theretofore capitalized. This office in a memorandum to you under date of July 9, 1923, held that as a matter of law this could not be done, and for that reason the certificate is returned to you without approval.

It is understood, however, that the proposed adjustment has been discussed with the commissioner, and you should dispose of the case as directed by him. The file is herewith returned.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT 16

BUREAU OF INTERNAL REVENUE, OFFICE OF DEPUTY
COMMISSIONER, INCOME TAX UNIT,
February 8, 1924.

MR. GREENRIDGE: There is returned herewith the case of the Standard Oil Co. of California, wherein the solicitor has disapproved the action of the

unit in permitting this company to file amended returns for the calendar year 1918.

You will note that the solicitor suggests that the case be closed upon the basis of the instructions given by the Commissioner of Internal Revenue. In this connection I should like to have a memorandum prepared to the Commissioner of Internal Revenue, fully setting forth all the facts in this case, and containing your recommendation as to whether or not the case should be closed upon the basis of the amended returns or permitting the valuations to be reopened by the taxpayer.

J. G. Bright,
Deputy Commissioner.

Exhibit 16½

February 14, 1924.

Memorandum for Deputy Commissioner Bright.
In re: Standard Oil Co. (California).

Reference is made to your memorandum dated February 9, 1924, wherein you request a memorandum fully setting forth all the facts in the case of the above-named company and a recommendation as to whether or not the case should be closed upon the basis of the amended returns, or permitting the valuations to be reopened by the taxpayer.

The essential facts in the case are these:

First. A period of correspondence with the taxpayer culminated in a conference beginning April 17, 1922, and ending May 6, 1922. During this conference the unit, represented by Engineers Wardwell and Evans, and the company, represented by Messrs. Tuttle and Gester, reached a settlement upon the several valuation features and signed a conference agreement, one of the conclusions of which states:

"The recoverable reserves, values and unit values, as of basic dates for all properties, were finally agreed upon."

Second. At this conference, certain claims of the company for a discovery revaluation in a lower zone on the Murphy-Coyote property were denied by the Unit, which denial resulted in a material reduction in values claimed and in subsequent depletion deductions. This denial hinged upon the question of the sufficiency of evidence to prove one of the most complicated and highly technical matters of petroleum geology—that of multiple producing zones—a matter upon which the most learned and experienced experts disagree.

Third. As a partial offset to this reduction in value under the circumstances just mentioned, it was informally agreed that after careful discussion among the engineers, auditors, and the company's representatives, and upon verbal advice from the solicitor, Mr. Carl Mapes, that the company should file amended returns for 1918 and subsequent years, in which development costs, capitalized in the original returns, should be charged off as an expense.

This agreement was confirmed in an office letter dated September 1, 1922, as follows:

"The understanding of this office by verbal statement from your Mr. Tuttle is, that amended returns for 1918 and subsequent years are to be filed, in which returns the intangible cost of development is to be charged off as expense."

Fourth. As a result of the April–May, 1922, conference, and the understanding above referred to, the company presented amended returns, using as a basis the values and deductions agreed upon, and charging off as expense the development costs which had been capitalized when the original returns were filed.

Fifth. The case proceeded to final audit and on June 9, 1923, the chief of audit section G addressed a communication to the solicitor asking for a ruling upon the question of whether or not these amended returns might be accepted.

Sixth. On July 9, 1923, the solicitor, Mr. Nelson Hartson, rendered an opinion, denying the company the right to file the amended returns and suggesting that the company be permitted to reopen the matter of valuations.

Seventh. Upon instructions from Deputy Commissioner Bright, contained in his memorandum of July 10, 1923, the result of the solicitor's opinion was communicated to the company in office letter of July 25, 1923. The company immediately protested this action, basing its protest upon the bad faith of the Government in seeking to repudiate an agreement and upon the disorganized

condition of the unit at the time when the original returns were filed, and which it claimed made the filing of acceptable returns impossible.

Eighth. This protest was carefully considered and on September 10, 1923, the chief of the oil and gas section, Mr. Thayer, addressed a memorandum to the head of the natural resources division, in which it was stated:

"Regardless of the solicitor's opinion as to the legality of the action taken by this office in the letter of September 1, 1922, it appears to be a matter of good principle to adhere to an agreement that was made in good faith by both parties. The Government would not permit the taxpayer to break such an agreement, and by the same token the Government should not seek to break the agreement."

Ninth. On September 28, 1923, this memorandum was discussed by Commissioner Blair, Deputy Commissioner Bright, and Mr. Thayer, chief of the oil and gas section, and as a result of this discussion, Deputy Commissioner Bright issued a memorandum to Mr. Greenidge, head of the division, the concluding paragraph of which reads:

"You are, therefore, instructed to close this case on the basis of accepting the amended returns for 1918 and subsequent years and the conference agreement of June 22, 1923."

Tenth. On September 29, 1923, an office letter was addressed to the company advising that the amended return would be accepted, and the audit of the case proceeded.

Eleventh. Upon conclusion of the audit the case was returned to the solicitor, as there appeared an overassessment in 1918 of $3,378,921.35, this being the difference between the tax computed on the basis of the amended returns ($13,593,303.96) and that originally assessed ($16,972,225.31), upon a net income of $27,763,885.97.

Twelfth. Under date of January 29, 1924, the solicitor returned the case to Deputy Commissioner Bright without approval, stating that:

"It is understood, however, that the proposed adjustment has been discussed with the commissioner and you should dispose of the case as directed by him."

Whatever recommendation now remains to be made must rest upon two considerations:

First. The agreement entered into by the representatives of the company, and by fully competent representatives of the commissioner, whose sole object was to protect the interests of the Government and who were guided by an informal opinion of the solicitor at the time the agreement was made.

Second. The practical effect in terms of tax liability and expense to the Government of reopening the case and working it on a different basis.

With reference to the first consideration, it may be said that nothing had been added to the case, except the solicitor's refusal to approve, since the memorandum of Deputy Commissioner Bright was written on September 29, 1923, directing that the case be closed on the basis of accepting the amended returns; and in the absence of a positive statement that the action of the unit is illegal the case should be closed as agreed.

With reference to the second consideration, it may be said that the engineers of the oil and gas section in the conference of April-May, 1922, resolved all doubt in favor of the Government, effected an equitable settlement, and at the same time established a basis upon which many other cases have been settled. If the case is reopened it will be at considerable expense to the Government, and it is conceivable that additional data may be presented upon which the unit would be compelled to allow the company's claim for higher values and greater depletion deductions. Moreover, although to compel the company to capitalize its development cost for 1918 and subsequent years would decrease the deductions under heading of expense, it would increase the deductions under heading of depletion, for all such capitalized charges are depletable. The actual effect in terms of tax liability can not be stated definitely until the returns for several years are audited on both bases, but it may be stated that on the whole, the option of charging to capital or expense merely means that the taxpayer may elect to reduce his tax liability materially during the year in which the charge is incurred, or moderately over a number of years. The same amount will be returned tax free either in a lump sum or in installments. It would appear, therefore, as a matter of good business judgment to close the case as agreed.

S. M. GREENIDGE,
Head of Division.

EXHIBIT 17

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, February 20, 1924.

Memorandum for Mr. Bright.

My attention has been called to your letter of September 20, 1923, in regard to the Standard Oil Co. of California, wherein you advise the company that its amended returns for 1918 and subsequent years in which intangible development items previously capitalized or charged off to expenses will be accepted, and notifying them that their case will be audited on that basis.

I think your letter is in error. It appears that you based your letter on some verbal understanding had between the conferees of the natural resources division and the representatives of the company. Any verbal understanding of an important matter like this is most unfortunate, and I do not feel that the bureau can be bound by it. In the first place, a matter of so much importance should be reduced to writing; in the second place, while great weight is given to agreements on the part of conferees, their agreements are not binding and no agreement can be binding unless it is approved by the commisisoner.

This matter was called to my attention some months ago and the facts as presented indicated that perhaps the understanding between the taxpayer and the conferees should be carried out, but a thorough investigation of the file convinces me that this would establish a dangerous precedent and should not be done. You will therefore please notify the taxpayer.

D. H. BLAIR, *Commissioner.*

EXHIBIT 18

MARCH 1, 1924.

Mr. M. W. MATTISON,
American Petroleum Institute, New York City.

SIR: A conference in the case of the Standard Oil Co. of California has been arranged for 2.30 on Tuesday, March 4, 1924, in the office of the Commissioner of Internal Revenue.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.

EXHIBIT 19

APRIL 4, 1924.

Mr. BLAIR: Under date of February 20, 1924, you addressed a memorandum to me stating in substance that the agreement entered into with the Standard Oil Co. of California, wherein representatives of the bureau agreed to accept amended returns of this company, permitting such company to charge as expense in the years incurred all intangible development items, which items had been previously capitalized in lieu of the company waiving any further claim for a higher value of its oil properties as of March 1, 1913, or other basic date, was in error. Shortly after this date a conference was held with the representative of the taxpayer, Mr. Mattison, at which time you informed me that no further action should be taken in connection with this case for at least 30 days.

The audit of this case based on the above agreement showed approximately $87,000 additional tax for the year 1917 and $3,000,000 overassessment for the year 1918. The waiver filed for the year 1917 was limited to December 31, 1923, and therefor the additional tax for that year can not be assessed without an additional waiver. Any overassessment due this company, either as a result of the present audit or based on a revised audit, can not be made unless the taxpayer should file a wavier for the year 1918 on or before June 15, 1924.

In view of the above it is important that early action be taken on this case, and I am, therefore, requesting instructions as to whether or not the unit shall proceed in accordance with your instructions of February 20.

——— ———,
Deputy Commisisoner.

EXHIBIT 20

NOVEMBER 26, 1924.

In re: Standard Oil Co. (California), San Francisco, California.

Mr. J. G. BRIGHT,
Deputy Commissioner.

With reference to the still undecided question of whether or not this company should be permitted to file amended returns in which development costs previously capitalized are charged to expense, your attention is invited to the attached copy of a recent recommendation from the solicitor's office, particularly to issue No. 4.

In the case of the Standard Oil Co., a certain part of its income is impounded each year from 1914 to 1920. It appears, therefore, under the solicitor's recommendations referred to, that this company might file amended returns reporting these impounded funds as income for the year in which they accrued. The adjustment necessary to file these amended returns would be relatively small, as the amount of funds impounded is not large, but once the right to file amended returns on any basis is conceded, a precedent would be established for accepting amended returns for 1918 and subsequent years in which adjustment would be made not only for impounded funds but also for the change from capitalized development costs to expensed development cost.

It is suggested that this matter might be discussed informally with the solicitor.

S. M. GREENIDGE,
Head Engineering Division.

EXHIBIT 21

JANUARY 19, 1925.

Mr. GREENIDGE: Reference is made to your telephone call on January 15 at which time you called attention to the fact that the time limit is running close on the case of the Standard Oil Co. of California.

In this connection, you are advised that if the statute is about to run in this case the tax should be assessed, provided proper waivers are not procured.

A copy of this memorandum is being furnished to the head of the consolidated returns division.

J. G. B., *Deputy Commissioner.*

EXHIBIT 22

APRIL 18, 1925.

Mr. BRIGHT: In compliance with your telephone request, I am transmitting the papers in the case of the Standard Oil Co. (California).

I have considered the facts in these papers and arrived at the conclusion that it would be necessary to have a valuation engineer's report on same. I have requested this and was holding the papers awaiting this report from the engineering division.

L. T. LOHMANN,
Head, Consolidated Returns Division.

EXHIBIT 23

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE, INCOME TAX UNIT.
May 1, 1925.

Memorandum to: Mr. L. C. Manson, general counsel.
From: Mr. L. H. Parker, chief engineer.
Subject: Additional data, Standard Oil Co. of California.

We are transmitting herewith in duplicate the following papers:

1. Memorandum from L. H. Parker, chief engineer, to Mr. W. N. Thayer, chief oil and gas section, covering status of case.

2. Memorandum from W. N. Thayer to L. H. Parker, covering status of case.
3. Memorandum from Mr. A. H. Fay, consulting engineer, to L. C. Manson, general counsel, covering status of case.

The writer has examined the original returns of the Standard Oil Co. of California, together with Mr. Thayer of the oil and gas section and we can find no notation on these returns stating that same were tentative.

Respectfully,

L. H. PARKER, *Chief Engineer.*

EXHIBIT 24

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE, INCOME TAX UNIT,
April 30, 1925.

To: W. N. Thayer, chief oil and gas valuation section, Income Tax Unit.
From: L. H. Parker, chief engineer.

DEAR MR. THAYER: Referring to our conference of yesterday with Messrs. Lohmann and Tungate in regard to the status of the case of the Standard Oil Co. of California, will you kindly advise me if the following is a correct statement of the facts as developed in the conference:

The oil and gas valuation section forwarded a final valuation in this case to audit on the basis of amended returns as agreed to in conference. They were audited on this basis, which resulted in an overassessment. The solicitor refused to O. K. this refund on the basis that the amended returns could not be accepted, but that the original returns should be used. The question involved was the right of the taxpayer to charge certain development costs to expenses instead of to capital, as had been done in the original return. The case having come back to audit from the solicitor's office, it was forwarded to the engineering division for action. The engineering division now has the files on this case but intends to return same to audit without charge, as it feels the solicitor's decision is not perfectly clear, or in any event is wrong if it be interpreted as a positive order not to accept the amended returns.

If the above statement is correct, will you kindly O. K. the original letter and return? If it is not correct, will you kindly give me a statement covering the same ground with such necessary changes as you desire?

Respectfully,

L. H. PARKER.

EXHIBIT 25

APRIL 30, 1925.

Memorandum for Mr. L. H. Parker, chief engineer for Senate investigating committee.
In re: Standard Oil Co. of California.

Replying to your memorandum of even date, I may say that a more exact statement of facts regarding the action taken in this case is as follows:

(1) In a conference held April 17, 1922, to May 6, 1922, both the taxpayer and the bureau reached the following agreement:

"The recoverable reserves, values and unit values, as of basic dates for all properties were finally agreed upon."

(2) On September 1, 1922, an office letter was addressed to the taxpayer stating:

"The understanding of this office by verbal statement from your Mr. Tuttle is that amended returns for 1918 and subsequent years are to be filed, in which returns the intangible cost of development is to be charged off as expense."

(3) On July 9, 1923, the solicitor rendered an opinion, upon the request of the audit division for a ruling, denying the company the right to file amended returns, and suggesting that the company be permitted to reopen the matter of valuation.

(4) On July 25, 1923, an office letter was addressed to the company, communicating to them the solicitor's decision and his recommendation that the valuation questions be reopened if the company desired.

(5) The company immediately protested the action of the bureau and another series of conferences were held among the officials of the unit and the whole matter discussed. As a result on September 29, 1923, another office letter was addressed to the company, advising them that the letter of July 25, 1923, might be disregarded and that the amended returns would be accepted and the case audited on the basis of the original agreement.

(6) The case was audited on the basis of the agreement and the amended returns and a certificate of overassessment for 1918 was issued in the amount of $3,378,921.35.

(7) The solicitor refused to approve this certificate of overassessment and the case was returned to the unit.

(8) The case has been in the files of the oil and gas section since March 19, 1925, awaiting final disposition; there is no valid reason for changing the valuation report previously made.

(9) There is no refund involved. The taxpayer has filed a claim for credit, partly against an additional tax assessed by a revenue agent and partly against taxes due for 1920.

(10) Inasmuch as the taxpayer has had already three letters, each contradicting the previous one, it is believed to be good policy to take no further action until all offices of the bureau are in accord, to the end that there shall be no further reversals of actions taken. The proper action to be taken is now a matter of discussion between the engineering and audit divisions.

(11) This is not a matter of law, but a matter of interpreting the regulations, and there are good and valid arguments on both sides. Moreover, it is purely an interoffice argument over an open case.

W. N. THAYER,
Chief of Section.

EXHIBIT 26

SENATE COMMITTEE INVESTIGATING BUREAU OF
INTERNAL REVENUE INCOME-TAX UNIT,
April 30, 1925.

To: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: Standard Oil Co.

DEAR MR. MANSON: In reply to your telephone call of to-day, regarding the status of the Standard Oil Co. of California, Mr. Parker had a conference with Messrs. Lohman, Tungate, and Thayer.

It seems that there has been considerable disagreement in the department as to whether or not the taxpayer should be permitted to file amended returns. The solicitor ruled that the amended returns could not be accepted, yet the case was ordered to audit on the basis of the amended returns and resulted in an overassessment in excess of $3,000,000, which overassessment the solicitor refused to O. K. The case was then referred to the commissioner and was ordered back to audit on the basis of the original returns, but before this could be done it was necessary to refer the case back to the engineering division for a revision of the valuation and depletion schedules. The case is now in the engineering division and Mr. Thayer states that it will be returned to the audit without change, upon the basis that the taxpayer agreed to accept the valuation determined by the oil and gas section on condition that the amended returns would be accepted.

Apparently the engineering division is holding out for the amended returns and the audit is holding out for closing the case on the basis of the original returns. There seems to be a lack of authority in the handling of this case.

Respectfully,

A. H. FAY, *Consulting Engineer.*

Approved:
L. H. PARKER, *Chief Engineer.*

(Whereupon, at 11.20 o'clock a. m., the committee adjourned until to-morrow, Tuesday, May 12, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, MAY 13, 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, Jones of New Mexico, and King.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. A. H. Fay, 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; Mr. A. W. Gregg, Solicitor, Bureau of Internal Revenue; and Mr. N. W. Thayer, chief of oil and gas section, engineering division.

The Chairman. You may proceed, Mr. Manson.

Mr. Manson. I will present this morning a study that we have made of an oil pool near Winona, in Osage County, Okla. Before going into the report on this pool I wish to call attention to the essential facts developed from this study.

Section 214 of the act confines discovery values to oil wells not acquired as the result of a purchase of a proven tract or a lease, and where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery or within 30 days thereafter.

The regulations define what shall constitute a proven tract or lease. Article 220, subdivision of Regulations 62, provides:

> A proven tract or lease may be a part or the whole of a proven area. A proven area for the purpose of this statute shall be presumed to be that portion of the productive sand or zone or reservoir included in a square surface area of 160 acres having as its center the mouth of a well producing oil or gas in commercial quantities. In other words, a producing well shall be presumed to prove that portion of a given sand, zone, or reservoir which is included in an area of 160 acres of land, regardless of private boundaries. The center of such square area shall be the mouth of the well, and its sides shall be parallel to the section lines established by the United States system of public-land surveys in the district in which it is located. Where a district is not covered by the United States land surveys the sides of said area shall run north and south, east and west.
>
> So much of a taxpayer's tract or lease which lies within an area proven either by himself or by another is "a proven tract or lease," as contemplated by the statute, and the discovery of a well thereon will not entitle such taxpayer to revalue such well for the purpose of depletion allowances unless the tract or lease had been acquired before it became proven. And even though a

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

It was the desire of your counsel to ascertain whether there was any system maintained in the oil and gas section for the purpose of——

The CHAIRMAN. You are speaking of the oil and gas section of the bureau now?

Mr. MANSON. The oil and gas section of the bureau—for the purpose of keeping a record of areas which were proven, in order that claimed discoveries might be checked against such proven areas, and also for the purpose of keeping a record of discovery values that were allowed. In other words, it occurred to me that unless there was some system similar to the tract index system maintained for the registration of titles to land it would be impossible to enforce these regulations, and that discovery values might be claimed upon proven areas, and the bureau would have no way of checking; and also that unless there was such a system two discoveries might be allowed upon the same area.

This thought was first called to my mind by the fact that in the Black case we had one well in which undivided interests were offered two different parties, and we found that in that case a different valuation was placed upon that well by the different owners of undivided interests in the same property. The result was that the taxpayer who owned the smaller interest got the greater value.

The thought suggested itself to my mind at that time that if there was any tract record kept at all of values allowed such a result would have been impossible and that the same sort of a system would have been required to check the proven areas.

For the purpose of ascertaining whether there was any such system, and if not, what results would follow from the absence of such a system, I instructed Mr. Fay to take a pool or a portion of a pool and check up the areas upon such pool as they were discovered and as they became proven, to ascertain whether or not there was any duplication of discovery values upon the same territory and whether or not regulations with respect to the allowances, or in fact the law, with respect to the allowances of discovery values, was being enforced.

Before going into the details, which will be presented by Mr. Fay, I desire to say at this time that we found several instances in the case of this one pool.

In the first place, this pool is entirely owned—the land is entirely owned by the Indians. The production of this land is reported to the Indian Office. We find that in, I think, 12 out of 35 leases the Income Tax Unit has no record whatever of wells the production of which has been regularly reported to the Indian Office. We find several instances where discovery values have been allowed upon areas which were proven within the language of these regulations at the time that the leases were acquired or upon which discovery value

was allowed. We also find several instances where two discoveries have been allowed on the same area or overlapping areas.

I will now ask Mr. Fay to give you his report on this matter.

Mr. GREGG. May I have a copy of the report?

Mr. MANSON. Yes.

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

Mr. FAY. The pool that we have taken for study is in Osage County, Okla., near the town of Winona. I have designated it as the Winona oil pool. I do not know that it has any specific name other than the name connected with the town or village of Winona.

In order to obtain a comprehensive view and an unbiased opinion as to the completeness and thoroughness of the work of the oil and gas valuation section, a careful study of a geographic area is used as a basis.

1. A pool or area was chosen that was leased and operated prior to 1920, as it is known that but few oil-tax adjustments or settlements have been made for later years.

2. An area was determined upon where costs (bonus) were known from an independent source.

3. An area was chosen where exact and complete production records were obtainable from a source free from the influence of income tax laws.

Preliminary to the study of the Winona pool in Osage County, Okla., a list of 220 leases in Osage County, giving the names of the purchaser, the location of the property, and the bonus paid to the Government, was obtained from the Bureau of Indian Affairs, Department of the Interior. This list was submitted to the oil and gas section January 19, 1925, for the following specific information:

Will you kindly give us the following information on these properties up to the year 1919? Totals only are required in each case:
The life of property in years.
Taxpayer's reserves in barrels.
Price of oil at basic date.
Hazard factor.
Discount factor.
Total discounted value allowed depletion unit.

In reply to the request for the above information, the following memorandum was received from Mr. Thayer, chief of the oil and gas section:

JANUARY 27, 1925.

Memorandum to Mr. S. M. Greenidge, head engineering division.

There is submitted herewith depletion schedules on 220 properties, as requested by Mr. Parker, chief engineer of the Senate investigating committee.

Inasmuch as Mr. Parker indicated that he desired information as to valuations made for these properties, the engineers have not shown the estimated life on "cost" properties.

For your information the following summary is made:

Number of leases upon which values have been established for the taxpayers named in the request	9
Number of leases where depletion is computed on cost	39
Number of leases upon which no information can be found in the Forms O of the taxpayers listed by Mr. Parker	172
Total	220

It would appear, therefore, that the leases as listed are not held by the taxpayers set forth in the list.

W. N. THAYER,
Chief of Section.

Senator WATSON. Does that necessarily follow; that is, they sent out Form O to these people who are supposed to own the rights, and they did not answer? Is that conclusive proof that they do not own the property?

Mr. FAY. No; it is not.

Senator WATSON. No; I suppose not. Many of them do not answer?

Mr. FAY. Many of them do not.

Senator WATSON. Yes.

Mr. FAY. But there should be some way whereby such information could be gained.

Senator WATSON. That is quite true, but I see that he concludes that they did not own the property, because they did not answer.

Mr. MANSON. Subsequently I understand you procured a list of the actual operators——

Mr. FAY. Yes, sir.

Mr. MANSON (continuing). Of this property, who are reporting their production to the Indian Office?

Mr. FAY. Yes.

Mr. MANSON. Did you request the information with respect to such operators?

Mr. FAY. All of them.

Mr. MANSON. And what was the result of that request? I believe you have a table here showing that.

Senator WATSON. You will come to that later on?

Mr. FAY. I will come to that a little later on, but there were 11 out of 35 in the leases that I asked for who were actually operating at present, upon which I could get no information

Mr. MANSON. All right; go ahead, Mr. Fay.

Mr. FAY. Out of the 220 leases——

Senator WATSON. Let me ask you, before you go on, does anything indicate that these are a complete list of operators?

Mr. FAY. They have in the Osage County.

Senator WATSON. Do those belong to the Indians?

Mr. FAY. They do.

Senator WATSON. And they get the royalties?

Mr. FAY. They get the royalties through the Interior Department. The Interior Department sells the leases at a bonus at public auction and the royalty is collected under the supervision of the Interior Department, and this money is allotted to the Indians under the law and regulations.

Senator WATSON. I imagine, then, that you could get a complete list of owners or operators through the Indian Office?

Mr. FAY. Unquestionably.

Mr. MANSON. We did get it.

Mr. FAY. I did get it on the work I was on.

Senator WATSON. I thought you could only get a part of it.

Mr. FAY. I got a complete list of the operators, but the Bureau of Internal Revenue did not have the information on 11 of the 35 that I asked for.

The CHAIRMAN. Are we to assume from that, then, that they paid no tax, as long as they had no record of it?

Mr. FAY. I would not give an answer to that, Mr. Chairman, because it may have come in through some other source.

Out of the 220 leases upon which information was asked up to the close of 1919 only 9 had been submitted for valuation at the request of the taxpayer; 39 of the leases in question were depleted on cost; the remaining 172 leases were reported upon the basis "No information can be found in the Form O of the taxpayer."

Exhibit 1 shows the leases in question, the name of the purchaser, the location, the cost, and the remarks made by the oil and gas section regarding each individual lease.

The fact that the department has no information on 78 per cent of these leases indicates a failure on the part of the taxpayer to supply necessary information to determine gains, losses, depletion, or other deductions.

It also shows a lack of adequate system in the department for obtaining the necessary data for a proper tax determination.

Since the records were so incomplete, it was necessary to confine the study to a smaller area, and even in this a large percentage of the data is missing, so that it is not possible to make a complete study of each lease. Such information as is available from any source is given.

The careful study of this specific oil pool near Winona, Okla., brings out a number of points of interest. A contiguous block of leases comprising 35 quarter sections of land in one solid block was selected for study. These leases were purchased at various dates prior to 1920 from the Interior Department. The Interior Department has furnished complete gross production figures from the date of purchase to the close of 1924. Among the points that are brought out by this detailed study are:

1. A failure on the part of the taxpayers to file data relating to leases upon which valuation and depletion should be determined by the Income Tax Unit.

2. The high price paid for certain leases is influenced by the fact that frequently a portion of the quarter section was proven at date of purchase by wells drilled in adjoining leases.

3. Discovery valuations have been allowed on areas actually proven by wells on adjoining leases before the taxpayer purchased the lease upon which a discovery valuation was claimed and allowed. In other words, proven territory has been purchased and discovery valuations allowed thereon. This is particularly true in the case of the Texas lease, northwest quarter section 18, and the Skelley lease, southwest quarter section 24.

4. Discovery valuations claimed on areas that are practically surrounded by proven territory at date of purchase. This is specifically shown in the case of the Tidal lease, northeast quarter of section 24, where a discovery valuation is claimed on well No. 8.

5. Discrepancies in valuations allowed for operators or owners of an equal interest in the same wells and identical leases. This is particularly true in the case of the Foster and Norwood properties and also the Gypsy and the Phillips properties.

6. This study also shows how an individual oil pool may be blanketed by many discoveries. The discoveries shown on the accompanying map, which have been allowed by the department, are for the years up to and including 1920. It is therefore more than likely that additional discoveries will be claimed in later years for areas not yet blanketed.

7. This study reveals also the fact that the department is very much behind in its work, the majority of the leases herein mentioned being valued and adjusted for depletion purposes to the close of 1920, and in some cases for 1919 only.

The accompanying map gives the name of the operator who at the close of 1924 was reporting production to the Indian agency at Pawhuska, Okla. The majority of these leases were purchased in 1918 and 1919. In many cases there have been transfers of leases and reorganization of operating companies, so that it is difficult to follow all the leases through the various transactions when so much of the essential data are not available.

The date of original purchase and the bonus paid are given on the map in each individual case, as well as the gross production figures for all years to the close of 1924. The production by leases and years is given in Exhibit A. The line-shaded areas represent areas upon which discovery valuations have been allowed by the department, with the exception of well No. 8, northwest quarter section 24, wherein discovery valuation is claimed, but as yet has not been allowed, the case not being completed by the department. The areas that are shaded by dots indicate those areas which were proven by wells on adjoining property at date of acquisition. The tables which I submit give detailed notes with reference to each individual lease.

The first table gives the date of the completion of each of the wells that are shown on this map.

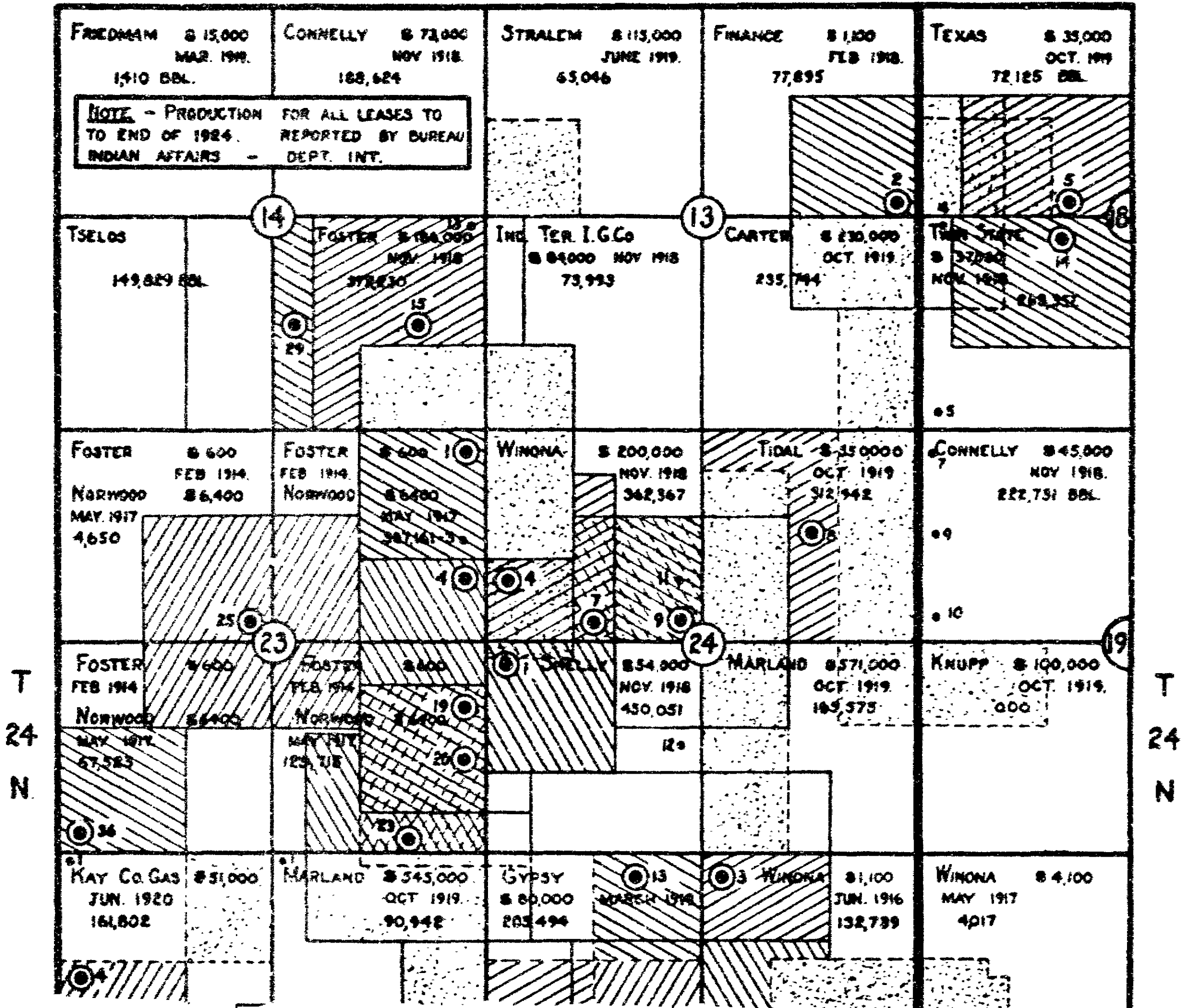
The second table gives the actual production to the close of the year, wherein the taxpayer has reported to the department, and in a parallel column is given the production reported by the Indian Bureau.

I am glad to state that in most cases the productions check very closely, so that I do not consider that we could have any misgivings as to the reports that are made to either bureau, so far as production figures are concerned.

As an example, I might state here that the Twin State on section 18 reports to the Income Tax Unit 181,384 barrels, and they report to the Indian Bureau 180,475 barrels.

Exhibit A and tables submitted by Mr. Fay are as follows:

OIL POOL NEAR WINONA OSAGE COUNTY - OKLA.



MAY 1917
4,650

Foster $600
Feb 1914
Norwood $6400
May 1917
67,583

Foster $600
Feb 1914
Norwood $6400
May 1917
123,115

May 1917
387,161

Shelly $54,000
Nov. 1916
450,051

Marland $571,000
Oct. 1919
165,575

Knupp $100,000
Oct. 1919
000

Kay Co. Gas $51,000
Jun. 1920
161,802

Marland $545,000
Oct 1919
90,942

Gypsy
$80,000
203,494

March 1916

Winona $1,100
Jun. 1916
132,739

Winona $4,100
May 1917
4017

Tidal
24,711 BBL

Tidal $215,000
Oct 1919
50,653

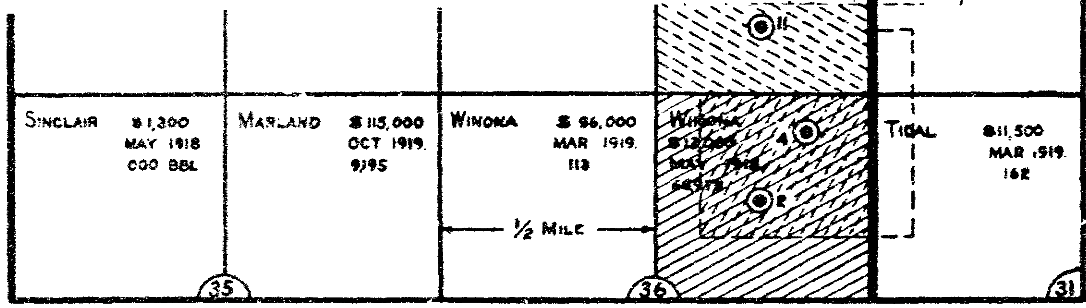
Winona
(Josey)
$11,300
May 1916
88,258

Winona $5850
Apr. 1916
134,025

Barnsdall — no bid
Apr. 1916
78,116

T 24 N.

T 24 N



92919—25. (Face p. 2898.)

Dates of completion of wells proving oil leases

Quarter section	Discovery No.	Well date	Other wells: Number	Other wells: Date
NE. sec. 13	2	June, 1919		
NW. sec. 18	5	September, 1920		
SE. sec. 14	15	July, 1919	13	March, 1919.
	29	April, 1920		
SW. sec. 18	14	July, 1920	4	September, 1919.
			5	October, 1919.
NW. sec. 23	25	March, 1920		
NE. sec. 23	1	September, 1918	3	October, 1918.
	4	January, 1919		
NW. sec. 24	[1] 4	April, 1919	11	July, 1919.
	[2] 7	May, 1919		
	[1] 9	June, 1919		
NE. sec. 24	8	March, 1920		
NW. sec. 19			7	September, 1919.
			9	Do.
			10	September or October, 1919.
SW. sec. 23	[1] 36	May, 1919		
	[3] 20	August, 1919		
	[1] 23	September, 1919		
SW. sec. 24	1	May, 1919	12	September, 1919.
NW. sec. 26	4	July, 1922	1	November, 1921.
NE. sec. 26			1	January, 1920.
NW. sec. 25	1	June, 1919		
	3	July, 1919		
	13	November, 1919		
NE. sec. 25	2	September, 1919	1	March, 1906.
SW. sec. 25			4	May, 1919.
SE. sec. 25	11	August, 1919	1	October, 1907.
			2	October, 1910.
NE. sec. 36	2	May, 1919		
	4	June, 1920		

[1] Foster. [2] Winona. [3] Norwood.

Comparison of net production as reported to Income Tax Unit and Bureau of Indian Affairs

Name	Lease	Period covered	Net production reported, Form O	Net production reported, Indian Bureau [1]
			Barrels	*Barrels*
Friedman	NW. 14	1922-1924	([2])	1,173
Connelly	NE. 14	1919-1923	([2])	157,185
Stralem	NW. 13	1920-1924	([2])	185,605
Finance	NE. 13	1919-20	25,199	24,713
Central States	do	1919-1921	([2])	24,713
Texas	NW. 18	1920	15,870	11,955
Toelos	SW. 14	1920-1924	([2])	124,855
Indian Territory	SW. 13	1919-1924	([2])	61,660
Carter	SE. 13	1919	1,137	
Twin State	SW. 18	1919-1922	181,384	180,475
Norwood	SE. 14 and 23	1918-1924	401,156	376,960
Foster	SE. 14	1919-1924	122,536	97,195
Do	Sec. 23	1918-1921	157,197	164,720
Winona	NW. 24	1919-1921	125,988	125,952
Foster	do	1919-1921	66,568	62,976
Potter	do	1919-1921	([2])	62,976
Tidal	NE. 24	1919-1923	210,724	221,955
Connelly	NW. 19	1919-1924	([2])	193,940
Skelly	SW. 24	1919-1921	245,899	295,570
Marland	SE. 24	1919-1922	111,635	116,150
Knupp	SW. 19		([2])	
Kay County	NW. 26	1921-22	60,540	60,005
Marland	NE. 26	1919-1922	63,110	61,545
Gypsy	NW. 25	1919-1922	71,086	72,745
Phillips	do	1919-1922	73,804	72,745
Winona	NE. 25	1919-20	31,195	39,005
Do	NW. 30	1921-1924	([2])	3,130

[1] The net production has been calculated on the basis of one-sixth royalty.
[2] No data.

Comparison of net production as reported to Income Tax Unit and Bureau of Indian Affairs—Continued

Name	Lease	Period covered	Net production reported, Form O	Net production reported, Indian Bureau
			Barrels	*Barrels*
Tidal	SW. 26	1922–1924	(2)	20,595
Do.	SE. 26	1920–1923	30,468	32,300
Winona	SW. 25	1919–1921	51,228	18,065
Do	SE. 25	1916–1921	121,413	109,660
Barnsdall	SW. 30.	1916–1924	(4)	65,095
Marland	NE. 35	1920–1922	5,665	5,625
Winona	NW. 36	1920–1924	(2)	95
Do	NE. 36	1919–20	34,329	34,567
Tidal	NW. 31	1919–20	264	135

[2] No data.

NOTE.—The gross production by leases and years as reported by the Bureau of Indian Affairs is given in Exhibit 10.

Senator WATSON. What I am wondering about in all of this is whether or not you claim that the Government has lost taxes, and if it is because of this condition that you recite. Has anybody failed to pay taxes that ought to have been paid?

Mr. MANSON. Where a discovery value was allowed that should not have been allowed, a greater depletion allowance, of course, is given than would otherwise be given, thus reducing the net income of the taxpayer.

Senator WATSON. Well, of course, that resolves itself, after all, into a technical question as to whether discovery value should or should not have been allowed.

Mr. MANSON. In the specific instances to which Mr. Fay will call attention, and which are set forth on this map, discovery values have been allowed on territory that was proven territory at the time the lease upon which discovery was allowed was claimed.

Senator WATSON. Well, I did not know about that.

Mr. MANSON. Which is in direct violation of the provision of the act.

Senator WATSON. I did not know that you were coming to anything like that.

Mr. FAY. I have been giving a description of each lease.

The CHAIRMAN. There can be no technicality about that. It is not questioned?

Mr. FAY. No.

The CHAIRMAN. And the act specifically provides it shall not be allowed.

Senator WATSON. Surely; I understand that.

Mr. FAY. There are one or two more of these production figures that I would like to give.

For instance, the Connelly lease, the northeast one-quarter section of 14–24–9. The Income Tax Unit has no data whatever on that production, but the Indian Bureau reports 157,185 barrels.

Mr. GREGG. May I ask a question right there?

Has the company been allowed any depletion?

Mr. FAY. Connelly has been allowed depletion on some other leases, on some other properties, but this specific property is not mentioned in Connelly's report.

Mr. GREGG. So he took no depletion on this property?

Mr. FAY. So far as I know, unless it is blanketed in somewhere else, but this individual lease does not appear in Connelly's report.

Mr. GREGG. Does the income from the lease appear in his report?

Mr. FAY. It does not. It may appear in gross income.

Senator WATSON. Are any of those properties in litigation out there to determine who owns them?

Mr. FAY. I think not. I do not think there can be any question on that, because they were bought direct from the Government.

Senator WATSON. I gathered from what you said at the beginning that there were conflicting titles.

Mr. GREGG. No; there have been transfers of property in reorganization, in selling a property to a purchaser.

The CHAIRMAN. I would like to get this straight in my own mind. You say that in this Connelly case this particular lease that you have just referred to does not appear, unless it appears in his gross income.

Mr. FAY. That is the only place it could appear, but there would be no way of identifying that.

The CHAIRMAN. In that case the bureau would not know whether this particular lease was reported or not, then, would it?

Mr. FAY. No.

Mr. GREGG. The point that I was going to bring out was that if he claimed a depletion as a deduction from income, he would have to show the production.

The CHAIRMAN. Yes; but he may not have reported that at all.

Mr. GREGG. He may not have reported the income from it.

The CHAIRMAN. Yes.

Mr. GREGG. Yes.

The CHAIRMAN. The bureau would not have known about that well if he did not report it under the procedure?

Mr. MANSON. However, the big point that I make in connection with this study, and the purpose of having the study made, was to ascertain whether or not the bureau maintained any system whereby, when a taxpayer claimed a discovery value, it could determine whether or not, under the law, he was entitled to it. In other words, it had no records which would show whether or not the territory upon which he claimed discovery value was proven territory at the time he acquired it.

Senator KING. Or, if they had no records, whether or not they made an independent investigation to determine it?

Mr. MANSON. Yes; or whether they had any system for the purpose of ascertaining whether or not they previously had allowed discovery value upon the same property; or, three, whether, if they had made a valuation of a particular well and a subsequent part owner of that well claimed a discovery value, it had any records or any system which would show to them the valuation that was already made on that original piece of property.

Those are the three points primarily that I desired to bring out by this study.

The CHAIRMAN. And the result of the study indicates that they have no system for that purpose?

Mr. MANSON. The result of the study indicates that they have no system for the purpose of developing such facts.

Go ahead, Mr. Fay.

Mr. FAY. The remainder of this report now takes up each individual lease, and you can follow it on the map there (Exhibit A). I will give you the number and the name.

L. Friedman Oil Co.: Northwest quarter of 14-24-9. This lease was purchased in March, 1919, at a cost of $15,000. At the close of 1924 one well had been drilled, with a gross production of only 1,410 barrels, as reported by the Bureau of Indian Affairs. The oil and gas section has no Form O data relating to this lease, although Friedman has filed the data relating to other leases.

E. L. Connelly: Northeast quarter of 14-24-9. This lease was purchased November, 1918, at a cost of $73,000. At the close of 1924 there were eight producing wells with a gross production of 188,624 barrels. The records of the oil and gas section show no Form O or data relating to this lease, although Connelly has filed data relating to other leases. The first well on this lease was completed prior to July, 1919, so that with production at that date there is no reason why Connelly should not have filed complete valuation and depletion data.

C. I. Stralem: Northwest quarter of 13-24-7. This lease was purchased in June, 1919, at a cost of $115,000, and at the close of 1924 had six producing wells and a gross production of 65,646 barrels. The department has no record of this lease. Well No. 1 was completed in February, 1920, which has given ample time for the taxpayer to have filed the necessary valuation and depletion data.

Finance Oil Co.: Northeast quarter of 13-24-9. This lease was purchased in February, 1919, for $1,100, to which some additional expense had been added, making the total cost $5,400. At the close of 1924 the property had three producing wells and a total gross production of 77,895 barrels. Well No. 1 was reported dry; well No. 2 (125 barrels) was completed June 13, 1919. The taxpayer has set up discovery on this well, claiming 46,500 barrels as reserves on approximately 50 acres. These reserves were allowed and a discovery value resulting in appreciation of $32,729 as compared with $53,745 claimed by the taxpayer. The discovery appreciation amounts to 70 cents per barrel for $2.25 oil. This discovery value is allowed on the basis of five-twelfths working interest.

The other five-twelfths working interest is owned by the Central States Oil Co., for which the department has no records.

Senator KING. Where are the other two-twelfths?

Mr. FAY. The Indians.

Senator KING. Oh, yes; I see.

Mr. FAY (continuing). The Texas Co.: Northwest quarter of 18-24-10. The lease was acquired for cash, $35,000, October, 1919. A portion of this lease was proven by well No. 2 of the Finance Oil Co., June 13, 1919. At the close of 1924 there were six producing wells with a total gross production of 72,125 barrels. Well No. 1 (40 barrels) was completed March, 1920, and well No. 2 (50 barrels) was completed March, 1920. These two wells were on the ground proven by Finance well No. 2 and are therefore depletable on cost.

Discovery was claimed and allowed on well No. 5 September 9, 1920, covering approximately 70 acres, the west edge of which overlaps the discovery area of Finance well No. 2 and Twin State No. 4.

The reserves claimed and allowed were 179,635 barrels. The discovery value and depletion claimed and allowed was $170,959, or 95.17 cents per barrel for $3.50 oil. Here the cost of 160 acres is being depleted against the reserves of approximately 70 acres. No reserves are estimated in the remaining north part of the 160 acres which has not as yet been drilled, but the entire cost is being depleted against the proven area. The depletion on cost amounts to 19.48 cents per barrel.

George Tselos——

Mr. GREGG. May I ask a question right there. On that lease well No. 5 was allowed discovery value. A part had been proved by Finance well No. 2 and part by Twin States well No. 14. Both of those had been brought in prior to the purchase of this lease?

Mr. FAY. They had.

Mr. GREGG. Is there any way of definitely determining that portion previously proved by those two wells was included in the valuation of well No. 5 of the Texas Co.?

Mr. FAY. The amount that was allowed the Texas Co. covers that shaded area of 70 acres. That is the amount that is allowed the Texas Co. I should say, without the actual calculation, that included about 35 acres of proven territory.

Mr. GREGG. It can not be definitely determined that that was included?

Mr. FAY. Sure; because it covers the 70 acres.

Mr. GREGG. The valuation?

Mr. FAY. The valuation.

GEORGE TSELOS. That is the southeast quarter of section 14.

Senator ERNST. The southwest.

Mr. FAY. It should be the southwest. That is right. I have no data as to the date when that was purchased, nor the cost. That was one of the cards that I overlooked when I was at the Indian Bureau to get a list of them. I missed that one, but it is small.

At the close of 1924 there were five producing wells, the gross production being 149,829 barrels. No records in the department regarding valuation, costs, or depletion.

Foster Petroleum Corporation, H. V. Foster, and Norwood Oil Co.: Southeast section 14-24-9. Records of the department do not contain any data relating to the Foster Petroleum Corporation, although the Indian Bureau reports the production of this property under the name of this corporation. This lease, however, the Indian Bureau records show, was purchased by H. V. Foster for $10,000 in May, 1918, but for some reason the lease reverted to the Government, and in November, 1918, it was again offered for sale and Foster and Norwood bid it in for $186,000. At the close of 1924 there were 15 producing wells, with a total gross production of 372,230 barrels. H. V. Foster has claimed and been allowed discovery valuation on wells No. 15 and No. 29, covering approximately 120 acres; the remaining 37 acres in the southeast corner was proven by well No. 1, which was drilled by Foster in the northeast quarter of section 23-24-9, so that this 37 acres was really proven ground at the time Foster purchased the lease in November, 1918. At the

time Foster filed his claims for discovery, 1921, he owned a one-half working interest, and the other one-half was owned by the Norwood Oil Co. H. V. Foster is given a discovery value of $180,092 for well No. 15 and $118,719 for well No. 29, or a total valuation of $298,811, which includes $93,000, the original cost of his one-half interest. The reserves claimed and allowed Foster for his one-half interest was 275,167 barrels for the discovery area and 58,195 barrels for the area (37 acres) proven at date of purchase. The Norwood Oil Co. set up its valuation on cost (December, 1918) $93,000, and has been allowed depletion on this basis only, no discovery being claimed or allowed. The Norwood Oil Co. received a depletion unit of 30.83 cents on cost, while H. V. Foster receives 33.8 cents on cost, plus 74.9 cents on discovery appreciation.

Mr. MANSON. There is a case where two interests each owned a half interest in the same property. One of them received a depletion of 30.83 cents and the other one something over a dollar.

Mr. GREGG. Did they acquire their interests at the same time?

Mr. FAY. They did.

The CHAIRMAN. Proceed, Mr. Fay.

Senator JONES of New Mexico. Before you proceed, let me ask you what system is adopted, or what plan is used for proving the area of determined territory, where there is a productive well brought in?

Mr. FAY. That is defined in the regulations, Senator; 160 acres square, with the well at the center, is defined as a proven area, and this is defined in the regulations.

Does that answer your question?

Senator JONES of New Mexico. It does in part, but why was a regulation of that kind adopted? What scientific fact authorized the adoption of such a regulation?

Mr. FAY. That was before my time in the department. It was brought out in one of our hearings heretofore. I do not know exactly how it was determined, Senator.

Mr. MANSON. We have maintained all the while that there is no scientific basis for any such regulation, and we discussed that question quite thoroughly in former hearings.

Senator WATSON. Yes; I remember about that. It has all been gone over.

Senator JONES of New Mexico. And the probabilities are that it can not be scientifically done. There is no proven area in reality, but it may be that they thought they had to adopt some standard.

Senator ERNST. Do you know the dates when they were applied? You were asked just now whether they were acquired at the same date or different dates.

Mr. FAY. Those were acquired on the same date.

Senator ERNST. Do you know what that date is? Have you any record of that? Does the map show it?

Mr. FAY. It only shows it for the month, Senator. I have marked that as November, 1918.

Senator ERNST. Then, down below there, you have May, 1917, in the southeast section.

Mr. FAY. That is another lease.

Senator ERNST. I see, and then you have February, 1914.

Mr. FAY. I think that is the date of purchase. That is the month, without the day.

Senator JONES of New Mexico. Then may I ask why these discovery values appear in some cases as 35 acres and in other cases as 70 acres, and why there is this varying acreage?

Mr. FAY. That can be very easily explained, Senator. When you drill a well in the center of 160 acres, it proves the entire 160 acres. You drill a well in a corner, which is away 300 feet from the boundary lines, that will prove so much of this lease as would be included in 160 acres square, with this well as a center, and on that basis it gives approximately 57 acres for that corner. It proves somebody else's ground over on the adjoining property.

Senator WATSON. That is, it gives 57 acres out of that particular 160 acres?

Mr. MANSON. Yes.

Mr. FAY. Fifty-seven acres out of the lease that is owned by those people who drill the well. Now, if you had drilled the well in the center of the south line, then you would prove 80 acres of the 160 acres. If you carried it three-fourths of the way up, you might prove approximately 120 acres.

Senator JONES of New Mexico. That is quite clear. Now, may I ask whether a record is kept of the remainder of the 160 acres which you say under the regulations that well had proved to be productive ground?

Mr. FAY. I might answer that in this way: While I was in the oil and gas section as a valuation engineer there were no records kept as to the extent of this proven area over on to somebody else's property. There were no records kept at that time.

Senator ERNST. What year was that?

Mr. FAY. In 1920.

Senator JONES of New Mexico. Are they now kept?

Mr. FAY. I do not like to answer that, becaue I am not sure of that. I do not believe that they are, but there may be something along that line.

Mr. MANSON. Our position on that, if I may interrupt, is this: That whatever records may be kept or whatever system may be followed is shown by the result of this study to be inadequate, because we do not claim that anybody has been derelict in duty here; that is, that any of these engineers who made the valuations are incompetent or that they have not done the best they could under the conditions; nor do we claim that any of them were corrupt or anything of that sort. But the whole purpose of the matter being presented this morning is to show that whatever the system is for checking proven areas or for checking to ascertain whether discovery is being claimed upon a proven area is an inadequate system, because——

Senator JONES of New Mexico. Well, right there, we might settle this thing in a short way.

Mr. GREGG. Is there any system of checking it?

Mr. FAY. I do not know, sir.

Senator JONES of New Mexico. Is there, Mr. Nash?

Mr. NASH. I beg your pardon?

Mr. JONES of New Mexico. Is there any system of checking these things in the bureau?

Mr. NASH. I do not know, Senator, whether there is or not. I am not familiar with the records that are kept in that division.

Mr. GREGG. We have just sent for the head of the oil and gas section. Neither Mr. Nash nor I are familiar with what records are kept.

Senator JONES of New Mexico. Then I will wait until the head of the oil and gas section comes.

Senator KING. I would like to ask Mr. Fay this question:

Do you think it is a sound or just policy to say, if you drive a well in the center of 160 acres and find oil, that that proves sufficient for taxable purposes the residue of that tract?

Mr. FAY. I question whether it does, because one well in all ordinary drilling operations will drain only 5 to 10 acres. That is all you can get out of one well.

Senator KING. Then, is it not a fact that perhaps two or three or four hundred feet away from a well which yields abundantly there may be——

Senator WATSON. You will get a dry hole.

Senator KING (continuing). There may be sand.

Senator WATSON. You can prove that by me.

Senator KING. You can prove it by your own experience?

Senator WATSON. Absolutely.

The CHAIRMAN. I would like to say in that connection that it has been testified previously that it proved several miles of territory.

Mr. FAY. No; I did not say it proved several miles, Mr. Chairman, and I did not mean to leave that impression. The point I made was that discovery should not be allowed within several miles of another well to prevent the extension of blanketing from one to the other.

Senator JONES of New Mexico. I think I might state here that in the Teapot Dome investigation it was contended by some very eminent people that a well had drainage for 9 or 10 miles away.

Mr. GREGG. Well, Mr. Fay just testified that a well drained 5 or 10 acres, and therefore only proved 5 or 10 acres. Senator, some time ago we went quite some length in explanation on this definition of discovery area. We were not entirely satisfied, but we had to have something more or less arbitrary. From Mr. Fay's testimony of a minute ago it seems that we have been too harsh in our definition.

Senator JONES of New Mexico. Under the general leasing law the geological structure is made the basis.

Senator KING. That is the only way.

Senator JONES of New Mexico. And it would seem to me that that is the only way, where a productive well is brought in, that the bureau should determine the extent, as far as geologists can do so, of the structure which is thus developed and discovered. An arbitrary 160 acres, it seems to me, can be supported by no logical reasoning or deduction.

Senator WATSON. On the other hand, Senator Jones, if you would undertake to follow an anticline you would have to follow a long way.

Senator JONES of New Mexico. That is true, but for the purpose of this law why should not that be done? If these people are going to take subsequent leases upon what the department says is a discovered structure, it does it knowingly, that as to that structure the department would consider that it has been proven territory, and that no discovery value would be permitted upon that structure, and it may extend 1 mile or may extend 10 or 20 miles, if your geologists

establish it as a structure. It seems to me that that is the only reasonable way that the matter can be studied, and when there is one well brought in then for the department to determine what is the extent, in its opinion, of that structure, and that that whole structure shall be considered as discovered territory and not have arbitrary lines of 160 acres, because that means absolutely nothing.

We know very well that in the Salt Creek field, for instance, when a few wells were brought in upon that structure, we knew within a reasonable degree of certainty the extent of the productive area, and it seems to me that this arbitrary fixing of 160 acres is all wrong, and that it can not be supported by anything except a mere arbitrary act.

Mr. MANSON. I do not believe that there are any cases where discovery is allowed by the bureau until a period of time has elapsed when actual drilling operations actually show the extent of the pool. In other words, the work of the department with respect to making these allowances and adjustments has always been so far behind that the extent of the area of oil pools has been actually demonstrated before the department was called upon to make the adjustment.

Senator JONES of New Mexico. Well, does not the statute fix the time within which this question of discovery value shall be ascertained?

Mr. MANSON. It fixes within 30 days of the discovery; yes.

Senator JONES of New Mexico. Yes.

Mr. MANSON. But I am talking now about the difficulty of defining the limits of the pool. I agree with the Senator that the geological structure is the only basis that can be used, but I do remark at this time that as a matter of fact, in the actual determination of these discoveries, whether or not a taxpayer is entitled to discovery at the time, the bureau knows the limits of the pool.

Mr. GREGG. The very obvious answer to that, Mr. Chairman, is that they may know it at the time that they value it, but we did not know it at the time that the other man made his discovery. That is the important point. We are looking at whether this property was proven at the time it was acquired. We can not look at events three or four years later to determine whether at that time in the past it was proven. I think that is rather plain. But on the question of the justification for the regulation we went into that a good deal, Senator Jones, before, and since that time I have found some memoranda in the files with reference to the Treasury decisions laying down that rule, giving the legal reasons for the 160-acre area, which, if the committee desires it, we can bring up and have it inserted in the record. Those files are quite voluminous.

Senator JONES of New Mexico. I should like a somewhat exhaustive study on that question, because I think it is very important.

Mr. GREGG. It certainly is very important, Senator.

Senator JONES of New Mexico. And if the Treasury Department is enforcing a rule which can not be justified from a scientific standpoint, of course the Treasury Department will be interested in changing the rule.

Mr. GREGG. We certainly should; yes, sir.

Senator JONES of New Mexico. I think it is a matter of very great importance.

Mr. GREGG. When we went into this matter previously, Senator Jones, we quoted from most of the leading authorities on oil matters to the effect that 1 or 2 or 3 or 4, or 4 or 5 wells will not prove the extent of an oil pool.

Senator JONES of New Mexico. That may be true: but, then, as a matter of practice, we know that in a field where one or two wells have been brought in people buy leases upon the theory that that is productive territory.

Mr. GREGG. Rather upon the hope. It is not proven yet.

Senator JONES of New Mexico. But they gamble their money on it.

Mr. GREGG. Yes, sir; they are gambling on it.

Senator JONES of New Mexico. And why not, as far as the Treasury Department is concerned; the Treasury Department has the benefit of that judgment of private parties in ordinary business transactions.

Mr. GREGG. I think that would require a change in the law. The law contemplates what property is actually proven—not what may possibly be shown but what is actually proven oil area.

Senator JONES of New Mexico. If the law is lame, let us consider a revision of that law, because in the general leasing act, I know there that it is the geological structure which is taken as the basis of known oil territory and unknown, and we are either doing wrong under the general leasing system or we are doing wrong here.

Mr. GREGG. I shall be glad, if the committee desires to go into that matter of the proven area under the existing law again, to submit everything that we have on it in explanation of our definition.

Senator JONES of New Mexico. Of course, if it has already been submitted, I do not want to duplicate the record. I have been absent, as you will know, for some little time, and I do not want to burden up the record with any duplication; but if it has not been put in here, I should like to have put into the record the reasons for this rule and also the reasons given for using the language which was used in the general leasing act, and the difference between the two, and why there should be any difference.

Mr. GREGG. That is the oil leasing bill of 1920?

Senator JONES of New Mexico. Yes.

Mr. GREGG. As I say, I have presented something on this for the department, but I have some more data which I have gotten since that time, and which I would be glad to put in and restate what was previously stated.

Senator KING. Would it not be a good idea also, Mr. Gregg, to have the Treasury Department, with its oil experts, review this question and the statute and the regulations and give us their mature judgment, first, as to whether they think the law is defective, and if so, in what respects, with their recommendations for changes; and, secondly, whether the regulations are just or unjust, and if the latter what recommendations they would make with respect to the modification or the complete change of the regulations.

Senator JONES of New Mexico. I think it is very important to have this statute construed with reference to the act of 1920, the general oil leasing act, because there the rights of the parties are fixed with respect to structures, and if they are not getting the discovery privilege on 160 acres, there is a reason for it.

As I recall, under that general leasing act you get a lease upon a certain area at 5 per cent royalty, but beyond—and I think it is beyond the 160 acres—you have to pay 12½ per cent royalty, because it is assumed that the land within that structure beyond the 160 acres has been discovered or made known as productive territory, for the purposes of the law at least, for the whole structure. Now, it certainly seems that those two statutes—the revenue statute and the general leasing act of 1920—should be construed together.

Senator WATSON. You are right about that, and I think it would be a good thing for the committee to go into the whole matter.

Senator JONES of New Mexico. Yes.

Senator WATSON. It is not only very important, but likewise very interesting.

Mr. GREGG. I should be glad to submit everything we have on it at as early a date as possible.

Senator KING. I think there is a feeling of great uncertainty among taxpayers, particularly oil producers, in regard to this method which has been adopted. I have not any concrete views myself, but I do think that in many instances the Government is being denied the just tax for many of these oil wells. I recently heard of a case where a man had made $3,000,000 in two or three wells which he had drilled and had not paid a cent of tax. It was all allowed as depletion and discovery, and yet it was within actually known fields. He received this deduction by way of discovery and depletion.

Senator JONES of New Mexico. We have one department of the Government—the Interior Department, for instance—establishing proven territory on one basis and the Revenue Bureau upon another basis, and the two ought to be brought together, it seems to me. Whenever the Interior Department, which has the granting of these leases, upon the public domain at least, decides that a given area is to be considered as proven territory, it seems to me that in some fashion that should be accepted by the Bureau of Internal Revenue.

Mr. MANSON. In addition to that, the United States Geological Survey keeps the records which would make the kind of duplication that we are bringing out here impossible.

The CHAIRMAN. May I ask at this point if, in view of this discussion, it is not possible for the bureau to further consider this matter before closing these many cases that are before the bureau?

Mr. GREGG. If anything is brought out, Mr. Chairman, which indicates that they are being closed in a wrong fashion, we will certainly stop closing them until we can get them on a right basis.

The CHAIRMAN. It seems to me that by this overlapping and this variation in valuations enough has been demonstrated to show that they have not been closed correctly.

Mr. GREGG. We want to see if there is some explanation of that. It looks on the face of it as if there was something to it, but we want to verify it from our own point of view.

Mr. MOSS. Mr. Chairman, if it is not improper now, I would like to inquire whether Mr. Manson and Mr. Fay have any suggestions in the way of remedy of what appears to be this morning a procedure which is not correct, so that we may have the advantage of their suggestions in preparing to meet the committee on it again.

Mr. MANSON. My suggestion along that line is this, that I believe that by a study of the modern tract index systems used for keeping track of real-estate titles a card system could be developed something along this line, that a card be made up for each quarter section in oil territory, that a taxpayer who expects to claim discovery value on any well be required to notify the department within a limited period of time as to when his well was brought in and that he expects to claim discovery value on it, describing his area, and that fact should be immediately entered upon the proper tract cards. If that be done, when any claim for discovery value is made, the fact is already noted on the card as to whether or not that is proven area. Furthermore, when a valuation is allowed within any quarter section, that fact should be noted. In that way, when you make a valuation for the undivided interest of A, and subsequently B comes along claiming a discovery in another undivided interest in that same property, your tract cards will immediately call your attention to the fact that you have made a valuation upon that property.

That strikes me—while I do not pretend to be an expert on this matter, and I do not pretend——

Senator JONES of New Mexico. Let me make a further suggestion: I have no doubt but what the Geological Survey undertakes to define every geological structure on which oil has been developed.

Senator KING. Private land, as well as public.

Mr. MANSON. Yes.

Mr. FAY. They have.

Senator JONES of New Mexico. Private land as well as public. They keep track of the production of oil all over the country and, unquestionably, they define, within reasonable limits, the extent of discovered or productive structures, and it may be that there is data in the Geological Survey which is already available to the Treasury Department; but if it is not, we ought to arrange in some way so as to make it available, and then, if that be done, whenever there is a new structure discovered, if the Geological Survey would define its boundaries for the benefit and use of the Treasury Department, and then keep the index system which Mr. Manson has just referred to, it would be an absolute check on the whole thing.

Senator KING. I am told that some of these large companies, as soon as there is a structure discovered, by wildcatting or otherwise, immediately have their experts go upon the ground, and they find out the geologic limitations of the structure and the course.

Senator JONES of New Mexico. The limitations of those structures are changing from time to time.

Senator KING. Yes.

Senator JONES of New Mexico. As subsequent developments would warrant.

Senator KING. And they keep very close tab upon these developments. They have their maps and they can tell pretty well the limitations of the structures. Of course, as you have said, there are subsequent borings, which oftentimes disclose that there is no oil, and sometimes the structure is much larger than originally anticipated; but certainly the Treasury Department, if it had a competent engineer in a field where they have an oil structure, could very quickly get a general idea, which would be sufficient to enable them to——

Senator JONES of New Mexico. We want to avoid the duplication of effort wherever possible, and if the Geological Survey is engaged in that business why should we not make this information from the Geological Survey available to the Treasury Department for its action, and let the Treasury Department rely upon the Geological Survey for information as to the extent of discovered territory? I do not see how this arbitrary 160 acres can possibly be justified.

Mr. FAY. Senator Jones, the Bureau of Mines is also doing some work along that line.

Senator JONES of New Mexico. Yes.

Mr. FAY. And the Bureau of Mines and the Geological Survey are working pretty much together and I think they are dovetailing their work to a considerable extent.

Senator JONES of New Mexico. Yes.

Mr. FAY. And I would suggest, in addition to the Geological Survey, you incorporate or take in the Bureau of Mines.

Senator JONES of New Mexico. I think again, in that case, if the Geological Survey and the Bureau of Mines are duplicating their effort, that ought to be stopped.

Mr. FAY. I do not think they are duplicating it. I think they are working together, Senator. The Bureau of Mines is taking over considerable of the production statistics, and the Geological Survey is dong the mapping of the geological structures. I think the two organizations are working pretty closely hand in hand, without overlapping. I know that is what they are trying to bring forth. They have been working along that line for a number of years, and I believe there is information in both of those bureaus that should be the basis for the Treasury Department's actions on discovery or proven areas.

Senator JONES of New Mexico. It seems so to me, that if there is valuable information there, it should be made available.

Mr. FAY. And that the information which is actually put out by the Geological Survey be accepted as authentic, and base the Treasury Department work thereon.

Senator KING. That is, authentic, prima facie?

Mr. FAY. Yes.

Mr. MANSON. Mr. Fay, do you know whether either the Bureau of Mines or the Geological Survey keep records of wells as they are brought in?

Mr. FAY. They did during the war period. I do not know whether they are doing it now or not. During the war period they had a map upon the wall that followed up the reports published in the Oil and Gas Journal and other oil papers, and every time they got a new well a new pin went into the map.

Mr. MOSS. Would it not be well to ascertain whether or not they are still doing that?

Senator JONES of New Mexico. I suggest that at an early date we had better ask the Director of the Geological Survey to come before us and tell us just what they are doing there.

Senator WATSON. Yes; that is a good suggestion. Get him up here.

The CHAIRMAN. You may go ahead, Mr. Fay.

Mr. FAY. This a continuation of H. V. Foster and the Norwood Oil Co.

Mr. GREGG. Mr. Thayer is here from the bureau, but I think we should have a little time to study this matter.

The CHAIRMAN. I was going to suggest that it might be well to have him hear this, so as to get the drift of it.

Mr. GREGG. Well, we will have it all in writing.

Senator KING. And I would like to have this printed as quickly as possible, because I would like to read it before the Director of the Geological Survey comes before us.

Mr. MANSON. I can furnish copies of this report to all members of the committee. If the members of the committee will keep those maps I will furnish the balance of the report, so that each member of the committee will have a copy of it. I will give you the maps and the copies then.

The CHAIRMAN. I think, in view of the fact that this may suggest some questions to be asked of Mr. Fay while he is here, we should proceed for a while and have him state some more from this list that he has just been presenting.

Mr. FAY. All right.

Section 23-24-9: The production from this section is also reported to the Indian Bureau as from the Foster Petroleum Corporation. H. V. Foster acquired his one-half interest in this section, 640 acres, February 4, 1913, for $2,400. The Norwood Oil Co. acquired its one-half interest in this same section May 1, 1917, for $25,600.

H. V. Foster and the Norwood Oil Co., therefore, own and control the working interest in all of section 23 and the southeast one-fourth of section 14, making a total of 800 acres, all of which has proven to be excellent oil property. There have been a number of discoveries set up on this area, both by H. V. Foster and by the Norwood Oil Co.

Senator KING. Is all of this Indian land?

Mr. FAY. Yes; it is all Indian land.

Senator JONES of New Mexico. By the way, I might suggest at this point that perhaps the Bureau of Indians Affairs has a good deal of information, or might be able to make some valuable suggestion, regarding these structures on Indian lands, as to how they are dealt with.

Mr. FAY. The Bureau of Indian Affairs has the production figures, and that is where I obtained my production figures for this study.

Senator JONES of New Mexico. On this main question, though, of discovery, whether or not the Indian Bureau has a practice there which has been enforced for a number of years, my recollection is that it has, that they have defined what is known as a productive area and what is known as a wild-cat area.

Mr. FAY. I think that has been defined for the Indian Bureau by the Geological Survey, both bureaus in the same department.

Senator JONES of New Mexico. That may be, but we wanted to ascertain the fact.

Mr. FAY. It would be worth investigating.

Senator JONES of New Mexico. Yes.

The CHAIRMAN. Finish your statement, please.

Mr. FAY. There have been a number of discoveries set up on this area, both by H. V. Foster and by the Norwood Oil Co. The valuation set up by Foster to January 1, 1921, including cost and dis-

covery appreciation for his one-half interest in this 800 acres allowed by the department, is $763,987.55, with the reserves of 667,598 barrels. The Norwood Oil Co. owning a like interest in the same 800 acres has been allowed a valuation, including cost and discovery appreciation to January 1, 1921, of $390,541.14, which is approximately one-half the amount allowed to H. V. Foster. The reserves allowed Norwood for the same tract was 501,867 barrels, or 166,000 barrels less than that allowed to Foster. The accompanying tables show the discovery valuation allowed Foster, as well as the discovery valuations allowed Norwood Oil Co. (See also Exhibits 2 and 3.)

Discovery valuations allowed H. V. Foster to January 1, 1922 (50 per cent working interest in 800 acres)

[SE. 14-24-9 and 23-24-9]

Discovery well	Date	Section	Price used	Discovery valuations	Acreage proven	Depletion unit [1]	Per cent of posted price	Reserves allowed
No. 1	May 19, 1918	NE. 23	$2.25	$50,352.10	61	$0.6874	30.5	73,241
Cost [2]	Nov. 15, 1918	SE. 14	....	21,500.25	37	.3695	....	58,195
No. 4	Jan. 27, 1919	NE. 23	2.25	156,113.35	55	1.1776	49.7	132,564
No. 19	May 23, 1919	SE. 23	2.25	69,232.87	60	.9452	42.0	73,241
No. 15	July 31, 1919	SE. 14	2.25	180,092.16	90	1.1348	50.4	158,696
No. 23	Oct. 21, 1919	SE. 23	2.50	58,960.13	37	1.2589	50.3	46,833
No. 25	Apr. 5, 1920	NW. 23	3.50	109,011.52	159	1.6380	46.3	66,552
No. 29	May 24, 1920	SE. 14	3.50	118,719.17	31	2.0371	58.2	58,276
Discovery valuations to Jan. 1, 1921			2.64	763,987.55	530	1.143	....	667,598

DISCOVERIES IN 1921

Discovery well	Date	Section	Price used	Discovery valuations	Acreage proven	Depletion unit	Per cent of posted price	Reserves allowed
No. 36	Nov. 8, 1921	SW. 23	$2.00	$92,080.52	57	$1.1602	58.0	79,348

[1] Cost plus discovery appreciation, not segregated.
[2] Cost of acreage in S. 14-24-9 proven at date of purchase, by well No. 1 in NE. corner of NE. ¼ sec. 23.

Discovery valuations allowed Norwood Oil Co. to January 1, 1921 (50 per cent working interest)

[SE. 14-24-9 and 23-24-9]

Discovery well	Date	Section	Price used	Discovery appreciation	Acreage	Depletion: Cost	Depletion: Discovery appreciation	Depletion: Total	Per cent of posted price	Reserves allowed
No. 1	May 19, 1918	NE. 23	$2.25	$15,568.65	61	$0.1816	$0.1104	$0.2920	.....	$140,975
No. 4	Jan. 27, 1919	NE. 23	2.25	97,799.40	55	.3083	.9755	1.2838	57.0	100,252
No. 15	July 31, 1919	SE. 14	2.25	26,500.00	90	.3083	.2650	.5733	25.4	100,000
No. 20	Aug. 6, 1919	SE. 23	2.25	15,585.60	80	.3083	.2834	.5917	26.2	55,000
No. 25	Apr. 5, 1920	NW. 23	3.50	28,207.14	159	.2176	.8059	1.0235	29.2	35,000
No. 29	May 5, 1920	SE. 14	3.50	88,280.35	31	.2176	.2497	1.4673	41.9	70,640

Total reserve allowed, $501,867.

Discovery appreciation	$271,941.14
Cost in 1918 (sec. 23)	25,600.00
Cost in 1919 (SE. ¼ sec. 14)	93,000.00
Total valuation	390,541.14

Senator WATSON. Did H. V. Foster and the Norwood Oil Co. own an equal interest in it?

Mr. FAY. An equal interest.

The CHAIRMAN. That is just the point. I thought Mr. Gregg wanted the head of the oil and gas section to tell the committee whether they had any system which would point out to them that variation in valuation for a half interest in the same property, it being clearly demonstrated in the case just specified by Mr. Fay that there were two valuations set up on the same property.

Mr. GREGG. I thought we would put in our whole answer at one time, after we had had time to study it.

The CHAIRMAN. I thought you were sending for the head of the oil and gas section to tell us.

Mr. GREGG. To hear this discussion.

The CHAIRMAN. I thought it was to answer as to the system. Mr. Fay said he did not think you had any system, and you sent for the head of the oil and gas section to tell us about that.

Mr. GREGG. We wanted him to hear the whole discussion.

Senator KING. If you do have a system, it is a very poor one.

Mr. MANSON. I say we only raise that question about the system. I do not want to be understood as saying that there is no system. My point is that if they had one it does not function.

Senator WATSON. What does that $600 mean there, and what does this $6,400 mean there [indicating on map]?

Mr. FAY. The $600 is the part that Foster paid for his quarter section in 1914. When Norwood bought in 1917 he paid $6,400 for his part, but it was before the discoveries came in. That is the same up there [indicating on map].

The CHAIRMAN. You may proceed with your statement, Mr. Fay.

Indian Territory Illuminating Gas Co.: Southeast one-quarter of 13-24-9. This property was purchased November, 1918, at a cost of $84,000. At the close of 1924 there were five producing wells with a total gross production of 73,993 barrels. There are no valuation and depletion data in the files of the oil and gas section.

Here is another little different case, which I do not imagine could be handled on any other basis.

Carter Oil Co.: Southeast one-quarter of 13-24-9. This lease was purchased October, 1919, for $270,000. A large portion of it was proven at the date of purchase. At the close of 1924 there were 16 producing wells and a total gross production of 235,744 barrels. The Carter Oil Co. owns five-sixths working interest and reserves of 245,267 barrels have been allowed by the department. The production figures from the Indian Bureau, together with undrilled area (four wells) indicate ultimate gross reserves of 534,000 barrels; approximately 100,000 barrels will be royalty oil. The department's production figures are for 1919 and 1920 only. On the basis of these reserves, the taxpayer is depleting on cost which gives a depletion unit of $1.10 per barrel. No discoveries were claimed or allowed. At the time the Carter Co. purchased this lease the Twin State Oil Co. had completed its wells Nos. 1 and 4. No. 4 was adjoining the property purchased by Carter and would prove about 38 acres of the Carter tract. The property on the north owned by the Finance Oil Co. had completed its well No. 2, which would also prove about 40 acres of the Carter tract, so that it may

be considered that the Carter Co. purchased proven ground. Depletion units later than 1919 have not been established by the oil and gas section.

That has been established on the basis of cost, without claiming discovery.

The CHAIRMAN. What became of the other sixth?

Mr. FAY. That is the royalty oil, Mr. Chairman.

The CHAIRMAN. I see.

Mr. FAY. Five-sixths represents the full working interests in all cases of these leases.

Twin State Oil Co.: Southwest one-quarter 18-24-10. This lease was purchased November, 1918, for $37,000 and at the close of 1924 had 13 producing wells and a total gross production of 263,351 barrels. The Twin State Oil Co. sets up discovery valuation on well No. 1 about 42 acres, and on well No. 4 of about 42 acres. The reserves claimed and allowed the taxpayer are 251,661 barrels, which gives a discovery appreciation of $62,832. Basing ultimate gross reserves on Indian Bureau data to close of 1924, the total should be slightly in excess of 400,000 barrels, of which one-sixth is royalty. The depletion unit on cost of 14.68 cents and on discovery appreciation, 24.94 cents per barrel, or a total of 39.62 cents. The Twin State Oil Co. owns full working interest. Depletion units have been determined to close of 1922.

H. V. Foster, Winona Oil Co., Potter Oil Co.: Northwest 24-24-9. This lease was purchased November, 1918, for $200,000 and to the close of 1924 has had twelve producing wells with a total gross production of 362,367 barrels.

Senator ERNST. This says 1918 here. Is that the date you mentioned?

Mr. FAY. November, 1918; yes.

Senator ERNST. I thought you said 1919.

Mr. FAY. 1918.

H. V. Foster owns an undivided one-fourth working interest, the Winona one-half working interest, and the Potter Oil Co. one-fourth interest. At the time this lease was purchased approximately 80 acres on the west side had been proven by well No. 3 of Foster and Norwood in section 23. Foster recognized 81 acres as proven but he sets up discovery valuation on wells No. 4 and No. 9, blanketing the remaining 79 acres.

Senator WATSON. Let me ask you right there. You say he sets up 81 acres as proven. That was just a mere statement, or is some reason given? How could he set aside 81 acres and claim that that is proven and nothing else is?

Mr. FAY. That was proven by an adjoining property, where they overlapped on to this property.

Senator ERNST. You can see that from the map.

Mr. FAY. The map shows that.

Senator ERNST. It is very clear.

Mr. FAY. This is the section here [indicating on map]. This portion [indicating on map] when they started in was proven territory.

Senator WATSON. That is, it was proven under this ruling?

Mr. FAY. Yes.

The value of the entire lease allowed Mr. Foster by the department on cost and these two discoveries was $123,369.58, including cost of $50,000, which represents a discovery appreciation of slightly over $73,000, on 79 acres. The depletion unit amounts to $1.16 on $2.25 oil, or 51.8 per cent of posted price.

The Winona Oil Co. which owns an undivided one-half working interest in this same land has been allowed discovery on well No. 7 (see map) resulting in discovery appreciation of $60,307, on a lease that cost $100,000. The value therefore allowed the Winona Oil Co. is $160,307 for one-half, as compared with $123,369 to Foster for a one-fourth interest.

The CHAIRMAN. That is a ridiculous situation, it seems to me.

Senator KING. Is there anything to indicate why there is such a disparity?

Mr. FAY. No; there is not.

The Potter Oil Co., owning an undivided one-fourth, is a subsidiary of the Barnsdall Oil Co. The latest Form O data available on the Barnsdall Oil Co. was received February 11, 1924, and contains data on depletion from 1913 to 1918 only. This information does not apply to the lease in question, as no wells were drilled until 1919. Therefore no comparison of the value of this one-fourth interest can be made with the values already allowed the other one-fourth and one-half interests.

Senator KING. Have you brought in, Mr. Fay, any of these companies down to date?

Mr. FAY. Down to——

Senator KING. To 1924.

Mr. FAY. Oh, no.

Mr. MANSON. He could not, because the department has not acted.

Mr. FAY. The department has not acted, and on many of them their production figures to the department only extend up to, perhaps, 1922. It takes them about a year to make up their report after the year has closed.

Senator KING. Have you examined the returns for any of these companies for 1923 or 1924?

Mr. FAY. No; I have not.

Senator KING. I should be glad to know from somebody what returns are being made now by some of these companies.

Mr. GREGG. I do not think that would be helpful, Senator King, because the returns would be unaudited; so I do not think there is any use of checking them up past the point where we have acted on them.

Mr. MANSON. That was my theory. You certainly were not bound by what the taxpayer might claim.

Senator KING. I was interested in knowing what the basis of computation was upon which these taxpayers act in their recent returns. I should be glad, for my own information, if none of the other members of the committee want it, if two or three returns could be furnished us by the department to show just how they are treating the valuations where they have had these large discoveries.

Mr. GREGG. The taxpayer is treating them in the same way as he did for prior years.

Mr. MANSON. Yes, sir; depletion has been fixed on the basis of those valuations. That goes on until the properties are exhausted.

Mr. GREGG. It goes on, and automatically applies for subsequent years. Of course, properties may be revalued.

The CHAIRMAN. What I wanted to know was whether the bureau could not stop the practice, now that the absurdity of the results have been pointed out?

Mr. GREGG. But I hope the chairman and the committee will withhold judgment as to the absurdity of the results until we have gone into it ourselves.

Mr. MANSON. They get more than 60 per cent of depletion in the first calendar year after the well is discovered. Probably the next year it will run to 15 or 20 per cent; so that within two calendar years from the date of discovery, namely, by 1920 or 1921, you have exhausted practically all of the depletion that has been allowed.

Senator KING. I think you will find some other claims made, which result in diminishing returns, some of which, I think, ought to be paid to the Government.

Mr. MANSON. What really happened is this: I expect that you will find some blank spaces on this map filled up with discovery values by the time the 1924 returns have been acted upon.

Senator KING. And all of those blank spaces have been allowed discovery value?

Mr. MANSON. Well, if the same policy is pursued in the future that has been pursued up to the date as of which this map is made, it will fill in the blank spaces on this map.

Mr. FAY. E. L. Connelly: Northeast one-quarter 19–24–10. Lease was purchased by D. R. Travis and the Testlog Oil Co., November, 1918, for $37,000. The property is operated by E. L. Connelly, who has reported to the Indian Bureau 12 producing wells and a total gross production of 222,731 barrels to the close of 1924. The first production was reported from this property in 1919, thus giving Connelly ample time to file the necessary depletion data. Also, Travis and the Testlog Oil Co. should show what disposition was made of this property and whether or not there was any taxable profit to them when Connelly acquired it.

On the basis of production reported to the Indian Bureau, and assuming that eight more wells will be required to complete the drilling program, the ultimate gross reserves should be 350,000, of which approximately 65,000 barrels will be royalty oil. Connelly has filed depletion data relating to other leases, but did not include this lease.

Skelly Oil Co., W. G. Skelly: Southwest one-quarter 24–24–9. This property was purchased by W. G. Skelly November, 1918, for $54,000 bonus, plus $13,203 other expenses. At the close of 1924 there were 23 producing wells with a total gross production of 450,051 barrels. This lease not being proven at date of purchase by Skelly, a discovery valuation has been allowed him based on reserves of 340,000 barrels, the total valuation for the discovery area being $337,216, representing a discovery depletion unit of 1.17 cents per barrel, which has been used for depletion purposes on the personal returns for W. G. Skelly. In the latter part of 1919 the lease was transferred to the Skelly Oil Co., and from that date the case has not been worked by the department.

Guffey & Gillespie (copartnership); Guffey-Gillespie Oil Co. (corporation); Tidal Osage Oil Co.——

Mr. MASON. What is the description of that property, Mr. Fay?

Mr. FAY. There are four or five of them. They are all listed under the word "Tidal."

Mr. MANSON. Oh, yes.

Mr. FAY. The Tidal Osage Oil Co. is an outgrowth of the Guffey & Gillespie Oil Co. reorganization. I have a page of history on that.

Prior to September, 1918, E. N. Gillespie and associates, one of whom was Mr. Guffey, were operating in Oklahoma as a copartnership, and held under lease 13 producing oil and gas properties, comprising 2,520 acres, and 27,928 acres of undeveloped territory in Oklahoma, Kansas, and Mississippi.

Senator KING. All Indian lands?

Mr. FAY. No.

Senator KING. Is any part of them Indian lands?

Mr. FAY. The five quarter sections that I have here were purchased after this reorganization, but were purchased by Guffey and Gillespie as individuals.

The taxpayer's (Guffey-Gillespie Oil Co.) valuation report, volume No. 1, page 1, states that the Guffey-Gillespie Oil Co. was incorporated September 13, 1918. The holdings of the copartnership, as enumerated above, were taken over by the corporation September 1, 1918—I do not know how they could be taken over, although this was before they were incorporated—at a value of $6,292,202. In addition, certain miscellaneous assets were acquired, which increased this amount to $7,955,260. For the total assets 220,000 shares of common stock of Guffey-Gillespie Oil Co., at an arbitrary value of $25 per share, were issued to E. N. Gillespie and his associates.

The jurat accompanying this valuation report is signed by Dickson Q. Brown as vice president of the Tidal Osage Oil Co., formerly the Guffey-Gillespie Oil Co. The valuation report of the Guffey-Gillespie Oil Co. covers the period from September 1, 1918, to August 31, 1920. It contains no mention of the organization of the Tidal Osage Oil Co. as the successor of the Guffey-Gillespie Oil Co. Inasmuch as this valuation report contains data to August 31, 1920, it is presumed that this date ends the existence of the Guffey-Gillespie Oil Co. and that later valuation and depletion data will be submitted by the Tidal Osage Oil Co.

The records of the department show that the Guffey-Gillespie Oil Co. as an operator and successor to Guffey & Gillespie has not been closed.

Inasmuch as there have been two transfers of this property through reorganization, and the fact that these transactions are more than five years old, the last of which occurred in 1920, the complete files of the three various owners should be handled jointly. It is barely possible that the valuation reports relating to the Tidal Osage Oil Co. are being withheld for the purpose of establishing values, or possibly some other precedent in the Guffey-Gillespie Oil Co. case which would have an important bearing upon the tax status of the successor, the Tidal Osage Oil Co.

Now, I have here a description of the individual leases.

Northeast one-quarter 24–24–9: Lease was originally purchased by Guffey and Gillespie October 27, 1919, for $550,000. At the time of purchase, approximately 125 acres had been proven by surround-

ing wells, the Winona lease adjoining on the west had one productive well near the boundary line and the Connelly lease adjoining on the east had production near the eastern boundary of the Guffey-Gillespie tract.

At the close of 1924 there were 12 producing wells with a total gross production of 312,942 barrels. The taxpayer estimates his reserves as 332,967 barrels and claims discovery on well No. 8 as per accompanying sketch map in the center of the section on an area of approximately 35 acres, technically not proven, although bounded on two sides by proven territory at date of purchase.

Senator ERNST. What section is that?

Mr. FAY. Section 24 of the northeast quarter.

Senator ERNST. Yes; I have it.

Mr. FAY. There is also a small area in the extreme northwest corner of the lease, which comes within the discovery area of well No. 8. From data supplied by the Indian Bureau, plus the production of eight additional wells, the ultimate gross reserves should be about 561,000 barrels, of which approximately 100,000 barrels will be royalty oil. Regulation 65, article 222 (2):

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

The taxpayer purchased this lease after the area (overlapping and surrounding area proven by well No. 8) had been proven by other wells adjoining. The application of the above regulation would preclude discovery valuation.

This case has not yet been closed.

Although the property cost $550,000 cash in 1919, and was to all intents and purposes proven territory, the taxpayer claims discovery as above stated. The case has not been closed by the oil and gas section for the year 1919, so that this discovery claim is still pending.

Southwest one-quarter 26-24-9: The valuation report supplied by the taxpayer fails to show any information relating to the date of purchase and the operations conducted on this particular lease. From data secured from the Indian Bureau there were at the close of 1924 two producing wells with a total gross production of 24,711 barrels. Whether any discoveries have been claimed is not known. The first production was in 1922, and the taxpayer's valuation and depletion data end August 31, 1920. No doubt a discovery claim may be set up at a later date.

Southeast one-quarter 26-24-9: Guffey-Gillespie Oil Co. purchased this tract October, 1919, at a cost of $215,000. A portion of this tract was proven by Winona Wells at date of purchase. To the close of 1924, there were six wells with a total gross production of 50,653 barrels. The first well was completed February 11, 1920, with an initial daily production of 50 barrels. The taxpayer sets up ultimate net reserves of 50,945 barrels, which he depletes on cost at the rate of $4.853 per barrel. Development expenses are capitalized and depreciated at $1.358 per barrel.

Based on Indian Bureau records and a completed drilling program, the total gross reserves should be approximately 170,000 barrels of which about 27,000 barrels will be royalty oil, which would result in a depletion unit of about one-third that claimed.

Northwest one-quarter, 31-24-10: This 160-acre lease was purchased by Guffey-Gillespie Oil Co., March, 1919, for $11,500. To the close of 1924 only one well had been drilled thereon, with a total gross production of 162 barrels. The first well was completed August 31, 1920. Apparently this well did not flow long as the taxpayer sets up ultimate reserves of only 264 barrels. The taxpayer capitalized drilling expenses, which he depreciates at the rate of $49.64 per barrel——

Senator JONES of New Mexico. How much per barrel?

Mr. FAY. $49.64.

Senator JONES of New Mexico. Right there——

Mr. FAY. And depletes his oil reserves on cost at $77.92 per barrel, Senator Jones.

Senator JONES of New Mexico. Oh, I see.

Senator KING. That would be over a hundred dollars a barrel.

Mr. GREGG. He only got 264 barrels out of the well. He is entitled to get back against those 264 barrels his cost. He got stuck and was taking out his costs.

Senator JONES of New Mexico. I was going to inquire whether, in making his returns for these various wells, some of them highly profitable, he charges up that difference there between the value of that oil and the hundred dollars a barrel which it cost him. What does he do with that?

Mr. FAY. He charges that off as a loss during that operating year.

Mr. GREGG. Isn't that right, Senator?

Senator JONES of New Mexico. I just wanted to know what the fact was and why he should put in that sort of a statement, if it was put in for the purpose of being allowed as a loss as against income from other properties?

Mr. MANSON. You see, if that was discovery value—this is not discovery value that he is depleting—he could not deplete it. He would not pay more than 50 per cent of the income from that well.

Senator KING. Under the present law?

Mr. MANSON. Under the present law.

Senator KING. But not the law when the return was made?

Mr. MANSON. No.

Senator JONES of New Mexico. If this discovery value was established within the 30 days as declared by the law, what effect would that have on the taxpayer's return?

Mr. FAY. The chances are that if that valuation had been actually set up at that time he would have had a much larger valuation set up, and the depletion unit would have been much smaller, but he has waited six or seven years, and has found out that there are only 264 barrels, and therefore it is all depleted on cost.

Senator JONES of New Mexico. Does the taxpayer have a right to make a choice as to whether he shall get depletion on cost or discovery? Has he a choice in the matter?

Mr. FAY. The first choice is on cost.

Senator JONES of New Mexico. Well, the question is whether he has a choice at all or not.

Mr. FAY. The law allows him to deplete on cost specifically. That is specifically stated in the law, that he can deplete on cost. Then, if discovery comes in, and if the value estimated at that 30-day period is considerably in excess of cost, or disproportionate to cost, then he can deplete on discovery instead of cost.

The CHAIRMAN. So he does have the option?

Mr. FAY. Yes; he would in that case.

Senator WATSON. Within that period?

Mr. FAY. Yes.

Senator KING. May he do it five years later?

Senator JONES of New Mexico. That is another point that I want to bring out.

Mr. FAY. Senator Jones, I have one or two cases that we have already compiled data on relating to that very point, which will probably be brought out, wherein valuation for discovery is set up in 1914 and 1915, with complete production figures to the close of 1922, and which are reflected back to 1914, and the only guess that we have to make as to future production is the remaining life of those wells after they have been producing 10 years. Those cases will be presented.

Senator JONES of New Mexico. All right.

Senator KING. Have those cases been settled; that is to say, has the taxpayer made a payment for 1918 upon the basis that you find his returns indicate?

Mr. FAY. I could not say that, Senator.

Senator KING. Has he made any payment at all?

Mr. FAY. He makes his initial payment when he files his return.

Senator KING. And that initial payment is based upon the return, is it?

Mr. FAY. That initial payment is based upon the return, and in many of these cases reassessment letters have been issued to taxpayers, showing their tax status. Is that right, Mr. Gregg?

Mr. GREGG. I imagine so.

Mr. MANSON. Where the depletion has not been determined by the bureau, you call attention to it in your notes, do you not?

Mr. FAY. Yes, sir.

Mr. MANSON. And in the other case, your figures refer to depletion allowances fixed by the bureau?

Mr. FAY. Yes. Where I have given depletion, it has reference to depletion that has been allowed by the oil and gas section, and on the basis of that the case will be audited or has been audited, and the taxpayer notified of the results.

Mr. MANSON. You would not have run these cases down if they had been finally closed?

Mr. FAY. No.

Mr. MANSON. As I said at the outset, the purpose of this whole study was to suggest a system to the oil and gas section.

Senator KING. Let me see if I understand it. In these cases that you are now presenting, Mr. Fay, does it show that the oil and gas section of the Income Tax Unit has examined the returns and has

approved or disapproved, and, if the latter, has made the assessment calling for an additional payment?

Mr. FAY. As far as I have gone, Senator King, these figures are based on the approval or disapproval of the oil and gas section, with what information they had at hand up to the close of 1919 or 1920, as the case may be. Now, I did not follow the cases any further than that, because I had my hands full with this one question.

Senator KING. You may have answered my question, but if so, I do not understand. Have they accepted these returns that have been filed?

Mr. FAY. Has the department?

Senator KING. Has the department accepted them? Is there anything to show that they accepted them, or that they made their subsequent assessments?

Mr. FAY. Oh, the depletion units of these valuations have been accepted or determined by the department, and on the basis of this determination the assessments will be made or have been made.

Mr. MOSS. And in each case you show by your notes, do you not?

Mr. FAY. Yes.

Senator KING. In any case, have they accepted the returns made and accepted the taxes paid and closed the case?

Mr. FAY. Oh, I could not say that.

The CHAIRMAN. In other words, Senator King, the engineering section of our investigating staff does not follow through to the audit section and a final closing. They point out what they find in the engineering section.

Senator KING. Yes; I know; but I was just wondering whether the engineering section's investigations would show whether any of these cases have been settled.

Mr. FAY. No; they would not.

The CHAIRMAN. In these particular cases they point out these cases have not been finally closed, but they went to the auditing division, and what may be done with them after that the engineering section would not know.

Mr. MANSON. In the natural course of events the auditing section, which would take up these cases after the oil and gas section had disposed of them, would have no facilities for setting aside anything——

The CHAIRMAN. They just compute the tax.

Mr. MANSON. They just compute the tax on the depletion units fixed by the oil and gas section.

Senator KING. I would like to know whether the department has accepted these depletion units which the taxpayers have submitted.

Mr. MANSON. In some instances, these are units fixed by the taxpayers, and in some instances by the department; but unless the contrary is shown in the notes in Mr. Fay's report, they have been either accepted or fixed by the taxpayer or determined by the oil and gas section.

Senator KING. Let me ask you this: From your examination of these and other reports or returns made by taxpayers of oil wells, do you find that, in the main, the returns made by the taxpayers have been accepted for depletion?

Mr. FAY. Not in full; no. Where the returns relate to production and reserves and the depletion unit came within what the oil and gas section has considered a reasonable allowance for depletion, they have accepted them, but in many cases I have come across where a taxpayer will claim $2 depletion and the unit has cut it down to a dollar and a half or a dollar and a quarter, or some other figure, revising it downward. Is that right, Mr. Thayer?

Mr. THAYER. That is correct.

Mr. FAY. I do not believe I have found any case where they have revised it upward.

Barnsdall Oil Co.: Southwest one-quarter 30-24-10. The records supplied by the Barnsdall Oil Corporation are for 1918 and previous years and data relating to the purchase and operations of this lease do not seem to be in the records. This lease was put up at auction in April, 1916, but at that date no bid was received for it. Apparently it was purchased at a later date.

In April, 1916, there were one or two very small wells on the property, which, by reason of their smallness, prevented anyone bidding on the property. At the close of 1924, there were seven producing wells on the property and a total gross production of 78,116 barrels. The records do not show that any discoveries have been claimed or allowed.

Sinclair Oil & Gas Co.: Northwest one-quarter 35-24-9. The Sinclair Oil & Gas Co. purchased this lease May 19, 1918, at a cost of $1,300. To the close of 1924, the Indian Bureau records show that there has been no production nor does the oil and gas section of the Income Tax Unit have any records regarding this particular lease.

Kay County Oil & Gas Co.——

Senator KING. Let me interrupt you here.

Mr. FAY. Yes, sir.

Senator KING. What was your purpose in furnishing us with that particular report?

Mr. FAY. To fill out the block.

Senator KING. Oh, I see.

Senator ERNST. He has covered this entire section.

Mr. FAY. I just wanted to make a complete study of one geographic area without leaving out anybody or without being prejudiced for or against anybody in any way, shape, or form.

Senator JONES of New Mexico. This whole report deals with just one structure and probably only a portion of the structure.

Mr. FAY. The producing area extends some distance to the north of this, but there is very little production on either the west or the east of it and none on the south of it immediately adjoining.

Senator JONES of New Mexico. We find this situation with respect to this structure. Now, have you made even a cursory examination of any other structures?

Mr. FAY. I have not. I have selected this structure at random, because it was a place where I was able to get a solid block, knowing the purchase price of the leases and the total production, and I could not have selected any other area as typical of the oil industry where I could get so much information or which would dovetail together as I got in Osage County, Okla. I could not have done

that if I had taken any other county, or had taken one in West Virginia or some other place. I would not have been able to get the production figures by quarter sections or by farms.

The CHAIRMAN. That was because it was not on file in any other Government bureau?

Mr. FAY. It would not be on file in any other Government bureau on that basis, but this is controlled by the Interior Department, Indian Agency, and that is why I selected that group.

Senator KING. In order to determine the method of treating these cases down there, do you not think you ought to make a study of a few isolated cases, say, in Texas, on private lands, not Government lands?

Mr. FAY. If we had time to do it, Senator.

Mr. MANSON. It has been a tremendous job to do this.

Mr. FAY. I have worked on this for the last month.

Senator KING. I would like to ask Mr. Thayer to furnish us some information, if we have to call some of these men and bring up a number of cases from Texas and California and Oklahoma on private lands.

Mr. GREGG. The committee has already taken up some of those. They took up 10 or 15 leases of the Gypsy Oil Co. and the Black and Simons case, and from what Mr. Fay said a few moments ago he has a few more isolated cases.

Mr. MANSON. We tried to produce this from two angles. For instance, we had the Gypsy case. There is a case where a lot of leases are owned by the same company but scattered over a great area. In this instance we have taken a compact geographical area, where leases are controlled by different people; and I want to say in that connection that in working up this case it has been necessary to go to the reports of all of these taxpayers and search through those reports to find whether or not the data are given for this particular lease. It has been a tremendous job to work up this one alone.

The CHAIRMAN. You may proceed, Mr. Fay.

Mr. FAY. Kay County Oil & Gas Co.: Northwest one-quarter, 26-24-9. The taxpayer purchased this lease in June, 1920, at a cost of $51,000. At the date of purchase between 35 and 40 acres were proven oil land in the northeast quarter of the lease, having been proven by a Marland well in the northwest corner of the Marland lease adjoining on the east. At the close of 1924 there were 10 producing wells on the property with a total gross production of 161,802 barrels. The reserves claimed and allowed the taxpayer were 159,580 barrels. Basing the ultimate reserves on the production as reported by the Indian Bureau to the close of 1924, and assuming that 10 additional wells will be drilled on this property, each of which has a productivity of 50 per cent of the average of the first 10 wells, there should be approximately 374,000 barrels gross reserves. Of this amount 55,000 barrels will be royalty oil, leaving the taxpayer's reserves as approximately 318,000 barrels as compared with 159,580 barrels claimed and allowed.

Mr. GREGG. May I interrupt? If these reserves were increased to that extent, would the net discovery valuation of the taxpayer be increased proportionately?

Mr. FAY. Part of it would, but then if he has the reserves, why not increase it?

Mr. GREGG. That is the point I wanted to bring out.

Mr. FAY. I would not object to increasing it if he had the reserves; but the point is this, that this man set up his reserves as of 30 days after discovery, and he did not get as many reserves as four years' production later on showed. That is the point I want to bring out here, and that many of the values for 1914, 1915, and 1916 are actually based on 5 to 10 years' production subsequent thereto.

To the cost of the lease the taxpayer has added development expenses to the extent of $48,379, which he depleted. The total depletion unit on cost is 66.49 cents per barrel.

The taxpayer claims a discovery in well No. 1, northwest corner of the lease, which is an offset well to Foster No. 36. The Foster well had an initial production of 200 barrels per day, while the Kay County well No. 1 was reported at 165 barrels per day. Each of these wells proved 57 acres in the respective lease and both were the same depth, namely, 2,146 feet. The date of completion of Kay County well was November 14, 1921, and Foster No. 36 November 8, 1921. The gross reserves estimated by Kay County for the discovery well is 19,982 barrels. The gross reserves set up by Powell for the Foster well was 47,612 barrels. The net reserves based on five additional wells for Kay County and three additional wells for Foster gave Kay County 79,098 barrels net reserves for a five-sixths working interest, while Foster is allowed net reserves of 79,348 barrels for five-twelfths working interest. The estimated development expenses for the Kay County discovery area are $79,670 as compared with $23,180 set up for Foster's one-half interest.

Foster's half interest is an adjoining lease. They are offset wells, these two that I am discussing here. The net discovery value claimed by Kay County was $34,679 and Foster (one-half interest) $164,000. The net value allowed Kay County for its five-sixths working interest was cost, namely, $18,389, while Foster was allowed $92,060 for one-half interest.

The CHAIRMAN. Five-sixths or five-twelfths?

Mr. FAY. Five-sixths.

The discovery appreciation claimed by Kay County was $16,388 and Foster $163,787. No discovery appreciation was allowed Kay County, while Foster was allowed $91,874.

The valuations of these two properties were based on the same market price of oil, namely, $2. It is to be admitted that the Kay County well was not quite as large as the Foster well, yet neither could be considered an exceptional well. There was not sufficient difference in the initial production of these two wells to justify the difference in valuation of these two discovery claims for adjoining offset wells.

Senator ERNST. Have you the figures to which you refer? You say they were gotten up on the initial production.

Mr. FAY. Yes; one was 165 barrels and the other was 200 barrels.

The reserves set up by Engineer Ligon for Kay County were based on three additional, each being 100 per cent of No. 1, and two wells, each at 75 per cent of No. 1. The reserves for Foster were based on three additional wells, each at 100 per cent of No. 36.

Kay County Oil & Gas Co.

	Five-sixths working interest, valuation by Ligon	Five-twelfths working interest, valuation by Powell
Cost June, 1920	$18,389	$213
Acres	57	57
Depth, feet	2,146	2,146
Date discovery	Nov. 14, 1921	Nov. 8, 1921
Initial production, barrels	165	200
Reserve (gross) discovery well	10,982	47,612
Number of additional wells	5	3
Net reserves, barrels	79,098	79,348
Estimated development	$79,670	$23,180
Net value claimed	$34,679	$164,000
Net value allowed	$18,389	$92,060
Discovery appreciation claimed	$16,388	$163,787
Discovery appreciation allowed	None.	$91,874
Posted price of oil	$2.00	$2.00
Lifting costs	$0.22	$0.24

Gypsy Oil Co., Phillips Petroleum Co.: Northwest quarter 25–24–9, Osage County, Okla.

This quarter section was purchased jointly by the Gypsy Oil Co. and the Phillips Petroleum Co. on March 5, 1919, for $80,000. The royalty is one-sixth whenever producing less than 100 barrels per well per day and one-fifth when producing more than 100 barrels per well per day. The Gypsy Oil Co.'s interest in this property was five-twelfths working interest, which cost $40,000. The cost set up by the Phillips Petroleum Co. was $43,000, which, no doubt, includes some additional expenses not incident to the Gypsy's connection with the transaction. The total production on this lease to the close of 1924 was 203,494 barrels. The Gypsy Oil Co. set up three discovery valuations on this 160 acres, as follows:

Well No. 1: Discovery, reserves, barrels, 38,798; value allowed, $37,224; depletion unit, $0.959.

Well No. 13: Discovery, reserves, barrels, 112,175; value allowed, $150,164, with a depletion unit of $1.338.

Well No. 3: Discovery, reserves, barrels, 50,883; value allowed, $26,773, with a depletion unit of $0.526.

Well No. 2, cost, reserves, 21,200 barrels; value allowed, $10,000, and with a depletion unit of $0.471. This makes total reserves of 223,056 barrels and a total value of $224,161.

The three wells were set up on the basis of proving 40 acres each. The remaining 40 acres has reserves set up as 21,200 barrels, and depletion based on cost as none of the wells were larg, enough to give a value "disproportionate to cost." The total reserves therefore set up by the taxpayer, and allowed by the department, are 223,056 barrels. The discovery valuations allowed were $214,161, which includes $30,000 as the Gypsy Co.'s cost of the 120 acres of discovery area. The other $10,000 of the $40,000 purchase was allocated to the other 40 acres, making the total valuation for reserves $224,161.

Reserves: There is quite a contrast between the valuation as claimed and allowed the Gypsy Oil Co. and that claimed and allowed by the Phillips Petroleum Co. for an undivided one-half interest in the same tract, same wells, same cost, and identical date of purchase. The Phillips Petroleum Co. (Exhibit 7) sets up 97,100

barrels as its total reserves and bases its depletion on cost of $43,000, giving a depletion unit of 44.3 cents per barrel.

Based upon the production reported by the Indian Bureau to the close of 1924, projecting a decline curve forward, the ultimate gross production from this property will not be in excess of 265,000 barrels, of which about 45,000 barrels is royalty oil, leaving only 220,000 barrels as the ultimate production for the entire working interest, or 110,000 barrels each. This ultimate working interest production compares very favorably with the estimate set up by the Phillips Petroleum Co., the difference being only 13,000 barrels, with possibly only six or eight years yet to run. It will, therefore, be seen that the Gypsy Oil Co. was allowed about twice the reserves to which it was entitled.

On November 1, 1923, the Gypsy Oil Co. traded its interest in this lease with estimated remaining reserves (on company's books) as 143,107 barrels, yet the production at this time was less than 5,000 barrels per year for the Gypsy interest, indicating that the future production will be only 10,000 to 12,000 barrels, which is much less than the taxpayer's set-up.

There will apparently be a possible loss on this transaction which the Gypsy Co. will be entitled to charge off when rendering its tax returns for 1923. This will represent the "discovery value" of excess reserves of about 130,000 barrels. Of course, this loss depends largely upon the nature of the transaction that was entered into. The Form O data submitted by the taxpayer does not show any of these details.

Mr. Gregg. This point occurs to me: There is very little of this that I know anything about or understand, but every once in a while there is something that I do know about, and I do not agree with this presentation.

Would the committee rather that I call attention to it now? For instance, he states that upon the subject of the exchange of this property, he charged off a loss on discovery value, which is not permissible under the law and never has been allowed. I do not know whether you want me to pass over these things now or to take them up at this time.

The Chairman. I think it would be better if you would put your reply in all at one time, Mr. Gregg, as you asked permission to do awhile ago.

Mr. Gregg. All right, sir.

Mr. Fay. In setting up discovery valuation of well No. 1, Exhibit 4, the Gypsy Oil Co. estimates that each well will drain 7 acres, and on this basis he estimates 14 acres additional at a productivity of 100 per cent of the first well, and 19 acres, inside locations, are estimated as producing at the rate of 50 per cent of the discovery well. Since the taxpayer's drilling program considers that one well will drain 7 acres, it will therefore require not less than five additional wells to extract the oil from this area. In setting up his development costs, the taxpayer deducts the cost of drilling and equipping only two additional wells at $20,000 each, or $40,000. The taxpayer's interest in this being 50 per cent, he therefore deducts $20,000 for completing his drilling program. The deduction should have covered five additional wells, or $50,000 for the tax-

payer's interest. He therefore, on discovery No. 1, has set up at least $30,000 excessive valuation due to this item alone.

Discovery well No. 2, Exhibit 5, is estimated to drain 7 acres, and taxpayer considers the entire 40 acres will have a productivity of 100 per cent of well No. 2. The reserves are set up on this basis, but they are not sufficiently large to make a value "disproportionate to cost," and he sets up a depletion unit of 47.1 cents per barrel. Here five additional wells have to be drilled to recover the oil, which would represent for the taxpayer's interest another $50,000 which has not been set up or deducted from the valuation of the 160 acres.

Discovery well No. 3, Exhibit 6, is assumed to drain 7 acres, and the remaining acreage is estimated as having a productivity of 100 per cent of well No. 3. In this case the taxpayer has properly deducted the cost of drilling and equipping five wells, and as a result his depletion unit is only 52.6 cents, including cost, as compared with 47.1 cents for cost.

Well No. 13, Exhibit 5, proves the remaining 40 acres, all of which is considered as having a productivity of 100 per cent. Here the taxpayer has deducted the cost of equipping and drilling four more wells instead of deducting five wells, which gives him an additional $10,000 excess valuation. The excess discovery valuation on this lease, due to the taxpayer not deducting sufficient development expenses, amounts to $90,000, which have been deducted in the process of arriving at the total discovery valuation of $224,161. The lease at the close of 1924 had 19 producing wells, with five drilled locations in the center. In arriving at the valuation only 11 wells have been deducted, leaving eight already drilled to be charged to expense, which in effect is a double deduction.

Senator KING. That is disadvantageous to the Government and would give the taxpayer a greater deduction?

Mr. FAY. It gives the taxpayer his legal deduction on cost.

Senator KING. What is the effect on the tax, then?

Mr. FAY. Reducing the tax.

Senator KING. That is what I mean.

Mr. FAY. Yes.

Mr. GREGG. There is no question of the taxpayer being entitled to that on cost?

Mr. FAY. No; if his reserves are all right.

The CHAIRMAN. You may proceed with the balance of your statement, Mr. Fay.

Mr. FAY. Marland Refining Co.: Southeast one-quarter 24-24-9. This quarter section was purchased by the Marland Oil Co. October, 1919, at a cost of $571,000. At the time of purchase the quarter section on the west, owned by W. G. Skelly, had been drilled and proven, as also had the quarter section on the south, owned by the Winona Oil Co. Since the adjacent ground had been drilled near the boundary lines of the lease, the proven area from the adjoining leases overlapped the Marland purchase to an extent of more than 100 acres. At the close of 1924 there were 13 producing wells on the property, with a total gross production of 165,575 barrels. This lease is controlled by the Marland Refining Co., and Form O data, submitted by Marland, indicates the following ownership:

	Reserves claimed and allowed (barrels)	Depletion on cost claimed and allowed
Marland Refining Co., one-sixth	23,977	$4.7629
Kay County Gas Co., one-sixth	23,977	5.3290
Franconia Gas Co., one-sixth	23,977	6.1380
Tom James Oil Co., one-sixth	23,977	5.9656
Kinney Cleary Oil Co., one-sixth	23,977	6.0321
Total	119,885	5.941

The bonus of $571,000 paid for the entire lease is allocated equally to each of the five interests. The development costs of $130,000 are capitalized as expended by the Kay, Franconia, Tom James, and the Kinney Cleary companies in approximately equal amounts, hence the lower depletion unit for Marland.

The reserves set up by the taxpayer for each one-sixth interest are 23,977 barrels, or a total of 119,885 barrels for five-sixths working interest. The amount allowed by the unit is the same. The total gross production reported by the Indian agency to the close of 1924 is 165,575 barrels.

Only 13 wells have been drilled on this lease, which would indicate that approximately 7 more wells should be drilled to be in keeping with the drilling program of the Skelly Oil Co., the Winona Oil Co., and the Gypsy Oil Co. on adjoining property. Assuming that seven more wells will be drilled and that the productivity of each well is equal to 50 per cent of the average of 13 wells, the ultimate reserves for this quarter section should be 257,715 barrels, of which amount 165,575 barrels have been produced. The royalty oil from the ultimate production, based on 20 completed wells, would be 42,952 barrels, leaving the net reserves to the Marland group of 214,765 barrels, which is approximately double the reserves allowed the taxpayer; this would reduce the above cost depletion units by approximately 50 per cent.

This is a specific case in which the use of subsequent production data would result in a lower depletion unit. The taxpayer did not take advantage of it.

Knupp Oil Corporation: Southwest quarter section 19–24–10. This lease was purchased by W. J. Knupp October, 1919, for $100,000. The records of the Indian Bureau to the close of 1924 show that no oil has been produced. It has not been possible to determine whether Mr. Knupp bought this property and resold it to the corporation or whether he purchased it as agent for the corporation. From what information is available, the property has not yet been drilled, so that valuation for depletion purposes will come up at a later date when oil is produced and the taxpayer may, under the regulations, set up discovery valuations.

Marland Refining Co.: Northeast quarter, 26–24–9. The Marland Refining Co. purchased this lease October, 1919, at a cost of $545,000. At the close of 1924, there were 13 producing wells and a gross production of 90,942 barrels. This lease is not very productive and the total gross reserves are small. Assuming that an additional seven wells are required to complete the drilling program, the ultimate

reserves on this 160-acre lease will be approximately 140,000 barrels, of which amount about 25,000 barrels will be royalty oil, leaving the taxpayer's ultimate net reserves as about 115,000 barrels, as compared with 110,890 barrels set up by the taxpayer and allowed by the department. The following table shows the ownership of this lease and the amount of reserves and depletion units allocated to each.

	Reserves claimed and allowed (barrels)	Depletion cost claimed and allowed
Marland Refining Co., one-sixth	22,178	$5.004
Kay County Gas Co., one-sixth	22,178	6.085
Franconia Oil Co., one-sixth	22,178	6.055
Kinney Cleary Oil Co., one-sixth	22,178	5.876
Tom James Oil Co, one-sixth	22,178	6.140
Total	110,890	5.825

The bonus of $545,000 was allocated equally to each of the five interests. Development and equipment to the amount of $101,000 is allocated by Marland to the other four interests and capitalized in approximately equal amounts hence a lower depletion unit for Marland.

Northeast quarter 35–24–9: Lease was purchased October, 1919, at a cost of $115,000. The following table shows the operating owners to whom the cost is allocated equally. The varying depletion units are due to minor items that have been capitalized:

	Reserves claimed and allowed (barrels)	Depletion on cost claimed and allowed
Marland Refining Co., one-sixth	1,614	$14.260
Kay County Gas Co., one-sixth	1,614	15.452
Franconia Gas Co., one-sixth	1,614	14.208
Tom James Oil Co., one-sixth	1,614	15,124
Kinney Cleary Oil Co., one-sixth	1,614	15,624

At the close of 1924, there was only one producing well with a total gross production of 9,195 barrels. The taxpayers set up total net reserves as 8,070 barrels, against which he is depleting the entire cost of $115,000. This lease appears to be on the south edge of the pool, and it is questionable whether it would pay to drill additional wells to a depth of about 2,100 feet. The Winona well on the east has produced only 113 barrels.

Winona Oil Co.: Northeast one-quarter 24–24–9. Lease was purchased in June, 1916, for $1,100. At the close of 1924, there were 11 producing wells and a total gross production of 132,729 barrels. The reserves on cost is less than 1 cent per barrel, and on discovery appreciation 43.4 cents per barrel. Taxpayer claimed discovery appreciation of $90,503, but was allowed $55,411. Two discoveries were allowed. At date of purchase about 60 acres in southeast corner of lease were proven by well No. 1 near the corner.

Northwest quarter 30-24-10: Lease was purchased May, 1917, at a cost of $4,100. At the close of 1924 there were three producing wells and a total gross production of 4,017 barrels. Taxpayer claims and is allowed reserves of 13,889 barrels, which he depleted on cost at $1.534 per barrel. At date of purchase approximately 35 acres were proven in southwest corner of lease.

Southwest one-quarter 25-24-9: This lease was purchased May 25, 1918, by the Josey Oil Co. for $11,300 bonus, plus a small amount of incidental expenses, making a total first cost of the lease of $13,159.10. It is the regular Interior Department form of lease, where royalties are one-fifth when the production is in excess of 100 barrels per day and one-sixth when the production is less than 100 barrels per day. The total gross production on this lease, to the close of 1924, was 88,258 barrels, with 10 producing wells. In the taxpayer's original set up, he claimed discovery valuation on June 16, 1919, as $80,000. This, however, was not allowed by the department, and in 1924, new Form O data were submitted, wherein the taxpayer depletes on the original cost of $13,159.10 on the basis of estimated net reserves of 86,784 barrels, making the cost-depletion unit 15.16 cents per barrel. The taxpayer capitalizes all of his drilling expense and equipment to the extent of about $93,000, which amount is depreciated on the unit basis. In 1919, his drilling expenses plus equipment, amounted to $66,661, which gives a depreciation unit of 76.8 cents per barrel. in 1920, an additional $30,522 development and equipment expenses is added, which increase the depreciation unit to $1.19 per barrel. The taxpayer's total net production to the close of 1921 was 51,227 barrels.

On May 9, 1922, the Josey Oil Co. sold its interest in this lease to the Winona Oil Co. for $70,000. The residual cost of the lease and equipment at date of sale was $39,169.81, and the taxpayer reports a profit of $30,830.19 on this transaction.

Southeast quarter, 25-24-9: Lease was purchased April, 1916, at a cost of $5,850. At the close of 1924 there were 14 producing wells and a total gross production of 154,025 barrels. The taxpayer claims and is allowed reserves of 148,592 barrels. Depletion on cost is almost negligible, while discovery appreciation of $30,433 is claimed and $21,809 is allowed. The discovery appreciation depletion unit of 30.5 cents per barrel has been allowed to the close of 1920. At date of purchase about 60 acres had been proven in Bartlesville sand. Discovery is claimed on well No. 11, Cleveland sand, and is allowed on approximately 130 acres.

There is a case where one sand is proven as oil land, and directly under it or above it another sand is encountered and another discovery value set up on the other sand.

Senator KING. With the same well?

Mr. FAY. Well, not the same well, but I have a case which I shall present in a day or two, showing two discovery values of the same well, where there are 14 discovery wells on 160 acres tapping five different sections.

The northwest quarter of 36-24-9: Lease was acquired March, 1919, for $96,000, and to the close of 1924 only one well has been drilled. This is probably regarded as a dry well, as total gross production reported by Indian Bureau is only 113 barrels.

Northeast one-quarter 36-24-9: Lease was acquired May, 1918, at a cost of $13,000. At the close of 1924 there were eight producing wells and a total gross production of 68,979 barrels. Taxpayer claims and is allowed reserve of 67,979 barrels. Taxpayer claims and is allowed reserves of 67,564 barrels, and is allowed discovery appreciation of $11,564, and is allowed discovery appreciation of $11,036, while he claimed $13,371. Depletion unit on cost amounts to 23.9 cents and 63.1 cents on discovery appreciation. Discovery is allowed on well No. 4 in Cleveland sand, and on well No. 2 in Bartlesville sand.

In this particular case none of it had been proven at date of purchase, but he sets up the two discovery values by reason of their being two different sands.

Senator ERNST. One overlapping the other.

Mr. MANSON. I will have a copy of this report for the members of the committee to-morrow morning.

(The exhibits submitted by Mr. Fay are as follows:)

EXHIBIT 1

Oil land in Osage County, Okla., leased or operated prior to 1920

[Purchased at Osage auction sales]

Owner	Location	Cost bonus	Remarks by oil and gas section
J. H. Alexander	NE. ¼ 33-22-10	$300,000	Depletion on total cost of $4,093.01. No reserves shown.
Amber Oil Co	SE. ¼ 35-22-8	13,500	No Form O.
	SW. ¼ 36-22-8	27,500	Do.
Atlantic Petroleum Oil Production Co.	SE. ¼ 19-22-11	26,000	No record in Form O.
	NE. ¼ 8-22-11	26,000	Do.
	SW. ¼ 27-25-8	17,500	Do.
H. G. Barnard	SE. ¼ 28-23-11	33,000	No Form O.
Carter Oil Co	SW. ¼ 29-23-8	56,000	No record in Form O.
	SE. ¼ 29-23-9	600	Do.
	NW. ¼ 8-25-11	8,000	Do.
	SW. ¼ 28-25-11	37,000	Do.
	SW. ¼ 26-24-8	49,000	Do.
	NW. ¼ 19-22-11	52,000	Do.
	NW. ¼ 9-26-6	3,600	Discovery in 1920, not completed.
	SW. ¼ 31-27-6	7,100	Discovery in 1921, not completed.
	SW. ¼ 35-27-7	17,500	No record in Form O.
	NW. ¼ 28-28-27	22,500	Do.
	NW. ¼ 26-24-8	73,500	Do.
	NW. ¼ 4-21-12	15,500	Do.
	NE. ¼ 5-22-12	16,000	Do.
	SE. ¼ 33-22-12	10,800	Depletion on cost $0.339.[1]
	NW. ¼ 15-23-8	172,000	Depletion on cost $14.26.
	NE. ¼ 36-23-8	10,000	Depletion on cost $1.8018.
	SW. ¼ 30-23-9	31,000	No record in Form O.
	SE. ¼ 19-27-11	10,000	Do.
	SW. ¼ 20-27-11	8,500	Do.
	SE. ¼ 35-24-8	41,000	Depletion on cost $6.429.
	SE. ¼ 5-21-10	147,000	No record in Form O.
	NE. ¼ 33-21-12	50,000	Do.
	SE. ¼ 21-26-8	12,500	Do.
	SW. ¼ 28-26-8	8,500	Do.
J. R. Cottingham	NE. ¼ 35-24-8	100,000	No Form O.
	NE. ¼ 24-25-10	23,000	Do.
	NW. ¼ 24-25-10	8,700	Do.
J. K. Crawford	SW. ¼ 10-23-6	200,000	Do.
Cosden Oil & Gas Co	NW. ¼ 24-20-11	2,400	No record in Form O.
	SE. ¼ 36-23-7	30,000	Depletion on cost, $0.778.
	SE. ¼ 23-25-9	6,500	Depletion on cost, $0.688.
	SE. ¼ 20-23-10	21,000	Depletion on cost, $1.902.
	SW. ¼ 24-21-11	5,500	No record in Form O.
	SW. ¼ 27-23-11	10,000	Do.
	NW. ¼ 34-23-9	21,000	Depletion on cost.
	SE. ¼ 29-22-10	145,000	No record in Form O.

[1] These figures, as $0.339, represent the depletion unit allowed by the bureau.

Oil land in Osage County, Okla., leased or operated prior to 1920—Continued

Owner	Location	Cost bonus	Remarks by oil and gas section
Carl K. Dresser	SW. ¼ 3-24-9	$15,000	Valuation not claimed.
	NW. ¼ 23-23-7	26,000	Do.
	SE. ¼ 23-23-7	26,000	Do.
	SE. ¼ 26-23-7	29,000	Do.
	SW. ¼ 31-25-9	16,000	Do.
	SW. ¼ 34-25-9	32,000	Do.
	NW. ¼ 17-23-11	51,000	Do.
Devonian Oil Co	NE. ¼ 3-24-8	2,100	No record in Form O.
	SE. ¼ 27-21-9	400	Do.
	SW. ¼ 14-21-10	9,700	Do
	NE. ¼ 3-20-12	6,000	Depletion on cost.
	NW. ¼ 20-20-12	3,300	Depletion on cost, $1.85.
	NE. ¼ 30-20-12	4,000	No record in Form O.
Daffield & Howard	SW. ¼ 3-20-12	30,000	No Form O.
W. B. Emmert	NE. ¼ 8-22-12	112,000	Do.
	NW. ¼ 8-22-12	35,000	Do.
59-Osage Oil Co	NW. ¼ 6-23-11	62,000	Do.
	SW. ¼ 19-28-9	6,500	Do.
	SE. ¼ 14-29-9	7,500	Do.
Flesher Petroleum Co	NW. ¼ 9-24-10	175,000	Depletion on cost $1.056.
	SE. ¼ 13-23-10	32,000	No record in Form O.
	SE. ¼ 1-22-9	130,000	Depletion on cost $0.685.
	NW. ¼ 20-23-10	25,000	No record in Form O.
D. W. Franchot	SW. ¼ 1-2-9	5,400	Do.
Foster & Norwood Oil Co	SE. ¼ 14-24-9	186,000	No Form O.
Foster & Davis	SE. ¼ 32-27-7	8,000	No record in Form O.
F. A. Gillespie	SE. ¼ 32-21-12	75,000	Depletion on cost $1.667.
E. N. Gillespie	SE. ¼ 22-24-8	41,000	No Form O.
	SE. ¼ 8-22-11	13,000	Do.
	NE. ¼ 32-22-10	67,000	Do.
	SW. ¼ 32-22-10	7,300	Do.
	NW. ¼ 33-22-10	52,000	Do.
	NW. ¼ 30-22-9	22,000	Do.
Gillespie & Grimes	NE. ¼ 6-20-10	40,000	No Form O.
	SW. ¼ 31-21-12	44,000	Do.
Guffey-Gillespie	NW. ¼ 34-22-10	430,000	Value not established.
	SW. ¼ 34-22-10	450,000	Do.
	SW. ¼ 27-22-10	105,000	Do.
	SE. ¼ 9-22-10	52,000	No record in Form O.
	SW. ¼ 23-24-8	182,000	Value not established.
	NW. ¼ 25-24-8	29,000	No record in Form O.
	NW. ¼ 4-23-9	41,000	Do.
	NE. ¼ 24-24-9	550,000	Value not established.
	SE. ¼ 25-24-9	215,000	No record in Form O.
Gilliland Oil Co	NE. ¼ 30-23-8	49,000	Do.
	SE. ¼ 20-23-11	37,000	Do.
	SW. ¼ 21-23-11	27,000	Do.
	SW. ¼ 26-23-7	16,100	Do.
	NE. ¼ 26-23-7	33,500	Do.
	NW. ¼ 31-24-11	61,000	Combined with adjoining lease, $0.875.
	NE. ¼ 23-23-7	21,100	No record in Form O.
	SW. ¼ 23-23-7	29,000	Do.
Gypsy Oil Co	SW. ¼ 16-21-10	170,000	Depletion on cost, $1.40.
	SW. ¼ 29-25-11	72,000	Depletion on cost, $1.69.
	SE. ¼ 16-21-10	28,000	Depletion on cost, $1.22.
	SW. ¼ 5-24-10	20,000	Depletion on cost, $0.473.
	SW. ¼ 17-27-8	600,000	Depletion on cost, $1.15.
	SW. ¼ 18-27-8	170,000	Depletion on cost, $1.062.
	SW. ¼ 23-26-9	11,500	No record in Form O.
	NE. ¼ 35-23-7	27,000	No valuation claimed.
	SW. ¼ 21-28-7	22,500	No record in Form O.
	SW. ¼ 5-24-8	26,000	No valuation claimed.
	SE. ¼ 26-24-8	227,500	Depletion on cost, $2.11.
Haverhill Petroleum Co	NW. ¼ 27-25-9	131,000	No record in Form O.
	NE. ¼ 27-24-8	104,000	Do.
Humphreys Petroleum Co	SW. ¼ 28-25-9	40,000	Do.
	SW. ¼ 30-25-9	37,000	Do.
Homa (Okla.) Oil Co	SW. ¼ 30-24-11	48,500	Do.
	NW. ¼ 32-24-11	9,100	Do.
Henry Oil Co	NE. ¼ 32-24-11	20,000	No valuation claimed.
	NW. ¼ 10-23-8	140,000	Depletion on cost, $192.435.
E. R. Kemp	SW. ¼ 4-21-10	70,000	Do.
	SW. ¼ 20-21-12	67,000	Do.

Oil land in Osage County, Okla., leased or operated prior to 1920—Continued

Owner	Location	Cost bonus	Remarks by oil and gas section
Kewanee Oil & Gas Co.	NE. ¼ 4-21-10	$69,000	Depletion on discovery $0.99.
	SW. ¼ 28-21-12	143,000	No record in Form O.
	NW. ¼ 5-20-12	43,500	Depletion on cost $0.32.
	SE. ¼ 33-23-11	31,000	No record in Form O.
	NW. ¼ 3-21-10	41,000	Depletion on cost $102.50.
	NW. ¼ 28-21-12	152,000	No record in Form O.
Marland Oil & Refining Co.	SE. ¼ 36-26-5	7,000	Do.
	NE. ¼ 21-28-7	100,000	Do.
	SE. ¼ 21-28-7	26,000	Do.
Marland Refining Co.	NE. ¼ 13-22-8	150,000	Depletion on cost $0.668.
	SE. ¼ 20-23-8	85,000	Valuation claimed in 1923.
	NE. ¼ 29-23-8	70,000	No record in Form O.
	SE. ¼ 29-23-8	35,000	Do.
	SE. ¼ 1-26-8	75,000	Do.
	SE. ¼ 12-26-8	140,000	Do.
	NW. ¼ 1-22-9	125,000	Do.
	NW. ¼ 12-29-9	50,000	Do.
	NW. ¼ 7-26-9	40,000	Do.
	NE. ¼ 9-22-10	65,000	Depletion on cost $0.854.
	SW. ¼ 28-25-10	65,000	No record in Form O.
	NW. ¼ 28-23-11	40,000	Do.
	NE. ¼ 3-24-9	52,000	Depletion on cost $1.284.
	NW. ¼ 9-24-9	51,000	No record in Form O.
	NW. ¼ 10-24-9	84,000	Do.
	SE. ¼ 21-24-9	571,000	Depletion on cost $4.76.
	NE. ¼ 26-24-9	545,000	Depletion on cost $4.71.
	NE. ¼ 35-24-9	115,000	Depletion on cost $16.80.
	NE. ¼ 33-25-9	180,000	No record in Form O.
	NW. ¼ 34-25-9	620,000	Depletion on cost $4.465.
E. W. Marland	NE. ¼ 16-24-8	84,000	No record in Form O.
	NE. ¼ 33-25-8	35,000	Do.
	NE. ¼ 30-27-8	50,000	Do.
	NW. ¼ 31-25-9	52,000	Do.
	NE. ¼ 16-21-10	45,000	Do.
	SE. ¼ 34-22-10	55,000	Do.
Midland Securities Co.	NE. ¼ 26-24-8	61,000	No valuation claimed.
	SE. ¼ 33-22-10	96,000	Do.
Minnehoma Oil Co.	NE. ¼ 12-26-8	22,000	Do.
	NE. ¼ 30-22-9	25,000	Depletion on cost, $2.30.
Monitor Oil & Gas Co.	NW. ¼ 36-22-8	30,000	Valuation not established.
	SE. ¼ 33-21-12	73,000	Do.
Middle States Petroleum Co.	SW. ¼ 25-24-9	11,300	Do.
Midland Oil Co.	NE. ¼ 19-22-11	44,000	No Form O record.
Mid-Continent Petroleum Co.	NE. ¼ 10-27-10	13,000	No valuation established.
P. & O. Gas Co. and Elmer Oil Co.	NE. ¼ 17-21-10	75,000	Depletion on cost, $1.275.
	SE. ¼ 17-21-10	200,000	Depletion on cost, $0.867.
	SE. ¼ 3-26-10	30,000	Depletion on cost.
Producers Oil Co.	NW. ¼ 33-21-12	70,000	No Form O
	SW. ¼ 25-24-8	102,000	Do.
	SE. ¼ 4-21-10	52,000	Do.
Papoose Oil Co.	NW. 3-26-10	68,000	Do.
Potter Oil Co.	NE. ¼ 15-25-8	14,000	Dry hole, no valuation.
Chas. Page	NW. ¼ 1-21-8	23,000	In process of valuation.
Frank Phillips	NE. ¼ 11-25-11	90,000	No Form O.
	SW. ¼ 12-25-11	70,000	Do.
Phillips Petroleum Co.	SE. ¼ 4-24-9	81,000	No record in Form O.
	SE. ¼ 9-24-9	33,000	Do.
	NE. ¼ 32-24-9	50,000	Do.
	SE. ¼ 32-24-9	10,000	Do.
	NE. ¼ 9-24-10	49,000	Depletion on cost, $3.044.
Rex Oil Co. and Pyramid Oil Co.	NE. ¼ 34-22-10	154,000	Depletion on cost $0.322.
Roxana Petroleum Co.	NW. ¼ 16-21-10	17,000	No record in Form O.
Redbank Oil Co.	NW. ¼ 14-22-8	27,500	Do.
	SE. ¼ 33-25-8	19,500	Do.
	NW. ¼ 9-27-10	20,500	Do.
	NW. ¼ 29-23-8	61,000	Do.
	SW. ¼ 33-25-11	48,000	Do.
C. I. Stralem	NW. ¼ 13-24-9	115,000	No Form O.
Sinclair Oil & Gas Co. (purchased 1918).	NE. ¼ 1-23-10	17,000	Valuations of Sinclair Osage properties have not been made by this section.
	SE. ¼ 31-24-11	25,000	Do.
	NE. ¼ 1-26-5	5,800	Do.
	SW. ¼ 36-26-5	1,500	Do.
Skelly Oil Co.	SE. ¼ 23-24-8	105,000	Case not valued by this section.
	NW. ¼ 32-25-9	22,000	Do.
W. G. Skelly	NE. ¼ 19-27-8	85,000	No record in Form O.
	NE. ¼ 12-23-10	87,000	Do.
	SW. ¼ 8-23-11	46,000	Depletion on cost $0.426.
	SW. ¼ 24-24-9	54,000	Depletion on discovery $1.177.
	SW. ¼ 34-22-12	39,000	No record in Form O.

Oil land in Osage County, Okla., leased or operated prior to 1920—Continued

Owner	Location	Cost bonus	Remarks by oil and gas section
C. W. Titus	NW. ¼ 10-20-12	$32,500	Depletion on discovery $0.398.
	SW. ¼ 32-23-11	21,500	Depletion on discovery $0.904.
Tuloma Oil Co	SW. ¼ 27-25-9	72,000	No valuations established.
	SE. ¼ 18-22-10	41,000	Do.
	NE. ¼ 36-24-10	40,000	Do.
The Texas Co	SW. ¼ 17-21-10	55,000	Depletion on discovery $1.02.
	NW. ¼ 20-21-10	35,000	No record in Form O.
	NE. ¼ 20-21-10	50,000	Do.
	NW. ¼ 17-21-10	87,000	Depletion on cost $0.65.
	SW. ¼ 7-23-11	25,000	Depletion on discovery $1.02.
Testlog Oil Co	SE. ¼ 16-24-8	100,000	Depletion on cost. No unit given.
	NE. ¼ 31-25-9	50,000	Do.
Tidal Oil Co	NE. ¼ 3-20-12	51,000	No record in Form O.
	NW. ¼ 31-21-12	17,500	Discovery depletion $0.388.
	SE. ¼ 19-21-12	41,000	Discovery depletion $0.839.
Wigwam Oil Co	SE. ¼ 22-24-11	17,000	No valuation established.
	SW. ¼ 14-24-11	5,500	Do.
Winona Oil Co	SW. ¼ 15-23-8	20,000	No valuation claimed.
	SE. ¼ 16-23-8	12,000	Valued together on cost. Unit $0.419.
	SW. ¼ 16-23-8	5,000	
	NW. ¼ 30-24-10	4,100	No valuation claimed.
	NW. ¼ 21-28-10	4,700	Do.
Gypsy Oil Co	NW. ¼ 20-27-8	141,000	No record in Form O.
Phillips Petroleum Co	NW. ¼ 25-24-9	80,000	Valuation not completed.
McMan Oil Co., McGraw (co-owners).	NE. ¼ 8-24-10	210,000	Gypsy interest on cost, $0.493; Phillips interest on cost, $0.762; McMan interest not completed.

EXHIBIT 2

Southeast quarter section 14, township 24 north, range 9 east—H. V. Foster's one-half interest (Form O) claimed by taxpayer

[Valuation Aug. 30, 1919; discovery July 31, 1919; well No. 15, 200 barrels initial production; 2,152 feet sand; 90 acres valued]

Years	Estimated barrels gross production	Estimated barrels net production	Profit per net barrel	Total profit	10 per cent C. D. F.	Present worth, Aug. 30, 1919
1	20,000	8,333	$1.80	$14,999.40	$0.9524	$14,285.43
2	12,500	5,208	1.80	9,374.40	.8658	8,116.36
3	5,500	2,292	1.80	4,125.60	.7871	3,247.26
4	3,000	1,250	1.80	2,250.00	.7155	1,609.88
5	1,825	760	1.80	1,368.00	.6505	889.88
6	1,200	500	1.80	900.00	.5914	532.26
7	840	350	1.80	630.00	.5376	338.69
8	610	254	1.13	287.02	.4887	140.27
9	475	198	1.13	223.74	.4443	99.41
10	370	154	1.13	174.02	.4039	70.19
11	300	125	1.13	141.25	.3672	51.87
12	245	102	1.13	115.26	.3338	38.47
13	200	83	1.13	93.79	.3035	28.47
14	170	71	1.13	80.23	.2759	22.14
15	145	60	1.13	67.80	.2508	17.00
16	125	52	1.13	58.76	.2280	13.40
17	107	45	1.13	50.85	.2073	10.54
		19,837				29,511.52
		198,370	10 additional such wells			295,115.20
		218,207				324,626.72
			Less physical equipment No. 15		$2,510.00	
			Less development, 10 wells		55,000.00	
						57,510.00
			Value of H. V. Foster's interest in oil reserves discovered			267,116.72

The above was disallowed by the unit.

Revised by taxpayer January 20, 1923

158,696 barrels (reserves), value		$236,092.16
Less cost discovery wells	$5,500.00	
Less development 7 wells and 2 lost holes	50,500.00	
		56,000.00
		180,092.16

Value accepted by unit.

EXHIBIT 3

Norwood Oil Co. (Form O) discovery well No. 15—SE. ¼ 14-24-9, Osage County, Okla.

[50 per cent working interest. Valued as of Aug. 30, 1919]

Estimated reserves (net barrels)	Gross revenue ($2.25)	New well costs	Operating expense (70 per cent)	Net revenue	C. D. F.	Present worth
37,975	$85,443.75	$45,000.00	$26,582.60	$13,861.25	$0.9842	$13,642.24
19,500	43,875.00		13,650.00	30,225.00	.9236	27,915.81
12,100	27,225.00		8,470.00	18,765.00	.8397	15,748.57
8,275	18,618.75		5,792.50	12,826.25	.7633	9,790.28
5,500	12,375.00		3,850.00	8,525.00	.6939	5,915.50
4,000	9,000.00		2,800.00	6,200.00	.6309	3,911.58
3,100	6,975.00		2,170.00	4,805.00	.5735	2,755.67
2,450	5,512.50		1,715.00	3,797.50	.5214	1,980.02
1,975	4,443.75		1,382.50	3,061.25	.4740	1,451.03
1,625	3,656.25		1,137.50	2,518.75	.4309	1,085.33
1,350	3,037.50		945.00	2,092.50	.3917	819.63
1,150	2,587.50		805.00	1,782.50	.3561	634.75
1,000	2,250.00		700.00	1,550.00	.3237	501.74
100,000	225,000.00	45,000.00	70,000.00	110,000.00		

Based on five locations. 90 acres.

Value of oil rights	$86,152.15
Cost of acreage proven	53,515.69
Appreciation by discovery	32,636.46
Appreciation by discovery as agreed upon in conference with engineers Mar. 12, 1925	26,500.00

EXHIBIT 4

From Gypsy Form O. F. Copperfield lease

COMPUTATION OF VALUE

Well No. 1 discovery: Completed June 2, 1919; proves 40 acres.

		Barrels
Total expected recovery from well No. 1 is		21,371
No. 1 drains 7 acres, a productivity of 3,053 barrels per acre.		
14 acres are estimated to be of equal productivity and to produce at the rate of 100 per cent a total of		42,742
19 acres inside locations estimated to produce at the rate of 50 per cent by being drained by surrounding wells, a total of		29,003
Total expected recovery from No. 1 discovery area		93,116
Gypsy's proportion (one-half of five-sixths)		38,798
Value of oil July 2, 1919, 30 days after completion, $2.25 per barrel.		
Gross value of Gypsy's interest, less cost of development and operating, estimated		$87,295.50
Less cost of operating on July 2, 1919, at 70 cents per barrel	$27,158.60	
Cost of drilling and equipping 2 wells, at $20,000 per well, estimated (Gypsy's one-half)	20,000.00	
		47,158.60
Net value to Gypsy Oil Co		40,136.90
Less 7.257 per cent for discount		2,912.73
Present worth to Gypsy Oil Co. as of June 2, 1919		37,224.17

EXHIBIT 5

From Gypsy Form O. F. Copperfield lease

COMPUTATION OF VALUE

Well No. 2 discovery: Completed July 17, 1919; proves 40 acres.

No. 2 drains 7 acres and is estimated to produce 8,907 barrels, or an average of 1,272 barrels per acre. The entire proven area is estimated to have equal productivity, so that from this discovery area (the entire 40 acres) estimated to have a productivity of 100 per cent.

		Barrels
Total expected recovery from area		50, 880
Gypsy's proportion (one-half of five-sixths)		21, 200

No valuation due to discovery claimed for this 40-acre tract.

Well No. 13 discovery: Completed November 4, 1919; proves 40 acres.

No. 13 drains 7 acres and is estimated to produce 47,250 barrels, or an average of 6,750 barrels per acre.

		Barrels
Entire 40 acres are estimated to produce at rate of 100 per cent a total of		270, 000
It is estimated that the production for the first 30 days of each well drilled will exceed 100 barrels per day. Hence the royalty is estimated to be as follows:		
One-fifth royalty on 19,520 barrels	3, 904	
One-sixth royalty on 250,480 barrels	41, 747	
		45, 651
Working-interest barrels		224, 349
Gypsy's part (one-half)		112, 175

Value of oil Dec. 3, 1919, 30 days after completion, $2.50.

Gross value to Gypsy Oil Co., less operating and development costs		$280, 437. 50
Less operating cost at 70 cents	$78, 522. 50	
Cost drilling and equipping 4 more wells at $20,000 per well, estimated	40, 000. 00	
		118, 522. 50
Net value No. 13, area as of Nov. 4, 1919		161, 915. 00
Less 7.257 per cent for discount		11, 750. 17
Present worth to Gypsy Oil Co. as of Nov. 11, 1919		150, 164. 83

EXHIBIT 6

From Gypsy Form O. F. Copperfield lease

COMPUTATION OF VALUE

Well No. 3 discovery: Completed July 8, 1919; proves 40 acres.

	Barrels
No. 3 drains 7 acres and is estimated to produce an average of 3,053 barrels per acre	21, 371
The entire discovery area is estimated to be equally productive, so that the remaining 33 are estimated to produce at the rate of 100 per cent productivity	100, 749
Total expected recovery from this area	122, 120
Gypsy's proportion (one-half of five-sixths)	50, 883

Value of oil as of August 7, 1919; $2.25 per barrel.

Gross value of Gypsy's interest, less development and operating costs (estimated)	$114, 486. 75

Operating costs at 70 cents per barrel	$35, 618. 00	
Drilling and equipping 5 wells at $20,000 per well, estimated (Gypsy's one-half)	50, 000. 00	
		$85, 618. 10
Net value to Gypsy Oil Co		28, 868. 65
Less 7.257 per cent for discount		2, 095. 00
Present worth to Gypsy Oil Co. as of July 8, 1919		26, 773. 65

Exhibit 7

Form O. Report for 1922

PHILLIPS PETROLEUM CO., COPPERFIELD LEASE—PRODUCTION DATA AND ESTIMATED RESERVES

Producing horizon: Bartlesville sand; depth, 2,060 feet.
Production figures represent gross production.

Year	Recovered oil	Average number producing wells	Average production per well	Future recoverable oil	Total recovered and recoverable oil
	Barrels			*Barrels*	*Barrels*
1919	42, 738. 25	5. 03	8, 497. 00		42, 738. 25
1920	75, 744. 66	18. 11	4, 182. 00		75, 744. 66
1921	36, 288. 36	19. 00	1, 910. 00		36, 288. 36
1922	22, 362. 87	19. 00	1, 177. 00		22, 362. 87
Future		19. 00	2, 935. 00	55, 765. 00	55, 765. 00
Total	177, 134. 14			55, 765. 00	232, 899. 14

	Barrels
Estimated gross recoverable oil from producing wells at end of taxable year 1922	55, 765. 00
Estimated gross recoverable oil from probable future wells	None.
Gross produced during taxable years 1919-1922	177, 134. 14
Estimated gross recoverable oil at beginning of year 1919	232, 899. 14
Taxpayer's interest is one-half of five-sixths, or	97, 041. 31

Exhibit 8

Form O. Report for 1922

PHILLIPS PETROLEUM CO., COPPERFIELD LEASE—DEPLETION SCHEDULE

	1919	1920	1921	1922
Estimated reserves at beginning of taxable year (barrels)	97, 041. 31	79, 233. 70	47, 673. 42	35, 553. 28
Production for taxable year (barrels)	17, 807. 61	31, 560. 28	15, 120. 14	9, 317. 87
Capital invested at beginning of taxable year	$43, 000. 00	$35, 109. 45	$21, 125. 09	$14, 425. 36
Additions to invested capital during year	None.	None.	None.	None.
Total capital subject to depletion	$43, 000. 00	$35, 109. 45	$21, 125. 09	$14, 425. 36
Unit cost	. 4431	. 4431	. 4431	. 4431
Depletion sustained	7, 890. 55	13, 984. 36	6, 699. 73	4, 128. 75

EXHIBIT 9

Form O. Report for 1922

PHILLIPS PETROLEUM CO., BARTLESVILLE, OKLA.—COST OF PROPERTY AS AT DATE OF ACQUISITION

Name of property: Copperfield lease.
Legal description: The NW. ¼ of sec. 25, T. 24 N., R. 9 E., Osage County, Okla.
Nature of interest: One-half of five-sixths working interest.
Other interest holders: Gypsy Oil Co., Tulsa, Okla., one-half of five-sixths working interest; Osage Tribe, one-sixth royalty interest.
Date lease effective: March 5, 1919.
Date of expiration of lease: Perpetual as long as oil and gas is produced.
Royalty rate: One-sixth.
Rentals: None.
Cost of interest (bonus): $43,000.
Cost (bonus) charged to capital.
Date of acquisition by Phillips Petroleum Co.: March 5, 1919.
Acquired from Osage Tribe.
Amount of cash paid: $43,000.
Amount of stock paid: None.
Other considerations: None.
Value of oil and gas contents: $43,000.
Surface value of property: Not owned by Phillips Petroleum Co.
Equipment: None; acquired nonproducing.

92919—25—PT 15——10

Exhibit 10

Schedule showing gross barrels reported as being run from leases listed below located in Osage County, Okla., for the years indicated; also operating owner and number of wells thereon

Description	Operating owner	1924		1923		1922		1921		1920		1919	1918	1917	1916
		Wells	Barrels	Wells	Barrels	Wells	Barrels	Wells	Barrels	Wells	Barrels				
NE. ¼ 14-24-9	E. L. Connelly	8	11, 520. 01	8	15, 939. 27	8	24, 983. 63	8	37, 813. 20	8	67, 864. 50	30, 503. 11			
NW. ¼ 19-24-10	do	11	11, 392. 87	11	13, 273. 96	11	24, 674. 48	11	48, 214. 78	12	70, 535. 82	54, 639. 44			
NW. ¼ 13-24-9	C. I. Stralem	6	3, 117. 22	6	4, 136. 18	6	5, 962. 04	6	17, 660. 68	6	34, 170. 57				
NE. ¼ 13-24-9	Finance Oil Co	3	4, 104. 68	3	5, 329. 82	3	9, 149. 12	3	13, 053. 28	3	24, 167. 01	22, 091. 73			
SW. ¼ 14-24-9	George Tselos	5	3, 284. 83	5	9, 334. 50	5	26, 542. 29	5	69, 070. 74	3	41, 596. 96				
SE. ¼ 14-24-9	Foster Petroleum Corporation	15	31, 581. 16	14	35, 453. 29	14	71, 918. 48	11	118, 122. 02	10	114, 585. 99	569. 59			
SW. ¼ 13-24-9	Indian Territory I. O. Co	5	7, 310. 63	5	12, 785. 54	5	11, 983. 04	4	17, 355. 58	3	19, 708. 62	4, 850. 30			
SE. ¼ 13-24-9	Carter Oil Co	10	13, 524. 26	11	20, 500. 14	14	32, 965. 04	16	69, 547. 57	16	99, 207. 91				
SW. ¼ 18-24-10	Twin State Oil Co	12	21, 794. 49	13	24, 987. 91	13	31, 518. 90	13	71, 573. 51	13	88, 999. 11	24, 477. 34			
SE. ¼ 18-24-10	Tidal Osage Oil Co	5	5, 094. 16	5	8, 158. 33	5	14, 353. 05	5	24, 477. 48	3	9, 251. 18	10, 213. 32			
NW. ¼ 24-24-9	Winona Oil Co	12	18, 169. 74	12	18, 408. 14	12	23, 499. 46	12	40, 513. 11	12	92, 954. 51	168, 822. 11			
NE. ¼ 19-24-10	Osage Development Co	4	1, 003. 70	4	1, 561. 68	4	2, 292. 00	4	4, 205. 28	4	7, 099. 82	8, 656. 19			
SW. ¼ 24-24-9	Skelly Oil Co	23	25, 474. 25	23	31, 397. 23	23	38, 494. 28	23	72, 387. 46	23	117, 041. 55	165, 256. 66			
SE. ¼ 19-24-10	Plymouth Petroleum Co														
NW. ¼ 25-24-9	Gypsy Oil Co	19	16, 419. 87	19	12, 483. 23	19	20, 981. 78	19	36, 122. 27	19	75, 869. 76	41, 617. 25			
SE. ¼ 26-24-9	Tidal Osage Oil Co	6	10, 182. 63	5	9, 089. 51	5	13, 543. 63	5	7, 431. 44	5	8, 695. 78	1, 710. 70			
NW. ¼ 31-24-10	do									1	161. 96				
NE. ¼ 24-24-9	do	12	46, 598. 60	11	53, 895. 91	9	46, 610. 63	9	91, 630. 63	9	74, 206. 40				
SW. ¼ 25-24-9	Winona Oil Co	10	7, 663. 88	10	8, 668. 28	10	14, 247. 38	10	18, 749. 82	10	23, 368. 89	15, 560. 05			
NW. ¼ 35-24-9	Sinclair Oil & Gas Co														
NE. ¼ 22-24-9	Evidence Oil Co														
NW. ¼ 18-24-10	Texas Co	6	4, 818. 52	6	7, 120. 98	6	14, 339. 02	6	27, 899. 92	6	17, 946. 72				
SW. ¼ 22-24-9	do	1	2, 136. 30					1	1, 317. 50	1	668. 36				
SE. ¼ 24-24-9	Marland Oil Co	9	12, 228. 55	9	13, 966. 01	9	16, 593. 33	12	25, 228. 49	13	94, 364. 87	3, 194. 50			
NE. ¼ 26-24-9	do	13	6, 734. 24	13	10, 353. 12	13	16, 361. 96	13	20, 635. 32	11	35, 838. 83	1, 019. 36			
NE. ¼ 35-24-9	do	1	1, 121. 16	1	1, 321. 31	1	1, 720. 26	1	2, 243. 23	2	2, 789. 00				
SE. ¼ 21-24-9	Skelly Oil Co														
SW. ¼ 19-24-10	Knupp Oil Corporation														
NE. ¼ 25-24-9	Winona Oil Co	10	9, 879. 73	10	11, 416. 86	10	19, 299. 49	10	39, 253. 51	11	36, 637. 20	10, 883. 83	2. 379. 97	2, 923. 13	65. 64
NW. ¼ 30-24-10	do	2	887. 16	3	898. 21	3	1, 272. 77	2	959. 56						
NW ¼ 36-24-9	do									1	112. 91				
NE. ¼ 36-24-9	do	8	7, 796. 72	8	7, 905. 04	6	11, 795. 72	6	17, 231. 34	6	18, 731. 34	5, 518. 95			
SE. ¼ 25-24-9	do	14	10, 398. 90	14	12, 036. 32	14	17, 137. 72	14	24, 137. 87	14	43, 383. 80	33, 885. 67	4. 785. 50	7, 210. 26	1, 049. 51
SW. ¼ 30-24-10	Barnsdall Oil Co	6	6, 073. 79	7	6, 304. 43	7	8, 200. 28	7	10, 477. 28	7	12, 802. 21	10, 042. 37	11, 019. 97	12, 478. 20	717. 79
NW. ¼ 23-24-9	Foster Petroleum Corporation	1	180. 00	1	281. 76	1	75. 08	1	265. 36	1	1, 046. 28	1, 282. 70	1. 519. 34		
NE. ¼ 23-24-9	do	6	8, 754. 39	6	12, 013. 04	6	17, 263. 28	6	23, 249. 31	6	26, 786. 96	183, 596. 93	65, 496. 99		
SE. ¼ 23-24-9	do	9	16, 401. 32	8	8, 706. 02	7	11, 864. 64	7	21, 438. 39	7	37, 524. 56	27, 780. 31			
SW. ¼ 23-24-9	do	6	18, 916. 92	6	22, 081. 53	5	23, 178. 20	3	4, 349. 70	1	996. 60				

NW. ¼ 11-24-9.	Loues Friedman Oil Co.	1	259.78	1	891.60	1	258.78		
NW. ¼ 26-24-9.	Kay County Gas Co.	10	37,617.90	7	52,179.58	6	69,901.81	2	2,103.12
SW. ¼ 26-24-9.	Tidal Osage Oil Co.	2	5,941.50	2	12,322.48	1	6,447.67		
NE. ¼ 18-24-10.	Twin State Oil Co.	1	2,330.35	1	3,259.58	2	7,813.54	2	30,310.73
SE. ¼ 22-24-9.	Foster Petroleum Corporation	3	2,874.72	2	1,996.40	2	4,825.30	1	3,984.62

Number of wells on leases from 1916 to 1919, inclusive, not shown.
The information shown above obtained from the records of the Osage Indian Agency, Pawhuska, Okla.

I certify that the above is a true and correct transcript of the records as shown in the office of the superintendent of the Osage Indian Agency.

GEORGE N. WISE,
Special disbursing agent in charge.

PAWHUSKA, OKLA., *February 16, 1925.*

The CHAIRMAN. If that is all, it will be in order to adjourn until 10 o'clock to-morrow morning.

Mr. GREGG. Before you adjourn let me say that, of course, it is going to take us almost as long to prepare our answer, to go into it and study it and see what the situation is from our point of view, as it took Mr. Fay to do it. In other words, we can not answer this or discuss it in a couple of days, until we have looked into all of these cases; so it is going to take us some time before we will be able to make our reply on that.

The CHAIRMAN. Do you mean to imply that you will not be ready during this session of the committee hearings?

Mr. GREGG. Oh, I think we can be ready before you adjourn.

The CHAIRMAN. Yes.

Mr. NASH. I think it will be ready in about a week.

Senator KING. I wish Mr. Thayer would also be prepared, in a general way, to tell us just how you are handling these oil cases, on the question of depletion and discovery, and not only in oil matters but as to other properties as well.

Mr. THAYER. I shall be very glad to do it.

The CHAIRMAN. Then, we will adjourn now until 10 o'clock to-morrow morning.

(Whereupon, at 12.15 o'clock p. m., the committee adjourned until to-morrow, Thursday, May 14, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

THURSDAY, MAY 14, 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 adjoinment 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. GREGG. I should like to submit a reply now in the case of the Gulf Oil Corporation, Mr. Chairman. May I proceed?

The CHAIRMAN. You may proceed.

Mr. GREGG. I would like, Mr. Chairman, to be permitted to present this in its entirety before I am asked any questions, if that is agreeable.

The CHAIRMAN. We will reserve our questions until later.

Mr. GREGG. The criticisms made by counsel for the committee and his staff with reference to the case of the Gulf Oil Co. were so elaborate and so varied that necessarily a reply to these criticisms must be detailed and lengthy.

The first criticism of this case made by counsel for the committee was with reference to the manner of its settlement. Counsel testified that——

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

This same criticism was repeated in a different form many times during the discussion of this case by the representatives of the committee.

The clear inference from these statements is that the field auditors completed their report on this case in one day and that the bureau approved the field auditors' report and fixed the amount of the tax in six days. Since these are not the facts we wish to put in the

record a statement of what actually happened in connection with the settlement of this case.

Two field auditors were originally sent from the bureau at Washington to audit the books of the Gulf Oil Co. during the latter part of October, 1920. Subsequently other auditors were assigned to assist them in this work, and the report of this field examination was completed on February 20, 1921. These field agents while auditing the books of the company were in constant touch with the bureau in Washington and with the then chief of the consolidated returns section, Mr. Councillor. On one occasion Mr. Councillor spent considerable time with these examiners in Pittsburgh conferring with them on their work. The first of the schedules covering taxpayer's claim for a depletion deduction, including depletion on cost, depletion on March 1, 1913, values and depletion on discovery value was filed as early as September, 1920, and from that time on the schedules were filed as completed until the last schedule with reference to the Eastern Gulf Oil Co., the smallest subsidiary company claiming depletion, was filed early in February, 1921.

At the same time that the field auditors were making their examination of the books of the company, the representatives of Ernst & Ernst were preparing the amended returns of the company. The representatives of Ernst & Ernst and of the bureau worked together on this work and were in current consultation with reference to it. Many changes were suggested by the field auditors and these changes were taken up by the representatives of Ernst & Ernst and incorporated in the amended returns. In other words, the preparation of the amended returns was made after consultation with the examiners and the check of these ameded returns was made by these representatives at the time the amended returns were being prepared. These amended returns were then audited in Washington in connection with the examining officers' report, at which time the company's claim for amortization was disallowed.

I have brought that out, Mr. Chairman, just to show that the audit of this report in the bureau was not a pro forma matter.

The sa[illegible] situation existed with reference to the depletion schedules. These schedules, which were filed continuously from September of 1920 until February of 1921 as they were completed by the taxpayer, were prepared after consultation and discussion with the representatives of the national resources division of the bureau.

I should like to bring out, in addition to that, at this point, that this was the first big oil case which ever went through the bureau: it was a new thing to everyone concerned--to the taxpayer and to the people in the bureau. The manner of preparing these statements was new and naturally, in doing this, the representatives of the taxpayer worked with the bureau to get their ideas as to how they should be prepared and the data that should be furnished.

The statement that the books of this company were completely rewritten by the representatives of Ernst & Ernst has been repeated and emphasized so much that it deserves special consideration. It should be realized at the outset that the accounting procedure necessary for income tax purposes is entirely foreign to any accounting procedure used prior to the incidence of the income tax laws. In no system of accounting except that required for income-tax purposes are depreciation and depletion based on the fair market value of the

assets as of March 1, 1913, recognized. For no other purposes other than for the income tax is depletion taken on the basis of the value of the property at date of discovery. There are many other instances where the accounting for tax purposes differs materially from any other accounting system and this difference necessitated changes by taxpayers of the accounting records previously maintained by them. Furthermore, the bureau requires that these adjustments peculiar to the income tax law be recorded on the books of the taxpayer. For example, Article 169 of the regulations provides that the depreciation deduction must be charged off on the books of the taxpayer, and since depreciation for tax purposes is on a different basis than depreciation under any ordinary system of accounting, this regulation necessitated some change by practically every taxpayer in his accounting procedure. Many similar instances could be cited as showing the requirements of the bureau for accounting records different from those ordinarily maintained by taxpayers.

What actually happened with reference to the rewriting of the books of the Gulf Oil Corporation was this: After the amended returns were prepared and the changes therein approved by the examining officers of the bureau, the adjustments in the records of the company necessitated by the rulings of the bureau were made. This was done with the entire approval of the examining officers. It should be noted in this connection that no records of the company were destroyed or replaced; no original entries in a record were changed; merely additional entries to reflect the changes made and approved by the examining officers and to cover other changes, such as depletion on discovery value recognized only by the income tax law, were made.

Let me elaborate a little on that.

The CHAIRMAN. Let me say at this point that, although you may not be aware of it, and this was testified to by Mr. Ernst before the committee in the early part of 1924, I think it was, and perhaps that was the basis for our repeating it.

Mr. GREGG. Yes, sir; I looked that up, of course. In making an income-tax return, as I have pointed out, records different from the ordinary accounting records must be kept. The bureau requires that these records be reflected on the books of the taxpayer. It is necessary, therefore, when you are making your tax return and making those adjustments peculiar to the tax law, that they be recorded on the books of the company.

I have given several examples. Amortization is another one. Amortization was never heard of prior to the income tax law; not in the sense that it is used in the income tax law, at least. An entry would have to be made on the taxpayer's book entirely different from entries required by ordinary accounting procedure. The regulations up to 1921 required that amortization be reflected in the taxpayer's annual balance sheet. I think that regulation was unwarranted; but it had to be on his books, anyway, and the original requirement was that it had to be on his balance sheet.

The CHAIRMAN. There is nothing in the statute, of course, that would compel that.

Mr. GREGG. No, sir; there is nothing on that; but we have always done it.

I will give you an illustration of two of the most important changes that had to be made in the books of the Gulf Oil Corporation.

The Gulf Co., prior to the preparation of these amended returns on a scientific basis, had taken depreciation and depletion together in a lump sum, based entirely on the earnings for the year. If the earnings were small it would take no depletion or depreciation, either. If they were large for a year they would take a big lump-sum allowance for depreciation and depletion. That had been their practice always.

Of course the bureau, in computing invested capital as of January 1, 1917, could not accept any depreciation or depletion adjustment such as that, and went back and made adjustments from the time of acquisition of the property on the basis recognized by the tax laws. That, of course, gave a different reserve for depreciation, and depletion as of January 1, 1917. An entry had to be made on the books of the company to reflect that change in depreciation and depletion, but the old records, the old entries, were still there. They were not erased or destroyed. Just an additional entry changing depreciation and depletion reserve was made.

The same thing is illustrated by the discovery depletion. No one had ever taken depletion on discovery value prior to the incident of the tax laws, or to the 1918 law, as a matter of fact. So, when these amended returns were prepared, the schedules showing depletion on the basis of discovery value being made, it was necessary to set up that also on the books of the company. Again, in doing that, it was just putting additional entries on the books to reflect the accounts which it was necessary to maintain for tax purposes.

I want to emphasize again the point that I have just made, that not a single book of the company was destroyed, and not a single entry on a single book was erased. Every record that there was when these amended returns were filed and when the books were rewritten, as it was stated, still exist. The only thing is that additional entries were made, and additional facts shown by the books to make them accord with the requirements of the income tax law.

It is apparent, therefore, that the changes made in the books of this taxpayer were only those changes made by all similar taxpayers in their records in order to comply with the provisions of the income tax law. And it is equally apparent that although this case was expeditiously handled by the bureau in order that it might be closed prior to the taking of office by Secretary Mellon, nevertheless the bureau did have ample opportunity to check and verify the amended returns and claims of the taxpayer.

The committee's engineer next criticized the values allowed the Gulf Oil Corporation on several leases. The criticisms were very specific and detailed and may be divided into four general parts:

(1) The allowance of vertical discoveries;

(2) The use of a price higher than the posted price of oil;

(3) Criticism of the failure to consider the cost of handling royalty oil; and

(4) Criticism of the discount factor used and of the failure adequately to consider the hazard factor.

Vertical discoveries: The allowance of a discovery value with reference to the different sands is a criticism of the law and not of the

treatment of the Gulf case. It has been allowed in other cases where proven. That was brought out in other cases which the committee has taken up.

With reference to the posted price of oil, as has previously been pointed out to the committee, the bureau has allowed in certain instances the use of a price higher than the posted price of oil in cases where discovery was made at a time of great depression. Again, in this instance, the treatment of the Gulf case was in accord with the general practice of the bureau.

The CHAIRMAN. At this point, let me ask you whether there is any justification under the law for that.

Mr. GREGG. The law does not tell us how to value at date of discovery. It is up to the bureau to use the accepted methods of valuing oil properties.

The CHAIRMAN. Then the regulations call for the posted price at that date, do they not?

Mr. GREGG. No, sir. There is nothing in the regulations about it, but I read from an order which was circulated in the oil and gas section, and prepared by the head of the oil and gas section, which stated that where the valuation was made as of a time of great depression, a price higher than the posted price of oil should be used. Of course, it was to be very carefully used, and restrictions were placed upon it.

The CHAIRMAN. Was there any order to value at other than the posted price when there were boom times?

Mr. GREGG. No, sir; it is only when the valuation is made at a time of depression.

Mr. MANSON. That was my criticism. I did not specially criticize the use of a higher price than the posted price when the price of oil was away down. My criticism was that if that is to be done, that the policy should be made consistent by using a lower price than the posted price when the price is extraordinarily high, as it was in 1920, and that there is only one of two consistent policies that can be taken—namely, to consider a price trend, which is done in the case when oil is extraordinarily low, but which carries with it the necessity of considering a liability to drop when oil is extraordinarily high, or to accept the posted price of oil arbitrarily in all cases.

My criticism was directed not to the use of the higher price. For instance, in the California fields, when oil has been down—and it has been down as low as 40 cents—I did not criticize the stepping-up process, but what I do criticize is failure to adopt a stepping-down process when you have the reverse of the situation.

Mr. GREGG. When I was answering with reference to the general question of discovery depletion, I quoted the oil and gas people with reference to that and said that in the cases where oil was discovered at a boom price the possibility of future decline in the price of oil was taken care of through the hazard factor.

At this point, since Mr. Manson has raised the question, I should like to say a few words about the price-trend method in valuing oil properties. I went into that as thoroughly as I could, and what I found was this, that oil men have been trying for a long time to work out a price-trend system, but the price of oil has been steadily increasing for years, and the price-trend method involves carrying into the future the history of the past and casting that forward.

That would have involved basic valuations on this increase in the price of oil, and the bureau itself refused to allow that when the question was presented to it.

The next matter is the matter of the cost of handling royalty oil.

The statement that the cost of handling royalty oil was not considered is incorrect. The per barrel operating cost was in fact determined by dividing the amount of the total cost of handling both company and royalty oil by the number of barrels of the company's share of the oil. This, of course, takes into consideration, in determining the per barrel cost of handling the company's oil, the cost also of handling the royalty oil.

I do not know whether that is clear, and I will try to amplify it. The operating cost of producing both the company's and royalty oil is divided by the amount of the company's oil to get the per barrel producing price, but we take into consideration, in determining the per barrel producing cost of the company's oil, the cost of producing the royalty oil also.

The CHAIRMAN. Because it raises the per barrel cost after you have deducted the royalty oil?

Mr. GREGG. Yes, sir. With reference to the discount rate and hazard factor this criticism of the discount rate and of the failure adequately to consider the hazard factor is a more serious one and requires more careful consideration.

It should be realized that in valuing a discovery well the greatest hazard in the oil industry has already been eliminated. I want to emphasize that. The presence of oil in commercial quantities must be assured before a discovery valuation is permissible. When the presence of oil in commercial quantities has been demonstrated by a discovery the only remaining factors concerning which uncertainty exists are these: First, the amount of the future production of the well; second, the future selling price of the oil; and, third, the cost of producing the oil. If in determining these factors the estimates are conservative and the hazard element is there taken care of, then the discount factor must compensate only for the use of the money. In other words, when hazard is taken care of in the estimates of the three items specified above, a 4½ or 5 per cent discount rate to compensate for the use of the money while it is tied up in the well is adequate.

Stating that in other words, if you take care of your hazard factor in determining those factors with reference to which uncertainty exists, as, for example, the amount of oil in the well, the cost of producing and the future price of the oil, if the hazard is taken care of there, it is not necessary to take care of it in your discount rate. Your discount rate then becomes simply a charge for the use of the money.

Mr. MANSON. Let me ask you this: You said that when you have established a successful well, your hazard is eliminated?

Mr. GREGG. No.

The CHAIRMAN. No; he said it was partially eliminated.

Mr. GREGG. I said the big hazard factor, whether or not there was oil on the property, had been eliminated.

Mr. MANSON. Well, here you have a 40-acre tract, and you put down one successful well. In order to drain that 40-acre tract to

get the reserves out of there, you are going to require a great many more wells. Some of those new wells you put in may be dry holes.

Mr. GREGG. Yes, sir. I did not make my point very well. The bringing in of the one well shows the existence of the oil there. There still exists the hazard factor with reference to the amount of the oil, as to whether your other well is going to bring oil. That should be taken care of in your estimates of your oil reserves, but the presence of oil in the one well is assured, when you bring it in, and if you adequately take care of the risk involved with reference to the possibility of other dry holes, you are taking care of the hazard factor at that time.

Mr. MANSON. On that point, Mr. Gregg, on the return on the capital, can you imagine anybody buying an oil well at a price which would return him only four and a half or five per cent on the capital invested, when he is assuming the risk of fire, lightning, the risk of being compelled to put down dry holes in order to recover his reserves, the risk of salt water, and all of the other risks incident to the oil business, if all the calculations result favorably to him?

Mr. GREGG. If anyone got that impression from my statement I expressed myself very poorly.

The point I was trying to make is this:

There are two factors to be considered in valuing an oil property; first, the hazard factor; and second, the discount factor. Those two factors are absolutely separate and distinct. Sometimes, through what I should say are rather slipshod methods, they may be combined and put together, but they are not properly considered together. Your hazard factor takes in the things which Mr. Manson has mentioned and others—the possibility of salt water, the possibility of the pinching out of the sand, and so on. All those elements are taken into consideration in the hazard factor. Now, if they are taken care of there, your discount factor involves only a charge for the use of the money. It does not make any difference to me, so far as I can see, whether you have a 25 per cent or a 50 per cent discount factor and no hazard factor, or whether you have a 5 per cent discount factor and a 20 or 45 per cent hazard factor. It does not make any difference what you call them; it is the result that counts.

The CHAIRMAN. Getting back to Mr. Manson's question, in computing this discount factor do you consider that even 4½ or 5 per cent is sufficient for the use of the money?

Mr. GREGG. The discount factor in this case was prepared after getting the yield on some several hundred securities, on bonds, the market for which was established at the date of these valuations, and it ranged from 4½ to 5 per cent; so 5 per cent was the rate that was used.

Mr. MANSON. Were they municipal bonds?

Mr. GREGG. No; they were not. I looked over the list rather hurriedly, and I did not go over it very carefully, but they were industrial bonds. There was an immense table presented.

In valuing the properties of the Gulf Co. for depletion purposes the hazard factor was taken care of in the estimates of recoverable oil and production costs, and consequently there was no necessity of providing for hazard in the discount rate.

In the estimates of recoverable reserves adequate consideration was given to such factors as the possibility of pinching out of productive sands, of water encroachments, of faulting or dry holes, and the resulting figure was reduced to take care of the hazard factor. As indicative of this, in the A. Focht lease the company in its own records estimated the reserves as 2,631,051 barrels. In valuing the lease for tax purposes this was reduced to 1,845,231, a reduction of 30 per cent. In the case of the Shumway lease the estimate of 9,199,330 barrels was reduced to 6,836,894, a reduction of 25.7 per cent. Furthermore in the estimates of production costs the record of the company over a period of years for all of its production was used. Since the hazard factor was taken care of in these items it was not necessary to use more than the 5 per cent actually used as a discount rate.

Senator KING. Mr. Gregg, I would like to ask if the experience in the oil fields, the Texas fields, and the Oklahoma fields, and especially in the Colingo and the Curran fields and in the Wyoming fields, has not proven almost conclusively a larger reserve than the estimates?

Mr. GREGG. Some of them have. From what I have been told, some of the fields have proved greater reserves than was estimated, and some lesser reserves than was estimated. For example, the Ranger field in Texas, I understand, had reserves which were much less than was estimated when the oil was brought in. In some territories it has been much larger than was estimated when the oil was brought in.

Senator KING. I was just wondering why, if the premise implied in my question was correct, the reserves in both fields—and I think that is a fact—are greater than the estimates, there should be such a large deduction there from the estimates for taxation purposes.

Mr. GREGG. That reduction, of course, cut down materially the value of the property, and took care of the hazard factor in that way, through the reduction of the estimated reserves.

Mr. MANSON. I would call attention to this distinction: When you reduce the number of barrels, you reduce your total valuation, but you do not necessarily reduce your depletion unit.

Mr. GREGG. That may be true in a long life property, but it is not true in property of a short life.

Mr. MANSON. However, when you increase your hazard factor, or you increase your discount factor, you do directly reduce your depletion unit.

In this particular instance I called attention to the fact that the representatives of practically every branch of the oil industry appeared before either the Ways and Means Committee of the House or the Finance Committee of the Senate—I have forgotten which, but I have quoted the testimony—and took the position that you could not interest capital in the oil business unless you could assure it about a 15 per cent return minimum per year, a 15 per cent return on the money. I take the position that if that is true, then 15 per cent is approximately the minimum discount factor which should be applied, and that any discount factor that is based upon such conservative bonds as will return a 4½ or 5 per cent rate has no application to a valuation of an oil well.

Mr. GREGG. Mr. Chairman, after I answer that, may I finish? I really think I ought to be allowed to get this all in after I have

answered that question. After I have completed my statement, I will be glad to answer any questions that I can.

With reference to the first point that Mr. Manson made, in the case of a long-lived property, an increase in the reserves may not necessarily increase your depletion rate, but in the case of a short-lived property, such as an oil well, where you get out between 50 and 90 per cent the first year, a reduction in your reserves cuts down almost equally your value, and consequently your depletion rate. That is on the first point.

On the other point, that 15 per cent is necessary in the oil industry, I think I have answered that question in this way: Those statements were made with reference to the oil industry as a whole, and, as I say, when you have brought in your well in commercial quantities, one of your big hazards has gone. The presence of oil is then assured.

In the second place, I did not contend, and have not argued, that a 4½ per cent or a 5 per cent compound of discount and hazard factor is sufficient in the oil industry. I would not contend that for a minute, but I say a 5 per cent return is a sufficient discount factor if the hazard factor is adequately taken care of in some other way, and as an illustration of that I gave the example that it seems to me immaterial whether you use a 50 per cent or a 25 per cent discount rate and no hazard factor, or whether you use a 5 per cent discount rate and a 20 or 45 per cent hazard factor.

Although events occurring after the basic date can not be considered in valuing the property as of the basic date, nevertheless they show whether or not the values placed on the properties were reasonable, and whether adequate allowance was made at the time for hazard.

I want to show from the production of these wells in question—and I am using, of course, subsequent events—that the estimates were reasonable. The reason for using subsequent events is that I do not know enough, and I do not think that the committee, probably, is sufficiently familiar with oil values to be able to consider the technical points in connection with an oil valuation—the geological conditions, and so on—and I thought the best way to bring out clearly this point was to show the actual happenings since the date of discovery.

Mr. Manson. On that point I remember that at the time we presented that case we called attention to the fact that the estimated reserves used as a basis of discovery values corresponded so closely to the actual production shown by subsequent events as to indicate that instead of estimating into the future, as a prospective purchaser who bought the well at the date of discovery would have to do, actual production figures had been used as the basis of determining these estimates.

Senator Ernst. I would suggest that Mr. Gregg be permitted to continue with his statement.

Mr. Gregg. I will answer that one point, and then I should like to be able to complete my statement.

I showed just a few moments ago that in the case of the Focht lease the reserves on the books of the company were cut by 30 per cent. That certainly is not very close. In the Shumway lease the reserves

on the books of the company were cut 25 per cent. That is not very close, and the figures I am going to give will show that if they had used actual subsequent events they would have taken a much higher valuation than they actually did take.

Senator JONES of New Mexico. Do I understand that in the one case Mr. Manson referred to, you did take the actual subsequent events, and in other cases you do not do so?

Mr. MANSON. At the time we presented that case we called attention to the fact that many of the reserves claimed as estimated corresponded so closely with the actual production that the relationship could be accounted for upon no other theory.

Senator JONES of New Mexico. I would like to inquire, if you have the actual figures before you make your estimate, what is the objection to using them?

Mr. MANSON. What we are trying to arrive at here is what would a purchaser of this property, at the date of discovery, when production is unknown, pay for this property? He is going to make an estimate based upon the initial production, and he is going to take into consideration the experience curves, and then he is going to discount that very largely, either by applying a big hazard factor or applying a high percentage of expected profits.

The CHAIRMAN. What we are discussing, Senator Jones, is the discount factor that involves these estimates.

Senator JONES of New Mexico. Yes.

Mr. MANSON. And you can not justify the use of a low discount factor by proving, after the production has been actually developed and you know exactly what it is, that your estimate of production was either approximate to the actual production or even below the actual production because the purchaser has not the experience before the well is producing oil that he would have after he has produced the oil.

Mr. GREGG. May I say a word in that connection?

I agree with Mr. Manson that subsequent events should not be taken into consideration; but I will confess perfectly frankly that I think it is impossible for one valuing a property as of a date five years prior to erase entirely from his mind subsequent events. I confess that, but what I wanted to show, if the committee will allow me, from these actual figures is that they did not use nearly so high estimates as they would have been warranted in using if they had considered actual production figures, and if you will permit me to, I will give the actual production figures.

Senator ERNST. Yes; I suggest that you proceed with your statement.

Mr. GREGG. In the Cushing district 15 discoveries were allowed the Gypsy Oil Co. The total amount of the discovery appreciation was $7,192,450.89. Up to the end of 1924 the net profit from this district was $9,810,720.20, or more than 36 per cent in excess of the value allowed. The Kansas district, where four discovery claims were allowed, shows a net profit of $2,500,000 in excess of the values allowed. The Bird Creek district has paid out more than 23 per cent in excess of the values allowed, and the properties were continuing to produce more than 2,700 barrels of oil daily.

As further evidence that the hazard factor was adequately considered in determining the probable reserves, the production of these

75 discovery leases has been compared with the estimate. Of the 75 it has been necessary to revise the production figures on 47, 28 producing as predicted in the estimates. Of the 47 leases where actual performance has shown that the estimates of reserves were erroneous, 3 were overestimated and 44 were underestimated. Overestimates in the three leases amounted to 83,316 barrels. Thus, through the recognition of hazard in the determination of reserves, the estimates were more than 6,000,000 barrels short of what subsequent events have proven to be the true reserves.

The committee's engineer criticized specifically the values placed on 11 leases, which he cited by name. Of these 11 leases cited by him, 5 only had an estimated value in excess of $10,000. Of these five, three, the Focht, Lapham, and Shumway, have already paid out more than $3,000,000 in excess of the value placed upon them. Two have been abandoned, the Call and the Chance, one having paid out approximately 25 per cent in excess of the valuation made, and the other having paid out less than the valuation. Nine are still in operation as producing leases.

The following table shows the records of these 11 leases, the valuation of which is criticized by the committee's engineer.

The first is the Lena Fife lease—and I would like to put this table in the record, but I doubt the necessity of reading anything other than the totals.

The CHAIRMAN. That will be all right.

(The statement referred to is as follows:)

Gypsy Oil Co.

	Ultimate production		Appreciation discovery values	Net profit to Dec. 31, 1924	Average daily production, Dec. 31, 1924
	Estimated	To Dec. 31, 1924			
	Barrels	*Barrels*			
Lena Fife	1,484,834	1,529,925	$1,094,715.07	$1,010,535.40	27.24
Eliza Lowe	130,071	123,190	85,161.67	33,082.88	2.62
A. Focht	1,614,217	1,786,634	1,833,603.18	2,376,963.56	193.56
J. B. Lapham	315,533	312,501	376,976.15	424,814.53	12.47
Robert Posey	15,790	16,439	2,286.65	14,443.55	2.44
Nellie Call	8,825	7,511	6,969.81	4,100.69	....
Bernice Stevens	8,738	8,515	6,469.86	5,952.26	.95
D. D. Adams	13,266	14,413	23,302.65	4,443.93	2.33
H. Starr	10,188	11,580	7,278.01	5,627.56	.87
M. L. Chance	4,922	5,949	5,561.08	6,780.83	....
Shumway	6,836,894	7,258,435	9,896,924.51	12,306,182.33	248.36
Total	10,443,278	11,075,092	13,339,248.64	16,155,839.04	490.84

Mr. GREGG. On these 11 leases which were specifically criticized, the estimated number of barrels of oil was 10,443,278. Up to January 1, 1925, they produced 11,075,092 barrels.

The appreciation in value allowed due to discovery for the 11 leases was $13,339,248.64. These wells have already paid out in profits to be applied against that appreciation $16,155,839.04, and they are still producing at the rate of 490 barrels a day. In other words, they have paid out in profits more than 25 per cent in excess of the value placed upon the 11 leases. If the actual figures had been used, an excessive valuation would have been allowed.

Most of the criticism of the committee's engineer was directed to the value placed on the Sumway lease in Butler County, Kans. Since this lease was the one dwelt upon by him and since it represents in the amount of value approximately 75 per cent of the value placed on the 11 leases, I shall take it up in detail later. Before getting to it, however, I want to point out a few facts about some of the other leases of less importance which were criticized by the committee's engineer.

With reference to the A. Focht lease the total discovery value allowed was $1,834,000. The sustained depletion on this discovery value of the lease prior to January 1, 1918, the effective date of the provision allowing discovery depletion, amounted to $1,274,230.90.

In other words, it was mostly paid out before it became of any benefit to the company. Up to December 31, 1919, the gross receipts from this lease were approximately $2,195,000 and discovery depletion was allowed in the amount of $306,000, or approximately 14 per cent. Certainly this does not seem to be an unreasonable allowance for depletion.

With reference to the Eliza Lowe lease, Mr. Fay criticizes the price of oil used in determining the value of the lease and states:

During the six months that elapsed before the 80 per cent price is reached, he will recover approximately one-fourth of his reserves and receive a depletion deduction such that there is no possibility of any operating profit.

He said that the oil price used in valuing the property was too high, that that price was not reached until six months later, and that during those six months he had taken out about one-fourth of his reserves; so there would be no possibility of any operating profit from the property.

As a matter of fact, this well was discovered on April 22, 1915, and consequently no discovery depletion was allowed for two years and eight months after the well came in; that is, up to January 1, 1918. By Mr. Fay's reasoning it is apparent that even if the valuation were excessive, it would have been of practically no benefit to the taxpayer. This lease up to the end of 1919 has produced a gross revenue of $114,000 against which discovery depletion had been allowed in the amount of $7,700; that is, 7 per cent of the gross revenue. Again this depletion allowance does not seem unreasonable.

Mr. MANSON. Do you take into consideration there the product of that well prior to the time that discovery is allowed?

Mr. GREGG. Yes; I am taking into consideration the product of the well for all time, and applying against it the discovery depletion.

Mr. MANSON. Well, the discovery depletion was not allowed over that period.

Mr. GREGG. Yes, sir; Mr. Fay overlooked that fact in his statement, however.

With reference to the Lapham lease, Mr. Fay again criticizes the price of oil used in making the valuation. In this case discovery was allowed in two sands, and the valuation given the sand which he criticizes amounted to only $14,900. Even if the price had been used which Mr. Fay thinks should have been used, the depletion of the company for the two years when it was allowed discovery depletion would have been only $1,150 in excess of what, in Mr. Fay's opinion, is the correct allowance. This seems trivial considering the size of the Gulf Oil Co. case.

Senator JONES of New Mexico. Do you understand, Mr. Gregg, that where oil was being produced and no discovery value was permitted, we afterwards changed the law so as to allow a discovery value?

Mr. GREGG. Yes, sir.

Senator JONES of New Mexico. Where the discovery had actually been made?

Mr. GREGG. The discovery section says that where a discovery has been made subsequent to March 1, 1913, and that appeared for the first time in the revenue act of 1918, so it applies back to all the discoveries made after March 1, 1913.

With reference to the Shumway lease, the Gypsy Oil Co. acquired this lease on January 24, 1916, when it was miles from any oil production, so that in no sense could it be called proved or even probable oil land at acquisition. Early in 1917 as a result of careful surveys the surface geology of the region was mapped and the indications were that the Shumway lease was very favorably situated if there was any oil in the surrounding territory. At this time shallow oil (550–600 feet) was being produced in the Eldorado pool, about 5 miles east and north of the Shumway, and a deeper oil from the Augusta pool 6 miles or more to the south. In March, 1917, the Alpine Oil Co. drilled a well into the deep sand (2,400 feet) about a half mile to the west of the Shumway, which opened an entirely new pool, not an extension of either the Eldorado or Augusta pools, as Mr. Fay indicated. This Alpine well was a small one and did not attract much attention until it was followed on May 30 by the Trapshooter well, which was a large one and which definitely established the existence of a new pool of great magnitude. Immediately Gypsy took steps to drill up the Shumway lease, which even then gave promise of being one of the best in this district. On July 15, 1917, the drill reached the sand and on July 16 the first oil was produced, although the well was not finished and put into regular production until several days later. Production after completion was estimated at 5,000 barrels per day. From this time until the full quota of wells was drilled, development proceeded rapidly, as was necessary, because Gypsy owned this single quarter section, surrounded by leases of its competitors.

The field was peculiar in the mid-continent field in that there was no gas. The oil was forced to the surface by hydraulic pressure. This fact was suspected in the early days of the field before the Shumway well came in. It was confirmed by the performance of the Trapshooter wells, some of which were drilled too deep—below the water table. As Shumway had a structural advantage of 20 to 30 feet over leases to the south and west, it was apparent that careful drilling and skillful handling would result in the production of a vast quantity of oil from Gypsy's lease.

Mr. Fay's criticism and comment on the Shumway valuation and the answers thereto are taken up as made.

First, he infers that Gypsy took advantage of one day in the price of oil, thus getting an increase of 20 cents per barrel. As a matter of fact, the first oil from the Shumway No. 1 was not produced until July 16, so, technically, the use of the August 15 advance is justified. Furthermore, the well was not finished until about July 20, which brings it still further within the limit.

On page 3265 Mr. Fay outlines the history of the Eldorado pool, and his outline is not accurate. The Shumway lease is in the Towanda pool in Butler County, Kans. It is about 5 miles west and south of the Eldorado pool, which was a shallow one, and about 6 miles north of the Augusta pool. The Towanda pool is not an extension of either but is independent and separated.

Mr. Fay then on pages 3266, 3267, and 3268 offers as evidence of excessive valuation sales of properties prior to the development of the field. A comparison of sales in this field in March with values set in August is of no value whatever. The Alpine well which indicated the existence of the pool—but not conclusively since within a month it produced water—was not brought in until March 28 and the Trapshooter well, which definitely proved the pool, was not brought in until May 30.

Mr. Fay states that allowance of 15 per cent should be made for dry holes, taking this allowance from the entire Butler County average. As a matter of fact, Butler County included three entirely separate and distinct pools and it was well known at the time the Shumway well was brought in that this was a new pool. Actual events subsequently showed that not a single dry hole was brought in on this lease. Mr. Fay states that the Gypsy had previously drilled five dry holes on the Towanda structure. This is contrary to fact since this is the first well drilled by Gypsy in this part of Butler County and as above stated there never was a dry hole on that lease.

The comparison of the value allowed the Gypsy Oil Co. on this lease with the sale of a working interest in the Dempsey lease and with the value placed on a part of the Carter Oil Co.'s property in this field and with the Alpine Co. is of no value. The Shumway lease had a structural advantage of 20 feet over the Dempsey lease. The Carter Oil Co. lease and the Shumway lease were valued by the same engineer. The Alpine Oil Co.'s properties were in no sense comparable to this lease since that well produced water within one month after it was brought in.

I had this all carefully explained to me, and I will try to show you how it was explained.

As I understand this Towanda pool, the force producing the oil was entirely hydraulic. There was no gas in it at all—a peculiar feature.

Assume that that represents the oil sand [indicating]. Here is your water pressure [indicating]. The water pushes the oil up on both sides. As the oil is taken out, the water comes in and forces the oil still further up.

The first well brought in in this pool was the Alpine well, which was brought in right at the edge of the water line, so close that within one month they had taken out the oil above the water line, and the water continued to push the oil up. The water then came into the well itself, and, of course, the well was worthless. Therefore, a comparison with the value placed on the Alpine, which produced water within one month, is not helpful.

The next well which was brought in there, which definitely proved the pool, was the Trapshooter well. That was brought in approximately here [indicating], and the Trapshooter property became very valuable and produced a good deal of oil.

The thing that made this lease, the Shumway lease, the most valuable of all was this, and this was known at the time they brought in the first well on the Shumway: They reached the oil sand——

Senator ERNST. You are speaking of the third one now?

Mr. GREGG. Yes; I am speaking of the one brought in by the Gypsy Oil Co. on the Shumway lease.

They reached the oil sand at a point between 20 and 30 feet higher than the point at which the Trapshooter reached it, and, of course, at a much higher point than that at which the Alpine had reached it. The result was that as the water forced the oil up this Shumway had a structural advantage of between 20 and 40 feet. That fact could be definitely determined at the time the first well was brought in by a comparison with the records of the Trapshooter and Alpine.

The CHAIRMAN. I do not understand why that second well that you have diagrammed there does not get the advantage of one higher up, because that reaches oil before the other one.

Mr. GREGG. No, sir; there is oil all through the sand. The question is who is going to get hit by the water first. The water is coming up from both sides. The water hits the lower well first. Of course, the one that had to go farthest down to strike the oil sand is the first one hit by the water, since the water is forcing the oil up. That is what I meant when I said that the Shumway had a structural advantage of 20 to 30 feet over the other properties.

In summarizing, I should like to state again the actual performance of the Shumway lease to show that the valuation placed upon it was conservative. In preparing the valuation the oil reserves were estimated at 6,800,000 barrels—and this is a case where Mr. Fay stated that actual production figures were used instead of facts known at the date of discovery—and up to January 1, 1925, the lease had actually produced more than 7,250,000 barrels. The appreciated value placed on the lease because of discovery was $9,800,000, and the net profits from the well up to December 31, 1924, were $12,306,000, and at that time the well was still producing at the rate of 248 barrels a day. It can not be claimed that the value placed on this lease was excessive when subsequent events have shown that the well has paid out approximately 25 per cent in excess of the value placed upon it.

Senator KING. Mr. Gregg, I wish you would put into the record a statement as to the method of assessing a tax upon a well, and I will give you a set of facts:

Assume that A obtains a lease, or rather he buys a piece of patented ground, say, 10 acres, for $10,000. He sinks a well at a cost of a hundred thousand dollars, and that embraces all of his equipment. He gets a pool and production, say, of a thousand barrels a day, and the estimates, so far as they can be made, are that that 10 acres has a capacity of, say, 6,000,000 barrels.

How do you assess that man? He is making a thousand barrels a day and does that for several years, and it has only cost him $110,000.

Mr. GREGG. Assume that the discovery value of that well—and I will have to do a lot of assuming, because I can not compute it

myself—assume that the discovery value of that well was $3,000,000, to make it easy, and that the reserves were——

Senator KING. Six million barrels.

Mr. GREGG. Six million barrels. He would be entitled to set up the $3,000,000 at date of discovery as his capital, and there would be applied against that 6,000,000 barrels——

Senator WATSON. Let me go back anterior to that. Who determines that discovery value and upon what basis is that determined?

Mr. GREGG. That is what I have been giving. He determines it first, and then we determine it for him, if we disagree with him in the department.

Senator JONES of New Mexico. Do you guess at it?

Mr. GREGG. I must admit that there are a good many elements of guesswork in it.

Mr. MANSON. I would like to discuss that particular feature.

Senator KING. I wanted to go through with this and put into the record just how he would treat that, first.

Mr. GREGG. All right, sir.

The discovery value was $3,000,000. The oil in the ground was 6,000,000 barrels. That would give him a depletion unit of 50 cents per barrel. Suppose that in a given year——

Senator KING. Why 50 cents a barrel?

Mr. GREGG. Six million units divided by the $3,000,000 value gives 50 cents a barrel. Assume that in a year he produced 10,000 barrels, which he sold, say, at $2 a barrel, or $20,000.

Mr. MANSON. But based on the depletion unit that you have used there, your sale price would be nearer $1 a barrel.

Mr. GREGG. Yes. Of course, that would depend upon what the price of oil was in the meantime.

Assume that we produced and sold during the year 10,000 barrels for $20,000.

Senator KING. Pardon me. My assumption was that he produced a thousand barrels a day.

Mr. GREGG. A thousand barrels a day. That is going to make it harder for me to compute. Suppose he produces for only 300 days a year.

Senator KING. Yes.

Mr. GREGG. So that he produces 300,000 barrels which he sold for $2 a barrel, or $600,000, his gross receipts from the sale of the oil.

Senator KING. Yes.

Mr. GREGG. He would have a depletion unit of 50 cents a barrel. Fifty cents a barrel on 300,000 barrels gives him a depletion of $150,000, and he would pay a tax on $450,000 for that year.

Senator KING. With, of course, the expenses that he incurred?

Mr. GREGG. Yes, sir; there would be, of course, other elements entering into that.

Senator KING. There is no hazard involved in that computation.

Mr. GREGG. Well, the hazard is supposed to have been taken care of in that assumed valuation of $3,000,000. The hazard is taken care of in determining the value of the property.

The CHAIRMAN. In other words, if there was no hazard, the price would have been higher than $3,000,000?

Mr. GREGG. It would have been higher if no hazard was taken into consideration, but the hazard was taken into consideration in determining the value of the property.

Senator KING. Do you think—and I express no opinion—that the law is as just as one could be framed to deal with this complicated situation, to assume a value of property entirely disproportionate to the cost?

Mr. GREGG. Of course, the law turns on that. You do not get the discovery value unless the value of the property when you bring in the well is disproportionate to cost. The law so states specifically. If the value of the property when you bring in your well is disproportionate to cost of the property, then you are entitled, under the law, to set up this discovery value as a basis for depletion.

Senator KING. Suppose he had paid $3,000,000 for the property?

Mr. GREGG. He would have no depletion on discovery value, because the market value of the property at the date of discovery would not be disproportionate to the cost of the property.

Senator KING. And if he had sold the property for $3,000,000, for which he had paid only $10,000 and spent a hundred thousand dollars for drilling the well, his vendee would get no discovery value?

Mr. GREGG. No; his vendee would take it up at the cost to him.

Senator KING. What would his tax be? Suppose his vendee for five years after purchase purchased 300,000 barrels at $2 a barrel?

Mr. GREGG. And he paid $3,000,000 for it?

Senator KING. And he paid $3,000,000 for it.

Mr. GREGG. His would be just the same as his vendor, who set up a discovery value of $3,000,000. It is the same proposition. In other words, the $3,000,000 discovery value to the vendor is the same capital for tax purposes as the $3,000,000 purchase price of the vendee.

Senator KING. But the vendee would be allowed a depletion each year?

Mr. GREGG. Oh, yes, sir; on the basis of the $3,000,000 he paid for the property.

Senator KING. What depletion would he be allowed and what factors do you consider in reaching depletion credit?

Mr. GREGG. Just as I stated a minute ago, he would compute it on his $3,000,000 cost, just the same as you would compute it for the vendor on his $3,000,000 discovery value. If he paid $3,000,000 for it and his reserves were 6,000,000 barrels, he would have a depletion unit of 50 cents per barrel.

Mr. MANSON. I would like to say this with respect to Mr. Gregg's statement:

As to his statements that different statements of fact by Mr. Fay were not correct, of course those must be checked before we can determine whether or not we wish to accept Mr. Gregg's statement.

The CHAIRMAN. In that connection I would like to say that I wish counsel would put in a complete reply at some later date and not attempt to answer piecemeal at this time.

Senator KING. Yes; I think that would be better.

The CHAIRMAN. If that is agreeable, I should like to have you proceed with your other case.

Mr. MANSON. The general theory of Mr. Gregg's defense here is one that I am as well prepared to discuss now as I ever will be.

The CHAIRMAN. But I think it ought to be discussed after a checking up on the facts.

Mr. MANSON. In order that this may not go on the record here, and in order that it may appear that I have taken exception to it, I just wish to make the general statement now that the whole theory of Mr. Gregg's discussion ignores every principle laid down in the regulations for the determination of discovery values, and I would elaborate upon that and demonstate it when I reply to the issues of fact raised.

(At 11.55 o'clock a. m. the committee adjourned.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

FRIDAY, MAY 15, 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, Jones of New Mexico, and King.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. A. H. Fay, investigating engineer for the committee.

Present on behalf of Bureau of Internal Revenue: Hou. 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. What are you going to take up this morning, Mr. Manson?

Mr. MANSON. I am going to take up some more oil matters this morning. I have some timber matters here, but the oil matter will be presented first. Shall I proceed now?

The CHAIRMAN. Yes.

Mr. MANSON. I will ask Mr. Fay to proceed.

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

Mr. FAY. At one of the earlier hearings the question was discussed regarding the overlapping of discovery areas, and I presented at that time a more or less hypothetical case of what can be done, and it was suggested by one of the members of the committee that I should find some specific instances where it had been done.

This morning I have four or five such instances which I wish to put into the record, the maps of which I have here. I will ask the members of the committee to look at the small map there marked "H. V. Foster." This is section 25, range 25–9, Osage County, Okla., Mr. H. V. Foster.

Mr. H. V. Foster acquired this lease of 640 acres on December 16, 1910 (100 per cent working interest).

Senator ERNST. This is the Winona oil pool?

Mr. FAY. No; this is not in the Winona oil pool, but it is within 5 or 6 miles of it.

Senator ERNST. I thought it was the same thing.

Mr. FAY. No; it is a pool to the north.

In this case no bonus was paid. He is allowed total discovery valuations amounting to $2,231,329 on reserves of 1,592,056 barrels.

The average depletion unit is $1.40 per barrel, or 53.6 per cent of the average of the posted prices of oil used in making valuations. The discovery valuations to January 1, 1922, covered 560 acres, leaving 40 acres upon which another discovery may possibly be claimed.

Referring to the H. V. Foster lease, section 25–25–9, discovery well No. 16 was completed December 4, 1919, with an initial production of 4,000 barrels. The taxpayer's engineer assumes in estimating his reserves that there will be six additional wells drilled upon this proven area of 49 acres, each well being equal to this 4,000-barrel well. No hazard factor has been used in arriving at the estimated production of these wells. The taxpayer's valuation report was filed with the department January 22, 1923, and his estimated reserves for this lease, as well as other leases, are based on actual production figures from date of initial production to the close of 1922. He is not consistent, for where it is to his advantage he uses the actual production figures to estimate his reserves, but in setting up his discovery valuation for well No. 16, especially, the records show that three small wells—No. 17, 720 barrels; No. 18, 150 barrels; No. 20, 10 barrels—were completed within 30 days after No. 16 was completed. Sufficient information was therefore available within the 30-day period to nullify the assumption that all of the proposed wells would equal No. 16. The department has accepted the estimate of six wells at 4,000 barrels each, and upon this basis given the taxpayer a discovery valuation of $467,000 for this particular proven area of 49 acres.

Senator ERNST. When did they grant him that; what is the date of it, do you know?

Mr. FAY. The taxpayer's report was filed on January 22, 1923. I have not the exact date of that at hand, but it has been since that date.

Then there follows a table showing the 10 discoveries, the date of discovery, the price used, the valuation allowed, the acreage proven, the depletion unit, the per cent of the posted price, and the reserves allowed in barrels. I hardly think it is worth while to read all of those figures.

The CHAIRMAN. I think not. The paper will go into the record?

Mr. FAY. It will be put in the record.

(The chart and table referred to are as follows:)

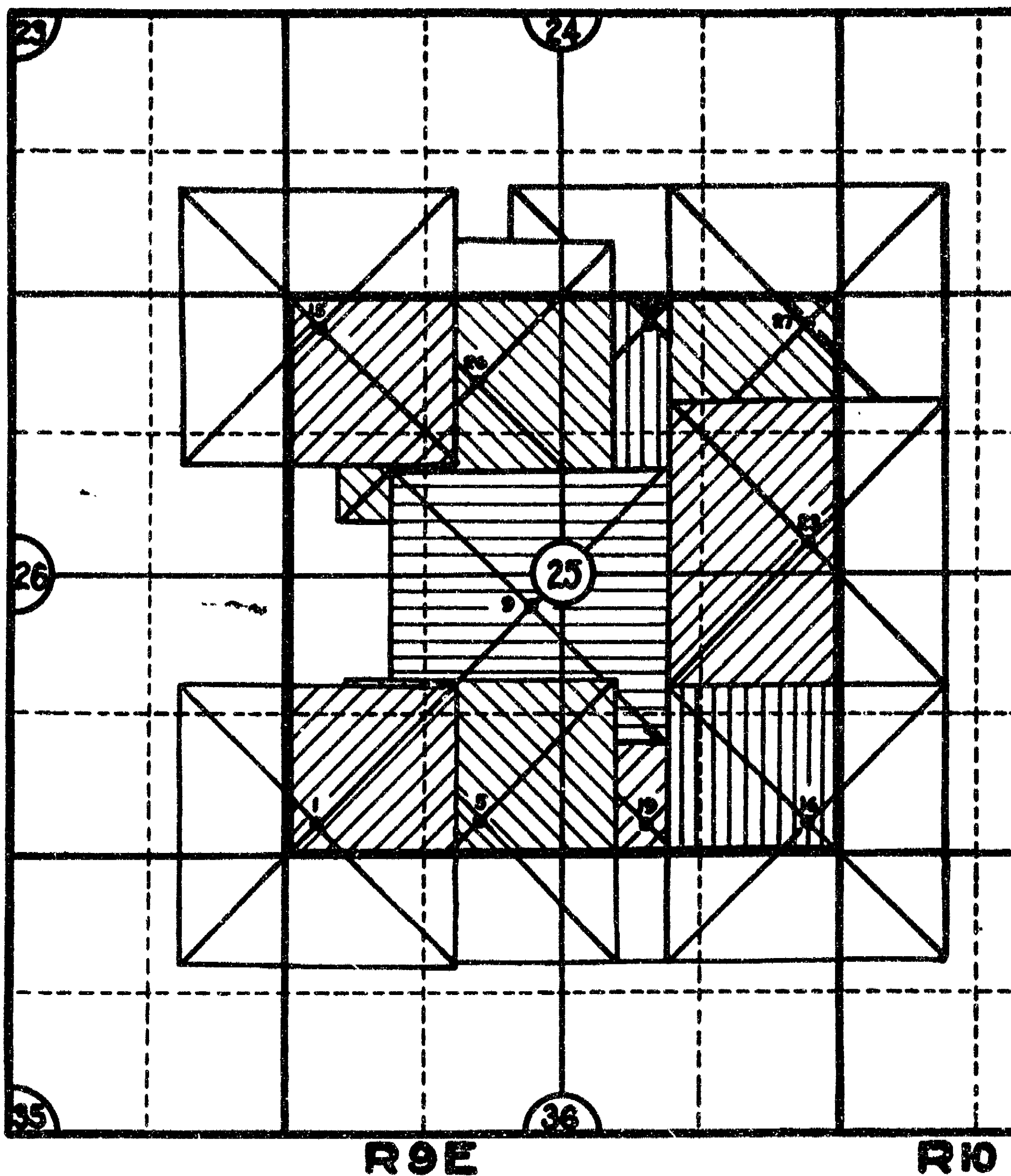
Discovery valuation allowed H. V. Foster to January 1, 1922, 100 per cent working interest. Sec. 25–25–9, Osage County, Okla.

Discovery well No.	Date	Price used	Valuation allowed	Acreage proven	Depletion unit	Per cent of posted price	Reserves allowed
							Barrels
1	Sept. 16, 1914	$0.55	$3,554.10	49.5	$0.0330	6.0	107,598
5	June 2, 1916	1.55	148,449.28	56.0	.8605	55.5	172,496
9	Oct. 10, 1917	2.00	161,146.72	123.25	.9640	48.2	167,168
15	Sept. 15, 1919	2.25	201,756.93	60.0	1.0823	48.1	186,331
16	Dec. 4, 1919	2.25	467,447.50	49.0	1.7656	78.4	264,750
19	Apr. 28, 1920	3.50	112,451.38	7.5	2.3435	66.9	47,984
23	June 20, 1920	3.50	339,729.12	96.25	1.7886	51.1	189,936
26	Sept. 22, 1920	3.50	502,990.29	67.0	2.0371	58.2	246,917
27	do	3.50	236,238.00	34.3	1.8842	53.8	125,376
35	Dec. 31, 1920	3.50	57,567.50	18.0	.6894	19.7	83,500
10 wells		2.61	2,231,329.82	560.8	1.40	53.6	1,502,056

Section: 25 Township: 25 N. Range: 9 E.

County: Osage State: Oklahoma

T 25 N



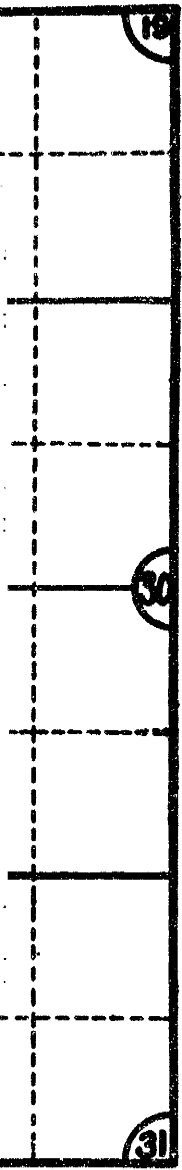
H. V. Foster

Discoveries Allowed

to

Jan. 1, 1922.

92919—25. (Face p. 2902.)



2002.)

Mr. FAY. This is another H. V. Foster lease, copartner with the Norwood Oil Co., lot 285, Osage County, Okla.

Lot 285 contains 960 acres, being the north half of sections 28, 29, and 30, township 25, range 11 east. Mr. Foster acquired a one-half working interest in this lease February 4, 1913, for $18,601 cash and on March 16, 1916, when the lease expired he paid $87,500 for the renewal, so that his total cost was $106,101. This was all unproven territory at the time of his purchase and he was therefore allowed, under the regulations, to set up discovery valuations, which have been allowed as shown in the accompanying table.

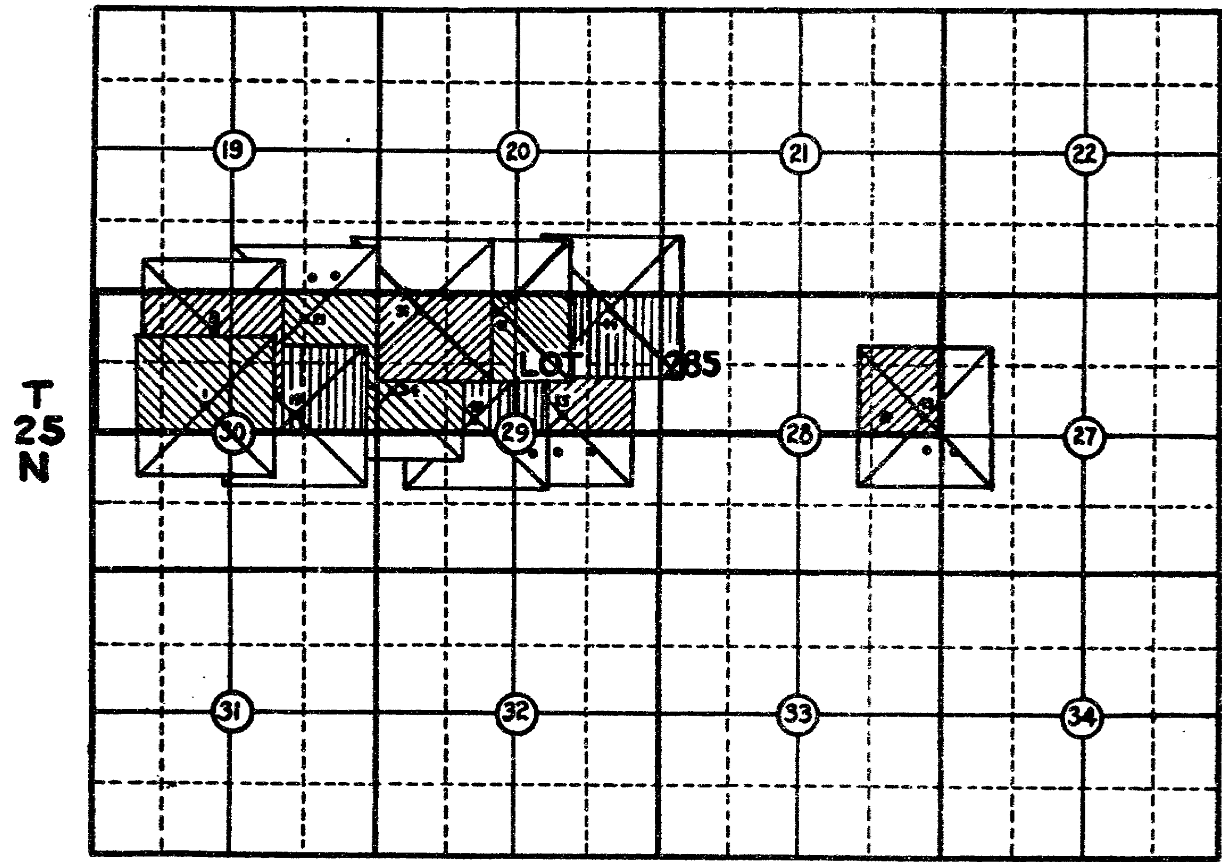
The Norwood Oil Co. acquired from J. H. Brennan, May 1, 1917, the other 50 per cent working interest for stock, the value of which was set up as $753,979.81.

In this connection, I would say that as I was working this up, I asked for the returns of J. H. Brennan, and a search has been made there for them. Five or six days ago one of the clerks of the department said that they were yet unable to find them. The reason I asked for that is that there is a possible taxable profit in that transaction, having gotten the ground before it was proven, and disposing of it for better than $750,000.

The original Norwood estimate of recoverable reserves, at date of acquisition, was 496,393 barrels. Taxpayer states that developments proved in 1919 this was excessive and therefore reduced his reserves by 66,000 barrels, which makes the estimated recoverable reserves, 430,393 barrels. The depletion unit allowed by the Income Tax Unit is $1.7518, based on cost. No discovery valuation was claimed by Norwood, because the cost of this lease was so great that wells subsequent to purchase did not have a value in excess of cost. The total value allowed H. V. Foster for his working interest was $755,873. This was depleted $229,073 to May 1, 1917, leaving $526,800 as Foster's interest May 1, 1917, as compared with the value of $753,979 placed on the stock of the Norwood Oil Co. This would indicate an excessive valuation allowed for the Norwood stock.

The estimated reserves allowed to H. V. Foster for his one-half interest was 903,104 barrels. To May, 1917, Foster had produced 378,822 barrels, leaving his reserves as 524,282 as compared with the reserves allowed to the Norwood Oil Co. for a like interest, namely, 430,393 barrels. The average depletion unit based on Foster's discovery valuation and cost, amounts to 80.3 cents per barrel, while the Norwood Oil Co.'s depletion unit on cost is $1.7518. The accompanying sketch map not only shows the discoveries allowed, but it shows also how successive discoveries may overlap and be extended to the extent of blanketing the entire lease or pool. Out of the 960 acres owned by Foster and the Norwood Oil Co., Foster has set up discovery valuations on 626 acres to January 1, 1922. There is no reason why discovery valuations may not be set up by both owners on the remaining 334 acres, in case good wells are brought in. Then there follows a table showing the valuation of each of the discoveries allowed to H. V. Foster.

(The chart and table referred to are as follows:)



H. V. Foster Discoveries Allowed to Jan. 1, 1922

Discoveries claimed and allowed H. V. Foster to January 1, 1922, lot 285

Discovery well No.	Date	Valuation	Discovery acreage
	May 14, 1915	$74,235.76	100.0
	Oct. 22, 1915	32,277.06	60.0
19	Feb. 13, 1916	99,148.28	91.0
:1	May 17, 1916	17,897.24	22.4
31	Nov. 20, 1916	27,983.68	78.0
4	Feb. 19, 1917	95,094.10	20.0
41	Aug. 18, 1918	109,560.72	53.0
44	Nov. 23, 1918	101,394.30	73.0
48	July 7, 1919	66,376.51	18.5
53	Feb. 29, 1920	102,534.09	19.25
49	Feb. 20, 1919	29,571.50	91.0
11 discoveries		755,873.24	626.15

H. V. Foster acquired a 50 per cent interest in this lease of 960 acres on Feb. 4, 1913, for $18,601, and on Mar. 16, 1916, when the lease expired he paid $87,500 for the renewal. These amounts are the cost of Mr. Foster's undivided half interest.

Mr. FAY. The next is the Standard Oil Co. of California. I have no map for that.

The accompanying table shows 10 discoveries on the Baldwin lease of the Standard Oil Co. of California. The dates of these discoveries are given, gravity of oil, the posted price of oil at date of discovery, and the posted price of oil as of July, 1922. The depletion unit is also given, as well as the percentage or ratio between the depletion unit and the posted price of oil at date of discovery.

Seven of these discoveries are in the first sand and three in the second sand. The area embraced by this lease is approximately 700 acres. The reserves for the Baldwin lease based on the 10 discoveries are 29,152,492 barrels. The total valuation given for these reserves is $19,530,000, the actual cost of which was $40,000,000. It has been brought out in former hearings that the relation between the depletion unit and the posted price of oil at date of discovery is approximately 40 per cent. This tabulation, however, shows that the per cent of depletion ranges from 45 per cent to 73 per cent of the posted price of oil at date of discovery. In addition to the depletion unit shown herein, operating and development costs, marketing, and other costs and losses will be deducted. The posted price of 25° oil in July, 1922, was 96 cents. The depletion unit determined for this particular discovery based on $1.28 oil is 93.8 cents, so that oil produced on the basis of this valuation would actually show a loss to the operator. The depletion units established will maintain during the life of the property unless the taxpayer should file an appeal for a readjustment based on either additional reserves or an erroneous estimate of reserves. While different depletion units have been given for the various discoveries, there are certain difficulties involved in handling the oil from separate wells so that the practical handling of a case of this kind would be through a single pipe line and the taxpayer would therefore render his returns on the basis of a composite depletion unit.

Then, there follows a table giving the date, the gravity of the oil, the price as of July, 1922, the price at date of discovery, depletion unit, and the percentage of depletion as regards the price used at the date of valuation.

Senator ERNST. Has this matter been concluded as yet?

Mr. FAY. This valuation has been allowed, but the case has not yet been closed.

(The table referred to is as follows:)

Standard Oil Co. of California, discoveries on Baldwin lease

Date	Gravity of oil (degrees)	Posted price		Depletion		Zone
		July, 1922	Date of discovery	Unit	Per cent of post prices of oil at date of discovery	
Feb. 27, 1917	23	$0.80	$0.79	$0.359	45.4	First sand.
June 30, 1917	23	.80	1.05	.518	49.4	Do.
Feb. 28, 1918	23	.80	1.07	.564	52.7	Do.
June 30, 1918	23	.80	1.32	.704	53.3	Do.
July 30, 1918	23	.80	1.30	.682	52.4	Do.
Sept. 30, 1918	23	.80	1.30	.669	51.4	Do.
May 31, 1919	23	.80	1.33	.612	46.0	Do.
Mar. 31, 1917	25	.96	1.07	.673	62.9	Second sand
Aug. 31, 1918	25	.96	1.30	.882	67.8	Do.
Nov. 30, 1918	25	.96	1.28	.938	73.3	Do.

Mr. MANSON. Mr. Fay, do you know whether or not, where several wells are handled through one pipe line, or where the product of several leases is handled through one pipe line, the product of each lease is measured into the pipe line separately?

Mr. FAY. Well, it will have to be measured into the pipe line separately, by reason of the royalty interest, but I could not say.

Mr. MANSON. Yes.

Mr. FAY. I could not say whether it was even practical to separate them on the individual wells of a particular lease. That is often difficult to do.

Mr. MANSON. The reason I ask the question is that in this case it appears that a depletion unit of 93.8 cents was allowed. The posted price of oil in July, 1922, was 96 cents, and you called attention to the fact that in addition to this depletion of 93.8 cents the various costs would have to be deducted, which would, as far as purposes of taxation were concerned, show a loss. The law now provides that not to exceed 50 per cent of the income from the well on a discovery valuation can be deducted. I was wondering whether, as a practical matter, if this oil is turned into a pipe line with oil of other wells, it would be possible to get the benefit of this whole depletion unit, notwithstanding the provision of the 1924 statute.

Mr. FAY. There would be, I think, an advantage to the taxpayer in that case.

Now, I have worked out a composite depletion unit for this entire group.

Mr. MANSON. Yes?

Mr. FAY. And it amounted to 67 cents per barrel.

Mr. MANSON. That would be considerably above the 96 cents.

Mr. FAY. Sixty-seven cents per barrel.

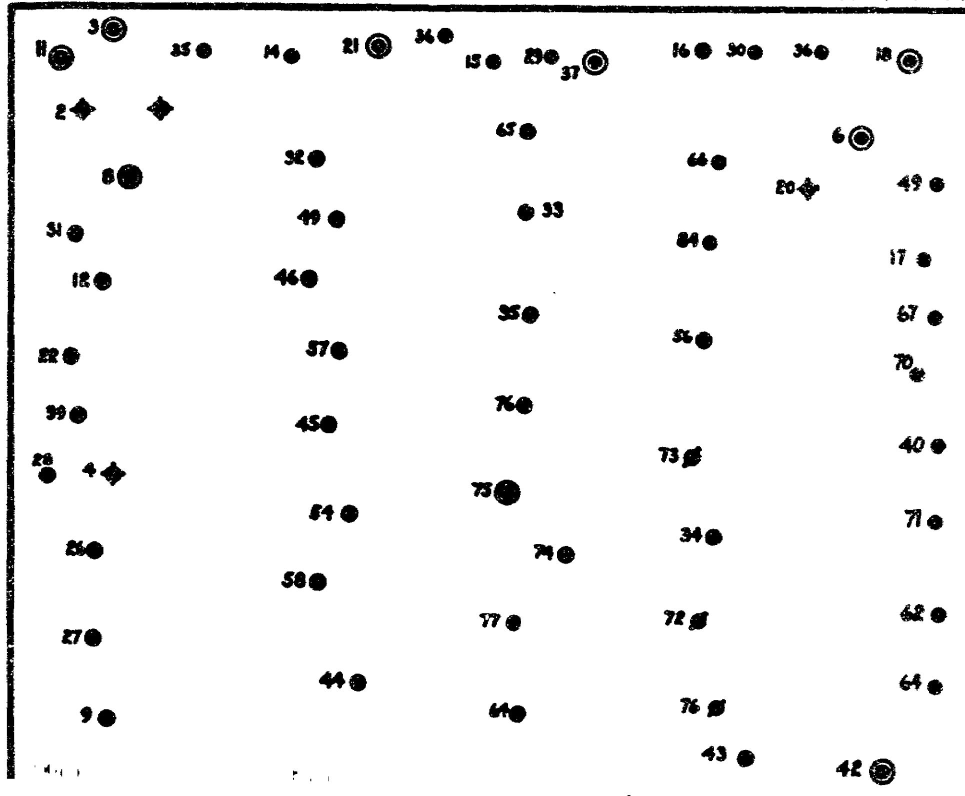
Mr. MANSON. Yes; I say that would be more than 50 per cent of the 96 cents.

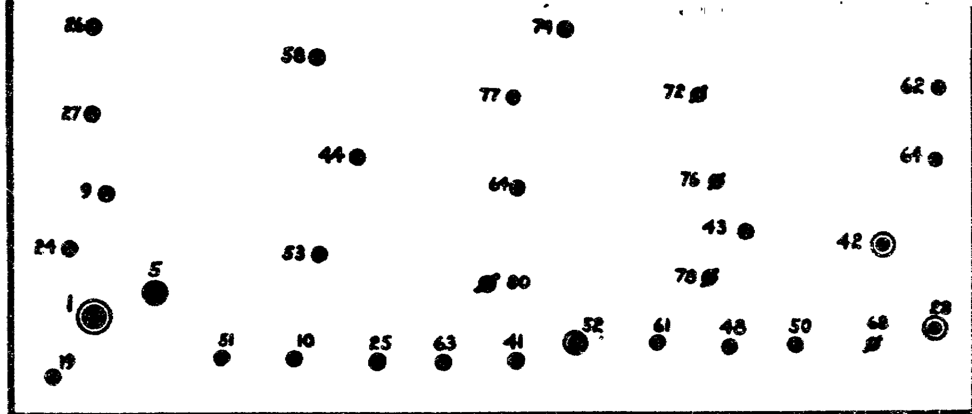
Mr. FAY. Oh, yes.

DISCOVERIES CLAIMED GYPSY OIL CO.

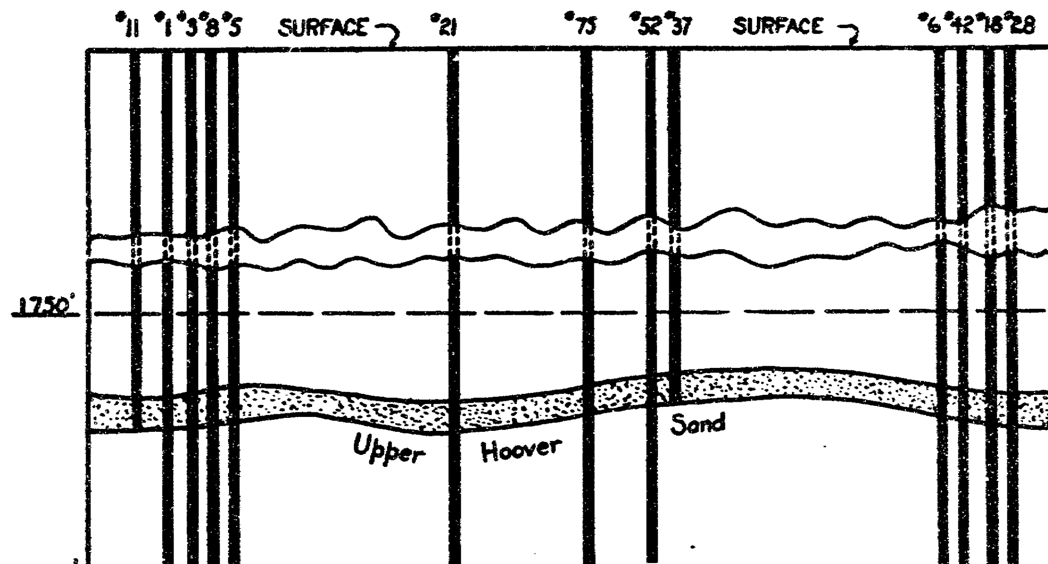
SHAWVER LEASE 160 ACRES NW SEC. 2 T. 24 N. R. I W.

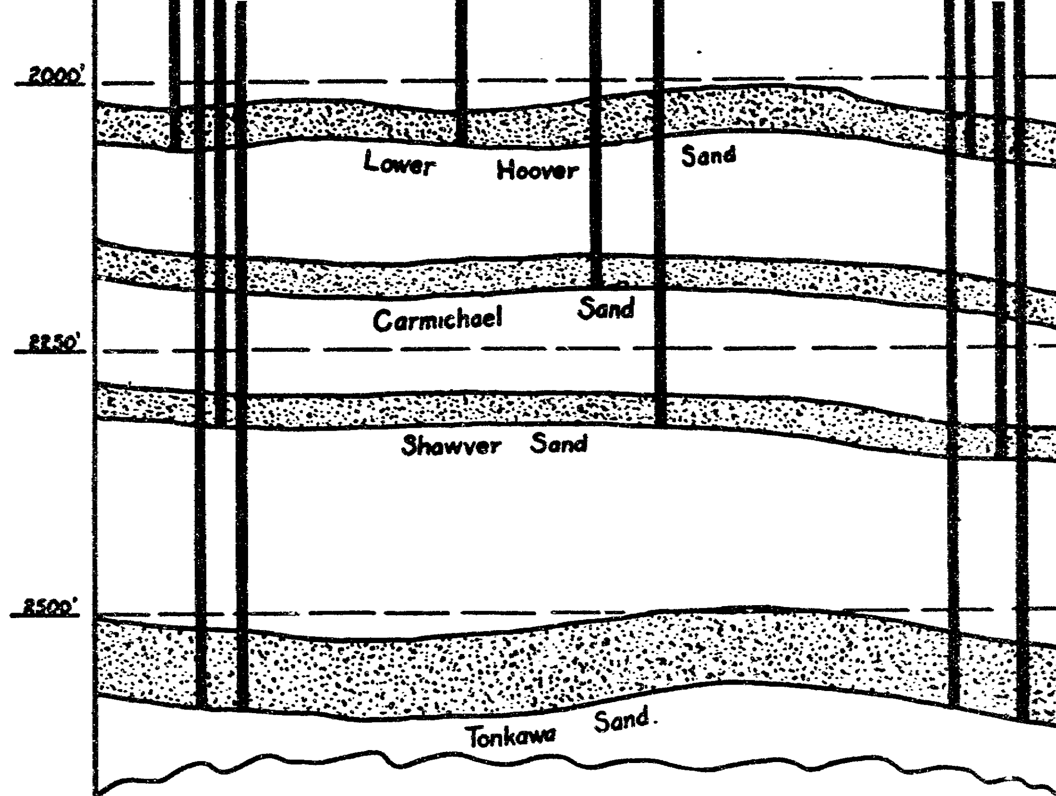
NOBLE COUNTY OKLAHOMA





DISCOVERY WELLS





92919—25. (Face p. 2907.)

Mr. MANSON. You do not know as a fact, then?

Mr. FAY. No; I could not say; I have not looked into that.

Mr. MANSON. All right.

Mr. FAY. This is a case of discovery where there are five different sands. The taxpayer is the Gypsy Oil Co. in section 2, township 24, range 1 west, Noble County, Okla.

This lease, known as the Lee Shawver lease, in Noble County, Tonkawa district, was acquired August 15, 1921, at a cost of $5,700; royalty one-eighth. The Gypsy Co. own a full working interest.

This lease is a typical case showing where discovery may be obtained on more than one sand. So far, 14 discoveries have been made (according to regulations) and claimed on five different sands. The accompanying map shows that 77 wells have been drilled on this lease, of which number 13 have been set up as discovery wells. Two discoveries are claimed for well No. 1, $444,951 for the upper Hoover sand, and $494,806 for lower Hoover sand. While this is a 160-acre lease, yet the 14 discoveries are claimed on the basis of 745 acres of proven oil-bearing sands.

The basis for these "discovery valuations" is the same as those brought out in former hearings, namely, 5 per cent discount, no dry hole or operating hazard, excessive reserves, and no profit factor as between a willing buyer and a willing seller. The total valuation claimed for this lease, by reason of these 14 discoveries, is $9,573,875, with reserves set up as 5,417,554 barrels. The majority of these discoveries were based on oil at $2.60 per barrel. The discount rate of 5 per cent does not apply to the first year's production. The composite discount over the entire life of these wells, which would represent the investor's total profit, varies from 1.28 per cent to 6.36 per cent. The average depletion unit for the entire lease is $1.77, with an average price of oil of $2.35. The relation between the depletion unit on "discovery appreciation" and the market price of oil is therefore 75.4 per cent, notwithstanding statements in former hearings that this figure is usually within the limits of 20 to 40 per cent.

The taxpayer's returns for 1922 and 1923, which include these discoveries, have not been audited nor has the oil and gas section made its report, but the records show that the computations have been checked preliminary to a review by the engineers. Since the department closed the earlier returns on the basis submitted by the taxpayer and apparently not concede any gross error, it is to be presumed that the case will be closed on the same basis to the end of 1923, with a discovery valuation of more than $9,500,000 for a lease that cost $5,700. The accompanying table shows dates, posted price of oil, discount, and reserves.

(The chart and table referred to follows.)

Gypsy Oil Co.—Depletion on discovery appreciation

[Lee Shawver lease, Tonkawa district, Oklahoma. Cost of lease, $5,700; depletion unit on cost negligible]

Sand	Sand depth	Thickness	Well No.	Date of discovery	Posted price	Price used	Discount	Reserves	Present worth, including casing-head gas	Depletion unit on discovery appreciation	Per cent of posted price	Degrees Baumé
1922 DISCOVERIES												
	Feet	*Feet*					*Per cent*					
Upper Hoover	1,841-1,878		1	Sept. 29, 1922	$2.00	$2.00	2.37	337,746	$444,951.70	1.32	66.0	44.8
Tonkawa	2,455-2,526		3	Dec. 21, 1922	2.20	2.20	1.28	1,012,092	1,749,759.08	1.73	78.6	44.8
1923 DISCOVERIES												
Upper Hoover	1,813-1,852	39	11	Mar. 4, 1923	2.60	2.60	1.91	867,703	1,968,409.14	2.268	87.4	
Do	1,788-1,813	25	37	June 3, 1923	2.20	2.20	4.20	334,703	496,086.67	1.481	67.4	
Lower Hoover	2,000-2,020	20	1	Mar. 7, 1923	2.60	2.60	1.66	246,845	494,806.00	2.002	78.1	
Do	1,952-1,970	18	21	Apr. 14, 1923	2.60	2.60	2.78	165,668	197,494.31	1.186	45.6	
Do	1,962-2,000	38	42	May 23, 1923	2.20	2.20	6.36	104,433	87,625.64	.839	38.1	
Carmichael	2,096-2,120	24	75	Nov. 11, 1923	1.75	1.75	3.10	96,847	62,496.09	.635	36.3	
Tonkawa	2,481-2,537	56	5	Feb. 18, 1923	2.60	2.60	4.69	867,617	1,877,872.52	2.162	83.2	
Do	2,404-2,506	102	6	Feb. 3, 1923	2.60	2.60	4.05	403,418	757,187.73	1.875	78.1	
Do	2,485-2,576	91	28	May 18, 1923	2.20	2.20	4.97	383,233	538,535.81	1.404	63.7	
Shawver	2,205-2,225	20	8	Apr. 1, 1923	2.60	2.60	2.38	165,931	267,184.43	1.578	66.3	
Do	2,162-2,179	17	18	Apr. 21, 1923	2.60	2.60	2.01	153,578	228,929.30	1.491	57.4	
Do	2,186-2,216	30	52	Aug. 14, 1923	2.20	2.20	2.48	377,740	502,538.92	1.331	60.6	
Totals and averages					2.35	2.34		5,417,554	9,573,875.35	1.77	75.4	

Senator ERNST. What is the criticism in that connection? What ought to have been done there, in your opinion?

Mr. FAY. The criticisms on this have been brought out in other hearings, with especial reference to the discount to determine present worth, the possible dry holes, the operating hazard, and the excessive valuation throughout.

Mr. MANSON. There are two real purposes in presenting this. The map before the Senator is prepared for the purpose of indicating the numerous discoveries which, under the law, may be claimed upon a small area of ground.

As to the other facts brought out by Mr. Fay, the discount rate, and so on, those are matters which I will discuss when I reply to Mr. Gregg's statement of yesterday.

Mr. FAY. With reference to these discoveries, the Gypsy Oil Co. is not wrong in setting up the discoveries. The granting, in principle, of the setting up of the discovery in itself is supported by the regulations, and the point I wish to make is that the regulations are so liberal as to permit so many discoveries within a specified area.

Senator ERNST. Are the regulations in accordance with the law, as you understand it?

Mr. FAY. The regulations are in accordance with the law, but they are exceedingly liberal. The law is not specific in defining the areas.

Mr. MANSON. There is no claim that that regulation is not in accordance with the law.

Senator ERNST. That is what I am trying to get at.

Mr. FAY. No; we are not saying that that is not in accordance with the law, but it shows this liberality. I have presented this case to show both a weakness in the law and in the regulations, as I look at it.

Mr. GREGG. Mr. Chairman, may I call attention at this time to one point in reference to the last lease which Mr. Fay discussed, and that is that he has referred simply to the claims of the company, and I want to bring out that those claims have not been checked or passed upon by the department as yet.

Mr. FAY. I made that statement, Mr. Gregg.

Mr. GREGG. And I wanted to emphasize it.

The CHAIRMAN. He made the statement that they have been checked.

Mr. FAY. They have been checked by the comptometer operator.

Mr. GREGG. Yes, sir; the computations have been checked, but the case has not yet been passed upon by the department.

The CHAIRMAN. This is one case where we want to close the barn door before the horse gets out, rather than to handle it the other way.

Senator KING. Do I understand that there have been no such cases that have been closed?

Mr. GREGG. No; I was just drawing attention to the fact that this case has not been finally closed as yet.

Mr. MANSON. Go ahead, Mr. Fay.

Mr. FAY. I have another lease here which has cost an enormous sum, on which discovery valuation is also set up on a portion of it.

This is the Gypsy Oil Co., a subsidiary of the Gulf Oil Corporation. I have no map for it.

On April 10, 1923, the Gypsy Oil Co. secured from the Government the Gladys McComb lease on the northwest quarter of section 23, township 27, range 5, Osage County, Okla., for a consideration of $1,195,005, being the bonus plus the necessary fees in consummating the transaction.

First discovery——

Senator KING. Was that actually paid?

Mr. FAY. Oh, yes: this was purchased at one of the auction sales of the Osage leases, held by the Interior Department for the benefit of the Osage Indians.

First discovery: A number of wells were started in April, 1923, the first producing well being well No. 4, which was completed on June 4, 1923, with an initial production of 3,100 barrels. This well was in the southwest quarter of the quarter section, and the taxpayer sets up discovery valuation on 40 acres proven by this well. The price of oil at date of discovery was $1.80 (gravity, 37.6°). The taxpayer estimates that this well will drain 10 acres at 31,300 barrels per acre. He estimates that the remaining 30 acres should be 50 per cent as productive as the first 10 acres, which gives additional reserves of 469,575 barrels, or a total of 782,626 barrels gross. The taxpayer's interest in this amounts to 636,498 barrels. In valuing these reserves he deducts the cost of four wells; does not include any dry-hole hazard; lifting costs are estimated at 18.2 cents per barrel, and tax is at 3 per cent.

That tax is the local State production tax.

The net value of the Gypsy Oil Co.'s interest in recoverable oil in No. 4 discovery areas (40 acres) is $853,758. This amount is reduced to present worth using a 5 per cent discount applied to the middle of the year after the first year's production. The total discount on this amount is $29,966, leaving a net present worth to the taxpayer of $823,791. From this he deducts $298,751 as being one-fourth cost of the lease, leaving for discovery appreciation on this 40-acre area $525,040; to this he adds $110,994 for the casing-head gasoline content, making the total appreciation $636,035, or $15,900 per acre for land which cost him $7,468 per acre. This results in a discovery appreciation depletion unit of 99 cents per barrel, while the depletion on cost of 40 acres amounts to 46.7 cents.

In the depletion schedule set up by the taxpayer for the period from June 4, 1923, to June 18, 1923, the taxpayer produces 32,550 barrels of oil; the reserves as of June 4 are 636,035 barrels. The depletion unit on cost for this amount of oil is determined by dividing the cost of the 160 acres ($1,195,005) by the reserves of 40 acres, and a depletion unit of $1.87 per barrel results. This depletion unit applied to the 32,550 barrels of oil gives depletion on cost as $61,111.

In addition to this, the taxpayer sets up depletion on discovery appreciation on this 40 acres on the basis of 99.9 cents per barrel, which results in an additional depletion of $32,526. The taxpayer's total depletion amounts to $2,876 per barrel for oil that is selling at $1.80.

Senator ERNST. Has that been finally adjudicated?

Mr. FAY. The status is the same as the other case, which I will mention at the close of this.

Senator ERNST. It is sometimes good to let us know in advance, so——

The CHAIRMAN. So that we will not be worrying about the loss to the Government?

Mr. FAY. Yes.

Senator KING. Well, the Income Tax Unit has not finally approved of this?

Mr. FAY. No.

Second discovery: On June 18 well No. 1 is completed, with an initial production of 1,200 barrels. This is estimated to drain 10 acres, resulting in reserves of this area of 11,718 barrels per acre. The taxpayer then estimates the remaining three wells (30 acres) would each have a productivity of 125 per cent of the first well, which gives additional reserves of 439,425 barrels or a total recoverable oil for the southeast 40 acres of 556,607 barrels, of which the Gypsy Oil Co.'s interest on June 18, 1923, was 452,801 barrels. In estimating the future productivity of the 30 acres the taxpayer had completed within the 30-day period two additional wells, each of which was less than his so-called No. 1 discovery well, so that there was no justification of estimating the future reserves of each anticipated well at 125 per cent of well No. 1. In the depletion schedule set up by the taxpayer, the total reserves as of June 18, 1923, were 1,056,749 barrels for the south 80 acres only. No reserves have been included or estimated for the north 80 acres.

Since preparing these notes, I looked in the Oil and Gas Journal yesterday to determine whether or not there were any wells drilled within the immediate neighborhood of these at the date of purchase, and I find that in the adjoining 160 acres to the east there was one well of 80 barrels initial production, one well of 1,800 barrels initial production, one well of 2,280 barrels initial production, and one well of 2,400 barrels initial production, and while I could not get the exact location of these wells, they are within these 160 acres adjoining on the east, and undoubtedly their 160 acre proven area would overlap at the date of purchase.

The CHAIRMAN. When were those discoveries made?

Mr. FAY. These wells?

The CHAIRMAN. Yes.

Mr. FAY. These wells were made prior to April 19, 1923; that is, they were reported in the Oil and Gas Journal of April 19, 1923. That was the date of the publication.

The CHAIRMAN. What date?

Mr. FAY. The date of publication was April 19, 1923, and it would take several days for these reports to get through and get them out in a weekly journal. This lease of the Gypsy Co. was purchased on April 10; so that there was an active drilling campaign on that date of purchase.

Mr. MANSON. I might interject at this point that this lease is a good illustration of the fact that discoveries are not confined, under the law, to what might be termed "wild-catting territory." No sound, responsible oil company, like the Gypsy Oil Co., would pay

$1,195,000 for a lease upon territory that was not pretty well established oil territory.

Senator JONES of New Mexico. I think that suggestion goes to the soundness of the rule limiting a discovery to 160 acres.

The CHAIRMAN. Proceed, Mr. Fay.

Senator KING. Before you do that, Mr. Fay: The first tax return that would be made by this company with respect to these properties which you are now discussing would be in 1923?

Mr. FAY. They would be the returns for the year 1923, filed in March, 1924.

Senator KING. And did they make their payment upon the returns which the company filed?

Mr. FAY. I did not see the return, Senator King.

The taxpayer depletes these reserves on cost by dividing the reserves into the residual cost ($1,133,893.38) of the entire 160 acres and determines a depletion unit of $1,073 on cost. He does not set up a discovery valuation on the second 40 (well no 1) but adds the reserves to the discovery reserves of well No. 4 and determines a depletion unit for discovery appreciation of 57.1 cents making his total depletion unit $1.644 for oil selling at $1.80 with production costs of 18.2 cents, tax amounting to approximately 6 cents per barrel and depreciation to be deducted.

Mr. MANSON. You mean by that the local tax?

Mr. FAY. That is the local tax; yes.

For that part of the year from June 18 to December 31, 1923, the net production was 521,899 barrels, on which the taxpayer sets up cost depletion of $548,184 and depletion on discovery appreciation of $291,768.

It will thus be seen that the taxpayer is depleting the cost of the entire 160 acres on the production of 80 acres and he will then have an opportunity to drill additional wells on the north 80 acres and set up discovery values thereon, having depleted the entire cost on the south 80. So long as the taxpayer is permitted to set up depletion on the basis as herein described, there will be no taxable income whatever.

The taxpayer is not consistent in his calculations, for when he sets up discovery value on 40 acres he allocates one-fourth of the total cost of 160 acres to the discovery 40. Yet when he depletes on cost, he uses the cost of 160 acres against reserves of 40 acres.

The following sets forth in detail the foregoing statements (depletion on cost and discovery):

Cost of lease, $1,195,005; reserves on 40-acre discovery No. 4, 636,428 barrels.

Discovery value, $823,791; cost of 40 acres, $298,751; discovery appreciation, $525,040.

Valve casing-head gas, $110,994; total discovery appreciation, $636,035.

Depletion unit on cost of entire 160 acres, using reserves of 40 acres only, $1.877; depletion unit, discovery appreciation, $0.999; total depletion unit, $2.876.

Production, June 4 to June 18, 1923, 32,550 barrels.

Depletion on cost, $61,111; depletion discovery appreciation, $32,526; making a total depletion of $93,637.

Reserves, June 4, 1923, 636,498 barrels; production, June 4 to June 18, 1923, 32,550 barrels.

Reserves, June 18, 1923, 603,948 barrels.

Reserves (discovery well No. 1) added June 18, 452,801 barrels; total reserves (80 acres), 1,056,749 barrels.
Residual cost, June 18 (160 A), $1,133,893.
Depletion unit on cost, $1.073.
Residual discovery appreciation, $603,507.
Depletion unit on discovery appreciation, $0.571.
Production June 18 to December 31, 521,899 barrels.
Depletion on cost, $548,184; depletion on discovery appreciation, $291,768; making a total depletion of $839,952; a gross income from oil at $1.80 of $939,418, and an income, after deducting depletion, of $99,466.

This income to bear all development, operating expense, depreciation and tax—approximate total of 62 cents per barrel.

Section 214, act of 1924, article 201-H, Regulations 65, states:

The deductions for depletion in case of discovery shall not exceed 50 per cent of the net income computed without allowance for depletion from the property upon which the discovery is made.

Senator ERNST. You say that that is the regulation or the law?

Mr. FAY. That is the law, and is repeated in the regulations.

The net income is determined by deducting from the gross income, the development, operating expenses, depreciation, and taxes. In the present case, the production for the last half of the year is 521,-899 barrels, with oil selling at $1.80 would give a gross income of $939,418. The taxpayer gives his operating costs as 18.2 cents, taxes 5.4 cents (3 per cent of $1.80), development costs determined from data submitted by taxpayer as 28.4 cents——

Senator WATSON. What tax do you refer to there?

Mr. FAY. The local State production tax, while depreciation is estimated at 10 cents per barrel, gives a total of 62 cents per barrel to be deducted from gross income. The deduction, therefore, amounts to $323,577, leaving the net income without deducting depletion as $616,841. Fifty per cent of this would be $308,420, while the depletion charged off by the taxpayer on the basis of "discovery appreciation" alone amounts to $291,768, and depletion charged off on the basis of cost is $548,184. The amount of depletion to be charged off on basis of discovery valuation is calculated to check very closely with the amount actually allowable. It will therefore be seen that article 201-H, Regulations 65, does not prohibit charging off exorbitant depletion.

The fact that the taxpayer paid $1,195,000 for this 160-acre lease is strong evidence that he considered it proven territory at date of purchase.

In setting up discovery valuations, the taxpayer has continued on the same basis for 1922 and 1923 as brought out in former hearings, viz, 5 per cent discount, no dry hole or operating hazard; excessive reserves; low operating costs and resulting high depletion units.

The case has not been audited for these later years, nor has the oil and gas section made its final report, but the records show that the computations have been checked, preliminary to a review by the engineers. Since the department closed the earlier returns on the basis submitted by the taxpayer and does not concede any gross error, it is to be presumed that the case will be closed on the same basis to the end of 1923.

Senator KING. Then the department has closed one of those cases by accepting those figures?

Mr. FAY. Senator King, these figures are as presented by the taxpayer, but not as yet accepted by the department.

The CHAIRMAN. But you have just stated——

Mr. FAY. I am presenting them to show what can be done in these cases.

Senator KING. Yes, but I understood you to say there that the bureau had closed a case.

Mr. FAY. In 1919; the earlier year.

Senator KING. Yes.

Mr. FAY. All of this is for later years, set up on the same basis as the 1919 returns were rendered.

The CHAIRMAN. In other words, the 1919 cases are closed, and they are presenting their claims on the same basis as that on which the 1919 cases were closed, and your assumption is that because they do not admit an error in closing the 1919 cases, they will go ahead and close those cases on that basis.

Mr. FAY. That is my understanding.

Mr. MANSON. In fact, the policy was defended here yesterday.

Senator KING. By the unit?

Mr. MANSON. Yes.

Senator KING. By whom?

Mr. MANSON. By Mr. Gregg.

Mr. FAY. Now with reference to the question——

Senator KING. I think, if that is the attitude, we had better free the oil people from the payment of any taxes whatever.

Mr. FAY. I have some further data showing the relation between the depletion unit allowed both on cost and "discovery appreciation" and the price of oil used at date of valuation, in which the point was brought out as to the percentage of the posted price that is considered and used as depletion.

The following tables show the depletion units allowed by the department on various leases, the posted price of oil at date of discovery valuation, and the relation between depletion allowed and the posted price of oil for leases owned and operated by the following companies:

1. Winona Oil Co.
2. Barnsdall Oil Corporation.
3. Twin State Oil Co.
4. Sinclair Oil & Gas Co.

The depletion units allowed the Sinclair Oil & Gas Co. are those as of May 1, 1916, at the date the Sinclair Oil & Gas Co. acquired certain leases. The posted price of oil as of May 1, 1916, was $1.55. Stock was issued for these leases so that the depletion unit is therefore based upon cost, not upon discovery valuation. The methods of determining the values were, however, the same as those employed in discovery valuation.

I do not think it is necessary to read these tables.

The CHAIRMAN. It is not necessary to read them, as long as they are to go into the record.

Mr. FAY. They are to go into the record.

(The tables referred to are as follows:)

Depletion on cost of lease and discovery appreciation (does not include development costs)

WINONA OIL CO.

	Date of discovery	Posted price	Price used	Depletion unit		Total	Per cent posted price
				Discovery appreciation	On cost of lease		
Osage No. 2, NE. ¼ sec. 9-20-12	July 19, 1916	$1.52	$1.55	$0.46155	$0.10611	$0.56766	37.3
Osage No. 3, SW. ¼ sec. 9-20-2	Mar. 24, 1917	1.70	1.70	.61167	.02334	.63501	37.4
Osage No. 7, NE. ¼ sec. 5-22-11	July 1, 1920	3.50	3.50	1.5304	.03360	1.56400	44.7
Osage No. 8, SW. ¼ 33-22-10	Mar. 4, 1918	2.25	2.25	.70529	.0698	.77509	34.4
Osage No. 9, SE. ¼ 27-22-10	Sept. 25, 1919	2.25	2.25	.71090	.00566	.71656	31.8
Osage No. 13, NE. ¼ 25-24-9	Oct. 30, 1919	2.25	2.50	.43346	.00858	.44204	19.7
Osage No. 27, NE. ¼ 20-29-9	July 23, 1918	2.25	2.25	.52096	.07366	.60362	26.8
Osage No. 30, SE. ¼ 30-20-12	June 29, 1918	2.25	2.25	.65685	.022438	.67920	30.2
Osage No. 32, NE. ¼ sec. 36-24-9	May 7, 1919	2.25	2.25	.66408	.231479	.89553	39.8
Osage No. 34, NW. ¼ 24-24-9	June 26, 1919	2.25	2.25	.3403	.564274	.90457	40.1
Osage No. 40 N 2, NE. ¼ sec. 1-21-11	May 14, 1920	3.50	3.50	1.11902	.028318	1.14734	32.8
Osage No. 11, SW. ¼ 31-22-12	June 25, 1919	2.25	2.50	.37964	.084215	.46386	20.6

BARNSDALL OIL CORPORATION

OKLAHOMA							
NW. 4-21-10	Mar. 19, 1915	$0.80	$0.80	$0.26925	$0.0133	$0.28255	35.4
NW. 4-21-10	Oct. 23, 1916	.90	.90	.27125	.0089	.28015	31.2
NW. 4-21-10	May 24, 1917	2.00	2.00	.45318	.0061	.45928	23.0
NW. 4-21-10	June 3, 1918	2.25	2.25	.53152	.0050	.53652	23.8
NW. 4-21-10	Oct. 4, 1917	2.00	2.00	.45318	.0061	.45928	22.95
NE. 13-22-10	July 11, 1913	.93	.93	.18057	.2590	.43957	47.2
NE. 27-22-10	Oct. 27, 1913	1.03	1.03	.35709	.1224	.47949	46.5
SE. 25-25-10	Jan. 29, 1916	1.30	1.30	.52609	.0331	.55919	43.2
31-25-10	Aug. 8, 1918	2.25	2.25	.7819	.1823	.9642	42.8
NE. 15-27-10	Apr. 17, 1917	1.70	1.70	.3738	.1393	.5131	30.2
SE. 3-24-11	Nov. 13, 1918	2.25	2.25	.75153	.0434	.79493	35.3
NW. 13-25-11	Apr. 17, 1918	2.25	2.25	.47321	.1339	.60711	27.0
NW. 14-25-11	do	2.25	2.25	.58108	.0167	.59778	26.6
SE. 30-25-11	June 18, 1915	.80	.80	.32794	.0162	.34414	43.1
SE. 30-25-11	Feb. 4, 1916	1.36	1.40	.50825	.0085	.51675	38.6
NE. 31-25-11	July 13, 1915	.78	.80	.28580	.0076	.3334	42.8
SE. 24-26-11	Aug. 6, 1913	1.01	1.03	.43472	.0201	.4548	45.0
NE. 20-27-11	Jan. 2, 1914	1.03	1.03	.18391	.0809	.2648	25.8
SW. 8-20-12	Apr. 27, 1914	.91	.88, .95	.28123	.1584	.4396	48.3
SE. 15-20-12	Apr. 23, 1913	.88	.88	.22334	.1226	.3459	39.3
NE. 22-20-12	June 7, 1917	.88	.88	.21847	.0758	.2942	33.4
Delaware district	June 25, 1914	1.05	1.05	.35627	.04629	.4025	38.3
NW. 8-23-12	Apr. 24, 1914	.91	....	.18493	.0337	.2186	24.1
Sarah Bolyn	Apr. 19, 1913	.88	.88	.14449	.0478	.1923	21.9

TWIN STATE OIL CO.

Hughes lease	July 10, 1919	$2.25	$2.25	$0.45077	$0.01555	$0.46632	20.6%
Mable Dale	Dec. 7, 1913	1.03	1.03	.15478	.11167	.26645	25.8
Vida Way	June 11, 1914	.75	.80	.33864	.02369	.36233	48.7
Brown	Aug. 26, 1917	2.00	2.00	.54900	.02297	.57197	28.6
Apple-Franklin	Dec. 20, 1913	1.03	1.03	.34313	.04397	.38710	37.2
Arrington	Dec. 22, 1913	1.03	1.03	.52012	.00071	.52083	50.5
Cochneuer	June 30, 1915	.40	.50	.20298	.00065	.20363	50.7
Mullen "B"	July 19, 1914	.75	.80	.25423	.00132	.25555	34.1
Holman	Feb. 10, 1917	.90	.90	.40675	.004114	.41086	45.6
Hart	May 27, 1918	2.25	2.25	.69035	.00319	.69354	30.8
West	do	2.25	2.25	.677745	.003345	.68109	30.2
Spurgeon	Feb. 22, 1914	1.01	1.00	.19801	.02449	.2225	22.3
Duncan	July 18, 1919	3.50	3.50	.27257	.14187	.41444	11.8
Hoke	Jan. 4, 1917	1.62	2.20	1.09038	.01560	1.1060	68.3
Zuay Lots	Aug. 17, 1917	2.00	2.50	1.03066	.04859	1.0793	53.9
Sherman	Apr. 16, 1918	2.25	2.75	.58514	.00117	.5863	26.0
Trent	Mar. 7, 1921	1.75	1.75	.62150	.00093	.62243	35.6
Robbins	Mar. 2, 1921	1.75	1.75	.65638	.00302	.65940	37.6

Depletion on cost date of acquisition, May 1, 1916 (purchased for stock, posted price of oil May 1, 1916, $1.55), Sinclair Oil & Gas Co.

Lease	Reserves (barrels)	Value	Depletion unit	Per cent of posted price
Butts, Bird Creek, Okla	97,410	$82,800	$0.699	45.1
Lucas, Bird Creek, Okla	26,000	18,219	.700	45.2
Skiatook, No. 13, Bird Creek, Okla	10,014	4,654	.464	29.9
Walden, No. 16, Bird Creek, Okla	26,923	7,827	.290	18.7
Brentnall, Cleveland, Okla	221,181	165,509	.746	48.1
Bosker, Cleveland Okla	86,181	52,630	.610	39.4
Craig, Cleveland, Okla	192,586	159,078	.826	53.3
Gibbons, Cleveland, Okla	201,292	153,030	.760	49.0
Gifford, Cleveland, Okla	113,243	90,240	.796	51.4
Mullendore, Cleveland, Okla	163,979	93,134	.568	36.6
Williams, Cleveland, Okla	82,785	39,170	.473	30.5
Walden, No. 15, Bird Creek, Okla	26,923	22,884	.850	54.8
Jefferson, Bald Hill, Okla	285,880	181,395	.634	40.9
Jackson, Cushing, Okla	480,900	387,800	.806	52.0
Kolvin, Cushing, Okla	887,600	735,341	.828	53.4
Manuel, Cushing, Okla	1,108,100	863,206	.779	50.2
Mickey, Cushing, Okla	276,100	147,106	.532	34.3
Stoll, Cushing, Okla	203,586	131,524	.646	41.7
Wacoche, No. 80, Cushing, Okla	267,300	197,911	.740	47.7
Wacoche, No. 81, Cushing, Okla	71,400	52,305	.642	41.1
Yargee, No. 83, Cushing, Okla	468,800	331,848	.707	45.6
Davis, Stone Bluff, Okla	546,239	431,581	.790	50.9
Gray, Stone Bluff, Okla	154,456	110,140	.713	46.0
	5,998,878	4,459,341	.744	48.1

Senator JONES of New Mexico. Will you call attention to the main points that are shown in those tables?

Mr. FAY. Yes. I will cite one or two examples which will point out what you have reference to, Senator.

The Arrington lease has a discovery valuation. On December 22, 1913, the posted price of oil is $1.03. The cost of this lease amounted to $0.00071 per barrel for the oil. The discovery appreciation is 52 cents a barrel, which amounts to 50 per cent of the posted price of the oil at the date of valuation.

The Hart lease has a cost depletion unit of three-tenths of 1 cent, discovery appreciation 69 cents per barrel, which amounts to a total of 30 per cent of the posted price of oil.

The CHAIRMAN. What was the posted price at that time?

Mr. FAY. $2.25.

Here is another one, where the posted price of oil was $3.50 per barrel, the Duncan lease, discovered July 18, 1919. The depletion set up on cost is 14 cents per barrel. The discovery appreciation is only 27 cents per barrel.

Senator JONES of New Mexico. Now, let me inquire: When they set up the depletion value, does that value persist through subsequent years, regardless of the price of oil?

Mr. FAY. It does.

Senator JONES of New Mexico. Then they do not allow a certain percentage of the oil?

Mr. FAY. No.

Senator JONES of New Mexico. But they allow that fixed price at the beginning, which goes through the various subsequent years, regardless of the price of oil?

Mr. FAY. The regulations provide that the value once fixed on a depletion unit shall be maintained during the life of that property, unless it is later discovered that there has been gross error in the

estimate of the reserves, in which event applications may be made to the commissioner for revision of the reserves.

Senator KING. Suppose a gross error is made against the Government?

Mr. FAY. They may make no application.

Senator KING. Then, the Government loses?

Mr. GREGG. May I interrupt, for the purpose of keeping the record straight?

The estimates of reserves has to be revised when it is shown that the estimate previously made is wrong, either in favor of the taxpayer or in favor of the Government?

The CHAIRMAN. Yes, sir; but who points it out in case it is in favor of the Government and against the taxpayer?

Mr. GREGG. The taxpayer does it if it is in his favor, and that is what we have the bureau for, to point it out if it is in the Government's favor.

Senator KING. Has there ever been an oil case where the bureau has sought a revision because of an error against the Government?

Mr. GREGG. I can not say. Of course, I am not familiar with all of the oil cases, but I do not think it would be ordinarily the action of the taxpayer to come in and state "You made a mistake in my favor." That is what we have the bureau down there for.

Senator KING. But I was wondering whether the bureau had ever discovered a case where the error had been so gross in failing to determine the amount of the reserves and in determining adverse to the Government, where the bureau had later asked for a revision?

Mr. GREGG. I think unquestionably so. I can not cite cases because I am not familiar with them all, but after you have the value fixed at a given amount, any time you increase the reserves you lessen your depletion rates per unit.

Senator KING. I was just wondering whether it had lessened the depletion rate.

Mr. GREGG. I am perfectly certain that that has been done.

The CHAIRMAN. I do not see how the bureau can do it, because it has been testified here that you can not go back over these old cases and dig them out.

Mr. GREGG. We would avoid it in subsequent years. When it is either in favor of the Government or in favor of the taxpayer we do not go back and change the reserves for past years. We change them for the future.

The CHAIRMAN. No matter what the error may be?

Mr. GREGG. You cannot estimate the reserves for an oil well accurately. Assuming that you make a fair estimate, to begin with, on the knowledge which you then have, you have depletion for two years on that basis. It then appears that your estimate was wrong; that it was either too great or too small. From then on you take your remaining capital undepleted, the part of your capital which has not been taken as depletion in those two prior years, and spread it over these remaining units, whether that is to the advantage of the taxpayer or to the advantage of the Government.

Senator JONES of New Mexico. How does the fact appear as to whether it operates one way or the other? How does the fact appear to the bureau?

Mr. Gregg. Well, ordinarily this would be a perfectly safe deduction; there may be exceptions to it, but I do not see how there could be. If you increase the estimate of reserves at the end of two years, then your depletion per unit is lessened. If you decreased your depletion reserves, your depletion per unit is increased. Is not that perfectly clear? I can give you an example which will illustrate it.

Senator Jones of New Mexico. How would it appear to the bureau that the one is this or the other?

Mr. Gregg. You mean, what is it that would call the attention of the bureau to the question?

Senator Jones of New Mexico. Yes; what would call the attention of the bureau to the question?

Mr. Gregg. I can not say. I suppose the engineers would be sufficiently familiar with the conditions in the field to do it, if it were not called to their attention by the taxpayer.

Mr. Manson. I can answer that.

The bureau has accepted as the basis for making estimates of reserves certain data, which I believe are compiled by the Bureau of Mines. They took a large number of cases of wells in different fields, which had run their full life, and they found there was a certain relationship in each field, a certain average relationship between the initial production and the production of the first year, the second year, and the third year, and so on. That has been charted, so that you have a curve. Now, when you have the initial production, the estimate of the total amount of reserves is predicated upon those curves.

Assume that you estimate that there is one million barrels of oil upon which your depletion allowance is established; that is, upon which you fix a value for depletion purposes of one million dollars. Sixty-five per cent of that, according to the basis of estimating, is recoverable during the first year.

Senator King. How much?

Mr. Manson. Sixty-five per cent. That is, assuming that it is 65 per cent, and that is nearly correct. Assume that 65 per cent is recoverable during the first year and 20 per cent the next year. That leaves 15 per cent. That 15 per cent will drag out over quite a number of years.

It now appears that at the end of the second year you have a production; that is, you have a production during the third year, and when that is added to the first and second years it is going to exceed the 1,000,000 barrels, and you know that the third year, even though it exceeds the 1,000,000 barrels, is not going to be the end.

In that instance it is manifest that the recoverable reserves have been underestimated. Where the recoverable reserves have been underestimated a revision of the reserves will operate to the benefit of the Government, because the taxpayer will get a lower depletion unit, but he will not get to exceed $1,000,000. But where the total recoverable reserves have been overestimated in the first instance and you get a revision it operates to the benefit of the taxpayer, because it enables him to get his $1,000,000 by increasing the depletion unit, even though there is not a million dollars' worth of oil in the ground.

Senator King. But that does not quite answer Senator Jones's question.

Senator JONES of New Mexico. No.

Mr. MANSON. Well, Senator Jones's question was, how did they know; what put them upon notice.

Senator KING. Before you answer that, take into account what we all know to be a fact, that many of these wells are opened up by a few individuals, some people will form a little company and "take a flyer," as they call it, wild-catting, and open a well. In a little while those people will sell it. Frequently there are 50 or 60 wells consolidated, and perhaps four or five or six or a dozen different corporations merged into one. Unless the department keeps an accurate check—and that can only be done by a very careful examination, and it seems to me by the continuity of the same employees, the same engineers, or at least men who are familiar with it, you are not going to discover those changes in depletion. That seems clear to me.

Mr. MANSON. Of course, in the case of a sale, then your whole basis of depletion changes. If the well is sold, the purchaser of that well then depletes upon the basis of what he pays for the well, regardless of the discovery value that was fixed on that well originally for the benefit of the initial producer.

Mr. GREGG. To answer Senator Jones's question, this may clear it up:

The original estimates of reserves, as Mr. Manson stated very clearly, are based upon the production curve prepared for the field, which would show so much production; for example, the first year, and so much the second, and so on. Suppose at the end of the second year you will have a production increase for those first two years, that it has been greater than the production curve indicated that it would be. That would then show that the contents of the reserves are greater than originally estimated. Of course, the exact amount can not then be determined, but they can reestimate the amount and respread it at that time.

The CHAIRMAN. Well, is that the practice, to revise it when the curve shows differently than the original curve?

Mr. GREGG. I understand so. I can look that up and make certain about it, if you desire. [After a conference with Mr. Nash.] Mr. Nash says it is.

Mr. NASH. Yes, sir.

Mr. MANSON. No; the discovery valuation is not revised.

Mr. GREGG. No; I did not say that the discovery valuation is revised. It is the estimates of recoverable units that are revised.

Mr. NASH. I have heard cases being discussed down in the bureau where they have revised the reserves.

Senator KING. Let me make this inquiry, in the light of the statement just made by Mr. Manson:

I have heard—and this is merely rumor—that where they have taken a large depletion, say, 65 per cent, or a very large one the first year, and the second year the depletion was nearly exhausted, then they would often sell for stock in a new corporation upon a very highly inflated value.

Mr. GREGG. To an outsider?

Senator KING. Yes.

Mr. GREGG. Or to a corporation that they owned themselves.

Senator KING. Well, they would own a part of it, yes; sometimes there would be a consolidation, with highly inflated values, and then the question of depletion is taken up again, and before that is exhausted it is up again, so that eventually they will never pay any tax, because it is all consumed in depletion, there being four or five changes in the ownership during the life of the producing well.

Mr. GREGG. This question leaves out too many facts for me to answer it.

If it is an actual sale for cash——

Senator KING. Oh, no; it is not that.

Mr. GREGG. Then, the purchaser is not entitled to set up the cost of the assets transferred for stock if the ownership of the asset remained the same in substance through the ownership of the stock. Then, they do not get any increased value whatever. The value set up on it would be——

Senator JONES of New Mexico. But is there not a very great opportunity to defraud the Government of its just taxes by reason of these transfers that Senator King has suggested?

Mr. GREGG. If you will remember, Senator, these transfers between affiliated corporations, so to speak, when the ownership remains substantially the same, were taken care of in the 1924 act; about three pages were devoted to attempting to stop that, as you will remember, the transfer to a corporation in exchange for stock, which does not increase the basis——

Senator JONES of New Mexico. No.

Mr. GREGG. A transfer between two corporations, where the ownership remains the same, does not increase the basis. I do not claim that we stopped every hole in that act, but we stopped every one we could think of, and we did everything we could to stop the practice. I think experience will show that it needs some more work.

Senator JONES. Have you any idea of the percentage of transfers of these wells between the time of discovery and exhaustion?

Mr. GREGG. I have not; no, sir. I would imagine that in the case of operations of the big companies the ownership remains in the companies. I think the transfers occur almost entirely between small corporations or individuals. I think the ownership of the big companies remains constant, as a usual thing.

Senator KING. Is it not a fact, however, that perhaps 90 per cent of the wells drilled are drilled by an individual or by a few individuals?

Mr. GREGG. I do not know, sir. I am not competent to answer that question.

Senator KING. I am told that that is the case, and that it has been the policy of the Standard Oil Co. and some of the other large companies to run no risks.

Senator WATSON. They buy after it is developed?

Senator KING. They buy after it is developed, and the poor fellows go out and raise a little money. I know in my own town hundreds of people have put money into wells, and ultimately the wells, if they succeeded in getting oil, were merged into some corporation.

Mr. MANSON. We had an illustration here of one of these cases this morning.

For instance, somebody doubtless discovered that there was oil in the pool upon which the Gypsy paid $1,000,000 for this lease.

The man that discovered that may have had a 10-acre lease on that little group. They get a discovery value on that 10-acre lease.

I think the statistics that I presented very early in the hearings here in reference to the percentage of discovery values that went to the large operators and the percentage that went to the wildcatters tend to show that after this pool has once been discovered the development of the pool is very largely in the hands of the large operators; and one of the points that I made at the time I presented those statistics was that it was my opinion that this law was intended for the relief of this little fellow that went in, perhaps on a 10-acre lease and took a lot of chances and discovered an oil pool; but the benefit of this law has gone to a very small percentage of that class of people.

Senator KING. I would like to ask Mr. Nash if it would be possible, without too much effort on the part of the bureau, to ascertain the amount of the tax paid for the production of oil during a given period. We know, for instance, that billions of barrels have been produced and hundreds of millions of profits have resulted from oil production. I am not speaking now of the refining, but just the production of crude oil. I was wondering if your books are so kept as to enable us, without too much effort on your part, to determine just what taxes are paid upon crude oil.

Mr. GREGG. If I may answer that, Senator King, you will find that our statistics of ' come published each year give the income, the deductions, and the taxes paid by the oil industry. However, I was never quite sure that that was entirely satisfactory, because I do not know how much of it was involved in the refining side of the industry.

Mr. MANSON. And the sale?

Mr. GREGG. Yes. I was never sure whether those figures were confined purely to production or not, but I think not. For that reason I have not considered them of articular value.

Mr. MANSON. I have gone into that matter and I find that the figures published are the statistics of income, covering the total net income of the oil industry, which includes the profits derived out of refining and which includes the profit of pipe-line companies, derived out of transportation solely, and which includes the profit made by peddling the oil in tank trucks and by selling it in filling stations.

Senator KING. I think it may be assumed, if you will pardon me——

Mr. MANSON. Yes.

Senator KING. In the light of the record of the Standard Oil Co., that the profits from refining and the vending of the refined product have been very great and probably much in excess of the profits from the production of crude. I should be glad to know just what the profits on crude are that are reported, because we know from statistics what the production has been. Then we can have some idea as to whether there is a fair tax being paid upon the production of crude oil.

Mr. MANSON. I might say to the Senator that I have undertaken, and I now have in process of work, the gathering of some statistics along that line. They will not show the total industry by any means, but I am endeavoring to go far enough to show what per-

centage of the net income, operating income, of an oil company is subject to tax, and I believe that our figures, while they will not be complete, will be a fair cross-section; at least, we are endeavoring to make them a fair cross-section of what the conditions are.

Senator KING. I can not speak, of course, for the unit, but I know, speaking for Mr. Gregg and the higher officials in the Treasury Department, they have appreciated the complexity of this subject, and I know Mr. Gregg, when we were framing the last bill, was very much concerned about trying to cover some of these leaks and to give us a measure that would be satisfactory. I conferred with him scores of times, doubtless to his very great disgust, to see if we could not do something about it.

Mr. FAY. Senator King, answering your question, and in conjunction with what Mr. Manson has just said, I have prepared a list of, I think, 27 oil-producing companies, and have prepared a series of questions in a questionnaire, covering the years 1917 to 1920. We have asked the oil and gas section, as well as the audit section, through Mr. Nash's office, to furnish us the production figures of these producing oil companies, in barrels, by years, the amount of discovery valuation, the cost of the property, together with the net taxable income, and also the amount of depletion that has been allowed, year by year, for each of these companies.

The oil and gas section has completed its part of the work in preparing the data that comes from that section of the organization and have passed it over to the audit division, and have asked the audit division to furnish the net taxable income and the gross income, all of which is determined after the valuation section has made its recommendations. Those figures will also show the amount of tax originally paid on the returns, the amount of tax finally assessed, and the date of the last assessment letter that went out.

I have looked over those cards in a preliminary way, and I find that they are going to represent in the neighborhood of some 75,000,000 to 100,000,000 barrels of oil out of about 700,000,000 barrels that we have in the United States, and by having those figures on the basis where we can tie them up to production in barrels we hope to have something that will be really tangible and which will be worth something not only to the committee but to the bureau itself.

Mr. MANSON. The reason that line of the work was stopped in 1920 is because of the fact that, in most instances, the bureau has not audited; that is, the engineers have not passed on the claims of the companies for years subsequent to 1920; but in order to bring the statistical work nearer down to date, we are taking from the returns of the company the fiscal data to and including 1923, which will not be as accurate as statistics just described by Mr. Fay, for the reason that they must necessarily be based upon the company's unaudited returns, rather than upon the actual allowances and the actual taxes as fixed by the bureau.

Senator JONES of New Mexico. Before we leave this question, I would like to know if the factor of production control is considered anywhere in connection with depletion, etc. I think it is within the knowledge of all of us that quite frequently they restrict the production of a given field very materially. We often hear of capping a well after it has been discovered. In some cases, they do not let

it produce anything for a considerable time, and in other cases they produce only a small percentage of what the well would actually produce if it were permitted to flow freely.

Is that question considered anywhere in connection with this oil reserve estimate which is made?

Mr. GREGG. I can not answer that, of course, Senator, of my own knowledge, but I have discussed that with oil men, and the answer I have always gotten is this, that it is impossible, outside of the Mexican oil fields, to control production. That is so for two reasons, the first, of course, being that a given individual operator whose lease is small may have his property drained by an adjoining lease if he does not produce his oil.

In the second place, and this is what the oil men say, that in capping a well to control production you lose somewhere around 25 per cent of the contents of the well. The reason for it there has never been much argument over, but they say that in doing that the subsequent production is almost always about 25 per cent less.

Senator JONES of New Mexico. Do you mean to say, then, that this thing is not done; that they do not control production?

Mr. GREGG. I do not know, as I say, but from what they have told me it is not done.

Senator JONES of New Mexico. Then, your answer concedes the point that no consideration is given to the question of oil control. That is apparent, but unless I am grossly misinformed it is a common practice to control production, and I have seen some instances of it, where they have closed down their valves, allowing just a small opening, in order to keep the well alive, and then awaiting depletion of the reserves and holding the oil for a better market price.

I am not condemning the practice at all. It may be a good thing, and doubtless is a good thing for the people who own these wells to be able to do that sort of thing, but that they do it I have no moral doubt. I was just wanting to know if that question was taken into consideration, and if so, what effect it had on this question of depletion.

Take that curve that Mr. Manson referred to awhile ago. That curve probably and undoubtedly was based upon the idea that the pool is permitted to go on at its ordinary natural growth of production; but if production is controlled, you have another situation entirely to be dealt with.

Mr. MANSON. You see that you have more than one well also to consider. For instance, you have a 40-acre or a 160-acre or a 640-acre tract, and you have demonstrated the fact that there is oil in there. I believe the curves are all predicated upon the theory that that whole area will be developed and drained as early as possible, and none of these estimates of reserves are based upon what one well will do, but all of the estimates of reserves and all of the figures used in arriving at discovery valuation are predicated upon the theory that a normal drilling program will be followed, and that the first well, which may only drain 5 or 6 or 7 acres, will be followed by other wells, which will exhaust that area within the length of time anticipated by the drilling program.

I think myself that the principal means of regulating production is by failing to develop known oil territory until you are forced to

develop it by the drilling in adjacent territory or until you see fit to develop it by the higher prices.

I called attention at some stages of the proceedings here—I have forgotten when it was—to the fact that by reason of most of the development—that is, the voluntary development—taking place at a time when oil is high most of the prices used as the basis for those valuations are high prices instead of average prices, or instead of such prices as would be reflected by a price trend.

The Senator some time ago asked a question about the use of high prices. I have shown on the record here that it is an established rule of the department, at least in the California field, that when oil once goes below 60 cents, in fixing discovery valuation, the engineers are to anticipate that oil will increase at a certain rate. In other words, they anticipate a rise in the market. I have also called attention to the fact that the price of oil is high and is bound to go down before any well could be exhausted; they do not anticipate any decline. I do not criticize the idea of anticipating an increase provided you will anticipate decreases when the price of oil is high.

Senator JONES of New Mexico. Could there not be found some basis for fixing the value according to the actual fact? Why fix a price now for a commodity that would be put on the market 10 years from now?

Mr. MANSON. Well, the justification for it is that a very large percentage of the product of an oil well is recovered during the first year, but I have called attention to cases here——

Senator JONES of New Mexico. Well, it may not be, Mr. Manson.

Mr. MANSON. Oh, no; I understand that.

Senator JONES of New Mexico. And I have in mind particular instances where production was actually entirely stopped, or nearly so, and certainly where they stopped drilling new wells to further develop the field.

Senator KING. I can not understand, Mr. Manson, why such a large allowance should be made for the first year, because the experience in Pennsylvania, Indiana, Wyoming, California, Texas, and Oklahoma shows that these wells have, many of them, a very long life. Take the wells at Taft and Colingo. They were producing 13 years ago, and their production now in the same fields is very great. Some of those wells are producing nearly as much as they were producing six or seven years ago.

Mr. MANSON. I will say for the Senator's benefit that the curves used for the purpose of estimating production are based upon the conditions in each field. In other words, some fields are short lived, with a gusher well, with an immense initial production. Those wells are short lived. Other fields, like the Pennsylvania field, and I think the West Virginia field, are very long lived. Some of them will run for 30 years or more. They do not use the same production curves for each; that is, for the whole country. Each field is considered by itself. I think those production curves as worked out by the Bureau of Mines—I have not been able to get the exact source of them—what are they, do you know?

Mr. GREGG. I think they were worked out by the Bureau of Mines. They are contained in our Oil and Gas Manual.

Mr. MANSON. Yes.

Mr. FAY. I can tell you about those. The Bureau of Mines, as a part of its work, has a study of oil-production matters and figures relating thereto, and in 1919, I think it was, they began a compilation of data to show these decline curves. When the oil companies began to file their tax returns with the Treasury Department, the Bureau of Mines detailed an engineer from their office to Income Tax Building No. 1, and he spent one year in Annex No. 1 going over returns which were filed by the taxpayers who are reporting production for income-tax purposes.

They went over the production of each individual well, where the production records of the corporations show the production of wells individually, and they compiled statistics from those individual wells, for each individual pool in the country, and they established probably 50 or 60 different sets of curves.

For instance, in Eastland County, Tex., the curves showed approximately 95 per cent of the oil coming back the first year. In the Okesa district, Oklahoma, and I remember that particularly, there is a 35 or 37 year life, and they estimate that 30 per cent of the oil is going out the first year. In the Pennsylvania field some of them are estimated at 40 years, with the first year's production running very low, 20 or 25 per cent.

We had one lease that was mentioned in one of our hearings, the Shumway lease in southern Kansas, reported from the records of the Gypsy Oil Co. in our hearings, and their report showed that better than 90 per cent of the ultimate reserves on that lease were recovered within the first year.

Senator KING. But it was a continuing production for an indefinite period.

Mr. FAY. For seven or eight years, but a very small production as compared with the initial production. Then, in connection with those curves——

Senator WATSON. I think they are operating wells in Pennsylvania that produce but half a barrel a day.

Mr. FAY. They do?

Senator WATSON. Yes; they have for a good many years. It is high-grade oil.

Mr. FAY. Then, in connection with those curves, the Treasury Department compiled from the statistics of the Geological Survey, by States and counties, the number of dry holes and gas wells in each county for a number of years, covering 10 or 12 years, up to the close of 1919 or 1920, so that it should be available, as it is in their hands, in the Oil and Gas Manual, showing any dry-hole factor for any county that was producing oil in 1920. Some of the counties run 15 per cent, some 75 per cent, and some of them 100 per cent dry holes.

Senator JONES of New Mexico. To come back to the question of the value of the oil which is used as a basis here for depletion purposes, is it not practicable and would it not be advisable to set aside those reserves in barrels, rather than in dollars, each year and give a money value to the actual transaction?

Mr. MANSON. You mean, each year give a depletion alowance based upon what the oil actually sold for?

Senator JONES of New Mexico. Yes. Would not that be fair both to the Government and to the taxpayer?

Mr. MANSON. It would seem worth considering.

Mr. GREGG. Of course, Senator, you have a proposition there whereby, if I catch your thought, you would be practically exempting them from tax. Assuming at the end of the year the price of oil had risen, and that you base your depletion for that year on the price for which the oil actually sold, and applying that price back to get the cost--

Senator JONES of New Mexico. You estimate a well to have so many barrels in it at the beginning. That is the basis of your calculations--that there are so many barrels in it--and if you take the actual fact from year to year, have you not done exact justice as between the taxpayer and the Government?

Mr. GREGG. That means that the only tax that the Government gets is on the discount.

Senator JONES of New Mexico. Well, you do not want to speculate in taxes. By guessing at the value in 5 or 10 years, it is fair neither to the taxpayer nor to the Government.

Mr. MANSON. The way it works out at present is this: If the production of the well is exactly the amount of the estimated reserves, and the price of oil during the period of production is exactly the price used as the basis of valuation, the only taxable income that well would get would be the amount you deduct as the anticipated profit.

Senator JONES of New Mexico. Well, is that not a fair thing to do?

Mr. MANSON. Yes. Then, for instance, if you anticipate profit, or if you use a discount factor, which is the same thing, 5 per cent, then your taxable income from that well, leaving out of consideration your 50 per cent provision of the 1924 act, would always be 5 per cent of the amount of money that you have set up as its value. In other words, the oil producer would always be paying on a 5 per cent income. If you accept 10 per cent he would always be paying on a 10 per cent income.

Under this practice of saying that the taxable income of a taxpayer can only exceed the amount that the engineer fixes in the first instance as the anticipated profit, that is, when the price of oil goes up beyond the price anticipated, or when the amount of reserves is underestimated. If, on the other hand, the amount of reserves is overestimated or the price of oil drops, there is no possibility of getting any tax; that is, the price of oil drops more than an amount which would be covered by the discount factor. We will say that the discount factor is 5 per cent and the price of oil drops 10 per cent. There would be no taxable income, leaving out of consideration your 50 per cent provision. Of course, the taxpayer's actual income depends upon the price of oil. If the price goes up he makes money. If the price goes down he does not make as much as he anticipated; but that, as a factor in taxable income, depends upon whether it goes above the price set.

Therefore I say when you start out and you value a well on the basis of $3 oil in 1920, when you know that before that well is exhausted that price is bound to go below that, and then you use only a 5 per cent discount factor, there is no possibility of collecting any tax there, except under the 50 per cent provision in the 1924 act.

Senator JONES of New Mexico. I would like to make the request of the Treasury Department that they analyze the suggestion which

I have just made and give the reasons both for and against adopting the change in the method.

Mr. GREGG. I will be glad to do so.

The CHAIRMAN. You may proceed, Mr. Fay.

Mr. MANSON. Will you proceed, Mr. Fay?

Senator WATSON. Let me ask you a hypothetical question, Mr. Gregg: Suppose we here should form a corporation and drill a well right out there?

Mr. GREGG. Yes, sir.

Senator WATSON. And after completion it shows quite a flow, and we cap that well. There is no other oil well within a hundred miles of it. Upon what basis of valuation do you start out to tax that well?

Mr. GREGG. The law specifically prescribes that it must be valued as of date of discovery or within 10 days thereafter.

Senator WATSON. Yes, I know that; but how do you start practically to do the thing which the law requires?

Mr. GREGG. We estimate first the reserves.

Senator WATSON. And that is a guess?

Mr. GREGG. That is in fact a guess.

Senator WATSON. Yes.

Mr. GREGG. Then we take the posted prices of the oil as within 30 days.

Senator WATSON. Yes.

Mr. GREGG. And say he will get so much in cash — -

Senator WATSON. But there is no production at all. We cap the well.

Mr. GREGG. All right, sir, but the man who would buy it from you would be governed by what he could get out of it.

Senator WATSON. Certainly.

Mr. GREGG. You multiply the posted price of oil within the 30-day period by the reserves. That would give you the amount of money that the purchaser would get out of the well over its life. Then you would deduct from that costs of developm ent and the production cost, the lifting cost, etc., and from that determination what the purchaser would get out of it over its life, and then you discount that back to make up for the use of the money and make allowance for the hazard in some way, and that gives you present value.

Senator KING. How do you allow those discount factors?

Mr. GREGG. That has been gone into very, very fully, and I think Mr. Manson is expecting to go into it more fully.

Mr. MANSON. I am; yes, sir.

The CHAIRMAN. I want to say this, that I think Senator Watson is wrong about this all being guesswork, because Mr. Fay has explained here, by district and by experience, what the well would contain.

Senator WATSON. But under this assumption there is no well within a hundred miles of it.

The CHAIRMAN. I know, but the Bureau of Mines statistics show that that particular field discloses a certain well.

Mr. FAY. I am afraid there that it would be almost hazarding a guess in that case if we had no production within a hundred miles.

Senator WATSON. Yes; as Senator Jones says, wells are drilled and capped and wells are off somewhere in isolated territory. I

do know that they do cap those wells for the purpose of selling that territory or enhancing the price of the land in that immediate territory.

Senator JONES of Mexico. Yes; and adjacent to San Juan field in New Mexico they are holding down production because of lack of transportation; I mean transportation at reasonable cost.

Mr. FAY. These are a few notes on the blanketing of oil pools by successive discoveries shown in the map from the Cabin Creek district of West Virginia.

As a typical example of the manner in which an oil pool may be blanketed with discovery valuations (in accordance with regulations) there is attached herewith a map showing the discoveries allowed the Pure Oil Co. in the Cabin Creek district, West Virginia. This map shows 15 discovery valuations which have been allowed. The Pure Oil Co. of New Jersey acquired these properties November 30, 1916, at which time a valuation was established for the entire holdings of the Columbus Producing Co. from which the Pure Oil Co. purchased the leases.

Valuation of undrilled proven area, abstracted from Taxpayer's Form O: On November 30, 1916, the Columbus Producing Co.'s development extended for about 4 miles along the strike of the Berea sand, in a strip from one-half to three-fourths mile wide. Every well which encountered the top of the Berea sand between 1,610 and 1,700 feet below sea level had been a producer of oil. On November 30, 1916, there were sufficient data available for a fairly satisfactory structure map. This gives the approximate location of the strip from which oil production may be expected. It is commonly the case in the West Virginia fields that the productive area is a long narrow strip ranging from a few miles up to 20 or 30 miles in length. In the Cabin Creek pool there was no evidence of a break in the structural conditions; the sand was shown to be 20 feet thick as far west as Coal River, 5 miles west of well No. 205; continuity of oil and gas production at least as far as Coal River was to be expected, and the territory beyond Coal River is reasonably classified as probable oil and gas territory, so far as the area within the producing interval of the sand was concerned. The sand is not so thick as it is further east, but the dip is apparently less steep and consequently favorable to oil accumulation. Under these circumstances even the most southwesterly lease had become valuable as prospective oil and gas territory.

With the exception of the Stover well—that is out to the west end of that lease [indicating on map]—all of the Columbus Producing Co.'s wells were on the Williams Coal Co. (Shonkland Co.) lease, which is the property you have in front of you. A large group had been drilled in both directions along the strike from the discovery well No. 1. Two wells had been drilled in Longbottom Creek about one-half mile east of this group and another small group had been drilled between Fairfield and Miami, near the eastern end of the Williams land. All of the company's oil wells showed sand elevation between 1,610 and 1,675 feet below sea level. Just across the east line of the Williams Coal Co. lease, however, the Imperial Coal Co. No. 4 was completed early in November with an initial production of 145 barrels.

The company's production to November 30, 1916, amounted to 590,544 barrels and the estimated future production of producing wells amounts to 969,250 barrels, making an estimated ultimate recovery of 1,559,794 barrels from 45 wells, or an average of 34,660 per well.

In order to complete development from the easterly end of the lease to a point one-half mile west of present development it is estimated that 186 wells will be required. Ninety-five of these are given a probability of 80 per cent and 91 are given a probability of 50 per cent, as are 60 locations west of the locations above.

Ninety-five locations at 80 per cent of 34,660, 2,634,160; 91 locations at 50 per cent of 34,660, 1,577,030, making a total of 4,211,190.

The average for all locations is in round figures 22,600.

The details relating to the subject of these wells are given in the following table:

Williams Coal Co. lease, valuation undrilled oil locations

	First year, 60 wells	Second year, 50 wells	Third year, 40 wells	Fourth year, 36 wells
Estimated ultimate production per well (barrels)	22,600	22,600	22,600	22,600
Columbus Producing Co. net interest (1924)	17,892	17,892	17,892	17,892
Estimated net all wells	1,073,520	894,600	715,680	644,112
Estimated net return per barrel	$2.50	$2.50	$2.50	$2.50
Present value factor (per cent)	82.4	82.4	82.4	82.4
Value date of completion	$2,211,451.20	$1,842,876.00	$1,474,300.80	$1,326,870.72
Estimated cost of wells	$732,000.00	$610,000.00	$488,000.00	$439,200.00
Net value	$1,479,451.20	$1,232,876.00	$986,300.80	$887,770.72
Average deferment (years)	½	1½	2½	3½
Discounted to present value at 10 per cent compound discount	$1,409,029.32	$1,067,424.04	$776,317.36	$635,199.95

Total present value, $3,887,970.67.
Total estimated reserves, 3,327,912 barrels.

I have another table showing the valuations that have been allowed on these 45 wells.

Senator KING. By the department?

Mr. FAY. By the department—discovery values.

I shall not read these figures, but will submit this table for the record.

(The table referred to is as follows:)

Pure Oil Co. Williams Coal Co. and Shonk Land Co.

[Discovery valuations, Cabin Creek pool]

Well No.	Completed	Depth (feet)	Initial production (barrels)	Monthly production (barrels)	Estimated future production (barrels)	Posted price date of discovery[1]	Estimated net profit per barrel	Present value factor	Present value of working interest	Acreage	Equipment	Discovery area cost	Total cost
1	Dec. 18, 1914	1,620	214	359	7,600	$1.45	$2.50	$0.758	$14,402.00				
10	Nov. 29, 1915	1,627	175	465	8,708	1.91	2.50	.769	16,741.13				
12	Jan. 5, 1916	1,624	323	2,211	21,850	2.26	2.50	.841	45,939.63				
17	June 13 1916	1,652	56	1,554	17,337	2.37	2.50	.821	35,584.19				
23	Feb. 19, 1916	1,652	101	843	12,033	2.00	2.50	.792	23,825.34				
36	June 28, 1916	1,621	50	240	6,017	2.60	2.50	.744	11,191.62				
30	July 6, 1916	1,648	40	1,230	14,883	2.58	2.50	.809	30,100.87				
29	July 8, 1916	1,632	196	3,355	29,153	2,58	2.50	.858	62,490.29				
52	Sept. 22, 1916	1,657	86	1,835	19,277	2.31	2.50	.830	39,909.78				
57	Oct. 7, 1916	1,661	114	5,715	42,275	2.51	2.50	.877	92,687.94				
88	June 26, 1917		101	8,400	147,436	3.10	2.95	.888	1,355,829.84	141.9	$13,911.73	$366,817.80	$380,729.53
185	Oct. 16, 1918		55	1,656	221,774	4.00	4.25	.831	509,467.83		17,778.57	293,454.24	311,232.81
200	May 21, 1920		162	4,848	305,242	6.10	6.52	.875	1,426,597.29	113.9	21,374.86	220,090.68	241,465.54
205	Oct. 9, 1920		268	8,040	325,272	6.10	6.52	.882	1,551,110.82	83.0	21,451.23	171,181.64	192,632.87
215	Feb. 22, 1922		221	6,730	610,360	?	3.40		1,509,607.48		15,851.31	268,999.72	284,851.03

[Wells 1 to 57:] Represents the value of 1 well at date of acquisition, Nov. 30, 1916.
Does not include equipment. Each of the 58 producing wells is valued as of Nov. 30, 1916.

Total value of 58 wells	$1,591,893.98
Total value of 186 locations	3,887,970.67
Value, date of acquisition	5,479,864.65

[1] Pennsylvania grade of crude oil. Cabin Creek oil commands a premium of 10 cents per barrel.

Mr. FAY. At the date of purchase of this property by the Pure Oil Co. there were 55 producing wells and two gas wells. (Exhibit 1.) Each well was valued on its own individual production and out of the 55 wells 10 were allowed discovery valuations, as per accompanying table.

Discovery valuations: With reference to the discovery valuation set up on 10 wells out of 57 shown in the accompanying table, the taxpayer uses as a basic date, November 30, 1916, the date that the property was acquired from the Columbus Producing Co.

Senator KING. Generally speaking, if I may interrupt, the discovery values are allowed without reference at all to what was paid for the property?

Mr. FAY. The discovery value is allowable when an estimate of the value of property after a well comes in is disproportionate to what the land cost them originally.

Senator KING. Suppose a man buys a piece of ground for $10,000, and gets a thousand or two or three thousand barrel well. They will allow us what they conceive to be the value of the well, with the property belonging to it, regardless of the fact it cost them only $10,000?

Mr. FAY. That is right.

Senator KING. Yes.

The CHAIRMAN. That is provided for by law.

Mr. FAY. That is the law.

Senator JONES of New Mexico. That is provided for by law, and it depends upon whichever is higher.

Senator KING. Yes.

Senator JONES of New Mexico. The cost or the discovery value?

Senator KING. Yes.

Mr. FAY. The market price of oil at that date for Pennsylvania crude was $2.60 per barrel. The taxpayer states that Cabin Creek commands a premium of 10 cents a barrel, thus making the price of oil used at this time $2.70. Well No. 1 was completed December 18, 1914, and is the discovery well. A discovery valuation has been so allowed by the department based on the price of oil as of November 30, 1916, two years later. The price of Pennsylvania crude oil, December 18, 1914, when the well was completed, was $1.45 per barrel, so that if this well is entitled to a discovery valuation, the market price of $1.45 plus any premium that may be paid for the Cabin Creek oil should have been used, and the value of the well determined as of November 30, 1916, by depleting the discovery valuation as of 1914 to the later basic date. The accompanying table shows the posted price of Pennsylvania crude oil at the dates the discovery wells were completed, together with the estimated net profit, per barrel, based on oil as at $2.70 per barrel. The discoveries allowed on the 10 wells are shown in the accompanying map, blanketing an area about 3 miles long. The taxpayer sets up for valuation at the date of acquisition, November 30, other undrilled areas as described above which he calls proven areas.

While the taxpayer admits that practically all of this strip of ground was proven at date of acquisition from one end to the other, a distance of 7 to 9 miles, yet in view of this, he has claimed and been allowed five additional discovery valuations on which he has received discovery appreciation for depletion purposes, a total of

$4,941,701. There are a number of discovery tracts shown on the accompanying map which were disallowed by the department.

I wish to submit these exhibits in connection with this report.

(The exhibits submitted by Mr. Fay are as follows:)

EXHIBIT 1

VALUATION OF PRODUCING WELLS

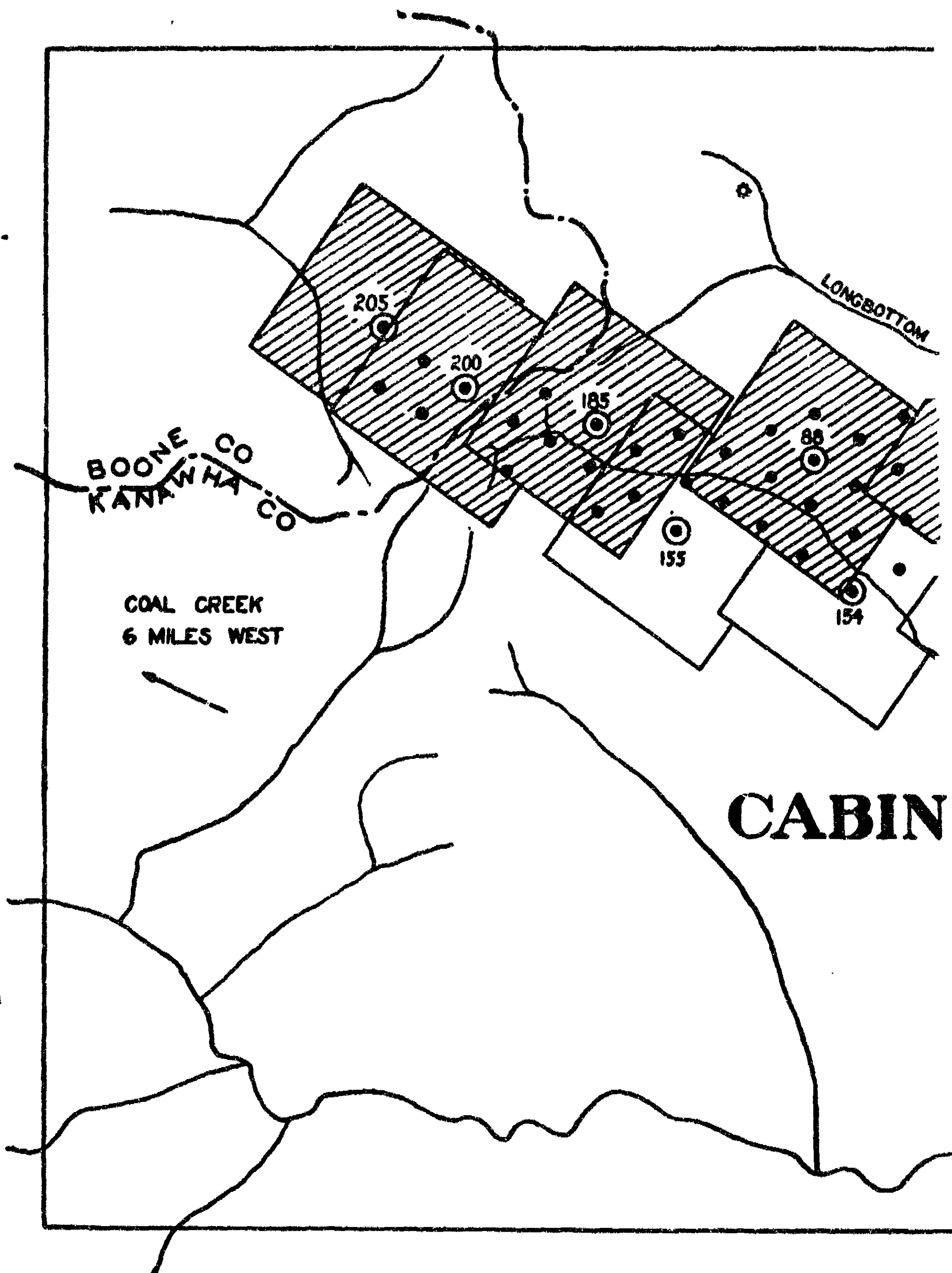
The following tabulation shows values arrived at for each of the wells producing on November 30, 1916. In the case of a few wells the future production is based on an estimated monthly rate. This was necessary in the case of wells less than a month old on November 30, 1916, and in the case of wells temporarily shut in.

The value of equipment is based on an inventory taken in March, 1917, projected back to November 30, 1916.

Cabin Creek District, value of producing wells at November 30, 1926

Well No.	Completed	Initial	Monthly production	Estimated future production	Columbus Producing Co. interest 19/24	Estimated net profit per barrel	Present value factor	Value of working interest
1[1]	Dec. 18, 1914	214	359	9,600	7,600	$2.50	$0.758	$14,102.00
2	Oct. 30, 1915	[2] 83	243	7,600	6,017	2.50	.744	11,191.62
3	Apr. 18, 1915	72	66	3,300	2,613	2.50		[3] 5,507.76
4	May 11, 1915	317	575	12,350	9,777	2.50	.778	19,016.27
5	June 4, 1915	130	600	12,650	10,015	2.50	.779	19,504.21
6	Aug. 21, 1915	29	306	8,700	6,887	2.50	.751	12,930.34
7	Sept. 19, 1915	103	1,260	19,100	15,120	2.50	.810	30,618.00
8	Nov. 2, 1915	73	775	14,500	11,480	2.50	.789	22,644.30
9	Oct. 23, 1915	142	1,095	17,500	13,854	2.50	.803	27,811.91
10[1]	Dec. 1, 1915	175	465	11,000	8,708	2.50	.769	16,741.13
11	Nov. 24, 1915	120	1,114	17,700	14,013	2.50	.804	28,166.13
12[1]	Jan. 5, 1916	323	2,211	27,600	21,850	2.50	.841	45,939.63
13	Mar. 16, 1916	123	1,166	18,150	14,369	2.50	.806	28,953.54
14	Jan. 9, 1916	64	1,053	17,100	13,537	2.50	.802	27,141.69
15	Sept. 13, 1916	13	959	16,300	12,904	2.50	.798	25,743.48
16	June —, 1916	(4)						
17[1]	Feb. 23, 1916	56	1,554	21,900	17,337	2.50	.821	35,584.19
18	Mar. 30, 1916	75	1,500	21,400	16,942	2.50	.82	34,731.10
19	Mar. 5, 1916	88	1,082	17,300	13,696	2.50	.803	27,494.72
20	Feb. 24, 1916	278	2,201	27,500	21,770	2.50	.840	45,717.00
21	June 2, 1916	155	618	12,850	10,173	2.50	.78	19,837.35
22	May 5, 1916	125	1,530	21,700	17,180	2.50	.82	14,087.60
23[1]	June 15, 1916	101	843	15,200	12,033	2.50	.792	23,825.34
24	May 6, 1916	124	1,932	25,200	19,950	2.50	.833	41,545.88
25	June 23, 1916	122	2,400	29,100	23,038	2.50	.845	68,667.78
26	July 11, 1916	100	2,240	27,000	22,087	2.50	.842	46,193.14
27	Nov. 3, 1916	61	1,162	18,150	14,368	2.50	.806	28,951.52
29[1]	July 10, 1916	196	3,355	36,800	29,133	2.50	.858	62,490.29
30[1]	July 11, 1916	40	1,230	18,800	14,883	2.50	.809	30,100.87
31	Aug. 26, 1916	50	1,314	19,600	15,517	2.50	.812	31,499.51
33	Aug. 25, 1916	270	4,065	42,500	33,646	2.50	.866	72,843.59
34	Sept. 30, 1916	100	3,215	35,700	28,263	2.50	.857	50,553.48
35	Sept. 15, 1916	46	1,200	18,500	14,646	2.50	.808	29,584.92
36[1]	June 30, 1916	30	240	7,600	6,017	2.50	.744	11,191.62
37	July 2, 1916	59	690	13,600	10,767	2.50	.784	21,103.32
38	July 25, 1916	45	240	7,600	6,017	2.50	.744	11,191.62
39	July 12, 1916	53	940	16,150	12,785	2.50	.797	25,474.11
42	Sept. 30, 1916	50	1,194	18,500	14,646	2.50	.808	29,584.92
44	Oct. 20, 1916	90	1,265	19,150	15,160	2.50	.811	30,736.90
45	Oct. 24, 1916	57	1,440	20,800	16,467	2.50	.817	33,633.85
46	Nov. 15, 1916	60	2,000	25,800	20,425	2.50	.835	42,637.19
50	Sept. 27, 1916	194	3,424	37,400	29,608	2.50	.860	63,657.20
52[1]	Sept. 24, 1916	86	1,835	24,350	19,277	2.50	.830	39,999.78
53	Nov. 28, 1916	15	450	10,850	8,590	2.50	.768	16,492.80
56	Oct. 16, 1916	487	7,123	7,123	60,800	2.50	.885	106,494.26
57[1]	Oct. 8, 1916	414	5,715	53,400	42,275	2.50	.877	92,687.94
Stove No. 1	Oct. 27, 1916	127	2,516	30,000	[5] 26,250	2.50	.847	55,584.38
			72,760	969,250	769,823			1,591,893.08

[1] Wells upon which discovery is claimed and allowed.
[2] 2,000,000 gas.
[3] This well valued at its equipment figure only.
[4] 4,000,000 gas. See gas valuation.
[5] Columbus Producing Co. 21/24 interest this lease.



92919—25. (Face p. 2938.)

THE PURE OIL CO

N CREEK WEST VIRGINIA DISCOVERY MAP

WILLIAMS LAND CO. (LEASE).

Discovery Wells ◉

Discoveries claimed and allowed — shaded

Other discoveries claimed. — not shaded

Scale

0 ½ 1 Mile

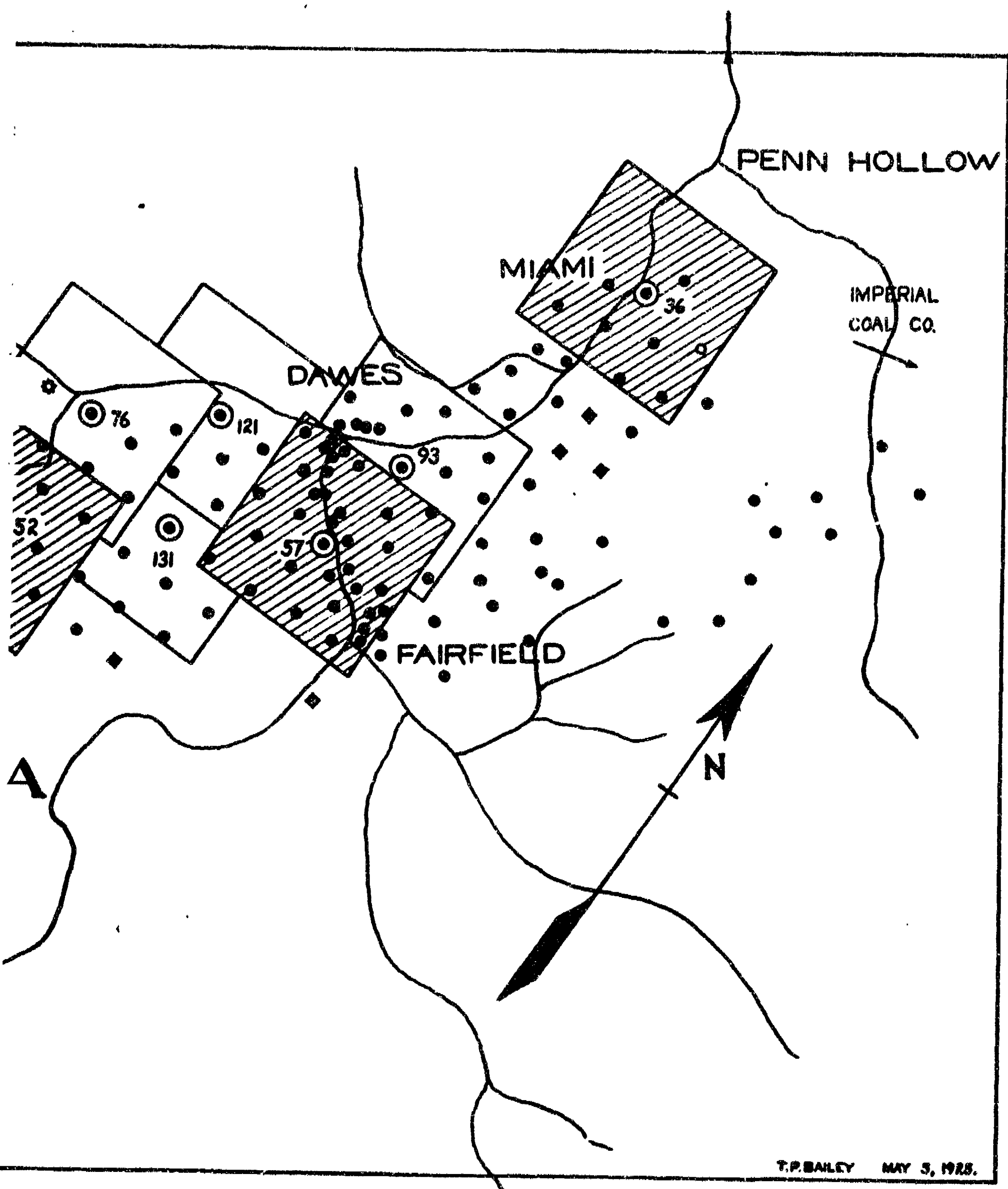

PENN HOLLOW
MIAMI
36
IMPERIAL
COAL CO.
DAWES
76
121
93
52
131
57
FAIRFIELD
A
N
T.P. BAILEY MAY 5, 1925.

EXHIBIT 2

Pure Oil Co. (Williams Coal Co., Shonk Land Co.), Cabin Creek Pool

Discoveries allowed			Discoveries disallowed		
Well No.	Date	Initial production	Well No.	Date	Initial production
1	Dec. 18, 1914	214 barrels.	76	Apr. 14, 1917	59 barrels after shot.
10	Nov. 29, 1915	175 barrels.	79	May 22, 1917	9 barrels natural.
12	Jan. 5, 1916	170 barrels after shot.			26 barrels after shot.
		43 barrels natural.	86	July 9, 1917	15 barrels natural.
17	Feb. 19, 1916	56 barrels natural.	93	July 16, 1917	29 barrels natural.
23	June 13, 1916	31 barrels natural.			222 barrels after shot.
36	June 28, 1916	30 barrels natural.	121	Dec. 20, 1917	22 barrels after shot.
30	July 6, 1916	40 barrels natural.	154	Feb. 28, 1918	33 barrels natural.
29	July 8, 1916	196 barrels after shot.	131	Mar. 28, 1918	15 barrels natural.
52	Sept. 22, 1916	86 barrels natural.			27 barrels after shot.
57	Oct. 7, 1916	50 barrels natural.	155	Apr. 26, 1918	39 barrels natural.
		414 barrels after shot.			
88	June 6, 1917	423 barrels after shot.			
185	Oct. 16, 1918	24 barrels before shot.			
		82 barrels after shot.			
200	May 21, 1920	85 barrels before shot.			
		173 barrels after shot.			
205	Oct. 9, 1920	24 barrels before shot.			
		425 barrels after shot.			
215	Feb 22, 1922	150 barrels natural.			
		384 barrels after shot.			

EXHIBIT 3

Valuation of oil properties taken from Form O.

PURE OIL CO., CABIN CREEK DISTRICT—TYPICAL EXAMPLE OF DISCOVERY VALUATIONS

Williams Coal Co. lease; 12,000 acres; bonus $16,285.71; discovery area, 141.9 acres; locations to be drilled, 14.

Cost of discovery well

Equipment	$5,457.02
Intangible	8,454.71
Total	13,911.73
Cost discovery area	366,817.80
	380,729.53

Well No. 88; one-eighth royalty; entire working interest owned by the Pure Oil Co.; date of discovery, June 26, 1917; date of valuation, June 26, 1917; daily production, 280 barrels; grade of oil, Cabin Creek 46° Baumé.

Price on date of valuation, $3.20 per barrel.

Estimated average lifting cost, 25 cents per barrel.

Estimated operating profit, $2.95.

	Discovery well	Additional wells	
		Seven	Seven
Date of completion	June 26, 1917	6 months.	6 months.
Monthly production rate ... barrels	8,400	4,200	4,200
Estimated ultimate production ... do	73,100	47,700	47,700
Company's net interest ... do	63,962	41,737	41,737
Estimated net per barrel	$2.95	$2.95	$2.95
Anticipated return	$188,687.80	$123,124.15	$123,124.15
Composite discount ... per cent	11.2	12.8	14.3
Present value at completion	$167,544.86	$107,364.26	$107,364.26
Estimated cost per well		$14,000.00	$14,000.00
Balance		$93,364.26	$93,364.26
Years discount at 10 per cent		½	1½
Present value per well	$167,514.86	$88,920.12	$80,834.78
Total	$167,544.86	$622,440.84	$565,843.46
Estimated reserves ... barrels	648,280	Total value	$1,355,829.84
Previous estimate ... do	296,640	Cost	380,729.53
Reserve adjustment ... do	351,640		975,100.31

EXHIBIT 4

TAXPAYER'S CONFERENCE

Date: November 26 to December 10, 1923.
Taxpayer: Pure Oil Co., Ohio Cities Gas Co.
Address: Columbus, Ohio.
Represented by: Mr. Brekaw, engineer; Mr. Batterton, accountant.
Credentials: Mr. Brokaw enrolled in department; power of attorney on file.
Matter presented: Revised Form O data and revaluations.
Issues discussed: Valuations of oil, gas, and casing-head gasoline properties; intercompany history of acquisition and affiliation; nature of various transactions involving acquisition of property.

CONCLUSIONS

Oil: Values set up for discoveries in 1920 will be adjusted by a factor for fair market value. Values set up for outside acreage appear excessive in certain instances and will be reduced from $10 to $5 per acre. Values established as of November 30, 1916, and at various discovery dates, other than in 1920, appear acceptable.

Gas: Excepting one group of properties, those producing in Boone County, taxpayer uses the porosity method in setting up valuation, November 30, 1916, on undeveloped gas acreage held. A 10-cent field price and many other factors used by the taxpayer were not justified. The valuation claimed, $2,054,-072.60; established in conference, $797,204.60.

The Boone County producing properties were sold in 1919. A schedule showing no loss on this transaction is to be submitted, since the valuation of these properties was not reduced.

Casing-head gasoline: The taxpayer's values for gasoline obtainable from the casing-head gas from the wells drilled or to be drilled on these properties were accepted as presented. Estimates of the available reserves are being prepared by taxpayer in accordance with suggestions by this section.

Interviewed by J. R. Paddock, C. R. Vorck, R. W. Keyser, C. H. McClain, A. B. Morris.

(Signed) J. R. P.
C. R. V.
R. W. K.
C. H. M.
A. B. M.
A. N. THAYER,
Chief of Section.

Mr. FAY. Exhibit No. 1 shows each of the 57 wells that have been valued by the department.

Senator KING. Mr. Fay, what do you say as to the fairness of this allowance by the department, from your observation and from your knowledge of those cases?

Mr. FAY. I feel that they are somewhat excessive. In this particular group there seems to be something missing in the case; that is, I can not get quite all of the connecting links in it. I had the full information before me, but this is a case where property was transferred on November 30, 1916, from the Columbus Producing Co. to the Pure Oil Co. Now, it was proper to make a valuation of the oil as of that date for making this exchange and determining the amount that the Pure Oil Co. should pay for this property, and they paid for it largely in stock. But the thing that I think is wrong in this particular case is that these discovery values in 1914, and several of them in 1915, should have been valued at a price nearly two years later, and yet have been allowed as discovery values.

Senator KING. Before the law was passed.

Mr. FAY. Well, the law provides that discovery values may be set up as after 1913; but the point I make is that these discovery values

should have been set up as of 30 days after discovery, if they are entitled to discovery value on these properties, but all of the valuations are dated November 30, 1916, when the price of oil was considerably in excess of what it was at those dates.

The CHAIRMAN. Can Mr. Gregg offer any explanation of that, as to why that was not done?

Mr. GREGG. No, sir; I can not see just the explanation of it, but I am sure that in a case such as this there must be one. We will look that up.

If Mr. Fay is through with his statement, I have a few statements that I wish to make just for the sake of the record.

Mr. FAY. I have one other statement that I wish to make.

The CHAIRMAN. Has not the Pure Oil Co. been in the limelight somewhat in recent years?

Mr. FAY. It is connected with the City Service Corporation. That may give you a line on it.

Mr. MANSON. I never heard of it before.

Senator JONES of New Mexico. I understand that a brother of the Vice President became the head of that corporation. That is one thing that attracted my attention to it.

Mr. FAY. In answer to Senator King's question as to why I feel that these values may be excessive, I would say that the value is based on $2.70 oil. They estimated the anticipated profit as $2.50. That allows only 20 cents operating costs for handling this oil, and had that valuation as to discovery been thrown back to December 18, 1914, it would have been valued on $1.45 oil.

Mr. MANSON. When was the well actually brought in?

Mr. FAY. December 28, 1914. That is the date when the well was completed.

The CHAIRMAN. And yet the valuation was made as of November 30, 1916.

Mr. FAY. At date of transfer; yes.

Then, the next well, No. 10, November 29, 1915, when oil was selling at $1.91. They still estimated the profits at $2.50 per barrel of oil.

On well No. 12, January 5, 1916, while oil was selling at $2.26, it is valued on the basis of $2.50 profit.

Well No. 17 was brought in on June 3, 1916, when oil was selling at $2.37, with an estimated profit of $2.50.

Well No. 23, February 19, 1916, when oil was selling at $2, with an estimated profit of $2.50.

Well No. 36, June 28, 1916, when oil was selling at $2.60, with an estimated profit of $2.50.

Well No. 30, July 6, 1916, when oil was selling at $2.58, with an estimated profit of $2.50.

Well No. 29, July 8, 1916, with oil selling at $2.58, with an estimated profit of $2.50.

Well No. 52, September 22, 1916, with oil selling at $2.31, with an estimated profit of $2.50.

Well No. 57, October 7, 1916, oil selling at $2.51, with an estimated profit of $2.50.

These prices are given as Pennsylvania crude, and the taxpayer states that these posted prices are subject to a 10 per cent advance by

reason of a premium paid for this particular grade of oil. I confirmed that statement by questioning the Geological Survey, petroleum division, the other day, and they told me that to-day Cabin Creek oil is commanding approximately a 50 cent premium, so that undoubtedly the 10 cents was right at those earlier dates.

These first 10 discoveries are used as a basis for valuing the productive oil land, and also to estimate the reserve of the undrilled area within these 10 discoveries, which amounted to 186 additional wells.

After getting that valuation for that land, and in the face of their statement that they say it was proven at the time of purchase, they are setting up five additional discoveries.

On June 26, 1917, well No. 101 was brought in and oil was selling then at $3.10 per barrel.

Senator ERNST. What you say is what has been done by the taxpayer?

Mr. FAY. This has been allowed by the department.

Senator ERNST. This has been allowed by the department?

Mr. FAY. I have the report as an exhibit.

Senator ERNST. That is what I want to know.

Mr. FAY. Well No. 101, with oil selling at $3.10 per barrel, and an estimated profit of $2.95.

The present value set up by the taxpayer and accepted by the unit for the 141 acres was $1,355,829.

Well No. 185, oil selling at $4 per barrel, the estimated profit is $4.25.

The present value allowed the taxpayer——

Senator JONES. Now, as to that well, are we to understand that where oil was selling at that time at $4 per barrel, the amount allowed for depletion on valuation is carried all through the subsequent years?

Mr. FAY. That is correct.

Senator JONES of New Mexico. Do you think, Mr. Fay, that that could be justified on any basis?

Mr. FAY. It can not be justified on any basis except by the law and the regulations as written at present.

Senator JONES of New Mexico. Does the law require it?

Mr. FAY. The law permits a discovery valuation.

Senator JONES of New Mexico. Yes; I understand that.

Mr. FAY. The regulations prescribe how it shall be determined.

Mr. MANSON. Is this a long-life property?

Mr. FAY. They estimate this at 16 years, and they are using 10 per cent discount for it.

Mr. MANSON. I myself can not see how anybody can say that a purchaser would anticipate that he is going to get a tremendously high price for oil over a period of 16 years, and if he would not anticipate this, then he would not pay that price as of the date of discovery, or 30 days thereafter.

Senator KING. How could you contemplate a continuity of those prices of $4 when all of our experience shows that any such price as that is abnormal? That is just like the skyrocket appearing in the sky. We do not have one every second. They are phenomena, and that is a phenomenal price.

Mr. FAY. In that connection, Senator King, Pennsylvania crude and West Virginia crude oil bring, roughly, $2 a barrel more than Oklahoma oil does. There is that difference.

Senator KING. Yes.

Mr. FAY. That this $4 sounds large, because we have been talking about Oklahoma oil at $2 or $2.50 and California oil at $1.40 or $1.50.

Senator JONES of New Mexico. I have known Oklahoma oil to go down to 35 and 30 cents a barrel.

Mr. FAY. That is right.

Well, No. 200——

Senator JONES of New Mexico. And I desire to call attention to this fact: It appears that here we have one company with a number of wells getting a different valuation out of the oil based upon the time of discovery, and the variation amounting to a very substantial sum.

Senator KING. Would it be possible, Mr. Nash, to get the taxes paid by a number of these oil companies for a given number of years?

Mr. FAY. That is what I asked for in these questions that we were talking about this morning.

Senator KING. And then show the amount of cash actually put in, in addition to the present value or the assets of the company? For instance, some of these companies, as we know, have put in but a few hundred thousand dollars, possibly a million or so, and they are now worth many, many millions, which is the result of profits which, perhaps, were reinvested. I was wondering whether you could ascertain just what taxes were paid by some of these companies now credited with having millions and tens of millions of assets, and with but very small investments, they having reinvested their undivided profits as capital.

Do you think, Mr. Fay, your inquiries will elicit that information?

Mr. FAY. I think they will.

Senator KING. And he will not have to supplement it by showing the assets of those companies now?

Mr. FAY. On this questionnaire that we have prepared, we are asking for the cost of the property, whatever it may be, and then the discovery appreciation that has been allowed, and I think the sum of those two will give the value of the property.

Senator KING. I know one company—it is not an oil company, but it illustrates my point—that invested $300,000. It has paid that money and millions of dollars of dividends, and has assets of perhaps $30,000,000 or $40,000,000.

Senator ERNST. Mr. Fay, you have given enough of those for the purposes of illustration, have you not?

Mr. FAY. I have two more that I would like to give, Senator, if permissible.

Senator ERNST. All right.

Mr. FAY. Well No. 200. They set up reserves of 305,342 barrels. The price of Pennsylvania crude at the date of that well was $6.10. They are estimating their total profits of $6.52 per barrel. That gives a total present value of their working interest of $1,426,597. The actual cost of this particular area of 113 acres as of November

30, 1916, was $220,090. That is what they paid for it at date of acquisition, when their own statements indicate very strongly that they considered it all proven and highly profitable oil land.

The next is well No. 205. That is the extreme west end, 325,272 barrels of reserves, $6.10 oil, profit $6.52, a valuation of $1,550,000, covering only 83 acres. This discovery area cost actually $171,181, and a large part of that was stock of the corporation.

Mr. GREGG. Does that complete the statement, Mr. Fay?

Mr. FAY. I have just one or two more here that I would like to put into the record at this point.

This is from the taxpayer's conference, the engineering division, on November 26 to December 10, 1923, and the conclusions are, with reference to oil:

> Values set up for discoveries in 1920 will be adjusted by a factor for fair market value. Values set up for outside acreage appear excessive in certain instances and will be reduced from $10 to $5 per acre. Values established as of November 30, 1916—

Which is the date of the 10 discoveries that I have been discussing—

> and at various discovery dates, other than in 1920, appear acceptable.

Senator KING. Who represented the department in that conference?

Mr. FAY. J. R. Paddock, C. R. Vorck, R. W. Keyser, C. H. McClain, and A. B. Morris.

The CHAIRMAN. Is this case closed?

Mr. FAY. The valuation has been closed, I believe, but I do not think the audit has been completed. As far as I know, it has not.

Mr. GREGG. As I understood Mr. Fay's statement, it contained really three criticisms.

The first is the criticism as to the blanketing of a given pool for discoveries. That is the matter of the definition of a discovery well, which the committee has announced its intention of going into further at some subsequent time; so I do not think it is necessary to say anything on that, and I assume that at such subsequent time they will also go into the question of the method of determining the amount recoverable through depletion; that is, the price of oil which should be used as Senator Jones suggested by his question.

The second point is his criticism of the values allowed the Pure Oil Co. and we will, of course, have that matter looked up and report back to the committee on it.

The third was a criticism of the values, and I want to answer this specifically at this time, claimed by the Gypsy Oil Co.

There are some violent assumptions, it seems to me, in Mr. Fay's statement.

The first is his assumption that these valuations will be allowed. I can assure the committee that what has been brought out will be very carefully considered when the department takes the matter up for consideration; that is, the matter of valuations claimed on these properties by the Gypsy Oil Co. This data will be very carefully considered then.

For one, however, I am not prepared by any means to accept the conclusions which Mr. Fay stated. I know very little about the oil industry, but from whatever little knowledge I have of it I know that as he went along he made some errors.

There is one point that I want to bring out with reference to his testimony about one of the Gypsy leases, where discovery was claimed by the taxpayer. He states that the net income from this well, without deducting depletion, is $616,841. Fifty per cent of that would be $308,000, while the depletion charged off by the taxpayer on the basis of discovery appreciation alone amounts to $291,000, and the depletion charged off on the basis of cost is $548,000.

He has criticized the value allowed for discovery depletion, and says:

The amount of depletion to be charged off on discovery valuation is calculated—

This is in the 1924 act—

to check very closely with the amount actually allowable.

In other words, the 50 per cent.

Now, let us take the facts for just a minute. This is one place where I could check them.

Fifty per cent of the operating profit from this property, without reference to depletion, is approximately, in round numbers, $300,000. Depletion on cost is $548,000, and depletion on this discovery value, which was criticized, is $290,000.

Now, under the very sections of the act which he cited there, the taxpayer is entitled to no deduction for depletion on discovery. He is limited solely to deduction for depletion on cost.

Mr. MANSON. Oh, no; depletion on cost is not limited by the statute.

Mr. GREGG. I say he is limited to his depletion on cost. It is $548,000, but he gets nothing on discovery value.

Mr. FAY. Why does the taxpayer set it up and use it in his deductions?

Mr. GREGG. I am not responsible for the action of the taxpayer; but I do say that the law actually limits him to a depletion on cost in that case.

Mr. MANSON. No, no.

Mr. FAY. No.

Senator JONES of New Mexico. My recollection of the law is that the concern that actually discovers the oil is the one concern that is allowed anything for discovery value.

Mr. GREGG. Yes, sir.

Senator JONES of New Mexico. In the case of a sale, the vendee is allowed depletion on the basis of the purchase price.

Mr. GREGG. Yes, sir. May I clear this up?

This taxpayer purchased at a fairly high price, and his depletion on cost would be fairly high. He claimed a discovery value in excess of his cost.

Now, the comparison is between the amount which should be allowed him if he depleted on his cost and the amount which should be allowed him if he depleted on his discovery value, and my point is that the limitation of the 1924 act would so apply that he would get nothing on discovery value and would be limited solely to his depletion on cost; so the discovery value would have nothing to do with this year at least.

Mr. MANSON. I do not want to commit myself on that, but I have a very strong hunch that he can take his discovery depletion in this particular instance up to $300,000 approximately, and that then, as against the balance of the income from that property, he can take about $500,000 off cost depletion.

Mr. GREGG. I might say, with all due respect, that Mr. Manson's hunch is wrong. The statute gives three depletions——

Mr. MANSON. I want to look that up before I commit myself on it.

Mr. GREGG. I think I can clear that up right now.

The statute gives three depletions; one on cost, one on March 1 value, and one on discovery value.

Let me emphasize there that the depletion must be based on one of those things. It says the depletion on discovery value shall not exceed 50 per cent of the income from the property upon which the discovery is claimed, unless the depletion on cost would exceed that 50 per cent, in which case the depletion allowed shall be that on cost.

In this case the depletion on cost is more than 50 per cent; so under the language of the statute the discovery depletion is out and the allowance is made on the basis of cost.

The CHAIRMAN. In that connection I want to say that I understood the witness perfectly clearly, that he said the taxpayer set it up. He did not say the bureau allowed it, and I think perhaps there is something to Mr. Manson's hunch, in view of the taxpayer's believing that he could get both. Anyway, the witness did not say that the bureau had allowed it; he said the taxpayer set it up.

Mr. GREGG. The point I am making is that under the law he is entitled to no depletion on discovery value under the facts stated by Mr. Fay.

Mr. FAY. Regardless of what the law is or what the regulations are, the taxpayer has claimed it in his return.

Mr. GREGG. And I say again that I am not responsible for what the taxpayer may have claimed, but the law is perfectly specific.

The CHAIRMAN. You do not object to his putting us on notice as to what the taxpayer claimed?

Mr. GREGG. No, sir; and I assure the committee that what has been brought out here will be very carefully considered when it is audited.

Mr. MANSON. I do want to say that it has been a matter of policy with me not to bring in anything here except something that was closed, but that in connection with these oil matters, where it is apparent that the statute requires consideration by the committee, it has been necessary, owing to the fact that the bureau is so far behind on oil matters, to bring in some matters that are not closed, that the committee may see how the law works and what its application is.

Senator ERNST. I think that is perfectly proper, Mr. Manson.

Senator KING. Mr. Gregg, I hope that the oil and gas section and its engineers will carefully examine the returns that are being filed now for the last year and make as early a disposition of those cases as possible. I think you ought to do that.

(At 12.35 a. m. the committee adjourned.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

FRIDAY, MAY 22, 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; and Mr. A. W. Gregg, solicitor, Bureau of Internal Revenue.

The CHAIRMAN. Proceed, Mr. Manson.

Mr. MANSON. I have a reply here in the matter of the Gulf Oil Corporation. This reply was prepared by Mr. Fay and deals with the answer of the bureau, presented by the solicitor. I will read Mr. Fay's reply, and then at the conclusion of this I desire to present my own views as to the adequacy of a 5 per cent discount factor in this matter, and as to the soundness of the position of the solicitor with respect to what constitutes the hazard factor, if any, in this matter.

The CHAIRMAN. Would this still be of moment if the discovery parts of the statute were prior; it would to some extent, but not to such a large extent, would it?

Mr. MANSON. Well, it would be——

The CHAIRMAN. It would be a factor in measuring the depletion, even though there is no discovery depletion?

Mr. MANSON. Yes; here is another angle. This case of the Gulf Oil Corporation up to the year 1920, I believe, is a closed case, but this company is to-day presenting its claim for discovery upon exactly the same basis as the discovery depletion was allowed.

The CHAIRMAN. Has any computation been made as to the effect it would have on the taxes for years subsequent to those closed?

Mr. MANSON. Well, no; because we do not know the facts with reference to the subsequent years.

The CHAIRMAN. I mean, have you not looked into it in the bureau to see what the facts are?

Mr. MANSON. As to subsequent years?

The CHAIRMAN. Yes.

Mr. MANSON. No.

The CHAIRMAN. If not, I think you ought to do so, so that we can get a complete picture. I mean by that that we are going from one thing to another, and I can not get a complete picture of it.

Mr. MANSON. I am having the computation made.

The CHAIRMAN. I would like to have a real case instead of having it presented on a theoretical basis. I do not care whether it is the Gulf Oil Co. case or the Sinclair Oil Co. case or any other case. I want a complete pitcure of how this method affects the taxpayers and the Government.

Mr. MANSON. I can have a computation made, for instance, as to the Gypsy Oil Co., which is one of the subsidaries. We could make a computation as to the whole Gulf Oil Co., but that would be——

The CHAIRMAN. Just make it for the Gypsy Oil Co. I just want to get a picture, and I hope the bureau will help on that.

Mr. MANSON (continuing). It would be almost a hopeless task in the length of time we have.

Referring now to Mr. Fay's reply, with reference to the handling of the tax returns of the Gulf Oil Corporation and its subsidiaries, the solicitor has reviewed the history of the case and does not bring out anything that does not already appear in the record. The testimony heretofore submitted recognizes that there was a field audit made in this case in that the statement is made that "the field auditor's report was received on February 20, 1921." The solicitor states that the inference to be drawn from statement of counsel is "that the field auditors completed their report on this case in one day and that the bureau approved the field auditor's report and fixed the amount of tax in six days."

The counsel for the committee has not at any time contended or attempted to convey the impression that the field audit was completed in one day. He does, however, contend that the field auditor's report was reviewed and approved by the Washington office within six days after it was received.

The solicitor, in connection with the field audit of this case, states:

At the same time that the field auditors were making their examination of the books of the company the representatives of Ernst & Ernst were preparing the amended returns of the company. The representatives of Ernst & Ernst and of the bureau worked together on this work and were in current consultation with reference to it. Many changes were suggested by the field auditors, and these changes were taken up by the representatives of Ernst & Ernst and incorporated in the amended returns.

The solicitor does not state upon what basis the amended returns were permissible. From his statem nt it would appear that the representatives of the bureau helped the taxpayer to prepare these amended returns, which were later used as a basis for claims for refund. He further states that the depletion schedules, "which were filed continuously from September, 1920, until February of 1921, as they were completed by the taxpayer, were prepared after consultation and discussion with representatives of the natural resources division of the bureau."

He further states "that the representatives of the taxpayer worked with the bureau to get their ideas as to how they should be prepared and the data that should be furnished." The bureau officials apparently got the idea of how the taxpayer wanted to file his schedules.

The solicitor states that as the books of the company were completely rewritten by representatives of Ernst & Ernst and this particular feature deserves special consideration, he seems to be under the impression that a different system of bookkeeping and accounting is absolutely necessary for income tax purposes. A standard system of bookkeeping or accounting needs no changing, but it may be necessary to enter additional accounts which have hitherto not been segregated. The solicitor states that depreciation for tax purposes is on a different basis than depreciation in the ordinary systems of accounting.

The CHAIRMAN. That is correct, is it not?

Mr. MANSON. I do not agree with that; no.

The CHAIRMAN. Oh, I think it is. Proceed. Pardon me for interrupting you.

Mr. MANSON. The basis may be different as to dates, but the rates of depreciation have not changed since the income tax law went into effect. There is no occasion or need for changing recognized rates of depreciation on standard equipment. Machinery does not depreciate any more rapidly by reason of the enactment of an income tax law, although many accountants seem to so consider it. The solicitor states that the books of the company were changed with the approval of the examining officers of the bureau, and he lays particular stress "that no records of the company were destroyed or misplaced, no original entries in a record were changed." At a number of points the solicitor makes special mention that none of the records of the company were destroyed. Neither counsel nor the engineer for the committee have stated, intimated, or even suggested that the records were destroyed. The only statements they have made are that the books were rewritten, and this the solicitor acknowledges.

The solicitor states that the criticisms by the committee's engineer are:

(1) The allowance of vertical discovery.

(2) The use of the price higher than the posted price of oil.

(3) Criticism of the failure to consider the cost of handling royalty oil.

(4) Criticism of discount factor and failure to adequately consider the hazard factor.

(1) Vertical discovery: With reference to the vertical discoveries. This criticism was not directed at the Gulf Oil Corporation valuations. This corporation's discovery valuations on more than one sand in the same lease were simply used as an example of what the law permits and what the regulations allow. The criticism therefore is directed to the law and regulations, for it does not appear to be reasonable and just to permit so many discovery valuations for depletion purposes. The right of a taxpayer to set up such valuations. as the regulations now stand, has not been questioned.

(2) Excessive price of oil: With reference to the use of the price of oil higher than the posted price. The solicitor defends the action of the Gulf Corporation by saying:

> The bureau has allowed in certain instances the use of a price higher than the posted price in cases where discovery was made at time of great depression. Again, in this instance the treatment of the Gulf case was in accord with the general practice of the bureau.

While this may be the general practice of the bureau and the records of the bureau do show that many vaulations have been made at a price considerably in excess of the posted price in times of depressed market conditions, it does not conform with either the law or the regulations. Both the law and the regulations provide that the valuation of discovery wells shall be made on the basis of the facts and knowledge obtainable at or within 30 days after date of discovery. The solicitor in his statement says:

That this was the first big case which ever went through the bureau.

If this was the first big case that ever went through the bureau, then this case sets the precedent for the use of an abnormal price of oil at times of depressed market conditions.

While this taxpayer as well as others have received an excessive valuation on this basis, the records of the bureau do not show at any time that an anticipated decline in price has been used when valuations were made at a time when prices were at a peak, and the industry was experiencing an era of prosperity in boom times.

The criticism offered by both the committee's engineer and counsel was not so much the fact that an anticipated price was used when the market was depressed as the fact that neither the taxpayers nor the bureau have been consistent and used declining price when prices were abnormally high.

The Solicitor states:

That in the case where oil was discovered at a boom price, the possibility of future decline in the price of oil was taken care of through the hazard factor.

Of all the cases examined there is no indication that an increased hazard factor of any kind, discount, dry hole, or reduction of flow has been used to offset the possible decline in price. The experience of the committee's engineer, who spent three years in the natural resources division, does not recall any such practice.

Referring to the Eliza Lowe lease and the valuation placed thereon. The principle is involved in which the taxpayer used an excessive price (or $1) of oil as a basis for his valuation. Oil was selling at 40 cents per barrel. The valuation determined resulted in a very large sustained depletion, and the only reason that the taxpayer did not receive the benefit therefrom was that this sustained depletion began to accumulate in April, 1915, when discovery depletion was not allowable as a deduction. The depletion unit, however, set up at this time would form the basis for depletion for any oil remaining to be produced after December 31, 1917.

The solicitor states that this depletion during the years 1915 to December 31, 1917, was of no practical benefit to the taxpayer. The only reason that the taxpayer received no benefit for those years was that the law did not allow discovery depletion as a deduction, but if the principles of valuation as used in the Eliza Lowe lease are accepted as correct and used as a basis for making discovery valuations for wells coming in after January 1, 1918, as in the case of the Adams lease, No. 117, Okmulgee, Okla., the taxpayer will then receive the benefit of an excessive depletion determined under the methods adopted in the Eliza Lowe lease. The same is also true with reference to the other leases named in the table, page 1998, Senate hear-

ings, while the solicitor's defense in this particular case is that the taxpayer did not actually receive the benefit of this excessive valuation. He did, however, receive the benefit of an excessive depletion unit on reserves that remained and for production for the years 1918 and later.

The solicitor states:

With reference to the A. Focht lease, the total discovery valuation allowed was $1,833,603. The sustained depletion on this discovery value prior to January 1, 1918, the effective date of the provision allowing discovery depletion amounted to $1,274,230.90. The discovery depletion that has actually been allowed was $306,000, or about 14 per cent of the discovery valuation, and that this does not seem to be an unreasonable allowance for depletion.

This may not appear to be an unreasonable allowance on a lease so valued, but the only reason that the full amount was not allowed was that the depletion sustained accumulated prior to the date that the law made discovery depletion allowable. The depletion unit determined for this particular lease was erroneously derived by reason of the excessive (35 per cent excess) price of oil used at date of valuation. Should any valuation subsequent to December 31, 1917, be determined upon the basis that this valuation was determined, the taxpayer would then receive the benefit of the entire amount of depletion sustained and allowable. This, of course, for 1924 and succeeding years would be limited to the 50 per cent restriction. The main point to be brought out in the valuation of this lease is one of principle, namely, the use of an excessive price of oil at date of valuation.

Referring to the list of leases set up in tabular form by the solicitor——

Senator KING. Not only in principle but in your contention, and if the contention of the engineer representing the committee is correct, then there is too great an allowance in this case and not sufficient tax collected by the Government.

Mr. MANSON. Well, the most of the benefit of this valuation was lost to the taxpayer, for the reason that most of the oil had been taken out of the lease before 1918, when the law became effective; but that does not alter the principle, nor does it alter the depletion rate upon the remaining reserves.

Referring to the list of leases set up in tabular form by the solicitor, to which the committee's engineer referred on page 1998 of the Senate hearings, the presentation of these leases at a former hearing was for one purpose only, to bring out but one principle involved in the valuation of oil land, namely, the use of the price of oil in excess of the market price of oil at the date of valuation. It was shown in 10 out of 12 of these valuations that the taxpayer had used a price in excess of the market whenever the market was considered exceedingly low or depressed. Reference has been made by the committee's engineer that 29 similar instances had been found in examining 70 valuations. These leases and valuations were referred to for no other purpose than to set forth this particular feature of discovery valuation. The solicitor lays particular stress upon the total value that had been allowed by the department, together with the estimated reserves and the production to the close of 1924. No reference whatever was made by the committee's engineer

to those leases as a whole, nor did the committee's engineer criticize the total value that was given those leases. He did, however, criticize the method by which certain discovery wells were valued on these particular leases. It is true these discovery values when totaled would represent the discovery appreciation allowed each lease, but only those discoveries were considered where a price of oil in excess of the market price was used for the purpose of valuation.

The solicitor defends the use of a price of oil in excess of the market price at date of valuation simply on the grounds that the law did not permit the sustained depletion to be allowed as a deduction prior to 1918. The argument is decidedly weak. If this principle were to maintain, there is no reason why a fictitious price may not be used at any time for any valuation. It is permitted by the department and recognized as proper in the California oil fields when the price is low and the limit to which it applies is only arbitrarily fixed and may at any time be changed, since it is not specifically provided for in the law and regulations.

Regarding the 20-cent excess price in the valuation in the Shumway lease, the records available to the department when this case was passed showed that the well was completed on July 15, 1917. That being a sworn statement by the taxpayer would ordinarily be considered as the date to be used in placing this valuation. Furthermore, the department recognized that this date was the proper date for valuation in that it accepted this date as the basis for valuation of the lessor's interest in this same well. No argument need be presented to defend this date, regardless of what the later records of the taxpayer's books may show.

The solicitor, notwithstanding the information that was on file in the department at the date this valuation was allowed, now states that—

> This well began production July 16, so that technically the use of the August 15 advance is justified. Furthermore, the well was not finished until about July 20, which brings it still further within the limit.

Whether the well began production July 16 or not, the original records show that it was completed on July 15, and under ordinary oil-well practice and experience production begins before a well is technically completed. The bureau, however, as stated above, recognized July 15 as the date of completion of the well for the valuation of the lessor's interests, and the lessor's value was based on oil at $1.70, not $1.90, as set up and allowed the Gulf Oil Corporation.

(3) Handling of royalty oil: The solicitor criticizes the statement of the committee's engineer, in which reference is made to an additional operating cost for the handling of royalty oil. On page 1988 of the Senate hearings the committee's engineer states:

> The taxpayer's valuation calculations do not reveal whether he has taken into account the cost of pumping, piping, and storing the royalty oil. It will certainly cost the lessee as much to pump and store this oil as he considers it will cost for producing and storing his own oil, namely, 20 cents a barrel. It is possible that operating costs may be determined on such a basis that this item will be provided for.

The records of this case do not segregate this item, and it was suggested by the committee's engineer as one of the items which should be taken into consideration in valuing the oil property.

The solicitor states:

> The operating cost of producing both the company's and royalty oil is divided by the amount of the company's oil to get the barrel-producing price, but we take into consideration in determining the barrel-producing cost of producing the royalty oil also.

If this is done as the solicitor states, no criticism can be found, but, as stated before, the taxpayer's records did not reveal whether this was the case or not. It is too important a matter in oil-well valuation to be overlooked.

I want to state at this point that I deem it of vital importance that the data before the engineers in the department, when they value an oil well, show whether the cost of taking care of the royalty oil is considered or not. In other words, Mr. Fay, in his discussion of this subject, merely called attention to the fact that the records did not show whether it was considered, and I do maintain that a proper valuation necessarily involves the ascertainment of the fact as to whether or not it is considered, and that the proper showing of data upon which to base valuation necessarily must contain that data, and that the mere fact that after this data is presented to the committee the company may assure the bureau that it has taken care of that does not justify the determination of the value of an oil well without knowing whether or not the question of taking care of the royalty oil has been provided for.

Shumway lease: With reference to the Shumway lease it matters not whether this was called the Towanda pool or the Eldorado extension. It was considered in the former hearings as an extension of the Eldorado pool, some 5 or 6 miles to the southwest, and it is specifically stated that it is in Towanda Township of Butler County. On page 2001 it was specifically noted that "There was an ideal structure in Towanda Township that was cited by prominent geologists." This, then, locates the structure without question. This particular pool, whether an extension of a known pool or a new pool, was discovered in March, 1917, by the Alpine Oil Co.

Regarding the taxpayer's reserves set up for this particular lease, especially for well No. 1, which was an exceptional well, having a daily initial production of 5,000 barrels. The average daily initial production for wells in the Eldorado district, Butler County, for the year 1916 was 255 barrels. It will thus be seen that while this well was twenty times as large as the average well for the county, the taxpayer assumes that each of the other wells on this discovery area will have a productivity of 75 per cent of this well No. 1, or fifteen times the average well in this county, and on this basis the taxpayer set up nine additional wells (p. 2004).

In order that the matter may be cleared up to the time of the discovery of this well, the production of the average well in that county was 255 barrels. The discovery well is brought in at 5,000 barrels.

What we criticize is the assumption that all of the other wells will be brought in on that discovery area, and all of the other wells necessary to drain the reserves from that area, which reserves are a part of this value, will produce at least 75 per cent of 5,000 barrels in face of the fact that the average production in the county is 255 barrels.

Senator KING. Is that for the purpose in part of swelling the price to be allowed for discovery valuation?

Mr. MANSON. By increasing discovery valuation?

Senator KING. Yes.

Mr. MANSON. Yes.

The taxpayer and the solicitor would have one believe that the estimate of reserves was reasonable and not excessive, since he uses a 25 per cent reduction based on well No. 1. The average initial production of each of the nine additional wells would then be 3,750 barrels. As a matter of fact, the records of the taxpayer show (p. 2003, Senate hearings) that nine wells were drilled and they actually averaged 3,850 barrels each initial production. The taxpayer's estimate, therefore, checks very closely with the actual performance of these wells, although the estimate was made approximately two years after these wells were completed. The initial production of these wells was not known as of August 14, 1917, and hence the discovery valuation can not be predicted thereon, and at the same time comply with the law and regulations.

That particular case furnishes a good illustration of a principle that I desire to make plain to the committee.

This law provides for a valuation on date of discovery or 30 days thereafter. In other words, this law provides for the valuation of a highly speculative piece of property. When the speculative element of a piece of property has been eliminated by the ascertainment of the actual production of the property over a long period of time, the value thus ascertained is not the value contemplated by the statute for this reason, that in the purchase of anything which is highly speculative in its nature, the speculative value placed upon it by the purchaser is necessarily discounted because of the speculative risk involved and because of the unknown factors which constitute the basis of such a value.

In this particular case the experience of that county indicated that 255 barrels was what could be expected from a well. A 5,000-barrel well was brought in. Any purchaser of that well, having no knowledge of the future production other than such as he could base upon facts which he could ascertain within 30 days of the time the 5,000-barrel well was brought in, would necessarily take into consideration the fact that that well was in its production so vastly different and so much greater—twenty times greater than the production common in that field, and there would be absolutely nothing to justify that taxpayer in assuming that the other wells which would be brought in upon the discovery area would be anywhere near 3,750 barrels.

Mr. Gregg, in his answer in this case, took this position, that the low discount factor, the discount factor of 5 per cent, was justified, for the reason that the hazards of the business had been taken care of by the application of a hazard factor.

Mr. Gregg did not think that after the yield of this territory had been estimated, the yield thus estimated would reduce by a hazard factor. Mr. Gregg did not state that to be the fact, for the reason that it was not the fact, and is not the fact. He predicated his entire position that a hazard factor had been introduced by showing that after the production of several years was known the production of several years exceeded the estimated reserves.

I content that the fact that subsequent production exceeded the reserves not only does not prove that a hazard factor was taken

into consideration as to the date of discovery but that it is not even evidence tending to show that such a hazard factor was taken into consideration.

Now, let us see how these reserves are, in fact, estimated.

Senator KING. You mean by the department?

Mr. MANSON. By the department or by anybody else.

There is only one sort of data as to what may be expected; only one published source of data as to what may be expected in any particular field, when the initial production or the production within the first 30 days is known. That sort of information is published in the Oil and Gas Manual issued by the department. Published and issued by the department, to be used by those claiming discovery values, it ought to at least be binding upon the department.

The source of that data has been explained to the committee. It is based upon actual production in different fields for different periods. It was assembled by an engineer from the Bureau of Mines for the benefit of the Income Tax Unit.

When we submit the initial production of a new well to the standards set up by those statistics we find that we can expect in a particular field that if our initial production is 5,000 barrels, the production for the next month will be so much, for the next quarter it will be so much, and for the following quarter it will be so much, and for the following quarter it will be so much.

Now, what is that? That is an average of past experience. Any average necessarily presupposes that some wells were above that and some wells were below it. An average presupposes a minimum below and a maximum above.

When we take a well, or the initial production of a well, and submit it to the test, and calculate the reserves based upon this depletion, what do we do? We know that we are making our calculations upon the basis of averages.

What would a purchaser of that property assume? The purchaser of that property would assume that the property might fall below the average. The purchaser of that property would therefore discount the average, or discount any figures that were arrived at upon the basis of an average, before he would assume that he was going to get back a certain number of barrels of oil out of that property.

If, as a matter of fact, after those reserves are exhausted, we find that the well exceeded the average, exceeded the estimate based upon the average, that does not prove, and it does not even tend to prove, that at the time the estimate of the reserves was made the reserves estimated in accordance with this standard were discounted. It merely establishes what all of the evidence we have been able to get establishes, namely, that instead of appraising oil wells as the law requires as of date of discovery, or within 30 days thereafter, it is the practice of the bureau to eliminate the hazards which the law contemplates shall be considered by basing their estimate of reserves upon actual production.

Up to the present time we have been unable to prove that assertion and have based it entirely upon the close relationship, as in this case, between the estimates and the actual production. Here the additional wells are estimated to produce 3,750 barrels, notwithstanding

a previous history of 225 barrels, and the actual production is 3,850 barrels. We have maintained all the time that that was evidence tending to show that the kind of a valuation contemplated by the law was not being made.

I will present a case to the committee this morning in which, after having the production not for 30 days but for 18 months, the bureau declines to make a valuation until further production is known.

Senator KING. From your examination would you infer or state that the practice of the department has been, with respect to determining value in regard to oil wells, that they do not do it within the 30 days as required by law, but that they wait until several years have passed, and then they make their findings, and if the yield is great they then allow a great value, and if it has gone down they then make the hazard so great that they bring the value far below the minimum in any general average that might be established or accepted?

Mr. MANSON. I will say this, that they base their valuations not upon values which could be ascertained within 30 days after discovery but upon actual production extending over several years; that they then attempt to justify the use of discount factors which are wholly inadequate by comparing the reserves with actual production. In other words, to get back to what I said before, what Congress contemplated in the act, and what is contemplated in the act, was the valuation of something which is of a highly speculative nature, and that by reason of that very highly speculative nature Congress contemplated that the valuations placed upon these oil wells would be very much lower than the actual values which have been placed upon them by eliminating the speculative element involved.

Senator KING. Is there anything to indicate from an examination of a number of the records of the cases in the department that valuations were fixed, even though tentatively, within 30 days, and then erased from the records, or modified or changed, and the discovery value greatly increased after two or three years of production, so that the production was in excess of the average?

Mr. MANSON. No; I can not say that we have any evidence of that. I do say that we have evidence of valuations having been based upon actual production, and that the fact that they have been based upon actual production has been used to justify a lower hazard factor than the valuation made as in accordance with the law would require; and I base that assertion upon two facts which are established in this record, namely, a relationship between estimated reserves and actual production, which could come about only after the production is known, and which is not justified by any experience; and I further base it upon the fact that I will present to the committee this morning a case where, after a known production of 18 months, the bureau goes on record by refusing to fix a value until further production is known.

Senator KING. Take the case that you are discussing now about the known wells. It seems to me that it could not be a mere coincidence that the production for valuation purposes should be so approximately near the production, if that estimate was made within 30 days after the discovery of the oil, and it must have been a long time

afterwards when they saw the continuity of the flow and the substantial yield of the wells.

Mr. MANSON. I will say furthermore that the whole case of the solicitor, in answering in the Gulf Oil Co. case, is that the valuations are justified by subsequent experience.

Senator JONES of New Mexico. Mr. Manson, I may be a little premature, but is it your idea that we should take this production curve which has been prepared by the engineer to which you have referred, and after applying a reasonable hazard factor, fix that as the discovery value?

Mr. MANSON. No; I think the production curve should be adhered to until a better production curve is produced for the purpose of determining the reserve, but that by reason of many uncertainties, which I intend to point out later, even after you have based your estimate of the amount of oil in the ground upon the production curve, you know that the production curve is the average, and because it is the average, the production is just as liable to fall below it as it is to fall above it.

Senator JONES of New Mexico. Well, we can not eliminate that hazard factor.

Mr. MANSON. No.

Senator JONES of New Mexico. I was taking this curve, and applying to it a reasonable hazard factor.

Mr. MANSON. That is what I contend should be done.

Senator JONES of New Mexico. That is what I assumed.

Mr. MANSON. Yes.

Senator JONES of New Mexico. And if we can not handle the matter in any other way, why do we not put that into a statute, that it shall be the basis of the allowance of discovery value?

Mr. MANSON. I believe that that will be almost necessary.

I have been reluctant to make any suggestions of remedies for different situations, for the reason that, as far as I am concerned, I have tried to hold my mind open on all the subjects that we have investigated until I had all the facts that time and money and help would permit us to get, and not to arrive at any conclusion until I do have all the information that I can get; but it has always been my view that it is necessary for Congress to provide more specifically as to how analytical appraisal methods shall be used.

Senator JONES of New Mexico. This question of discovery value is one which is granted to these producers as a matter of grace. It is not a thing which must be allowed them at all in any income tax law. Now, why should we leave such an important thing to the mere whim, as it seems to me has been done in practice, with individuals in the bureau?

Mr. MANSON. Well, I do not believe it should be so left. I believe the discretion has been used——

Senator JONES of New Mexico. And would it not be fair if the Congress should not only see that this curve should be taken into consideration and used——

The CHAIRMAN. When you speak of "this curve" you mean the curve created by the Bureau of Mines?

Senator JONES of New Mexico. Yes; created by the Bureau of Mines, based upon past experience in oil fields generally.

Mr. Manson. I might make this suggestion, Senator——

Senator Jones of New Mexico. And also fix the percentage of the hazard factor.

Mr. Manson. I believe that there are several things which should be done here.

In the first place, under your general leasing act you have based the mineral area upon geologic structures. The administration of your act has been put in the hands of the Bureau of Mines, but in every instance the determination of the geologic structure has been left to the Geological Survey. In other words, in that way, in so far as the general leasing act is concerned, the Government has utilized the benefit of expert knowledge and the expert help that it has in the different departments where it finds that expert knowledge and help to be.

I believe that if the discovery feature of this law is to be permitted to stand in any form, the discovery area should be defined in accordance with the terms of the general leasing act and a definition of a particular discovery area should be vested in the Geological Survey.

That is one feature of it. Another feature of it is that I believe that the method of determining value should be tightened up by the law itself, so that such a wide discretion as has been heretofore exercised can not be exercised in the future and that Congress should provide, in the case of oil wells, at least, a certain minimum hazard factor.

I do not mean to say that the present curves should be made perpetual. I believe that those curves should be changed from time to time, as more experience is had, but I do believe that you have in the Bureau of Mines and in the Geological Survey the technical help, and I do believe that those curves should be recognized by the act, and that they should be made and published for the guidance of all taxpayers, and that when so made and published they should be binding upon the taxpayer and binding upon the Government as the basis for determining reserve, and that then the curve should provide at least a minimum hazard factor, as well as the minimum discount factor.

Senator Jones of New Mexico. Why not provide definitely just what that hazard factor shall be? If we establish rates definitely on the amount of income that a person may have, why should we not have a discovery rate definitely fixed for the amount of discovery allowance?

Mr. Manson. I wish to call attention—and it is not, perhaps, in order with the point that I am presenting, but has a bearing here—I wish to call attention to this fact: A mechanical genius can work for years and while working can practically starve to develop something that is useful for mankind; but when he has developed that thing, when he sells his patent he pays a full income tax upon what he receives for it. If he manufactures his patent, and thereby makes money, he pays a full income tax upon the income that he derives from the effort of those years of labor and privation.

The Chairman. Would not that be equally true in the case of a lawyer or a doctor in preparing himself?

Mr. Manson. It is true in the case of a lawyer or doctor, or any professional man who deprives himself until he reaches the age of

about 40, up to which time no professional man can really be said to be upon a paying basis.

On the other hand, under this law—I do not care how strict you make it; you can make an ideal law—a man goes out and discovers something which he did not put in the earth: it is not a creature of his brain nor a child of his effort, but something that was put there by the forces of nature, and he not only gets the benefit of what was put there by the forces of nature but, on top of that, he escapes, to a certain extent, taxation upon the income that he derives therefrom.

At the time that this law was enacted in 1918 the country was using something like 60,000 barrels of oil a day more than it was producing. We were at war. As an emergency war measure I think this provision of this act may be justified.

Senator KING. Well, it was not because of the demands, but people were going out and making discoveries, as they did of manganese and chrome and other precious metals, and with the high prices which prevailed the people would have gone into the oil fields, as they did.

Mr. MANSON. I am not criticising——

Senator JONES of New Mexico. I would like to say right here, because I happen to know that the reasons advanced by Mr. Manson for a provision in the act are well founded, and that same provision applied to the discovery of these other metals.

Senator KING. Oh, yes.

Senator JONES of New Mexico. The rare metals and other things which were needed for war purposes at the time. That was the purpose of this provision in the act. It was to bring about future discoveries.

Mr. MANSON. Yes.

Senator JONES of New Mexico. And increased production.

Mr. MANSON. Then, at that time also, you had a high rate of taxation, and it was represented to Congress that this high rate of taxation would take away from a man in one year the fruit of his efforts over several years, during which he had no income against which he could charge his losses. The situation had existed at that time. The necessity for discoveries, on the one hand, and the high rate of taxation have both disappeared. At the present time most of this discovery value goes to corporations. I presented some statistics here as to the distribution of it. The most of it goes to large corporations, which have actually charged off from year to year their expenses for drilling dry holes, and which get this discovery value in addition to that. At the present time, you have a 12½ per cent tax rate, so that you allow no discovery value at all. The most that you are taxing is 12½ per cent on the net income, except, of course, in the case of some individuals who probably pay a higher rate than that, but the most of those individuals are lessors.

Senator JONES of New Mexico. I might add at this point a little emphasis to what Mr. Manson has said about charging off as cost the exploration of these large companies. It affects those large companies very differently from what it does a company organized for the purpose particularly. If it is a small concern, a newly organized concern for the purpose of drilling a well upon a certain structure, there is no profit of this concern against which the expense might be

charged off if it should turn out to be a dry hole. Then there is a real hazard; but in the case of large companies they set aside for exploration purposes a certain amount of money a year. There is no hazard there of any sort so far as the tax law is concerned.

I wish to call attention further to a class of cases which should be dealt with. I do not know that any inquiry is necessary regarding it, but reference has been made to professional services. We all know that a lawyer, for instance, will engage in a piece of litigation which extends over a period of years, and under the present law he is charged a tax upon the fee which he ultimately receives as of the one year, or a particular time in which it is received, although it may be the fruits of his labor for a number of years.

The same thing is true with regard to many construction companies. Take a company that is building a bridge across the Hudson River, for instance, or building a tunnel under the Hudson River. It will take a number of years in which to complete the work, and you do not know when the work is going on whether you are going to finally wind up with a profit or a loss; but if it happens to wind up with a good profit you are charged for the year in which it is received, as if it were a whole net income as of that particular time.

I think that is grossly unjust, and that we should devise some means for dealing with that question.

Perhaps the same principle might be applied, instead of the so-called discovery value, to a distribution in some way in the profits over a series of years, and perhaps it would be fairer to the rest of the taxpayers, who are engaged in other industries, than the present method of allowing a discovery value at all.

Senator KING. In view of what the Senator said concerning the taxation of professional men, this is not quite in harmony with what you have been stating, and I do not want to digress too far, but I would like to ask Mr. Nash or Mr. Gregg, in view of some letters which I have received, to what extent engineers and dentists and professional men are conducting a business which is personal, and which ought to remain personal, are forming corporations, thus to escape the tax?

Mr. NASH. It has not come to my attention, Senator, that that practice is being followed to a very great extent.

Mr. GREGG. I do not think it has been followed at all. Of course, in most cases lawyers can not incorporate.

Senator KING. No; not lawyers; I did not mention them. I said dentists, engineers, and some professional men.

Mr. GREGG. I do not know of any doctors or dentists, either, who are incorporating. I have heard of engineers doing it sometimes, particularly when they are doing engineering construction work requiring capital; but I do not think it is done to amount to anything.

Senator KING. I have heard that there are some dentists who are doing it.

Mr. NASH. We have a few instances of doctors incorporating in the form of a clinic.

Senator JONES of New Mexico. Is there not a large number of so-called personal-service corporations?

Mr. NASH. Those are mostly brokerage concerns and insurance people, etc.

Senator JONES of New Mexico. Well, that would be in the same class as Senator King referred to?

Mr. MANSON. I might say here that I have tried to make some study of that question, and the principal change that there has been in the form of doing business appears to be among brokers and investment bankers. In former years, there were very few brokerage houses which were incorporated. Most of them did business on a very elastic capital. They would underwrite a bond issue, which would require a lot of money. They would pledge their personal credit with the banks to borrow the money to swing the bond issue. As soon as the bonds were disposed of they had no further use for the money and would pay it back. I have noticed that a good many of such concerns have incorporated in the last three or four years, and that they perhaps are the worst offenders when it comes to accumulating undivided profits.

Senator KING. Mr. Manson, is it not a fact that many small business enterprises now, which formerly were voluntary associations or partnerships or personal businesses, are incorporating for the purpose of reducing their tax?

Mr. MANSON. The only way I would be able to answer that question is this: I think the immense falling off in individual incomes from business and partnerships is, to a certain extent, attributable to the fact that the individual businesses and partnerships have incorporated.

Senator KING. Is it not a fact that many men who have incomes derived from various sources—they may superintend some of the enterprises and industries themselves, or the enterprise and industry may be of an entirely different character; one may be the sugar business, another railroad stocks and bank stocks and stocks of various industrial enterprises—transfer all of their stock to a corporation, which they form, and they hold their stocks in that way. Then, of course, the corporation has the earnings, and the corporation pays the tax, and the individual thus escapes a heavy income tax.

Mr. MANSON. There are cases of that sort.

Senator KING. I know of many myself. Perhaps I should not say "many," but I know of a number myself. I have heard business men rather boast in mentioning the fact that they were doing that, and that it saved them a considerable amount of tax.

Mr. MANSON. I do know of such cases, but I must say this, that I expected to find them by the thousands, and instead of that, I am finding them, perhaps, by the dozens.

Senator JONES of New Mexico. May I suggest that there is no inducement under the present law for a small business to incorporate? On the other hand, there is every inducement for a small business being carried on through corporate form to disorganize and become an individual business or to go into a partnership?

Senator KING. Do you think the 12½ per cent——

Senator JONES of New Mexico. Well, here is the point: An individual, under the present law, must have an income of about $50,000 a year in order to make his average tax about 12½ per cent, as in the case of corporations, and anyone who has an individual income of less than $50,000 a year will pay less tax by doing it in

individual or partnership form, which is an absolute discouragement or prevention of people doing a small business in corporate form, although it might be very desirable for many reasons that they should do it as a corporation, rather than as a partnership or as an individual.

Mr. MANSON. Take three or four men who from a partnership would have an income of, say, $10,000 a year.

Senator KING. Each?

Mr. MANSON. Each. They incorporate that business, and their aggregate corporate and individual taxes will run them up to the rate of taxation that they would pay on an income of——

Senator KING. $50,000.

Mr. MANSON (continuing). $75,000 a year—$50,000 or $75,000 a year.

The CHAIRMAN. Just finish your report, Mr. Manson.

Mr. MANSON. Reverting to the case about which I was reading at the time we got away from this report, where the average production of the wells in the county was 255 barrels, a 5,000-barrel well was brought in, and the other wells were estimated to produce 3,750 barrels, and actually did produce 3,850 barrels.

Senator KING. Would it not be well, if you will pardon me, in making up the record for printing, that you show by a few introductory interpolated words in the record that this statement of yours may appear in continuous form?

Mr. MANSON. Yes. This refers to the Shumway lease.

The drilling records for Butler County show a dry-hole hazard of 15 per cent. The taxpayer assumed none. His entire hazard is confined to the 25 per cent discount for future wells based on the daily production of well No. 1, which was considered an extraordinarily large well. No prospective buyer who has any knowledge of the oil industry would have for one moment considered investing in a property on such a narrow hazard margin where eight or nine million dollars were involved. The solicitor states:

> The comparison of the value allowed the Gypsy Oil Co. on this lease, with a sale of a working interest in the Dempsey lease and with the value placed on a part of the Carter Oil Co.'s property in this field and with the Alpine Co., is of no value.

The purchase of a one-half working interest in the Dempsey 80-acre lease, from the Gladys Bell Oil Co. by the Gypsy Oil Co. for $340,000 needs no argument to show what the Gypsy Co. thought a proven lease was worth when it comes to parting with cash. The Dempsey lease cornered the Shumway lease, and was surrounded by producing wells (pages 2007 and 2008, Senate hearings) and had one 2,250-barrel well completed. While the Gypsy Co. is willing to pay only about $4,500 per acre for proven ground, a discovery valuation of $200,000 per acre, for depletion purposes, is not considered by the taxpayer as unreasonable.

As to this dry-hole hazard, it must be borne in mind that in making a discovery valuation on an 80-acre tract, the discovery valuation made at date of discovery or within 30 days thereafter is made as of the date when the first producing well is brought in.

Now, it is not unreasonable to assume that it is going to take one well for each 5 acres to recover the reserves, the value of which is included in this discovery valuation, and if that is an 80-acre tract,

that means that you will have 16 wells on that tract. It is necessary then, we maintain, that you take into consideration the fact that some of those wells may be dry wells.

That works two ways. In the first place, it not only reduces your recoverable estimated reserve, but, in the second place, it costs money to drill a well. So that in determining the value of that 80 acres, if a fair estimate of the value is to be made on it as of the date when you have only got one producing well on it, it is necessary to take into consideration that you may have to throw out money for the drilling of wells, which will not produce a barrel of oil.

In this particular case of the Shumway lease the statistics for that particular county show that 15 per cent of all of the wells drilled in that county were dry holes, and, therefore, our engineer and your counsel maintain that any valuation made of that property as of date of discovery, any valuation which would be such as to be the basis of the purchase of that property, of that 80 acres, as of the date when the first well was brought in, or within 30 days thereafter, must necessarily take into consideration the hazard incident to the possibility, at least, of the drilling of dry holes.

Senator JONES of New Mexico. Do I understand that, in case of a discovery on an 80 acre tract, by one well, that they estimate the whole 80 acres?

Mr. MANSON. The whole 80 acres.

Senator JONES of New Mexico. As reserve, in computing the value of that well?

Mr. MANSON. In computing the value of that lease. They will estimate up to 160 acres. In other words, if the discovery well is in the center of 160 acres, the oil rights to all of which are owned by one taxpayer, there will be included in the valuation set up the estimated reserves of the whole 160 acres. If the taxpayer's area is only 80 acres, if his lease is only 80 acres out of the 160, while the discovery well will prove the whole 160 acres, the valuation for discovery purposes of that taxpayer will only cover 80 acres, or in case of 40 acres, it will cover 40 acres; but the point I wish to make here is that in fixing a discovery value, the discovery value is not made upon the return of the particular discovery well, but the discovery value includes the whole area, provided the whole area falls within 160 acres, with the well in the center.

Senator JONES of New Mexico. Now, let me inquire: Suppose I have a lease on one 40 acres, and I drill a well and discover oil. I am allowed discovery value only on that 40 acres. Who gets the discovery value on the other 120 acres?

Mr. MANSON. Nobody would get it there.

Mr. GREGG. They might subsequently bring in a well on that——

Mr. MANSON. Of course, that depends. Let me take a piece of paper.

We will call this 160 acres, divided into four forties. The discovery well is brought in at this corner of this forty [illustrating on diagram].

Senator JONES of New Mexico. The southeast quarter of the northeast quarter?

Mr. MANSON. Yes; the southwest corner of the northeast quarter.

Senator JONES of New Mexico. Yes.

Mr. MANSON. We will say it is right approximately on the line.

Senator JONES of New Mexico. Yes.

Mr. MANSON. That well will prove the whole 160 acres. We will now assume that the 40 acres upon which the well is located belongs to A, or A has a lease on it. We will assume that before A brought in this well B acquired a lease on this area.

Senator JONES of New Mexico. The northwest quarter?

Mr. MANSON. On the northwest quarter—C on the southwest quarter and D on the southeast quarter. Inasmuch as these leases by B, C, and D were acquired prior to the development of the discovery well by A, B, C, and D can each claim a discovery whenever they bring in wells on their areas. If, however, E, F, and G—I am taking three other persons now.

Senator JONES of New Mexico. You are assuming that B, C, and D sell.

Mr. MANSON. Yes; assuming that B, C, and D sell, and E, F, and G buy their respective forties, then E, F, and G can not claim discovery if they buy after A's discovery well is brought in; but it will be borne in mind that after A's discovery well is brought in the property of B, C, and D will be proven property and immensely valuable, that B, C, and D will get a high price for these leases, which high prices will be depleted as cost depletion by E, F, and G.

The CHAIRMAN. In lieu of the discovery valuation?

Mr. MANSON. In lieu of the discovery valuation.

Senator JONES of New Mexico. But if B, C, and D were to operate the property they would be permitted a discovery value?

Mr. MANSON. Oh, yes; they would be permitted a discovery value.

Senator JONES. Under what rule?

Mr. MANSON. The law provides that you can get a discovery, provided you did not buy a proven tract or lease. Inasmuch as this area was not proven by A's well at the time B, C, and D bought, they did not buy a proven tract or lease. For instance, you take this quarter up here, or these 40 acres here [indicating on diagram].

Senator JONES of New Mexico. Above the 40 acres of A?

Mr. MANSON. Yes; above the 40 acres of A. That is on proven territory even after A's well is brought in.

Senator JONES of New Mexico. That 40 is practically as near to the 40 acres of A as to either of the others.

Mr. MANSON. Well, take this case. Here you have 360 acres. You have three quarter sections here. This becomes proven area by a well here. This becomes proven area [indicating on diagram]——

Senator JONES of New Mexico. Talk so that the record will indicate it.

Mr. MANSON. Yes: they are lying in here.

Senator KING. In parallelogram form?

Mr. MANSON. Yes; in parallelogram form. The north quarter section can become proven area, and the south quarter section can become proven area, and a purchaser of the middle quarter section can acquire it after the north quarter section and the south quarter section are proven, and still get a discovery value on it.

The CHAIRMAN. I think that was practically clearly shown on the blue print that was submitted by Mr. Fay.

Mr. MANSON. Yes.

Senator KING. I am told that in the Signal Hill field and in the Santa Fe oil field, as I am told, as well as in others in Texas—I have not been there; so I do not know—there will be wells discovered on small subdivisions, small tracts, perhaps an acre. Some of those oil holdings are of less than an acre. There will perhaps be hundreds of wells on 160 acres, all in different ownership, or most of them in different ownership. What is the practice of the bureau in those instances? Do they allow a discovery value on each?

Mr. MANSON. There are conditions under which they could. For instance, if the other areas do not change hands——

Senator KING. You see those derricks there within 40 feet of each other on different leases.

Mr. MANSON. I do not know whether any of the members of this committee have ever seen the Spindle Top field near Beaumont, Tex., but it looks like a forest.

Senator JONES of New Mexico. Yes; and I have seen others in the same stage of development.

Senator KING. Is it a fact that they do allow discoveries on each of those separate lots, say, on an acre or a half an acre?

Mr. GREGG. It depends on how they were acquired. If they were acquired prior to the time that the land was proven territory, the law permits the discovery on each one of them.

Senator JONES of New Mexico. Take the illustration which Mr. Manson gave regarding the four 40-acre tracts. If B should sell his 40 acres, rather than to go into the production of oil, he, of course, would get advantage of the discovery made by A, so far as the actual value of his property is concerned. If he sells and makes a large profit on the transaction, how is that profit taxed?

Mr. GREGG. That is a rather peculiar provision of the law. It is taxed in full, although if he held it and operated it, it would not be taxed in full.

Senator JONES of New Mexico. Then, suppose the owner of tract B was not able to finance the drilling of the tract, he would have to pay a very large tax upon the sale of the property, and does not that tend to impose an undue burden in some way upon the man who is not able to go ahead with production, as compared with the man who is able to go ahead with production.

Mr. MANSON. In other words, the property has a greater value in the hands of a man even before it is developed; it has a great deal more value in the hands of a man who can develop it than it has in the hands of a man who can not develop it. The man who can not develop his property can not get anywhere near the price for it which would be allowed as a discovery value.

Let me put it this way: I do not want to state anything that is not developed by the records, but I have some personal knowledge of an oil field which is quite in point on this matter, and I think it proper for me to relate it.

Practically all oil leases contain a provision to the effect that development work shall begin within a certain period of time, usually two years. The big oil companies will go out and take up leases on vast areas in likely oil territory. We will say the conditions are such that they do not want to expand production, but some promotor comes along, and they will almost give him a lease

on five acres. He goes out and raises the money by selling stock to anybody that will buy it.

Senator KING. To the "suckers"?

Mr. MANSON. Yes; to the suckers—and drills a well. Now, if he strikes oil, for all practical purposes he has proven that area for the benefit of the oil company that owns all of the rest of that territory. In other words, it is no longer a speculative venture, as far as they are concerned. They are out what little oil he can get out of that five-acre area, but he may have established the existence of oil over a large area. They have saved the entire lease for the oil company, because development started within two years of that lease. It may cover 2,000 acres, and they have saved the lease. The venture has relieved the oil company from the necessity of risking its capital for the purpose of determining whether or not there actually is oil in that area, and on top of that, after the oil has been demonstrated to be there by these wild-catters' operations, the oil company can still claim discovery values on each 160 acres in the whole area, because they acquired the lease prior to the time he brought in this well.

That is a common practice, particularly in Texas. I know of several fellows who thought they were going to get immensely rich.

Senator JONES of New Mexico. They not only lease 2,000 acres, but they try to get 20,000 acres, and even more than that, on a structure or a supposed structure.

Mr. MANSON. That is something that has not developed by any investigation in the bureau, but it is a matter of my own personal knowledge.

Senator JONES of New Mexico. Maybe the bureau has never investigated it, but if they will go to New Mexico, they will find that that is the general practice, that they try to get very large areas, and in many instances they will not take a lease unless they do get these very large areas, I think, as a rule 5,000 acres is the minimum.

Senator KING. That is held by private individuals, I suppose?

Senator JONES of New Mexico. Well, private individuals, and even from the State.

Senator KING. But not from the Federal Government, because they would not lease so much from the Government.

Senator JONES of New Mexico. The Government allows them 2,560 acres.

Senator KING. What I meant was 5,000 acres, or something like that.

Senator JONES of New Mexico. Yes.

Mr. MANSON. To go back to this Shumway lease, as I have called your attention to, this area in which this Shumway lease is located was proved by the Alpine Oil Co.'s well.

The solicitor recognizes that the Alpine Co.'s well produced water within one month after it was brought in. This then should have been a sufficient indication to the Gypsy Co. to introduce a water hazard in the valuation of its properties in its new pool or southwest extension of an old pool. Records showed a decided water hazard in the old pool. The solicitor states that "The force producing the oil was entirely hydraulic. There was no gas in it at all, a pecu-

liar feature." He further says that "as the water comes in it forces the oil still further up. The first well brought in in this pool was the Alpine well, which was brought in right at the edge of the water line, so close that within one month they had taken out the oil above the water line and the water continued to push the oil up. The water came into the well itself, and of course, the well was worthless." On this basis the solicitor states that "a comparison of the value placed on the Alpine property with that of the Gypsy Co. is not helpful. It certainly is not helpful to the Gypsy's interest for the reason that the Alpine well went bad before the Gypsy well came in and this being so would necessarily have a tendency to reduce the anticipated value of the Gypsy property. The solicitor states, "There is oil all through the sand, the question is who is going to get hit by the water first. The water is coming up from both sides." While he states that the geological structure of the Shumway lease was from 20 to 30 feet higher than the Trap Shooter and the Alpine well, yet under the conditions known at the date of discovery, the water hazard was there and any prospective purchaser would have so considered it. The water line had not been definitely fixed when Gypsy Well No. 1 came in in July, 1917. The records in the Gypsy Co.'s case upon which the discovery valuation was based, took no cognizance whatever of the possible water hazard. They did not consider the dry hole hazard and while the production to the close of 1924 does show that the estimate or reserves at date of discovery was somewhat under the final production, yet a prospective purchaser would not have had seven years' production records from this lease from which to predicate the reserves. As stated in the hearings recently, page 2004, the production to the close of 1920 corresponded very closely to the actual estimate set up as of August, 1917.

In the table set up by the solicitor, the headings are misleading. It is noted that he sets forth in one column, "Net profits to December 21, 1924." In some instances the figures used therein may possibly be net profits but in the case of the Focht lease, the amount of $2,376,962 set up represents gross receipts from sale of 1,786,734 barrels of oil, from which development, operating, local taxes, depreciation, marketing expenses, and depletion must be deducted before net profit can be determined. The same would appear to be true in the case of the Lapham, Robert Posey, Lena Fife, and the Shumway leases. The majority of the production in the Focht lease was put on the market when oil was selling at $1.50 or less per barrel, so the figures given could not possibly be "net profits." The same was also true of the Lena Fife lease and the Lapham lease.

With reference to the reserves, whether or not the actual production of over a period of 10 years subsequent to discovery has a bearing upon the reserves set up at date of discovery is of little importance. The low provides that the discovery value and its reserves shall be estimated at the date of discovery or within 30 days thereafter, and that whatever value is placed thereon should be that which would induce a willing buyer to buy and a willing seller to sell.

The solicitor states that the net profits from the Shumway lease up to December 31, 1924, were $12,306,000 and that the discovery valuation placed thereon was only $9,800,000. The solicitor is in

error in that instead of being net profits, the $12,306,000 represents gross income to the close of 1924. From this amount there will necessarily have to be deducted all of the drilling expenses, pumping and lifting costs, local and State tax, leakage, depreciation of equipment, as well as a reasonable allowance for fire, wind, and other hazards. The solicitor states, "It can not be claimed that the value placed on this lease was excessive when subsequent events have shown that the well has paid out approximately 25 per cent in excess of the value placed thereon." By reason of the deductions above, the well has not paid out an excess of 25 per cent.

In comparing the gross receipts of $12,306,000 with the discovery appreciation of $9,800,000, the net difference is $2,500,000. The discovery appreciation was based on oil at $1.90 a barrel. During the year 1918 the taxpayer marketed 3,486,454 barrels at an average price of 29½ cents per barrel above the price used as a basis for the valuation. This increase in price gave the taxpayer an additional income of $1,134,703. During the year 1919 he marketed 341,745 barrels at 38.1 cents above the price used as a basis for valuation, which gave an excess gross income of $130,204.

I call attention to the increase in price here, for the reason that the increase in price would increase the gross income, and therefore the gross income would not be used for the purpose of showing that the estimated number of barrels of oil in the ground was correct.

During 1920 he marketed 217,331 barrels at a price of $1.516 in excess of the price used at date of valuation, which represented an additional income of $329,473. It will therefore be seen that while the taxpayer's gross income from these wells to the close of 1924 was $2,500,000 in excess of his discovery appreciation, $1,600,000 of this is due to an increase in the price of oil over that on which the valuation was made. So far as facts were known at date of valuation, the market price of oil may as well have dropped far below $1.90 as to have gone above $1.90 a barrel as it did.

Practically all discovery valuations made after December, 1914, were made on an ascending market to the close of 1920. Hence the only reason for the leases in question to show a gross income in excess of discovery appreciation.

(4) Discount rates: With reference to the discount rate and the hazard factor, the solicitor states:

> This criticism of the discount rate and of the failure adequately to consider the hazard factor is a more serious one and requires more careful consideration. It should be realized that in valuing a discovery well, the greatest hazard in the oil industry has already been eliminated.

The solicitor seems to reason that when the presence of oil in commercial quantities has been demonstrated by a discovery, the only remaining factors concerning which uncertainty exists are these: (1) The amount of future production, (2) the future selling price of oil, (3) the cost of producing oil. He further states, "If in determining these factors, the estimates are conservative and the hazard element is taken care of, then the discount factor must compensate only for the use of the money." And he therefore assumes that a 4½ per cent or 5 per cent discount rate is amply adequate to compensate anyone for the use of money invested in an oil well. The fact that he acknowledges that 4½ per cent to 5 per cent is

cient compensation for the use of money in this hazardous industry, is so ridiculous that argument against it seems unnecessary. All mining industries recognize that in order to return a fair percentage on the investment, there should be an annual compensation of 15 per cent to 25 per cent a year to even invite capital to take part in this great basic industry. Of all the hazardous industries wherein natural resources are involved, oil undoubtedly heads the list, gold mining probably the second, and yet, the solicitor defends the 5 per cent discount allowed this taxpayer when the oil and gas section now recognizes 10 per cent as the proper discount. While 10 per cent is low, why should the solicitor defend the discrimination shown the Gulf Oil Corporation in the former tax settlement, and possibly perpetuate this practice into later years, upon which basis the taxpayer has set up his valuation of 1921, 1922, and 1923. He defends 5 per cent discount on the basis that "The discount factor in this case was prepared after getting the yield on several hundred securities, on bonds, the market for which was established at the date of these valuations and it ranged from 4½ to 5 per cent, so 5 per cent was the rate that was used."

The hazard factor in oil well operations should include many things, among which may be enumerated the dry holes; a reduction in flow by reason of decreased gas pressure: the loss of holes in drilling; influx of water, as in the Eldorado field in Kansas and the Salt Dome field in Texas: the loss of oil by fire, lightning, and wind, uncertain prices, etc. The solicitor considers that since the Gypsy Co. discounted the initial production of the discovery well 25 per cent or 30 per cent to determine the productivity of future wells, that amount was enough to take care of all hazards.

When actual production figures can be used as a basis for estimating reserves they, of course, would reflect all hazard incident to that particular lease. In other words, with two to five years actual production figures it is not difficult to determine what hazard factor should have been applied. The regulations require that a discovery valuation shall be based on facts known at or within 30 days after discovery, and any valuation for tax purposes shall be such as would be determined as between a willing buyer and a willing seller. The willing buyer or prospective buyer, in case of a discovery well, has not a number of years of production figures upon which he can rely when he is bidding for an oil well that is less than 30 days old. This is the period in the life of an oil well when these hazards are to be figured; it is the period when these hazards are greatest: and, for the reason that many factors are absolutely unknown during the tender age of this oil well, the hazard factor must be increased to a remarkable extent.

Regardless of how conservative the estimate of oil reserve may be, a prospective investor would not place his money in this industry on such a narrow margin of profit. There may possibly be times or occasions when the owner of a lease or well may underestimate his reserves, and it is possible that some one more experienced in oil-well practice might consider that the reserves were larger, and on this basis only pay the price asked by the owner. If he did this, he would have in mind not only the 5 per cent which the solicitor says is sufficient compensation for the use of the money in the oil industry,

but would figure that the major portion of his profits would be on reserves which he considered in excess of those estimated by the owner of the property.

The CHAIRMAN. In connection with the discovery appreciation, the real test that the solicitor ought to have made there was the test as to the number of barrels, and not the price. Is not that correct?

Mr. GREGG. We gave them both in my statement and in the table.

The CHAIRMAN. Did the table show the excess number of barrels or just the excess number of dollars received?

Mr. GREGG. Both. The estimated number of barrels was 6,000,000, and the production up to January 1, 1925, was 7,250,000. It was continuing producing at the rate of 248 barrels per day.

Senator JONES of New Mexico. Right there may I inquire, was that just a good guess, or what was it based on?

Mr. GREGG. The estimates were considerably lower than the actual production.

Senator JONES of New Mexico. But why does it happen to be below? What was the basis for it? Was it a good guess, or did you have some foundation for making the estimate?

Mr. GREGG. I do not know on what basis the estimate of future production is made.

Senator JONES of New Mexico. Then, do you mean to say that it is always a guess?

Mr. GREGG. No, sir. I should say in a known pool it could be estimated fairly accurately from past experience. In a new pool I should say there would be always a large element of guess work in it or opinion.

Senator JONES of New Mexico. So, under the present law some one in the department is considered a good guesser, and he is put on this particular job.

Mr. GREGG. There are a good many elements of valuation that involve purely opinions, which are, in some instances, almost guesses; yes, sir.

Senator KING. Mr. Gregg, where these estimates—I will not use the word "guess"—with respect to these nine wells——

Senator JONES of New Mexico. Well, I used the word "guess" advisedly, because, if it is not a guess, there is some basis for the estimate.

Senator KING. It is a guess, Senator.

Mr. GREGG. I think in the known pools they use the past production in estimating the future production of new wells; but I should say that in a new pool there would be a large element of guesswork in it.

Senator KING. I was going to ask whether the records show that these estimates for these nine wells, as to each one of them, corresponded substantially with the production as shown years afterwards made within 30 days.

Mr. GREGG. None of these valuations were made within 30 days, Senator. It is perfectly impossible for that to be done.

Senator KING. Exactly.

Mr. GREGG. The law was not passed until years after some of these discoveries were made.

Senator KING. So the fact is that perhaps two or three years after this well was discovered and after it had been flowing and producing substantially 3,700 barrels per day, actually 3,800 plus, in most instances they went back to the date of discovery and verifying this by the production for a number of years they said, "Well, if we had been estimating the value of this property within 30 days, we would have guessed that the production was approximately what the wells show has been produced."

Mr. GREGG. No, sir; I should not say that.

Senator KING. Is not that the way it works out in this case?

Mr. GREGG. I do not think so; no, sir. I would say this: The law put on us the duty of determining the value as of a date in the past, many years in the past. I think I have to admit that it is impossible for any man making a valuation now on oil properties as of six or seven years ago, to take entirely out of his mind subsequent events.

Senator KING. Let me ask this question with respect to these wells: Did anybody, the company or the Government, within 30 days, or within a very short time after oil was discovered on this property, fix a value for any purpose whatsoever?

Mr. GREGG. No, sir; it did not become necessary.

Senator KING. I was wondering whether a sale was made that fixed the value.

Mr. GREGG. No, sir; not that I know of.

Senator KING. What kind of return was made by the owners within the year, for the first year after production?

Mr. GREGG. There was absolutely no discovery value in this case for the first year after production.

Senator KING. What kind of return was made for taxation purposes?

Mr. GREGG. I do not understand what you mean by what kind of return was made for taxation purposes.

Senator KING. The owner of these wells must have made some sort of return, either to the State or to the Federal Government for the purpose of the taxation of these wells.

Mr. GREGG. Yes, sir.

Senator KING. This property.

Mr. GREGG. Yes, sir.

Senator KING. Now, what kind of a return was made by them? That is not quite accurate, but what value, if a value is shown at all, or what facts were stated upon any of those returns, from which the value of the property, at its market value, could be determined as of the date of discovery?

Mr. GREGG. It was not necessary to value them, and the returns afterwards, in the majority of cases—in all cases, I may say, showed no valuation of the property.

Senator KING. Was the value of the property checked up for capital stock purposes?

Mr. GREGG. Sir?

Senator KING. Was the value of the property checked up for capital stock purposes, aside from the discovery value?

Mr. GREGG. I do not imagine so. What do you say, Mr. Nash?

Mr. NASH. I do not think it was a capital sale in 1916.

Mr. GREGG. No. I do not think so. I do not know.

Senator KING. What I was trying to get at was whether there was any system in the bureau to find out whether it harmonized.

Mr. GREGG. It is not checked, because the returns are on a different basis, and I do not think it would be particularly helpful.

Senator KING. It would help a backward taxpayer into a logical position as to the value of his property.

Mr. GREGG. I know that we have done that in some cases. I know that in the case of copper mines we made them pay the capital stock tax on the same basis of value that they had for income-tax purposes. I do not know of any other cases in which it was done. I have no knowledge as to whether it has been done in other cases or not.

Senator KING. What is the date of the discovery wells there?

Mr. MANSON. These wells run all the way from 1914 to 1917.

Senator KING. Suppose you had owned those wells, Mr. Gregg, between 1914 and 1917——

The CHAIRMAN. He would not be here now.

Senator KING. No; and you were operating the same and developing them, what sort of returns did the law in 1914, 1915, 1916, and 1917 require you to make for Federal taxation?

Mr. GREGG. Those are all leases, are they not?

Mr. MANSON. Yes.

Mr. GREGG. For 1914 and 1915 the company would be entitled to no depletion.

Senator KING. Have you allowed them depletion?

Mr. GREGG. I have never looked into it, but the law did not allow a lessee depletion. Let me take a minute on that and be sure.

Mr. MANSON. Let me clear up the Senator's question. For instance, a well is discovered in 1914. There is no discovery depletion allowed on that well until 1918, but it is necessary to go back——

Senator KING. Is it retroactive?

Mr. MANSON. Yes: it is necessary to go back and determine the value at date of discovery in 1917, or within 30 days thereafter. In order to determine the depletion now it will be applied at least to the production of that well in 1918 and subsequent years.

Senator KING. That is exactly what I am trying to get at. In 1918 they did have a producing record, and I was wondering if, when you made your returns, assuming that you were the owner in 1914, 1915, and 1916, you did not somewhere in those returns place a value upon that property that was entirely different, far below, the 1918 value, which was fixed for depletion unit purposes.

Mr. GREGG. No, sir: it was not necessary to value the property as of date of discovery under any law prior to the 1918 law. Under the 1918 law, it was necessary to go back and value discoveries made since 1913 for the purpose of computing the depletion on discovery value in 1918 and subsequent years, if those wells were still producing.

Senator KING. Do you know whether any returns were made by the owners of those wells for 1914, 1915, 1916, and 1917, to the State of Texas?

Mr. GREGG. No, sir.

Senator JONES of New Mexico. When we framed the 1917 act we provided for an excess-profit tax.

Mr. GREGG. Yes, sir.

Senator JONES of New Mexico. And it always had to appear as invested capital.

Mr. GREGG. Yes, sir; but it appeared as invested capital at cost, and not at value as of date of discovery.

Mr. MANSON. Discovery value did not enter into invested capital. It was not supposed to.

Senator KING. Just the cost of the lease, then.

Mr. GREGG. Just the cost.

Senator JONES of New Mexico. But they put a value upon the property at a given time for the purpose of estimating the excess-profits tax.

Mr. MANSON. As of date of acquisition.

Senator JONES of New Mexico. Yes.

Mr. GREGG. But that applies only in case where they purchased it for stock, and none of these leases were purchased for stock. You see, if these leases were purchased for stock, then for excess-profits tax purposes they went into invested capital on the basis of value at the date of acquisition. If a well had been discovered prior to the acquisition by the company, and it was acquired by the company, by the issuance of its stock, it would have been necessary to value it for invested capital purposes as of date of acquisition; but that is not true in any of these cases, as I understand it.

The CHAIRMAN. Have you another case, Mr. Manson?

Mr. MANSON. I have something more that I wish to say in connection with this subject.

The CHAIRMAN. Are you going to put in that case that you have now, or later?

Mr. MANSON. I can put it in now. This is the valuation allowed to E. L. Connelly.

This report deals with two factors.

In the first place, it is further cumulative evidence of the different values placed upon the same property on behalf of different taxpayers. There is treated in connection with an examination of this case the fact that in connection with one lease at a conference the following occurred, quoting from the conference report:

> The estimate of reserves on the Hattie Vaughn lease was not made pending the receipt of further production records since the discovery was made in 1922. The value of this lease to be determined when the question of reserve is settled.

This determination was after the department had 18 months' production of this well.

Mr. GREGG. By whom is that signed?

Mr. MANSON. This is signed by John Cullen and W. W. Duncan.

The CHAIRMAN. In other words, at that time they refused to fix the reserves, although it was 18 months after discovery?

Mr. MANSON. Although it was 18 months after discovery.

Mr. Gregg, in his answer in the Gulf Oil case, defended the use of a 4½ and 5 per cent discount factor upon the ground, first, that the hazards had already been taken care of, as was shown by subsequent production. I have already discussed that angle of this matter, and do not intend to say anything further about it.

Second, he made the statement that when a producing well was brought in and the existence of oil was established in commercial

quantities, the most of the hazards were then eliminated. I have already called attention to the fact that in valuing an oil property for discovery purposes it is not the product of the initial well only that is valued, but the valuation may extend to the reserves of 160 acres of land, which will require many additional wells, with the incidental hazard of dry holes.

If we are to determine discovery value as the law requires, as within date of discovery or within 30 days thereafter, in addition to the dry-hole hazard, which is incident to every valuation of an area greater than will be drained by one well, there has also to be taken into consideration the water hazard—a thing that may occur in any oil well at any time.

In making a valuation as of date of discovery, or 30 days thereafter, the prospective market price of oil, in other words, a price which a purchaser would expect to receive, is the price upon which such a purchaser will base the amount he would pay for that well at that time.

It has been shown here that the market price of oil is used as the basis of these valuations when the market price of oil is high, but that during period of depression the market price of oil is not used but an increase in price is anticipated.

What purchaser in buying an oil well would assume, without making some provisions for a large profit, that the price of oil is going to continue at a high point.

I therefore take the position that some of the greatest hazards in connection with the purchase of an oil well, and a hazard which no purchaser would overlook, is the liability of the price of oil dropping—a possibility which develops into a probability if the value of the oil is fixed at the posted price of oil at a time when the posted price of oil is high. So that the possibility, and in some instances the probability, of a reduction in price is a great factor.

Assume that we base our value upon the posted price of oil as of to-day. We discount that at an annual rate of 5 per cent. It is manifest that so small a reduction in the price of oil as even 5 per cent reduction will wipe out the entire profit anticipated. The violent fluctuation of the price of oil is a fact that is so well known——

Senator JONES of New Mexico. Do you mean to say that there are cases which show that where the price of oil was low they did not take that as the value of the discovery?

Mr. MANSON. I have produced plenty of them, and I will produce more. I have some more here.

Senator JONES of New Mexico. What reason appears in the record for that?

Mr. MANSON. That the valuation was fixed at a time when the price of oil was depressed, and, of course, in valuing this well several years after the date of discovery, when they know that soon after the date of discovery the price of oil went up, it is very easy to justify a valuation anticipating a rise in price; but I maintain that the kind of a valuation which Congress fixed in this act to be made at the date of discovery or within 30 days thereafter can not justify an anticipated raise in price.

Who on earth would think of buying an oil well upon a valuation or at a price computed by anticipating an increase in the price of

oil? I maintain that there is no investor in oil who would think of paying a price based even upon the posted price of oil, when oil is high, without taking into consideration the possibility, if not the probability, of the price of oil going down before he had recovered the reserves upon which that value is based.

Senator KING. This is the way it works out, to give you an analogous case:

A man owns a ranch in New Mexico, with 10,000 head of beef cattle. He wants ot sell his beef cattle in June, when they are fat, but the market is pretty well supplied and people are not eating much beef in the summer months, and that man has to sell them for $40 a head on foot. They do not assess him then until two years later. When they come to assess the tax they find that five or six months later, or two months later, because of some great demand in Europe for beef cattle, the price of steers went up to $60 a head. Therefore they value his steers at $60 a head.

Senator JONES, of New Mexico. That is as of a prior date.

Senator KING. Yes; as of a date in June.

Mr. MANSON. Then there is another hazard factor involved in the valuation of an oil well, if the valuation is to be determined as Congress provided, and that is the possibility of increase in the cost of operation. That is a chance, at least, that the purchaser of such a well takes—a change which the purchaser of that well would be bound to take into consideration if he were buying that well knowing no more about the cost of operation than what could be ascertained on the date of discovery, or within 30 days thereafter.

Another factor is the fire hazard, a fire that is always present, and which often occurs in the oil fields. Just imagine! This hazard is so great that no insurance company will carry it. An oil well or oil tank can not be insured.

Insurance companies do carry risks, for which they charge premiums up to 5 per cent. This risk is so great that they will not carry it.

Is not that the best evidence that the insurance risk upon an oil well is at least 5 per cent?

Senator JONES, of New Mexico. I have known some instances in which they have charged 10 per cent for the insurance upon the property.

Mr. MANSON. Well, I was able to find instances where they charged up to 5 per cent. I did not go any further.

Senator JONES, of New Mexico. Take a mushroom town in the West, where the buildings are made of timber, and there is no adequate provision for fire protection.

Senator KING. Or water protection.

Senator JONES of New Mexico. Or water protection, and all that sort of thing. In many such cases they charge as high as 10 per cent for insurance.

Mr. MANSON. I would now call attention to the fact that the fire hazard alone in the case of these properties is equal to the entire discount factor which has been applied here to cover all other hazards, as well as to cover the use of money and any profit that is expected to be made out of the venture.

The solicitor has attempted to justify the use of a 4½ or 5 per cent factor, which upon some industrial bonds produce no greater return than that.

Attention has already been called to the fact that these discovery valuations were made as of date from 1914 up to and including 1920, some of them. It is a well-known fact that during the most of that period of time, during all that period of time practically, the World War was going on. During the most of that time the governments of the world were competing in the money market to borrow money. No security could be sold during that period of time, except Government and municipal bonds, which would return a net income to the investor of less than 4½ per cent. During practically all of that time there was not an industrial corporation in this country that could have borrowed the money upon its bonds that would net a return to the investor of less than 6 per cent. This company itself, notwithstanding its financial strength, could not have borrowed money on its bonds for the purchase of these properties at a rate of return such as is set up here as the discount factor which is to cover the use of the money of all of the hazards involved and the profit.

That being true, the discount factor applied here is not even sufficient to take care of the use of the money, and notwithstanding the fact that the company has assumed every risk incident to the oil business, has assumed every hazard incident to what is claimed by people in the business to be the most hazardous business there is. It has assumed all of that at a rate of return not sufficient to pay for the use of the money, and without the slightest hope of one nickel of profit, and any profit must be predicated on top of the annual value of the money engaged in the enterprise.

I maintain for that reason that the application of a discount factor here of 5 per cent is not only unreasonable, but reduces itself to absolute ridiculousness.

I had hoped that there would be no attempt upon the part of the bureau to defend the application of that discount factor to the case. I know that in other cases they are now applying a discount factor of 10 per cent, which I believe to be the law, in view of practically the entire oil industry before the committees of Congress, that money can not be induced to go into the oil business unless it can be guaranteed a return of at least 15 per cent.

But the defense of the application of this rate in this closed case can not help but lead us to believe that the same rate will be applied in the case of other valuations subsequently claimed, which are now pending in the department, and in which the claims of this same character are being based upon a 5 per cent discount factor.

Senator KING. You say they are pursuing the same course now?

Mr. MANSON. The taxpayer is computing his claim for depletion upon the same basis. I had no reason to suppose that, in view of the fact that the bureau has apparently adopted the policy of employing a 10 per cent factor, any less factor would be applied here, until the bureau defended this factor before this committee.

Senator KING. Mr. Manson, to what extent, from the investigation made by you or your engineers, has this same policy of estimating the discovery value been adhered to or followed in dealing with other companies?

Mr. MANSON. I know of no other company which has been given the benefit of a five per cent discount factor. The general policy as laid down in this valuation is the policy pursued by the bureau in all cases, that is, the methods of valuation. In a few isolated cases, I am told that they do apply a hazard factor, although we have not yet been able to discover the cases.

Senator KING. But is it apparent from the examinations made by you and your engineers that the discovery value is not fixed as of the date of discovery, but they take into account, for the purpose of assuming to fix it as of that date, the continuity of production, and many of those factors and conditions which two or three years subsequent development disclosed?

Mr. MANSON. I am satisfied in my own mind, as is the engineering staff of the committee, that is, Mr. Fay and Mr. Parker, who have devoted attention to this subject—we are all satisfied that the basis of determining value as of date of discovery is subsequent production.

The CHAIRMAN. Going back to the Connelly case that you have referred to, you mentioned incidentally how these other several values were based on the same well. Is that matter in the records of the Connelly case?

Mr. MANSON. Yes; it is brought out in the report of the Connelly case. I am submitting this report. It is simply cumulative evidence. I will say this, that the taxpayers who got the low depletion rate objected upon the ground that the other taxpayers got a high one, but had it not been for the fact that these fellows kicked, I can see no bureau method for detecting the situation or disturbing it. Of course, before the thing was finally closed up, the fellows that got the small depletion rate objected, and the whole thing was taken up and reconsidered, and one depletion rate applied to all of them.

(The report submitted by Mr. Manson in connection with the case of E. L. Connelly is as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE, INCOME TAX UNIT,
May 21, 1825.

To: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: E. L. Connelly, an example of unequal values for like interests.

DEAR MR. MANSON: The attached report gives details relating to the valuations assigned various coowners in two different leases. It also shows that the department recognizes that valuations were made for each owner, independently of the other, and that at a later date an adjustment was attempted. The cases, however, are not as yet closed.

I wish to call to your special attention, on page 4, to a statement by the department wherein it recognizes the use of production data for as long a period as possible before a discovery valuation is determined. The case cited herein contains production records for 18 months, but the valuation has been deferred for additional and later production records.

Respectfully,

A. H. FAY,
Consulting Engineer.

Approved:

L. H. PARKER,
Chief Engineer.

Exhibit B

UNEQUAL VALUATIONS OF SIMILAR AND IDENTICAL WORKING INTERESTS

Unequal valuation of working interests in identical leases was brought out in former hearings. This is further illustrated in the case of a lease in which a taxpayer, E. L. Connelly, of Tulsa, Okla., is a coowner.

The files of this case as supplied by the department to the Senate committee contain information on two leases in which Mr. Connelly owns a part interest. These are the Leander Moore lease, Erah County, Tex., and the Yarma Richards lease, Creek County, Okla. It has already been brought out in the study of the Osage pool that the Bureau of Indian Affairs has reported production on two leases in the Winona pool wherein Connelly's name is credited with a gross production to 1924 of 411,355 barrels. Connelly has not reported these leases to the Income Tax Unit. The only logical reason that the committee's engineer can assign or give for this is that it is possible Connelly may have purchased his interest in these two Winona leases since 1923. The original purchaser of these two leases was D. W. Travis, but the department records contain no information regarding D. W. Travis and his operations.

Leander Moore lease, Erath County, Tex.: The seven-eighths working interest in the Leander Moore lease, Erath County, Tex., is owned by eight different taxpayers. The cases of two of the taxpayers have never been worked, one depleted on cost, and five set up discovery valuation. These five cases were worked by four engineers in the oil and gas section, resulting in valuations so materially different that the depletion units allowed ranged from $0.41 to $1.27.

The Form O data submitted by E. L. Connelly and J. J. Larkin were prepared by the same company in the same form and claimed the same depletion units, yet on being worked by the unit, Larkin was allowed a depletion unit of $0.41 and Connelly a depletion unit of $0.79.

The case of Frank Moore was worked by two engineers, one of whom established a depletion unit on discovery valuation of $0.95; the other set up a depletion unit of $1.27.

In September, 1924, Mr. Williams, an engineer in the oil and gas section was assigned the case of Seth Ely and E. W. Sinclair. (Exhibit 2.) Seth Ely had set up a claim for $1.10 depletion unit which checks very closely with $1.09 as claimed by Connelly and Larkin. This unit was cut down to $0.51 for both Sinclair and Ely.

In reviewing the case of Seth Ely it was found by Williams that other interests in this lease had been allowed very different depletion units. As a result the case was reworked and a valuation made of the entire seven-eighths working interest, which gave a depletion unit of $0.49 (Exhibit 2), which is to be applied to all the interest holders in this lease. It is a question whether Frank D. Moore, E. W. Sinclair, Seth Ely, and E. L. Connelly will stand for this reduction, since they have been officially given a larger unit. Case is still pending.

The taxpayers had evidently not been notified of this change by December 30, 1924, as on that date Mr. Connelly wrote a letter (Exhibt 1) to the Commissioner of Internal Revenue protesting his depletion unit of $0.79 on the grounds that an operating partner of his had received a higher depletion unit, viz, $1.27.

Leander Moore lease (E. L. Connelly): E. L. Connelly acquired a nine one hundred and twenty-eighths of seven-eighths working interest of this lease April 3, 1918, for $175.78. The valuation data submitted by Mr. Connelly in Form O was received by the department June 16, 1923, claiming discovery valuation on wells No. 2 and No. 5 of $27,946.65. The depletion unit set up on this basis, including cost and discovery, was $1.09 per barrel. This valuation was cut down by the Income Tax Unit to $20.500 and a depletion unit of $0.79 set up. The Income Tax Unit has reconsidered the case of different taxpayers interested in this lease, as shown in Exhibit 2, and drew up a depletion schedule for the entire seven-eighths interest and allocated the interests in accordance to ownership. This resulted in cutting down Mr. Connelly's valuation still further, namely, to $12,733.21 and a composite depletion unit on cost and discovery of $0.49462 for two discoveries, one on $2.25 oil and the other on $3 oil.

Yarma Richards lease, Creek County, Okla.: The seven-eighths working interest in the Yarma Richards lease, Cushing district, Oklahoma, is owned by six different taxpayers. The cases of four of these have been worked, resulting in depletion units ranging from $0.29 to $0.72 on $0.80 oil.

Of the four taxpayers, two are relatively large oil companies, the Gypsy Oil Co. and the Margay Oil Co. The Gypsy Oil Co. was allowed a depletion unit of $0.72 on discovery. The Margay Oil Co. claimed a depletion unit of $0.88, which was reduced in a conference with the unit's engineers on July 25, 1924, to $0.60. Well No. 2 was completed May 26, 1914, when oil was selling at $0.80.

The other two small taxpayers whose cases have been worked are individuals, J. J. Larkin and E. L. Connelly. J. J. Larkin was allowed a depletion unit of $0.29 and E. L. Connelly a unit of $0.34 based on discovery.

December 30, 1924 (Exhibit 1), Mr. Connelly sent in a protest stating that one of his operating partners had been allowed a depletion unit of $0.60 and he felt that he should be allowed the same unit as the Margay Oil Co.

The values and reserves on the Richards lease which give a depletion unit of $0.60 per barrel were agreed upon in conference with the Margay Oil Co., July 25 to 28, 1924. In a signed statement (Exhibit 2) by Henry A. Campbell, assistant chief of section, he states,

"Accordingly the same units are being used in the schedules prepared for J. J. Larkin and E. L. Connelly. It will, of course, be used in the other taxpayer's cases as they appear."

Since this unit will be used in cases not completed and in cases as they may come up, apparently the depletion unit allowed the Gypsy Oil Co. of $0.7174 per barrel will necessarily remain unchanged inasmuch as the Gypsy case was closed under a signed agreement in August, 1922, this then will not have the opportunity of being reworked with "other taxpayer's cases as they appear."

Yarma Richards lease (E. L. Connelly): E. L. Connelly acquired a one-sixteenth of seven-eighths working interest in this lease March 3, 1914, for $2,500 cash. Valuation data submitted by Mr. Connelly in Form O was received June 16, 1923, claiming a discovery valuation on well No. 2 of $46,442.16 and a depletion unit of $1.16. In view of the fact that the posted price of oil at the basic date was $0.80, this depletion unit was excessive. The value, subject to depletion, was cut down by the Income Tax Unit to $16,421.52, which gave a depletion unit of $0.39. This valuation was protested by Connelly, Exhibit 1, on the grounds that an operating partner (Margay Oil Co.) had received a depletion unit of $0.60. The Income Tax Unit then reconsidered the case and drew up a depletion schedule allowing Mr. Connelly a valuation of $22,-822.97 and a depletion unit of $0.60 a barrel on oil that was selling at $0.80 a barrel. This gives Mr. Connelly and his partners a depletion deduction of 75 per cent of the posted price of oil at date of valuation.

Yarma Richards lease (Margay Oil Co.): Margay Oil Co. claim a depletion unit of $0.88 based on the average price of oil of $1.20 since the date of discovery in 1914 (not posted price). The taxpayer sets up the operating expense, deferment, etc., as $0.32 a barrel.

The oil and gas engineers allowed a depletion unit of $0.60 (as of basic date, on $0.80 oil); this would leave $0.20 for operating expenses, deferment, etc., which is $0.12 less than that claimed by the taxpayer in original Form O.

PRODUCTION SUBSEQUENT TO DATE OF DISCOVERY USED AS A BASIS OF VALUATION WITHIN 30 DAYS OF DISCOVERY

With reference to the Margay Oil Co.'s valuation, it was agreed to in the conference of July 25, 26, and 28, 1924, that the valuation of the Hattie Vaughn lease would be deferred. The discovery on this particular lease was made in 1922, and the conference report, Exhibit 3 (j), states,

"The estimate of reserves on the Hattie Vaughn lease was not made pending the receipt of further production records since the discovery was made in 1922. The value of this lease to be determined when the question of reserves is settled.

"JOHN CULLEN,
"W. W. DUNCAN."

The regulations specifically state that valuation for discovery shall be made within 30 days after date of discovery. Here is an instance in which the production records for 18 months subsequent to date of discovery are in the department and yet the valuation engineers decline to set up discovery valuation on this lease by reason of the fact that they desire additional production records before they determine the amount of reserves that shall be set up. This goes to show that as in the case of the Gypsy leases, and many others

which the committee's engineer has presented, that actual production records for a number of years are used as a basis of setting up reserves as of discovery date. Exhibit 4 attached herewith shows the actual production of all of the wells on Vaughn lease, beginning July, 1922, when the first well came in and ending with December, 1923, after five wells had been producing for a period of one year.

EXHIBIT 1

TULSA, OKLA., *December 30, 1924.*

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

SIR: I am in receipt of your undated letter advising that my protest against the deficiency in my taxes for the year 1919, dated November, 1924, is being given consideration, and that, due to certain statutory provisions you desire form of waiver for 1919, and that in accordance with my request you are inclosing engineer's findings in regard to my depletion allowance.

I am inclosing herewith income and profits tax waiver for the year 1919, as requested by you.

In reviewing the engineer's depletion schedule on properties on which depletion is being claimed by me, I find that the units used by the engineer are considerable under those claimed by me in Form O submitted.

Since receiving the information in regard to the depletion allowed, I have discussed the unit rates allowed with operating partners interested with me in the leases on which I have claimed depletion, and I find that, although the unit rate of depletion claimed by me on the Yarma-Richards lease was excessive, yet the rate allowed by the engineer is considerably under that allowed my other operating partners. I find that a unit of approximately 60 cents for both cost and appreciation was allowed on the Yarma-Richards lease, and I, of course, should be allowed the same unit.

In the case of the Leander Moore lease, the unit rate of depletion allowed by the engineer is also considerably under the unit rate allowed an operating partner of mine in the same lease. There is no reason for this difference as the Form O information submitted by me showed a unit rate of depletion of approximately $1.08 for both cost and appreciation, and the information and rate was obtained from the Form O of the operating partners referred to.

It appears to me that as a matter of equity I should be allowed a rate of depletion the same as that allowed my operating partners in the leases in which I am interested, as conditions are identical. If this is done it will be agreeable to me to send you at once signed agreement consenting to assessment of deficiency.

Yours truly,

E. L. CONNELLY.

EXHIBIT 2

FEBRUARY 3, 1925.

Memorandum to Mr. W. N. Thayer in re Leander Moore property.

The difficulty in the cases you gave me for review lies in the fact that various working interests in the Leander Moore lease were valued for discovery purposes by various engineers at different times. The engineers who made the original valuations are not now with the section. These engineers apparently did not attempt to reconcile the various figures set up nor to work the case as a whole.

In September, 1924, Mr. Williams, now an engineer of this section, was assigned the case of Seth Ely to work. In reviewing it he found that various valuations and units had been allowed the other interests in the Leander Moore property, and he immediately requisitioned all the other cases in order to attempt to secure uniform results.

As a result a valuation of the entire working interest has been made, resulting in a net working interest value of $181,094.58, with reserves of 366,127.20 barrels, resulting in a unit of 0.49462. The status of the cases as of to-day is as follows:

Name	Interest	Units previously allowed	D. W. W.'s unit
Frank L. Moore	24/128	1.27 and 0.95	0.49482 schedules prepared.
E. R. Kemp estate	24/128	Never worked	
W. L. Connelly	12/128	Not worked	
E. W. Sinclair	9/128	0.5115	Do.
J. J. Larkin	9/128	0.4166	Do.
Seth Ely	12/128	0.5115	Do.
E. L. Connelly	9/128	0.79655	Do.
Skelly Oil Co	16/128	Depleted on cost	

The previous engineers who handled these cases are L. M. Lucid, J. B. Lockwood, and D. J. De Butts.

The valuations and reserves allowed by this section in the final report made by Mr. Williams result from an analytical appraisal accepting taxpayer's cost of development and reserves, but used a lifting cost of 30 cents per barrel. No hazard was applied, but 10 per cent deferment on the six-twelfths was used.

The other difficulty is from the Yaron Richards leases, in which Mr. Larkin and Mr. Connelly have working interests with others.

The interests shown and the units established at various times are shown as follows:

J. J. Larkin, one-sixth of seven-eighths, $0.28534.

Margay Oil Co., one-fourth of seven-eighths, 0.60.[1]

Gypsy Oil Co., one-third of seven-eighths, 0.7174.

A. L. Funk, one-sixth of seven-eighths, not worked.

Homer Preston, one-eighth of seven-eighths, not worked.

E. L. Connelly, one-sixteenth of seven-eighths, 0.33722.

HARRY A. CAMPBELL,
Assistant Chief of Section.

EXHIBIT 3

CONFERENCE NOTES TO BE FILED IN FORM O

MARGAY OIL CORPORATION,
Tulsa, Okla., July 25, 26, and 28, 1924.

Mr. J. A. Padon has power of attorney on file and enrolled in the department.

Conferees: W. G. Cullen, J. T. Kent, John Cullen, and W. W. Duncan.

(*a*) New Form O received July 21, 1924, supersedes former Form O filed November 21, 1921. Did not give the data upon all the properties of the taxpayer; also the additional data of 1921, 1922, and 1923 has been added.

* * * * * * *

(*g*) The data submitted upon the Yarna Richards lease was discussed. The estimate of reserves was accepted as shown in Form O. The discovery value depletion unit of 60 cents per barrel, which would include casing-head gas revenue, was agreed upon and schedule for discovery appreciation was revised.

* * * * * * *

(*j*) The estimate of reserves on the Hattie Vaughn lease was not made, pending the receipt of further production records, since the discovery was made in 1922. The value of this lease to be determined when the qeustion of reserves is settled.

JOHN CULLEN,
W. W. DUNCAN,
Conferees.

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[1] The values and reserves which gave the unit of 60 cents were agreed to in conference on July 25 to 28, 1924. Accordingly the same units are being used in the schedules prepared for J. J. Larkin and E. L. Connelly. It will, of course, be used in the other taxpayers' cases as they appear.

EXHIBIT 4

Production data, Margay Oil Corporation, Hattie Vaughn Leasehold

Month	Gross production, by months (barrels)	Average number of producing wells	Average gross production per well, by months (barrels)	Net production, by months (barrels)
1922				
July	29, 341. 53	0. 8387	34, 984. 54	12, 836. 62
August	23, 702. 58	1	23, 702. 58	10, 369. 88
September	17, 310. 60	1. 3000	13, 315. 85	7, 573. 39
October	31, 407. 84	3. 5161	8, 932. 58	13, 740. 93
November	19, 055. 38	4	4, 763. 84	8, 336. 73
December	31, 425. 50	4. 9032	6, 409. 18	13, 748. 66
Total	152, 243. 43	1. 3068	116, 500. 94	66, 606. 51
1923				
January	12, 775. 18	5	2, 555. 04	5, 589. 14
February	5, 955. 18	5	1, 191. 04	2, 605. 39
March	6, 236. 94	5	1, 247. 39	2, 728. 66
April	5, 464. 96	5	1, 092. 99	2, 390. 92
May	7, 558. 58	5	1, 511. 72	3, 306. 88
June	6, 861. 07	5	1, 372. 21	3, 001. 72
July	8, 200. 36	5	1, 640. 07	3, 587. 66
August	9, 529. 16	5	1, 905. 83	4, 169. 01
September	6, 803. 45	5	1, 360. 69	2, 976. 51
October	8, 835. 45	5	1, 767. 09	3, 865. 51
November	9, 281. 91	5	1, 856. 38	4, 060. 84
December	11, 097. 13	5	2, 219. 43	7, 819. 32
Total	98, 599. 37	5	19, 719. 87	46, 101. 56

Interest owned: Seven-sixteenth working interest to December 15, 1923; seven-eighth working interest thereafter.

Mr. MANSON. I have a whole lot of material here that I would like to go into the record.

The CHAIRMAN. Go ahead. We will sit here until you do it.

Mr. MANSON. I do not want to go into too much detail here, because it is all covered in this report, and it does not appear to be any new point.

Senator KING. Mr. Chairman, I suggest that Mr. Manson go over the record, after he has examined it carefully, and put in those parts that he thinks emphasizes his points.

The CHAIRMAN. I understand, Mr. Manson, that you desire to put these into the record without reading them?

Mr. MANSON. Yes; I have stated the point.

The CHAIRMAN. I think the bureau wants that, too.

Mr. GREGG. Yes; then we will have it in full.

Mr. MANSON. I will put these two reports in the record.

(The reports submitted are as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT,
May 4, 1925.

To: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: Union Natural Gas Co. of Pittsburgh.

DEAR MR. MANSON: I am attaching herewith a brief chronology of the Union Natural Gas Co. of Pittsburgh, showing the steps taken toward closing a case

upon which the tax for the year 1917 is still in dispute. This case is presented as one of the large cases which still remains unsettled and to point out briefly the number of conferences which have been held on this case.

Respectfully,

A. H. FAY,
Consulting Engineer.

Approved.

L. H. PARKER,
Chief Engineer.

UNION NATURAL GAS CORPORATION, PITTSBURGH, PA.

A review of the files of this case shows that there is still pending an additional tax of approximately $200,000 for the year 1917. There have been apparent delays on the part of the taxpayer and the department has not been able to close this case for any year.

The following chronology best illustrates the conditions prevailing in this case.

May 29, 1918. Schedules filed answering questions in the 1917 tax returns.

March 19, 1919. Taxpayer requested to file valuation data.

April 3, 1919. Second request asking for valuation data.

April 4, 1919. Taxpayer desires to comply with request for valuation data and asks extension of time and conference.

April 8, 1919. Conference granted for April 16.

April 16, 1919. No conference memorandum.

January 26, 1920. Taxpayer asks for ruling regarding drilling expenses.

April 19, 1920. Taxpayer asked to file affiliated questionnaire.

May 26, 1920. Second request for affiliated corporation questionnaire.

July 21, 1920. Third request for affiliated corporation questionnaire given to August 16 to reply.

December 4, 1920. Taxpayer refers to letter of January 26, 1920, asking for ruling on method of handling labor and drilling costs for gas wells.

January 4, 1921. Taxpayer reminds department in answer received in reply to letters January 26, 1920, and December 4, 1920.

December 9, 1920. Affiliated corporation questionnaire received by department.

January 13, 1921. Coal valuation section asks for data to substantiate coal-land values.

January 22, 1921. Taxpayer asked to file consolidated income and profits tax return for 1919.

February 4, 1921. Coal valuation reports mailed by taxpayer.

February 12, 1921. Taxpayer advised regarding drilling costs per request of December 4, 1920.

August, 1921. Form O oil and gas valuation data for 1917, 1918, and 1919 received.

October 10, 1921. Taxpayer asks for conference. Conference arranged for October 18.

December 13, 1921. Taxpayer preparing amended returns for 1917 to 1920 asks status of case.

December 27, 1921. Valuation oil and gas properties in progress by oil and gas section.

January 3, 1922. Taxpayer asks for extension of time for filing amended returns.

January 10, 1922. Extension granted to February 15, 1922.

February 18, 1922. Taxpayer asks for 90 days' extension to file amended returns.

February 28, 1922. No extension granted.

March 1, 1922. Taxpayer asks further extension.

March 18, 1922. No extension granted.

November 7, 1922. Letter to taxpayer explaining valuation methods.

January 29, 1923. Revenue agent's report filed showing additional tax for 1917, $232,440.70.

February 1, 1923. Conference oil and gas section.

April 30, 1923. Taxpayer asks for conference.

May 2, 1923. Conference granted May 10.

May 11, 1923. Conference oil and gas section, discoveries disallowed.

January 10, 1924. Assessment letter showing additional tax for 1917, $198,-190.75; for 1918, $2,719.30. This letter shows that taxpayer paid for 1917, $446,676.13, and for 1918, $289,400.58. The consolidated net income for 1917 was $3,330,708.48, while the aggregate net income for 1917 was $4,553,827.21. The consolidated invested capital for 1917 was $13,448,957.62.

February 8, 1924. Protest filed regarding A-2 letter January 10, 1924.

May 2, 1924. Taxpayer asks for conference May 13, 1924.

May 13, 1924. No conference memorandum.

July 22, 1924. Conference held in oil and gas section.

August 21, 1924. Conference held in consolidated audit section with request that another conference be held September 12.

September 12, 1924. Conference, consolidated audit section; certain balance sheets requested.

September 23, 1924. Balance sheets received by department.

October 21, 1924. Conference, consolidated audit section.

December 1, 1924. A 300-page revenue-agent's report received covering the years 1918 to 1921, inclusive, showing additional tax due of $29,865.01.

March 14, 1925. Department refers to taxpayer's appeal and asks for additional information.

April 2, 1925. Taxpayer granted extension to April 24, 1925, to file additional information.

Exhibit A

Senate Committee Investigating
Bureau of Internal Revenue
Income Tax Unit,
May 4, 1925.

To: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: Mascot Oil Co. of California.

Dear Mr. Manson: Attached herewith is a brief report on the Mascot Oil Co. of California in which two points may be stressed.

1. It is one of those cases which has been long drawn out and final settlement has not yet been made. It is best to explain by a brief chronology of the case.

2. The engineering data upon which tax adjustments are being made were filed November 26, 1924, and were prepared by Roger F. White and Walter S. Clute, both former valuation engineers of the oil and gas section.

Mr. White has been out of the department considerably less than two years, yet he appears in conference for the taxpayer.

Respectfully,

A. H. Fay,
Consulting Engineer.

Approved.

L. H. Parker,
Chief Engineer.

MASCOT OIL CO. LOS ANGELES, CALIF.

A review of the files of this case show that tax settlements have been pending since 1917. On June 4, 1920, an assessment letter was issued covering the years 1917 and 1918, in which was shown an additional assessment of $12,-694.33 for 1917 and an additional assessment of $38,030.51 for 1918.

On August 23, 1920, the taxpayer filed an abatement claim for the full amount of the additional tax for 1917 and 1918. This claim apparently lay dormant for about three years.

December 28, 1923, an assessment letter was mailed showing an overassessment of $1,063.24 for 1917 and an additional tax of $265.52 for 1918.

On September 18, 1924, another assessment letter was prepared showing an overassessment of $3,791.41 for 1917 and $12,906.07 for 1918. Inasmuch as this does not wipe out the amount of additional tax which was assessed in 1920 and 1923, the taxpayer has filed a protest which is now under consideration.

On October 30, 1924, an assessment letter was issued for the year 1919, showing additional tax of $16,077.82. Upon receipt of this, the taxpayer filed a protest. No action has been taken for 1920 and succeeding years.

Under date of November 26, 1924, the taxpayer filed a supplemental valuation report, prepared by Roger F. White and Walker S. Clute, both former valuation engineers of the oil and gas section. Mr. White has been out of the department less than two years, yet he appears in conference as a representative of the taxpayer.

The following chronology of this case from September 22, 1923, to the close of December, 1924, will give some idea of the consideration that has been given the taxpayer and yet no closure of the case has been effected.

TAX LIABILITY OF THE MASCOT OIL CO.

A-2 letter June 4, 1920.

	Amount of tax
Year 1917:	
Paid	$9,049.19
Additional	12,694.33
Total	21,693.52
Year 1918:	
Paid	58,138.49
Additional	38,030.51
Total	96,169.00

August 23, 1920. Abatement claim filed for full amount of additional tax for 1917 and 1918.

A-2 letter December 28, 1923.

	Amount of tax
Year 1917:	
Assessed	$21,693.52
Change	1,063.24
Total	20,630.28
Year 1918:	
Assessed	96,169.00
Change	265.52
Total	96,434.52

Appealed January 23, 1924, and asked for adjustment under provisions of section 328, act of 1918.

A-2 letter September 18, 1924.

	Amount of tax
Year 1917:	
Previously assessed	$21,693.52
Overassessment	3,791.41
Total	17,902.11
Year 1918:	
Previously assessed	96,169.00
Overassessment	12,906.07
Total	83,262.93

Overassessment certificates issued.

A-2 letter October 30, 1924 (1919 only).

Tax originally paid	$16,077.82
Additional assessment	14,399.63
Total tax for 1919	30,477.45

THE MASCOT OIL CO.,
Los Angeles, Calif., December 10, 1924.

CHRONOLOGY

September 22, 1923. Finch's valuation memorandum:

Depletable sum	$370,000.00
Equipment	241,686.96
Property value	611,686.96

February 15, 1924. Finch's supplementary memorandum sustains 3-1-13 value and reserves as set up in memorandum of September 22, 1923.

June 11, 1924. Audit conference. Messrs. Barrett and Jackson, auditors; Baxter, engineer; Butts, representing taxpayer. Mr. Butts accepted valuation as of 3-1-13, but requested that 1-1-14 value be redetermined. Engineering conference memorandum was not written up, as there were no engineering issues discussed or argued. Mr. Barrett wrote audit conference memorandum, which has been lost, and no copy can be found.

September 18, 1924. A-2 letter sent to taxpayer.

September 26, 1924. Taxpayer's reply to A-2 letter of September 18, 1924, accepts depletion based on Finch's memorandum. Article 207, regulation 45, states that no revaluation will be allowed during the continuance of the ownership under which value was determined.

November 18, 1924. Letter of protest to commissioner. Taxpayer protests matter of depletion based on 3-1-13 value.

November 24, 1924. Taxpayer requested conference on the question of depletion unit for November 28 or 29.

November 25, 1924. Letter from taxpayer submitting Mr. White's supplemental valuation report and requesting conference on December 3 and 4.

November 29, 1924. Mr. Butts, taxpayer's representative, was notified by phone that conference had been arranged for December 5 at 2 p. m., Mr. Grunewald, corporation audit conferee, case being in audit.

December 5, 1924. Conference held. Auditors present, Messrs. Grunewald, conferee, Miller, and Jackson. Engineers present, Messrs. Moss and Baxter. No conference memorandum being in case or Form O to indicate that 3-1-13 value was not rightfully a subject for discussion or revision, taxpayer was told that the maximum value allowable is $4,680 per acre. Taxpayer refused to accept this value and conference extended to the next day, December 6, 1924. Taxpayer's representatives present, Messrs. Butts and White.

December 6, 1924. Conference concluded. Auditor present, Mr. Southworth; engineers present, Messrs. Cullen, conferee, Moss, and Baxter; taxpayer's representatives present, Messrs. Butts and White. Messrs. Moss and Baxter withdrew statement that 3-1-13 property value could be revised to the maximum of $4,680 per acre and asserted that property value of $611,686.96, as set up in Finch's valuation memorandum, is reasonable and fair and should not be revised. J. Cullen, conferee for oil and gas section, overruled Moss and Baxter and told taxpayer's representatives that the 3-1-13 property value and reserves would be revised to $750,000 and 4,000,000 barrels, respectively; 3-1-13 value of physical equipment to be taken at $241,686.96, and years 1917 and 1918 not to be reopened.

December 7, 1924. Baxter found reference to the conference of June 11, 1924, stating that taxpayer had accepted 3-1-13 value and reserves as determined by Finch.

December 8, 1924. Moss and Baxter instituted fruitless search for a copy of said missing conference memorandum of June 11, 1924. Reference to data on file in oil and gas section clearly substantiates Finch's determination of 3-1-13 value and reserves.

December 9, 1924. Search for missing memorandum continued.

December 10, 1924. Further search for missing memorandum. J. Cullen proposed submitting case to officers of division for immediate settlement.

Mr. MANSON. I have remarked several times that in connection with the oil valuations in the bureau there appeared to be no terminal facilities.

I want to call the committee's attention to a case of a profit on a sale of an oil property made by S. G. Kennedy and W. A. Springer, Tulsa, Okla.

These gentlemen sold an oil property in December: that is the contract for sale was signed in December, 1916; this contract requiring the approval of the Secretary of the Interior, which approval was gotten in 1917. The profit on the deal amounted to approximately $6,000,000.

Senator KING. That was upon Indian lands, was it?

Mr. MANSON. I assume so.

The profit on the deal amounted to about $6,000,000 and giving to each of these two individuals a profit of about $2,900,000.

This report gives a rather full history of this case in the department and this case was kicked around from pillar to post until the statute of limitations ran and no tax whatever was assessed upon that profit.

Mr. GREGG. No tax at all upon that profit?

Mr. MANSON. No tax at all.

Mr. GREGG. Not the 1916 tax?

Mr. MANSON. Not the 1916 tax. They came to the conclusion that the profit was taxable in 1916 and the statute of limitations had run as against 1916.

The CHAIRMAN. Does the report show the amount of tax that has been lost to the Government?

Mr MANSON. Yes; it is shown in the report.

The CHAIRMAN. Will you just read that?

Mr. MANSON. As showing the history of this thing—this report is not very long, and I would like to read the whole report.

The question involved in this case is the sale of capital assets and a determination of the year in which the sale was made. Messrs. Kennedy and Springer entered into a contract with the Osage Hominy Oil Co. on December 18, 1916, for the sale of an undivided one-half interest in an oil lease for $6,025,000, the contract being subject to the approval of the Secretary of the Interior. The money was deposited during December, 1916, with the Liberty National Bank, of New York City, in escrow pending the approval of the sale of the lease by the Secretary of the Interior. The Secretary of the Interior approved the sale of this lease on January 26, 1917, at which time the money was turned over to Messrs. Kennedy and Springer.

April 13, 1920, Solicitor Johnson ruled that this was a 1917 sale.

July 22, 1920, J. P. Gillmore, attorney for the taxpayers, filed a brief protesting this ruling.

September 15, 1920, oil and gas section determined profit on sale as $2,903,352, to each Kennedy and Springer.

September 18, 1920, the taxpayer was advised that the tax would be assessed on the basis of a 1917 sale. October 19, 1920, the A-2 letter was addressed to Mr. Kennedy, showing additional tax due of $1,638,375.87.

November 5, 1920, at the taxpayer's request, the case was sent to the committee of appeals and review, and on November 22 the committee rendered an opinion adverse to the solicitor's opinion, placing the sale in 1916.

January 17, 1921, Solicitor Mapes ruled that this was a 1917 sale, thus sustaining the former solicitor's opinion.

February 22, 1921, Robert L. Owens addressed a letter to Commissioner Williams in regard to the case, protesting against the solicitor's ruling that this was a 1917 sale.

February 26, 1921, Commissioner Williams replied to the Senator. The last paragraph of his letter is as follows:

> Under the circumstances I feel compelled to approve the opinion of the solicitor.

On July 13, 1921, Senator J. W. Harreld addressed a letter to Commissioner Blair regarding this case and the commissioner replied on July 20 that he "would give it consideration as quickly as he could get to it."

On August 3, 1921, a memorandum was prepared for Mr. Batson, deputy commissioner, by A. H. Fay, chief of the natural resources subdivision (Exhibit 1), giving a brief review of the case, showing the amount of tax due on the basis of a 1917 sale as $3,313,793, and on the basis of a 1916 sale as $567,037, together with the following statement:

> As the matter now stands, it would seem that in view of the conflict of opinions. the matter should be taken up with the commissioner and some definite course decided upon.

December 9, 1921, committee on appeals and review again reviewed the case rendering an opinion that this should be considered as a 1917 sale. (Exhibit 2.)

May 10, 1922, case sent to Attorney General for ruling as to date of sale.

November 13, 1922, the Attorney General, Harry M. Daugherty (Exhibit 3), rendered an opinion in this case placing the sale in 1916 and not in 1917 as ruled by the solicitors of the Internal Revenue Bureau.

December 13, 1922, memorandum to the deputy commissioner by N. T. Johnson, chairman of the committee on appeals and review, returns the files with the statement:

> I do not know where the remainder of the file is, but I am returning this part of the record which has been on my desk for some time.
>
> It is understood that the Attorney General has recently rendered an opinion with respect to the date upon which the transaction was consummated and if that decision is to be followed the recommendation of the committee is nullified, since it is understood that he holds that the transaction was consummated in 1916 and the profit derived therefrom was subject to the rates of tax imposed by the revenue act of 1917.

After the Attorney General's ruling the case was referred to the oil and gas section for a revaluation, and on February 26, 1923, the oil and gas section determined a net profit for the Springer interest of $2,914,250. (Exhibit 4.) This valuation was approved and case audited on the basis of the Attorney General's ruling. The assessment letter was prepared in which $279,459 additional tax for 1916 was determined, but as no waiver was on file for 1916, and as the statute of limitations had expired, the additional tax was not assessed.

April 14, 1923, the taxpayer protests a tax due for 1917 in which he contends that the commissions paid on this transaction were paid in 1917 and not in 1916. In the previous audit, the unit placed the

commissions in 1916, inasmuch as the Attorney General had ruled that the sale was as of 1916. The taxpayer contends that his books of accounts were kept on a cash receipts and disbursements basis and as this commission was paid in 1917, it should be allowed as a deduction in 1917.

In a confidential memorandum (Exhibit 5) to the committee of appeals and review from the deputy commissioner, April 18, 1924, is the following:

> As to the question raised by the taxpayer, that he keeps his accounts on the cash receipts and disbursements basis, this point was not taken into consideration by the Attorney General in his decision and there is a possibility that if this point had been raised by the taxpayer, the profit would have been ruled as 1917 income, as it was not received by the taxpayer until January 26, 1917. It would therefore appear that in order that the taxpayer sustain his contention, that the commission on the sale of lease is 1917 expense, as he sets forth in his brief received February 9, 1924, due to the fact that he keeps his books on a cash receipts and disbursements basis, it will be necessary for him to file a waiver for 1917 in order that taxes may be computed on all moneys received during the year.

February 9, 1924, taxpayer addressed Commissioner Blair, filing an appeal which was later (May 7, 1924), followed by a brief to committee on appeals and review. (Exhibit 6.)

May 7, 1924, taxpayer addresses a long letter to committee on appeals and review, setting forth his reasons why the $37,500 commissions paid should be allowed as of 1917.

November 22, 1924, Solicitor Hartson denies taxpayer's appeal.

March 28, 1925, taxpayer's claim for $7,608.64 rejected, and A-2 letter mailed, showing a net additional tax for the years 1918-19 and 1920 of $24,196.89.

	Correct tax Mar. 28, 1925	Tax previously assessed
1918	$15,702.73	$22,544.01
1919	58,251.86	40,641.43
1920	80,234.23	66,806.49

(The exhibits accompanying report in case of S. G. Kennedy and W. A. Springer are as follows:)

EXHIBIT 1

AUGUST 3, 1921.

Memorandum for Mr. Batson:
Re S. G. Kennedy and W. A. Springer.

All of the papers relating to the Kennedy-Springer case, with the exception of a copy of Solicitor Mapes' opinion dated January 17, 1921, are in this office.

The case was audited and an A-2 letter sent to the taxpayers on the basis of the sale being consummated in 1917. This was on the basis of Solicitor Johnson's opinion dated April 13, 1920, placing the actual sale as of 1917. On November 22, 1920, the matter was taken up with the committee on appeals and review when a decision was rendered adverse to the Solicitor's original opinion, placing the consummation of the sale as of 1916. The matter was again referred to the Solicitor's office and Mr. Mapes on January 17, 1921, rendered an opinion contrary to the committee's ruling. As the matter now stands it

would seem that in view of the conflict of opinions the matter should be taken up with the commissioner and some definite course decided upon. The case has also been audited on the basis of a 1916 sale, and the tax due on the basis of the two audits is given below:

	Tax due 1916 basis	Tax due 1917 basis
Kennedy	$289,308.44	$1,675,418.02
Springer	277,729.10	1,638,375.87
	567,037.54	3,313,793.89

A. H. F.,
Chief, Natural Resources Subdivision.

Exhibit 2

December 9, 1921.

Deputy Commissioner,
Income Tax Unit:

The attached recommendation of the committee, approved by the commissioner, is transmitted to you for the guidance of the Income Tax Unit.

CAR.

The appellant has been informed of the attached decision through Mr. James W. Beller, Continental Trust Building, Washington, D. C.

Sir: You are advised that the Commissioner of Internal Revenue has approved the recommendation of the committee on appeals and review on your appeal in the case of Mr. W. A. Springer and Dr. S. G. Kennedy, Tulsa, Okla., that the action of the Income Tax Unit holding that the sale of certain oil and gas leases owned by the appellants was consummated in 1917; that the profits from such sale subject to tax at the rates in effect for that year be affirmed; and that the cost be accepted as the fair market value on March 1, 1913, of the leases in question for the purpose of computing profit upon subsequent sale in 1917.

Since Messrs. Springer and Kennedy were engaged in the oil business, the committee is of the opinion that profits derived from the sale of leases in question constitute income from a trade or business and as such is subject to the excess profits tax imposed by the revenue act of 1917, and further recommends that the sale of the leases be considered as creating an abnormal condition affecting the income of Messrs. Springer and Kennedy for that year and the excess profits tax be determined and assessed under the provisions of section 210 of the revenue act of 1917 and articles 18, 24, and 52 of regulations 41.

The case and related papers have accordingly been referred to the Income Tax Unit for reaudit in accordance with the rulings contained herein and you will be further notified as to such further action as the unit may take in accordance with this decision.

Respectfully,

F. G. Smith,
Secretary, Committee on Appeals and Review.

Exhibit 3

November 13, 1922.

The honorable the Secretary of the Treasury.

Sir: Acknowledgment is made of the receipt of your communication of May 10, 1922, in which you present a statement of facts and request my opinion on the question of law thereby raised, and with which you inclose the opinion of the Solicitor of Internal Revenue, together with copies of briefs filed with the Commissioner of Internal Revenue by attorneys for the taxpayers concerned in this question.

The facts set out in your communication show that on December 18, 1916, S. G. Kennedy and W. A. Springer (parties of the first part) entered into a contract with the Osage-Hominy Oil Co. (party of the second part), under which parties of the first part "have agreed to and do hereby sell" and "the party of the second part has agreed and does hereby purchase for itself or its nominee" first parties' undivided one-half interest in an approved departmental oil and gas mining lease covering restricted lands in the Osage Nation, Okla. Under the terms of paragraph 19 of such lease it could not be assigned without the approval of the Secretary of the Interior. According to the terms of the contract of sale, an assignment in quadruplicate of the interest of Kennedy and Springer in the lease was to be delivered to the Liberty National Bank, New York City, to be by it delivered to the Osage-Hominy Oil Co., provided the latter should deposit with such bank "contemporaneously with the delivery of said assignment" $500,000 in cash and a note executed by the Oklahoma Producing & Refining Co. for $2,500,000, payable to the Osage-Hominy Oil Co., and indorsed by it and two other parties, and "on or before 12 o'clock noon of Saturday, December 23, 1916," the further sum of $3,025,000 in cash, upon the payment of which the assignment was to be delivered to party of the second part. The money and note were to be turned over to Kennedy and Springer in the event of the final approval by the Secretary of the Interior of the assignment of their interest in the lease mentioned. The assignment was delivered to the bank on December 18, 1916, the money and note were deposited with the bank on December 20, 1916, and on the same day (December 20, 1916) the Osage-Hominy Oil Co. deliverey to the venders a vender's lien to secure payment of the note and receive from the bank the assignment, which it filed with the Secretary of the Interior. On January 26, 1917, the Secretary of the Interior approved the assignment, and shortly thereafter the bank paid to Kennedy and Springer the $3,525,000 and delivered to them the note referred to.

The question on which an opinion is requested is whether the sale was a transaction occurring in the year 1916 or one occurring in the year 1917, and therefore, whether the gains, profits or income if any derived therefrom are taxable as of 1916 or 1917.

The contract of sale may be summarized as follows:

First. That the venders should, coincidently with signing of the contract, execute upon proper departmental forms assignments, in quadruplicate, to the vendee and deliver the same to the Liberty National Bank of New York, to be held by it in escrow, under certain conditions hereinafter set forth.

Second. That the vendees, upon the signing of the contract, should deposit with the bank $500,000 in cash and a note for $2,500,000, dated December 18, 1916 (the date of the contract), payable June 1, 1917, with interest at 6 per cent from date.

Third. That the vendees should deposit with the bank on or before December 23, 1916, a final payment of $3,025,000 in cash.

Fourth. That the bank should hold in escrow the moneys, the note, and the assignments upon the following conditions:

(*a*) Upon the payment by the vendee on or before December 23, 1916, to the trustees of the $3,025,000 the assignments were to be delivered to them.

(*b*) Should the vendees fail to make this payment on or before December 23, 1916, the assignments were to be returned to the vendors together with the note and the $500,000 which, it was provided, should be the liquidated damages.

(*c*) Upon the approval of the assignment by the Secretary of the Interior, the bank was authorized to pay over to the venders the moneys and note in its possession.

There was also a provision in the contract to the effect that in the event the approval of the Secretary could not be obtained to the assignment to the Osage-Hominy Oil Co., then the venders could execute the assignment to any nominee designated by the Osage-Hominy Oil Co.

It was also provided that upon approval by the Secretary of the assignment the vendees shall be entitled to one half of "all of the oil in tanks or produced from the above described property after 7 o'clock a. m., December 18, 1916," less operating expenses.

It was also provided that the vendee should use their utmost diligence in obtaining the approval of the Secretary, and that if they failed to do all they could do, in consequence of which the assignment should not be approved

within 90 days, the bank was to pay over to the venders the sum of $3,000,000 as liquidated damages.

Certain provisions in the above summarized contract of sale are important factors in this consideration. It is clear from the contract that it was the understanding of the parties that sale should date as of December 18, 1916. This appears not only in the wording "have agreed and do hereby sell," but further in that interest on the vendee's note should run at 6 per cent from December 18, 1916, and that vendees were to receive one half the oil in tanks or produced "from and after 7 o'clock a. m., December 18, 1916," and that vendee might nominate another to receive the lease in his stead.

If any true escrow was created by a contract such as the one above, I am of the opinion that it could not extend into the year 1917. The provisions of the contract set the last date upon which the purchase price could be deposited with the bank and the assignment delivered to the vendee as December 23, 1916. In the event of failure to conclude all elements of the transaction by that date (save only the fulfilling the condition subsequent of approval of the Secretary of the Interior) $500,000 as liquidated damages were to be paid the venders and the assignments were to be returned to them. But on December 20, 1916, all provisions of the contract had been fulfilled. The Liberty National Bank, which held the assignment in escrow, actually and manually delivered such assignment, in quadruplicate, to the purchaser, the Osage-Hominy Oil Co. and thereupon the escrow holding of the assignment terminated, this being in the year 1916, and within the time limit set by contract of the parties. From that hour the vendee was in possession of the assignment with full power of transferring it to whomsoever it pleased. The only remaining thing necessary was the approval by the Secretary of the Interior of the assignment, as required by the Osage allotment act (34 Stat. L. 539), to be followed by an accounting by the vendees for one-half of all the oil in the tanks or produced from the property in question from and after 7 o'clock a. m., December 18, 1916, less one-half of the operating expenses of the entire lease during the period from December 18, 1916, to the date of the approval of the assignment.

In this interpretation we can not lose sight of the well-established rule that—

"Whether an instrument placed with a third party is to be an escrow or a completely executed instrument depends on the intention of the parties."

Furthermore:

"A presumption exists in favor of the complete instrument and an intention to the contrary must clearly appear." (16 Cyc. 568 and cases cited thereunder.)

Section 3 of the allotment act provides as follows:

"That the oil, gas, or other materials covered by the lands for the selection and division of which provision is herein made are hereby reserved to the Osage Tribe for the period of 25 years from and after the 8th day of April, 1906; and leases for oil, gas, and other materials, covered by the selections and divisions of land herein provided for, may be made by the Osage Tribe of Indians through the tribal council, and with the approval of the Secretary of the Interior, and under such rules and regulations as he may prescribe."

Section 44 of the regulations promulgated by the Secretary of the Interior on July 3, 1912, provides:

"Approved leases or any interest therein may be sublet, transferred, or assigned with the consent and approval of the Secretary of the Interior and not otherwise. Subleases, transfers, or assignments, when so approved, shall be subject to the terms and conditions of the original leases and the regulations under which such leases were approved as well as to such additional requirements as the Secretary of the Interior may prescribe. The sublessee transferee, or assignee shall furnish with its sublease, transfer, or assignment a satisfactory bond as hereinbefore prescribed in connection with lease.

"Any attempt to sublease, transfer, or assign an approved lease or any interest therein without the consent and the approval of the Secretary of the Interior shall be absolutely void and shall subject the original lease to cancellation in the discretion of such Secretary."

It was therefore obligatory on the parties to the contract to insert the clause providing for the approval of the Secretary of the Interior, as otherwise the assignment of the lease would have been null and void. The intent of the instrument itself however, is clear that such approval was in no wise one of the conditions precedent to complete the transaction. On the contrary

it is treated throughout as a condition subsequent thereto. The parties closed all negotiations save only that the vendee in further protection of large sum of money deposited as purchase price left it with his agent, the Liberty National Bank, until the Secretary of the Interior had affixed his stamp of approval.

The retroactivity of the approval of the Secretary of the Interior is borne out by the decisions of the Supreme Court in the cases of Lomax *v.* Pickering (173 U. S. 26) and Lykins *v.* McGrath (184 U. S. 169).

It is my opinion that, all the terms of the contract having been complied with by December 20, 1916, the approval of the Secretary of the Interior was a condition subsequent, relating back to the date of the contract, making the whole transaction effective as of the year 1916, and therefore causing any profit realized by the taxpayers by the sale of this lease to be profit realized in the year 1916 and therefore taxable as of that year.

Respectfully,

H. M. DAUGHERTY, *Attorney General.*

The honorable the SECRETARY OF THE TREASURY.

EXHIBIT 4

OIL AND GAS VALUATION SECTION

S. G. KENNEDY, *Tulsa, Okla.*

Sale of capital assets, taxable year 1917

Sale price		$3,012,500.00
Original cost	$1,374.25	
Physical equipment added	58,447.19	
Miscellaneous expense in connection with sale	1,100.00	
Commission on sale	37,500.00	
Total investment date of sale	98,421.44	
Estimated depletion and depreciation sustained	171.44	
Net investment		98,250.00
Net profit on sale		2,914,250.00

On November 12, 1912, the property, consisting of an oil lease on 4,780 acres of Osage Indian lands, was bid in by S. G. Kennedy and W. A. Springer at $1.15 per acre. On February 1, 1913, the principal chief of the Osage Nation approved the lease and the same was approved by the Commissioner of Indian Affairs on February 12, 1913, and by Warren L. Fisher, Secretary of the Interior, on March 3, 1913. It is held that taxpayer did not acquire title to the property until the lease was finally approved by the Secretary of the Interior on March 3, 1913, hence the basis for calculating profit or loss on subsequent sale would be based on cost and not on March 1, 1913, value.

Taxpayer owned an undivided one-half interest in the property at date of acquisition. In 1913 an undivided one-half interest in the lease was assigned by Kennedy and Springer to White and Sinclair, the taxpayer retaining a one-fourth undivided interest.

Two wells were drilled in 1913 and two in 1914. No more development work was done until the spring of 1916. No production records are available prior to December 18, 1916. The estimated depletion sustained is based upon estimated production as compared with the production record from December 18 to 31, 1916.

The amount shown as physical equipment added is one-half the inventory of physical equipment as acquired by the Osage-Hominy Oil Co., the purchasing company at date of acquisition. The commissions and incidental expense items are taken from the revenue agent's report.

Recommended by:

JOHN CULLEN,
Engineer.

Approved by:

S. M. GREENIDGE,
Assistant Chief of Section.

February 6, 1923.

EXHIBIT 5

From: Natural Resources Audit Division, section F-9.
To: Committee on Appeals and Review.
Case of: S. G. Kennedy, Tulsa, Okla.
Confidential memorandum.

As to the question raised by taxpayer, that he keeps his accounts on the cash receipts and disbursements basis, this point was not taken into consideration by the Attorney General in his decision, and there is a possibility that if this point had been raised by taxpayer the profit would have been ruled as 1917 income, as it was not received by taxpayer until January 26, 1917. It would therefore appear that in order that the taxpayer sustain his contention, that the commission on the sale of lease is 1917 expense, as he sets forth in his brief received February 9, 1924, due to fact that he keeps his books on a cash receipts and disbursement basis, it will be necessary for him to file a waiver for 1917 in order that tax may be computed on all moneys received during the year.

——— ———,
Deputy Commissioner.

APRIL 18, 1924.

EXHIBIT 6

HON. D. H. BLAIR,
Commissioner of Internal Revenue, Washington, D. C.

In re S. G. Kennedy, Tulsa, Okla. IT: NR: F-9. JMM-2408.

SIR: An appeal is hereby taken from the action of the Income Tax Unit in holding that a commission paid in the year 1917 should be included in a computation to arrive at the profit realized on the sale of a lease in 1916, in spite of the fact that the taxpayer is reporting on the cash receipts and disbursements basis. The additional tax involved is $7,608.64.

The unit has been advised of a decision handed down by the Attorney General wherein it was held that the profit on the sale of a lease was income for the year 1916. Upon a reaudit of the case and based on the decision named above, the unit has applied a commission paid on account of the lease in February, 1917, in the amount of approximately $37,000, against the sale price of the lease in arriving at the profit realized therefrom, and which sale occurred in the year 1916.

It is our contention that inasmuch as the taxpayer has consistently reported on the cash receipts and disbursements basis, only those expenditures actually made in the year 1916 are to be considered in the computation of the profit realized from the sale of the lease, and that expenditures made subsequent to the sale are applicable to the year in which expended.

To substantiate further our contentions, we recite the following hypothetical question: Should the item of commission have been questioned and not definitely determined and paid until three or four years subsequent to the date of sale, would the department compel the taxpayer to file an amended return for the year in which the sale took place, and disallow the deduction for the year the commission was actually paid, when the returns were filed on the cash receipts and disbursements basis?

The unit is basing its argument on that part of the decision which reads to the effect that inasmuch as the sale was determined to have been made in the year 1916, any profits realized therefrom should be taxed at the 1916 rate, and therefore in determining the taxable profit they have taken into consideration all expenses relative thereto irrespective of the year such expenses were made and in spite of the fact that all returns have been filed on the basis of actual receipts and disbursements.

For the reasons above stated we request that the case be transferred to the committee on appeals and review for a final decision. This action is not taken for the purpose of delaying the payment of the tax assessed.

Respectfully submitted.

JAMES P. GILMORE,
Attorney for S. G. Kennedy.

Mr. MANSON. As to the Attorney General's ruling, the case was referred to the oil and gas section for revaluation.

Mr. GREGG. May I interrupt, Mr. Manson?

Mr. MANSON. Yes.

Mr. GREGG. Did the statute run at that time, when it was referred back to the oil and gas section on the 1916 assessment?

Mr. MANSON. The case was referred for revaluation on February 26, 1923. I think you are better able to calculate that than I am. It is out of my mind at the present time.

Mr. GREGG. It would depend upon when the return was filed.

Mr. MANSON. In this case the taxpayer got out of paying the tax on the profit. In 1917 he comes in and deducts the commissions he paid for the effecting of the sale from his 1917 tax.

The CHAIRMAN. I would like to ask the solicitor whether it is not correct that the tax is assessable on the years when the money is received?

Mr. GREGG. In the case of the sale there is no more difficult fact in the income tax law than determining the year in which a gain is realized from a sale. In this case, as I remember it, delivery was made and possession taken in 1916; but since it was Indian lands, the approval of the Secretary of the Interior was required, and that was not secured until 1917. The question then arose as to whether that made it 1916 or 1917 sale.

When Mr. Manson is finished, I would like to say a word on this case.

Senator KING. That is a condition precedent instead of subsequent.

Mr. GREGG. That was the question.

Mr. MANSON. That was my view of it.

Senator KING. You were right in that connection, and Attorney General Daugherty was absolutely wrong.

The CHAIRMAN. There is a case that I am interested in now before the court of appeals—it is not my individual case, but a case that I am interested in—where they insisted on collecting the tax in the year that the money was received.

Mr. GREGG. It depends very largely upon the approval of the Secretary of the Interior as to whether it is a condition precedent or subsequent.

The CHAIRMAN. Go ahead, Mr. Manson. Finish up your 1917 story. I did not hear that.

Mr. MANSON. 1917 is in regard to a different question. There, this taxpayer deducted commissions that he paid from his 1917 returns, after it has been determined here that the sale was the 1916 sale.

The CHAIRMAN. How was that ruled on?

Mr. MANSON. The solicitor held that the deduction was a 1916 deduction.

Mr. GREGG. So he did not get that, anyhow.

Mr. MANSON. No, no; he does not. But it is not necessary to go into that angle of the situation. That does not really amount to anything.

Senator KING. Let me make one inquiry here. Pending a settlement of a controversy, when the statute of limitations is about to expire, may not the department go and seize the property?

Mr. GREGG. Oh, we could have assessed the tax and stopped the running of the statute.

The CHAIRMAN. Was there not an A-2 letter of assessment?

Mr. MANSON. No.

Mr. GREGG. No; it is not an assessment.

Mr. MANSON. I can not see, in reading this report, how there could be any reason for that being anything other than a 1917 sale, for the reason that the sale could not be consummated without the approval of the Secretary of the Interior. If the Secretary of the Interior had refused to approve, there would have been no sale. Therefore there was no sale until he approved it.

Mr. GREGG. If there was no income law in 1917, we would have had a fine chance to tax him on the 1916 income!

Mr. MANSON. Yes.

The CHAIRMAN. Do I understand that you did not know that the tax was lost?

Mr. GREGG. No; we thought at least we got the 1916 tax. It is rather hard to give an explanation of how——

Senator KING. As I understand it, you would like to look into it down there and make a further statement for the record?

Mr. GREGG. Yes, sir; we would certainly like an opportunity to examine into this case.

Mr. MANSON. I have several reports here that were prepared for the purpose of giving the history of an oil case in the oil and gas section to show that there has not seemed to be any way that the limitations that are placed upon the taxpayer as to the time when he is to furnish information are enforced, and there seems to be just one delay after another.

These reports are brief, and they are just presented for the purpose of showing the delays in the oil and gas section.

The CHAIRMAN. Is the Sinclair Oil Co. one of them?

Mr. MANSON. Yes; the Sinclair Oil Co. The Union Natural Gas Co. of Pittsburgh is another, and the Mascot Oil Co. of California is another.

(The reports submitted by Mr. Manson on the Sinclair Consolidated Oil Corporation, and its subsidiaries, are as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE
INCOME TAX UNIT,
April 27, 1925.

To: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: Sinclair Consolidated Oil Corporation.

DEAR MR. MANSON: Attached herewith is a report on the Sinclair Consolidated Oil Corporation and its subsidiaries.

The case has been pending in the department for anumber of years and since it is not closed, no definite statement can be made as to any final settlements. The main point apparently to be brought out in this case is the extraordinary amount of delay that the taxpayer has been able to inject into the handling of this case. There still remains approximately $5,000,000 of taxes due for 1918 and preceding years. No adjustments have been made nor even determinations as to amount of tax that may be due for 1919 and succeeding years. The case is best described under the chronological events listed in the report.

Respectfully,

A. H. FAY, *Consulting Engineer.*

Approved.

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE
INCOME TAX UNIT,
May 2, 1925.

Memorandum to: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: Sinclair Oil & Gas Co.

With reference to the depletion claimed and allowed the taxpayer, I find that the engineer's report sets up the following depletion, claimed and allowed.

Date	Claimed amended returns	Allowed on cost
June 30, 1916	$1,478,155	$5,794,025
June 30, 1917	6,183,786	5,794,525
June 30, 1918	4,285,246	3,503,963

This is the depletion claimed on the amended returns. I have not the original returns available, so I do not know what was claimed thereon. The case is being audited on the amended returns and not on the original returns.

Respectfully submitted.

A. H. FAY, *Consulting Engineer.*

EXHIBIT C

An examination of the files of this case shows that during the income tax period since 1916 to date no final action has been taken by the department. The case is now protested with taxes in excess of $5,000,000, determined to the close of 1918. No audit for subsequent years has been attempted, although a field audit for the earlier years is now in progress.

Inasmuch as the case is not closed, no statement as to the final settlement can be made. Suffice to say, however, it is a large case and one that has been delayed by the taxpayer in not supplying proper data upon which final audit can be made. The department has not been able to force a settlement. The taxpayer has repeatedly asked for extension of time and has as often been given additional time. The case may best be explained by the following statement of chronologic events from February, 1918, to May, 1924.

EXHIBIT D

CHRONOLOGIC CORRESPONDENCE IN CONNECTION WITH THE HANDLING OF THE TAX RETURNS OF THE SINCLAIR OIL & GAS CO.

February 16, 1918. Taxpayer asks for 30-day extension for filing 1917 returns. Taxpayer advised he would have 60 days from June 30, 1917, which was the end of the company's fiscal year.

March 4, 1918. Abstracts of returns 1911 to 1917 for a number of companies sent to the revenue agent at Little Rock, Ark., for examination. These companies were part of the Sinclair holdings.

May 29, 1918. Revenue agent in charge at New York asked for amended returns covering fractional year May 1 to June 30, 1916.

August 29, 1918. Agent in charge at New York asked to secure amended returns for Washington office.

March 19, 1919. Sinclair Oil & Refining Corporation asked to furnish basis for valuation depletion, depreciation, etc.

April 15, 1919. Taxpayer asks for 60 days extension to file "schedules for (valuation, cost, depletion, depreciation, et cetera," in accordance with information called for in Form "L."

May 15, 1919. Taxpayer asks for additional Forms L schedules. Schedules sent as requested.

June 12, 1919. Taxpayer asks for 30-day extension to file Form L. Extension to July 15 granted.

June 20, 1919. Revenue Agent Yarbrough, Arkansas division, asks for a field audit of the Sinclair holdings.

August 7, 1919. Taxpayer asks for additional schedules L and N. Copies mailed as requested.

August 12, 1919. Taxpayer delivers first installment of schedules as per Forms L and N.

October 29, 1919. Superficial examination of depletion schedules 1917, made out and forwarded to audit.

April 9, 1920. Recommendation made for field audit at New York office.

June 15, 1920. Depletion schedules as per taxpayer received by department.

September 1, 1920. Auditors detailed to field audit at New York office.

September 20, 1920. Photostats of subsidiary company's returns sent field auditor at New York.

July 6, 1921. Taxpayer advised depletion and valuation schedules incomplete. Asked for additional details.

August 20, 1921. Taxpayer again requested to supply details as to valuation, etc.

September 27, 1921. In compliance with a verbal request from Mr. H. F. Sinclair valuation methods were explained to him.

November 10, 1922. Revaluation made on basis of information at hand. No data had been submitted to give proper depletion allowances. Depletion disallowed.

December —, 1922. Additional and incomplete valuation data filed.

March 3, 1923. Informal conference regarding method of procedure to be followed in valuing Sinclair properties. The conference memorandum contains the statement: "Values will be made by individual properties."

March 27, 1923. Claim for refund filed.

April 20, 1923. Brief filed by taxpayer regarding invested capital and depletion, based on stock-market quotations.

May 15, 1923. Taxpayer asked to supply waivers for various subsidiaries.

May 28, 1923. Taxpayer again asked to supply waivers for various subsidiaries.

May 29, 1923. Telegram from taxpayer advising waivers had been mailed.

May 31, 1923. Letter from J. G. Bright, deputy commissioner, instructing S. M. Greenidge, head of natural resources division, to arrange for taxpayers' conference.

June 6, 1923. Taxpayer advised to arrange date for conference on or before June 15, 1923.

June 15, 1923. Files do not show record of conference held.

November, 1923. Valuation reports and depletion schedules considered by oil and gas section on basis of information at hand, and case referred to audit.

December 1, 1923. Amended returns for all years filed by taxpayer.

December 11, 1923. The following memorandum, bearing this date, appears in the files of the case: "The case of the taxpayer and other taxpayers audited in connection with it have not received as thorough a review as they should have, in view of the necessity of closing part of the cases on December 13, and in view of the general requirements as to expedition at this time. Certain adjustments to which exceptions might be taken are passed for the reason that the taxpayer will undoubtedly file a protest, and consideration can then be given to them. (Signed) GERALD, *Reviewer*."

February 8, 1924. Assessment letter mailed to taxpayer showing excess of $5,000,000 additional taxes due to the close of 1918. Records of the department indicate that this was the first assessment letter mailed to the corporation.

March 7, 1924. Taxpayer files an appeal in regard the proposed assessment.

April 7 and 8, 1924. Conference with taxpayer regarding points raised in taxpayer's appeal.

May 1, 1924. Field audit ordered, and during the past 10 months two to seven auditors have been engaged continuously on this case. The department now states that the field audit will be completed within one or two months. After this the regular office audit will be in order and an assessment letter prepared on the basis of the findings of the field examination above referred to.

The accompanying table shows the amount of taxes previously assessed or paid, the amount of additional taxes as per assessment letter of February 8, 1924, which assessment is now under protest. The amount of depletion allowed by the department is also shown. The year 1918 is the latest for which any tax determination has been made.

Sinclair Oil & Gas Corporation and subsidiaries

	Tax previously assessed or paid	Additional tax per letter Feb. 8, 1924	Depletion allowed
Jan.-June 30, 1916	$60, 922. 43	$753. 10	$795, 773. 00
June 30, 1917	168, 798. 86	1, 195, 796. 85	5, 814, 467. 00
June 30, 1918	714, 467. 98	1, 198, 482. 18	3, 516, 744. 00
July 1-Dec. 31, 1918	277, 938. 69	2, 699, 401. 23	1, 329, 476. 00
Total	1, 222, 127. 96	5, 094, 439. 36	11, 456, 460. 00

Waivers are on file for all years.

Exhibit E

With reference to the valuation of the Sinclair oil property the department suggests two alternatives for making this valuation in a memorandum by Mr. Bright, May 31, 1923, to Mr. Greenidge, head of the Division of Natural Resources. (Exhibit 1.)

(1) To place a value on the entire holdings of the corporation, based on the market value of the stocks issued for the property, and then allocate this amount to individual subsidiaries and further allocate to the individual leases.

(2) To place a value on each individual lease owned by the subsidiaries or Mr. Sinclair, which were turned over to the corporation at various dates.

The Income Tax Unit has made valuations of the various leases by both analytical appraisals and on the basis of sales, for example: There is one piece of property acquired on February 12, 1916, which was thoroughly developed with 130 producing wells, 1,360 acres, embracing 11 leases. A quotation from an engineer's memorandum is as follows:

"The above purchase averages $960 per barrel day, as of February 12, 1916, at $1.30 per barrel, which equals $1,144.60 at $1.55 per barrel. Since the daily average is based on the first 42 days of the year, gives a value of $960 per barrel, it is believed that the purchase was made on the basis of $1,000 per daily barrel, as of date of transfer, February 12, 1916. This basis raised from $1.30 to $1.55 oil, would give $1,192.30 per barrel as of March 1, 1916."

The majority of properties owned by the taxpayer were acquired on May 1, 1916, at which time stock was issued to the various parties owning or controlling the leases acquired by the taxpayer. The question then arises as to the value of the properties turned in for stock. As stated above, the valuation of the various leases has been determined by the oil and gas section, both on analytical appraisals and on sales bases. Where the analythical appraisal was used the posted price of oil, $1.55, was used as the basis for valuation. The valuation of these leases by analytical appraisals is on the same basis as that used for discovery valuations, and the results will be used for both invested capital purposes and for depletion. The taxpayer for the early years has not been insistent upon discovery valuations for depletion purposes, but has accepted the valuations as of May 1, 1916, for both depletion and invested capital. This gives him a greater advantage than the discovery valuations would, in that discovery valuations can not be used for invested capital purposes.

In making the valuations of these properties as of May 1, 1916, the taxpayer has submitted actual production figures to the close of 1921 and in some cases to the close of 1922. While the valuations made are as of May 1, 1916, yet the actual production figures for at least five years subsequent thereto

have been used by the taxpayer and accepted by the unit as the basis for determining reserves as of that date. The same applies also to valuation of other properties acquired subsequent to May 1, 1916. The taxpayer as well as the unit could legitimately use any and all production prior to May 1, 1916, but the regulations do not permit the utilization of subsequent information.

Referring to the valuations as of May 1, 1916, there is shown in Exhibit 2 the depletion unit allowed in a number of leases and its relation to or its percentage of the posted price of oil. It will be noted that in this case the taxpayer's percentage of depletion varies from 35 to 75 per cent of the posted price of oil, which is in line with valuations for discovery purposes. Development expenses, operating costs, and depreciation on equipment will be additional deductions from income.

In setting up the amount of reserves the taxpayer has not used any hazard factor for future drilling—in fact, very little information is given as to how he has determined his reserves other than that he has used the actual production over a period of years to the close of 1921 and, estimated on this basis, what the remaining wells might produce. The table given in Exhibit 3 shows the majority of those leases wherein an excess of 50,000 barrels of reserves are set up. The name of the lease is given, its district or State, together with the reserves claimed by the taxpayer. In a parallel column is given the reserves allowed by the unit on its latest valuation recommendations. It will be noted that in the majority of the cases the unit has accepted the taxpayer's estimated reserves. In a few cases the taxpayer has been given more reserves than he claimed, and in a number of cases the reserves have been reduced to some extent. The total reserves claimed by the taxpayer on these larger leases is 45,501,451 and the amount allowed by the department for the same leases is 48,742,170 barrels.

It will thus be seen that on the major leases owned by the taxpayer that the department has allowed him in excess of 3,000,000 barrels of oil more than claimed in his returns.

Exhibits 4, 5, and 6 are taken from the amended returns filed by the taxpayer and are given here to show the magnitude of the business conducted. It also shows the amount of deductions set up in the returns and the amount of tax which the taxpayer considers that he should pay.

EXHIBIT 1

MAY 31, 1923.

Mr. S. M. GREENIDGE,
Head Natural Resources Division.

In re Sinclair Oil & Refining Corporation.

I have made an examination of the brief submitted in the above-named case with reference to its invested capital as of January 1, 1917, and the valuation of its oil properties as at the date of organization, also the data obtained from you at the conference held with the auditors of your division on this case. The taxpayer in his brief states that the market value of the stock of the parent corporation as at the date of organization is the sole basis for determining the value of the properties acquired, citing section 325B of the revenue act of 1918. They further state that the department should accept the apportionment of the assets to the several subsidiaries (which they state in their own judgment more equitably than any other reflects the true situation), for the purpose of valuing the assets acquired.

In connection with the above the following facts are disclosed:

The parent organization (Sinclair Oil & Refining Co.) was organized on April 29, 1916. The subsidiary companies were organized on the following dates: Sinclair Oil & Gas Co., April 25; Sinclair-Cudahy Pipe Line Co., April 25; Exchange Oil Co., April 29; Sinclair Oil & Refining Co., previously the Cudahy Pipe Line & Refining Co., organized in 1908, charter and name changed on April 29, 1916. The meager information at hand shows conclusively that the formation of these subsidiaries was coincident with the forming of the holding company for the purpose of turning over to the subsidiaries the properties acquired from other corporations, particularly for managerial purposes. All producing properties were transferred to the Sinclair Oil & Gas Co., pipe line properties to the Sinclair-Cudahy Pipe Line Co., refineries to the Sinclair Refining Co., and miscellaneous securities to the Exchange Oil Co.

There were approximately 21 companies, partnerships, or individual leases acquired at or about this time, and in the majority of cases the individual companies filed separate returns for the years 1916 and 1917. No information whatever has been furnished by the taxpayer as to the values of these properties at the date acquired, or balance sheets showing the book assets of such companies. The committee has ruled on two or three occasions that the market value of the stock of the vendee corporation could not be accepted as indicating the value of the property or stock acquired with its stock; therefore, as this organization was practically formed at the same time in order that the unit may properly determine the value of the properties or stock acquired with the stock and bonds of the Sinclair Oil & Refining Co., it will be necessary that they furnish evidences of the values of the properties or stocks acquired. This may be done by (a) proving value of assets through retrospective appraisals showing each specific property and conforming to the requirements of T. D. 3367, (b) comparison with established values of contiguous properties, and (c) proof of market value of the stock of the underlying companies. This may further be substantiated by submitting evidences of the ownership of each underlying company before acquisition and the amounts of subsidiary securities issued to the owners of the underlying companies.

It is possible that the market value of the stock of the parent or holding company does reflect the value of the properties acquired, but if this is true, it will be necessary to establish the value of these properties by the methods outlined above. It appears to me that the most important feature in this case is the allocation of the properties to the four subsidiaries, and before it will be possible to place a value on the producing properties it is absolutely essential that the unit be provided with information to show what properties were transferred to it.

It is therefore suggested that a conference be arranged with the representatives of this taxpayer and they be requested to furnish the information and data necessary to prove the values of these properties as at April 29, 1916.

J. G. BRIGHT,
Assistant Deputy Commissioner.

EXHIBIT 2

Sinclair Oil & Gas Co., depletion on cost of leases purchased for stock

[Does not include development costs]

Name of lease	Location	Date	Posted price	Reserves (barrels)	Depletion unit on cost of lease	Per cent of posted price
Adams, No. 108	Kansas	Sept. —, 1916	$1.20	1,045,847	$0.9230	78.6
Furman, No. 114	do	Oct. —, 1918	2.25	143,910	.6371	28.3
Linn, No. 119	do	July —, 1916	1.52	593,347	.4168	27.4
Penley, No. 120	do	Dec. —, 1916	1.15	264,879	2.0564	178.2
Skaer, No. 122	do	do	1.15	149,229	1.342	116.9
Starkey, No. 123	do	do	1.15	196,646	1.2711	171.0
Brentmell, No 25	Cleveland, Okla	May 1, 1916	1.55	221,181	.746	48.1
Craig, No. 28	do	do	1.55	192,586	.826	71.8
Gibbons, No. 30	do	do	1.55	201,292	.760	49.0
Giffins, No. 31	do	do	1.55	113,243	.796	51.4
Mullendon, No. 35	do	do	1.55	163,979	.568	36.7
Jefferson, No. 6	Bald Hill	do	1.55	285,880	.634	40.9
Jackson, No. 55	Cushing	do	1.55	480,900	.806	52.0
Kolvin, No. 62	do	do	1.55	887,600	.828	53.4
Manuel, No. 68	do	do	1.55	1,108,100	.779	51.5
Stall, No. 76	do	do	1.55	203,586	.646	47.7
Waroche, No. 80	do	do	1.55	267,300	.740	47.7
Yorgee, No. 83	do	do	1.55	468,800	.707	45.7
Ardworth, No. 86	Healdton	do	1.15	791,918	.513	44.6
Huxie, No. 91	do	Dec. —, 1916	1.15	270,000	.569	49.4
Westheimer, No. 100	do	May 12, 1916	1.55	1,320,803	.520	33.6
Davis, No. 188	Stone Bluff	do	1.55	546,239	.790	50.9
Gray, No. 190	do	do	1.55	154,456	.713	46.1
Reynolds, No. 192	do	May 1, 1916	1.55	121,699	.246	15.9

EXHIBIT 3

Comparison of reserves as set up by taxpayer and reserves allowed by the bureau

[Leases in excess of 50,000 barrels]

Name of lease	Location	Reserves	
		Taxpayer	Bureau
		Barrels	*Barrels*
W. J. Crockett	Texas	1,006,466	1,006,466
J. B. Stuart	Stevens County, Tex	142,052	142,052
E. Reynolds, No. 192	Stone Bluff, Okla	121,699	121,699
S. M. Daniels	Texas	119,980	119,980
J. W. Davis	North Texas	383,317	170,714
T. J. Earnest	do	1,165,514	570,355
T. V. Henderson	do	143,160	109,862
C. Martin	do	149,893	133,077
Osage, No. 154	Oklahoma	158,644	158,644
Osage, No. 64	do	653,164	969,092
Osage, No. 68	do	110,135	117,818
Osage, No. 70	do	523,125	448,585
Osage, No. 81	do	304,553	255,419
Osage, No. 90	do	822,502	780,997
Russell Davis	do	378,166	378,166
F. A. Manning	Texas	58,514	58,414
R. M. Rogers	do	76,061	76,061
J. R. Smith	do	56,628	56,628
W. L. Thornton	do	93,905	93,905
B. L. Danley & Bro	do	67,911	67,911
Osage, No. 22	Osage, Okla	56,905	56,905
Osage, No. 96	do	98,165	98,165
E. E. Gray		95,050	95,050
D. Morrison, Nos. 2 and 137	Oklahoma	96,917	138,889
D. Morrison, Nos. 1 and 136	do	42,256	90,277
L. Holman	Carter County, Okla	556,403	556,403
I. Keck, No. 92	do	168,361	145,750
F. Lohman	do	391,076	391,076
Million & Thomas	do	1,003,292	1,172,383
J. S. Mullen	do	406,779	456,351
E. T. Richards	do	555,244	482,485
T. S. Arrington, No. 102	do	337,049	397,365
T. S. Cochenam, No. 103	do	237,201	189,511
L. Holman	do	78,587	78,587
T. S. Mullen, "A"	do	450,481	450,481
Osage Homing	Osage County, Okla	4,993,738	5,780,738
Ardworth, No. 86		791,918	791,918
J. L. Bryan et al., No. 319	Gulf coast	364,655	364,655
J. L. Bryan heirs, No. 513	do	1,696,714	1,696,713
E. H. Jackson	do	57,119	57,119
Masterson irrigation, No. 516	do	1,176,828	1,176,828
Masterson trustee, No. 543	do	196,716	196,716
E. Thomas	do	180,219	180,219
A. L. Woodward	do	191,531	191,531
E. Williams	Bald Hill, Okla	113,929	101,547
E. Butts	do	85,647	97,410
M. Heblison	Blackwell, Okla	76,415	77,675
G. Brentnell, No. 25	Cleveland, Okla	252,240	221,181
J. B. Booker, No. 27	do	92,583	86,181
P. B. & W. J. Craig	do	192,586	192,586
A. C. Gibbons	do	228,985	201,292
F. Gifford	do	135,321	113,243
Maskrod	do	88,229	70,804
Mullendere	do	189,594	163,979
W. H. A. Williams	do	84,326	82,785
S. M. Boone, No. 40	Cushing, Okla	50,130	45,912
R. Bruner	do	753,385	732,250
S. Dacon	do	1,069,783	1,480,000
H. Dunson	do	1,167,650	1,817,200
Q. V. Jackson	do	347,639	480,900
Jemima	do	79,222	75,000
L. Keys, No. 60	do	1,552,381	2,370,000
J. Kechel, No. 61	do	301,283	441,300
L. Kelvin, No. 62	do	696,467	887,600
J. B. Lapham, No. 63	do	313,019	488,000
S. Long, No. 65	do	502,357	667,100
E. Lowe, No. 66	do	55,253	81,900
R. Manuel, No. 68	do	979,914	1,108,100
R. Mickey, No. 69	do	202,384	276,100
H. Mitchell, No. 70	do	91,103	85,975
W. Hoffer, No. 71	do	211,378	309,600
J. W. Powell, No. 72	do	773,466	1,248,000

Comparison of reserves as set up by taxpayer and reserves allowed by the bureau—Continued

Name of lease	Location	Reserves	
		Taxpayer	Bureau
		Barrels	*Barrels*
Wm. Stoll, No. 79	Cushing, Okla	130,813	203,586
I. Wacoche, No. 80	do	171,720	267,300
J. Wocoche, No. 81	do	60,685	63,000
M. Yarges, No. 83	do	320,008	468,800
G. Ansley, No. 84	Healdton, Okla	296,859	320,902
Apple-Fronkige, No. 85	do	689,293	535,365
Huxie, No. 91	do	369,455	270,000
Urbann, No. 99	do	66,674	66,674
S. Westheimer, No. 100	do	2,284,589	2,540,000
J. B. Adams, No. 108	Kansas, Okla	996,755	1,045,847
T. E. Dempsey, No. 110	do	74,045	74,045
J. C. Dillenbeck, No. 111	do	305,343	305,343
O. A. Furman, No. 114	do	140,475	143,910
J. W. Hazlett, No. 115	do	91,878	91,878
W. H. Linn, No. 119	do	666,468	593,347
F. H. Penley, No. 120	do	264,879	264,879
C. S. Kaer, No. 122	do	211,678	149,229
J. W. Starkey, No. 123	do	216,592	196,646
R. A. Nelson, "A"	Bull Bayou, La	168,066	168,066
Osage Wyoming	Wyoming	184,677	184,677
Salt Creek	do	2,193,307	2,310,311
M. Austin, No. 1	Garber, Okla	1,039,739	313,362
F. M. Belveal, No. 4	do	456,304	647,218
T. Campbell, No. 7	do	1,345,413	1,166,192
L. Crews, Nos. 2 and 11	do	193,695	333,962
Louisa, No. 13	do	319,016	366,069
J. Dively	do	47,149	50,232
C. K. Walker, Nos. 1 and 39	do	764,814	525,810
Total		45,506,451	48,742,170

EXHIBIT 4

Sinclair Consolidated Oil Corporation and subsidiaries income-tax return, June 30, 1918

1. Gross sales		$55,017,618.23
2. Cost of goods sold		38,659,326.41
		16,358,291.82
Other income:		
3. Operating and trading	$870,170.36	
4. Interest United States securities	2,754.93	
5. Interest other sources	3,896,930.42	
6. Rentals	28,499.14	
10. All other income	8,448.03	
		4,819,902.38
		21,174,194.80
Deductions:		
12. Ordinary expenses	5,317,715.29	
14. Repairs	774,449.55	
15. Interest	5,537,048.21	
16. Taxes	344,863.47	
17. Debts	54,309.78	
18. Exhaustion	1,698,797.09	
20. Depletion	4,300,651.15	
		18,027,834.54
		3,146,360.26
Net taxable income		3,048,959.34
Total tax		267,874.24

Exhibit 5

Sinclair Consolidated Oil Corporation and subsidiaries income-tax return, June 30–December 31, 1918

Item		
1. Gross sales		$42,947,297.42
2. Cost of goods sold		31,090,331.85
		11,856,965.57
Other income:		
3. Operating and trading	$244,010.54	
4. Interest, United States securities	16,745.16	
5. Interest, other sources	1,824,973.62	
6. Rentals	34,580.50	
10. All other income	55,948.87	
		2,176,258.32
		14,033,224.25
Deductions:		
12. Ordinary expenses	3,250,582.72	
14. Repairs, etc	555,052.32	
15. Interest	2,811,665.30	
16. Taxes	208,590.37	
17. Debts	70,085.32	
18. Exhaustion	1,389,074.47	
19. Amortization	1,740,588.39	
20. Depletion	1,816,768.57	
		11,843,307.46
Net income		2,189,916.80
Net taxable income		1,938,849.09
Total tax		230,532.47

Exhibit 6

Sinclair Consolidated Oil Corporation and Subsidiaries—Income Tax Return Year 1919

Item		
1. Gross sales		$124,852,392.27
2. Cost of goods sold		92,769,904.81
		32,082,487.46
Other income:		
3. Operating and trading	$4,440,232.85	
4. Interest United States securities	64,450.27	
5. Interest other sources	7,797,192.25	
6. Rentals	493,976.12	
10. All other income	136,180.63	
		12,932,032.12
		45,014,519.58
Deductions:		
12. Ordinary expenses	14,750,966.20	
14. Repairs	2,291,900.87	
15. Interest	10,948,288.88	
16. Taxes	1,130,100.24	
17. Debts	256,905.65	
18. Exhaustion	4,979,810.11	
19. Depletion	6,790,338.92	
		41,348,310.87
		3,666,208.71
22. Sale capital assets, loss		150,755.82
24. Net income		3,515,452.89
Net taxable income		3,447,504.35
Total tax		344,750.44

Mr. MANSON. I wish to call attention to another case, the report of which shows that the valuation is manifestly based upon subsequent production. I do not want to go into detail in regard to it. That is really the only point that is brought out in it.

The CHAIRMAN. What case is that?

Mr. MANSON. That is the case of the California Petroleum Corporation.

(The report submitted in case of the California Petroleum Corporation is as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT,
May 2, 1925.

Memorandum to: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.

Attached herewith is a brief report on the California Petroleum Corporation. Two points may be brought out on this case, namely, that the valuation March 1, 1913, was based on subsequent production to the close of 1922. Second, that the valuaton allowed by the department was based upon a report prepared by an ex-employee, Mr. Louis H. Evans, who had not been out of the department more than six months when he filed his valuation report.

Treasury Circular No. 230 prohibits ex-employees from appearing in cases wherein claims are involved within a period of two years after separation from the department. This is submitted simply as one instance, showing how Treasury Circular 230 is not strictly adhered to.

Respectfully submitted.

A. H. FAY, *Consulting Engineer.*

EXHIBIT B

CALIFORNIA PETROLEUM CORPORATION

This corporation is operating in California, with a number of subsidiaries, and as in the case of the Union Oil Co., its March 1, 1913, value is based upon a low price of oil at that date, and the future production is valued on the basis of a rising scale of prices. For example, one of the principal properties of the American Oil Fields Co., a subsidiary, on March 1, 1913, a valuation was determined on the basis of 49 cents per barrel, with 5 cents per year increase to a maximum of 94 cents. Production costs were estimated at 5 cents per barrel in 1913, which was gradually increased to 60 cents per barrel in 1922. This particular property contained 86 wells at date of valuation, with approximately 480 acres of proven oil lands. The reserves estimated as of March 1, 1913, were 32,897,000 barrels. In making this estimate, it must be borne in mind that the actual production figures from March 1, 1913, to December, 1922, were available. This particular property had produced prior to March 1, 1913, approximately 6,000,000 barrels. From March 1, 1913, to the close of 1922 it produced 19,700,000 barrels, so that it only remained to estimate what would be produced after 1922, which amount is set up as approximately 13,000,000.

In making this valuation the taxpayer not only had the advantage of nine subsequent years of production, but he introduced no hazard with respect to dry wells, while he admits that approximately 55 additional wells must be drilled to extract all of the oil. No production hazard was introduced, nor has there been given any consideration to a possible profit factor for a prospective purchaser. The discount rate is 10 per cent applied to a midyear production.

On November 7, 1923, the California Petroleum Corporation addressed a letter to Mr. John F. McCormack, a former employee of the department, care of

the American Petroleum Institute, 15 West Forty-fourth Street, New York City, in which was taken up the matter of invested capital and discussed the basis on which it desired to establish its invested capital. The letter states:

"If the department refuses to grant us invested capital based on the market value of stock at date of organization. * * *

"When you get back to New York please take the matter up with Mr. Mattison and get his views on the subject and then take the matter up again at Washington, in order that this question can be definitely settled."

VALUATION REPORT BY FORMER GOVERNMENT EMPLOYEE

In connection with the valuation of the properties of the California Petroleum Corporation, the valuation reports upon which depletion has been determined were prepared by Mr. Louis H. Evans, former valuation engineer in the oil and gas section. He resigned from this section early in 1923, and on September 7, 1923, filed his valuation report with the department, said report being signed by Evans August 22, 1923. On September 11, Mr. Evans, in conjunction with Mr. John F. McCormack, a representative of M. W. Mattison of the American Petroleum Institute, had an informal conference in the valuation section regarding the valuation report filed. The records of the department indicate that the original Form O containing valuation data was received in November, 1921, with production statistics to the close of 1920. The information filed was not sufficiently complete to determine the proper amount of depletion, and on December 28, 1922, an assessment letter was mailed to the taxpayer showing an additional tax of $465,685.71, which tax is now under protest.

The files of this case were in the oil and gas section, in which section Mr. Louis H. Evans was employed, and yet within a period of six months from the time he left the department he filed an exhaustive valuation report for this taxpayer and was accorded hearings, all of which is in violation of Treasury Circular No. 230.

EXHIBIT C

The following entries are taken from a diary kept by F. K. Baxter, engineer in California subsection, oil and gas section:

"October 16, 1924. Informal conference with L. N. Evans and Moss, Weedy, Roger, Frazer, Mills. F. H. B. declined to attend.

"W. N. T. talked about Evans' plea for greater concession as to price of oil to be used in making engineering appraisals. Expressed opposition, but said his mind is open, which means Evans will get approximately what he is asking for.

"October 17, 1924. Moss in conference with Stewart, vice president, and Evans, engineer for California Petroleum Corporation. While Evans appeared nominally as taxpayer's engineer, he was permitted by Campbell to argue case with Government representatives, even though he is not enrolled.

"October 27, 1924. Moss again asked Thayer what right Evans has to argue the case since he is not enrolled in the department and is not an employee of the taxpayer in the true meaning of the word. Thayer told Moss he had seen Mr. Stewart earlier in the day and had told him that Evans can not argue the case, but can act only in an advisory capacity to Mr. Stewart.

"Moss in conference on California Petroleum Co. represented by Stewart, vice president, with Evans as his engineer. Evans had just as much effect on the conference as if he had been allowed to appear as taxpayer's representative, for he heard all the discussion, entered into it, and either through the vice president as mouthpiece, or directly, argued the case.

"October 28, 1924. Moss and F. K. B. told J. C. that Evans has no right to argue case of California Petroleum Corporation until enrolled. J. C. says W. N. T. called up committee on enrollment who told him it is better to allow Evans to argue case without enrollment than with enrollment. No explanation of this apparent absurdity.

"October 29, 1924. Evans taking full part in conference of California Petroleum Corporation.

"October 30, 1924. Moss in conference on California Petroleum Corporation case, Evans and McCormick representing taxpayer.

"October 31, 1924. Moss in conference with California Petroleum Corporation, Evans and McCormick representing taxpayer.

"November 3, 1924. Moss and Cullen in conference with California Petroleum Corporation. Evans representing taxpayer."

Mr. MANSON. I have a report on the Shell Oil Co. The principal point that I see in this case is the use of an anticipated increase in the price of oil as the basis for a discovery valuation as of the date of discovery.

I will present that report as an exhibit.

(The report submitted by Mr. Manson in case of the Shell Oil Co. is as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT,
March 26, 1925.

To: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: The Shell Co.

Attached herewith is a discussion of the case of the Shell Co., wherein the principal question involved is the matter of valuation of the property at date of acquisition.

This is a case where 9,000 acres of oil land, on which there were 113 producing wells, was purchased for stock in 1915. The taxpayer claims a valuation which is practically equal to the par value of the stock, but in accordance with regulations the value of the stock in this particular case must be determined by the value of the assets, which is conceded by the oil and gas section.

This case has been pending for a number of years. In fact, no tax settlement has as yet been made for the years 1916 to 1918, inclusive. The contention of the bureau is that the case would have been closed some time ago had it not been for a disagreement on the part of valuation engineers as to the value of the property turned in for stock.

Mr. Baxter, who had charge of the California section in the oil and gas valuation section, places values at $7,500,000 to $10,000,000, as compared with $12,366,156 claimed by the taxpayer. Mr. Baxter was supported by one other engineer, who placed the value at $9,880,000. The taxpayer's claim was supported by John F. McCormack and accepted by Mr. Pelton, valuation engineer, and approved later by Messrs. Griggs and Shepherd, special conferees, and Mr. Thayer, chief of oil and gas section. On this basis the case has been sent to audit for the years 1916 to 1918, inclusive. As late as January 12, 1925, the audit division has requested certain additional information from the revenue agent in charge at San Francisco before the case can be closed.

This case shows on its face a series of delays resulting from various causes and a failure to close even within the statutes of limitation without securing waivers for the continuation of the case. A revenue agent's report in the case under date of September 23, 1924, shows no tax due for 1916, 1917, and 1918.

Year	Gross income	Tax paid, original return	Depletion claimed (returns)	Depletion claimed (Form O)	Depletion allowable (basis Jan. 16, 1924)
1915	[1] $1,882,000		[1] $62,703	[1] $560,639	[2] $5,684
1916	3,901,000	$17,307	1,226,976	869,443	865,661
1917	9,803,000	135,041	1,572,909	1,159,130	1,147,061
1918	14,567,000	786,882	1,307,555	1,251,480	1,239,267
Total			4,170,163	3,840,692	3,257,671

[1] Full year. [2] 1 month.

On the basis of the valuation agreed to January 16, 1924, there will result an additional income of approximately $900,000 by reason of excess depletion deducted on the original returns. The taxpayer has three refund claims pending for the year 1916, aggregating about $13,000.

This case also shows the use of an increasing price of oil for valuation purposes instead of the price at date of valuation, hence inconsistency on the part of the unit.

Respectfully,

——— ———, *Consulting Engineer.*

EXHIBIT B

THE SHELL OIL CO.

The question involved in the Shell Co. case is the matter of valuation of oil lands at date of acquisition, December 3, 1915, as a basis of tax determination for the years 1916, 1917, and 1918. This valuation will also be a basis for income taxes for succeeding years.

The land purchased comprised 9,320 acres, on which were 113 producing wells, 105 abandoned or suspended wells, 1 well being drilled and sufficient undrilled (probable oil-bearing ground), acreage for 292 additional wells. The production prior to the purchase of this property was 42,717,551 barrels. The total production to the close of 1918 was 73,645,909 barrels.

The consideration for which this property was acquired was $500 in cash and $12,999,500 in stock. Of this amount $12,994,107 was applicable to oil land and equipment at the rate of $1,394 per acre. Inasmuch as stock was given for tangible assets, the value of stock therefore should be determined on the basis of the value of the assets acquired therefor (Exhibit 1). The taxpayer's estimated reserves as of date of purchase were 67,300,000 barrels, which, together with the actual production from 1900 to 1915, makes the original reserves 110,017,551 barrels. The taxpayer's first presentation of values had been tentatively approved, first, by Norval White at $12,730,000; second, by Ralph Wardwell at $12,491,398. The taxpayer's third and last set-up for oil reserves was accepted by Mr. H. A. Pelton, valuation engineer, as $12,336,156, and approved by Messrs. Griggs and Shepherd, special conferees.

In the matter of valuation of this property there was a disagreement on the part of the engineers in the bureau as to what the proper value should be. Mr. F. K. Baxter placed one valuation on the property at the maximum price at which sales had occurred, at $10,165,750. An analytical appraisal was made by Valuation Engineer Percy L. Ports, placing the value at $9,880,712. Mr. Baxter's contention was that the taxpayer's claim was much too large by reason of the operating costs being entirely too low. Mr. Baxter prepared one valuation based on an analytical appraisal, accepting the taxpayer's estimated reserves but modifying the valuation by introducing operating costs which he considered in keeping with other companies and with actual field conditions. Upon this basis he determined the value of $9,637,994. A second valuation based on an analytical appraisal by Mr. Baxter, wherein he revised the taxpayer's estimate of reserves and used what he considered the proper lifting cost, and with these two changes he arrived at a value of $7,230,814.

Revision of reserves.—In connection with the revision of the taxpayer's estimate of reserves it will be noted in Exhibits 6c and 6d that the Shell Co.'s average future production curve is approximately a straight line, which would give reserves far in excess of what could be expected after all drilling had been done. In Exhibit 6d Mr. Baxter has plotted a curve for the Coalinga field, using field data compiled and published in the Oil and Gas Manual (Treasury Department), which shows a far different curve for future production than that assumed by the Shell Co. Estimating the future production on the basis of the Oil and Gas Manual curve, the reserves amount to 54,378,813 (Exhibit 6b) barrels, as compared with 66,963,600 (Exhibit 6a) barrels as set up by the taxpayer, or a difference of 12,500,000 barrels.

In connection with the Oil and Gas Manual curve it should be stated here that the data for this curve were compiled by the engineers of the United States Bureau of Mines from well records submitted to the Treasury Department by the various operating companies. This curve is not a theoretical curve as to what the well should do in this field, but it is based upon the actual production of many wells over a period of years, and, as stated above, it was prepared by engineers of the Bureau of Mines absolutely independent of any organization, either collecting or paying taxes. The curve data compiled by the Bureau of Mines was accepted as authentic by the Treasury

Department and published by the department as a guide for estimating the future production of oil wells. Mr. Baxter's second valuation ($7,230,814) would therefore appear to be more nearly in accordance with Treasury Department regulations than any other valuation that had been set up, although it is $5,000,000 less than what the taxpayer claimed and was allowed. There is one criticism which might be directed to Mr. Baxter's second valuation, in fact, to all of his valuations, in that he has used a 10 per cent discount factor to determine the present worth, when as a basis for determining a value as between a willing buyer and a willing seller, undoubtedly a larger discount factor should have been used. The 10 per cent discount factor, however, is in accordance with bureau practice, and, of course, Mr. Baxter could not use any other factor.

Market price of oil.—Another point in determining the value of these properties by an analytical appraisal is the matter of market price of oil. The California crude oil in question is heavy, with a gravity of 21° to 22° Baumé, and as such does not command the high price that Oklahoma or eastern oil receives. The market price of California crude oil on March 1, 1913, was 50 cents per barrel for 21° to 23° oil. The price of this oil October 3, 1914, to November 20, 1915, was 40 cents per barrel. From November 20, 1915, to December 28, 1915, the price was 45 cents per barrel. From that date on it increased at intervals (5 cents to 10 cents per barrel) until June 7, 1917, when it reached 92 cents per barrel, and July 10, 1920, $1.70 per barrel. On July 25, 1922, the price was 73 cents per barrel or 2 cents under price used by Baxter (75 cents) for that year. The prices over this period of seven years were without any radical fluctuations.

The valuation by Mr. Baxter starts with 45 cents for the production of oil during the year 1916. The price then is stepped up 5 cents per barrel per year until 1925, when the maximum price is estimated as 90 cents per barrel, and future production to the close of 1940 is valued on the 90-cent basis. Whether the price basis used is right or wrong, it is not in conformity with the bureau's practice in other fields. As has been developed in previous hearings, it has apparently been the practice of the bureau to utilize the posted price of oil as the basis of calculation as of any particular date, either for discovery or acquisition. While Mr. Baxter uses a uniform increment of prices over a period of years, he has been consistent in that he has also increased his operating costs proportionately. For example, for 1916, he estimated the operating cost as 15 cents per barrel, the market price 45 cents per barrel . While in 1925, he estimates the operating cost of producing oil as 63 cents and the expected price of oil as 90 cents per barrel.

Taxpayer's valuation allowed.—The valuation prepared by Mr. Baxter, valuation engineer, oil and gas section, were not satisfactory to the taxpayer. Since the taxpayer would not accept any of the lower valuations, he called on Mr. J. F. McCormack, local representative of Mr. M. W. Mattison, accountant, and tax advisor for the American Petroleum Institute. After a number of conferences, one of which was held January 16, 1924 (Exhibit 2), it was finally agreed to allow the taxpayer the set-up claimed by Mr. McCormack and the taxpayer, of $12,336,156. Regarding the taxpayer's appraisal as presented by Mr. McCormack, Mr. A. W. Thayer, chief of oil and gas section, on May 1, 1924 (Exhibit 3), states that—

"On January 16, 1924, the company submitted a poorly prepared analytical appraisal to support its contentions, this appraised value being $12,366,156."

In the same communication Mr. Thayer states:

"Analytical appraisals, unless made with great care, and giving due weight to essential factors are not reliable indices for value. Regulations 62 very properly state that an appraisal by the analytical method shall not be used if any other method is available."

Mr. Thayer admits that sales of other properties in the vicinity indicated a value of about $10,500,000. On May 1, 1924 he submitted the case (Exhibit 3) to the special conferee for adjudication and on May 2, 1924 (Exhibit 4), Messrs. Griggs and Shepherd, special conferees, prepared a memorandum recommending that the case be closed upon the valuation presented by Mr. McCormack, and accepted by Mr. Pelton, which Mr. Thayer admits was "a poorly prepared analytical appraisal." On May 6, 1924 (Exhibit 5), Mr. E. H. Finch, valuation engineer, prepared a valuation memorandum in accordance with instructions from Messrs. Griggs, Shepherd, and Thayer under date of May 2, 1924. On the basis of this valuation the case was sent to audit for 1918 and previous years.

It will be seen that the taxpayer's claims were thus allowed in the face of six valuations, each of which was less than $10,000,000. The average of the six valuations was $8,929,118. It might also be said that before this agreement (Exhibit 2) was arrived at, Mr. Baxter had been sent to California to make a brief survey of this particular property and to interview the officials of the company at the San Francisco office. Before he returned, however, on January 22, 1924, the conference of January 16, 1924 had been held and the taxpayer's claims for valuation allowed.

Delay.—Although this company submitted Form L schedules to the unit in October, 1919, and these were followed up by a revenue agent's report dated November 30, 1919, and submission of Form O data in 1923, this case still remains open. Mr. Thayer states that efforts by the oil and gas section to close this case during the past year have been prevented largely by a disagreement between the subsection chief in charge of California valuation section and one of the engineers in the section, over the matter of valuation of the companies' properties.

A statement regarding this case, including analytical, sales-acreage and stock discount valuations by Mr. Baxter is appended hereto as Exhibit 6.

EXHIBIT 1

In re: Shell Co. of California, San Francisco, Calif.
Mr. THAYER,
Chief, Oil and Gas Valuation Section.

It is recommended that the assets acquired from the California Oilfields (Ltd.) and the American Gasoline Co. in 1915 by the Shell Co. of California be valued as of the actual date of transfer December, 1915, disregarding the fact that by the terms of the contract of sale the results of the business carried on by the predecessor concerns from January 1, 1915, to date of transfer were to be taken over by the successor.

It is considered that the amount of cash and stock (issued at an agreed market value based upon quotations of sales on the London Stock Exchange) paid by the Shell T. & T. Co. in 1913 to the stockholders of the California Oilfields (Ltd.), can not be taken as determinative of the value of the assets of the California Oilfields (Ltd.), acquired by the Shell Co. of California in 1915 in exchange for its stock. The necessity for a valuation as of December, 1915, is apparent when the possibility is considered that prospective oil-producing lands as of 1913 may have been proven either worthless or oil-producing prior to December, 1915.

The sales of stock of the Shell Co. of California for cash are not indicative of the actual value thereof, for the reason that such sales were made only to the Anglo-Saxon Petroleum Co. and there was no change of beneficial interest.

H. O. HARRIMAN,
Reviewer.
ROBT. P. SMITH,
Chief, Review Section.

Approved.

S. N. G.,
Head Nat. Res. Division.

JULY 10, 1923.

EXHIBIT 2

TAXPAYER'S CONFERENCE, OIL AND GAS SECTION

JANUARY 16, 1924.

Taxpayer: Shell Co. of California.
Address: San Francisco, Calif.
Represented by: W. M. Smith, J. F. McCormack.
Credentials: Enrolled in department; power of attorney on file for Mr. Smith only.
Matter presented: Valuation of properties acquired for stock as of December 3, 1915.
Issues discussed: Values and reserves of properties in the Coalinga field, California, acquired by taxpayer for stock December 3, 1915.

Conclusion:

Value of oil	$12, 336, 156. 87
Plant and equipment	3, 403, 713. 19
Value property	15, 739, 870. 06
Recoverable reserves.......barrels	67, 000, 000

The above values are agreed upon to represent the value of the assets acquired for stock December 3, 1915.

Interviewed by H. A. Pelton.

A. W. THAYER,
Chief of Section.

EXHIBIT 3

ENGINEERING DIVISION—OIL AND GAS SECTION

MAY 1, 1924.

Memorandum to special conferees, engineering division.
In re Shell Co. of California.

Although this company submitted Form L schedules to the unit on October 4, 1919, and these were followed up by a revenue agent's report dated November 30, 1919, and submission of Form O data in 1923, this case still remains open. Efforts by the oil and gas section to close this case during the past year have been prevented largely by a disagreement between the subsection chief in charge of California valuation, and one of the engineers in the section, over the matter of valuation of the companies' properties.

I have personally examined the files of the case, and have come to the conclusion that the claims of the taxpayer are reasonable and should be allowed; however, in order that the case may be considered fairly and impartially upon its own merits as disclosed by the data on file, I am referring it herewith to the division's special conferees for an opinion.

The facts in the case are these:

(1) After the submission of Form L Mr. Norval White (former chief of section, but at that time a valuation engineer), on October 30, 1919, made a superficial examination and allowed depletion at the rate of 19 per cent per barrel. On this basis, the reserves set up in Form L of 70,988,358 barrels were worth $13,487,787.

(2) On December 16, 1920, Mr. Ralph Wardwell reexamined the case and placed a value upon the same reserves of $12,491,398.

(3) Mr. Wardwell on February 6, 1922, sustained this prior valuation subject to revision after complete data had been filed in the matter of intangible development costs.

(4) The matter of charging off intangible development costs was discussed with the auditors of section G March 14 and 15, 1923.

(5) On June 21, 1923, complete Form O data were filed setting up a cost of the oil reserves as of January 1, 1915, at $12,460,332.56.

(6) Since this was a stock purchase the oil and gas section held that the assets acquired must be valued to determine the value of the stock issued for them.

(7) On September 14, 1923, the company submitted a brief showing that a transaction occurring in 1913 between the California Oilfields (Ltd.) and the Shell Trading & Transport Co. clearly reflected the value of the assets later acquired by the Shell Co. of California, and on this basis the value of the oil reserves on January 1, 1915, would be $12,491,582.

(8) On January 16, 1924, the company submitted a poorly prepared "analytical appraisal" to support its contentions, this appraised value being $12,366,156.

(9) On the same date the engineer in charge of the case agreed in conference with the company's representatives that this value reflected the value of the assets acquired, and agreed to close the case on this basis, with a reserve of 67,000,000 barrels, both values and reserves to be as of December 3, 1915, which was held to be the actual date of transfer of the properties.

(10) Subsequent to this the subsection chief in charge of California work vigorously disagreed with the settlement made and submitted an "analytical appraisal" of his own showing a value of the oil reserves to be $9,637,994.

Analytical appraisals, unless made with great care, and giving due weight to all essential factors, are not reliable indices of value. Regulations 62 very properly state that an appraisal by the analytical method shall not be used if any other method is available.

In this case other methods are available. Sales of other properties in the vicinity indicate a value of about $10,500,000, without considering any "en bloc" value; and there are enough transactions in the stocks of the companies involved to reflect the value of the assets with reasonable accuracy, and this value seems to lie between $12,000,000 and $13,000,000, with an estimated reserve of oil between 60,000,000 barrels and 70,000,000 barrels.

A. W. THAYER,
Chief of Section.

EXHIBIT 4

HEAD OFFICE ENGINEER DIVISION,
May 2, 1924.

Attention of Mr. W. N. Thayer, chief of oil and gas section.
Re Shell Co. of California.

The question at issue is the value of the assets finally acquired for the stock of this company of December 3, 1915.

A conference was held with the taxpayer's representatives and the points involved have also been discussed with engineers of the oil and gas section by the undersigned. The facts are covered in your memorandum dated May 1, 1924.

After careful consideration of all facts it is recommended that the case be closed on the basis of the taxpayer's conference memorandum dated January 16, 1924, which shows that an agreement was reached between the taxpayer's representatives and engineer H. A. Pelton and taxpayer allowed recoverable oil reserves of 67,000,000 barrels with a value of $12,336,156.87.

C. C. GRIGGS (signed) C. C. G.,
Assistant Head of Engineering Division.
A. R. SHEPHERD (signed) A. R. S.,
Special Conferee.

(Note in Mr. Thayer's handwriting):

Mr. BAXTER: Please note above recommendation and have this case closed accordingly.

A. W. T.

MAY 3, 1924.

EXHIBIT 5

ENGINEERING DIVISION OIL AND GAS VALUATION SECTION

Fee owners and operators, Shell Co. of California, 343 Sansome Street, San Francisco, Calif.

Incorporated July 30, 1915, California laws.

Taxable years 1915, 1916, 1917, and 1918.

Prior years, none.

Depletion computed on cost as at date of acquisition in 1915 and 1916.

Cost of properties

Year acquired	Name	Amount paid	Physical equipment	Value of oil
1915	(a) Oil fields, Turner and W. K.	$15,739,870.06	$3,403,713.19	$12,336,156.87
1916	(b) British Consolidated	349,859.31	98,795.53	251,063.78
Do	(c) Camwell	93,100.00	54,861.50	38,238.50
1917	(d) Republic and Empire	360,000.00	156,331.31	203,668.69

Price of oil and depletion units at date of acquisition

Property	Price of oil	Depletion unit
	Cents	
(a)	45	$0.184122
(b)	67	.11997
(c)	45	.45685
(d)	99	.17992

Drilling costs charged to expense.

Depletion

Year	Gross income from oil	Depletion claimed (returns)	Depletion claimed (Form O)	Depletion allowable
1915	[1] $1,882,297.12	[1] $62,703.90	[1] $560,639.90	[2] $5,684.69
1916	3,901,050.66	1,226,976.88	869,443.09	865,661.51
1917	9,832,062.96	1,572,909.25	1,159,130.44	1,147,061.12
1918	14,567,174.62	1,307,555.58	1,251,480.51	1,239,267.28

[1] Entire year. [2] December only.

DISCUSSION

The date of acquisition of properties acquired for stock in 1915 has been determined to be December 3. See accompanying memorandum of head of natural resources audit division, dated October 15, 1923.

Taxpayer submitted on September 6, 1923, a brief dealing with pending tax matters which had been investigated by a revenue agent and which were later the subject of conferences on March 14 and 15 and various dates from June 20 to July 18, 1923, as well as on January 16, 1924.

Of the nine points involved and enumerated in the brief, only two affecting allowances for depletion and depreciation remained to be settled. These were (*a*) the treatment of development charges prior to 1916 and (*b*) the cost of properties in the Coaligna field acquired by the taxpayer in 1915. The question regarding development costs has been settled, as stated on page 2 of the brief, the taxpayer charging intangible costs to expense and claiming depreciation at 10 per cent on all tangible costs.

The matter of values and reserves in the Coaligna field properties acquired by taxpayer for stock December 3, 1915, was discussed in conference of January 16, 1924 (see accompanying conference memorandum). The attached schedule shows the depletion computed upon the final determination by this section of values and reserves. Taxpayer's reserves and values on other properties claimed in Form O, submitted on November 19, 1923, have been accepted.

Depreciation rates were in the main settled in the conferences of June 22 to June 26, 1923. In the conference of January 16, 1924, the value of physical equipment was reduced from $6,331,704.85 to $3,403,713.19. The revenue agent's computations should be modified accordingly.

This memorandum is based on special conferees' memorandum dated May 2, 1924, and also upon Mr. W. N. Thayer's memorandum dated May 1, 1924.

Case may be audited and closed as to 1915 to 1918, inclusive

Recommended by E. H. Finch, engineer.

Approved by W. N. Thayer, chief of section.

MAY 6, 1924.

EXHIBIT 6

REPORT TO MR. L. H. PARKER, CHIEF ENGINEER OF THE SENATE COMMITTEE INVESTIGATING THE BUREAU OF INTERNAL REVENUE

[Prepared at the written request, dated February 26, 1925, of Mr. W. N. Thayer, chief of oil and gas valuation section]

Subject: The Shell Co. of California, valuation of oil property as of date of acquisition.

FOREWORD

The writer, in fairness to all concerned, takes this opportunity to state that this report does not contain, and the writer does not intend it to contain, any imputation of unfairness on the part of anyone concerned. Honest difference of opinion may well exist on many questions and, especially, on one of valuation.

The writer has been called upon to supply specified information and to defend his contention that oil value allowed the taxpayer is excessive; and he has done so honestly, fairly and to the best of his ability.

HISTORY

A complete chronological history of the case in its course through the oil and gas valuation section accompanies this report.

DISCUSSION

The taxpayer, having submitted the required Forms L and O data, was requested to come to Washington for conference with representatives of the oil and gas valuation section, and the date of conference was set for June 20, 1923.

Accordingly, conference was begun on said date, the taxpayer being represented by—

Mr. John Lauder, treasurer; Mr. J. C. Burtt, engineer; Mr. W. M. Smith, of Price-Waterhouse; Mr. Watson, of Price-Waterhouse; and the department being represented by Mr. H. A. Pelton, valuation engineer.

On June 23, 1923, the taxpayer's representatives and Mr. Pelton had come to an agreement that the taxpayer's claimed values and reserves as of date of acquisition were substantially correct and Mr. Pelton wrote his conference report of June 23, 1923, accordingly. Preparatory to having it typed, Mr. Pelton submitted his report to the writer for approval; and the latter refused approval on the ground that values claimed were excessive as regards the Coalinga property and contended—

First. That the date of acquisition of the Coalinga property could not be made retroactive by resolutions of the boards of directors of the companies involved.

Second. That the cost of the Coalinga property at acquisition, or the fair market value of the stock exchanged for the assets, could only be determined by valuation of the assets.

Thereupon, the taxpayer enlisted the services of Mr. John F. McCormack, of Mattison & Davey.

The writer referred his contentions to various members of the unit, and in the end, said contentions were sustained. Thus, the questions at issue were narrowed down to the determination of the value of the assets of the California Oilfields (Ltd.) Coalinga oil property as of date of acquisition by the Shell Co. of California, December 3, 1915.

The writer maintained that the best evidence of fair market value is in comparative sales. Therefore, he made the following allocation of the lands in question and applied to each classification of acreage an oil value per acre in excess of any that can be substantiated by actual sales in the Coalinga field.

1,929	acres proven, at $5,000 per acre	$9,645,000
576	acres probable, at $500 per acre	288,000
2,104	acres possible, at $100 per acre	210,400
4,470	acres probably worthless, at $5 per acre	22,350
9,079	Total	10,165,750

This was done to set a maximum and to refute the taxpayer's claimed oil value of $12,460,332.56 as of January 1, 1915.

There followed conferences with the taxpayer's representatives and discussions of the case among members of the unit, and on July 6, 1923, upon complaint from Mr. Smith, of Price-Waterhouse, the commissioner issued instructions to expedite progress of the Shell Co.'s case.

On July 17, 1923, Mr. Greenidge granted the taxpayer 60 days' extension of time to prepare and submit a final brief.

On September 14, 1923, Mr. Smith, of Price-Waterhouse, submitted, in duplicate, copies of a brief entitled "Amended data regarding property, cost, acreage, content, and depletion."

On November 5, 1923, the writer left Washington en route to California to gather oil-field data, get in touch with recent oil-field developments, and incidentally to confer with representatives of the Shell Co. in San Francisco. On November 22, 1923, the writer sent Mr. Thayer a letter from San Francisco and made the following recommendation:

"It is recommended that the assets of California Oilfields (Ltd.) as acquired for stock of the Shell Co. of California be valued as of December 3, 1915, for invested capital and depletion purposes on the basis of—

"$5,000 per acre for proven oil land.
"$500 per acre for probable oil land.
"$100 per acre for possible oil land.
"$5 per acre for other land.

"Also that taxpayer's estimate of recoverable reserves as of December 3, 1915, be accepted."

On January 16, 1924, a conference was held in Washington between W. M. Smith and J. F. McCormack, representing the taxpayer, and H. A. Pelton, representing the Government. In this conference, values and reserves of properties in the Coalinga field, California, acquired by taxpayer for stock, December 3, 1915, were agreed upon as follows:

Value of oil	$12,336,156.87
Plant and equipment	3,403,713.19
Value of property	15,739,870.06
Recoverable reserves (barrels)	67,000,000

On January 22, 1924, the writer arrived in Washington. After several discussions of the case in which he took exception to the engineering appraisal by Mr. McCormack upon which the conference agreement of January 16, 1924, was based, the writer and Mr. Thayer came to an agreement as to the maximum oil value that would be allowed. This was done to expedite the case and end the controversy. Said agreement was based on Mr. Thayer's computation of an average figure, as follows:

Comparison of valuations

Nowal White (tentative)	$12,730,000.00
Ralph W. Wardwell (tentative)	12,491,398.23
H. A. Pelton (taxpayer's accepted)	12,336,156.87
P. L. Ports (appraisal)	9,880,712.40
F. K. Baxter (computed sales)	10,165,750.00
	5)57,604,017.50
	11,520,803.50
Average of all appraisals	11,859,566.00
Value on computed sales basis	10,165,750.00
Value on stock basis	12,460,332.00
	3)34,485,648.00
Net average	11,495,216.00

On March 15, 1924, a hearing on this case was held before the special committee of conferees, composed of Messrs. Griggs and Shepherd. The taxpayer was represented by Messrs. McCormack and Smith; Messrs. Pelton and Baxter represented the Government. Mr. Thayer was present during the latter part of the hearing. The writer made the following statements:

1. That his value of $10,165,750 was the maximum value based on comparative sales and therefore is a check on the unreasonableness of the value of oil $12,336,156.87 as determined by the taxpayer's engineering appraisal and agreed to in the conference memorandum dated January 16, 1924.

2. That he considers the oil value indicated by the taxpayer's engineering appraisal too high because the operating cost used in its determination are much too low.

3. That the case was submitted to Mr. P. L. Ports for umpire valuation and his determination of oil value is $9,880,712.40, which is even lower than the writer's maximum value based on comparative sales.

4. That the average oil value, $11,520,803.50, as determined by Mr. Thayer, lends a weight to the tentative valuations by Mr. White and by Mr. Wardwell and by Mr. McCormack, respectively, equal to the weight accorded the separate valuations by Mr. Ports and the writer. Messrs. White and Wardwell merely accepted the taxpayer's claimed value, tentatively, and Mr. McCormack's valuation practically sustains the taxpayer's claim.

Messrs. Griggs and Shepherd expressed the opinion that inasmuch as the oil value now claimed through Mr. McCormack's appraisal exceeds Mr. Thayer's average value by only 6 per cent (7 per cent in reality) the taxpayer's claimed oil value should be allowed.

Mr. Griggs stated that he would take the case under advisement and would call upon Messrs. Pelton and Baxter for further discussion on Monday, March 17, 1924.

On March 19, 1924, the writer was called before Messrs. Griggs and Shepherd in conference and was requested to personally make an engineering appraisal of the oil property in question.

On April 22, 1924, Messrs. Finch and Baxter, having prepared an engineering appraisal of the Coalinga property, went before Messrs. Griggs and Shepherd to submit and explain said appraisal. After but 15 minutes had been consumed, Mr. Griggs was called into another conference and left, stating that he would call Messrs. Finch and Baxter into conference again the next day. However, he failed to do so, and on May 2, 1924, Messrs. Griggs and Shepherd wrote a memorandum to Mr. Thayer recommending that the case be closed on the basis of the taxpayer's conference memorandum dated January 16, 1924.

ANALYTICAL APPRAISALS—SET-UP FOR THE VALUATION OF $9,637,994 COMPARED WITH THE SET-UP ALLOWED AMOUNTING TO $12,336,156

The engineering appraisal by the writer, showing an oil value of $9,637,994, was set-up on the basis of the drilling program, expected production, and development costs indicated on the taxpayer's engineering appraisal by J. F. McCormack. The expected price of oil was increased from 85 cents to a price of 90 cents for the year 1925 and succeeding years. The operating costs were increased to conform to the taxpayer's own statements and include a portion of the overhead. Accompanying this report are copies of the following listed data.

(*a*) Engineering appraisal No. 1, by F. K. Baxter.

(*b*) Diagram showing relation of lift costs (operating costs) to yearly production.

(*c*) Diagram showing comparison of decline curves.

Reference to diagram (*b*) plainly shows that the lift costs, assumed by the taxpayer in his analytical appraisal, and his set-up of expected oil recovery are mutually inconsistent, as well as inconsistent with knowledge of field conditions. Four major companies, operating fee-owned producing properties adjoining those of the taxpayer in the Coalinga field show the following lift at operating costs, respectively, for the year 1916:

14.84 cents.
23 cents.
12.50 cents.
15 cents.

Reference to diagram (*c*) shows that in his analytical appraisal the taxpayer has assumed a practically stright-line production decline subsequent to the drilled-up condition and through the important productive period of the property's life. This is contrary to actual performance of any oil property. Accordingly the reserves allowed the taxpayer as of December 3, 1915, are excessive, as is the value of oil. In this connection attention is called to page 1 of taxpayer's Exhibit D, Form L, which states:

"Our estimate assumes a total of 406 wells on the property when it is finally drilled up, with a total production of 59,626,000 barrels after January 1, 1915.

"The amount of available oil as of January 1, 1915, reported in Form L, for the years 1915 to 1918, was 70,379,358 barrels and was made January 1, 1919, by E. D. Nolan, of the Shell Co.'s geological staff. This figure was reached by estimating the future as of January 1, 1919, which was 50,060,000 barrels, and adding the previous years' production (1915–1918, inclusive) to this amount. The estimate is larger than the one submitted herewith by reason of the later data available by 1919.

"Detail of the estimate made by Mr. Nolan other than the summary in Form L, already submitted, are lacking and can not, therefore, be supplied.

"Considering the productive history previous to 1915 we do not believe the 1919 figure is entirely justified, since it takes account of subsequent developments by Shell Co. which could not be predicted January 1, 1915. We submit our estimate, which has been carefully made from data available previous to 1915, to show that the 1919 figure is high and should therefore not be increased in arriving at the oil content of the property as of January 1, 1915."

It is noted that the above estimates, just quoted, include reserves for properties outside of the California Oilfields (Ltd.) property. Based on the taxpayer's own data, the reserves of the California Oilfields (Ltd.) property as of January 1, 1916, are 55,730,156 barrels.

COMPARATIVE SALES

The accompanying list of sales and the map entitled "Bona fide transactions of properties in the Coalinga oil field, California, and proven area, 1913, California State mining bureau, Bulletin 69," detail sales of Coalinga oil properties.

It will be observed that the highest price paid for proven and partly developed oil lands in the Coalinga field and, in fact, the highest price (of record in this office) paid for any oil land in said field was that paid for the W. K. and Turner property (see transactions 27 and 28) by the California Oilfields (Ltd.) in August, 1913, as follows:

W. K. Oil Co., 342 acres, at $5,120	$1,750,000
Turner Oil Co., 320 acres, at $4,690	1,500,000
Total (662 acres)	3,250,000

Average maximum price per acre, $4,909.37.

CONCLUSION

In conclusion, the following determination of value of the property in question is made on the basis of—

$5,000 per acre of proven oil land,
$500 per acre of probable oil land,
$100 per acre of possible oil land,
$5 per acre of probably worthless oil land,

using the oil-land classification as indicated on the taxpayer's map labeled "Form L, Exhibit E," but corrected to conform to the taxpayer's amended data filed November 28, 1923.

The taxpayer first reported the total acreage of all of his Coalinga property as 9,320 acres, which included 460 acres in addition to the California Oilfields (Ltd.) lands. Later he amended this figure and reported 9,539 acres, the difference, 219 acres, being made up of 160 acres tank farm site and 50 acres overplus in section 19 that were overlooked in the first computation. This 219 acres was included in the deed to Shell Co. from California Oilfields (Ltd.) and is worthless for oil production.

The 460 acres acquired from others than the California Oilfields (Ltd.) comprises 314 acres of proven land, 46 acres of probable oil land, and 100 acres of possible oil land. Therefore the correct classification of lands purchased from the California Oilfields (Ltd.) is as follows:

	Acres
Proven oil land	2,221
Probable oil land	530
Possible oil land	1,639
Probably worthless	4,689
Total California Oilfields (Ltd.) lands	9,079

The property value of the lands purchased from the California Oilfields (Ltd.) as of December 3, 1915, is therefore determined on the acreage basis, as follows:

2,221 acres proven, at $5,000		$11,105,000
530 acres probable, at $500		265,000
1,639 acres possible, at $100		163,900
4,689 acres worthless, at $5		23,445
Property value		11,557,345
Less:		
Surface value, at $2	$18,158	
Plant and equipment	3,403,713	
		3,421,871
Oil value		8,135,474

It will be noted that this oil value of $8,135,474 includes oil cost of probable, possible, and probably worthless lands to the extent of $438,629 which may not be depleted until oil shall be produced therefrom. It follows that the capital sum returnable through depletion as of December 3, 1915, is $8,135,474 less $438,629, or $7,696,845.

The accompanying analytical appraisal No. 2, by the writer, differs from the one submitted by the taxpayer in that future production subsequent to the year 1920 (when the property is assumed to be fully drilled) has been determined by using the Oil and Gas Manual curve for the east side Coalinga field, the expected price of oil has been increased to 90 cents in 1925 and subsequent years, and the operating costs have been made to include a portion of the overhead. For income-tax purposes an analytical appraisal may be made for proven land only. Therefore, the oil value shown by this appraisal should check the oil value for the proven land as shown by the acreage basis. This comparison shows as follows:

Value determined on acreage basis	$7,696,845
Value determined by appraisal No. 2	7,230,815
Difference	466,030

These two values check within about 6 per cent. It is further noted that the writer's appraisal No. 2 indicates reserves which check very closely with reserves as determined by taxpayer's engineer.

	Barrels
Reserves as of Jan. 1, 1915 (taxpayer's engineer)	59,626,000
Less reserves for sections not in purchase	791,800
	58,834,200
Less 1915 production	3,104,044
Reserves as of Jan. 1, 1916 (taxpayer's engineer)	55,730,156
Reserves as of Jan. 1, 1916 (writer's appraisal No.)	54,378,830
Difference	1,351,326

Reserves as determined by writer's analytical appraisal No. 2 check reserves as determined by taxpayer's engineer within 2½ per cent.

A further indication of the fair market value of the property of the California Oilfields (Ltd.), acquired by the Shell Co. of California on December 3, 1915, is indicated by the following computation based on the taxpayer's data submitted:

Liabilities assumed	$5,753,575.05
Par value of Shell Co.'s stock paid	12,999,500.00
Cash paid	500.00
Value of property as claimed	18,753,575.05

Less:
Appreciation of—
Equipment $2,827,991.66
Stock discount 2,599,900.00
.... $5,427,891.66

Fair market value of property	13,325,683.39
Less equipment	3,403,713.19
Fair market value of oil as of Dec. 3, 1915	9,921,970.20
Less cost of oil outside of proven land	438,629.00
Fair market value of oil in proven land	9,483,341.20

This figure, $9,483,341.20, is comparable to fair market value of oil in proven land as determined by the writer's engineering appraisal No. 1, i. e., $9,637,994.66.

The following summary of valuations affords a clear comparison of results:

Summary of valuations submitted

[A. A. indicates analytical appraisal; S. D. indicates stock discount. (See R. A. R.) Figures in parentheses supplied by writer]

Name of person submitting valuation	Surface value at $2 per acre	Equipment value	Oil value unproven land	Oil value proven land	Property value
Norval White	(1)	(1)	(2)	$12,730,000.00	
R. W. Cardwell	(1)	(1)	(2)	12,491,398.23	----------
[illegible]	(3)	$3,403,713.19	(2)	12,336,156.87	$15,739,870.06
[illegible] Potts, A. A.	($18,158.00)	3,403,713.19	($438,629.00)	9,880,712.40	13,741,212.59
F. K. Baxter, acreage	(3)	(3,403,713.19)	520,750.00	9,645,000.00	13,569,463.19
F. K. Baxter, A. A. *1	18,158.00	3,403,713.19	438,629.00	9,637,994.00	13,498,494.19
F. K. Baxter, acreage	18,158.00	3,403,713.19	438,629.00	7,696,845.00	11,557,345.19
F. K. Baxter, A. A. *2	18,158.00	3,403,713.19	438,629.00	7,230,815.00	11,091,315.19
F. K. Baxter, S. D.	18,158.00	3,403,713.19	438,629.00	9,483,341.20	13,325,683.39
Taxpayer, Form L	(3)	6,331,704.85	(2)	12,460,332.56	18,792,037.41
Taxpayer, A. A.	(3)	3,403,713.19	(2)	12,336,156.87	15,739,870.06

[1] Superficial examination; final review of the case to be made after submission of complete data.
[2] Included proven.
[3] Nominal.

EXHIBITS

Accompanying this report are the following listed exhibits:

(1) Engineering appraisal No. 1.
(2) Engineering appraisal No. 2.
(3) Diagram showing relation of lift costs to total yearly production.
(4) Diagram showing comparison of decline curves.
(5) History of the case of the Shell Co. of California in its passage through the oil and gas valuation section.
(6) Comparative sales data and map, Coalinga field.

OPINION

Finally, the writer desires to state that in his opinion the fair market value of oil contained in the lands which the taxpayer acquired from the California Oilfields (Ltd.) as of December 3, 1915, is as follows:

Oil value, unproven land	$520,570
Oil value, proven land	9,645,000
Total oil value	10,165,570

The taxpayer, by the submission of additional data, may be able to show additional values, such as dry gas and gasoline. He may even be able to prove, by new appraisal methods, that he is entitled to more value than this writer can at present justify. If so, the facts should be considered and adjustment made accordingly.

Respectfully submitted.

F. K. BAXTER,
Valuation Engineer.

MARCH 12, 1925.

Exhibit 6A

Shell Co. set up excepting lift costs

Year	a Wells	b Average well	c Net to taxpayer a×b	d Expected price	e Expected income c×d	f Production costs well year b×g	g Production costs per barrel	h Total production costs c×g	i Drilling and equipment	Net expected income	Present worth 10 per cent, 6/12
		Barrels	*Barrels*								
1916	176	32,095	5,684,800	$0.45	$2,558,160.00	$4,814.25	$0.15	$847,320.00	None.	$1,710,840.00	$1,629,369.80
1917	225	28,105	6,323,600	.50	3,161,800.00	4,777.85	.17	1,075,012.00	$1,813,000.00	273,788.00	237,045.65
1918	254	24,949	6,337,000	.55	3,485,350.00	4,740.31	.19	1,204,030.00	1,073,000.00	1,208,320.00	951,056.59
1919	269	22,359	6,014,600	.60	3,608,760.00	4,695.39	.21	1,263,066.00	555,000.00	1,790,694.00	1,251,313.18
1920	275	20,293	5,580,600	.65	3,627,390.00	4,667.39	.23	1,283,538.00	222,000.00	2,121,852.00	1,380,243.51
1921	275	18,720	5,148,000	.70	3,603,600.00	4,680.00	.25	1,287,000.00		2,316,600.00	1,369,921.41
1922	275	16,905	4,649,000	.75	3,486,750.00	4,564.35	.27	1,255,230.00		2,231,520.00	1,199,665.15
1923	272	15,185	4,130,300	.80	3,304,240.00	4,403.65	.29	1,197,787.00		2,106,453.00	1,029,465.71
1924	271	14,068	3,812,400	.85	3,240,540.00	4,361.08	.31	1,181,844.00		2,058,696.00	914,658.05
1925	263	12,965	3,409,900	.90	3,068,910.00	4,278.45	.33	1,125,267.00		1,943,643.00	785,037.41
1926	255	11,819	3,013,800		2,712,420.00	4,136.65	.35	1,054,830.00		1,657,590.00	608,650.40
1927	246	10,938	2,690,700		2,421,630.00	4,047.06	.37	995,559.00		1,426,071.00	476,036.76
1928	237	10,008	2,372,000		2,134,800.00	3,903.12	.39	925,080.00		1,209,720.00	367,101.63
1929	216	9,360	2,021,800		1,819,620.00	3,837.60	.41	828,938.00		990,682.00	273,299.44
1930	210	8,159	1,713,300		1,541,970.00	3,508.37	.43	736,719.00		805,251.00	201,948.90
1931	189	7,282	1,376,300		1,238,670.00	3,276.90	.45	619,335.00		619,335.00	141,202.19
1932	146	6,202	905,600		815,040.00	2,914.94	.47	425,632.00		389,408.00	80,712.60
1933	114	5,831	664,700		598,230.00	2,857.19	.49	325,703.00		272,527.00	51,352.26
1934	85	5,160	438,600		394,740.00	2,631.60	.51	223,686.00		171,054.00	29,301.55
1935	58	4,864	282,100		253,890.00	2,577.92	.53	149,513.00		104,377.00	16,253.59
1936	41	4,222	173,100		155,790.00	2,322.10	.55	95,205.00		60,585.00	8,577.02
1937	30	3,833	115,000		103,500.00	2,184.81	.57	65,550.00		37,950.00	4,884.17
1938	22	3,109	68,400		61,560.00	1,834.31	.59	40,356.00		21,204.00	2,480.87
1939	15	2,787	41,800		37,620.00	1,700.07	.61	25,498.00		12,122.00	1,289.30
1940	14	2,300	32,200		28,980.00	1,449.00	.63	20,286.00		8,694.00	840.71
			56,963,600						3,663,000.00	25,548,976.00	13,041,707.85
Less physical equipment											3,403,713.19
Oil value											9,637,994.66

EXHIBIT 6B

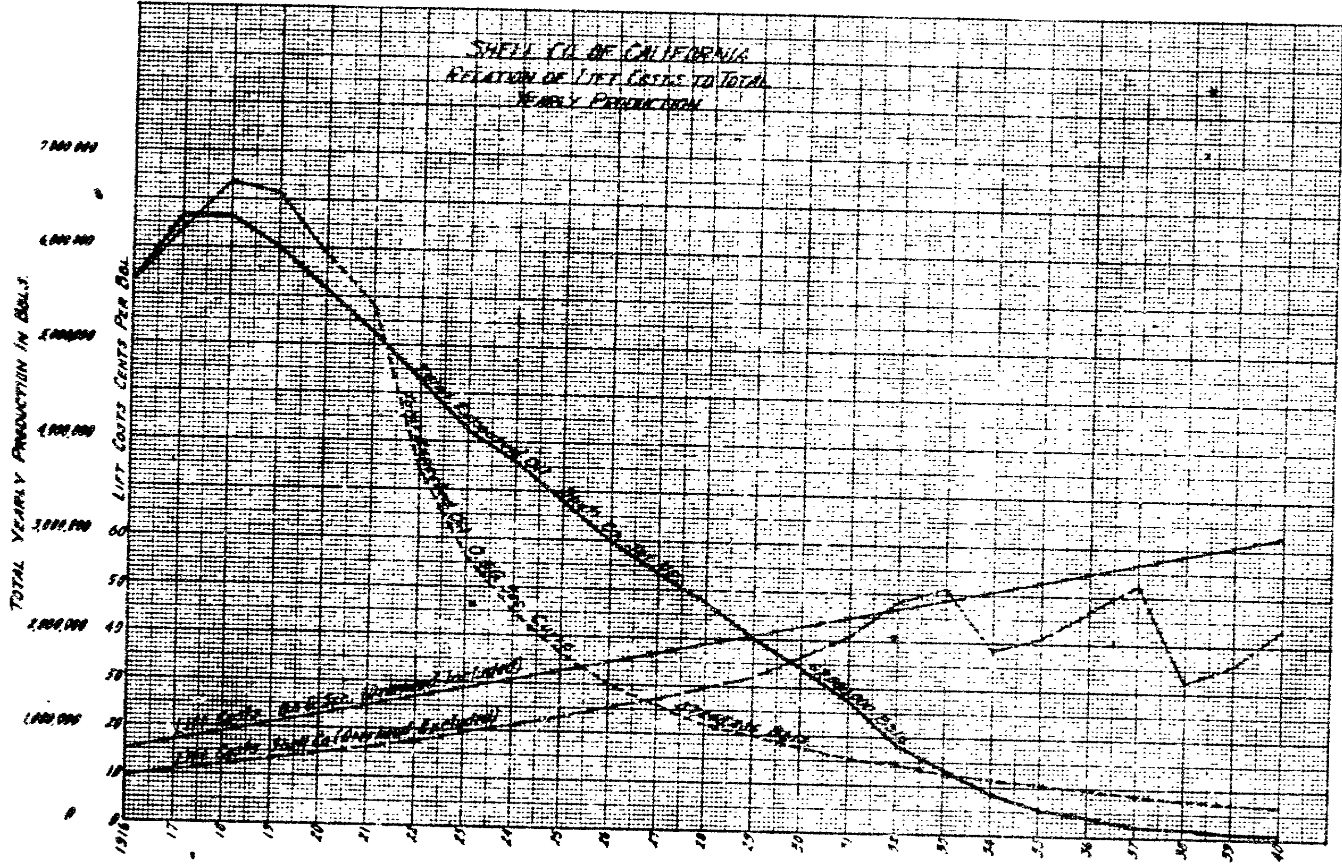
Shell Co.'s set-up with exception of decline curve and lifting costs

Year	a	b	c	d	e	f	g	h	i		
	Wells, Shell Co. set-up	Average well	Net to taxpayer a × b	Expected price	Expected income c × d	Production costs, well year	Production costs per barrel	Total production costs c × g	Drilling and equipment	Net expected income	Present worth, 10 per cent, 6/12
		Barrels	*Barrels*								
1916	176	[1] 32,095	[2] 5,648,800	$0.45	$2,541,960.00	$4,814.00	$0.15	$847,320.00	None.	$1,694,640.00	$1,613,941.24
1917	225	[1] 28,105	[2] 6,323,600	.50	3,161,800.00	4,778.00	.17	1,075,012.00	[2] $1,813,000.00	273,788.00	237,045.55
1918	254	[1] 24,949	[2] 6,337,000	.55	3,485,350.00	4,740.00	.19	1,204,030.00	[2] 1,073,000.00	1,208,320.00	951,056.59
1919	269	[1] 22,359	[2] 6,014,600	.60	3,608,760.00	4,695.00	.21	1,263,066.00	[2] 555,000.00	1,790,694.00	1,381,313.18
1920	275	[1] 20,293	[2] 5,580,600	.65	3,627,390.00	4,667.00	.23	1,283,538.00	[2] 222,000.00	2,121,852.00	1,390,243.51
1921	275	[1] 16,000	[2] 4,400,000	.70	3,080,000.00	4,000.00	.25	1,100,000.00		1,980,000.00	1,170,873.00
1922	275	[1] 13,000	3,575,000	.75	2,681,250.00	3,510.00	.27	965,250.00		1,716,000.00	922,521.60
1923	272	[1] 10,750	2,924,000	.80	2,339,200.00	3,118.00	.29	847,960.00		1,491,240.00	728,798.81
1924	271	[1] 9,200	2,493,200	.85	2,119,220.00	2,852.00	.31	772,892.00		1,346,328.00	596,160.07
1925	263	[1] 7,900	2,077,700	.90	1,869,930.00	2,607.00	.33	685,641.00		1,184,289.00	478,334.33
1926	255	[1] 6,900	1,759,500		1,583,550.00	2,415.00	.35	615,825.00		967,725.00	355,338.94
1927	246	[1] 6,100	1,500,600		1,350,540.00	2,257.00	.37	555,222.00		795,318.00	265,485.10
1928	237	[1] 5,450	1,291,650		1,162,485.00	2,126.00	.39	503,744.00		658,741.00	199,901.54
1929	216	[1] 4,900	1,058,400		952,560.00	2,009.00	.41	433,944.00		518,616.00	143,070.60
1930	210	[1] 4,400	924,000		831,600.00	1,892.00	.43	397,320.00		434,280.00	108,913.08
1931	189	[1] 4,075	770,175		693,158.00	1,834.00	.45	346,579.00		346,579.00	79,016.55
1932	146	[1] 3,775	551,150		496,035.00	1,774.00	.47	259,041.00		236,994.00	49,121.75
1933	114	[1] 3,475	396,150		356,535.00	1,703.00	.49	194,114.00		162,421.00	30,604.99
1934	85	[1] 3,175	269,875		242,888.00	1,619.00	.51	137,636.00		105,252.00	18,029.67
1935	58	[1] 2,950	171,100		153,990.00	1,564.00	.53	90,685.00		63,307.00	9,858.17
1936	41	[1] 2,780	113,980		102,582.00	1,529.00	.55	62,689.00		39,893.00	5,647.65
1937	30	[1] 2,600	78,000		70,200.00	1,482.00	.57	44,460.00		25,740.00	3,312.74
1938	22	[1] 2,475	54,450		49,005.00	1,460.00	.59	32,126.00		16,879.00	1,974.84
1939	15	[1] 2,300	34,500		31,050.00	1,380.00	.60	20,700.00		10,370.00	1,200.83
1940	14	[1] 2,200	30,800		27,720.00	1,342.00	.61	18,788.00		8,932.00	863.72
			54,378,830						3,663,000.00		10,634,528.05
Less physical equipment											3,403,713.19
Oil value											7,230,814.86

[1] Manual curve, Shell Co. set-up.

[2] Shell Co. set-up.

Surface value negligible


SHELL CO. OF CALIFORNIA
RELATION OF LIFT COSTS TO TOTAL
YEARLY PRODUCTION
TOTAL YEARLY PRODUCTION IN BBLS.
LIFT COSTS CENTS PER BBL.
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4,000,000
3,000,000
2,000,000
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EXHIBIT 6E

HISTORY OF THE CASE OF THE SHELL CO. OF CALIFORNIA IN ITS PASSAGE THROUGH THE OIL AND GAS VALUATION SECTION

June 2, 1923. H. A. Pelton, valuation engineer for the Government, phoned Mr. Smith of Price-Waterhouse, representing the Shell Co. of California, and set June 20, 1923, as the final date for conference on the case of the Shell Co. of California.

June 20, 1923. Messrs. Lauder and Burtt, officers of the Shell Co. of California, and Mr. Smith of Price-Waterhouse, representatives of the taxpayer, came in at 1.30 p. m. conference with Pelton.

June 21, 1923. Mr. Burtt of Shell Co. of California came in for conference at 9.30 a. m.

June 22, 1923. Shell Co. of California in conference with Pelton. Taxpayer represented by Mr. Burtt in the forenoon and Messrs. Lauder, Burtt, and Watson in the afternoon. Mr. Watson is an employee of Price-Waterhouse.

June 23, 1923. Mr. Burtt, representing the Shell Co. of California, spent part of the forenoon in conference with Mr. Pelton, who made pencil draft of the proposed conference report and submitted same to Mr. Baxter for approval. The latter refused to approve this conference report on the grounds that it would allow excessive value in both oil and equipment, and contended—

First. That the date of acquisition could not be made retroactive by resolutions of the boards of directors of the companies involved.

Second. That the cost at acquisition, or the fair market value of the stock exchanged for the assets, could only be determined by valuation of the assets, in the instant case.

June 25, 1923. Shell Co. of California, represented by Messrs. Burtt and McCormack, in conference all day long with Pelton and Baxter.

June 27, 1923. Messrs. Burtt and McCormack spent several hours in the California subsection discussing the case of the Shell Co. of California.

June 28, 1923. Mr. Baxter consulted with Mr. Smith, of the natural resource review section, relative to the case of the Shell Co. of California.

June 29, 1923. Messrs. Thayer and Baxter discussed the case of the Shell Co. of California. Mr. McCormack came in for a few minutes.

June 30, 1923. Messrs. Thayer, White, Pelton, and Baxter, members of the oil and gas valuation section, discussed the case of the Shell Co. of California.

July 2, 1923. Messrs. Thayer, White, Pelton, and Baxter continued their discussion of the case. Mr. E. H. Finch, who later worked on this case, reported for duty in the oil and gas valuation section.

July 3, 1923. Mr. Burtt, of the Shell Co. of California, came in for conference with Mr. Baxter. Discussed valuation of the Coalinga property. Mr. Burtt stated that the Shell Co. would furnish additional information.

July 5, 1923. Mr. McCormack came into the California subsection to inquire as to the status of the Shell Co.'s case. Mr. Burtt phoned at 10.15 a. m. asked for a conference and said he would bring Mr. Smith at 2 p. m. Conference granted and held with Mr. Baxter.

July 6, 1923. Messrs. Burtt and Smith, representing thte taxpayer, came in for one and a half hours' conference with Mr. Baxter and submitted letter and telegram relative to the company's organization and its acquisition of the California Oilfields (Ltd.) property. Upon complaint of Mr. Smith, of Price-Waterhouse, the commissioner issued instructions to expedite progress of the Shell Co.'s case.

July 7, 1923. Mr. Harriman, of the natural resource review section, came into the California subsection, at Mr. Thayer's request, to study the case of the Shell Co. of California.

July 9, 1923. Mr. Harriman got case of Shell Co. for examination.

July 11, 1923. Mr. Chase, section G, unit 8 (affiliations), was given Shell Co.'s case so that he might look into relationship of the several affiliations of the Shell Royal Dutch group.

July 12, 1923. Mr. Smith, of Price-Waterhouse, called to see Mr. Thayer. Mr. Thayer requested of California subsection estimate of company's Coalinga reserves.

July 16, 1923. Mr. Greenidge called Messrs. Thayer, Smith, and Baxter into his office to discuss the advisability of granting taxpayer's request for a 60 to 90 days' extension for the purpose of submitting new data. It was decided to grant such extension contingent upon the securing of 1917 and 1918 waivers on all companies that may possibly be affiliated with the taxpayer.

July 17, 1923. Mr. Greenidge stated verbally that the Shell Co. of California is going to submit data upon which they intend to make their stand. Time limit has been set to September 15, 1923, beyond which no further extension of time is to be asked or granted.

July 19, 1923. Mr. Thayer sent in list of affiliated companies of the taxpayer to be filed with the case. This list was prepared by Mr. R. K. Chase, of affiliations, section G, unit 8.

July 21, 1923. Received letter from Price-Waterhouse relative to 60-day extension, also power of attorney for William M. Smith, which Mr. Greenidge had borrowed.

July 23, 1923. Mr. Thayer borrowed Mr. W. M. Smith's letter relative to Shell Co.

July 24, 1923. Mr. Thayer returned Price-Waterhouse's letter with copies of reply. Filed same with case.

September 14, 1923. Mr. Smith, of Price-Waterhouse, brought in duplicate copies of a brief relative to the taxpayer's cost at acquisition. Mr. Thayer handed same to Mr. Baxter to have them stamped in.

October 11, 1923. Messrs. Greenidge, Thayer, and Baxter, with Mr. Smith, of Price-Waterhouse, discussed the case of the Shell Co. of California. Mr Greenidge stated that Mr. Baxter would soon be sent to California to get in touch with recent oil field developments, and while there would look further into Shell Co.'s case.

October 12, 1923. Messrs. Baxter and Sellers (audit G) discussed Shell Co.'s case.

October 15, 1923. Mr. Sellers brought in his first draft of memorandum relative to Shell Co.'s case. Stated that at first he had been of the opinion that date of acquisition could be made retroactive, but changed his mind after talking with Mr. Harriman. Mr. Sellers said he would have his memorandum typed and submitted through channels if Mr. Alexander, head of audit, is agreeable thereto.

October 17, 1923. Mr. Smith, of Price-Waterhouse, came into conference with Messrs. Sellers and Baxter 10 a. m. to noon. Discussed brief submitted September 14, 1923.

October 23, 1923. Mr. Sellers came in to get list of Shell Co. affiliations.

November 5, 1923. Baxter left for California.

January 16, 1924. Conference between taxpayer's representatives and H. A. Pelton. Conference memorandum written agreeing that taxpayer shall be allowed:

Recoverable oil reserves	barrels	67,000,000
Oil value		$12,366,156.87

January 22, 1924. Baxter arrived in Washington, having discussed Shell Co.'s case with officers and representative in the company's San Francisco office.

February 6, 1924. Messrs. Thayer, Pelton, and Baxter discussed engineering appraisal of Coalinga property submitted by Mr. McCormack. Mr. McCormack called to say that he is going to Texas and that Mr. Smith, of Price-Waterhouse, has all powers of attorney and will file same.

February 7, 1924. Mr. Thayer discussed Shell case with Pelton first and then with Baxter, and later with both together. Mr. Thayer stated that he had put the settlement of valuation of the Coalinga property in the hands of an umpire.

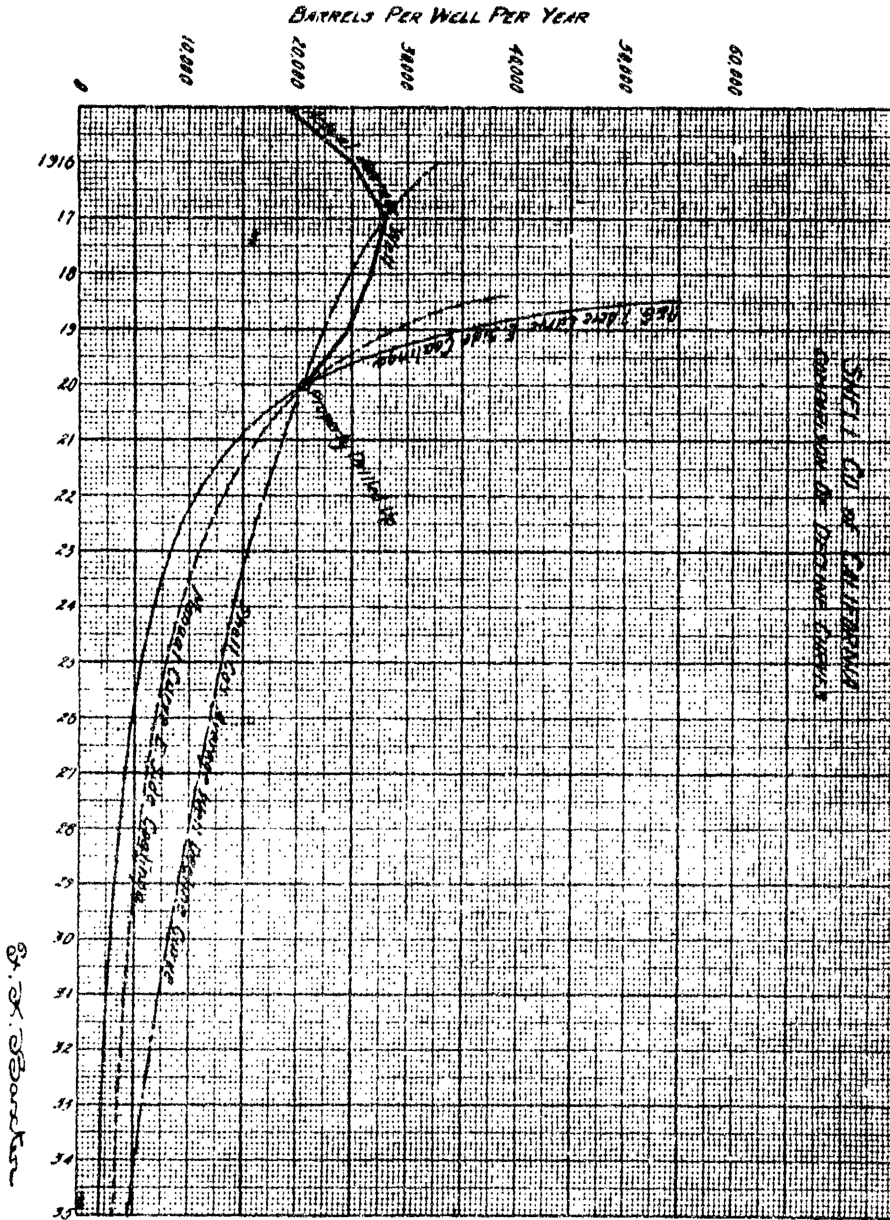
February 23, 1924. Messrs. Thayer and Baxter discussed case and came to an agreement to expedite case and end controversy. Mr. Finch to write up the case.

March 15, 1924. Hearing of Shell Co.'s case before the special committee of conferees composed of Messrs. Griggs and Shepherd. Taxpayer represented by Messrs. McCormack and Smith. Government represented by Messrs. Pelton and Baxter. Mr. Thayer was present during the latter part of the hearing. Messrs. Thayer and Baxter were the only representatives of the Government who did not express opinion that taxpayer's claimed value should be allowed.

Baxter made following statements:

1. That his check on the unreasonableness of the taxpayer's engineering appraisal was based on comparative sales.
2. That he considers taxpayer's engineering appraisal too high because it uses lifting or operating costs that are much too low.
3. That case was submitted to Mr. Ports for umpire valuation and his determination of value is even lower than Baxter's estimate.

4. That Mr. Thayer has arrived at an average figure by using valuations by Messrs. White, Wardwell, and the taxpayer (all three of which merely accept the taxpayer's claimed value) and given each a weight equal to that given the appraisal by Mr. Ports and the estimate based on comparative sales by Baxter, thus allowing the taxpayer's claim a weight of 3 when it should have a weight of 1 at the most.



Messrs. Griggs and Shepherd expressed the opinion that inasmuch as the value claimed by the taxpayer exceeds Mr. Thayer's average value by 6 per cent it should be accepted. Mr. Griggs stated that he would take the case under advisement and would call upon Messrs. Pelton and Baxter for further discussion on Monday next (March 17). Case to go before the special committee composed of Messrs. Greenidge, head of division; Mr. Griggs, assistant head of division and former nonmetals valuation engineer; and Mr. Shepherd, metals valuation engineer.

March 19, 1924. Messrs. Griggs and Shepherd requested that Baxter personally make an engineering appraisal of the Shell Co.'s Coalinga property.

April 22, 1924. Messrs. Finch and Baxter, having prepared an engineering appraisal of the Coalinga property, went before Messrs. Griggs and Shepherd to submit and explain said appraisal. After about 15 minutes had been consumed in the discussion Mr. Griggs was called into another conference. He stated he would call Messrs. Finch and Baxter into conference again next day. However, he failed to do so and no further conference on the Shell case has been held.

May 1, 1924. Mr. Thayer wrote memorandum relative to valuation of taxpayer's property.

May 2, 1924. Messrs. Griggs and Shepherd wrote memorandum recommending that the case be closed on the basis of the taxpayer's conference memorandum dated January 16, 1924.

May 3, 1924. Mr. Thayer brought back the complete file of the case with the following note written on the memorandum of Messrs. Griggs and Shepherd.

"Mr. Baxter: Please note above recommendation and have the case closed accordingly.

"W. N. T.

"MAY 3, 1924."

May 6, 1924. Valuation report by E. H. Finch, years 15-20, inclusive.

May 12, 1924. Case sent to audit.

EXHIBIT 6-D

COALINGA

Index to transactions

Purchaser or lessee	Vendor	Sale or lease
21. Amer. Pet. Co	From (?)	Sale, 1908.
22. Amer. Pet. Co	From (?)	Do
23. Amer. Pet. Co	From (?)	Do.
24. Amer. Pet. Co	From (?)	Do.
25. Amer. Pet. Co	From (?)	Do.
26. Amer. Pet. Co	From (?)	Do.
3. Amy Oil Co	From (?)	Do.
15. Assoc. Oil Co., lease	From Shawmut Oil Co.	Sale, 1906.
2. Cal. Oil & Gas	From (?)	Lease, 1909.
27. Cal. Oilfields	From W. K. Oil Co. (see No. 11 above)	Sale, 1913.
28. Cal. Oilfields	From Turner Oil Co. (see No. 11 above)	Do.
14. Coalinga Pet., lease	From Edgar Adams	Sale, 1905.
4. Consol. Oil Lands Co	From Silver Tip Oil Co.	Lease, 1908.
29. Gen'l. Pet. Corp	From Coalinga National	Sale, 1919.
30. Gen'l. Pet. Corp	From Ozark Oil Co.	Sale, 1918.
10. Homestead Dev. Co.	From Coalinga Central	Sale, 1912.
13. Malcolm Murray, lease	From Queen Oil Co.	Sale, 1908.
16. Nevada Pet. Co	From (?)	Do.
1. Pacific States Pet	From (?)	Lease, 1909.
17. Premier Oil Co., lease	From Union Oil Co.	Sale prior to 1913.
18. St. Paul Consol., lease	From S. O. [illegible] Co.	Sale, 1919.
20. Seneca Oil Co	Incorporation	1908.
11. Shell Oil Co	From Calif. Oilfields, Ltd	Sale, 1915.
12. Spinks Crude Oil Co	From (?)	Sale, 1909.
5. S. O. Co	From Coalinga Oil Co.	Sale, 1916.
6. S. O. Co	From Homestake	Sale, 1908.
7. S. O. Co	From Sauer Dough	Sale, 1916.
8. S. O. Co	From Coalinga Peerless	Sale, 1917.
9. S. O. Co	From Gen'l. Pet. Co.	Do.
19. Ward Oil Co	Incorporation	1908.

1, 2, and 4 leases, no bonus paid.

3. Sale, cash, and stock, 1908, no wells.

Cash	$20,000
Stock, estimate	12,500
Twenty acres at $1,625	32,500

Sec. 6-21-15, E. ½ NW. ¼ of SE. ¼.

NOTE.—In 1908 moderate wells in section 6, Silver Tip well drilling adjoining quarter. The Lucile Well, section 6, proved district in 1906, a 100-barrel well. First production about June, 1909, about 300 b/d.

Purchaser, Amy Oil Co.; vendor, (?). (In 1907 prod. from two wells one-half mile northeast and from two wells one-eighth mile southwest, in 1908 three more wells prod. one-eighth mile east.)

5. Sale, cash, February, 1916, 6 wells. One hundred and sixty acres at $633=$101,283. Section 20-19-15, NW. ¼, 6 wells; total, 71 b/d.; 1,100-1,900 feet, 34 Gr. Prod. from Feb., 1918, to Dec. 1918, 152,848 barrels. 1916 value well and other equipment, $10,668. Purchaser, S. O. Co. of California; vendor, Coalinga Oil Co.

6. Sale, cash, June, 1916, 4 wells. One hundred and sixty acres at $866= $138,330.00. Section 20-19-15, NE. ¼, 4 wells; total, 62 b/d. 1,100-1,900 feet, 34 Gr.; 1916 value well and other equipment, $3,054. Purchaser, S. O. Co. of California; vendor, Homestake Oil Co.

7. Sale, cash, March, 1916, 9 wells. Thirty acres at $2,500=$75,000. Section 22-19-15, W. ½ of NW. ¼ of SW. ¼ and NW. ¼ of SW. ¼ of SW. ¼, 9 wells; total, 161 b/d. 1,050-1,300 feet, 21 Gr. Prod. Mar., 1916-Dec., 1918= 141,434 barrels. Property paid out in June, 1918; 1916 value, well and other equipment, $7,231. Purchaser, S. O. Co.; vendor, Sauer Dough Oil Co.

8. Sale, cash, January, 1917, 15 wells. One hundred and sixty acres at $1,250=$200,000. Section 22-19-15, NW. ¼, 15 wells; total, 322 b/d. 975-1,775 feet, 19 Gr. Prod. January, 1917-Dec., 1918, 290,340 barrels. 1917 value of well and other equipment, $8,729. Purchaser, S. O. Co.; vendor, Coalinga Peerless Oil Co.

9. Sale, cash, December, 1917, 8 wells. 465.39 acres at $2,000=$931,000. Section 2-19-15 S. ½ and NW. ¼ and SE. ¼ of NE. ¼, 8 wells; total, 772 b/d. 750-2,350 feet, 17 Gr. Prod. Dec., 1917-Dec., 1918, 350,335 barrels. 1917 value well and other equipment, $38,095. Purchaser, S. O. Co.; vendor, General Petroleum Corporation.

10. Sale, bonds and stock, November 16, 1912, 12 wells. 160 acres, section 12-20-14 N. ½ of S. ½.

Stock at par	$500,000
Bonds	232,250
	733,250
Plant and equipment	150,065
	583,185

12 wells; total, 320 b/d. 848-1,580 feet 14 gr. 1912 price oil, 34¢; average production, 16 b/d well:

1912 value first-mortgage bonds	$233,250
Estimate by company, cash value stock	254,458
	477,708
Plant and equipment	150,065
160 acres, at $2,042	327,643

Purchaser, Homestead Development Co., vendors B. & B. Oil Co. 40 acres and Coalinga Central Oil Co. 120 acres.

11. Sale, cash and stock, January 1, 1915, 113 wells. 9,320 acres at $1,394=$12,984,107.19. Secs. 2, 10, 14, 15, 21, 22, 26, 27, 29, 32, 34, and 36-19-15 and section 2-20-15. 113 wells prod. 4,322,833 b/yr.=115 b/d/w. 22 gr. 105 aband. or susp., 1 drilling, 292 new loc. Prod. prior to purchase, 42,717,551 barrels. (Total prod., 1918, incl., 73,645,909 barrels.) Unit value, $0.193. Consideration, $500 cash $12,999,500.00 stock. Applicable to oil and gas contents, $12,984,107. Applicable to surface and agriculture, nominal. Applicable to plant and equipment nil. (For former transfer section 2-20-15, sections Nos. 27 and 28 below, August, 1913.)

Cost, 1915	$0.193	$12,984,107
Est. reserves, 1915		$67,300,000
Prod. prior to purchase	barrels	42,717,551
Est. reserves, 1915	do	67,300,000
Total reserves as of 1900	do	110,017,551

Purchaser, Shell Oil Co. of California, vendor California Oil Fields Co. (Ltd.).

12. Sale, cash and stock November 3, 1909, 1 well.

Cash	$94,421.23
Stock, par value	15,000.00
40 acres, at $2,235	109,421.23

Section 12-20-14, NW. ¼ of NE. ¼, 5 wells drilling 1909. 40 acres considered highly probable. 60,000 shares sold and issued direct by company at $1 par value, $60,000 (in 1909 (?)). (In 1909, production in line wells, 3 sides, and 3 wells on property.) Purchaser, Spinks Crude Oil Co., vendor, (?).

13. Leases, bonus and royalty, October 25, 1908, no wells. 40 acres at $887 per acre, plus ⅛ royalty; cash bonus, $35,485. Sec. 14-20-14, NE. ¼ of SE. ¼. Probable territory. Lessee, Malcolm Murray, Coalinga; lessor, Queen Oil Co. (In 1908, prod. from 6 wells 1/16 miles and 5 wells ⅛ mile N. 13½ Gr.)

14. Lease, bonus and royalty, March 12, 1905, 1 well. 80 acres at $134 per acre, plus ⅛ royalty; cash bonus, 10,795. Sec. 14-20-14 E. ½ of NE. ¼. 1 well prod. (?) 600 feet. 12½ Gr. Purchase of the ⅛ royalty held by lessor made by the lessee April 1, 1917, $9,000. Estimate by lessee that ⅔ oil removed between 1904 and 4/1/17, 257,071 barrels. Lessee, Coalinga Petroleum Co.; lessor, Edgar Adams. (In 1905, prod. from 8 wells 1 mile S., and 1 well ½ mile E.)

15. Lease, bonus and royalty, October 19, 1916. 8 wells. 60 acres at $1,625 per acre, plus ⅛ royalty; cash bonus, $97,502; 8 wells, 2,500 per month, or 42 b/d/w. Had proved unprofitable to vendor account of water up to 1916. Lessee, Assoc. Oil Co.; lessor, Shawmut Oil Co.

16. Sale, December 23, 1908, no wells. 3 parcels of property, 800 acres at $1,624=$1,301,000. NW. ¼ sec. 18-20-15, and W. ½ section 20-20-15, and E. ½ section 30-20-15. Possible productive area, 800 acres. (In 1908, prod. from 4 wells ½ mile W. of section 18, and 6 wells ½ mile W. of section 30.) Purchaser, Nevada Petroleum Co.; vendor, (?).

17. Lease, bonus and royalty. Prior to 1913, 8 (?) wells. 160 acres at $610 per acre, plus ⅙ royalty; cash bonus, $100,000. Section 24-20-14, SE. ¼. First prod. 1907. First prod. 1907, 14 Be. Gr. Property has not paid out, with 24 plus wells, by 1918. American Petroleum Co. paid $800 per acre for property cornering on this, December, 1908, statement of company. Lessee, Premier Oil Co.; lessor, Union Oil Co.

18. Lease, for stock, December 1, 1910, 16 wells. 160 acres S. ½ of N. ½, section 23-20-14. Exchanged 400,000 shares stock at $1 par value, plus ⅛ royalty.

Leasehold interests	$341,952.41
Improvements	58,047.59
160 acres at $2,500, stock bonus	400,000.00

Prod. prior to transfer, 684,330 barrels; expend. for depelop. prior to transfer, $176,531. Lessee, St. Paul Consol. Oil Co.; lessor, So. Pac. Co.

19. Incorporation, 1907. Eighty acres section 12-20-14, N. ½ of NW. ¼. (In 1907, prod. from 4 wells adjoining line on north, and 6 wells ¼ mile E.) Land and $20,000 given for $100,000 in stock, Ward Oil Co.

20. Incorporation, 1908. Eighty acres section 12-20-14, S. ½ of SW. ¼. (In 1907 prod. from 4 wells ¼ mile N., and 6 wells ¼ mile E; company drilled 3 wells in 1908.) Land and $30,000 given for $250,000 in stock. Seneca Oil Co.

21. Sale, May, 1908, no well. Three hundred forty-one and forty-four hundredths acres at $1,535=$523,207. Section 6-20-15, E. ½. In 1908, 31 wells. prod. 1/16-¼ mile W. Purchaser, American Pet. Co.; vendor (?).

22. Sale, May, 1908, no well. Three hundred and thirty-five and thirty-eight hundredths acres at $1,550=$519,656.71. Section 18-20-15 W. ½. Purchaser, American Pet. Co.; vender (?). (In 1908 nearest prod. 7 wells ½ mile W., 5 wells 1/8 mile NW. and 7 wells ⅛ mile SW. Company drilled 4 wells in 1908; avg. 100 b/d/w.

23. Sale, December, 1908. — wells, 83.45 acres at $2,235=$194,197.15. Section 19-20-15, S. ½ of SW. ½. (In 1908, nearest prod. ¼ mile NW. 17 wells; and 6 wells ¼ mile S.) Purchaser. American Petroleum Co., vendor (?).

24. Sale, April, 1908, no well. Two hundred and fifty-three and three-tenths acres at $2,240=$567,138.65. Section 30-20-15. SW. ¼ and S. ½ of NW. ¼. (In 1907, nearest prod. 2 wells ¾ mile W.) Purchaser, American Petroleum Co., vendor (?).

25. Sale, August, 1908, no well. Sixty-two and ninety-nine one-hundredths acres at $2,245=$141,459.63. Section 30-20-15, N. ½ of NW. ¼ (N. tract.) (In 1908, nearest prod. 2 wells ¼ mile S. and 16 wells ¼ mile W.) Company drilled 3 wells in 1909. Purchaser, American Petroleum Co., vendor (?).

26. Sale, May, 1908, no well. Three hundred acres at $714=$214,152.21. Section 32-19-15 S. ½ exc. N. ½ of NW. ¼ of SE. ¼. (In 1908 nearest prod. 1 well ⅛ mile N. and 6 wells ⅛ mile N. and 4 wells ⅛ mile W.) Purchaser, American Petroleum Co., vendor (?).

27. Sale, August, 1913, 14 wells. (Later purchased by Shell Co., see No. 11 above.) 342 acres at $5,120=$1,750,000; sec. 2-20-15, N. ½. 14 wells, avg. 79 b/d/w, total 1,112 b/d. Prod. Oct. 1, 1912–Oct. 7, 1913, 506,106 barrels; prod. year 1911, 550,000 barrels; prod. year 1912, 516,000 barrels. Started drilling 1907; 1 producing well in 1908; 3 producing wells in 1909; 7 producing wells in 1910; 9 producing wells in 1911: 12 producing wells in 1912. Sale price figures, $1.158 per bbl. daily prod. 14 wells proved ⅛ of property. Price of oil, 58¢ per barrel, 21 Be. Gr. Purchaser, Cal. Oil Fields Co.; vendor, W. K. Oil Co.

28. Sale, August, 1913, 7 wells. (Later purchased by Shell Co., see No. 11, above). 320 acres at $4,690=$1,500,000. Sec. 2-20-15. S. ½, 7 wells producing avg. 175 b/d/w. 5 wells drilling. Prod. Oct. 1, 1912–Oct. 7, 1913, 472,638 barrels or 184 b/d/w. Price oil 50¢; 21–29 Gr. sale price figures $1,158 per barrel of daily production. Purchaser, California Oilfields Co.; vendor, Turner Oil Co.

29. Sale, April 1, 1919, 2 wells. S. ½ N. ½ N. ½, 8-20-15 west side. 80 acres at $1,510=$120,821.50 not including equipment. Westerly 10 acres proven, 70 acres doubtful or worthless. Purchaser, General Petroleum Corp; vendor, Coalinga National Oil Co.

30. Sale, July 31, 1918, 6 wells. West side, N. ½ NE. ¼, NE ¼ and NE. ¼ NW. ¼ NE. ¼ 26-20-14. 30 acres at $2,331=$69,927.70, not including equipment. (Sale price reported by Ozark Co., $60,000, which held 20 acres only.) Production, (?) Purchaser, General Petroleum Corporation, vendor, Ozark Oil Co.

Mr. Manson. After I got the report in the Shell case I asked Mr. Fay to try to ascertain whether the use of an anticipated increase in the price of oil was general and I got a report from him:

In connection with the valuation of the Shell Oil Co., wherein a sliding scale price was used when the price of oil was low, I am attaching herewith notes on the Union Oil Co. of California, wherein a number of leases were valued March 1, 1913, when the price of oil was 60 cents per barrel. The valuation allowed the Union Oil Co. for these particular leases was an upward sliding scale price of 5 cents per year for a period of nine years, which is in accordance with the method used in the Shell case.

There are also a number of discovery valuations allowed the Union Oil Co. for the year 1920 when the price of oil was $1.35, $1.55, $1.75, and $1.88 per barrel. This posted price was allowed in each valuation with no consideration of the fact that while the price was high, it might some day go down.

In that connection, I want to call attention to the fact that the price of California oil is very much lower than other oils, and that these prices of $1.35 to $1.88 are peak prices.

After checking up these leases of the Union Oil Co., I ran across a memorandum dated October 24, 1924, initialed W. N. T. (W. N. Thayer), relating to the price to be used in analytical appraisals of California oil properties. A copy of this memorandum is attached herewith, which I consider sufficient to represent the method used without going into other cases to find other examples as in the case of the Union Oil Co.

The Chairman. What does that memorandum say?

Mr. Manson. I will now read this memorandum. It is headed "Engineering division, oil and gas valuation section." In re oil prices to be used in analytical appraisals, California oil properties, and reads:

This section does not approve the use of price trends in the valuation of oil properties

However, in establishing valuations of California oil properties as of March 1, 1913, and subsequent dates up to but exclusive of December 28, 1915, the office practice has been to allow an expected price of approximately 25 cents more than the posted price of oil over the expected life of the property.

On May 7, 1923, a memorandum was prepared by S. M. Greenidge, R. F. White, Louis H. Evans, F. K. Baxter, C. E. Moss, and H. A. Pelton, recommending that the same procedure be followed with respect to the low price of the heaviest oil (60 cents) which prevailed in California in 1922 and 1923.

This memorandum dated May 7, 1923, is sustained hereby and the posted price of any grade of oil, plus approximately 25 cents, is to be recognized as the fair average expected price over the expected life of the property when the price of the lowest grade of oil is 60 cents. This increase is to be applied by an increment of 5 cents per year for each of the next succeeding nine years. When the posted price of the lowest grade of oil is in excess of 60 cents at date of valuation, the posted price of any grade shall be used without any increment.

This memorandum is initialed "WNT," and is dated October 24, 1924.

The CHAIRMAN. Is there any memorandum in the files that you found showing that a decrease was taken when the price was high?

Mr. MANSON. No; we have not found any case where it was done. We have asked them if they had any such cases, and they have not supplied us with them. I will offer this report for the record.

(The report submitted by Mr. Manson is as follows:)

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE INCOME TAX UNIT,
May 2, 1925.

Memorandum to: Mr. L. C. Manson, general counsel.
From: A. H. Fay, consulting engineer.

In connection with the valuation of the Shell Oil Co., wherein a sliding scale price was used when the price of oil was low, I am attaching herewith notes on the Union Oil Co. of California, wherein a number of leases were valued March 1, 1913, when the price of oil was 60 cents per barrel. The valuation allowed the Union Oil Co. for these particular leases was an upward sliding scale price of 5 cents per year for a period of nine years, which is in accordance with the method used in the Shell case.

There are also a number of discovery valuations allowed the Union Oil Co. for the year 1920 when the price of oil was $1.35, $1.55, $1.75, and $1.88 per barrel. This posted price was allowed in each valuation with no consideration of the fact that while the price was high, it might some day go down.

After checking up these leases of the Union Oil Co., I ran across a memorandum dated October 24, 1924, initialed W. N. T. (W. N. Thayer), relating to the price to be used in analytical appraisals of California oil properties. A copy of this memorandum is attached herewith, which I consider sufficient to represent the method used without going into other cases to find other examples as in the case of the Union Oil Co.

Respectfully submitted.

A. H. FAY,
Consulting Engineer.

UNION OIL COMPANY OF CALIFORNIA

In connection with the price of oil used in making valuations for the Shell Oil Co. as of March 1, 1913, wherein a sliding scale price is used when the price of oil is low, the departmental records show that this same method of valuation of oil leases has been used in other cases. For example, the Union Oil Co. of California, a number of leases have been thus valued.

Lofus lease.—300 acres, March 1, 1913, value was based on 60-cent oil with an upward sliding price of 5 cents each year, to a maximum of $1.05 per barrel. The operating expenses were also increased from 58 cents per barrel to 99 cents per barrel.

Hole fee.—181 acres. The March 1, 1913, value of this property was based on 60-cent oil stepped up by 5-cent intervals to $1.05 per barrel. The operating costs range from 66 cents per barrel on March 1, 1913, to $1.04 as a maximum.

Stearns fee.—500 acres. The March 1, 1913, value was determined on the basis of 60-cent oil with 5 cents per barrel per year, increased to a maximum of $1.05. Operating expenses were increased from 66 cents per barrel to $1.04 as a maximum.

Stearns fee.—100 acres. The March 1, 1913, value was determined on the basis of 60-cent oil, with 5 cents per barrel increase each year until a maximum of $1.05 was attained.

In connection with the March 1, 1913, valuations it should be stated that the records on file in the department contain actual production data to the close of 1921. The taxpayer in setting up his reserves as of March 1, 1913, therefore had the advantage of at least eight years succeeding production, which he has reflected back as actual reserves at date of revaluation.

In setting up discovery valuations for the Union Oil Co. of California, when the price of oil was high, there was no consideration of the fact that the price of oil might drop during the succeeding years, as shown in the following leases.

Thompson-Goodwin lease.—In 1920 a discovery valuation was placed on the Thompson-Goodwin lease for a proven area of 15.64 acres. Market price of oil, namely, $1.88, with no consideration of either an increased or a lower price of oil in the future.

Copeland lease.—June, 1921, discovery area 10 acres. The market price of oil at date of this discovery was $1.35. Operating costs at date of discovery were 16 cents, and in setting up valuations they were gradually increased to a maximum of 20 cents per barrel.

Copeland lease.—November, 1921, discovery area 30 acres. Market price of oil was $1.55 with operating costs at date of discovery of 16 cents, which was gradually increased to a maximum of 20 cents per barrel. No consideration was given to a possible decrease in the market price of oil.

J. A. Coyle lease.—August, 1920, discovery area 20 acres. Valuation is based on the market price of oil at $1.75 per barrel, with operating costs at 16 cents, gradually increased to 20 cents.

Dorsey lease.—December, 1920, discovery area 10 acres. Discovery valuation based on market price of oil $1.60, operating costs ranging from 15 to 20 cents per barrel.

McFadden lease.—June, 1920, discovery area 26.56 acres. Discovery valuation based on the market price of oil $1.60, with operating expenses from 15 to 20 cents per barrel.

E. L. Newell lease.—June, 1920, discovery area 16.95 acres. Discovery valuation based on oil at $1.48 per barrel with operating costs at 15 to 20 cents per barrel.

In each of the above leases, and there are many more, no consideration was given to a sliding price of oil for future years. It will therefore be noted that the taxpayer has, when the price of oil was low, taken the advantage of a possible increase in price, and when the market price was at its peak, he has also taken the advantage of this price and assumed that the future prices would remain unchanged. The department has recognized this basis of valuations in the leases cited, as well as in others.

ENGINEERING DIVISION, OIL AND GAS VALUATION SECTION

In re: Oil prices to be used in analytical appraisals of California oil properties.

This section does not approve the use of price trends in the valuation of oil properties.

However, in establishing valuations of California oil properties as of March 1, 1913, and subsequent dates up to but exclusive of December 28, 1915, the office practice has been to allow an expected price of approximately 25 cents more than the posted price of oil over the expected life of the property.

On May 7, 1923, a memorandum was prepared by S. M Greenidge, R. F. White, Louis H. Evans, F. K. Baxter, C. E. Moss, and H. A. Pelton, recommending that the same procedure be followed with respect to the low price of the heaviest oil (60 cents) which prevailed in California in 1922 and 1923.

This memorandum dated May 7, 1923, is sustained hereby and the posted price of any grade of oil, plus approximately 25 cents is to be recognized as the fair average expected price over the expected life of the property *when the price of the lowest grade of oil is 60 cents.* This increase is to be applied by an increment of 5 cents per year for each of the next succeeding nine years. When the posted price of the lowest grade of oil is in excess of 60 cents at date of valuation, the posted price of any grade shall be used without any increment.

CALIFORNIA SUBSECTION

Allowable increase in price of oil for valuation purposes.

In connection with appraisals made after the price of crude[1] oil has been cut to 60 cents, the following agreement was reached:

That with crude[1] oil at 60 cents, an abnormal condition obtains similar to that which existed in 1913—both cases due to temporary overproduction.

(California State Mining Bureau Bulletin 69, page 53.)

It was generally recognized in 1913 that only exceptional properties could be developed and operated with crude[1] at 40 cents. (See California State Mining Bureau Bulletin 69, p. 9.) With the present purchasing value of a dollar, 50 per cent of the 3-1-13 dollar, 60 cents crude[1] is comparable to 40 cents crude[1] in 1913.

It is recognized that as of 1913 a flat price of 35 cents for appraisal purposes with the then existing costs would show no value for properties which had a very substantial fair market value as evidenced by actual consummated sales.

In making 1913 valuations, a 25-cent increase was allowed to show an average expected price of 60 cents over the life of the property.

The average price received for crude[1] oil in California for the past 10 years was 88 cents.

It is reasonable to expect that the average price which may be expected for the next 10 to 20 years will at least average $0.85. This much admitted without attempting to diagnose price trends or possible exhaustion of California petroleum resources.

Inasmuch as appraisals based on 60-cent crude[1] with present costs show a fair market value entirely out of line with their actual sales value, a similar 25-cent increase over the posted price for all grades is admitted to be a reasonable expectancy, such increase to be equitably distributed over the life of the property to show an average expected price of 25 cents over the posted price.

May 7, 1923.

LOUIS H. EVANS.
R. F. WHITE.
H. A. PELTON.
F. K. BAXTER.
S. M. GREENIDGE
C. E. MOSS.

Mr. MANSON. I now offer a report on the Foster Oil Co. That is another report presented for the purpose of showing the lack of terminal facilities.

(The report on the Foster Oil Co. submitted by Mr. Manson is as follows:)

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT,
April 4, 1925.

To: Mr. L. C. Manson, general counsel.
From: Mr. A. H. Fay, consulting engineer.
Subject: Foster Oil Co.

DEAR MR. MANSON: Attached herewith is a report on the Foster Oil Co., which is a typical case, which the bureau is not able to close by reason of the insistence of the taxpayer to further reduce his tax.

[1] Lowest grade oil.

In this particular case the question of discovery valuation of leases in Louisiana is involved, wherein the department did not originally give the taxpayer all that he claimed. A small additional tax has been assessed for the year 1919 by reason of certain depletion allowances, which amount the taxpayer now endeavors to restore for the year 1919 and thus establish what the department considered in its original valuation as an excessively high depletion unit.

The taxpayer is now endeavoring to have the case reconsidered for the purpose of establishing his original claim, and should he be successful in this there would be absolutely no tax on the sale of assets, amounting to $5,300,000 in February, 1920.

No tax has as yet been determined by the department for the year 1920, although the engineers' valuation report showed a profit on the sale of capital assets in excess of $2,000,000. This information was before the auditor when he audited the 1919 returns.

Respectfully,

A. H. FAY,
Consulting Engineer.

Approved.

L. H. PARKER,
Chief Engineer.

FOSTER OIL CO.

The Foster Oil Co. is one of those tax cases which the department has not yet been able to close for the year 1919, owing to protest on the part of the taxpayer and his insistence for a second revaluation.

The department's assessment letter of January 23, 1925, assessed an additional tax of $22,420.35, a large portion of which was due to the disallowance of depletion. The original tax paid was $34,147.28. The taxpayer claimed a total of $140,138.45 for depletion on all of the producing leases. The engineering division allowed the taxpayer depletion to the extent of $95,194.70, the total disallowance being, therefore, $44,943.75. The taxpayer now protests this disallowance, and in his letter of March 13, 1925 (Exhibit 1), demands a reconsideration of the valuation of certain leases in Louisiana, claiming that there is gross error in the information which he originally filed. He now desires (Exhibits 2, 3, 4, 5, 6, 7, and 8) to file a new Form O schedule for the revision of the discovery valuation allowed in 1919, which also is to be used as the basis of the valuation of these leases as of December 12, 1919, when the property was transferred by J. B. Foster to the Foster Oil Co. A revision of the depletion schedule based on these leases to absorb the disallowance of $44,943.75 will result in a depletion unit for these leases of $1.94 per barrel. The taxpayer originally claimed $1.79 (Exhibits 9 and 10) per barrel when oil was selling at $2.25. On the basis of $1.79 per barrel, the depletion on these leases amounted to $39,530.13. The composite depletion unit allowed by the department on these five leases was 84.2 cents. The taxpayer's main contention, as set forth in recent correspondence, is the allowance of sufficient depletion on these properties to offset the disallowance on the former valuation dated October 13, 1924.

It amounts to very little, since the produttion during 1919 was 37,125 barrels from a property that contained, at that time, according to the department's figures, 1,724,932 barrels of oil. There is apparently another reason why the taxpayer is so insistent upon the establishment of this higher depletion unit. This property was sold in 1920 to the Gilliland Oil Co. for a consideration of $5,373,756.43, a portion which would be subject to taxes resulting from the sale of capital assets.

The taxpayer states that these oil properties were acquired as a result of a gift by J. B. Foster, December 12, 1919. At this date there were 30 or 40 producing wells on the property, yet Mr. Foster, for some reason, desired to dispose of this property and therefore gave it to the Foster Oil Co., of which he owned 98 per cent of the stock. The taxpayer's amended return (Exhibit 11) for the year 1919, page 32, states:

"On december 12, 1919, Mr. J. B. Foster, president and one of the stockholders of the Foster Oil Co., donated and transferred to the company without consideration his interest in certain oil and gas mining leases and leasehold estates, equipment, tank farms and steel storage located in Red River, Claiborne, and De Soto Parishes in the State of Louisiana, with the understanding and condition that said company was to assume all outstanding obligations

incurred on account of the purchase and development of said properties; and out of the earnings and proceeds of said properties to reimburse him the net amount of his investment therein."

Copies of the contract conveying this gift have not been found in the files of this case, but he submits an appraisal (Exhibit 9) to show that his total investment therein, in oil alone, is $3,460,691.

In connection with the reimbursement to Mr. Foster, subsequent to his gift to the Foster Oil Co., the following paragraphs from the contract (Exhibit 12) of sale by the Foster Oil Co. to the Gilliland Oil Co. may be of interest:

(2) "Thirty thousand shares of the common stock of the Gilliland Co. to be issued to any person or persons designated by the party of the first part."

(4) "The party of the second part, Gilliland Oil Co., agrees to assume and pay all outstanding unpaid charges and obligations incurred in the purchase, development, and improvement and supplies whether same be in the name of Foster Oil Co. or J. B. Foster or Gilliland to Foster, and further agrees to cancel any and all claims or accounts the Gilliland Oil Co. may hold or claim against Foster Oil Co. or J. B. Foster."

While Mr. Foster transferred these leases to the Foster Oil Co. it appears that he is amply protected in the event that a sale is made, the Foster Oil Co. specifically recognizes that Mr. Foster is to be reimbursed in that amount of his investment. The contract between the Foster Oil Co. (of which Mr. Foster owned 98 per cent of the stock and was president of the company) and the Gilliland Oil Co. is so broad in the two paragraphs quoted that Mr. Foster will undoubtedly be able to legally reimburse himself for this gift for any amount that he considers due him.

It is also interesting to note that in the same amended return (p. 32) for 1919 the taxpayer states:

"The valuation of the nonproducing leases is the appraisement of Frank Phillips and James K. Crawford, under date of November 10, 1919, appraising for the Gilliland Oil Co. its one-half interest in said lease, the remaining one-half interest therein being at that time the interest therein of Mr. J. B. Foster, and which he subsequently transferred to the Foster Oil Co."

Since this appraisement for the Gilliland Oil Co. was on November 10, 1919, and on February 14, 1920, the Gilliland Oil Co. purchased this identical property, the question might arise as to the motive of Mr. Foster for donating and transferring said property to the Foster Oil Co. As to whether this was a gift or not is not an engineering question, and there is nothing in the files to show that the case was referred to the solicitor for an opinion.

The engineering division, in its valuation report for these properties, October 13, 1924 (Exhibit 1), recognizes this transfer of property from Foster to the Foster Oil Co. as a gift and, as such, places a gross value thereon of $3,318,220, including equipment, showing a profit $2,082,707.94 on the sale of this property by the Foster Oil Co. to the Gilliland Oil Co., on which no tax adjustment has as yet been made. The engineering report states:

"The Louisiana leases were acquired by the company through gift from the president of the company, Mr. J. B. Foster, on December 12, 1919. These leases have been revalued at date of gift and depletion computed accordingly. The value set up at date of gift was found to be very high and has been revised as shown on the schedule attached to Form O, also on the schedule showing the sale of capital assets.

"The profit from the sale of the productive and unproductive leases has been revised by lowering the value of the productive leases at date of gift, by reducing the allowable depletion and by disallowing the depletable additions. The expenses of development are stated to have been charged to expense, but the returns do not bear out this statement and consequently this item is disallowed."

The unit has accepted the taxpayer's valuation of November 10, 1919, for the unproductive leases as $887,987.50; the net oil value of the productive leases as established by the unit is $1,479,901.35, as compared with $3,476,691 (Freeborn appraisal May 11, 1921) claimed by the taxpayer. The unit also accepts, without change, the taxpayer's estimate of reserves on the Oakes, Jackson, and Pugh leases.

The taxpayer's appeal contends that the Form O data used as a basis for his discovery valuations prior to December 12, 1919, is erroneous and incomplete. The value claimed as of December 12, 1919, is the discovery value less depletion to that date.

The taxpayer has had every opportunity to present complete and detailed information as indicated by the department's letter of July 30, 1923 (Exhibit 13), wherein he was asked specifically to furnish for the years 1919 and 1920:

(1) "The total number of barrels of oil by months produced from each tract that is credited to you and the amount of cash received therefor."

(2) "A concrete statement of development and operating costs for each tract from which production was obtained during the above years."

This was asked for in order to complete the Form O data, which was on file in the department on that date. The taxpayer in this particular letter was given 30 days to furnish this information.

On October 5, 1923 (two months later), the taxpayer stated (Exhibit 14) that on account of being short of help in his office, he would not be able to furnish the desired information within the time requested and asked for an additional 15 days. However, on October 16, he did submit the additional information previously requested by the department.

He now comes forward with the statement (Exhibit 5), under date of March 13, 1925, that the actual production to April 30, 1922, was in excess of the amount that he had been allowed in the department's valuation of October 13, 1924. This date of April 30, 1922, is approximately a year and a half prior to the date of October 16, 1923, when the taxpayer filed the information requested by the department. It will therefore be seen that all of this information, up to the close of April, 1922, was available to the taxpayer in 1923, when he filed his Form O data.

While the case is still pending before the department, there is a disposition on the part of the department to give the taxpayer a revaluation as indicated by the fact that under date of February 12, 1925 (Exhibit 3), the taxpayer was given "For your information and guidance there is inclosed copy of valuation report." On March 10, 1925 (per conference memorandum, Exhibit 4), Mr. Cochran, attorney for the corporation, had a conference in the oil and gas section in which—

"He requested information in regard to methods and figures used by this section in establishing valuation and computing depletion. Mr. Cochran was furnished copies of engineers' memorandum and depletion schedules. The computations by this section were explained."

At another conference (Exhibit 6) in the engineering division, oil and gas section, March 13, 1925—

"Mr. Cochran was advised not to appeal direct to the commissioner but to file his data in support of his protest direct with C. A. 25, and that such information would then be forwarded to the oil and gas section for consideration."

On March 14, 1925 (Exhibit 7), Mr. Cochran again called at the engineering division and asked for an extension of time in which to prepare his valuation data.

"Mr. Cochran has, therefore, been advised that the information needed should be supplied to the department within 90 days from this date."

On the same date the following memoranda (Exhibit 8) was prepared and placed in the case.

"Mr. F. R. Clute,
Head of corporation audit division:

"The Foster Oil Co.,of Tulsa, Okla., has submitted an affidavit under date of March 13, 1925, showing that the Form O previously filed is grossly in error. This statement by the taxpayer has been checked and found to be correct. It is therefore requested that no further action be taken on this case until this section transmits a new engineer's memorandum on this case.

"S. M. Greenidge, *Head of Division.*"

The so-called additional information which may be filed by the taxpayer should be actual production figures over a period of years, although the same production figures were available when the original report was filed. The discovery valuations that are allowable should be based upon information known or ascertainable at date of discovery or 30 days thereafter, so that the taxpayer could not, according to regulations, come in at this late date and have a discovery revaluation made in the light of subsequent information. The unit was extremely liberal in its valuation of October 13, 1924, and the allowances made by the department certainly check as closely as could be expected on a discovery valuation. Reserves (barrels) claimed by taxpayer, 1,926,400; allowed by the department, 1,724,932; actual production to April 30, 1922, 1,807,183. The taxpayer does have a right under the regulations to a readjustment of his

depletion rate should there be found any gross error in the matter of estimating the recoverable units. In this case the taxpayer's claim for the recoverable units is about 100,000 barrels in excess of the amount that was actually allowed by the department. The department's composite depletion unit at the date of discovery valuation was 84.2 cents. A new depletion unit based on the original valuation but with the new reserves as later determined would be 81 cents, or 3.24 cents less than the original depletion unit allowed, in which event the taxpayer would receive no benefit for the year 1919.

The reason back of this desire for a reappraisal of this property is for the department to go on record by establishing a depletion unit of approximately $1.80 per barrel for 37,125 barrels produced in 1919. Should this value of $1.80 per barrel be allowed, there would result no profit from a sale of property, which, according to the taxpayer's statement, was acquired as a gift, plus development costs, and sold at a price in excess of $5,300,000. The taxpayer, in his original returns (Exhibit 16), reports a profit of $5,280.66 on this transaction.

TAX LIABILITY

The tax liability for the year 1920 has not as yet been determined. When the 1919 return was audited the auditor had before him the engineer's valuation report, wherein depletion was determined for both years, 1919 and 1920. This same valuation report recognized a sale of capital assets showing an excess of $2,000,000 profit, which would represent a substantial tax for the year 1920. Yet, with this large income determined by the engineering division, no attention was given to it in the audit section, and the returns for the year 1919 only were audited. The taxpayer's appeal specifically relates to the year 1919, wherein only a small amount of tax is involved. The amount of tax paid in 1920 was $31,548.42 on a reported gross income of $664,676.23, including sale of capital assets. The 1922 return shows a loss of $111,409.77 on a gross income of $702,620.30.

TAXPAYER'S BASIS OF VALUATION

The discovery valuations, as set up by the taxpayer in the Shaw lease, are not entirely in conformity with the regulations. For example, in the Shaw A lease the taxpayer, in setting up a valuation as of December 12, 1919, dates his discovery on a well which came in July 19, 1919, at 2,000 barrels per day. Following this, Nos. 2, 3, 4, and 5 were drilled, the average of which was less than No. 1. Well No. 6 was brought in January 6, 1920, at 20,000 barrels per day. He includes the production of the large well of January 6, 1920, for the purpose of determining a valuation as of July 19, 1919, and December 12, 1919. The taxpayer's engineer states that by reason of the unusual condition in the geological structure the recovery is assumed at 600 barrels per acre-foot.

PRICE OF OIL

There is at this time a rising market price of oil, the posted price of oil at this date being $2.25, but he estimates that the future average price will be not less than $3.25 per barrel. His operating costs are estimated at 60 cents; so that he sets up his net operating profit of $2.65 per barrel, which he applies to his estimated reserves.

DISCOUNT

The discount factor used is 8 per cent over the life of the property and not 8 per cent per annum. As a hazard factor in the matter of reserves, the taxpayer estimates that at least one-fourth of the reserves should be considered as profit for a prospective purchaser. He therefore reduces his reserves by this amount, using 75 per cent of the total reserves for the basis of valuation. Having established a valuation on this basis, he dates back to July, 1919, for depletion. He determines his December 12, 1919, valuation by deducting from discovery valuation the actual number of barrels of oil produced to that by date, multiplied by $2.25 per barrel, the selling price of oil, instead of using $1.85 per barrel, as established by his valuation.

In the case of the Oakes lease, the discovery well No. 1 was brought in May 2, 1919, at 200 barrels per day, but discovery valuation was not set up or claimed until after well No. 11 came in November 29, 1919, at 12,500 barrels

per day. These two wells are used as a basis for discovery valuation, from which would be deducted the amount of oil produced from May 2 to December 12 to determine the value at date of transfer. Here again, as in the Shaw lease, when oil is selling at $2.25 per barrel he anticipated that $3.25 will be the average price of oil and 60 cents is operating costs, so that his discovery valuation is set up at a net operating profit of $2.65 per barrel.

With reference to the Jackson lease, he bases discovery value on the average initial production of the first six wells, setting up his value as of August 36, 1919, and December 12, 1919. In determining the value as of December 12, 1919, he should have used only wells Nos. 1, 2, and 4, which had a total initial production of 1,350 barrels, or 450 barrels each. However, he has included two additional wells, one of 1,000 barrels initial production January 6, 1920, and one of 6,000 barrels initial production January 28, 1920, both of which he has reflected back to the valuation dates, which is not in accordance with regulations. In estimating his future production, he has, at least, attempted to be reasonable in that he estimates that there will be six additional locations, but that on account of offset wells adjoining the property he does not assume that these future wells will have as large an initial production as the first six wells. This amount he discounts by 66⅔ per cent. However, while he assumes that these six additional locations will produce only one-third as much as the first six wells, he arrives at an average production at each of these locations of 972 barrels, which is considerably in excess of wells Nos. 1, 2, and 4, which alone should have been used as a basis for determining the value of the property as of December 12, 1919. In reality the taxpayer is estimating his future locations at double the average production of the three wells that came in before December 12, 1919.

The price of oil, as used in the valuation of the Jackson lease, is set forth in his amended returns, page 39, as follows:

"The posted price of oil at the time of discovery was $2.25 per barrel and the present price is $3.25, but it has commanded a premium over the posted price. It is reasonable to suppose that the prospective purchaser could safely assume an average price of $2.75 per barrel. The sand being found at a shallow depth, the cost of development and operations is estimated at 40 cents per barrel, thus making the net return per barrel $2.35."

In determining the value of these properties as of date of discovery as December 12, 1919, Freeborn & Co., who made the engineering appraisals, state on page 14 of their report:

"Owing to the lack of marketing and storage facilities practically all the deep sand and many of the shallow sand wells have had to be pinched in from the beginning. Hence the production records do not afford means of determining the rate of decline of individual wells or the field."

On page 15 of this appraisal mention is made of the salt-water situation:

"In December, 1919, after about 500,000 barrels of oil had been taken from the deep sand, the deep-sand wells began making b. s. and salt water. The first appearance of salt water was in the northwestern part of the pool. Tests showed that salt water was prevalent throughout the greater portion of the pool. Inasmuch as oil was under hydrostatic pressure, it was evident that if the wells were allowed to flow to anything like capacity the oil would soon be so badly cut as to be worthless, if not cut off altogether. Some of the wells stopped flowing altogether."

Continuing on page 16:

"The producers do not dare to allow the wells to produce except through chokers, and it is evident that careful treatment and perhaps concerted action on the part of the producers will be necessary in order to save the deep-sand pool from irreparable damage. If the situation is carefully handled, a large portion of the oil should be recovered."

Continuing on page 17:

"If the structure is approximately as described, it would appear that the Foster Oil Co.'s Oakes lease is the most favorably situated in respect to the salt-water menace. Most of the salt-water wells are on the edges of the pool.

'There have been recently completed three salt-water wells in the shallow-sand area at the depth of the deep sand, thus indicating that salt water may be prevalent at the greater depth even in the shallow-sand pool."

On page 18 he states:

"In view of facts given above, it is believed that in the long run the shallow-sand area has greater possibilities than the deep-sand pool. While the latter

is more spectacular, it can not be expected to have the lasting qualities of the shallow sand on account of much greater thickness of the latter and its comparative freedom from salt water. The deep sand must necessarily be limited in production by the physical conditions."

While the department did not accept these methods of valuations, yet this is the basis for determining the depletion unit which the taxpayer appeals to have restored, and sustain his claim for a revaluation of these Louisiana leases. The entire set-up by Freeborn & Co. fails to conform with regulations at so many different points that it is worthless and should not be considered except possibly for dates, wells, initial production, and total production to date of valuation report. The department did not give this set-up very favorable consideration in 1924, as noted by the following comment of October 13, 1924:

"The value set up at date of gift was found to be very high and has been revised as shown on schedules attached to Form C and on the schedule showing sale of capital assets. The profit from the sale of the productive and unproductive leases in Louisiana on February 14 to the Gilliland Oil Co. has been revised by lowering the value of the productive leases at date of gift by reducing the allowable depletion and disallowing the depletible additions."

EXHIBIT 1

ENGINEERING DIVISION, OIL AND GAS VALUATION SECTION

Foster Oil Co., Tulsa, Okla. Lessee—Kansas, Oklahoma, Louisiana.
Taxable years: 1919 and 1920. 1917 closed; 1918 valued.
Organized: Oklahoma, April 18, 1916.
Depletion computed upon cost, discovery, and value at date of gift.
Drilling costs charged to expense.

Depletion

Taxable year	Gross income from oil	Depletion claimed	Depletion allowable
1919	$364,288.98	$140,138.45	$95,194.70
1920	630,922.27	112,366.22	102,638.23

DEPRECIATION

The rates of depreciation claimed on equipment in Kansas, and Oklahoma appear reasonable. No depreciation is claimed on the Louisiana property.

ORDINARY AND NECESSARY EXPENSES

The deductions under this schedule appear reasonable in relation to the volume of business.

LOSSES

The deductions under Schedule A-23 are acceptable for both years.

SALE OF CAPITAL ASSETS 1919

This office has no basis for checking the profit on the sale of warehouse stock.

The profit from the sale of four leases to the Lone Star Gas Co. is believed to be correct.

SALE OF CAPITAL ASSETS IN 1920

The profit of $94,654.20 reported from the sale of a lease in section 6-9W-5N, Caddo Co., Okla., is believed to be correct.

The profit from the sale of the productive and unproductive leases in Louisiana has been recomputed as follows:

Selling price:		
Cash		$500,000.00
30,000 shares of Gilliland stock		1,200,000.00
Deferred payment		2,500,000.00
Debt assumed by Gilliland		1,173,756.43
Depletion sustained		27,271.12
Value at date of gift:		
Productive leases	$1,479,901.35	
Unproductive leases	887,987.50	
Depletable additions	None.	
Depreciable additions	91,113.22	
Storage oil	40,317.54	
Profit	2,082,707.94	
		5,401,027.55

DISCUSSION

The taxpayer claims depletion on properties in both Louisiana and Kansas. The depletion allowable on the Kansas property has been computed according to schedules established by W. C. F. in memo. of July 16, 1924.

The Louisiana leases were acquired by the company through gift from the president of the company, Mr. J. B. Foster, on December 12, 1919. These leases have been revalued at date of gift and depletion computed accordingly. The value set up at date of gift was found to be very high and has been revised as shown on the schedules attached to Form O and on the schedule showing sale of capital assets.

The profits from the sale of the productive and unproductive leases and equipment in Louisiana on February 2, 1920, to the Gilliland Oil Co., has been revised by lowering the value of the productive leases at date of gift, by reducing the allowable depletion, and by disallowing the depletable additions. The expenses of development are stated to have not been charged to expense, but the returns do not bear out this statement, and consequently this item is disallowed. The other item of depletable additions is entirely unexplained and is also disallowed until substantiated.

The value of the 30,000 shares of Gilliland stock received as part payment has been checked and found to be as set up.

Recommended by:

D. W. W., *Engineer.*

Approved by:

W. N. THAYER, *Chief of Section.*

OCTOBER 13, 1924.

EXHIBIT 2

FOSTER OIL CO.,
Tulsa, Okla., February 3, 1925.

COMMISSIONER INTERNAL REVENUE,
Washington, D. C.

(Attention Hon. J. G. Bright, Deputy.)

SIR: Referring further to your communication of January 23, 1925, IT:CA:2558-N-6:, in which you advise that an examination of our income and profits tax return for the year 1919 disclosed an additional tax liability:

The detailed statement attached to your letter shows that of the claim for depletion submitted by us in the sum of $140,138.45 only $95,194.70 has been allowed. As this claim covers several properties described in detail in Schedule 5-C attached to our return above referred to, and in order that we may fully perfect our appeal and exceptions to adjustments made, will you please advise us what amount of our claim for depletion has been allowed on each of said properties and furnish us with a copy of engineer's memorandum thereon?

If we may have this information at an early date it will greatly assist us in perfecting our appeal within the time requested in our appeal this day forwarded.

Respectfully,

FOSTER OIL CO.,
By J. W. MARSHALL,
Its Secretary.

EXHIBIT 3

TREASURY DEPARTMENT,
INTERNAL REVENUE BUREAU,
February 12, 1925.

FOSTER OIL CO.,
P. O. Box 162, Tulsa, Okla.

SIRS: Reference is made to your letter dated February 2, 1925, relative to your income tax liability for the year 1919. In reply you are granted an extension of 25 days from the date of this letter within which to complete your protest against office letter to you dated January 23, 1925. For your information and guidance there is inclosed copy of valuation report.

In your reply please refer to the symbols IT:CA:2558-E-2.

Respectfully,

J. C. BRIGHT,
Deputy Commissioner,
By E. B. COOK,
Chief of Section.

Inclosure: Valuation report.

EXHIBIT 4

TAXPAYER'S CONFERENCE,
ENGINEERING DIVISION, OIL AND GAS SECTION,
March 10, 1925.

Taxpayer: Foster Oil Co.
Address: Tulsa, Okla.
Represented by: Mr. Cochran.
Credentials: Power of attorney.
Taxable years: 1919-1920.
Issues discussed: None.

Conclusions: Mr. Cochran requested information in regard to methods and figures used by this section in establishing values and computing depletion.

Mr. Cochran was furnished copies of engineer's memoranda and depletion schedules. The computations by this section were explained.

Returns are in C. A. No. 25.

Sixty-day period expires April 1, 1925.

JOHN CULLEN,
Conferee.
W. N. THAYER,
Chief of Section.

Interviewed by:
D. W. WILLIAMS,
ALEXANDER J. BELL.

EXHIBIT 5

WASHINGTON, D. C., *March 13, 1925.*

In re: Income tax deficiency claimed against Foster Oil Co., a corporation of Tulsa, Okla., for the year 1919.

Hon. J. G. BRIGHT,
Deputy Commissioner Internal Revenue, Washington, D. C.

DEAR SIR: In support of our application for the return or transfer of the files in this matter from the audit division to the engineering division, we submit herewith the attached tabulated and verified statement of reserve as originally claimed and as allowed, as compared with actual production to April 30, 1922, and showing facts which are inconsistent with our present Form O and which, among other facts, necessitate the preparation and filing of a new Form O to be considered in connection with out protest.

Yours truly,

FOSTER OIL CO.,
By A. D. COCHRAN,
Its Attorney in Fact.

Valuation data, Louisiana lease

	Shaw	Shaw A	Oakes	Jackson	Pugh	Total
	Barrels	*Barrels*	*Barrels*	*Barrels*	*Barrels*	*Barrels*
Original Form O	436,000.00	375,500.00	231,500.00	457,500.00	425,900.00	1,926,400.00
Government allowance	426,002.53	183,893.84	231,570.40	457,549.00	425,916.19	1,724,932.97
Actual production to Apr. 30, 1922	631,969.20	202,082.82	474,228.80	292,736.29	206,116.86	1,807,133.17

UNITED STATES OF AMERICA,
District of Columbia, ss:

A. D. Cochran being first duly sworn, on oath states that he is the attorney in fact for the Foster Oil Co., a corporation of Tulsa, Okla.; that the above and foregoing tabulated statement has been carefully compiled from reliable data and sources of information; and that the facts and figures therein set forth are true and correct as he verily believes.

A. D. COCHRAN.

Subscribed and sworn to before me this 13th day of March, 1925.

[SEAL.]

JANET W. LAKE,
Notary Public.

My commission expires May 26, 1926.

EXHIBIT 6

TAXPAYER'S CONFERENCE,
ENGINEERING DIVISION, OIL AND GAS SECTION,
March 13, 1925.

Taxpayer: Foster Oil Co.
Address: Tulsa, Okla.
Represented by: Mr. Cochran.
Credentials: Power of attorney on file. Not enrolled.
Conclusions: Mr. Cochran was advised not to appeal direct to the commissioner, but to file his data in support of his protest direct with C. A. 25, and that such information would then be forwarded to the oil and gas section for consideration.
Interviewed by: W. N. Thayer.

W. N. THAYER,
Chief of Section.

EXHIBIT 7

MARCH 14, 1925.

Memorandum in re Foster Oil Co., Tulsa, Okla.

Mr. A. D. Cochran called and requested that he be given a sufficient length of time to furnish new Form O for above-named taxpayer in connection with the return for 1919 and subsequent years.

Investigation developed that the case is being sent from the corporation audit division to the engineering division to be reworked because of the incompleteness of information heretofore submitted by taxpayer. Mr. Thayer, chief of the oil and gas section, stated over the telephone that a sufficient length of time would be granted taxpayer in which to furnish to the department the necessary information. Mr. Cochran has therefore been advised that the information needed should be supplied to the department within 90 days from this date.

S. M. GREENIDGE,
Head of Division.

EXHIBIT 8

MARCH 14, 1925

Mr. F. R. CLUTE,
Head Corporation Audit Division
(Attention Mr. E. B. Cook, chief section 25.)

The Foster Oil Co. of Tulsa, Okla., has submitted an affidavit under date of March 13, 1925, showing that the Form O previously filed is grossly in error. This statement by the taxpayer has been checked and found to be correct.

It is therefore requested that no further action be taken on this case until this section transmits a new engineer's memorandum on this case.

S. M. GREENIDGE,
Head of Division.

EXHIBIT 9

Form O, Schedule 5, Louisiana leases—Depletion December 12 to December 31, 1919

[All leases acquired in year 1919]

	Shaw	Shaw "A"	Oakes	Jackson	Pugh	Total
A. Recoverable oil barrels	426,000	375,500	231,500	457,500	425,900	1,916,400
B. Production for year 1919 barrels	6,145	675	3,792	6,207	20,306	37,125
C. Capital invested, 1919	$809,500.00	$695,024.00	$441,004.00	$745,163.00	$770,000.00	$3,460,691.00
E	809,500.00	695,024.00	441,004.00	745,163.00	770,000.00	3,460,691.00
F. Unit cost, 1919	1.90	1.85	1.90	1.63	1.80	
G. Depletion, 1919	11,675.50	1,248.75	7,204.80	10,117.40	36,554.80	66,801.25

Average unit cost per barrel, $1.79.
NOTE.—For items A and C, see valuation report of Freeborn Engineering Co. as on Dec. 12, 1919.

EXHIBIT 10

TULSA, OKLA., *May 11, 1920.*

FOSTER OIL CO.,
407 Exchange National Bank Building,
Tulsa, Okla.

GENTLEMEN: This is to certify that in accordance with your request we have examined certain of your properties in Claiborne, Red River, and De Soto Parishes, La., together with all records and other data pertaining thereto, and that we have arrived at the following valuation of your interest as of date of the first or discovery well, also as of the date of December 12, 1919:

Lease	Estimated recoverable oil (barrels)	Valuation at date of first well	Valuation as of Dec. 12, 1919
Jackson	1,490,000	$751,000	$745,163
Shaw	1,025,000	825,000	809,500
Shaw A	1,314,000	704,000	695,024
Oakes	1,145,000	461,500	441,004
Pugh	940,000	818,600	770,000
King	24,300	18,279	16,000
Total		3,578,379	3,475,728

Following are general information, well logs, production records, estimate of recoverable oil, valuations, maps, and other data on which the above conclusions are based.

Respectfully submitted.

F. W. FREEBORN ENGINEERING CORPORATION,
By R. W. CLARK, *V. H. C.*

EXHIBIT 11

FOSTER OIL CO.,
December 31, 1919.

SCHEDULE F, ADJUSTMENT BY WAY OF ADDITIONS

EXPLANATION

This item arose as follows:

On December 12, 1919, Mr. J. B. Foster, president, and one of the stockholders of Foster Oil Co., donated and transferred to the company, without consideration, his interest in certain oil and gas mining leases and leasehold estates, equipment, tank farms, and steel storage located in Red River, Claiborne, and De Soto Parishes, in the State of Louisiana, with the understanding and condition that said company was to assume all outstanding obligations incurred on account of the purchase and development of said properties; and out of the earnings and proceeds of said properties, to reimburse him the net amount of his investment therein.

The fair market value of said property as of December 12, 1919, is as follows:

(1) Nonproducing leases	$887,987.50
(2) Producing leases	3,476,691.00
(3) Equipment and machinery	391,827.42
Total valuation	4,756,505.92
(4) Debts assumed	566,672.97
"Paid-in surplus"	4,189,832.95

As appears more in detail at page No. 34 of this company's amended corporation tax return for the year 1919.

The basis of the valuation of the nonproducing leases, (1) above is the appraisement of Frank Phillips and James K. Crawford under date of November 10, 1919, appraising for the Gilliland Oil Co., its one-half interest in said leases. The remaining one-half interest therein being at that time the interest therein of Mr. J. B. Foster and which he subsequently transferred to the Foster Oil Co. A copy of said appraisement by Phillips and Crawford is hereto attached. From this appraisement we have deducted the valuation of the six producing properties, leaving the valuation of the nonproducing properties at the sum of $887,987.50, as is shown at pages 32 and 33 hereof.

For the valuation of the six producing properties we have used the appraisement of the Freeborn Engineering and Construction Co. prepared by them for the purpose of depletion on account of discovery, which is attached hereto as a part of this company's 1919 amended return, which appraisement is the amount of $3,476,691.

The machinery, equipment, etc., is appraised at its original cost.

The net fair market value of said properties, after deducting the amount of the obligations assumed, is $4,189,832.95. Said property is tangible property paid in to the company by a stockholder as a gift and at a value definitely known and accurately ascertainable as of the date of transfer clearly and substantially in excess of any consideration paid therefor. And said amount of $4,189,832.95 was accordingly entered upon the books of the company as "Paid-in surplus" as is provided for in articles 836 and 837 of Departmental Regulations 45 (1920 edition).

EXHIBIT 12

GILLILAND OIL CO.—MEMORANDUM OF AGREEMENT

[From page 108, F. W. Freeborn Engineering Corporation Report]

This agreement made and entered into on this the 14th day of February, 1920, by and between Foster Oil Co., a corporation incorporated under the laws of the State of Oklahoma, with its principal office at Tulsa, Okla., party of the first part, and Gilliland Oil Co., a corporation incorporated under the laws of the State of Delaware, with its principal office at Tulsa, Okla., party of the second part.

Witnesseth, that the party of the first part, Foster Oil Co., agrees to convey or assign to the party of the second part, Gilliland Oil Co., all of its right, title, and interest in the oil leases, tank farms, storage, equipment, and oil in storage and all other property in connection therewith of whatsoever nature located in the State of Louisiana.

In consideration therefor Gilliland Oil Co., party of the second part, agrees to pay Foster Oil Co., party of the first part—

One. Five hundred thousand dollars, receipt of which is hereby acknowledged by the party of the first part.

Two. Thirty thousand shares of the common stock of Gilliland Oil Co., to be issued to any person or persons designated by the party of the first part.

Three. The proceeds of one-fourth of all the oil produced and saved from the net working interest, exclusive of royalties and bonuses, on the combined properties now owned by both of the parties hereto in the State of Louisiana, until the same amounts to $2,500,000. It is understood that the one-fourth of the oil which is to go to the credit of the party of the first part is to include all oil sold up to this time and unpaid for and all unsold oil now in storage on the properties, on steel tank farms, or in the pipe lines.

Four. The party of the second part, Gilliland Oil Co., agrees to assume and pay all outstanding unpaid charges and obligations incurred in the purchase, development, and improvement and supplies, whether same be in the name of Foster Oil Co., or J. B. Foster, or Gilliland & Foster, and further agrees to cancel any and all claims or accounts the Gilliland Oil Co. may hold or claim against Foster Oil Co. or J. B. Foster, except the amount due G. R. McCullough from the Foster Oil Co., as covered by separate agreement.

Five. The party of the first part, Foster Oil Co., relinquishes all claims whatsoever nature that it may have against Gilliland Oil Co. by reason of amounts paid on the development account of said property and for other purposes and is to have and retain the proceeds of sale of all oil runs for which settlement has been received by it.

The parties hereto mutually agree to procure, execute, and deliver all assignments, leases, stocks, deeds, minutes, certificates, or other instruments necessary to carry this agreement into effect within 15 days from the date hereof.

In witness whereof the parties hereto have hereunto and unto a duplicate hereof, set their hands and seals this 14th day of February, 1920.

FOSTER OIL CO.,
By J. B. FOSTER,
Its President.

Attest:
[SEAL.] J. W. MARSHALL, *Secretary.*

GILLILAND OIL CO.,
By J. W. GILLILAND,
Its President.

Attest:
[SEAL.] J. W. HAYES, *Secretary.*

EXHIBIT 13

TREASURY DEPARTMENT,
INTERNAL REVENUE BUREAU,
July 30, 1923.

FOSTER OIL CO.,
P. O. Box 162, Tulsa, Okla.

SIRS: In connection with the review of your Form O data, now on file in this office, additional information is required.

With respect to each producing property in the State of Louisiana from which you receive income during the taxable years 1919 and 1920, please submit—

1. The total number of barrels of oil by months produced from each tract that is credited to you and the amount of cash received therefor.
2. A complete statement of development and operating costs for each tract from which production was obtained during the above years.

You are requested to acknowledge the receipt of this letter within 15 days from its date direct to the Commissioner of Internal Revenue, Washington,

D. C. referring to IT:NR:OG:DR-1538) and to furnish the required information within 30 days from the date of this letter.

Your failure to supply the necessary information within the time mentioned will result in your case being closed on the basis of the information at hand.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.
W. N. THAYER,
Chief of Section.

EXHIBIT 14

FOSTER OIL CO.,
Tulsa, Okla., October 5, 1923.

Mr. J. G. BRIGHT,
Deputy Commissioner, Washington, D. C.

DEAR SIR: Additional data asked for in your letter of July 30, 1923, under above file number, beg to advise that the information will be furnished at the earliest possible moment, but on account of being short of help in the office we will not have the same ready to forward at the end of the time requested.

However, we will ask for an additional 15 days in which to file the data required.

Yours truly,

J. W. MARSHALL, *Secretary.*

EXHIBIT 15

TREASURY DEPARTMENT,
INTERNAL REVENUE BUREAU,
October 24, 1923.

FOSTER OIL CO.,
Tulsa, Okla.

SIRS: This is to acknowledge receipt of your letter dated October 16, 1923, submitting additional information previously requested by this office.

You are advised that these data will be given consideration as soon as the orderly procedure of this office will permit.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.
By H. A. C.,
Acting Chief of Section.

EXHIBIT 16

Sale of capital assets, Foster Oil Co., December 31, 1920 (Schedule 7)

1. Louisiana properties as per attached sheets.
2. Date of disposal of property: February 14, 1920.
3. Manner of disposal: Sale.
4. (*a*) Name and address to whom property was transferred: Gilliland Oil Co., Tulsa, Okla.
   (*b*) No connections between persons disposing of property and purchaser.
5. Bona fide sale.
6. Amount received in cash $500,000.00
7. Amount received in stock (shares) 30,000
   (*a*) No par value 1,200,000.00
   (*b*) Actual cash value of stock.
   (*c*) Cash value determined: Market value.
8. Amount received in other consideration 2,500,000.00
   (*a*) Deferred payments in amounts equal to one-fourth proceeds of the sale of working interest oil.
   (*b*) Debt assumed by Gilliland Oil Co. on date of disposal 1,173,756.43

9.	Cash value of all consideration received for property	$5,373,756.43
10.	Value of property as on date of acquisition	4,364,678.50
11.	Total addition to capital returnable through depletion added subsequent to date of acquisition	40.070.00
	Total developing expenses not shared to profit and loss	80,097.76
12.	Total capital returnable through depreciation to date of disposition	910,113.22
	Storage oil at book value	40,517.54
13.	Gross value of property as at date of disposition	5,435,277.02
14.	Total depletion sustained from date of acquisition to date of disposal	66,801.25
15.	No depreciation.	
16.	Net value of property as at date of disposition of property	5,368,475.77
17.	Profit sustained from disposition of property	5,280.66

MEMORANDUM COVERING INTERVIEW WITH MR. D. W. WILLIAMS, VALUATION ENGINEER, OIL AND GAS SECTION

April 1, 1925.

Mr. Williams was questioned in regard to the proposed action to be taken by the oil and gas section in valuing certain leases of the Foster Oil Co., located in Louisiana and Kansas.

Mr. Williams stated that just what the action of the unit would be had not been determined on. He did admit, however, that the original Form O of the taxpayer was incorrect and that undoubtedly relief would be furnished him on the basis that his new Form O was correct.

As to why the original Form O was incorrect, he could not state, except that, of course, the last Form O contains information as to production carried down to a later date than that contained in the first Form O.

L. H. Parker,
Chief Engineer.

Mr. Manson. By way of apology or explanation for offering all of these reports on that subject, I have not wanted to make the charge that there appears to be no way of bringing the matter to a head in the oil and gas section, upon the basis of any one or two cases, and, for that reason, I have offered quite a number of these cases, and feel that I have gone as far as it is necessary to go for the purpose of establishing that point.

I do believe it would facilitate the work of the bureau and tend to get it current, so far as the oil and gas section is concerned, if in the first place the law was observed relative to making valuations as of date of discovery or within 30 days thereafter.

Here we have a report on a case where, even after the expiration of 18 months they refused to make a valuation and, of course, there is absolutely no way to get that work current if they are going to wait to find out how much a well has produced before they ascertain what it will be anticipated to produce at the date of discovery.

In the second place there appears to be little, if any, attempt made upon the part of the section to force the taxpayer to present such information as may be necessary for the purpose of determining these valuations, of disallowing his claimed valuations for lack of information.

The Chairman. Is there not some sort of a petroleum institute to which the oil industry belongs, or which it maintains?

Mr. Manson. There is a petroleum institute. It appears to be represented, so far as the bureau is concerned, by a man by the name of Mattison.

Senator King. Do you mean to say he is in the bureau?

Mr. Manson. No; he represents it before the bureau in the work.

The Chairman. I bring that up because it is current among a

good many of the employees of the bureau, and is also current among our staff, that they really control the situation in the oil and gas section, and that that is the reason for these evidences of delay and favoritism, etc.

Mr. MANSON. Well, I have hesitated to make any general charges, but I do believe the oil people get away with pretty nearly anything they want, as far as the oil and gas section is concerned.

The CHAIRMAN. I think the staff believes that a large number of them do; that is, the employees of the bureau, and I know that our staff has a very definite conviction that they can go in there and get anything they want in the oil and gas section. That idea is very prevalent. I submit that as hearsay information, but that is the feeling as to the lack of progress made in that section.

Senator KING. The Petroleum Institute is really a sort of funnel, if I may use that expression, through which all of the oil interests pour forth their activities. It is the coordinated organization of the oil industry of the United States.

Mr. MANSON. I checked up on these——

The CHAIRMAN. I think it was that organization that tricked Congress into all of these discovery valuations and depletion, etc. I really believe that Congress was tricked.

Senator KING. I believe it might be to the best interests of all concerned if the oil and gas section and the mining section of your organization down there were reorganized.

The CHAIRMAN. I would like to ask Mr. Manson before we adjourn, and I assume that he is nearly through——

Mr. MANSON. I am through.

The CHAIRMAN (continuing). What the situation is with regard to the anthracite-mining settlement. I understood from Mr. Parker, I think it was, that no case of the anthracite coal producers had been settled.

Mr. MANSON. That is my information. In other words, I got the information in this way. I have called the attention of our engineers to several anthracite cases, and none of the cases to which I called their attention had been closed.

The CHAIRMAN. Mr. Nash, could you look it up, and not rely upon us to remind you again, about the status of those anthracite cases?

Mr. NASH. Senator, that was mentioned here once before, and I am having that checked up. As yet, I have not received a report on it. I wanted to check that up for my own information. It was the first time that this situation had ever come to my attention.

The CHAIRMAN. I would like to know if my information is correct, that there are no anthracite cases that have been closed, because we were particularly interested in the matter of the depletion of anthracite coal mines, as to the amount allowed, because of the criticism that the committee received on the amount of depletion that was claimed by the companies and what they were really allowed.

Mr. MANSON. I think the chairman called my attention to five or six cases.

The CHAIRMAN. Yes.

Mr. MANSON. And we called for the files in those cases, and found that they had not been acted upon, and we dropped the matter there.

Senator KING. Mr. Nash, in the Income Tax Unit, who would specifically or directly come into contact with the oil and gas section and the metals section? Would it be Mr. Blair, or anybody intermediate between him and the heads of those sections?

Mr. NASH. Mr. Greenidge is the head of the engineering division, and that is divided into s ctions.

Senator KING. Yes.

Mr. NASH. The oil and gas section, the metals section, the nonmetals section, the timber section, etc. Mr. Greenidge is responsible to Mr. Bright, the deputy commissioner in charge of the Income Tax Unit, and Mr. Bright, in turn, is responsible to Mr. Blair.

The CHAIRMAN. Who has knowledge of the audits after they have passed through the engineering section?

Mr. NASH. After the valuations are made in the engineering section, if it is a straight corporation case, it goes into the corporation audit division under Mr. Clute.

If it is a consolidated case, it goes into the consolidated audit division, which was formerly under Mr. Lohman, and now is under Mr. Robinson.

If it is a personal or individual case, it goes into the personal audit division, under Mr. Lewis.

Each of those division heads is in turn responsible to Mr. Bright.

The CHAIRMAN. Has Mr. Alexander a title? And to whom is he responsible?

Mr. NASH. Mr. Alexander has the title of supervising internal revenue agent, and is responsible directly to Mr. Bright.

The CHAIRMAN. So that none of these other sections that you have referred to have any control over Mr. Alexander?

Mr. NASH. No; not at the present time. Mr. Alexander used to be the head of the old national resources audit division, which was abolished last July and consolidated in with three other divisions. Since that time Mr. Alexander has worked on special assignments from Mr. Bright.

The CHAIRMAN. An ex-employee of the bureau, whose name I do not know by the way, has sent me two or three suggestions with reference to the conduct of the bureau, and most of them we have dealt with, as I recall the testimony before the committee; but there was one that he referred to where, at one time, there was a sort of a committee of review where these controverted questions between employees might be taken for settlement, or to straighten out the minds of the individuals who had disagreed, and also that this same committee had a right to pick out any particular case, as we have done, and analyze it to see the methods followed in settling it, so that there was a sort of clearing house where these controverted questions might be settled or drawn to the attention of the commissioner, or the deputy commissioner, or the assistant to the commissioner. He said that that committee had existed at one time, but was later abolished, and he recommended that it be reinstituted.

Do you know anything about that?

Mr. NASH. That was before my work in Washington, Mr. Chairman. I think there was a review division in the Income Tax Unit, through which all audit cases passed for an examination after they had been closed by the auditor. That was abolished on a recom-

mendation of the tax simplification board in 1921 or 1922, because it was the neck of the bottle, so to speak, and thousands of cases were damming in there. They were not moving, and instead of having the review examination that was desired they really were getting an entire reaudit of these cases. That meant an audit in the audit division, another audit in the review division, and then possibly a subsequent examination in the solicitor's office or in the committee of appeals and review. So when it was abolished they cut out one step in the machinery. In its place they established a review section in each division; the review section to be responsible to the head of the division, and to review the work of the auditors in that division, not in a detailed way but just enough to satisfy themselves that the work of the auditor was correct.

The CHAIRMAN. But I think the evidence has disclosed that they are under the control and supervision of the section which may be criticized and, of course, those employees would be loth to criticize their superior officers. I disagree with that procedure, because of that very reason. and I was wondering whether the bureau might not consider this and let us know whether they thought it worth while to establish some four or five committees, like our staff has organized here within the bureau, where those people may go to criticize or where, on complaint, a Member of Congress or a private citizen may go and see whether the committees agree. These men, of course, should be entirely independent of anybody under the commissioner.

Mr. NASH. Senator, we were hoping to overcome our present difficulty by placing representatives from the solicitor's office in the review section, beginning June 1, and holding themselves responsible directly to the solicitor.

The CHAIRMAN. You think that will answer the purpose?

Mr. NASH. I believe that it will correct our present difficulty.

I want to say that outside of the engineering division we have had very little difficulty in these review sections.

The CHAIRMAN. You may not have had any difficulty, but that might be due to the passiveness of the employees rather than to the fact that real results were obtained.

Mr. NASH. I want also to add this: In the review sections we have our higher-grade employees. It is an advancement for a man to get into the review section. He gets a higher classification under the classification law, and he gets a higher salary. He is a better qualified man technically than the auditors who are in the auditing divisions.

The CHAIRMAN. But he usually gets that promotion, Mr. Nash, through the recommendation and the influence of his superior; and therefore that man is under obligations to his superior.

Mr. NASH. He does not get it entirely on the recommendation of his immediate superior.

The CHAIRMAN. I mean that it was at the suggestion of his superior that he got the place, or probably would not get it. If there was a man there who showed by the quality and volume of his work that he was not fit for the review section, and his chief of section said so, he would not get the position. Therefore the employees desiring promotions, which is a perfectly natural and normal thing, and try to please the chief, so that they may be promoted,

and I believe that is a dangerous thing in a matter involving so much Government money and Government practice.

Mr. NASH. Senator, we do not take the judgment of any one man in making an advancement of that sort.

The CHAIRMAN. But you would not promote a man whose chief said he was not a fit man for the place, would you?

Mr. NASH. We would certainly look into it, but we would not be guided entirely by his judgment.

The CHAIRMAN. No; perhaps not; but you would hardly put him there if his chief said that he was not a good man.

Senator KING. You would not promote him over the objection of his chief. You may not take the recommendation of the chief for promotion, but you would not actually promote over the objection of the head of the division. You would not know that he was there, Mr. Nash?

Mr. NASH. I personally might not know that he was there, but the most competent employees that we have in the Income Tax Unit are in the review division, the most dependable men that we have are there, and that is why we have a great deal of confidence in them.

Mr. MANSON. I want to call your attention in that connection—it seems to be pertinent to what you are discussing now—to a fact that has been brought to my attention.

For instance, in rating employees, one of the points upon which an employee is rated is cooperation. I have looked over the rating of practically all of the engineers——

The CHAIRMAN. In fact, I have looked over them all.

Mr. MANSON. Yes.

The CHAIRMAN. And I saw Mr. Shepherd rated at 100.

Mr. MANSON. Yes. And I noticed that in the two sections of the engineering division, which we think are the weakest, the heads of the sections get a higher rating, and a good share of the difference between their rating and the rating of the heads of other sections is due to the fact that they get a higher rating on cooperation.

The CHAIRMAN. Which means doing what the chief tells them.

Mr. MANSON. Well, I appreciate the necessity of cooperation being considered an element in rating, but in those circumstances the rating that is made is reviewed by——

The CHAIRMAN. The same man.

Mr. MANSON (continuing). By the same man.

The CHAIRMAN. I noticed that. I noticed that Mr. Greenidge fixed a rating and then approved it in a good number of cases, so that his judgment is not questioned by anybody on his rating sheets.

Mr. NASH. I just want to say that the ratings in the engineering division have not been accepted by the commissioner and are being reexamined.

The CHAIRMAN. I am glad of that.

Senator KING. Lest there should be some misunderstanding of my former criticism, if it may be so denominated, I did not mean to include Mr. Grimes. I think Mr. Grimes is working very assiduously to correct the errors.

Mr. NASH. I wondered what your criticism was when you said you did not think the mining section was functioning, because we think it is.

Senator KING. Well. I think so, too. What I had reference to more particularly was Mr. Greenidge's division.

Mr. NASH. Mr. Grimes is a subordinate of Mr. Greenidge.

The CHAIRMAN. It seems to me it ought to be reversed.

Mr. NASH. The metals section is really functioning very well.

The CHAIRMAN. What do you want to take up to-morrow, Mr. Manson?

Mr. NASH. Senator, before we adjourn, I wish to make this statement: The committee asked me yesterday to check up and see if I had any records in the bureau of March 1, 1913, values that had been used or might be used on subsequent cases. I stated that I thought we had this information in our information section.

Our information section was established September 11, 1923. I had the head of this section come up this morning and explain to me just what sort of information he had on file, and this is a summary of it:

Allocation of dividends showing percentage taxable and nontaxable.

Allocation of liquidating dividends showing percentage return of capital, taxable for surtax, and taxable for both normal and surtax.

In cases of sales of stock of corporations having natural resources subject to depletion, the information unit has recorded tax-free distributions received since March 1, 1913, by stockholders of such corporations.

March 1, 1913, value of securities shown by market quotations or determined under A. R. M. 34.

That is the subject we had under discussion yesterday.

Market quotations of securities for all years subsequent to 1896.

Dates, and percentages of payments of stock dividends and stock dividends and stock rights.

Taxable status of stockholders in reorganization, merger and consolidation transactions.

Status of contributions, showing those deductible and not deductible.

Information on refunds of estate taxes made to various estates.

Matters pertaining to cases coming under the office of the Alien Property Custodian.

There is a card record of all March 1, 1913, values that have been determined September, 1923, similar to this [exhibiting card].

This is a card taken from the files, and it reads:

Salisbury Cotton Mills, Salisbury, N. C., March 1, 1913. Value of stock, $207.44; determined on information furnished by corporation under the principles of A. R. M. 34.

The instructions in the audit division are that whenever an auditor has a case which involves the valuation of a stock or a security he makes a request for the information as to the value on this Form 1488, which is routed to the information section. The information section fills out on this side of the form any information they have as to that stock or security and returns it to the auditor.

As I understand it, no individual auditor now has any authority to determine a stock valuation himself, but must refer his case to the information section, where all valuations are either originally made or are on file.

The CHAIRMAN. I notice that there is no record there, apparently, of the valuing of oil properties, by the citation that you have just

made of the records as kept; I mean where there are three or four people claiming an undivided interest in an oil well, and where one sells in one year and another in another year. There is no record there of the value placed on that particular oil well.

Mr. NASH. Not unless it is incorporated, Senator.

The CHAIRMAN. I mean that. There does not appear to be anything that insures the bureau getting a case like that reported yesterday, where one stockholder reported the sale and was required to pay a tax, and the others did not report it and were relieved.

Mr. NASH. The case which was reported and discussed yesterday took place and was closed prior to the establishment of this information section in the bureau. Furthermore, this would not check up on a taxpayer who failed to report a transaction. The only check we have on that is our examining agent's work in the field.

The CHAIRMAN. But should there not be some system of putting the bureau on notice, or one of the other stockholders, to see if they were making a report, and not simply rely on the field agent?

Mr. NASH. Senator, do you think we should leave on file a list of all the stockholders in every corporation, and check the transactions of one stockholder against those of all of the others, to see if they are reporting similar transactions?

The CHAIRMAN. Here is, for instance, a corporation such as the Perlman Rim Corporation, which was absorbed by the Standard Parts Co. Would not that put you on notice as to the stockholders in the Perlman Rim Corporation?

Mr. NASH. But we do not have any record of the Perlman Rim Corporation stockholders.

Mr. MANSON. Could you not call for them? In other words, here you have a case, where you know the stock was sold by a considerable number of people at a profit. It would seem to me to be a simple proposition to call upon that corporation. You are put upon notice of this fact, and it would seem to be a simple proposition to call upon that corporation for a list of the stockholders, and to make a check against their individual returns, and to see whether they reported that profit.

The CHAIRMAN. You do that in the case of dividends. You require all those in the shape of dividends to report them. Why not require this?

Mr. NASH. If we were to attempt to examine and audit all of the income-tax returns from the bureau at Washington, I think probably some procedure of that sort would be advisable. The trend of our work now is to use this examining force out in the field, and to check as much as possible against the taxpayer's books. Our examining procedure in the field is such that our agent, when he discovers such a transaction in the books of either corporation, will immediately verify it, not only with the corporations which are involved, but also with the stockholders in either corporation.

The CHAIRMAN. Is it not possible in a collector's district—I want to say that I am earnestly anxious that the bureau be decentralized as much as possible—to put some system into the collectors' districts to check up corporations making sales or making combinations or amalgamations which have absorptions?

Mr. NASH. We do check such facts in every district every year. The collector sends a deputy to the office of the secretary of the

State in each district. He prepares a record of all changes in corporations for that year such as reorganizations, consolidations, new corporations formed, and other corporations liquidated, and all that sort of thing. That information is all acquired, tabulated, and made use of.

The CHAIRMAN. I confess to some ignorance as to the functions of a revenue agent as distinguished from the functions of a collector. Just what is the difference between a revenue agent and a collector? Some districts have a revenue agent and some of them have only a collector; is that it?

Mr. NASH. The country is divided into 65 collection districts, and into 35 districts supervised by revenue agents in charge.

The function of the collector is very clearly defined by the law; that is, to collect taxes and deposit such collections to the credit of the Treasurer of the United States.

We have divided our work, so that the collector also does a certain amount of investigative work. It is also his duty to discover delinquent taxpayers, and that is a duty that we confine solely to collectors.

The duty of a revenue agent is investigative. He can not collect taxes, and it is not his duty to search out delinquents. After a taxpayer has filed a return and it requires subsequent investigation, the revenue agent in charge carries out that investigation.

Until 1918, the revenue agent in charge investigated all income-tax returns.

When the exemptions were lowered several million returns came in which involved taxes of just a small amount. The collectors' offices at that time were organized to take over a part of that investigative work and thus relieve the office of the agent in charge. Returns up to $5,000 net income were left in collectors' offices for investigation and subsequent audit.

The work that came into the bureau did not progress rapidly, but the collectors did keep up with their end of the work. About two years ago we increased the limit on returns that were handled in collectors' offices to $15,000 gross in order to lessen the number of returns that were coming into the bureau and to give us a chance to catch up here. Last year we increased the limit to $25,000 gross. Now approximately 95 per cent of the personal returns remain in the collectors' offices for examination and audit. The other 5 per cent come into the bureau, together with the returns from partnerships and all returns from corporations, fiduciaries, etc.

The CHAIRMAN. Is there any reason for having both a revenue agent and a collector?

Mr. NASH. It is the old internal revenue organization; as far back as I know. The revenue investigative work was done by the revenue agent, and the collection of taxes was a duty that devolved upon the collector.

Mr. MANSON. The revenue agent in charge and his subordinates are all responsible to Washington.

Mr. NASH. They are responsible directly to Washington.

Mr. MANSON. As are also the field agents of the bureau, while the collector is local.

Mr. NASH. He is local, within the State or district.

The CHAIRMAN. Do you think there is any real reason for having both of them?

Mr. NASH. The ideal organization, if it could be worked out, would not call for two administrative officers in a district. There are several elements that enter into this question that would have to be eliminated before you could get to that point.

For instance, the collectors are political appointees, and while to-day, most of them, are very good men, in the past we have had some few unsatisfactory experiences with collectors.

The CHAIRMAN. But the revenue agents were all right, were they?

Mr. NASH. The revenue agents are civil-service employees, and most of them are men who have worked up through the department.

Senator KING. Mr. Chairman, may I say that several years ago I gave a great deal of attention to this, when Mr. McAdoo was Secretary of the Treasury, and after quite an investigation I reached the conclusion that we would get far better and more efficient work by having one organization. I went to Mr. McAdoo and Mr. Osborne, and then, succeeding him, Mr. Roper, and urged them to inaugurate this reform. I know that Mr. Roper was very seriously considering it, and if it had not been for the pressure of the war and the tremendous task devolving upon the organization of the Treasury Department I think the reform would have been made.

In my opinion, if I may say so—and, of course, your judgment, Mr. Nash, would be better than mine—it would be better to have one organization and have it responsible to Washington. I would have the collectors named from the office here; I would make them a part of the official family, if I may use that expression, of the Treasury Department. I have gone into towns in Idaho and Utah and I have found one man there in a little town, sent out to collect the tax, and a revenue man investigating the same man. You would frequently find that they would send men down to St. George in my State, 200 miles from Salt Lake City, at a tremendous cost, because they had to have automobiles to go over the mountains there in those years, and it would cost perhaps $150 or $200 to make the trip, to investigate and collect a little tax of not more than $50.

Mr. NASH. Senator, I think we have the field force in every section very well organized, and organized to operate economically. The average traveling expense for a deputy collector for the whole country is less than $50 a month. That includes hotel bills and transportation. The average traveling expense for a revenue agent is less than $400 a year.

Senator KING. That is due, perhaps, to the fact that they do not get out enough.

Mr. NASH. No; that is because we restrict the area in which they operate. A deputy collector, for instance, in any State will operate in an area of just two or three counties, depending upon the population, and his post of duty or headquarters is within that area. The revenue agent will operate also within a restricted area, and, of course, the bulk of the work of our revenue agents is in the larger cities.

Senator KING. Of course, in the sparsely settled States like Utah, Idaho, Montana, Wyoming, Nevada, and some parts of California, the suggestions which I have made have much force because of the great area that they have to cover.

Mr. NASH. Yes; the travel expense would be greater out there because of the fact that it is sparsely settled.

Senator KING. Yes.

Mr. NASH. We do not have as many revenue agents in the entire country west of Denver as we have in New York City.

The CHAIRMAN. Who is in the best position to work out a plan of legislating this dual system out of existence and putting it into one system?

Mr. NASH. Well, that is one thing I have been working on for about two years, Senator.

The CHAIRMAN. I did not ask it for the purpose of inferring that you had not given it some thought, but I mean some one who could bring it to an issue. Could you bring it to an issue at the next session of Congress, or would the bureau be willing to undertake to bring it to an issue?

Senator KING. Would Secretary Mellon sponsor such a movement? Would it have the approval of the Treasury Department?

Mr. NASH. I can not speak for the Secretary. However, it is a subject that has already been given a great deal of consideration. It has been discussed many times in the bureau. There are many obstacles in the way of it that would have to be removed.

Mr. MANSON. You feel that you have to fight a political army to put this in operation?

Mr. NASH. There might be some political difficulties.

Mr. MANSON. That is one of the things that makes you hesitate?

Mr. NASH. That is one of the obstacles.

Senator KING. Do not consider that, because I think you will find some who will be back of you in that movement, and who will do all they can to put it through, if the Treasury Department will present a concrete plan to effect this reform.

Mr. NASH. Another thing is that we have this six or seven thousand trained employees, who are not under the civil service, and there is no legitimate reason for separating them from their positions.

Senator KING. Well, many of them should be separated.

Mr. NASH. That may be true in a very few cases.

Senator KING. Yes.

Mr. NASH. But we would have to devise some way with the Civil Service Commission to take care of the efficient people that are now in this organization, without a civil service status.

Senator KING. Oh, yes.

Mr. NASH. It would necessitate drastic changes in legislation to either transfer the duties of the collector over to the revenue agent or to transfer the duties of the revenue agent over to the collector.

Senator KING. It would be better to transfer them from the collector to the revenue agent.

Mr. MANSON. I think so, too.

Senator KING. Mr. Nash, I sincerely hope that you will work this out and in some concrete way give us the result, because, speaking for myself, I am going to make a recommendation in any report that we make, if I have to make it alone, in favor of this reform.

Mr. NASH. This proposition has been discussed with the members of the Appropriations Committees, and it has been discussed with the Budget Bureau.

Senator KING. I wish you would act this year, because I wish to cover it in this report.

Mr. MANSON. Mr. Chairman, I feel that I shall have to have either to-morrow or Monday to work with our chief auditor to try to speed up some matters. It is immaterial to me whether I take to-morrow or Monday.

The CHAIRMAN. I would like to ask the bureau at this time whether they are going to want any time next week. I understood you wanted to put in some replies.

Mr. GREGG. We have about three things to reply on.

Then, there was the general criticism of the oil and gas valuation which the engineers have been working on. I have it on my desk now, but it will probably take me just as long to go over it. That is one thing I have pending. That will not take very long, though.

The CHAIRMAN. I think we had better adjourn until Monday, then.

Mr. NASH. I would appreciate that very much, because Mr. Blair is out of town.

The CHAIRMAN. We will adjourn until Monday morning at 10 o'clock.

(Whereupon, at 1.10 o'clock p. m., the committee adjourned until Monday, May 25, 1925, at 10 o'clock a. m.)