INVESTIGATION OF BUREAU OF INTERNAL REVENUE

HEARINGS

BEFORE THE

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

SIXTY-EIGHTH CONGRESS

SECOND SESSION

PURSUANT TO

S. Res. 168

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

MARCH 19, 21, 25, 30, MAY 8, 14, 15, 26, 1925

PART 16

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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

THURSDAY, MARCH 19, 1925

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

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

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

Present also: Mr. L. C. Manson, of counsel for the committee; Mr. L. H. Parker, chief engineer for the committee; Mr. Raleigh C. Thomas, investigating engineer for the committee; Mr. Edward T. Wright, investigating engineer for the committee; and Mr. J. M. Robbins, assistant engineer 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. James M. Williamson, attorney, office of solicitor, Bureau of Internal Revenue; Mr. A. R. Marr, attorney, office of solicitor, Bureau of Internal Revenue; Mr. F. T. Eddingfield, engineer, office of solicitor, Bureau of Internal Revenue; and Mr. W. S. Tandrow, valuation engineer, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. This is the matter of the Los Angeles Shipbuilding & Dry Dock Co., San Pedro, Calif.

The Shipping Board made this taxpayer an allowance of $311,487.06 for amortization of war facilities. The Income Tax Unit made an allowance for amortization amounting to $2,915,922.70. The allowance made by the Shipping Board was not considered, and was not deducted from the allowance made by the Income Tax Unit. This makes a difference of tax of $225,703.19. We have made an examination of the returns of this taxpayer. This allowance was included in a payment made by the Shipping Board to the taxpayer in 1921. In 1921 the taxpayer returned no receipts whatever as payments upon war contracts. That is an item specially called for in the return.

From an examination of the records in this case it appears that in allowing this taxpayer a deduction of $2,915,922.70 for amortization there was included in this amount the sum of $311,487.06, which sum had already been paid to the contractor by the United States Shipping Board Emergency Fleet Corporation for amortization of its plant facilities installed during the war period under certain instructions from the United States Shipping Board Emergency

Fleet Corporation, thereby making a duplication of allowance for amortization.

The Los Angeles Shipbuilding & Dry Dock Co. was organized on April 21, 1917, for the purpose of shipbuilding, ship repairing, and dry docking. The company had an authorized capital stock of $1,500,000.

It was the original plan of the organizers of this company to secure a contract from the Cunard Co. for the construction of two 8,800 dead-weight tons steel vessels. While the negotiations preliminary to the securing of this contract were under way, the United States Shipping Board Emergency Fleet Corporation was organized, and it became necessary to build ships for the Shipping Board rather than for private companies.

The taxpayer had the following contracts with the Shipping Board:

Contract No. 4,, dated May 13, 1917, for eight hulls, at a total price of $10,883,840.

Contract No. 92, dated October 18, 1917, for 10 hulls, at a total price of $15,136,000.

Contract No. 92, supplemental, dated April 1, 1918, for 12 hulls, at a total price of $20,592,000.

All of the above contracts were completed.

Contract No. 440, dated July 10, 1918, for 10 hulls at a total price of $17,160,000. This contract was suspended January 25, 1919.

On September 19, 1919, an agreement supplemental to contract No. 440 was executed providing for the cancellation of five hulls and the reinstatement of the other five. These five reinstated hulls, however, were to be of 11,000 dead-weight tons each, instead of 8,800 dead-weight tons, which was the tonnage of all the other ships constructed by the company. They were, however, to be built at the same price per hull as called for in the original contract.

The portion of the original contract No. 440 which had not been reinstated in the supplemental agreement was set forth as three-eighths of the entire original contract for the purpose of adjustment. This ratio was based on the original tonnage of 88,800 tons for the 10 ships as compared to 55,000 tons for the five reinstated hulls as provided for in the supplemental agreement.

The method of computing losses sustained by the contractor by reason of the partial cancellation of contract No. 440 was set forth in the supplemental agreement of September 19, 1919. A copy of this portion of the agreement is attached as Exhibit B.

In accordance with this agreement the taxpayer submitted a claim to the Shipping Board covering six items, as follows:

Raw materials	$70,448.13
Finished products	337,980.14
Commitments	5,761.10
Overhead	712,641.60
Plant improvements	756,943.06
Amortization	284,863.94
Total	2,168,637.97

It will be noted at that point that its claim for plant facilities is divided into two items, aggregating something over a million dollars.

The following, in regard to the amortization items of this claim, is quoted from a Shipping Board memorandum on the case:

Amortization: As will be noted by the foregoing schedule this item was claimed in two parts, one for plant improvements and the other for plant amortization. It will be noted from the summary of contract provisions that the contractor was to be allowed for a reasonable allowance for three-eighths parts of such money spent solely and exclusively on account of contract 440. Money spent in additions and improvements to contractor's plant and plant equipment, outside of such part spent solely and exclusively on account of contract 440, was not to be included. The contractor claimed a total of $756,943.06. The items in the contractor's claim were gone over carefully by a member of the old construction claims board, and there was allowed as a total all items order after the date of original contract, July 10, 1918, and before the suspension, January 25, 1919, three-eighths of a total of $809,033.25, which resulted in an allowance of $303,387.45. Small tools, consisting of items or compressed-air tools, in the amount of $21,598.99 was apportioned three-eighths to cancellation, which netted an allowance of $8,099.61. This made a total allowance on this item of $311,487.06.

Plant amortization: This item—

that is, as distinguished from the item that I have just discussed of plant improvements—

was claimed in the sum of $284,863.94. No allowance was made for this item. According to the supplemental agreement this item was left open to be considered by the claims board of the Fleet Corporation. It subsequently came before the construction claims board which succeeded the general cancellations, claims, and contracts board, and, in view of the allowance which had been made for plant improvements, nothing was allowed for plant amortization.

The balance of the items in the claim were settled, as shown by the summary below:

No.	Item	Claimed	As recommended
1	Raw materials	$70,448.13	$57,133.16
2	Finished products	337,980.14	291,961.13
3	Commitments	5,761.10	
4	Overhead	712,641.60	149,804.41
5	Plant improvements	756,943.06	311,487.06
6	Amortization	284,863.94	
	Grand total	2,168,637.97	810,385.76
	Salvage: 40 per cent of $349,094.29		139,637.72
	Due contractor		607,748.04

The CHAIRMAN. Do I understand you to say in reading that that there was no item for amortization specifically allowed?

Mr. MANSON. There were two items, which are amortization claims, one of $756,943.06, which was denominated in the claim as plant improvements, and the other one was denominated in the claim plant amortization, $284,863.94.

The CHAIRMAN. As I remember it, in one of the other cases that we had up for consideration, there was considerable discussion as to whether this amortization by the Shipping Board or any other contractual department of the Government was not required to be specifically allowed as amortization.

Mr. MANSON. There was a great deal of discussion on that point. It was the contention of the bureau that even though the purpose of allowance by a Government department was to allow the contractor contractual amortization, yet, unless the Government department making that allowance, specifically labeled that as plant amortization, under the regulations it would not be so considered by the unit. In this instance, there are two items claimed for purposes which constitute the amortization of war facilities. One of

them is denominated plant improvements, and the other is denominated plant amortization.

The CHAIRMAN. Did the Income Tax Unit have this information before it when it adjusted the taxpayer's claim?

Mr. MANSON. I take it that that is true.

Mr. THOMAS. The settlement was made a long time before.

Mr. MANSON. The settlement was made a long time before.

Mr. THOMAS. The settlement with the Fleet Corporation was made a long time before the adjustment of amortization with the taxpayer.

The CHAIRMAN. That was not the question I asked. I asked whether the Income Tax Unit had this information before it when it adjusted the taxpayer's claim.

Mr. THOMAS. I can not answer that question yes or no, but I would say that the information was available.

The CHAIRMAN. Well, was it in the bureau?

Mr. THOMAS. I do not know, sir. It was in the Shipping Board, where they were supposed to make an examination of the accounts as to settlements between the Shipping Board and the taxpayer.

Mr. MANSON. There was nothing in the records of the Income Tax Unit to show that this information was on file with the Shipping Board?

Mr. THOMAS. No; there was nothing to show that.

The CHAIRMAN. In any event, even though it was not there, your view is that they should have checked up this case with that contractual department of the Government?

Mr. MANSON. That is our position exactly. We had no difficulty in securing the information.

The CHAIRMAN. Even if there was no allowance for amortization specifically by the Shipping Board, then, according to the bureau's own contention, the amount allowed for amortization should have been reported by the taxpayer's return?

Mr. MANSON. Yes.

The CHAIRMAN. And that was not done?

Mr. MANSON. That was not done.

Mr. GREGG. Are you certain of that?

Mr. MANSON. I am certain that the taxpayer reported nothing.

Mr. GREGG. They did not report this allowance in their income return?

Mr. MANSON. As receipts on war contracts, which this would be.

Mr. GREGG. I just wanted to get that very clearly.

Mr. MANSON. Yes. I have had that——

Senator KING. You say that it was?

Mr. GREGG. Yes, sir; that is the information we have.

Mr. MANSON. I have had that run down very carefully, that the contractor reported nothing as a receipt on war contract, and that was required to be specifically stated on the return, for the reason that it was subject to a different rate of taxation.

Senator KING. May I interrupt to make this statement, although it is quite improper, perhaps to break into this? Mr. Gregg, I remember a number of years ago, when there was so much criticism of the Shipping Board and also some of those having contracts with the Shipping Board and with the Government for the construction not alone of war vessels, but of different classes of ships for the Shipping

Board and for the Government. The criticism was that they were securing large contracts from the Government, contracts out of which they made great profits, and that the returns did not take into account the profits which they made, or at least they got such large reductions from claims that the plants were of no value when the war was over, etc.; that they paid for the plants and had them on hand, and that then they made large profits besides. I was wondering whether that matter was brought to your attention.

Mr. GREGG. Not specifically; no, sir. I have not gone into it myself.

Mr. MANSON. This plant was subsequently sold by the taxpayer, and the amortization allowed by the Income Tax Unit represented the difference between the sale price and the depreciated cost of the plant.

The CHAIRMAN. Who were the officers of the company, do you know?

Mr. MANSON. I do not know, I am sure. Do you know who they were [addressing Mr. Thomas]?

The CHAIRMAN. Is counsel satisfied that it was a bona fide sale?

Mr. MANSON. Oh, I am satisfied that it was a bona fide sale. The price was a pretty good price, considering the conditions. They got $500,000 for a shipyard.

In answer to your question as to who the officers of the company were, Mr. Fred L. Baker was president and treasurer, and Mr. Earl M. Leaf vice president and general manager, Mr. L. J. Hedrick comptroller, and Mr. George M. Thompson accountant. I do not take it that Mr. Thompson was an officer of the company.

Under date of January 29, 1921, an agreement was entered into between the taxpayer and the United States Shipping Board in which all claims arising out of the partial cancellation of contract No. 440 were settled by payment to the taxpayer of $670,748.04, payment was made February 25, 1921. This settlement, as may be seen from the above, included an item for contractual amortization in the sum of $311,487.06.

The company completed its war work December 31, 1918, and on that date was sold to the Los Angeles Shipbuilding & Dry Dock Corporation for the sum of $500,000, it being deemed inadvisable under the conditions then obtaining in the shipbuilding industry for the company to attempt to continue as a going concern.

This sale covered the following items:

1. Work in process of construction.
2. Unexpired insurance.
3. Materials and supplies.
4. Leasehold.
5. Buildings and equipment.
6. Dry dock.
7. Floating equipment.
8. All other equipment, tools, and materials.
9. Claims against the city of Los Angeles.

In its income-tax returns for 1918 and following years, the taxpayer claimed amortization. A report on this claim was submitted by an engineer of the Income Tax Unit October 14, 1920. Inasmuch

as this report was submitted previous to the sale of the plant, a redetermination became necessary. Under date of May 1, 1923, a report of the redetermination of this claim was made by an engineer of the Income Tax Unit. This report shows that amortization in the amount of $4,646,268.54 was claimed on costs amounting to $5,088,572.89.

Amortization in the amount of $2,915,922.70 and spread over the years 1917 and 1921, inclusive, was allowed on facilities costing $3,302,807.79.

This allowance was based on the difference between the cost of amortizable facilities and the portion of the sales price which was allocated to those facilities. Facilities, the costs of which were deducted from the taxpayer's claim, included:

1. The dry dock (which was not used for war work)	$728,069.45
2. Leasehold (the sales value of which was zero)	1,000,000.00
3. Work in process	29,667.37
4. Materials and supplies	11,979.53
5. Unexpired insurance	16,048.75

On the final page of the engineer's report—that is, the report of the Income Tax Unit engineer who handled the amortization allowance in this case—the following statement appears:

No contractual amortization allowance has been received.

From the above it will be seen that the Income Tax Unit allowed amortization in the sum of $2,915,922.70 on the difference between the depreciated costs of the amortizable portion of the plant and equipment and the sales price of the same. From the record in this case there is no evidence to show that the taxpayer included in its returns the amount of $670,748.04 received by it from the United States Shipping Board on February 25, 1921, upon which date the Shipping Board gave the taxpayer a check in that amount, which amount was in full settlement of all pending claims of the taxpayer against said Shipping Board and which included $311,487.06 for amortization. Further, the record fails to disclose that any contractual amortization from the Shipping Board was taken into account by the unit either as earned income or as a deduction from capital assets. There is, moreover, a statement by the taxpayer as given in the engineer's report on this case that no contractual amortization was received. That the engineer accepted this statement without adequate efforts toward verification appears from the fact that the Shipping Board settlement was made more than two years before the engineer's report was submitted. It is, therefore, evident that there has been a duplication of amortization allowed to the extent of $311,487.06. This duplication results in a loss in tax to the Government of approximately $225,703.19.

I offer the report of Mr. J. M. Robbins, assistant engineer for the committee, approved by Mr. Raleigh C. Thomas, investigating engineer, Mr. L. H. Parker, chief engineer, as Exhibit A. I also offer the Exhibit B that I have already referred to.

(The exhibits submitted by Mr. Manson in Los Angeles Shipbuilding & Dry Dock Co. case are as follows:)

EXHIBIT A

MARCH 3, 1925.

Mr. L. C. Manson, counsel Senate committee investigating Bureau of Internal Revenue.
Office Report No. 23.
Taxpayer: Los Angeles Shipbuilding & Dry Dock Co., San Pedro, Calif.
Subject: Amortization.

Amounts involved

Cost on which amortization is claimed	$5,088,572.89
Cost on which amortization is allowed	3,302,807.79
Amortization claimed	4,646,268.54
Amortization allowed	2,915,922.70
Contractual amortization allowed by United States Shipping Board	311,487.06
Estimated proper allowance	2,604,435.64
Approximate difference in tax	225,703.19

Synopsis of case.—From an examination of the records in the case it appears that in allowing this taxpayer a deduction of $2,915,922.70 for amortization there was included in this amount the sum of $311,487.06, which sum had already been paid to the contractor by the United States Shipping Board Emergency Fleet Corporation for amortization of its plant facilities installed during the war period under certain instructions from the United States Shipping Board Emergency Fleet Corporation, thereby making a duplication of allowance for amortization.

History of case.—The Los Angeles Shipbuilding & Dry Dock Co. was organized April 21, 1917, for the purpose of shipbuilding, ship repairing, and drydocking. The company had an authorized capital stock of $1,500,000.

It was the original plan of the organizers of this company to secure a contract from the Cunard Co. for the construction of two 8,800 dead-weight ton steel vessels. While the negotiations preliminary to the securing of this contract were under way the United States Shipping Board Emergency Fleet Corporation was organized, and it became necessary to build ships for the Shipping Board rather than for private companies.

The taxpayer had the following contracts with the Shipping Board:

Contract No. 4, dated May 13, 1917, for eight hulls at a total price of $10,883,840.

Contract No. 92, dated October 18, 1917, for 10 hulls at a total price of $15,136,000.

Contract No. 92, supplemental, dated April 1, 1918, for 12 hulls at a total price of $20,592,000.

All of the above contracts were completed.

Contract No. 440, dated July 10, 1918, for 10 hulls, at a total price of $17,160,000. This contract was suspended January 25, 1919.

On September 19, 1919, an agreement supplemental to contract No. 440 was executed providing for the cancellation of five hulls and the reinstatement for the other five. These five reinstated hulls, however, were to be of 11,000 dead-weight tons each, instead of 8,800 dead-weight tons, which was the tonnage of all the other ships constructed by the company. They were, however, to be built at the same price per hull as called for in the original contract.

The portion of the original contract No. 440 which had not been reinstated in the supplemental agreement was set forth as three-eighths of the entire original contract for the purpose of adjustment. This ratio was based on the original tonnage of 88,800 tons for the 10 ships as compared to 55,000 tons for the 5 reinstated hulls as provided for in the supplemental agreement.

The method of computing losses sustained by the contractor by reason of the partial cancellation of contract No. 440 was set forth in the supplemental agreement of September 19, 1919. A copy of this portion of the agreement is attached as Exhibit B.

In accordance with this agreement the taxpayer submitted a claim to the Shipping Board covering six items, as follows:

Raw materials	$70,448.13
Finished products	337,980.14
Commitments	5,761.10
Overhead	712,641.60
Plant improvements	756,943.06
Amortization	284,863.94
Total	2,168,637.97

The following, in regard to the amortization items of this claim, is quoted from a Shipping Board memorandum on the case:

"*Amortization.*—As will be noted by the foregoing schedule, this item was claimed in two parts; one, for plant improvements, and the other for plant amortization. It will be noted from the summary of contract provisions that the contractor was to be allowed for a reasonable allowance for three-eighths parts of such money spent solely and exclusively on account of contract 440. Money spent in additions and improvements to contractor's plant and plant equipment, outside of such part spent solely and exclusively on account of contract 440 was not to be included. The contractor claimed a total of $756,943.06. The items in the contractor's claim were gone over carefully by a member of the old construction claims board and there was allowed a total, all items order after the date of original contract, July 10, 1918, and before the suspension, January 25, 1919, three-eighths of a total of $809,033.25, which resulted in an allowance of $303,387.45. Small tools, consisting of items of compressed air tools, in the amount of $21,598.99 was apportioned three-eighths to cancellation, which netted an allowance of $8,099.61. This made a total allowance on this item of $311,487.06.

"*Plant amortization.*—This item was claimed in the sum of $284.863.94. No allowance was made for this item. According to the supplemental agreement this item was left open to be considered by the claims board of the Fleet Corporation. It subsequently came before the construction claims board which succeeded the general cancellations, claims, and contracts board, and, in view of the allowance which had been made for plant improvements, nothing was allowed for plant amortization.

"The balance of the items in the claim were settled, as shown by the summary below:

No.	Item	Claimed	As recommended
1	Raw materials	$70,445.13	$57,133.16
2	Finished products	337,980.14	291,961.13
3	Commitments	5,761.10	
4	Overhead	712,641.60	149,804.41
5	Plant improvements	756,943.06	311,487.06
6	Amortization	284,863.94	
	Grand total	2,168,637.97	810,385.76
	Salvage: 40 per cent of $57,133.16+$291,961.13−$349,094.29, which is		139,637.72
	Due contractor		670,748.04

Under date of January 29, 1921, an agreement was entered into between the taxpayer and the United States Shipping Board in which all claims arising out of the partial cancellation of contract No. 440 were settled by payment to the taxpayer of $670,748.04. Payment was made February 25, 1921. This settlement, as may be seen from the above, included an item for contractual amortization in the sum of $311,487.06.

The company completed its war work December 31, 1918, and on that date was sold to the Los Angeles Shipbuilding & Dry Dock Corporation for the sum of $500,000, it being deemed inadvisable under the conditions then obtaining in the shipbuilding industry for the company to attempt to continue as a going concern.

This sale covered the following items: (1) Work in process of construction; (2) unexpired insurance; (3) materials and supplies; (4) leasehold; (5) buildings and equipment; (6) dry dock; (7) floating equipment; (8) all other equipment, tools, and materials; (9) claim against the city of Los Angeles.

In its income-tax returns for 1918 and following years the taxpayer claimed amortization. A report on this claim was submitted by an engineer of the Income Tax Unit October 14, 1920. Inasmuch as this report was submitted previous to the sale of the plant, a redetermination became necessary. Under date of May 1, 1923, a report of the redetermination of this claim was made by an engineer of the Income Tax Unit. This report shows that amortization in the amount of $4,646,268.54 was claimed on costs amounting to $5,088,572.89. Amortization in the amount of $2,915,922.70 and spread over the years 1917 and 1921, inclusive, was allowed on facilities costing $3,302,807.79.

This allowance was based on the difference between the cost of amortizable facilities and the portion of the sales price which was allocated to those facilities. Facilities, the costs of which were deducted from the taxpayer's claim, included:

1. The dry dock (which was not used for war work)	$728,069.45
2. Leasehold (the sales value of which was zero)	1,000,000.00
3. Work in process	29,667.37
4. Materials and supplies	11,979.53
5. Unexpired insurance	16,048.75

On the final page of the engineer's report the following statement appears: "No contractual amortization allowance has been received."

Discussion of case.—From the above it will be seen that the Income Tax Unit allowed amortization in the sum of $2,915,922.70 on the difference between the depreciated costs of the amortizable portion of the plant and equipment and the sales price of the same. From the record in this case there is no evidence to show that the taxpayer included in its returns the amount of $670,748.04 received by it from the United States Shipping Board on February 25, 1921, upon which date the Shipping Board gave the taxpayer a check in that amount, which amount was in full settlement of all pending claims of the taxpayer against said Shipping Board, and which included $311,487.06 for amortization. Further, the record fails to disclose that any contractual amortization from the Shipping Board was taken into account by the unit either as earned income or as a deduction from capital assets. There is, moreover, a statement by the taxpayer as given in the engineer's report on this case that no contractual amortization was received. That the engineer accepted this statement without adequate efforts toward verification appears from the fact that the Shipping Board settlement was made more than two years before the engineer's report was submitted. It is, therefore, evident that there has been a duplication of amortization allowed to the extent of $311,487.06. This duplication results in a loss in tax to the Government of approximately $225,703.19.

The auditor's computations in this case are attached as Exhibit C.

Respectfully submitted.

J. M. ROBBINS,
Assistant Engineer.

Approved:

L. H. PARKER,
Chief Engineer.
RALEIGH C. THOMAS,
Investigating Engineer.

EXHIBIT B

Extract from memorandum concerning settlement of claims by Los Angeles Shipbuilding & Drydock Co., San Pedro, Calif., against the United States Shipping Board Emergency Fleet Corporation

"That in the computing and settlement of losses sustained by contractor from the suspension and/or cancellation of the other five vessels of contract No. 440 S. C., not herein reinstated, it is agreed as follows:

"1. Owner will take over and reimburse contractor for all raw material which contractor purchased on account of contract No. 440 S. C., and has on hand and can not use in the performance of that portion of contract No. 440 S. C. herein reinstated. If work has been done by contractor on any of such raw material, owner will also reimburse contractor for cost of work done on same.

"2. Owner will take over and reimburse contractor for all finished products (comprising ships' machinery and equipment and parts thereof) which contractor purchased on account of contract No. 440 S. C. and has on hand and can not use in the performance of that portion of contract No. 440 S. C. herein reinstated. Such reimbursement shall include actual cost of the article plus incoming freight charges plus handling charges. If any such articles were being made in contractor's own plant, reimbursement for same shall cover costs, including labor on same up to but not after the date of suspension of the hulls of said contract No. 440 S. C.

"3. In regard to all commitments and/or subcontracts made by contractor on account of said contract No. 440 S. C., but canceled by contractor in pursuance with the suspension by owner of the hulls of said contract No. 440 S. C., owner will assume all of such commitments and/or subcontracts which can not now be reinstated and made use of in the performance of that portion of said contract No. 440 S. C. herein reinstated. Owner will negotiate the settlements and settle for same. Contractor will cooperate and assist in negotiating such settlements whenever owner may require or request.

"4. All such material, machinery, and equipment which owner takes over and reimburses contractor for or settles for under commitments and subcontracts shall become therewith the property of the United States of America and shall be subject to such disposition as owner may deem proper.

"5. Contractor shall be reimbursed with three-eighths portion of the overhead properly chargeable to contract No. 440 S. C. up to the date of settlement.

"6. Prospective profits which contractor might have made from the performance of said three-eighths portion of said contract No. 440 S. C., which under the terms of this supplemental agreement will not be performed, shall not be included.

"7. Money spent in additions and improvements to contractor's plant and plant equipment, except a reasonable allowance for three-eighths part of such money spent solely and exclusively on account of said contract No. 440 S. C., shall not be included.

"8. Amortization, if any, of contractor's plant other than the additions and improvements thereto mentioned in paragraph 7 hereof shall be taken up and considered by the district cancellations claims, and contracts board, for recommendation to the general cancellations, claims, and contracts board of owner.

"9. In no event shall the total aggregate payments made or to be made by owner account suspension and cancellation, including amortization, if any, of contractor's plant, exceed three-eighths of the total lump-sum purchase price provided for in contract No. 440 S. C."

EXHIBIT C

In re Los Angeles Shipbuilding & Drydock Co., San Pedro, Calif.

The following schedule shows the amount of amortization allowed by the Income Tax Unit spread over the years 1918, 1919, 1920, and 1921:

1918	$2,443,920.47
1919	321,699.07
1920	129,664.20
1921	20,638.96
Total amount of amortization allowed	2,915,922.70

The following schedule shows the amount of amortization allowed by the United States Shipping Board spread over the years 1918, 1919, 1920, and 1921:

1918	$261,167.41
1919	34,457.13
1920	13,930.16
1921	1,932.36
Total amount of amortization allowed	311,487.06

TEST COMPUTATIONS

Deduct from the amortization determined by the Income Tax Unit the amount of amortization allowed by the United States Shipping Board, spreading the amounts under consideration over the years 1918, 1919, 1920, and 1921.

In the computation of tax for the years in question reference was made to the revenue agent's report, and the income as reported therein used as a basis for these computations. These figures were used rather than figures appearing in A–2 letters and returns for the reason that inasmuch as the agent had access to the books of this corporation the figures appearing in the report are apt to be nearer correct than those appearing in the information furnished through correspondence with the taxpayer.

1918: The computation for the year 1918 shows a net income of $303,213.59, an invested capital of $500,000, and a total tax of $210,295.95. Since the return shows no tax previously assessed, there appears in favor of the Government a tax of $210,295.95.

1919: The computation for the year 1919 shows a net income of $1,020,494.48, an invested capital of $706,599.12, and a total tax of $783,405, as against the tax previously assessed in the sum of $494,674.31, showing a difference in favor of the Government of $288,730.69.

1920: The computation for the year 1920 shows a net income of $2,111,378.83, an invested capital of $1,057,720.71, and a total tax of $1,426,454.87, as against the tax previously assessed in the sum of $225,844.27, showing a difference in favor of the Government of $1,426,454.87.

1921: A loss is shown for the year 1921; therefore there is no tax due. Neither has a tax been assessed upon the original return.

1918

Net income as shown by revenue agent's report		$41,946.18
Add amortization allowed by United States Shipping Board		261,167.41
Net income		303,213.59
Invested capital		500,000.00
War-profits credit		53,000.00
Excess-profits credit		43,000.00
Excess-profits tax, 30 per cent		None
65 per cent		169,138.83
Total excess-profits tax		169,138.83
War-profits tax, 80 per cent		200,170.87
		200,170.87
Net income	$303,213.59	
Less:		
War and excess-profits tax	$200,170.87	
Exemption	2,000.00	
	202,170.87	
	[1] 101,042.32	10,125.08
Total tax		210,295.95
Tax previously assessed		None
Difference in favor of the Government		210,295.95

1919

Net income as shown by revenue agent's report		$986,037.35
Add amortization allowed by United States Shipping Board		34,457.13
		1,020,494.48
Invested capital		534,302.78
Add amortization allowed by United States Shipping Board, 1918		261,167.41
		795,470.19
Less income tax, 1918		88,871.07
Invested capital, 1919		706,599.12
War-profits credit		73,659.91
Excess-profits credit		59,487.93
Excess-profits tax, 20 per cent		16,386.38
40 per cent		351,670.26
Total excess-profits tax, year 1919		368,057.64

[1] At 12 per cent.

Excess-profits tax 1918 rates, 30 per cent		$24,549.57
65 per cent		571,464.18
		596,013.75
War profits tax		757,467.66
Computations in accordance with section 714 of the revenue act of 1918:		
Portion of tax, 1918		$756,583.25
Portion of tax, 1919		478.47
Total war and excess profits' tax, 1919		757,061.72
Net income	$1,020,494.48	
Less war and excess profits' tax	757,061.72	
	[1] 263,432.76	26,343.28
Total tax for 1919		783,405.00
Tax previously assessed		494,674.31
Difference in favor of the Government		288,730.69

1920

Net income as shown by revenue agent's report		$2,097,448.67
Add amortization allowed by United States Shipping Board		13,930.16
		2,111,378.83
Invested capital		1,092,223.05
Add amortization allowed by United States Shipping Board:		
1918	$261,167.41	
1919	34,457.13	
		295,624.54
Less income tax, 1918		1,387,847.59
Income tax, 1919		330,126.88
Invested capital, 1920		1,057,720.71
Excess-profits credit		87,517.66
War-profits credit		108,772.07
Excess-profits tax, at 30 per cent		37,206.94
65 per cent		1,234,892.55
Total excess-profits tax, 1918 rates		1,272,099.49
War-profits tax, 80 per cent		1,602,085.41
Excess-profits tax, 20 per cent		24,805.29
40 per cent		759,933.88
Total excess-profits tax, 1920 rates		784,739.17
Computations made in accordance with section 714 of the revenue act of 1918:		
Portion of tax, 1918		$1,600,483.32
Portion of tax, 1920		784.74
Total tax		1,601,268.06

[1] At 10 per cent.

Net income, 1920	$2,111,378.83	
Less tax as computed above	1,601,268.06	
	[1] 510,110.77	$51,011.08
Total tax for year 1920		1,652,279.14
Tax previously assessed		225,844.27
Tax in favor of the Government		1,426,454.87

1921: Loss shown for the year 1921. No tax due. No tax previously assessed.

This corporation reported a loss in its return for the year 1918, consequently no assessment was made. The revenue agent, however, reported a net income of $41,946.18, which amount has been increased by the amount of amortization allowed by the United States Shipping Board in the sum of $261,167.41, upon which an excess profits and war profits tax has been computed at the rates of 65 and 80 per cent, respectively.

The return for the year 1919 shows that this corporation reported a net income of $746,172.24, upon which was assessed a tax of $494,674.31. The revenue agent's report discloses a net income of $986,037.35, which amount has been increased by the amount of amortization allowed by the United States Shipping Board in the sum of $35,457.13. Upon that portion of income received from Government contracts an excess profit and war profits tax has been computed at 1918 rates, the remainder being subject to excess-profits tax rates prevailing in 1919.

The return for the year 1920 shows that this corporation reported a net income of $991,564.19. According to the return an assessment was made in the sum of $720,518.58. There seems to be a conflict between the return and the revenue agent's report in the amounts which have been assessed, the revenue agent's report showing an assessment of $225,844.27. If the amount shown by the return was assessed, the difference in favor of the Government would be $931,760.56, instead of $1,426,454.87 shown by this report. The report of the revenue agent discloses a net income of $2,097,448.67. This amount has been increased by the amount of amortization allowed by the United States Shipping Board in the sum of $13,930.16. Upon that portion of net income received from Government contracts an excess-profits and war-profits tax has been computed at 1918 rates, the remainder being subject to excess-profits tax rates prevailing in 1920.

The following table gives a summary of the tax as shown in the revenue agent's report for the years 1918 to 1920, inclusive, and the corresponding tax as computed by the auditor, taking into consideration the duplication of amortization of $311,487.06. The computation is approximate and shows an approximate loss in tax to the Government of $225,000.

Year	Tax as shown by revenue agents' report	Tax as shown by test computations	Difference
1918	$4,793.54	$210,295.95	$205,502.41
1919	767,213.22	783,405.00	16,191.78
1920	1,648,270.16	1,652,279.14	4,008.98
			225,703.19

Mr. MANSON. I offer for the record a set of tables consisting of corporate statistics compiled by the committee under my direction. These tables speak for themselves. They are prepared from transcripts of corporate returns furnished by the Income Tax Unit to the committee. They are not complete but represent the work as far as we were able to carry it—up to about the 1st of March. The

[1] At 10 per cent.

work of compiling these statistics is proceeding, and the tables I am now offering for the record will be supplemented later by complete tables covering the same subjects.

Senator KING. Will there be any duplication by the tables which you will subsequently offer of those which you now offer?

Mr. MANSON. The others will contain more information.

The CHAIRMAN. What percentage of the corporation returns do these statistics cover?

Mr. MANSON. About 50 per cent.

The CHAIRMAN. I might say for the benefit of Senator King that I asked Mr. Manson to get that before the committee as early as possible, because I thought there would be considerable subject matter in those statistics for us to study for the purposes of any report that we may want to make later covering, perhaps, a revision of the law.

Senator KING. Yes. Have you concluded the case which you have just been presenting, Mr. Manson?

Mr. MANSON. Yes; I have.

Senator KING. I regret having been absent from these sessions on other committee work nearly every day, but is that the only case bearing upon ships, shipyards, and shipping interests?

Mr. MANSON. Oh, no; we have several more in process of preparation, and I received from the Shipping Board yesterday data on six shipbuilding cases which we have not had an opportunity to look into as yet.

Mr. MANSON. The next case that we wish to present to the committee is that of Witherbee, Sherman & Co.

The CHAIRMAN. Where are they located?

Mr. MANSON. They are located at Port Henry, N. Y.

Before going into this case I will call the committee's attention to what I think is its most pertinent feature.

We have had a great deal of discussion about the use of the analytical method of appraisal for the purpose of arriving at the value of mining properties. Counsel for the committee has repeatedly called attention to the fact that in making these appraisals the value of the property which is incident to its possession of capital, to its organization, to its manufacturing facilities, has been thrown back into the ground as a part of the value of the mineral which is being depleted for the purpose of ascertaining depletion.

As will be brought out, in this case a valuation was made based upon the value of the mineral. It is possible to do that in this case, for the reason that this company was engaged in mining and in selling ore and ore concentrates. It also operated a blast furnace, but the amount of ore passing through the blast furnace was but a small fraction of its production, so that the results of its operation reflected the results of its mining business.

An appraisal was finally arrived at in this case that amounts to three times as much as the appraisal based upon the results of the operation of the company as a mining company, and this appraisal is predicated upon the theory that this company may construct a blast furnace, and that if they do construct a blast furnace the profits they will get out of their ore, if they convert it into pig iron, will be so much greater than the profits they are getting by selling

the ore that the value of their mine will be raised from about $4,892,000 to about $12,500,000.

This case is the only one that we have come across where it is possible to segregate the foreign values that have been brought in by the analytical appraisal, to the value of ore in the ground, and the reason it is possible here is that the foreign values were not present, but were actually imported into the case in order to increase this valuation.

The CHAIRMAN. In other words, when valuing this particular property, they did not value it as though it was an undeveloped property that might be sold by a willing seller and purchased by a willing buyer, but added to the value all of the elements which made a completed business.

Mr. MANSON. Yes. Mind you, this is a developed property, and the company is engaged in the mining of ore and in the selling of ore and in operating a concentrating plant and in the selling of concentrates, and the valuation placed upon the profits made by that process results in a valuation for depletion purposes of $4,892,523.07.

Senator KING. Would this be an analogous case:

I own a coal mine, and I am operating it and selling my bituminous coal in a live and virile market. I conceive the idea of putting in coke ovens, and also a by-product plant to handle the coal-tar products, which may otherwise escape, and from the latter I get dyes, pharmaceuticals, chemicals, the basis of aspirin, etc.

Mr. MANSON. The making of perfumes?

Senator KING. The making of perfumes, and out of this I make enormous profits. I am still running my mine to supply my customers with bituminous coal; I am still running my coke ovens; but I make out of my perfumes, pharmaceuticals, and medicines, large profits. Now, they take into account those large profits made from these auxiliary or ancillary businesses; they consider those profits with a view to increasing the value of the coal in the ground?

Mr. MANSON. Yes; but this valuation is made on the theory that you are contemplating doing all of those things, and that will give your coal mines that sort of value.

Senator KING. You might just as well argue that if a man has a forest and has a sawmill and then he conceives the idea of adding a cabinet plant or a furniture plant, from which he makes large profits, he must consider the profits there for the purpose of augmenting the value of the timberland.

Mr. MANSON. It would be equally logical, in my opinion——

Senator KING. It is absurd——

Mr. MANSON (continuing). To assume that a taxpayer might construct a plant for the manufacture of watch springs, in which event he could get a value of a million dollars a ton.

Senator KING. For his ore.

Mr. MANSON. For his ore.

The CHAIRMAN. In other words, then, that would give him an unfair or preferential advantage over his neighbor who might only be mining coal or mining ore and selling it direct without a manufacturing plant.

Senator KING. Yes.

Mr. MANSON. That is it exactly.

Senator KING. Who is the engineer who has charge of those matters in the department?

Mr. MANSON. That work comes under the mines valuation section. In this case the valuation made by the mines valuation section was predicated upon the value of the ore, and the valuation was made by Mr. F. T. Eddingfield. The case was taken to the committee on appeals and review. There are some other elements that enter into the case, but in order that the real point might be clear, as I go through the history of this case, I desire to call the committee's attention at the outset to the basis of the result that is finally arrived at.

Senator KING. May I ask whether, from your investigation, you have discovered that this is an isolated case of whether the same principle is applied in other mining cases where the property is used not only for the getting out of the ore and devoting it to ordinary purposes, but in cases where some other collateral business has been injected?

Mr. MANSON. Well, I am unable to answer that question. I have repeatedly called attention to the fact that the various valuations to which I have called the committee's attention contained elements which were foreign to the value of the ore or to the natural deposit in the ground. I might refer specifically to the United States Graphite Co. case, where the value of the product consisted almost entirely in the value of the business, which was world-wide. It was a business organization which was world-wide for the disposal of this graphite after it had been converted into a merchantable product.

Senator KING. Mr. Nash, I know, of course, that you can not keep all of these matters in your mind, and that they have not all been brought to your attention, but has this particular phase of this case been brought to your attention in connection with any other case?

Mr. NASH. No, sir; it has not, Senator.

Mr. MANSON. The taxpayer's claim for depletion in 1916 was based upon the amount claimed by the taxpayer. There was no appraisal of the property made in connection with that.

The CHAIRMAN. What was it at that time?

Mr. MANSON. It was about 62 cents a ton, if I remember right.

The CHAIRMAN. Yes; but what was the total valuation, so that we may compare it with those other figures that you have been giving?

Mr. MANSON. There was no valuation made as to that.

The CHAIRMAN. When was the first valuation made, then?

Mr. MANSON. There is a valuation involved in this case that was made some time in 1910, and that is the valuation that was finally accepted. The valuations made by the mines section of the Income Tax Unit was made in 1921, as of March 1, 1913.

The CHAIRMAN. Was that at variance with the amount claimed by the taxpayer?

Mr. MANSON. Very much so. The taxpayer's valuation as of March 1, 1913, is $12,506,634. The valuation made by the mines valuation section is $4,892,523.07. The valuation made by the committee on appeals and review is $10,500,000. I said that was $12,500,000. It is $10,500,000, approximately twice that made by the mines valuation section.

It would appear that taxes for the years 1916, 1917, and 1918 are closed, although an unlimited waiver is on file for the year 1917, the legality of which may be questionable. For the year 1919 the statute of limitations would appear to become effective on April 14, 1924, there being no waiver on file. The department has been requested to take action toward obtaining waiver for 1919 taxes, or make jeopardy assessment in order to protect the Government's interests.

Taxpayer's 1916 depletion deduction was accepted and case closed by the department in 1918. In 1917 tax returns the taxpayer claimed a depletion deduction to which the unit could not agree. The metals valuation section first took the position that no value should be given the ores owing to the fact that taking the ruling price for iron ores and operating cost as of March 1, 1913, into consideration gave insufficient profit to absorb the plant and equipment cost. The taxpayer took the position that the best basis for valuation of their property were offers of purchase on the part of the Standard Oil Co. and the Bethlehem Steel Co., and that the regulations provided for such a basis of valuation. It was the contention of the metals valuation section that the taxpayer failed to submit evidence of a bona fide offer on the part of either the Standard Oil Co. or the Bethlehem Steel Co., and the evidence was not sufficient to sustain the valuation sought by the taxpayer. The taxpayer appealed to the committee of review and appeals from the decision of the metals valuation section. The committee in making its decision on both invested capital and March 1 value agreed with the taxpayer and did not permit or invite the engineering division to present its side of the case, relying wholly, according to the record, on the taxpayer's reports and statements.

Witherbee, Sherman & Co. was incorporated June 25, 1900, under the laws of the State of New York, with an authorized capital stock of $3,000,000, divided into 30,000 shares of the par value of $100 each. Previous to incorporation the business had been conducted by the partnership of Witherbee, Sherman & Co., which was organized in 1894, but these interests had operated the group of mines since 1849. The capital stock of the corporation was issued to the members of the partnership in proportion to the amount of their respective interests. The mines of this company contained probably the largest and best-known deposits of magnetic iron ore in the eastern section of this country. The business of the company consists of mining and selling iron ores, either crude or in the form of concentrates. A part of its total output is smelted in a blast furnace which the company has operated on its own account since 1919. The ore bodies owned by this corporation are located at Witherbee and Mineville, N. Y., the blast furnace being located at Fort Henry, N. Y. In addition to the above activities, the Ore Carrying Corporation, a subsidiary, is engaged in the business of transporting ores and fuel by water routes, for which it owns and operates a fleet of steamships and barges. The Mineville Light, Heat & Power Co., a subsidiary, operates an electric light and power distributing plant.

In the 1917 tax return filed by this company taxpayer claimed depletion in the sum of $893,745.45, based on fair market value as of March 1, 1913, of $12,506,634, with 19,859,434 tons of crude ore. This claimed valuation results in a depletion rate of 62.97 cents per ton of crude ore.

The taxpayer submitted insufficient data with its return to substantiate its deduction for depletion. Considerable correspondence took place during 1920 regarding additional information, and several conferences were held with the taxpayer. From information submitted several valuations were made by the metals valuation section, the section finally recommending a valuation by Mr. F. T. Eddingfield, dated February 11, 1921, of $4,892,523.07.

The taxpayer submitted a sworn brief on March 1, 1921, presenting facts and its arguments. It was claimed that the present value method as used by the unit was wrong and that the fair market value as between a willing buyer and willing seller should be used, the unit ignoring potential profits under different methods of operation which justified two prospective purchasers in making offers for the property.

On April 6, 1921, Mr. Frank L. Nason, geologist and mining engineer, made an affidavit giving the history of his connection with the Standard Oil Co. in 1910 and 1911 and regarding his report of valuation of the taxpayer's property, made for them; that is, made for the Standard Oil Co.

On October 23, 1921, the unit wrote the taxpayer in reference to their 1917 return, giving information in connection with the analytical appraisal made by the metals valuation section which it had recommended to be used as the basis of audit of 1917 returns.

On October 28, 1921, Mr. Talbert, tax consultant for the taxpayer, appealed to the committee on appeals and review from the rulings of the unit, both as to values for depletion and invested capital.

On January 7, 1922, Mr. Talbert submitted a brief in connection with its appeal to the committee on review and appeals in which he set forth arguments as to claims for March 1 value and invested capital.

On March 1, 1922, the committee on review and appeals handed down a decision No. 896, which was approved by the Commissioner of Internal Revenue. This decision reversed the unit's rulings on both March 1 value for depletion and invested capital. (See Exhibit B.)

On April 11, 1922, in a memorandum to Mr. Fay, the metals valuation section disagreed with the findings of the committee on the March 1, 1913, value on the ground that such finding was not based on fact. The section also reminded Mr. Fay that it was not called upon to present its side of the case although it was promised such a hearing by the committee.

Senator KING. Who was Mr. Fay?

Mr. MANSON. Mr. Fay was at that time the chief of the natural resources subdivision.

On April 14, 1922, Mr. Fay directed a letter to Mr. Chatterton, assistant deputy commissioner, enclosing a copy of Hamilton's memorandum and requested an opportunity to put the matter before the commissioner.

The matter then appears to rest until September 23, 1922. The natural resources subdivision was ordered by C. P. Smith, assistant commissioner, to close the case of the Witherbee, Sherman & Co.

It appears from the record that the taxpayer in its original return for the year 1916 made a deduction for depletion of mines of $872,384. Upon investigation by the revenue agent $671,065 of this

amount was disallowed. Depletion was allowed by the agent at 15 cents per ton on 1,342,130 tons of ore mined during the year 1916, in the amount of $201,319.50. An additional tax was assessed on the amount of depletion disallowed, $671,065 at 2 per cent in the amount of $13,421.30. The taxpayer filed an abatement claim with the bureau for the abatement of this additional tax.

This claim was settled by L. F. Speer, deputy commissioner, as follows: The taxpayer contended that since the tax in question covered the year 1916, and the property was acquired previous to March 1, 1913, it was entitled to compute the depletion deduction on the basis of the fair market value of the mine content as of March 1, 1913. It was submitted that the operative ore bodies, en bloc, had a value which a purchaser could have afforded to pay in cash on March 1, 1913, as follows:

Tonnage	19,859,434
Value	$12,506,634
Value per ton	$0.6297

It was determined that the ore mined in 1916 amounted to 1,342,130 tons, which should be valued at 62.97 cents per ton, and that the depletion should be $845,139.26. Since the revenue agent allowed $201,319.50, additional depletion in the amount of $643,819.76 should be allowed. The tax on this amount at 2 per cent equalled $12,876.40 which it was determined should be allowed on the claim of $13,421.30 and $544.90 of the claim rejected. Taxes for the year 1916 were therefore closed on this basis.

The taxpayer, in its 1917 return——

Senator KING. Are you still quoting Mr. Speer now?

Mr. MANSON. No; this is a report of our own engineer.

Senator KING. Oh, I though you were still quoting from Mr. Speer.

Mr. MANSON. No.

The taxpayer, in its 1917 return, made a depletion deduction of $893,745.45, using the same depletion rate of 62.97 cents per ton of ore mined. During 1920 the case was referred to the metals valuation section for the determination of proper values for depletion and invested capital. A conference was held with the taxpayer in December, 1920, and it was agreed that complete data would be submitted. In a leter dated January 20, 1921, Mr. Francis, president of the corporation, protested further investigation, and the submission of additional data, stating that information had been furnished as a basis for the 1916 determination which was satisfactory at that time and that under the regulations the matter should not be reopened.

The metals valuation section made several valuations of these mines, as follows:

Date	Engineer	Value for depletion determined
Dec. 15, 1920	A. W. Gaumer	None.
Feb. 2, 1921	F. T. Eddingfield	$3,411,569.99
Feb. 7, 1921	J. A. Grimes	[1] None.
Feb. 11, 1921	F. T. Eddingfield	[2] $4,892,523.07

[1] Exhibit C.

[2] Exhibit D.

It was finally decided to use the Eddingfield valuation of February 11, 1921 (Exhibit D), in the determination of depletion, but same was not satisfactory to the corporation. On March 1, 1921, the Witherbee, Sherman & Co., through their tax consultant, P. S. Talbert (formerly chief of the technical division of the Income Tax Unit), submitted a sworn brief and argument setting forth their position. On April 6, 1921, an affidavit by Frank L. Nason, geologist and mining engineer, was submitted.

From the above affidavits it would appear that in June, 1910, Mr. Frank L. Nason was employed by the Standard Oil Co. to make an examination of a very large iron-ore property on Moa Bay, Cuba; that he was recommended for the work by Mr. Frank S. Witherbee, president of Witherbee, Sherman & Co., and Mr. S. Norton, general superintendent; that the Standard Oil Co. was about to embark on a new policy and had decided to put up a blast furnace and steel plant near either Troy or New York City; and that their first move was to secure an ample iron-ore supply.

Mr. Nason sailed for Cuba June 11, made the necessary examination, and on his return reported that in his opinion the Cuban property was unsuited to their purpose. This report being sustained by a subsequent party of engineers, the Standard Oil Co. decided to drop the Cuban proposition.

Subsequent to the Cuban examination the Standard Oil Co. arranged with Professor Nason to make an examination of the Witherbee, Sherman & Co. properties. Although the properties were not for sale in the ordinary sense, the company advised that it had no objection to an examination.

I now quote the following from the brief of the taxpayer:

> Professor Nason thereupon spent some months in an exhaustive examination of the properties and reported that, in his judgment, they were worth (ore bodies alone) $10,652,400, to which must be added approximately $2,000,000 as the value of the plant and equipment. (Exhibit E.) In the meantime, Witherbee, Sherman & Co. itself had been considering what it would sell out for, and, independently, had reached the conclusion, without conference with Professor Nason, and without knowing anything about his conclusions, that it would sell if it could get $12,500,000 for its property. A sale at that time would undoubtedly have been concluded but for the fact that suit was brought for the dissolution of the intended purchaser, and it thereupon dropped all negotiations looking to an extension of its activities into new fields.

I wish to call the committee's attention at this point to the fact that it appears the Standard Oil Co. was in the field looking for an iron property. They sent Professor Nason down to Cuba. He examined the property down there and reported that it was not suitable for their purposes. This property was not on the market for sale, but the owners agreed to permit Professor Nason to examine it. He examined it and he made a report that the ore bodies were worth $10,652,400. About that time, because of the fact that suit had been brought against the Standard Oil Co., having in view the bringing about of its dissolution, negotiations with reference to this matter were dropped.

I submit at this point that that does not constitute a bona fide offer for the property, such as can be made the basis of its value.

Shortly thereafter some negotiations were had with the Bethlehem Steel Co. and which it is claimed resulted in an offer, first, of $7,500,000, which was subsequently increased to $9,000,000.

In 1913, Witherbee, Sherman & Co. employed Professor Nason to bring his report up to date—that is, the report that he had previously made for the Standard Oil Co.—which he did by eliminating the ores mined and including the ores developed since 1910, some 5,750,000 tons, making the net tonnage "in sight" as of March 1, 1913, 19,859,434 tons and the value as of that date $12,506,634. Professor Nason's reports were never delivered to the unit, but from the data submitted on November 28, 1917, a copy of this valuation has been assembled. (Exhibit F.) This valuation was corrected on July 19, 1918, to a total of $13,247,434.

The metals valuation section in their reply to brief took the position that the offers (on which no sale was made) for the property in 1910, when the iron business was very prosperous, would not necessarily be the value as of March 1, 1913, because the iron business was then entering a period of depression. It was also their opinion that the reported value as of 1910 did not represent an engineer's estimate of the present worth of an operator's profit on the ores in the property, but represented an extra profit which might be made on pig iron by a furnace company in or near New York City, and in addition certain intangible values due to the condition of the iron industry in 1910, such as the strategic value of ore deposits in New York, to a furnace company operating in or near New York City.

Regulations 45, article 201 (b) states "where there has been no sale and the fair market value at the basic date is to be used such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date." Regulations 45, article 206 (a) states that due weight will be given to all factors and evidences having a bearing on the market value, such as cost, etc., "disinterested appraisals by approved methods such as the present value method and other factors."

It is the opinion of this office that the March 1, 1913, value of ores only is $4,892,523.07, ascertained by the present worth method, using a life of 22 years, a profit per ton of shipping product of $1.19, and a rate of 7 per cent and 4 per cent.

I would call attention to the fact that that discount rate of 7 and 4 per cent used by the unit in arriving at its value was a very low discount rate.

Senator KING. Is there any evidence to show the value of the property in 1913, based upon the sales of contiguous property?

Mr. MANSON. No; there is not. The only evidence based on sales or what might be considered comparative sales methods is this appraisal made by Nason for the Standard Oil Co., which never resulted in an offer, which never resulted in a sale, and a claimed offer by the Bethlehem Steel Co. of $7,500,000 to $9,000,000, which resulted in nothing.

Senator KING. Yes; but those were long subsequent to 1913.

Mr. MANSON. No; those were back in 1910.

Senator KING. Oh, they were in 1910?

Mr. MANSON. At a time when the steel industry was in a considerably different condition than it was in 1913.

Senator KING. Pardon me, but when was Nason's first investigation made for the Standard Oil Co., after he went to Cuba and then came back? In what year was that?

Mr. MANSON. That was in 1910.

The taxpayer in its brief, in response to the position taken by the metals valuation section, says:

The fallacy of the bureau's method lies in its insistence on using the results of Witherbee, Sherman & Co.'s operations as the test of value, ignoring the potential profits under different methods of operation, which justified the two prospective purchasers in making the offer they did. To fully appreciate this it must be remembered that Witherbee, Sherman & Co. produced and sold ore only (except for a small quantity of iron produced in a blast furnace of its own, as above stated) either in its crude form or as concentrated to bring the iron content up to or slightly above the standard of 60 per cent, while both the prospective purchasers desired the property as a source of raw material for the operation of their own steel plants to be located in the East.

Witherbee, Sherman & Co. itself realized that it was not getting all the profit possible out of the sale of its products, and after the failure of negotiations to sell, itself spent a considerable sum in the development of plans for a large blast-furnace plant of its own.

They are at the present time working on plans for the erection of two 400-ton furnaces, to operate in conjunction with the present 250-ton furnace, operation of which they took over in 1919. The estimated costs of operation of the above furnace and sales value of the pig iron shows a potential value to the ore of about two and a half times the profit of selling ores to outside parties. The operation of the present furnace by themselves and also by the outside interest——

The CHAIRMAN. I would like to ask at this point whether anybody here knows what the price of ore, the raw ore, was at that time, as related to 62.97 cents per ton.

Mr. WRIGHT. It was about 6¼ cents per unit, a unit being 20 pounds.

Senator KING. For the ore, or for the pig iron itself?

The CHAIRMAN. No; I was asking about the ore. They gave a value to the ore in the ground of 62.97 cents.

Senator KING. Yes; I understand that.

Mr. MANSON. That is, they gave a depletion of that.

The CHAIRMAN. Yes; they fixed the value at that for depletion purposes.

Mr. MANSON. No; that is the depletion unit that was originally allowed for the 1916 depletion.

The CHAIRMAN. Yes; but what was the value fixed per ton of ore in the ground?

Mr. WRIGHT. It would be $3.90, according to Professor Nason's figure, per ton of 60 per cent ore, or 6½ cents per unit.

Mr. MANSON. Now, continuing with my quotation from the brief of the taxpayer:

The operation of the present furnace by themselves and also by the outside interest who operated the furnace a number of years substantiate results that might be expected and profits obtained. Circumstances, however, have prevented the realization as yet of the plans, which involve the expenditure of six or seven millions of dollars.

Still quoting from the brief of the taxpayer:

The strategic position and economic advantages of the properties were well known to Witherbee, Sherman & Co., and clearly justified it in refusing to sell for less than $12,000,000, even though its operations as then, and for reasons explained above, since conducted do not show a normal profit on such value, and also clearly justified the prospective purchasers in making offers which did take into consideration potential profits they were in a position to realize, which in itself does substantiate the value per ton of crude ore as arrived at by Professor Nason.

On October 23, 1921, Deputy Commissioner Batson advised the taxpayer by letter that the following valuation and depletion rate had been determined:

Total expected marketable product----------tons--	12,576,980
Present worth of ores as of March 1, 1913----------	$4,892,523.07
Unit of depletion per ton of marketable product----------	$0.389

That is the depletion unit arrived at by the metals valuation section.

The taxpayer appears to have valued its property at $12,500,000, including in such valuation "potential profits" arising from the manufacture and sale of pig iron from its ores and which it states in its brief "shows a potential value to the ore of about two and one-half times the profit of selling ores to outside parties."

This value it attempts to justify by referring to Professor Nason's valuation of 1910 amounting to $12,652,400 (Exhibit E), made for the Standard Oil Co. and covering some $19,600,000 in property. This report was brought up to March 1, 1913, by Professor Nason; the corrected valuation as reported on July 19, 1918, being $13,247,434 for ores only, showing a value per ton of $0.66705. (Exhibit F.)

Careful analysis indicates that this valuation can not properly be used as a basis for depletion, since the figure represents the total expected profits for the life of property without discounting to present worth, nor have the plant costs been deducted therefrom.

Using Professor Nason's figures, in which profits are figured on a unit of iron basis (unit equals 20 pounds), an appraisal is completed, as follows:

Value for depletion as of March 1, 1913

	Units of iron			Expected profits	
	Crude ore (tons)	Per ton	Total	Per unit	Total
1910, ores in sight	15,962,988	$33.584	$536,102,673	$1.987	$10,652,400.00
Ores developed to Mar. 1, 1913	5,750,000	33.636	193,409,073	1.980	3,829,499.64
	21,712,988	33.598	729,511.746	1.985	14,481,899.64
Ores mined to Mar. 1, 1913	1,853,554	52.798	97,863,564	1.261	1,234,466.00
	19,859,434	31.806	631,648,182	2.097	13,247,433.64
Expected profits per unit, $0.02097					
Expected profits per ton of crude ore, $0.6671					
Less expected plant, estimated					2,013,340.80
					11,234,092.84
Discounted at 20-year life, 7 and 4 per cent, $0,482711					5,422,820.00
Less actual plant cost					1,042,870.20
Present value, ores only, Mar. 1, 1913					4,379,949.80

The valuation above, $4,379,949.80, arrived at from Professor Nason's figures on a profit per unit of iron bases, checks fairly closely the Eddingfield valuation of $4,892,523.07, based on information submitted by the taxpayer on Form D and a profit per ton of concentrated basis.

The valuation engineer for the bureau has placed a value for invested capital at date of acquisition of $1,436,437.88, as follows:

Investment at January 1, 1900:	
Plant and equipment	$173,628.82
Mines	100,000.00
Real estate	710,713.19
Bonds, stocks, inventories, etc	452,095.87
Total value allowed	1,436,437.88
Intangibles (not allowed)	1,563,562.12

Thousands of acres of land were acquired on which no development has been done. To attach a fictitious value to such lands is exceeding the limits of the regulations and on this account the records as found by the revenue agent's report, are accepted.

It would appear that the differences between the unit and the company arise from the segregation and classification of these assets. At the time of organization all real estate, plant equipment and mineral lands were included on the books in a single entry $2,548,807.64, as shown by the first journal entry on corporation's books accounting for $3,000,000 of stock. The unit requested a schedule showing the items aggregating this sum, but in view of the fact that the books did not show the segregation, the length of time which had elapsed, and the death of the persons who were familiar with the situation in 1910, it did not feel that a statement could be made that would be accurate; however, a segregation was made, as follows:

Estimated value of property and plant June 23, 1900

Mineville, surface lands only, 1,855 acres, at $10	$18,550.00
Mineville, surface lands, including mineral rights, valuation placed on surface only, 8,146 acres, at $10	81,460.00
Mineville, Old Ben mining plant	75,000.00
Mineville, miscellaneous plants, buildings, and houses	110,500.00
Port Henry, furnace plant, docks, etc	106,500.00
Mineral reserves	2,156,797.64
	2,548,807.64

It would appear that Witherbee, Sherman & Co. when incorporated in 1900 acquired their properties from the partnership of Witherbee, Sherman & Co., the capital stock of the corporation being issued to the members of the partnership. Shortly after organization $1,000,000 par value of the total $3,000,000 of stock issued was acquired by the Lackawanna Steel Co. for $1,000,000 cash.

The taxpayer claimed a value for invested capital at date of acquisition of $3,000,000.

Taxpayer's arguments:

It is shown above that the unit based its conclusion as to segregation of items making up the aggregate of $2,548,807.64 on the revenue agent's estimate of values. How or why the agent 20 years after the fact and without records to go on was able to make a statement more reliable and accurate than that made by the officers of the company, some of whom knew from personal knowledge in a general way the properties acquired, does not appear, but the absurdity of the bureau's conclusion is manifest on its face. Here was a mining property which had been operated for 50 years for the production and sale of iron ore. The owners knew they had large reserves of ore in the mine, but never concerned themselves with endeavoring to find out or set upon the books any estimate of how much. Because they have no record evidence to show how much ore was in sight at the time, the bureau gravely asserts that the mine itself was worth $100,000, but the intangibles attaching to the property—

that is, good will—was worth $1,563,562.12. This is the first instance which has come to the attention of the writer where any good will value is ascribed to the business of mining iron ore, which has a standard selling price fixed by recognized markets. Certainly no producer of iron ore can get a price for his product in excess of the market value of similar ore by reason of any good will attaching to his business.

Taxpayer's appeal: On October 28, 1921, Mr. P. S. Talbert appealed to the committee on appeals and review.

DECISION OF COMMITTEE ON APPEALS AND REVIEW

On March 1, 1922, the committee on appeals and review handed down its decision (No. 896) in this case (Exhibit B) and same was accepted for the guidance of the Income Tax Unit by D. H. Blair, Commissioner of Internal Revenue.

In this decision the recommendations of the Income Tax Unit were not sustained, as follows:

Ores only	Committee's decision	Unit's recommendation
(*a*) Value for depletion, as of Mar. 1, 1913	$10,500,000	$4,892,523.07
(*b*) Value for invested capital, as of date of acquisition	3,000,000	1,436,437.88

On March 21, 1922, the taxpayer was notified by letter of the committee's decision. Taxes for 1917 and subsequent years have been computed based on this decision.

On November 9, 1922, the case was again referred to the committee because of an apparent misstatement in information submitted by the taxpayer. The statement was made by the taxpayer that Professor Nason was employed in 1913 to bring his report of 1910 up to date, while his report was dated in 1917, four years later. The matter was investigated by the committee, an affidavit obtained from Mr. Nason confirming his employment in 1913, which was "sufficiently clear and explicit to be accepted as conclusive upon this point."

After careful review of this case your engineers are of the following opinions:

That as to (*a*) Value for depletion, as of March 1, 1913, the committee on appeals and review erred in the decision:

1. In not permitting the engineers of the unit to attend the hearings and to present their arguments.

2. In accepting statements of the taxpayers as to reported bids on its property, without sufficient evidence as to nature of such bids and whether bona fide.

3. In interpretation of the regulation as to the procedure "when there has been no sale and the fair market value at the basic date is to be used, such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date."

4. In accepting as "fair market price for ores only" a price which included "the potential profits under different methods of operation, which justified the two prospective purchasers in making the offers they did"; and which was from the evidence based on prospective profits (outside of those arising from the mining and selling of iron ores and concentrates) in the manufacture of pig iron, giving "a potenital value to the ore of about two and one-half times the profit of selling ores to outside parties."

5. In assuming that "an estimate made at or about March 1, 1913, should be given more weight in the determination of values as of that date than the method used by the unit," without ascertaining whether such valuation was indicative of "present value" or not.

That as to (*b*) value for invested capital, as of date of acquisition, the committee was correct in its decision: It is our opinion that the sale "shortly after organization" of $1,000,000 par value of the total capital, $3,000,000, for $1,000,000 cash to the Lackawanna Steel Co. established the value of the

total capital, $3,000,000, exchanged for the property, including the assets which the unit classified as intangibles, and disallowed in the amount of $1,563,562.12. It is suggested, however, that the date of this transaction is important and appears to be lacking.

We desire by way of comment to note that the information regarding the Lackawanna sale was submitted to the committee subsequent to the unit's recommendation.

The CHAIRMAN. If I remember correctly, you said that they used a discount factor of 7 per cent.

Mr. MANSON. That is, the bureau?

The CHAIRMAN. Yes; I understand that is the bureau.

Mr. MANSON. Yes.

The CHAIRMAN. But did not they have the actual profits of the corporation at that time, so as to know just what the actual experience was, rather than computing it on a discount factor of 7 per cent?

Mr. MANSON. Well, the difference is this: If they took the actual profit to the end of the accepted period, it is necessary to discount this profit, because it will not be realized until the expiration of time necessary to exhaust the deposits. In other words, a dollar that you will not have until 10 years from now is not worth as much as a dollar that you have at the present time, because you are deprived of the use of it in the meantime.

Senator KING. I do not understand that. If they sell a million tons of ore a year and make $500,000 profit, why do you say that they do not realize that profit until the end of 10 years?

Mr. MANSON. Well, they do not realize the profit until they sell the ore.

Senator KING. But they realize the profit on the ore which they do sell?

Mr. MANSON. Oh, yes.

Senator KING. And they were annually selling this ore?

Mr. MANSON. Yes.

Senator KING. From which they derived a profit?

Mr. MANSON. Yes.

Senator KING. Then I do not understand.

Mr. MANSON. In this valuation of Professor Nason's——

Senator KING. But the question of the chairman was why did you use the factor of 7 per cent discount there when you knew just what the profits were?

The CHAIRMAN. I think the Senator has confused my question somewhat. You arrived at the value of the property by a different method than by taking the previous year's profits.

Mr. MANSON. No; I take it that the bureau took the profit that the company had made on each ton of ore and multiplied that by the number of tons of ore in the ground. They then determined the period of time that it would take to recover that ore and discounted to present worth the future expected profits by using a discount factor of 7 and 4 per cent.

The CHAIRMAN. Well, if it were known that the taxpayer had no other facilities except the mining of the raw ore, how did they come to include these other factors, such as manufacturing, etc.?

Mr. MANSON. The bureau did not include those. Professor Nason, whose valuation was finally adopted by the committee on appeals and review, made a valuation which the company, in its

brief, claims is predicated upon the value of the ores to a person who has a blast furnace and sells pig iron instead of ore.

The CHAIRMAN. Well, I understand that, but the bureau did accept those figures. You said the bureau did not take those figures, but the bureau did take those figures.

Mr. MANSON. Well, I meant the metals valuation section did not take them.

The CHAIRMAN. That is different. I asked why the bureau did not accept the actual conditions, rather than to assume a condition, on the assumption that they had smelting plants, reductions plants, and manufacturing plants.

Mr. MANSON. The only answer to the Senator's question is found in the decision of the committee on appeals and review, in which the committee on appeals and review take the position that Professor Nason made his appraisal at or about the time as of which value is to be determined, while the bureau made their appraisal several years afterwards, and that they attached greater weight to Professor Nason's appraisal than they did to the metals valuation section's appraisal. That is the explanation contained in the committee's decision.

Senator KING. Does the committee's decision show that they took into account, using your expression, the potential value which would be derived from the use of the ore, for collateral or other purposes—manufacturing, for instance?

Mr. WRIGHT. It shows indirectly, because they state in this decision that these offers were bona fide; that is, they considered them bona fide, and the offers did include that. So, indirectly, they did.

Mr. MANSON. When we come to test Professor Nason's appraisal by another method; when we come to take the tons of ore which he used and apply it to the number of tons which he estimated to be there, the result is a figure which approximates closely the metal valuation section's figure before you apply the discount factor.

The CHAIRMAN. I would like to ask Mr. Gregg if there is anything in the statutes fixing the method which the bureau must use in arriving at these values?

Mr. GREGG. No, sir; there is not a word in the statutes about how a value should be arrived at. There is a good deal of law on it.

The CHAIRMAN. There is a good deal of law on it?

Mr. GREGG. Yes, sir; but not in connection with the income tax law. There are a great many decisions determining values by the courts in connection with other propositions.

The CHAIRMAN. Is there anything which you can refer to which justifies the bureau in fixing these collateral values which we have just been discussing?

Mr. GREGG. I would like to wait in answering that until the counsel for the committee finishes his statement.

The CHAIRMAN. All right.

Mr. GREGG. Then I want to make a few general statements on it.

The CHAIRMAN. There seems to be such a wide possibility for discretion in matters of this kind, and it seems to me there should be a definite rule.

Mr. GREGG. I think the chairman made the same suggestion before the Finance Committee when we were discussing this matter up there, and my answer then was this, that there are so many different

values which we have to determine, the factors in each case vary so, the evidence available in the different cases varies so, that I think it would be utterly impracticable to write a statute telling us how to value a property. We have to value everything—plant equipment, natural resources, oil and gas, intangibles, patents, copyrights, and everything you can think of. I think it would be utterly impracticable to give us ironclad rules telling us how to value those things. I do not think anybody could work it out. In the first place, I think it would probably be too arbitrary. It would be worth less than the present system in the second place.

The CHAIRMAN. Then you believe that it would be left entirely discretionary with the bureau as to whether they should take into consideration these collateral possibilities; for instance, that you should use your discretion as to whether you would take the actual value of the ore in the ground as compared with other ores in the ground nearby, or should take into consideration the possibilities of even reducing the product in the ground to lead pencils or watch springs, or things of that sort?

Mr. GREGG. No, sir; I think in determining it there is a right way and a wrong way to do it. Sometimes there is no clear right or wrong way.

As to the considering of the possibilities of the use of the ore in finished products, I would like to take that up when the counsel finishes with his case.

The CHAIRMAN. Have you finished with that, Mr. Manson?

Mr. MANSON. I wish to call attention to the fact here that in this particular case there is no complete copy of the Nason appraisal, which was made the basis of the determination of value by the committee on appeals and review in the bureau. For that reason, it is impossible for us to make the kind of an analysis of that valuation that we would like to make. The fact of the matter is, however, that the taxpayer himself, in advocating the use of this valuation, contends that these foreign elements should be considered, and the taxpayer himself in attacking the valuation made by the metals valuation section attacks that valuation upon the ground that they did not consider the profits which might be made by a mine owner if the mine owner had a blast furnace and converted his iron ore into pig iron and sold the pig iron instead of selling the ore, as this taxpayer did.

The CHAIRMAN. Let me ask you at this point, Mr. Gregg, whether you contend or believe that it would be difficult to write a statute making that clear-cut decision?

Mr. GREGG. I do not think there would be any difficulty about it at all.

The CHAIRMAN. No, sir; it seems to me that it would be a perfectly plain matter to write a statute covering cases of that kind.

Senator KING. Yes.

Mr. MANSON. The most important feature of this case is that it brings out clearly what I have heretofore contended with respect to other cases, that elements were considered in arriving at the value of minerals in the ground which were wholly foreign to the value of those minerals in the ground. In those other cases it was impossible to separate from the data we had the value of the minerals in the ground from the additional values that had been given to it.

This case is important in that in this case the difference between the value of the mineral when sold as ore and its value when sold as pig iron is clearly brought out.

Senator KING. I would like to ask Mr. Gregg a question:

How would it do to amend the statute requiring, in the event of inquiries being made by the assessors in the various States, our department—your department—to furnish evidence of the value which was placed by the taxpayer upon these properties?

Mr. GREGG. That can be done to-day, Senator.

Senator KING. I venture the assertion that many of these persons, where they, for State tax purposes, have an ad valorem, would gladly seize upon the value, as in this case here, which has been placed upon it by Mr. Eddingfield of $4,000,000 plus.

Mr. GREGG. That can be done. The governor of any State now can get information concerning any taxpayer at any time.

Senator KING. You can see the point I am making there, because I have no doubt that in many of these States where they have the ad valorem tax they make a return to the State of insignificant value, and they make a return to the Federal Government of an enormous value, so they will catch the State and the Government coming and going.

The CHAIRMAN. I would like to ask Mr. Manson at this point whether he can ascertain the assessed value of this property by the State?

Mr. MANSON. I will have to ask somebody else.

The CHAIRMAN. I mean that you can write there and get it.

Mr. MANSON. Yes.

Senator KING. Write to the assessor.

Mr. MANSON. Yes.

Senator WATSON. Is this an isolated case, or is it the policy of the bureau?

Mr. GREGG. May I ask a few questions in that connection, Senator Watson?

Senator WATSON. Yes.

Mr. GREGG. I think it would be helpful to know in this connection whether the case that has been brought up is to form the basis of a criticism of the general policy or of the settlement of the specific case. Does counsel for the committee criticize the general policy of the bureau from this case, or their judgment in the settling of this particular case?

Mr. MANSON. I criticize both. I have called attention to a number of cases here in which I have argued that the bureau, in making its valuation of natural deposits of ores, had thrown into the value of the ore in the ground values which arose out of selling organizations, which arose out of manufacturing processes, and which arose out of other elements that were entirely foreign to the value of the ore in the ground. In this particular case that is brought out more clearly than in any other case that I have presented. In this particular case the owner of the ore in the ground did not possess the facilities for giving the foreign value to his ores which had been given to the ores in other cases which I have called to the committee's attention, and in that respect I call particular attention at this time to the United States Graphite Co. case.

The CHAIRMAN. In that connection, Mr. Gregg, I do not quite see your reason for raising that question, because, before the Finance Committee, you reported that there were some 53,000,000 tax returns received by the bureau, and it must be obvious to you, of course, that the committee can not check all of those 53,000,000 returns.

Mr. GREGG. Yes.

The CHAIRMAN. I would like to know just what you are driving at by trying to find out whether it was the custom or policy that we were criticizing, or a question of criticizing a particular case.

Mr. GREGG. It seems to me it is important. If it is contended that an erroneous policy is being applied in the settlement of our cases, then we would answer that by showing either that the policy was not erroneous, or that it was not applied in all other cases. If it is the settlement of this particular case that is being criticized, then our answer is to defend the settlement in this particular case.

The CHAIRMAN. I want to say for the committee that you can defend both the policy of the bureau and the settlement of this particular case. We have not restricted your defense to any narrow construction of the matter.

Mr. GREGG. No; but before I answer counsel's criticism, I want to know what the criticism is.

Senator KING. Speaking for myself, Mr. Gregg, I disclaim that I have any purpose in view other than to find out what these general policies are, and, if they are wrong, with your help to correct them. If it is legislation that is needed to correct it, then we should know that. It seems to me that when attention is called here by a specific case to a policy which, after full consideration, we think is wrong, the department ought to aid us in determining whether that is just an isolated case. If it is, we can dismiss it; but if it is the general policy, the matter should be given some consideration.

Senator WATSON. That is why I asked the question.

Senator KING. And then you ought to help us in determining whether it is a general policy and to aid us with your views in determining how it should be corrected.

Mr. GREGG. Let me ask another question, which I think will straighten the matter out:

In any analytical appraisal method of determining values, factors such as efficiency of the organization and their facilities for operating a given property, enter into the value. Is not that correct?

Mr. MANSON. As it is applied by the bureau, they do.

Mr. GREGG. In any analytical appraisal method, do not those factors enter into your computation?

Mr. MANSON. That all depends on who is using the analytical appraisal. It all depends upon who applies it.

Mr. GREGG. I do not think so at all.

Mr. MANSON. Here we have had an analytical appraisal applied by two different men, with results vastly different. My position has been from the start that, to the extent that those elements did enter into the valuation of a property for depletion purposes, the property is overvalued, and it has been my purpose in presenting these cases to show the necessity for some legislation which will make it incumbent upon the bureau to eliminate those elements, so far as those elements can be eliminated.

Mr. GREGG. Let me go back to the same question from a different angle:

What valuation does counsel for the committee think was a correct valuation in this case?

Mr. MANSON. Well, I am not making a valuation in this case. I have pointed out the defects of the valuation adopted here. I do not pretend to be an expert competent to make a valuation myself.

The CHAIRMAN. I would like to ask Mr. Gregg at this point whether the two valuations which have been discussed, one of $4,500,000 plus and the other of $10,000,000 to $12,000,000, were not both arrived at by the analytical method?

Mr. GREGG. The latter valuation, as far as the department is concerned, I do not think was; but I would like to come to that later. All of this may look somewhat like sparring to the committee, but the point I am trying to bring out is this, by way of explanation of the question which I asked and which the chairman criticized me for asking:

If the analytical appraisal method of the value in itself is under attack, we want to put in evidence to show that it is the accepted method of valuation. We have already done that, but if it is still under attack we want to put in cumulative evidence to show it. Now, analytical methods of valuation do take into consideration to some extent at least, such factors as efficiency of management and facilities for operation. The only expert witnesses that we have here on this point are the engineers for the committee, and I noticed when I was asking the question that they were nodding their heads. If you want them to answer it, I should be glad to have them. For example, in the valuation which I judge from the statement of counsel for the committee was the valuation which they thought was correct, the so-called Eddingfield valuation of $4,800,000, factors of management, efficiency, etc., entered into it, because, as counsel for the committee has stated, the average profit which the company had been making per ton of ore had been considered. Now, obviously, those elements entered into the valuation.

So if the analytical appraisal method is under attack I should like to know it. If it is the method as applied in this case which is under attack, that is an entirely different question and justifies my question to Mr. Manson.

Senator KING. If the analytical method, as the bureau has applied it, permits such great differences as between $4,000,000 plus and $12,000,000 plus on a little iron-ore deposit, I would attack the system. If this is just an isolated case where there has been some mistake that is not compatible to the general rules of the analytical method as applied, then I would very quickly dismiss this case.

Mr. GREGG. That is the point I wanted to bring out.

Mr. MANSON. I just wish to say in that connection that to refer to the method of appraisal as the analytical method is like referring to a species of fruit as apples. The analytical method of appraisal, as such, does not mean anything particularly. It all depends upon who uses it, and it all depends upon the factors that you take into consideration. I maintain that in the use of the analytical method of appraisal you do not eliminate, so far as possible to eliminate, elements of value which are foreign to the value of the ore in the

ground. The method and system is wrong. I do not mean by that to say that you can not use the analytical method of appraisal. To use the comparison that I used a few minutes ago because some apples are not fit to eat it does not necessarily follow that all apples are not fit to eat. The use of this method depends upon the result arrived at. The soundness of it depends upon the care that the engineer has taken in considering the elements.

I do believe that we have shown, in a sufficient number of cases that that care has not been exercised to warrant Congress in placing some restrictions upon the use of the analytical method of appraisal for purposes of determining the value of ores. Exactly what those restrictions should be I am not prepared at this time to say. My nose has been so close to particular cases that, as far as I am concerned, I have not as yet reached the point where I have been able to give very much broad consideration to this subject; but I do see the necessity for so limiting, by statute, the use of this method, that it will be the duty, under the law, of engineers and of the bureau to eliminate factors which are foreign.

I concede that there is probably some element of value due to organization, possession of capital, possession of plant, etc., in the Eddingfield appraisal; but it is a very much less element than it is in the other appraisal, which even carries it beyond the facilities in the possession of the taxpayer. That illustrates the fact that you can go way beyond reason and still use the analytical method of appraisal, and that there is some necessity for putting some stop limit on it.

Mr. GREGG. May I ask a question there? Mr. Chairman, may I ask the engineers for the committee, since counsel does not wish to express an opinion on it, what they think is the correct valuation in this case?

The CHAIRMAN. Certainly.

Mr. GREGG. Will one of you gentlemen please tell me?

Mr. WRIGHT. I would say that the Eddingfield valuation is correct, with all the information he had.

Mr. GREGG. All right, sir.

Mr. WRIGHT. And I would further say that the Nason report is not a valuation report, that the committee erred in accepting the mine valuation, which is nothing more or less than a total profit valuation, and I have attempted to complete that valuation to its present value, as the present regulations call for, and the figures check very closely with Eddingfield's.

Senator KING. It would seem to me that the department and you, Mr. Gregg, as an expert, a man upon whom the Committee on Finance has relied very greatly, because that committee had confidence in you, and I am sure you would not abuse that confidence, because we will need you again in framing the next statute, ought to be willing and glad to have some method adopted which will not permit such great disparities as the difference between $4,000,000 plus and $12,000,000 plus on a piece of property. Now, whether it is the analytical method that is at fault, or whether it is mere judgment that is at fault, I am expressing no opinion at the present time, but if any such conditions do prevail as to permit such great discrepancies in valuation, it seems to me that you ought to, and the department ought to, welcome suggestions from us if we can give any, or

devise some way yourselves by which those evils, because they are evils, may not be continued.

Mr. GREGG. I think I have shown, Senator King, that I am glad at all times to do anything I can to help in improving the revenue laws. If I were called upon from a consideration of the metal cases called to my attention by Mr. Grimes, wherein he did not agree with the settlement, to draft a general statute to guide the bureau in the valuation, I will admit that I could not do it.

Let me say this in connection with the general proposition of value and the chairman's point made in that same connection:

As I understood Mr. Manson's answer to the inquiry, he said that he recognized that the analytical method of appraisal had to be used in some instances in determining valuation, but his criticism was as to the factors used; in other words, that in this case the analytical appraisal method was unintelligently used. I think that is a fair construction of his statement.

Let me show you for a minute the difficulties in connection with the valuation. The engineers for the committee have said that the correct valuation is $4,800,000 in even figures. In this one case I will give you the factors that we had in figuring the value of the property. We had the company's claim of a value of $12,500,000, in round figures. We had an offer in 1913, and there is some evidence, as I understand it, to disclose that such an offer was made, of $9,000,000 by the Bethlehem Steel Co. We had this fact that the Standard Oil Co., whose——

Senator KING. Resources are great.

Mr. GREGG (continuing). Resources are beyond question, sent an engineer to make a valuation. Regardless of the factors that he considered in arriving at that valuation, we have the fact that his report indicated a value of the total properties of around $12,500,000. We have the affidavit of the president of the company that they would have sold at that time for $12,500,000. Those are factors that we have in connection with this valuation.

On the other hand, let me read you a few of the valuations that were made in the unit.

This property was appraised by Mr. Gaumer, an engineer in the metals valuation section, a very able chap, who gave it a value of nothing.

It was appraised by Mr. Eddingfield in 1921, and he gave it a value of $3,500,000.

It was apparised by Mr. Grimes in February, 1921, and he gave it a value of nothing.

It was appraised by Mr. Eddingfield in 1921, on February 11—and this is the value which the engineers of the committee think is correct—at $4,800,000, and you will note that those three last valuations were made within a week or two of each other.

Now, Mr. Grimes, who has been so praised by this committee and by its counsel, is in this case $5,000,000 off from what the engineers of the committee think is a correct valuation.

Can you tell me with that data before us that there is anything showing that there was a rank lack of intelligence in the action of the department? Our valuation finally arrived at was $5,000,000 different from the valuation that the engineers of the committee think is correct. That valuation is also $5,000,000 from the valuation

of Mr. Grimes, whom the committee thinks so much of. Now, if you can tell me how to lay down a statute as to how to value property I will quit.

Mr. MANSON. Mr. Grimes's valuation was based upon the actual operations of the company.

Senator KING. And not on the value of the property.

Mr. MANSON. And not on the value of the property. In other words, that value was taken by determining what it cost to mine the ore and what they got for the ore, and by deducting from the total thus obtained the plant, and there was not enough left to absorb the plant.

My position in this matter is this: I have never attempted in this or any other case to say that the value of any particular piece of property was any particular amount. I do not know that it is incumbent upon us to do that.

Senator KING. You present the facts.

Mr. MANSON. We present the facts. I have called attention to the fact that in this case the value of $4,800,000 was attacked by the taxpayer upon the ground that it did not include the value that that property would have if they owned blast furnaces and if they converted their iron ore into pig iron.

I assume from the fact that the committee on appeals and review accepted the valuation that the taxpayer contended for, that the valuation they accepted did include those elements. I have directed my attack upon that determination to the fact that in this case we know approximately how much of a value has been imported into the property that is not there at all, and it is illustrative of what I have contended in many cases. I do not mean to say that counsel for this committee or its engineers can lay down a hard and fast rule for making valuations. I do not believe it can be done.

The CHAIRMAN. Getting back to the question that I asked Mr. Gregg a while ago, I would like to know if he still thinks that it is impossible for Congress to write a statute eliminating these outside factors which have just been discussed by counsel?

Mr. GREGG. I do not know. I have not studied it enough to know whether you could write a definition of value. It might be possible to say that in determining fair market values all facts which would influence the profit from the production of the property but which have no effect on the value of the property in the ground should be eliminated. Something of that sort in general language could be written, but something which would be an accurate guide I do not think could be written.

The CHAIRMAN. But that particular statement that you have just made would be a fairly accurate guide; at least it would be better than having no guide at all.

Mr. GREGG. I do not think so. I think we have a guide in the matter of market value.

There is just one more thing in this connection that I want to bring out, and I will not burden the committee any longer.

Counsel for the committee says that he does not think it incumbent upon him to set up a value himself. That is perfectly true; but I wish to say that it is very easy to criticize a value when it is set up: it is more easy to do that than it is to set up one. I think I can take

any value that anybody will set up and criticize it, and with good grounds.

In this instance I would like to point this out: If there is any one thing that the committee has criticized us for it is the use of the analytical appraisal method where we have any other evidence. In this case the engineers for the committee claim that we should use the result reached by the analytical appraisal method used by Mr. Eddingfield. I have not gone into that, and I have not the slightest idea whether it is correct or not.

Remember this, however, that we had a number of other elements indicative of the value of this property which were not analytical appraisals—an offer in 1913 of $9,000,000 and a report by an engineer sent out by the Standard Oil Co. to determine the value of this property, to form the basis of a possible purchase by the Standard Oil Co., which indicated a total value of $12,500,000.

Now, I remember distinctly a little case that the chairman of the committee has rather kidded me with reference to—the New Jersey Calcite Co. case—where we used the analytical appraisal method and did not use some leases made in adjoining territory some several years later. You criticized that settlement.

In this case I dare say that if we had accepted Mr. Eddingfield's valuation based upon his analytical appraisal—and Professor Nason's report, made approximately at the same time, showed a valuation of just half of what Mr. Eddingfield's valuation was—I think we would have been just as much criticized by the committee for using Mr. Eddingfield's valuation as we have been for using the other valuation.

I do not think it is a matter that you can give either a right or wrong answer to. I think it is a matter of judgment, and possibly we went wrong in this case.

Senator WATSON. What was the basis of valuation of the Standard Oil Co.'s representative? Did he just lump it all, or did he put in different factors?

Mr. GREGG. No; it seems that he did not consider the factors which he should have considered, but he made his report in general terms. From the statement made, I think it was not an accurate appraisal.

The CHAIRMAN. If I remember correctly, counsel does not admit—and I am not passing any judgment upon it—that these were bona fide offers or that any offers were really made.

Mr. MANSON. Oh, no; we do not admit that any offers were made. We take the position that, so far as the records show, there is no evidence of an offer made by the Bethlehem Steel Co., and the records do not even purport to show any offer by the Standard Oil Co.

Mr. GREGG. All right, sir.

Mr. MANSON. If the Standard Oil Co. sent an engineer to make an appraisal or valuation, the Standard Oil Co. never acted upon that valuation. From the language of the taxpayer's brief, it is indicated that the appraisal made for the Standard Oil Co. was a determination of profit that the Standard Oil Co. could make out of that property if it did buy it and if they erected a blast furnace; but that does not mean that the Standard Oil Co. would have offered for the property all of the profit they expected to make out of it if they did buy it and build a blast furnace.

Mr. GREGG. I did not intend to give the impression, Mr. Chairman, that an offer had been made at $12,500,000. There was no such offer. The facts are that this engineer sent out by the Standard Oil Co. to set a value, to form a basis for negotiations by the Standard Oil Co., made a report giving a value of approximately $12,500,000.

The affidavit of the president of the company is that at that time the officials of the company agreed amongst themselves—not with the Standard Oil Co.—that they would sell for $12,500,000. The difficulty of proving these offers, etc., as far back as that is quite apparent, but there is some evidence as to 1913. There is a letter in the files, as I understand it, from the president of the company, written in 1913, before this question ever arose, to, I think, the secretary of the company, saying that he had just been talking to, I think it was, Mr. Schwab, and that Mr. Schwab was then agreeable to raising his previous offer of $7,000,000 to $9,000,000.

On the basis of the facts that we have in this case I can not see that a general criticism can be made of the bureau, and I do not think that any particular criticism can be made of the settlement in this case.

Senator WATSON. Do you recommend casting aside the analytical method of appraisal, Mr. Manson?

Mr. MANSON. Do I recommend it?

Senator WATSON. Yes.

Mr. MANSON. Oh, no; it can not be done.

Senator WATSON. It can not be done?

Mr. MANSON. No. I do say it is used in a good many cases where it is not necessary to use it, and I do say that I believe its use should be restricted.

In that connection I would like to call attention to this, that as to whether, in determining the value of these properties, the prospective profits to be made out of elements foreign to the value of the ore in the ground are to be considered is an economic question that should be determined by Congress and not by an administrative body; and if, in the view of Congress, it is desirable that there be thrown into these values for the purpose of depletion value which arises out of organization, which arises out of the possession of capital, which arises out of a market which has been built up, which arises out of manufacturing processes, and the possession of a manufacturing plant, that is a matter that I think Congress ought to determine, but the vast difference in the amount of depletion allowed when those values are taken into consideration is a matter that, in my judgment, ought not to be left to an administrative body.

Senator KING. Mr. Gregg, it does seem to me that a system, when it is applied by honest men, which, as far as I am concerned, I concede with respect to these matters, and men who desire to do the right thing, leaves a gap there of from nothing to $12,500,000 upon a piece of property needs some correction; and my interest in this particular case, may I say, is not so much in the case itself as it is in ascertaining whether the same principle has been applied in favor of injecting into the question of determining value for depletion purposes of what I consider, with my incomplete information, collateral and extraneous elements that ought not to be considered.

If, for instance, the honest men in your department will say that a coal mine, to come back to my original illustration, in determining the question of depletion, may take into account the fact that it has a subsidiary corporation, or contemplates a subsidiary corporation, which will deal with the by-products and will make enormous profits—if one agent of the Government can take that into account, and another may not, and therefore, on two properties, situate side by side, have a greatly different value, something ought to be done to correct it.

Mr. GREGG. In a proper analytical appraisal those elements do not enter into it. I do not concede, however, that this case was settled on the basis of an analytical appraisal. It was settled on the basis of what happened in 1913, and it is a very, very peculiar case in every respect, and it represents, in my opinion—and I am perfectly confident of this—a unique case, and not an illustrative case.

The CHAIRMAN. In that connection I would like to say that two things occur to me, and they are these: If in the case of one taxpayer he accepts the bureau's valuation—say Mr. Eddingfield's valuation—and makes no protest, and in the case of another taxpayer he does, like this taxpayer, make a protest, in the former case the taxpayer pays much higher taxes and much more taxes than the man who makes the protest, and that fact in itself does not seem to assure justice as between taxpayers.

Mr. GREGG. It does not, Senator, and it is very unfortunate that that is the condition. But take the present situation. One taxpayer accepts the finding of the unit in his case and lets it go. Another one may go to the Board of Tax Appeals and quit there. A third may take those two steps and then carry it through to the district court. Another may go to the circuit court of appeals, and finally one may take it to the Supreme Court. Each one may have gotten a different settlement at each step when they quit. Then can not all go to the Supreme Court for final settlement, and, as far as I can see, there is no remedy for this situation.

The CHAIRMAN. That may be true; but that does not estop Congress from endeavoring to find a remedy.

Mr. GREGG. No, sir.

The CHAIRMAN. If a remedy can be found.

Mr. GREGG. And I am perfectly willing, as I said, to help as far as I can.

Senator KING. We want the genius of yourself and your associates to see if we can not make these things a little more clear.

Mr. GREGG. I will be very glad to do anything I possibly can.

The CHAIRMAN. Another comparable case, it would seem to me, would be this, that in one case the taxpayer in making his claim puts in no collateral opportunities that he may use his product for, and settles his case with the bureau on the theory that he does not anticipate a blast furnace, he does not anticipate a pharmaceutical goods plant, and he gets one settlement, while the man across the table, with the same identical plant, may build up a case and say, "I am contemplating putting in a blast furnace; I am contemplating putting in a pharmaceutical goods plant; I am contemplating putting in a coke plant; I am contemplating using my by-products, and therefore the potential value of my plant is much

greater than the potential value of the plant of the other man," thereby getting a greatly reduced volume of taxes as compared with the man in the first instance.

Mr. GREGG. As I have just said, Senator, the valuation arrived at by a proper use of the analytical appraisal method does not take those factors into consideration, and, as I have pointed out, this case was settled not on the basis of the analytical method but it was entirely settled on the basis of the findings made at that time.

Senator WATSON. What does "analytical" mean? Does it undertake to analyze all of the different factors? There is no use of having an analytical method if that is not so. You might just as well say that the ore or the coal in the ground is worth so much in the ground.

Mr. GREGG. No; what properly should be done in using the analytical appraisal method is to determine all of the units in the ground, the estimated profit from the sale of the units, when they are produced, and it should take into consideration, of course, the cost of producing them. The profits are from the sale of the ore when it is produced, and not from the sale of the needles into which it may be made. Those collateral uses to which a by-product may be put should not enter into a proper analytical appraisal.

Senator WATSON. Then, what is an analytical appraisal?

Mr. GREGG. It is just what I have said. I have attempted to tell you what one was.

Senator WATSON. No; you have told me what one was not.

Senator KING. No; he said taking the units in the ground.

Mr. GREGG. Taking the profit per unit, the estimated units in the ground, the cost of production, and discount it back.

Senator WATSON. Do you agree to that, Mr. Manson—as a definition. now?

Mr. MANSON. No; I will not agree to that definition.

Senator WATSON. Then there is no analytical method. What is your idea of the analytical method?

Mr. MANSON. My idea of an analytical method is, in the first place, to analyze the profit——

Senator WATSON. The profit?

Mr. MANSON (continuing). Analyze the profit which can be made per ton of product and ascertain how much of that profit is due to factors which are foreign to the value of the ore in the ground and eliminate those factors. That is the first step I would make in making my analysis.

Mr. GREGG. Can those factors be eliminated?

Mr. MANSON. In many instances they can.

Senator WATSON. Wait right there. If they can not be eliminated in all instances, how are you going to make a general rule to put on paper?

Mr. MANSON. I do not pretend to be able to say we could make a general rule or lay down in the bureau a formula. I do not believe it could be done. any more than Mr. Gregg does. I think our difference of view on that subject would be largely eliminated if we ever got down to an intelligent discussion of this matter across the table. I do believe, however, that it is possible to put into the law a state-

ment that elements foreign to the value of the ore in the ground shall be eliminated, and I do believe it possible for engineers to eliminate those factors. I do not believe it possible to do so in the law, but I believe it is possible for an engineer making the valuation to do so. That is particularly true of the engineers in the Income Tax Unit, for the reason that they have access to information that no other set of engineers in the world have access to. All of the information with respect to sales of all properties is open to them. I believe that to arrive at a proper use of the analytical method of appraisal generally it is necessary to accumulate a large body of statistical information, so that in applying that method it can be tested from time to time by actual sales which take place and the factors used in cases where the value can be compared to actual sales can be based upon information obtained where actual sales data is available—in other words, to proceed from the known to the unknown in applying the method. I do believe that a great deal of progress has been made in the metals valuation section in doing that very thing. I think they have done an enormous amount of very valuable work in the last four or five years. By comparing values worked out on the analytical basis with actual sales where it has been possible to do so, then modifying their factors so as to conform to the actual sales, and then using the factors thus arrived at in cases where actual sales value is not available, I am satisfied that the foreign elements can be eliminated; but there has been a very marked tendency, it appears to me, upon the part of the committee on appeals and review and upon the part of conferees to overturn the careful work of engineers, whose work has been done in accordance with the kind of practice I have just described, and still use an analytical appraisal and arrive at an absurd result.

I would like to say one more thing in reply to what Mr. Gregg has said about this offer of the Bethlehem Steel Co.

In the first place, there is no evidence in the record that the Bethlehem Steel Co. ever made an offer, other than a letter written by the president of this company to the secretary of this company. That letter said that Mr. Schwab might consider raising his offer from $7,500,000 to $9,000,000. It did not say that that was for the ores alone. In fact, it can not be believed that the Bethlehem Steel Co. would buy this property, or could buy this property, without buying the plant, and if you will deduct the plant value from the price of $9,000,000 you come down pretty close to the $4,800,000 that was estimated by Mr. Eddingfield.

The CHAIRMAN. In that connection I want to point out to what an absurdity this can be reduced. For example, there are two identical properties. In one case the taxpayer takes, as I said before, the bureau's ruling that his property is worth $4,800,000. In the other case, under identically the same conditions, they have an offer, or an alleged offer, or it might even be a fictitious offer, of $12,500,000. The first taxpayer would not know that the other taxpayer had been offered $12,500,000 for his property, so he would be satisfied with the settlement fixed by the bureau, and knowing of no other value that he might get on his property, while his neighbor might get a value of three times as much, because he had an offer of this

nature, which was three times higher than the value placed on his neighbor's property.

Mr. GREGG. Of course, we should iron that out in the department and give them both the same value.

The CHAIRMAN. But I contend that that is not done, because the same engineer might not handle the two cases.

Mr. GREGG. That is true; but I wish to say in answer to that that if they have a bona fide offer it is certainly better evidence than an analytical appraisal method, which we think should be resorted to only as a last resort.

The CHAIRMAN. What would you suggest to the first taxpayer, then, who did not have an offer?

Mr. GREGG. There is no way in the world that he can get the evidence unless he happens to know of this offer. If the bureau knows that this offer was made for that adjoining property on a higher basis, then it should give this taxpayer the same value.

The CHAIRMAN. I concede that.

Senator KING. What I am interested in finding out is this, if I may be pardoned, Mr. Chairman.

In the discussion here you have applied this analytical method, or have rather limited it to cases of metal deposits. It seems to me, if I understand it, that it could be extended to all industrial activities and to many business concerns. Take the illustration I gave a moment ago. I might have a forest of timber and have mills to saw the timber into lumber and then sell the lumber at a reasonable profit. I am contemplating at some future time, when it is possible that I may establish right there, in close proximity to my mills, factories for the manufacture of tables and chairs, etc.

Mr. MANSON. Yes; and you might put in an alcohol plant, and——

Senator KING. Yes; I would use the surplus also for making pulp to be used in the manufacture of paper. Now, I do not see how it is possible for a proper analytical appraisal to contemplate those factors, and I was wondering if it had been done to any extent in any of the sections of the Income Tax Unit.

Mr. GREGG. Let me answer you, Senator, on that. I agree with you perfectly that those factors should not enter into the valuation, and a proper analytical appraisal method does not take them into consideration.

The CHAIRMAN. But they were taken into consideration in the United States Graphite Co. case, were they not?

Mr. MANSON. Oh, yes.

Mr. GREGG. As a matter of fact, I can not answer as to that, because I am not familiar with that case; but there are some factors of management which enter into most analytical appraisals which can not be eliminated. However, I agree perfectly that they should be eliminated just as far as possible.

Senator KING. Mr. Gregg, I should be glad, before we are called upon to submit a report, to hear from the department as to what extent, if they can give us that information before we conclude, there have been departures from what you conceive to be a rational interpretation of the law, because I have thought myself that they were

only sporadic cases, and that aside from some of these mining cases that principle had not been applied and extended to other activities.

Mr. GREGG. Senator, I think perfectly frankly, it is the unusual case that is being taken up.

Senator KING. Of course, you may say that.

Mr. GREGG. I think this is a very unique case. I do not think you will find two in the department comparable to it. I think that in the average analytical appraisal case these elements, which we all agree should not enter into the valuation, the collateral factors, do not enter into it. I am perfectly willing to stand behind that statement.

Senator KING. Well, I think that is true.

Mr. GREGG. Mr. Chairman, may we have a few minutes in the morning to take up the oil situation before Mr. Manson proceeds?

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

Mr. MANSON. How much time will you want to use?

Mr. GREGG. About 30 minutes.

Senator KING. Can we not go on this afternoon, Mr. Chairman?

Mr. GREGG. I will have nothing ready to present this afternoon, although I could put in our oil statement, but I do not think it is worth while meeting for just that purpose. I do not believe it will take over 30 minutes to do that.

The CHAIRMAN. We can discuss that amongst ourselves.

Senator KING. Will you have anything for to-morrow, Mr. Manson?

Mr. MANSON. Yes; we will have something to present.

The CHAIRMAN. Then, we will go on again to-morrow morning at 10 o'clock.

(Exhibits presented by Mr. Manson in the case of Witherbee-Sherman & Co. are as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE, INCOME TAX UNIT,
March 11, 1925.

To: Mr. L. C. Manson, general counsel.
From: Mr. E. T. Wright, investigating engineer.
Subject: Witherbee, Sherman & Co., office report No. 22.

Since writing the above report, a waiver for 1919, dated March 7, 1925, has been placed in the files expiring December 31, 1925.

The taxes for 1917 and 1918 have been completed on the bases of invested capital as decided by the committee of appeals and review and value for depletion as recommended by the metals valuation section.

Year	Taxes already assessed	Taxes computed as above	Additional tax indicated
1917	$122,126.53	$333,335.49	$211,208.96
1918	35,281.53	125,241.67	89,960.14
Total	157,408.06	458,577.16	301,169.10

Respectfully submitted.

E. T. WRIGHT.

MARCH 10, 1925.

Office Report No. 22.
Mr. L. C. Manson, counsel Senate Committee for Investigating Bureau of Internal Revenue.
Taxpayer: Witherbee, Sherman & Co.
Business: Mining and selling iron ores.
Subject: Decision of the committee of review and appeals reversing recommendations of the metals valuation section in connection with (*a*) values for depletion as of March 1, 1913; (*b*) values for invested capital.

AMOUNTS INVOLVED

(*a*) *Values for depletion*

Taxpayer's valuation as of March 1, 1913	$12,506,634.00
Feb. 7, 1921, valuation by J. A. Grimes	None.
Feb. 11, 1921, valuation by F. T. Eddingfield	4,892,523.07
Valuation allowed by committee on review and appeals	10,500,000.00

(*b*) *Values for increased capital*

Invested capital claimed by taxpayer	$3,000,000.00
Invested capital determined by engineering division	1,436,437.88
Invested capital allowed by committee on review and appeals	3,000,000.00

STATUS OF CASE

It would appear that taxes for the years 1916, 1917, and 1918 are closed, although an unlimited waiver is on file for the year 1917, the legality of which may be questionable. For the year 1919 the statute of limitations would appear to become effective on April 14, 1925, there being no waiver on file. The department has been requested to take action toward obtaining waiver for 1919 taxes, or make jeopardy assessment in order to protect the Government's interests.

SYNOPSIS OF CASE

Taxpayer's 1916 depletion deduction was accepted and case closed by the department in 1918. In 1917 tax returns the taxpayer claimed a depletion deduction, to which the unit could not agree. The metals valuation section first took the position that no value should be given the ores owing to the fact that, taking the ruling price for iron ores and operating cost as of March 1, 1913, into consideration, gave insufficient profit to absorb the plant and equipment cost. The taxpayer took the position that the best basis for valuation of their property were offers of purchase on the part of the Standard Oil Co. and the Bethlehem Steel Co., and that the regulations provided for such a basis of valuation. It was the contention of the metals valuation section that the taxpayer failed to submit evidence of a bona fide offer on the part of either the Standard Oil Co. or the Bethlehem Steel Co., and that the evidence was not sufficient to sustain the valuation sought by the taxpayer. The taxpayer appealed to the committee on review and appeals from the decision of the metals valuation section. The committee, in making its decision on both invested capital and March 1 value, agreed with the taxpayer and did not permit or invite the engineering division to present its side of the case, relying wholly, according to the record, on the taxpayer's reports and statements.

HISTORY OF THE COMPANY

Witherbee, Sherman & Co. was incorporated June 25, 1900, under the laws of the State of New York, with an authorized capital stock of $3,000,000, divided into 30,000 shares of the par value of $100 each. Previous to incorporation the business had been conducted by the partnership of Witherbee, Sherman & Co., which was organized in 1894, but these interests had operated the group of mines since 1849. The capital stock of the corporation was issued to the members of the partnership in proportion to the amount of their respective interests. The mines of this company contained probably the largest and best known deposits of magnetic iron ore in the eastern section of this

country. The business of the company consists of mining and selling iron ores, either crude or in the form of concentrates. A part of its total output is smelted in a blast furnace which the company has operated on its own account since 1919. The ore bodies owned by this corporation are located at Witherbee and Mineville, N. Y., the blast furnace being located at Fort Henry, N. Y. In addition to the above activities, the Ore Carrying Corporation, a subsidiary, is engaged in the business of transporting ores and fuel by water routes for which it owns and operates a fleet of steamships and barges. The Mineville Light, Heat & Power Co., a subsidiary, operates an electric light and power distributing plant.

HISTORY OF THE CASE

In the 1917 tax return filed by this company taxpayer claimed depletion in the sum of $893,745.45, based on fair market value as of March 1, 1913, of $12,506,634, with 19,859,434 tons of crude ore. This claimed valuation results in a depletion rate of 62.97 cents per ton of crude ore.

The taxpayer submitted insufficient data with its return to substantiate its deduction for depletion. Considerable correspondence took place during 1920 regarding additional information, and several conferences were held with the taxpayer. From information submitted, several valuations were made by the metals valuation section, the section finally recommending a valuation by Mr. F. T. Eddingfield, dated February 11, 1921, of $4,892,523.07.

The taxpayer submitted a sworn brief on March 1, 1921, presenting facts and its arguments. It was claimed that the present value method as used by the unit was wrong and that the fair market value as between a willing buyer and willing seller should be used, the unit ignoring potential profits under different methods of operation, which justified two prospective purchasers in making offers for the property.

On April 6, 1921, Mr. Frank L. Nason, geologist and mining engineer, made an affidavit giving the history of his connection with the Standard Oil Co. in 1910 and 1911 and regarding his report of valuation of the taxpayer's property made for them.

On October 23, 1921, the unit wrote the taxpayer in reference to their 1917 return, giving information in connection with the analytical appraisal made by the metals valuation section which it had recommended to be used as the basis of audit of 1917 returns.

On October 28, 1921, Mr. Talbert, tax consultant for the taxpayer, appealed to the committee on appeals and review from the rulings of the unit, both as to values for depletion and invested capital.

On January 7, 1922, Mr. Talbert submitted a brief in connection with its appeal to the committee of review and appeals, in which he set forth arguments as to claims for March 1 value and invested capital.

On March 1, 1922, the committee on review and appeals handed down a decision No. 896, which was approved by the Commissioner of Internal Revenue. This decision reversed the unit's rulings on both March 1 value for depletion and invested capital. (See Exhibit B.)

On April 11, 1922, in a memorandum to Mr. Fay, the metals valuation section disagreed with the findings of the committee on the March 1, 1913, value on the ground that such finding was not based on fact. The section also reminded Mr. Fay that it was not called upon to present its side of the case, although it was promised such a hearing by the committee.

On April 14, 1922, Mr. Fay directed a letter to Mr. Chatterton, assistant deputy commissioner, inclosing a copy of Hamilton's memorandum and requested an opportunity to put the matter before the commissioner.

The matter then appears to rest until September 23, 1922. The natural resources subdivision was ordered by C. F. Smith, assistant commissioner, to close the case of the Witherbee, Sherman & Co.

DISCUSSION

1916 TAXES

It appears from the record that the taxpayer in its original return for the year 1916 made a deduction for depletion of mines of $872,384. Upon investigation by the revenue agent $671,065 of this amount was disallowed. Depletion was allowed by the agent at 15 cents per ton on 1,342,130 tons of ore mined during the year 1916, in the amount of $201,319.50. An additional tax

was assessed on the amount of depletion disallowed, $671,065, at 2 per cent in the amount of $13,421.30. The taxpayer filed and abatement claim with the bureau for the abatement of this additional tax.

This claim was settled by B. F. Speer, deputy commissioner, as follows: The taxpayer contended that since the tax in question covered the year 1916 and the property was acquired previous to March 1, 1913, it was entitled to compute the depletion deduction on the basis of the fair market value of the mine content as of March 1, 1913. It was submitted that the operative ore bodies, en bloc, had a value which a purchaser could have afforded to pay in cash on March 1, 1913, as follows:

Tonnage	19,859,434
Value	$12,506,634
Value per ton	$0.6297

It was determined that the ore mined in 1916 amounted to 1,342,130 tons, which should be valued at 62.97 cents per ton, and that the depletion should be $845,139.26. Since the revenue agent allowed $201,319.50, additional depletion in the amount of $645,819.76 should be allowed. The tax on this amount at 2 per cent equaled $12,876.40 which it was determined should be allowed on the claim of $13,421.30 and $544.90 of the claim rejected. Taxes for the year 1916 were therefore closed on this basis.

1917 TAXES AND SUBSEQUENT YEARS

(*a*) *Valuation for depletion as of March 1, 1913.*—The taxpayer in its 1917 return made a depletion deduction of $893,745.45, using the same depletion rate of 62.97 cents per ton of ore mined. During 1920 the case was referred to the metals valuation section for the determination of proper values for depletion and invested capital. A conference was held with the taxpayer in December, 1920, and it was agreed that complete data would be submitted. In a letter dated January 20, 1921, Mr. Francis, president of the corporation, protested further investigation and the submission of additional data, stating that information had been furnished as a basis for the 1916 determination which was satisfactory at that time and that under the regulations the matter should not be reopened.

The metals valuation section made several valuations of these mines as follows:

Date	Engineer	Value for depletion determined
Dec. 15, 1920	A. W. Gaumer	None.
Feb. 2, 1921	F. T. Eddingfield	$3,411,569.99
Feb. 7, 1921	J. A. Grimes	[1] None.
Feb. 11, 1921	F. T. Eddingfield	[2] 4,892,523.07

[1] Exhibit C. [2] Exhibit D.

It was finally decided to use the Eddingfield valuation of February 11, 1921 (see Exhibit D), in the determination of depletion, but same was not satisfactory to the corporation. On March 1, 1921, the Witherbee, Sherman & Co., through their tax consultant, P. S. Talbert (formerly chief of the technical division of the income tax unit), submitted a sworn brief and argument setting forth their position. On April 6, 1921, an affidavit by Frank L. Nason, geologist and mining engineer, was submitted.

From the above affidavits it would appear that in June, 1910, Mr. Frank L. Nason was employed by the Standard Oil Co. to make an examination of a very large iron ore property on Moa Bay, Cuba; that he was recommended for the work by Mr. Frank S. Witherbee, president of the Witherbee, Sherman & Co. and Mr. S. Norton, general superintendent; that the Standard Oil Co. was about to embark on a new policy and had decided to put up a blast furnace and steel plant near either Troy or New York City and that their first move was to secure an ample iron ore supply.

Mr. Nason sailed for Cuba, June 11, made the necessary examination and on his return reported that in his opinion the Cuban property was unsuited to their purpose. This report being sustained by a subsequent party of engineers the Standard Oil Co. decided to drop the Cuban proposition.

Subsequent to the Cuban examination the Standard Oil Co. arranged with Professor Nason to make an examination of the Wetherbee, Sherman & Co. properties. Although the properties were not for sale in the ordinary sense the company advised that it had no objection to an examination.

Quoting from brief:

"Professor Nason thereupon spent some months in an exhaustive examination of the properties and reported that in his judgment they were worth (ore bodies alone) $10,652,400, to which must be added approximately $2,000,000 as the value of the plant and equipment. (Exhibit E.) In the meantime Witherbee, Sherman & Co. itself had been considering what it would sell out for, and independently had reached the conclusion without conference with Professor Nason and without knowing anything about his conclusions, that it would sell if it could get $12,500,000 for its property. A sale at that time would undoubtedly have been concluded but for the fact that suit was brought for the dissolution of the intended purchaser, and it thereupon dropped all negotiations looking to an extension of its activities into new fields."

Shortly thereafter some negotiations were had with the Bethlehem Steel Co. and which it is claimed resulted in an offer, first of $7,500,000, which was subsequently increased to $9,000,000.

In 1913 Witherbee, Sherman & Co. employed Professor Nason to bring his report up to date, which he did by eliminating the ores mined and including the ores developed since 1910, some 5,750,000 tons, making the net tonnage "in sight" as of March 1, 1913, 19,859,434 tons, and the value as of that date $12,506,634. Professor Nason's reports were never delivered to the unit, but from the date submitted on November 28, 1917, a copy of this valuation has been assembled. (Exhibit F.) This valuation was corrected on July 19, 1918, to a total of $13,247,434.

METALS VALUATION SECTION'S ANSWER

The metals valuation section in their reply to brief took the position that the offers (on which no sale was made) for the property in 1910 when the iron business was very prosperous would not necessarily be the value as of March 1, 1913, because the iron business was then entering a period of depression. It was also their opinion that the reported value as of 1910 did not represent an engineer's estimate of the present worth of an operator's profit on the ores in the property, but represented an extra profit which might be made on pig iron by a furnace company in or near New York City, and in addition certain intangible values due to the condition of the iron industry in 1910, such as the strategic value of ore deposits in New York, to a furnace company operating in or near New York City.

Regulations 45, article 201 (b) states "where there has been no sale and the fair market value at the basic date is to be used, such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date." Regulations 45, article 206 (a), states that due weight will be given to all factors and evidences having a bearing on the market value, such as cost, etc., "disinterested appraisals by approved methods such as the present value method and other factors."

"It is the opinion of this office that the March 1, 1913, value of ores only is $4,892,523.07, ascertained by the present worth method, using a life of 22 years, a profit per ton of shipping product of $1.19, and a rate of 7 per cent and 4 per cent."

TAXPAYER'S ARGUMENT

"The fallacy of the bureau's method lies in its insistence on using the results of Witherbee, Sherman & Co.'s operations as the test of value, ignoring the potential profits under different methods of operation which justified the two prospective purchasers in making the offers they did. To fully appreciate this, it must be remembered that Witherbee, Sherman & Co. produced and sold ore only (except for a small quantity of iron produced in a blast furnace of its own, as above stated) either in its crude form or as concentrated to bring the iron content up to or slightly above the standard of 60 per cent, while both the prospective purchasers desired the property as a source of raw material for the operation of their own steel plants to be located in the East.

"Witherbee, Sherman & Co. itself realized that it was not getting all the profit possible out of the sale of its products, and after the failure of negotia-

tions to sell, itself spent a considerable sum in the development of plans for a large blast furnace plant of its own."

"They are at the present time working on plans for the erection of two 400-ton furnaces to operate in conjunction with the present 250-ton furnace, operation of which they took over in 1919. The estimated costs of operation of the above furnace and sales value of the pig iron shows a potential value to the ore of about two and one-half times the profit of selling ores to outside parties. The operation of the present furnace by themselves and also by the outside interest, who operated the furnace a number of years substantiate results that might be expected and profits obtained. Circumstances, however, have prevented the realization as yet of the plans, which involve the expenditure of six or seven millions of dollars.

"The strategic position and economic advantages of the properties were well known to Witherbee, Sherman & Co., and clearly justified it in refusing to sell for less than $12,000,000, even though its operations as then and, for reasons explained above, since conducted do not show a normal profit on such value, and also clearly justified the prospective purchasers in making offers which did take into consideration potential profits they were in a position to realize, which in itself does substantiate the value per ton of crude ore as arrived at by Professor Nason."

On October 23, 1921, Deputy Commissioner Batson advised the taxpayer by letter, that the following valuation and depletion rate had been determined:

Total expected marketable product (tons)	12,576,980
Present worth of ores as of Mar. 1, 1913	$4,892,523.07
Unit of depletion per ton of marketable products (cents)	38.9

COMMENT

The taxpayer appears to have valued its property at $12,500,000, including in such valuation "potential profits" arising from the manufacture and sale of pig iron, from its ores and which it states in its brief "shows a potential value to the ore of about two and one-half times the profit of selling ores to outside parties."

This value it attempts to justify by referring to Professor Nason's valuation of 1910, amounting to $12,652,400 (Exhibit E) made for the Standard Oil Co., and covering some $19,600,000 in property. This report was brought up to March 1, 1913, by Professor Nason, the corrected valuation, as reported on July 19, 1918, being $13,247,434 for ores only, showing a value per ton of $0.66705. (Exhibit F.)

Careful analysis indicates that this valuation can not properly be used as a basis for depletion, since the figure represents the total expected profits, for the life of property, without discounting to present worth, nor have the plant costs been deducted therefrom.

Using Professor Nason's figures, in which profits are figured on a unit of iron basis (unit equals 20 pounds), an appraisal is completed, as follows:

Value for depletion as of March 1, 1913

[Professor Nason's figures used as basis of present worth]

	Crude ore (tons)	Units of iron		Expected profits	
		Per ton	Total	Per unit	Total
1910, ores in sight	15,962,988	33.584	536,102,673	$1.987	$10,652,400.00
Ores developed to Mar. 1, 1913	5,750,000	33.636	193,409,073	1.980	3,829,499.64
Total	21,712,988	33.598	729,511,746	1.985	14,481,899.64
Ores mined to Mar. 1, 1913	1,853,554	52.798	97,863,564	1.261	1,234,466.00
Total	19,659,434	31.806	631,648,182	2.097	13,247,433.64
Expected profits per unit, $0.02097					
Expected profits per ton of crude ore, $0.6671					
Less expected plant, estimated					2,013,340.80
					11,234,092.84
Discounted at 20-year life, 7 per cent and 4 per cent, $0.482711					5,422,820.00
Less actual plant cost					1,042,870.20
Present value, ores only, Mar. 1, 1913					4,379,949.80

The valuation above, $4,379,949.80, arrived at from Professor Nason's figures on a profit per unit of iron bases, checks fairly closely the Eddingfield valuation of $4,892,523.07, based on information submitted by the taxpayer on Form D and a profit per ton of concentrates basis.

(*b*) *Values for invested capital.*—The valuation engineer for the bureau has placed a value for invested capital at date of acquisition of $1,436,437.88, as follows:

Investment at January 1, 1900

Plant and equipment	$173,628.82
Mines	100,000.00
Real estate	710,713.19
Bonds, stocks, inventories, etc	452,095.87
Total value allowed	1,436,437.88
Intangibles (not allowed)	1,563,562.12

Thousands of acres of land were acquired on which no development has been done. To attach a fictitious value to such lands is exceeding the limits of the regulations, and on this account the records as found by the revenue agent's report are accepted.

Taxpayer's facts

It would appear that the differences between the Unit and the company arise from the segregation and classification of these assets. At the time of organization all real estate, plant equipment, and mineral lands were included on the books in a single entry, $2,548,807.64, as shown by the first journal entry on corporation's books accounting for $3,000,000 of stock. The unit requested a schedule showing the items aggregating this sum; but in view of the fact that the books did not show the segregation, the length of time which had elapsed, and the death of the persons who were familiar with the situation in 1910, it did not feel that a statement could be made that would be accurate. However, a segregation was made, as follows:

Estimated value of property and plant, June 23, 1900

Mineville, surface lands only 1,855 acres, at $10	$18,550.00
Mineville, surface lands, including mineral rights valuation placed surface, only 8,146 acres, at $10	81,460.00
Mineville, Old Ben mining plant	75,000.00
Mineville, miscellaneous plant buildings and houses	110,500.00
Port Henry, furnace plant, books, etc	106,500.00
Mineral reserves	2,156,797.64
	2,548,807.64

It would appear that Witherbee, Sherman & Co., when incorporated in 1900, acquired their properties from the partnership of Witherbee, Sherman & Co., the capital stock of the corporation being issued to the members of the partnership. Shortly after organization $1,000,000 par value of the total $3,000,000 of stock issued was acquired by the Lacakawanna Steel Co. for $1,000,000 cash.

The taxpayer claimed a value for invested capital at date of acquisition of $3,000,000.

TAXPAYER'S ARGUMENTS

"It is shown above that the unit based its conclusion as to segregation of items making up the aggregate of $2,548,807.64 on the revenue agent's estimate of values. How or why the agent 20 years after the fact and without records to go on, was able to make a statement more reliable and accurate than that made by the officers of the company, some of whom knew from personal knowledge in a general way the properties acquired, does not appear, but the absurdity of the bureau's conclusion is manifest on its face. Here was a mining property which had been operated for 50 years for the production and sale of iron ore. The owners knew they had large reserves of ore in the mine, but never concerned themselves with endeavoring to find out or set up on the books any estimate of how much. Because they have no record evi-

dence to show how much ore was in sight at the time, the bureau gravely asserts that the mine itself was worth $100,000, but the intangibles attaching to the property—that is, good will—was worth $1,563,562.12. This is the first instance which has come to the attention of the writer where any good-will value is ascribed to the business of mining iron ore, which has a standard selling price fixed by recognized markets. Certainly no producer of iron ore can get a price for his product in excess of the market value of similar ore by reason of any good will attaching to his business."

TAXPAYER'S APPEAL

On October 28, 1921, Mr. P. S. Talbert appealed to the committee on appeals and review.

DECISION OF COMMITTEE OF APPEAL AND REVIEW

On March 1, 1922, the committee on appeals and review handed down its decision (No. 896) in this case (Exhibit B) and same was accepted for the guidance of the Income Tax Unit by D. H. Blair, Commissioner of Internal Revenue.

In this decision the recommendations of the Income Tax Unit were not sustained, as follows:

	Committee's decision	Unit's recommendation
(a) Value for depletion, as of Mar. 1, 1913 (ores only)	$10, 500, 000. 00	$4, 892, 523. 07
(b) Value for invested capital, as of date of acquisition	3, 000, 000. 00	1, 436, 437. 88

On March 21, 1922, the taxpayer was notified by letter of the committee's decision. Taxes for 1917 and subsequent years have been computed based on this decision.

On November 9, 1922, the case was again referred to the committee because of an apparent misstatement in information submitted by the taxpayer. The statement was made by the taxpayer that Professor Nason was employed in 1913 to bring his report of 1910 up to date, while his report was dated in 1917, four years later. The matter was investigated by the committee, an affidavit obtained from Mr. Nason confirming his employment in 1913, which was "sufficiently clear and explicit to be accepted as conclusive upon this point."

CONCLUSION

After careful review of this case your engineers are of the following opinions:

That as to (*a*) value for depletion as of March 1, 1913, the committee of appeals and review erred in the decision—

1. In not permitting the engineers of the unit to attend the hearings and to present their arguments.

2. In accepting statements of the taxpayers as to reported bids on its property without sufficient evidence as to nature of such bids and whether bona fide.

3. In interpretation of the regulation as to the procedure "when there has been no sale and the fair market value at the basic date is to be used such value will be determined by the method which a prospective vendor and vendee in the industry would use in arriving at the sale value of the property at the basic date."

4. In accepting as "fair market price for ores only" a price which included "the potential profits under different methods of operation, which justified the two prospective purchasers in making the offer they did," and which was from the evidence based on prospective profits (outside those arising from the mining and selling of iron ores and concentrates) in the manufacture of pig iron, giving "a potential value to the ore of about two and one-half times the profit of selling ores to outside parties."

5. In assuming that "an estimate made at or about March 1, 1913, should be given more weight in the determination of values as of that date than the method used by the unit," without ascertaining whether such valuation was indicative of "present value" or not.

That as to (*b*) value for invested capital as of date of acquisition, the committee was correct in its decisions. It is our opinion that the sale "shortly after organization" of $1,000,000 par value of the total capital of $3,000,000 for $1,000,000 cash to the Lackawanna Steel Co. established the value of the total capital, $3,000,000, exchanged for the property, including the assets which the unit classified as intangibles and disallowed in the amount of $1,563,562.12. It is suggested, however, that the date of this transaction is important and appears to be lacking.

We desire, by way of comment, to note that the information regarding the Lackawanna sale was submitted to the committee subsequent to the unit's recommendation.

Respectfully submitted.

EDWARD T. WRIGHT.

Approved by—

L. H. PARKER.

EXHIBIT B

RECOMMENDATION NO. 896, COMMITTEE ON APPEALS AND REVIEW

Recommended, in the appeal of Witherbee, Sherman & Co., Port Henry, N. Y., that the action of the Income Tax Unit in fixing the worth of the company's ores in place as of March 1, 1913, at $4,892,523.07 and its unit rate per ton for depletion of the marketable product at 38.9 cents, be reversed; that a valuation of the company's ores as of March 1, 1913, be fixed on the basis of a report made by Professor Nason and certain offers made at or about that time at $10,500,000 with a total tonnage of 19,859.434 tons; that a depletion unit per ton be allowed upon this basis of 52.87 cents; and that $2,000,000 be accepted as the value of the depreciable assets on March 1, 1913.

It is further recommended that the action of the Income Tax Unit in classifying and valuing the assets paid in at date of organization of the corporation in 1900, for which capital stock was issued, be reversed, and that all the assets paid in be classified as tangible assets and a value allowed of $3,000,000 for the purpose of computing the invested capital of the corporation for 1917 and subsequent years.

MARCH 1, 1922.

Mr. COMMISSIONER,

(For Deputy Commissioner, Head Income Tax Unit):

The committee has had under consideration the appeal of Witherbee, Sherman & Co., from the action of the Income Tax Unit in fixing a total valuation of the iron ores in place as of March 1, 1913, at $4,892,523.07, and a depletion rate per ton of the marketable product at 38.9 cents; and also from the values placed upon the assets of the corporation at date of organization as stated in a memorandum of the valuation engineer dated September 22, 1921, which approved the valuation fixed by the revenue agent in his report.

It appears that Witherbee, Sherman & Co. was organized as a partnership in 1849 and operated as such until June, 1900, at which time a corporation was organized which acquired all the assets of the partnership for the issue of $3,000,000 par value of its capital stock. The business of the company consisted almost wholly of the mining and selling of iron ore. The iron ore is mined from a group of mines which have been operated by the present interests since 1849.

In 1910 the Standard Oil Co. entered into negotiations with Witherbee, Sherman & Co. for the purchase of its mines. This company had its engineers investigate the properties of Witherbee, Sherman & Co. and approached that company with the request that it be permitted to examine the properties. Apparently the properties were not for sale, but the company advised that it had no objection to the examination. The Standard Oil Co. secured the services of Prof. F. L. Nason, recognized as one of the leading valuation engineers in the country on this class of ores. Professor Nason spent several months on the property in 1910, made an exhaustive examination, and reported that in his judgment the ore bodies alone were worth more than $10,000,000 and that the plant had a value of approximately $2,000,000. In the meantime the stockholders of the corporation had discussed among themselves the advisability of making the sale and reached the conclusion that the corporation would sell

the properties for $12,500,000. Before the negotiations were completed the Supreme Court of the United States handed down a decision requiring the dissolution of the Standard Oil Co., and all negotiations were dropped. Shortly after this investigation other steel interests entered into negotiations for the purchase of the property, and it is understood that a bona fide offer of approximately $9,000,000 was made and declined. There is a copy of a letter in the file from Mr. Witherbee, president of the company, to Mr. W. C. Witherbee, the treasurer, dated February 4, 1913, giving details of an interview with Mr. Schwab relative to the sale of the property and expressing the view that Mr. Schwab was then ready to pay $10,000,000 for the property.

Early in 1913 the corporation employed Professor Nason to bring his report up to date, which he did by eliminating the ore mined and included in "ore in sight" some 5,000,000 tons which had been shown to exist by development between the date of the original report in 1910 and 1913, making the net tonnage "in sight," including probable ore in developed ore bodies, as of March 1, 1913, 19,859,434 tons, and the value as of that date of the ore bodies alone, $12,506,634, which amount was set up on the balance sheet of February 28, 1913, as the value of operated ore bodies.

With respect to the valuation of the assets acquired at the date of organization in 1900, it appears that shortly after the corporation was formed the Lackawanna Steel Co. acquired $1,000,000 par value of the total $3,000,000 of stock issued for $1,000,000 in cash. The Income Tax Unit has accepted this purchase of stock as fixing the actual cash value of all the assets acquired at organization as $3,000,000. The difference between the company and the Income Tax Unit appears to arise from the segregation and classification of these assets. The unit segregates and fixes the value of the assets on the basis of the revenue agent's report, as follows:

Investment at January 1, 1900

Plant and equipment	$173,628.82
Mines	100,000.00
Real estate	710,713.19
Bonds, stocks, inventories, etc	452,095.87
Total	1,436,437.88
Intangibles (not allowed)	1,563,562.12

while the company contends that the assets should be segregated and valued as follows:

Cash	$75,548.52
Receivers	80,000.00
Inventory	27,286.60
Accounts receivable	21,427.94
Stocks	165,902.32
Bonds	9,640.00
Ore	60,187.20
Chattels	11,309.87
Wharf	478.82
Office	314.60
Property and plant	392,010.00
Mineral reserves	2,156,797.64
Total	3,000,903.51

An examination of the record in this case indicates that the Income Tax Unit rests its conclusion that the value of the ores in place on March 1, 1913, was $4,892,523.07 on a mathematical calculation based on the tonnage estimated as in sight and the results of Witherbee, Sherman & Co.'s operation of the property. The amount so fixed was ascertained by the present worth method, using a life of 22 years, a profit per ton of shipping product of $1.19, and a rate of 7 per cent and 4 per cent.

In the consideration of this question the committee feels that an estimate made at or about March 1, 1913, should be given more weight in the determination of values as of that date than the method used by the unit. In fact, the committee feels that the unit has done nothing more than to make an appraisal now as of a date in the past and that an estimate made at or about the time

certainly must be considered as being more accurate than an estimate made at the present time.

The question at issue is, What was the property worth on March 1, 1913? Article 1561, regulations 45, provides that what the fair market price or value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear. Market value has been defined in article 1563, regulations 45, as the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having knowledge of the facts, will trade.

Article 206, regulations 45, deals with the determination of the fair market value of mineral property and reads in part as follows:

"Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital-stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court, disinterested appraisals by approval methods such as the present value method and other factors * * *."

In view of the facts in this case as understood by the committee, it is thought that the best evidence of value is what property really sells for. The next best evidence is a bona fide offer to purchase by a responsible party. The property in the instant case was not sold. The committee feels that a bona fide valuation was made at the instance of a prospective purchaser in 1910 and that this valuation was made upon a conservative basis. This valuation was made by a valuation engineer who is an expert in the valuation of property of this character. The valuation fixed in 1910 was early in 1913 brought up to date as heretofore explained. Other evidence is on file which indicates that the owner was willing to sell its ore properties, plant and equipment on March 1, 1913 for approximately $12,500,000.

The committee recommends that the estimated tonnage of 19,859,434 tons fixed as of March 1, 1913, and a valuation of $10,500,000 be accepted and that a depletion rate of 52.87 cents per ton to be allowed in computing the taxable net income of this corporation for 1917 and subsequent years.

In the consideration of the second point it is necessary only for the committee to express the opinion that the segregation of the assets at the time paid in on June 1, 1900, as fixed by the unit, is inaccurate and to call attention to the fact that the committee is unable to agree that a company engaged in this particular kind of business, where the market price of the product was fixed, acquired any substantial amount of good will from the partnership. In fact, the committee believes that in this case no good will whatever was transferred to the corporation at date of organization in 1900. It would, therefore, appear that the total assets paid into the corporation in 1900 should be classified as tangible assets and that the sale of one-third of the capital stock of the corporation for $1,000,000 established the actual cash value of the assets at the time paid in.

In view of the foregoing, it is recommended that the action of the Income Tax Unit in fixing a value of the tangible assets at $1,436,437.88 and disallowing $1,563,562.12 as intangibles, be reversed; that the total assets paid in be treated as tangible property paid in for stock and that a valuation of $3,000.000 be accepted as representing the actual cash value of such assets at the time paid in; and that the value of the depreciable assets on March 1, 1913, of $2,000,000 be accepted.

M. T. JOHNSON
Chairman Committee on Appeals and Review.

Accepted for the guidance of the Income Tax Unit:

D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT C

Memorandum to auditors in re Witherbee Sherman Co., Port Henry, N. Y.

March 1, 1913, value and depletion

Mar. 1, 1913, ore reserve (tons crude)	19, 859, 434
Recovery (per cent)	[1] 49. 7
Units of iron	[1] 616, 834, 125
Average cost per ton of crude ore (1909–1916)	$1. 757
Average sales price per unit of iron for 10 years pre-war period (Mr. Nason's report)	. 0625
Total expected sales (616,834,125, at $0.0625)	38, 552, 133. 00
Total expected cost (19,859,434, at $1.757)	34, 893, 026. 00
Total expected operating profit	3, 659, 109. 00
Less expected future plant expenditure	[2] 1, 794, 217. 00
Total expected net profit	1, 864, 890. 00
Valuation factor, 22 years, at 7 and 4 per cent	458216
Mar. 1, 1913:	
Value of operating profit	854, 522. 00
Plant value	1, 442, 870. 00
Value of ores only	None.

There is no March 1, 1913, value for these ore deposits as indicated by the expected operating profit. I recommend that depletion be allowed on the cost of the ores to the taxpayer.

JOHN ALDEN GRIMES,
Valuation Engineer.

February 7, 1921.
Approved:

O. R. HAMILTON.
Chief, Metals Valuation Section.

EXHIBIT D

Memorandum to auditors in re Witherbee, Serman & Co., Port Henry, N. Y.

Operating owner of magnetic iron ore property acquired prior to March 1, 1913. The bulk of the crude ore mined is concentrated before marketing.

Ore reserves, crude ore, as of March 1, 1913 ---- tons	19, 859, 434
Average recovery as indicated, 1913 to 1919 ---- per cent	63. 33
Total expected marketable product ---- tons	12, 576, 980
Average operating profit 1909 to 1916, including capitalized development but not including interest on indebtedness	$1. 19
Total expected operating profit	14, 966, 606. 20
Total expected plant to be depreciated after March 1, 1913	3, 056, 211. 00
Value of plant as of March 1, 1913	1, 042, 870. 20
Total estimated plant additions after March 1, 1913	2, 013, 340. 80
Total expected operating profit, less plant additions, after March 1, 1913	12, 953, 265. 40
Life 22 years at risk rate 7 and 4 per cent factor	. 458216
P. W. of ore reserves plus plant as of March 1, 1913	5, 935, 393. 27
Plant as of March 1, 1913	1, 042, 870. 20
P. W. of ores only as of March 1, 1913	4, 892, 523. 07
Unit of depletion per ton (shipped)	. 389

[1] Estimated from the taxpayer's figures for 14,109,434 tons (71 per cent of the total reserve) at 49.7 per cent recovery, 7,012,659 tons of concentrates and 438,239,109 units of iron.

[2] The taxpayer has spent more than this amount from March 1, 1913, to date. The amount deducted is at the rate of 16.3 cents per ton of crude ore, less plant value as of March 1, 1913.

Depletion account

Year	Tons shipped	Depletion		
		Sustained	Claimed	Allowed
1913	479,568	$186,551.95	$88,499.44	$47,956.80
1914	276,099	107,402.51	66,218.92	27,609.90
1915	416,314	161,946.14	75,254.95	41,631.40
1916	823,155	320,207.29	872,384.50	320,207.29
1917	812,683	316,133.69	893,745.45	316,133.69
1918	543,772	211,605.10	635,759.60	211,605.10
1919	384,092	149,411.79	404,040.70	149,411.79

NOTE.—1916 case settled in 1918 allowed depletion of $845,139.26, which is therefore the depletion sustained and allowed for 1916.

F. T. EDDINGFIELD,
Valuation Engineer.

February 11, 1921.
Approved:

O. R. HAMILTON,
Chief Metals Valuations Section.

EXHIBIT E

[Witherbee, Sherman & Co.'s properties, valuation by Frank L. Nason]

Valuation for Standard Oil Co. in 1910—Purchase price recommended

Total cash valuation		$19,600,000.00
Deductions:		
Undeveloped ores	$2,593,000.00	
Unexplored lands	310,000.00	
Mace mine	4,600.00	
Winter mine	5,000.00	
Cook mine	75,000.00	
Arnold Hill	350,000.00	
Jackson Hill	2,500,000.00	
Livingston tract	160,000.00	
Comaquay Cuba	500,000.00	
50% L. C. & H. R. R	200,000.00	
Mineville plant	2,000,000.00	
Hand lot	250,000.00	
		8,947,600.00
Value "ore in sight"		10,652,400.00
Plant and equipment		2,000,000.00
Total 1910 valuation		12,652,400.00

Detailed value, "ore in sight," 1910, and March 1, 1913

Mines	Crude oil	Concentrates	Units of iron	Value at 1.98¢
Norton	5,000,000	1,682,100	107,650,000	
Palmer Hill	937,500	389,160	24,906,250	
Barton Hill	2,171,963	1,023,533	65,506,404	
Harmony	937,500	586,670	37,546,875	
Old bed, class A	1,898,063	1,898,063	113,883,780	
Old bed, class B	1,552,962	1,063,779	68,081,854	
Sherman Hall	2,728,000	1,170,000	74,883,600	
Smith	37,000	25,690	1,643,910	
Joker, class A	700,000	700,000	42,000,000	
Total reserves	15,962,988	8,540,931,	536,102,673	$10,652,400

EXHIBIT F

Valuations for depletion as of March 1, 1913, by Prof. F. L. Nason

	Crude oil	Concentrates	Units of iron	Value
Total reserves 1910 (Exhibit E)				$10,652,400.00
Less ore mined 1910 to Mar. 1, 1913:				
Barton Hill	31,839	16,905	1,124,850	
Harmony	643,852	479,170	31,445,731	
Old bed, class A	317,524	317,524	19,307,025	
Old bed, class B	793,790	661,267	42,608,094	
Smith	66,549	63,406	3,177,864	
Total	1,853,554	1,528,272	97,863,564	1,937,698.58
Reserves, Mar. 1, 1913	14,109,434	7,012,659	438,239,109	8,677,134.36
Developed to Mar. 1, 1913	5,750,000			3,829,500.00
Total	19,859,434			12,506,634.36

Valuation as of March 1, 1913, reported November 28, 1917

	Tonnage	Value	Value per ton
Operating ore bodies	19,859,434	$12,506,634.00	$0.666
Undeveloped ore bodies	24,000,000	5,527,000.00	
Unexplored mineral areas		470,000.00	
Total		18,503,634.00	

Corrected valuation as of March 1, 1913, reported July 19, 1918

	Tonnage	Value	Value per ton
Jan. 1, 1918	15,962,988	$10,652,400.00	$0.66732
Reserves added up to Mar. 1, 1913	5,760,000	3,829,500.00	.666
Total	21,712,988	14,481,900.00	
Less mined to Mar. 1, 1913	1,853,554	1,234,466.00	.666
Total	19,859,434	13,247,434.00	.66705

(Whereupon, at 12.10 o'clock p. m., the committee adjourned until to-morrow, Friday, March 20, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

SATURDAY, MARCH 21, 1925

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

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

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

Present also: Mr. L. C. Manson, of counsel for the committee; Mr. Raleigh C. Thomas, investigating engineer for the committee; and Mr. Hugh Archbald, investigating engineer 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. R. Marrs, attorney, office of the solicitor, Bureau of Internal Revenue.

The CHAIRMAN. Mr. Nash, have you any information as to the outcome of the Standifer case yet?

Mr. NASH. An A–2 letter was sent to Mr. Standifer.

Mr. Standifer asked for some additional time to bring his attorneys, books, etc., from the coast to Washington, and I have heard nothing of it since that time. I think that information came to me two or three weeks ago. I recall that Mr. Standifer came to see me and asked if I could give him some additional time. I told him that Mr. Alexander, of the solicitor's office, was handling the case and he would have to make arrangements with him. He told me at that time they had already given him some time to bring his attorneys here. He wanted additional time for that purpose.

The CHAIRMAN. Have you any method of following up these cases the committee has asked about from time to time?

Mr. NASH. Yes, sir. We are keeping a card index, Senator, on every case that comes before the committee, and of the subsequent action that is taken with reference to each case.

The CHAIRMAN. I have a memorandum here of some of the cases unfinished so far as our records show; for instance, the Northwest Steel Co. case.

Mr. NASH. The Northwest Steel Co. case was referred for a field investigation and the field report just came in last week and has been referred to the solicitor's office where a report is being written.

The CHAIRMAN. Then there is the Penn Sand & Gravel Co. case, in which I understand there was to be a revaluation made.

Mr. NASH. I have a copy of the memorandum on the Penn Sand & Gravel Co. case. This memorandum is dated February 2, addressed to Mr. Bright and signed by the commissioner:

Reference is made to the Penn Sand & Gravel case, now pending in the corporation audit division:

I understand the case is being audited on the valuation report dated December 9, 1924, which allowed this company a discovery value of about $150,000 as a basis for depletion. This allowance appears to have been made under memorandum from the solicitor of the internal revenue, questioning the right of this taxpayer to be given any discovery value because certain evidence appeared to be in the files, leading to the conclusion that other property known to contain gravel deposits in that vicinity had been purchased after the discovery of this property at a price not materially different from the cost.

The solicitor advised that a thorough investigation be made before action was taken, and in line with this suggestion an engineer made a field examination, after which the valuation report dated October 17, 1924, disallowed any discovery value because there was no material disproportion between the value upon discovery and the price of the property.

In view of the suggestion made by the solicitor and verified by the engineer after a field examination I believe the basis for depletion in this case should be the price of the property and that the conference report of December 9, 1924, allowing this discovery value should be disregarded. The case should be audited on the valuation report of October 17, 1924.

The CHAIRMAN. That means that that is what will be done?

Mr. NASH. Yes, sir; that is the commissioner's order.

The CHAIRMAN. Then there is the United States Graphite Co. case. Do you know the status of that case?

Mr. NASH. I did not understand that we were to take any further action on the United States Graphite Co. case. I think Mr. Hartson put in a reply to it, and since that time I am quite sure there has been no action taken.

The CHAIRMAN. Does the clerk of the committee remember whether that is so?

Mr. CARSON. As I recall, I think there was a reply. These two or three cases seem to stand a little bit open as yet. If this is all the bureau desires to say with reference to those cases they may be closed. There was the New Jersey Calcide case and the Climax Fire Brick case. I do not know whether the bureau's reply is complete as to those cases.

The CHAIRMAN. Look it up, Mr. Nash, and let me know if it appears to be open or closed.

Mr. GREGG. The New Jersey Calcide case is closed so far as we are concerned.

Mr. NASH. I am quite sure no further action is contemplated in those three cases—the Climax Fire Brick, the New Jersey Calcide, and the United States Graphite.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. I desire to call the attention of the committee to the obsolescence allowance made to the Marting Iron & Steel Co. of Ironton, Ohio. This taxpayer purchased an old 150-ton blast furnace in 1912. The blast furnace was acquired with the other assets of the Lawrence Steel Co., which was absorbed in the consolidation with the taxpayer. The blast furnace was operated until July, 1920, when it was blown out, and subsequently scrapped.

The taxpayer's claim for obsolesence was $178,719.15. That represents cost less the salvage value of salvaged materials and less

depreciation. It represents the taxpayer's loss on the blast furnace. The special conferees, Mr. Shepherd and Mr. Griggs, allowed this obsolescence claim to be spread over the years 1918 and 1919 and six months of 1920.

It is the position of the committee's staff that this blast furnace was really obsolete at the time it was purchased. The company in its claims contends, and I believe properly, that a 150-ton blast furnace located at a point isolated from its other operations could not be economically operated, and that it was only due to war conditions which permitted them to operate this furnace as long as they did.

Up to 1918 obsolescence was not a deduction permitted by law, although the bureau recognized the loss of useful value as a proper deduction. That deduction, however, under the regulations was required to be taken in the year when the use of the property was abandoned.

The sole ground for claim for obsolescence on this blast furnace is its size. There has been no development, according to our engineers—and we believe that the engineers of the bureau will not contend that there has been any change in the art—with respect to blast furnaces since about 1900. There has been some change and some development with respect to auxiliary appliances, but such auxiliary appliances can be applied to an old furnace as well as to a new one, and in this particular instance new auxiliary appliances were used. But this furnace became obsolete away back in about 1900, when the change in the art developed the 500 to 600 ton blast furnace. I am advised that a 500-ton blast furnace was found at that time to be the most economical unit and is still the most economical unit. In other words, there was no change in the art with respect to blast furnaces in 1918. There has been no change in the art with respect to blast furnaces in so far as it would affect this claim since about 1900.

The regulations of the bureau very properly provide that obsolescence is that gradual decrease in value which accumulates over the course of years, due to changes in the art and the progress of scientific development, and that it shall be spread over the period of time when it is obvious that a facility is becoming obsolete to the time when its use is finally abandoned. We take no exception to that regulation. As to whether it is a common practice to permit the entire accumulated obsolescence of facilities to be charged against high tax years we do not know. We believe that as a rule the regulations in this respect are followed.

We take the position with respect to this case that it is another one of those cases illustrating the fact that no matter how sound the regulations may be or how sound the general practices may be, it seems that there appears to be no effective way of keeping the special conferees within the law and the regulations and within the well-settled practices of the bureau.

Mr. GREGG. May I ask a question before you go any further so that I can have the facts clearly?

Mr. MANSON. Certainly.

Mr. GREGG. I did not quite get the facts which you stated as to this case. They have had this blast furnace since prior to 1900?

Mr. MANSON. No. This was an old blast furnace, 60 years old. In 1912 this taxpayer acquired the furnace with the oth r property of a company with whom it consolidated. In other words, I take the position that the obsolescence began to run on this blast furnace at about 1900, when the 500-ton blast furnace became, you might say, the standard of economic blast-furnace construction.

The CHAIRMAN. What you object to is that the entire question of obsolescence was allowed to run against high-tax years?

Mr. MANSON. Yes. My position is that the loss upon this furnace was due to obsolescence and should have been spread over the entire period from the time the company acquired the furnace, and inasmuch as obsolescence was not allowable under the law until 1918 that portion of it should be charged against 1918, 1919, and 1920, which actually occurred in those years.

The CHAIRMAN. And yet, as a matter of fact, they allowed it all?

Mr. MANSON. They allowed it all.

Mr. GREGG. Just to get the facts straight, let me ask another question. They acquired this blast furnace in 1912 in connection with a consolidation?

Mr. MANSON. Yes; and it was then an old furnace.

Mr. GREGG. It was then an old furnace?

Mr. MANSON. Yes.

Mr. GREGG. It was then depreciated, as I understand your statement, from 1912 up to 1917?

Mr. MANSON. Yes.

Mr. GREGG. And it was scrapped in 1919?

Mr. MANSON. It was scrapped, and they deducted from the cost the depreciation which accrued subsequent to 1912 and the salvage value. I am not taking any exception to that——

Mr. GREGG. I just wanted to get the facts in that connection.

Mr. MANSON. My exception goes to the manner of spreading the allowance for obsolescence. I contend it is not only unsound practice but that it is directly contrary to the established practice of the bureau and to the opinion of the solicitor which I am about to read.

Mr. GREGG. Before you read that, let me ask another question. Have you the cost of the blast furnace? Do you know what that was in 1912?

Mr. MANSON. The cost on which obsolescence is claimed was $256,804.42.

Mr. GREGG. That was the cost as of 1912, I suppose?

Mr. MANSON. Yes.

Mr. GREGG. Over what years was obsolescence spread by the company?

Mr. MANSON. It was spread over the years 1918 and 1919 and six months of 1920.

Mr. GREGG. Up to the date it was scrapped?

Mr. MANSON. Yes; up to the date it was scrapped. We believe that this case is covered on all fours by the decision of the solicitor published in Cumulative Bulletin No. 5, July–December, 1921, at page 148. I am now reading from the opinion of the solicitor:

Opinion is requested as to whether, under the provisions of section 214(a)8 of the revenue act of 1918 and article 166 of Regulations 45 obsolescence which accrued prior to January 1, 1918, may be deducted in income and excess profits tax returns for 1918 and subsequent years.

The question arises in connection with bulk freighters operating on the Great Lakes. A number of 5,000-ton bulk freighters were constructed in 1900. In 1910 the docks in the larger harbors along the Great Lakes were greatly enlarged and improved so that only vessels of 10,000 tons capacity or larger could be conveniently and economically accommodated. As a result of this condition the larger and newer type of vessels could carry freight at a cheaper rate than the 5,000-ton vessels and began at that time to dominate the lake trade and displace the smaller types. The physical life of the 5,000-ton vessels is generally conceded to be 33 years. However, for the reasons above stated, they have all been abandoned or will be abandoned by the close of the year 1921. Their salvage value is estimated at 20 per cent. In the past depreciation has been allowed at the rate of 3 per cent, in accordance with A. R. R. 27 (C. B. 2, p. 129). The owners now claim that 20 per cent of the cost of the vessels remains on their books as a loss by reason of obsolescence and seek to deduct this 20 per cent loss during the years 1918, 1919, 1920, and 1921. The unit contends that they should be allowed to take only that portion of the obsolescence which actually accrued subsequent to January 1, 1918, and the remainder of the loss should be taken in the year in which the vessels are sold, scrapped, or permanently abandoned.

Prior to the act of 1918 there was no specific provision in the income tax acts for a deduction on account of loss due to obsolescence, but the bureau had taken care of such losses by allowing what was termed "loss of useful value," deductible only in the year in which the property was sold or permanently abandoned. (Arts. 177, 178, Reg. 33 (rev.), arts. 143, 166, Reg. 45.) The present law provides:

"SEC. 214 (a). That in computing net income there shall be allowed as deductions:

* * * * * * *

"(8) A reasonable allowance for the exhaustion wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

The same provision occurs in section 234(a) with respect to corporations. This act was effective for the taxable year 1918.

The whole theory of the present act is that taxable income for any given year is determined by transactions which occur within that taxable year. Section 210 provides:

"That * * *, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax at the following rates."

Section 212(b) provides:

"The net income shall be computed upon the basis of the taxpayer's annual accounting period * * *."

Section 214(a) provides:

"That in computing net income there shall be allowed as deductions: (1) All the ordinary and necessary expenses paid or incurred during the taxable year * * *. (4) Losses sustained during the taxable year * * *. (7) Debts ascertained to be worthless and charged off within the taxable year."

Under these and similar provisions of the act this office has consistently ruled that items of income received or accrued during any given taxable year must be returned for that year, and that losses incurred in one taxable year must not be deducted from the income of other taxable years. It has been held that the failure to take depreciation in any taxable year does not entitle the taxpayer to deduct in any other taxable year a greater amount for depreciation than would otherwise be allowed. (Art. 167, Reg. 45.) Article 166 of Regulations 45 provides:

"Inasmuch as under the provisions of the income tax acts in effect prior to revenue act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future obsolescence as may be expected from experience to result from the normal progress of the art."

It will be noted that this article provides only for future obsolescence.

There appears to be nothing, therefore, in the act or in the regulations which indicates that it was intended that the obsolescence which accrued in taxable years prior to 1918 could be accumulated and deducted from gross income in years subsequent to that date; or that Congress had any intention

that this particular provision should be given a retroactive effect beyond January 1, 1918.

The contention of the taxpayer is directly opposed to this well-established construction of the act and ought not, in the judgment of this office, to be conceded. The facts, as indicated by the affidavits of the taxpayer, show that obsolescence began in 1910, when the larger vessels began to displace the 5,000-ton freighters. Any loss due to obsolescence should, therefore, be spread over the period from 1910 to the date of abandonment (L. O. 862; C. B. 1, p. 127), and it follows from what has been said above that only that portion of such obsolescence which accrued subsequent to January 1, 1918, can be taken in returns for 1918 and subsequent years.

Any further loss not taken care of by depreciation and obsolescence and not compensated for by insurance or otherwise may be taken in the year in which the vessels are sold and scrapped.

It is concluded that the obsolescence which accrued prior to January 1, 1918, may not be deducted in income and excess-profits tax returns for 1918 and subsequent taxable years.

CARL A. MAPES,
Solicitor of Internal Revenue.

The CHAIRMAN. Who did you say were the conferees in this case?

Mr. MANSON. Mr. Shepherd and Mr. Griggs.

The CHAIRMAN. I direct this inquiry to representatives of the bureau. I ask if they think anything could be gained by the committee if some of these employees or members of the staff were to come before the committee, because some of the members of the committee have a very definite conviction that there is something peculiar about the conduct of a number of the staff down there, including Mr. Alexander, Mr. Shepherd, and Mr. Greenidge, and a Mr. Robinson, who used to be with the bureau, and Deputy Commissioner Bright. We have had some talk among ourselves whether it would be a good thing to have them come here and tell us how some of these things happen and how they reached some of their conclusions. I would like to ask Mr. Gregg and Mr. Nash if they think that any such procedure would enlighten the committee at all.

Mr. GREGG. If the committee wants to examine any of those gentlemen of course we will be glad to have them appear here.

The CHAIRMAN. It seems to run through a number of these cases that this same group that I have just mentioned is involved, and I say frankly that some of the members of the committee have a very definite conviction that all is not right with some or all of those employees. I want to be perfectly open and frank with the representatives of the bureau here and not try to trick them or trap them in any way, and subpœna these men down here without them knowing about it.

Mr. GREGG. If at any time the committee wants any of the employees of the bureau we will very glad to bring them down. I think the chairman has in mind now more particularly the special conferee system. I want to ask Mr. Nash about that. Is that still in existence?

Mr. NASH. Shepherd's work as a special conferee was discontinued immediately after the United States Graphite Co. case, one of the earlier cases looked into last fall. But if the committee desires and if Mr. Manson will notify us within 30 or 40 minutes before we come up what case he is going through, and if he wants any employee, anyone who may have worked on that particular case, we will be glad to bring him up with us.

Mr. GREGG. There is this point: We dislike to take too many men out of the bureau and bring them up here every day. We hate to take more than necessary, so if the committee will let us know which employees they want to examine we will be glad to bring them up.

The CHAIRMAN. We would not want them all at once. We probably would not want more than one at a time.

In connection with what Mr. Nash said about Special Conferee Shepherd, I wish to say that there are some rather peculiar statements made by Mr. Greenidge. I do not charge that those statements represent the attitude of the bureau, but they may represent somewhat the attitude of mind of some of the employees of the bureau in connection with these cases. A good many of these cases have been settled, perhaps in the usual way, by others whose names have appeared in the testimony, which leads some members of the committee to believe that they were unduly influenced or were weak, I do not know which, and submitted too readily to the taxpayer's viewpoint. I want to say that I do not know the reason, and I do not want to prejudge and say that there was any undue influence or dishonesty exercised, but at least the record shows rather peculiar circumstances.

Mr. NASH. In justice to some of those men whom you have mentioned I think that if such a suspicion exists in the minds of the members of this committee they ought to come before the committee and explain the action which they took in these cases.

The CHAIRMAN. I mention this so as not to spring something suddenly on the representatives of the bureau, because I do not want to do that. We will take the matter under advisement; and if we desire any of those men brought before the committee, we will go back and review some of the cases and propound some questions for them to answer.

You may proceed, Mr. Manson.

Mr. MANSON. Just to get back to the case for a minute, I wish to say that the principle involved in the opinion of the solicitor which I have just read is identically the same as the principle involved in the Marting Iron & Steel Co. allowance. In both instances obsolescence was due to a marked increase in the size of the economical unit. In one instance it was a vessel and in the other instance a blast furnace. The development of the art rendered in both cases the old and smaller units unprofitable to operate. I believe the principles laid down in the solicitor's opinion are absolutely sound. I believe that as general rule they are applied. That is my own personal conviction.

The CHAIRMAN. I would like to ask Mr. Gregg whether he knows that has been the general practice?

Mr. GREGG. Yes, sir; it is. It is a question that arises in a good many cases, and that has been the general practice.

Mr. MANSON. I do not know anything to the contrary, and I do not assume anything to the contrary, although this is the only obsolescence case that has so far come to our attention.

The CHAIRMAN. I may say here that that in part confirms some of the views of some of the committee, to which I referred previously, because of the way these unusual cases had gone through.

Mr. GREGG. I would like to answer this case before you come to that conclusion, because I think from the statement that it is an unusual case, and it seems to me there is an answer to it.

The CHAIRMAN. You certainly will have an opportunity to put in your answer.

Mr. MANSON. I have here the engineer's report and some exhibits which I shall later offer, but at this point a brief history of the development of the blast furnace may be of interest to the committee.

In Roman times, in Britain and Belgium, iron was made in a conical hole in the ground. The hole was dug in a hill top and the wind rushing through a converging tunnel to the bottom of the fire hole was the air blast. Only one tuyer was used.

History does not recite when the bellows was invented. Loose pistons through hollow bamboo was used to force air through the fire in prehistoric times in Asia and India. Thirty-five centuries ago Egyptian pictures show goat-skin bellows.

The Catalan forge was the standard method of iron making in the Middle Ages. It was a square stone container about 4 feet high with open top and bellows attached at the bottom. It produced only lumps of metal which were heated and forged. The German improvement on the Catalan furnace was made in the medieval period and was a Stuckofen furnace of 150 tons per year capacity and was 16 feet high.

The next stage was the enlargement of the Stuckofen, later called blow oven, which melted the iron permitting it to be cast. This was the form of blast furnace first used in Belgium in 1340.

In 1550 bellows worked by cams on water-wheel axles were produced.

In 1680 English blast furnaces were 30 feet high and made pig iron by casting in the sand floors.

Charcoal was the universal fuel up to the middle of the eighteenth century, when coke was first used. It was late in the nineteenth century before coke was used in America.

The first "bloomaries" in America were worked in 1644 and a few blast furnaces were worked prior to 1800. In 1804, in America, a furnace with two bellows operated by water wheel was in operation. Since 1750 furnaces as high as 28 feet had been constructed.

By the end of the eighteenth century furnaces were producing as much as 2,000 tons per year.

In 1846 engines were substituted for water wheels for blast purposes. In 1819 coke was first used successfully in America.

The Catalan forge had been improved by 1875 to a bloomary type of forge. In 1828 the hot blast was invented for the blast furnace.

The type of blast furnace in operation about the year 1828 was of masonry construction. The stack was 20 to 40 feet high and unlined. In 1860 a riveted plate shell on cast-iron columns was constructed.

Original top-filling device for automatic charging was installed in 1896.

The fire brick hot-blast stove was first used in 1860. They were 25 feet in diameted and 135 feet high. Seven stoves are used for two furnaces. Cast housing shelting pig beds are being done away with for pig-casting machines. Blowing engines of the vertical,

horizontal, and vertical-horizontal type are being supplanted by steam turbo blowers. Turbo blowers were first installed in 1910. Horizontal gas-blowing engines of the horizontal type have been in use since about the year 1910.

From 1895 to 1900 furnaces had grown to the size of 500 tons per day. This growth was gradual. From the old 50-ton furnace used in the early part of the nineteenth century they grew to 400 tons per day about 1890 and to 600 tons per day at the beginning of the twentieth century, or about 1900.

A charge distributer was first introduced to the interior of the blast furnaces in 1895. This was for distributing the charges after they were dumped in the furnace.

Gas-driven blowing engines were first practically introduced in 1895 in England and in 1903 in America. The present-day furnaces are from 90 to 100 feet high. The 600-ton furnace is 21 feet in diameter and 100 feet high. The mechanical system of filling was introduced in 1905. In 1906 the "dry blast" was introduced for changing and rendering constant the moisture content of the air.

Casting into chills instead of into sand beds was first tried prior to 1860, but did not come into large use until 1890. The casting machine was later developed.

Aside from the development of the blast furnace itself there has naturally been pronounced development of auxiliaries to the furnace. These developments were most pronounced from the beginning of the nineteenth century up until about 1900, and include such auxiliaries as machinery for the handling of raw materials and feeding the furnace, this process having been carried on by hand in the early days, the boiler-plant blowing apparatus, blast stoves, machinery for handling of the iron and cinder, collecting of iron dust, water supply system, pumping machinery, waterway system, and electric supply.

Although great strides have been made in the development and improvement of these auxiliaries, the outstanding improvement in the blast furnace proper has been the increase in its size, which increase seems to have reached its limit of efficiency between the years 1895 and 1900, when the 500 and 600 ton capacity was constructed.

In a great many instances the original furnaces have been retained and improved auxiliaries installed in order to operate the old furnaces more economically and efficiently.

In the engineer's report on the Marting Iron & Steel Co. case the following facts are shown:

Invested capital has been fixed as of the date of reorganization in 1912 upon insufficient evidence. A retrospective appraisal, as of 1912, conforming at least in some degree to Treasury Decision No. 3367, should have been required of the taxpayer. (See art. 836, reg. 62.)

Obsolescence has been allowed taxpayer on a 60-year-old blast furnace discarded in 1920 and scrapped in 1923 on the basis that said obsolescence was all deductible in the high-tax years 1918, 1919, and 1920. It is obvious that the progress of the art of blasting furnaces has been a gradual one and that the theory used by the unit does not correspond with the facts.

Allowance has been made in direct contradiction to the solicitor's opinion 114. Cumulative bulletin No. 5, pages 148, 149, and 150; also this allowance is contrary to decision No. 137, United States Board of Tax Appeals.

The allowance has been made by the special conferees direct without a preliminary conference before appraisal section; it has been made against the judgment of two engineers who examined the furnace in the field.

Invested capital—Values set up as of date of reorganization, 1912

	Appraisal (so called)	Stock issued
Marting Iron & Steel Co	$768,000	$628,000
Ironton Iron Co	675,000	675,000
Lawrence Furnace Co	220,000	206,700
Total	1,663,000	1,509,700

The $1,663,000 shown above has been allowed for invested-capital purposes. By appraisal, so called, we mean that the taxpayer states these values were obtained by an appraisal of September, 1912, of the physical assets of the companies. Inasmuch as only the totals are on record and no actual appraisal is shown giving the necessary bill of material and prices to enable a check to be made, we do not call the above an appraisal at all in the engineering sense of the word. There is no guaranty that cash, intangibles, and other items were not included in the appraisal or that proper depreciation was taken.

Obsolescence: This deduction is claimed on old Lawrence Furnace Co., only, as follows:

Cost of blast furnace and land, 1912 (stock value)		$206,700.00
Cost of land		8,400.00
Net cost of blast furnace		198,300.00
1917 addition—stock bins and trestle		47,825.00
1917 addition—Hassman hot-blast stove		10,679.42
Total cost to Jan. 1, 1918		256,804.42
Plant operated to January 1, 1920, and then blown out. Sold to junk dealer (in part) August, 1923.		
Sale price for plant sold	$12,385.00	
Salvage value, 150-horsepower boiler retained	200.00	
Salvage value, steel bins and trestle	2,500.00	
		15,085.00
Residual cost		241,719.42
Depreciation (6 per cent) 5 years on $198,300	$59,490.00	
Depreciation (6 per cent) 1 year on $15,504.42	3,510.27	
		61,000.27
Amount allowed as obsolescence		178,719.15
Spread as follows:		
1918=Dec. 30		71,487.66
1919=Dec. 30		71,487.66
1920=June 30		35,743.83
		178,719.15

History of case: In 1912 the Marting Iron & Steel Co., a corporation organized in 1899, absorbed the Ironton Iron Co. and the Lawrence Furnace Co. Upon consolidation stock was issued to the stockholders of the three plants as follows:

Marting Iron & Steel Co	$628,000
Ironton Iron Co	675,000
Lawrence Furnace Co	206,700
	1,509,700

The first investigation of taxpayer's claim for obsolescence, amounting to $143,908.59, was made by engineer L. L. Thwing on June 12, 1923. Mr. Thwing left the service before completing the report on this case. The data secured by him, however, was used by Mr. C. D. Watkins, engineer, who made an office report on November 15, 1923, the result of which was to disallow the claim entirely. (See Exhibit A.)

The taxpayer appealed this action. Engineer M. William Nolan was assigned to the case, and after a field examination, submitted a report on July 17, 1924, disallowing the claim in its entirety. (See Exhibit B.)

The taxpayer was then granted a conference before the special conferees, without a previous conference before the appraisal section, under date of November 12, 1924. (See Exhibit C.) At this conference the conferees agreed to an allowance for obsolescence of $178,719.15, which represented the revised total claim of the taxpayer.

On November 15, 1924, further conference was granted the taxpayer with regard to invested capital as of date of acquisition. This conference was also held before the special conferees, Mr. Griggs and Mr. Shepherd, and also before Mr. W. C. Gordon, valuation engineer metals section, and M. W. Nolan, appraisal engineer, and Miss Heft, auditor, corporation audit. (See Exhibit D.)

On November 17, 1924, Mr. Nolan, appraisal engineer, on instruction from the special conferees, made up a report allowing the taxpayer the full amount of obsolescence claimed, same to be spread over the years 1918, 1919, and six months of 1920. (See Exhibit E.)

On November 22, 1924, Mr. Gordon, valuation engineer, metals section, prepared a report covering the invested capital features of this case and recommended allowance on this case of $1,663,000 for same as of date of reorganization, 1912. (See Exhibit F.)

On January 22, 1925, A–2 letter was mailed taxpayer showing the completion of the audit based on the new invested capital and obsolescence granted. It might be noted, however, that there is still a request pending before the unit from the taxpayer for his taxes to be computed under the provisions of section 210 of the revenue act of 1917 and sections 327 and 328 of the revenue act of 1918; in other words, taxpayer is claiming right to special assessment.

We submit that the invested capital of the taxpayer upon date of reorganization in 1912 has been fixed upon insufficient evidence. The value of taxpayer's stock at this time would have been determined either by (*a*) an appraisal of the property by disinterested authorities; (*b*) the certificate of the assessed value in the case of real estate; (*c*) evidence of a market price in excess of the par value of stock or shares * * * "generally allowable claims of this article

will arise out of transactions in which there has been no substantial charge of beneficial interest in the property paid into the corporation, and in all cases the proof of value must be clear and explicit."

We contend that the taxpayer's mere statement that the par value of the stock was fixed by an appraisal made in September, 1912, is not sufficient evidence unless said appraisal is submitted in detail. An appraisal in the engineering sense of the word does not mean an opinion or total value guessed at or roughly estimated by the taxpayer or his representatives. It means a detailed statement showing the items appraised, their replacement cost, depreciation allowed to each item, etc. In the absence of a real appraisal made in 1912 it appears to us that the unit should have required a retrospective appraisal as of that date, conforming in a reasonable degree to Treasury Decision 3367. Inasmuch as this furnace was still intact at the time of inspection, it would have been an easy matter to have drawn up a bill of material, applied 1912 prices to same, and arrive at a reasonable figure for the value of the physical assets of the company.

The final report allows taxpayer to deduct from his 1918, 1919, 1920 returns all the obsolescence which has accrued in this blast furnace over its 60 years of life.

We contend that this is directly in opposition to the intent of the law, regulations, and solicitors' opinions.

In Bulletin F of the Income Tax Unit, the following definition is given:

> Obsolescence means the gradual reduction in the value of property due to the normal progress of the art in which the property is used, or to the property becoming inadequate to the growing needs of the trade or the business. Obsolescence, a gradual lessening of value, must be distinguished from "loss of useful value" (art. 143, Reg. 45), which contemplates an abrupt termination of usefulness.

The taxpayer claims that at the end of the war in 1918 he saw that his furnace would become obsolete, and therefore he charged off all the obsolescence in the years 1918 and 1919. The unit makes him spread this also over the six-month period in 1920, covering that time which elapsed before the furnace was discarded.

It appears to your engineers that the war had nothing to do with the obsolescence of this blast furnace. From its age, if the war had not occurred, it would in all probability have been scrapped before the war period even began. In this connection see section 214(a)8, section 234(a)7, revenue act of 1918:

"Obsolescence which accrued prior to January 1, 1918, may not be deducted in income and excess profits tax returns for 1918 and subsequent taxable years."

Further, in Solicitor's Opinion No. 114, it is stated "That losses incurred in one taxable year can not be deducted from the income of other taxable years."

We maintain that obsolescence should be figured in this case by the value of the property at the date of acquisition in 1912 to the date when same was discarded in July, 1920. Quoting further from solicitor's opinion 114, this is sustained as follows:

> There appears to be nothing, therefore, in the acts or in the regulations which indicates that it was intended that obsolescence which accrued in taxable years prior to 1918 would be accumulated and deducted from gross income in years subsequent to that date; or that Congress had any intention that this particular provision would be given a retroactive effect beyond January 1, 1918.

The view we take against the accumulating of obsolescence which really occurred in prior years in order to charge off this deduction in the high-tax years is further corroborated in Decision No. 137 of the United States Board of Tax Appeals, as follows:

Due allowance must be made, in ascertaining gain or loss upon the sale of capital assets, for exhaustion, wear and tear, and obsolescence occurring during the period of ownership, whether or not deductions had been taken therefor in prior tax returns.

The revenue act of 1918 does not give a taxpayer the right to elect whether to take deductions in the years in which the facts justifying them occur, or to waive them and make legal returns as if such tax had not occurred. The commissioner should compute the taxes for each year on the basis of all the facts, even though the taxpayer may previously have ignored some of the facts to his own detriment.

The basis for computing deductions and adjustments for exhaustion, wear, and tear, and obsolescence in case of property acquired before March 1, 1913, is the cost (properly adjusted to that date) or the market value on that date whichever is higher.

Submitted November 22, 1924; decided January 16, 1925.

Taxpayer has been granted a conference before the special conferees in order to determine on his case without the usual conference before the section involved. In other words, one of the usual steps which most taxpayers are obliged to go through has been omitted. Further, the engineer of the appraisal section who made one of the field examinations has made this allowance under the instruction of the special conferees and against his own judgment. Further, this engineer has requested the head of the appraisal section, Mr. Keenan, to recall this report on obsolescence on account of its impropriety, but without result.

In conclusion:

1. We maintain that the invested capital of the taxpayer has been fixed without the presentation of that clear and convincing proof which is supposed to be required in such cases.

2. Taxpayer has been allowed to accrue and accumulate all his losses due to obsolescence into the high tax years on the basis of an unsound theory when the actual facts would prove a gradual reduction in the value of the property due to the normal progress of the art.

3. That ample decisions and regulations were in existence at the time this taxpayer's case was decided, on which would have precented the allowance, if any reasonable study had been given to the case. It thereby sets a precedent which is very harmful and which gives the taxpayer treatment not accorded to others.

4. We again find as in other cases that the special conferees in attempting to settle this case have done so in opposition to the valuation engineer who had handled same, without giving the study to the matter which was required.

I have endeavored to state the facts accurately, but if the statement of facts as it appears in the engineer's report is contrary to the oral statement I have made, I will ask the bureau to be governed by the facts contained in the written reports submitted by the engineers.

Certain exhibits were referred to in the engineers' reports, and I will insert those in the record at this point.

(The exhibits referred to are as follows:)

EXHIBIT A

OFFICE REPORT ON OBSOLESCENCE CLAIM OF THE MARTING IRON AND STEEL CO., IRONTON, OHIO

The examination of the facilities involved in the above-mentioned taxpayer's claim for obsolescence was made at its Lawrenceburg furnace in Ironton, Ohio, on June 12, 1923, by Engineer L. L. Thwing. The taxpayer was represented by H. A. Berg, general manager.

CLAIM

The taxpayer has claimed $143,908.59 as obsolescence on the cost of the Lawrenceburg plant, this plant being one of the three owned by the taxpayer. The taxpayer claims that 50 per cent, or $71,954.30, should be deducted equally in each of the years 1916 and 1919.

At the time of the field investigation the taxpayer claimed the residual value to be $19,447.11 (exclusive of land) on the basis of scrap. In 1923 the plant was sold for $20,000 scrap value, which establishes its residual value.

The net book cost of the three plants at January 1, 1916, is found by the taxpayer to be as follows:

Total cost as per books, Jan. 1, 1916		$1,160,540.58
Land values:		
Aetna, 43 acres, at $1,000	$43,000.00	
Ironton, 16 acres, at $1,000	16,000.00	
Lawrenceburg, 393 acres, at $25	9,800.00	
Coal mine (common to the three)	8,939.59	
		77,739.59
Net cost (except land)		1,082,800.99

According to the appraisal made in 1922 by an appraisal firm, the total value at January 1, 1916, of the three plants was practically double the book value, or $2,082,355, of which the Lawrenceburg plant as appraised at $373,950, or 17.96 per cent. On this basis the taxpayer allocated to the Lawrenceburg plant 17.96 per cent of its book cost of $1,082,800 at January 1, 1916, or $194,471.06. This causes the claimed book cost of the Lawrenceburg plant, $194,471.06, to be arrived at by a percentage which was based upon an appraisal of the property as of January 1, 1916.

The taxpayer then computes the "obsolescence" claim as follows:

Cost of Lawrenceburg plant at Jan. 1, 1916		$194,471.06
Less residual value, estimated at	$19,477.11	
Less depreciation (1916–1919) 4 per cent per year	31,115.36	
		50,562.47
Loss		143,908.59
Loss in 1918, 50 per cent	$71,954.29	
Loss in 1919, 50 per cent	71,954.30	
		143,908.59

ENGINEER'S DISCUSSION

This claim is not set up in accordance with existing regulations, and, furthermore, is not adequately supported with complete facts and data to determine what obsolescence, if any, is properly allowable.

Existing regulations contain the following information with respect to depreciation and obsolescence:

"Allowances for depreciation may under not circumstances be based on a fictitious cost price or value of property or on its replacement value. If property were acquired prior to March 1, 1913, and its fair market value as of that date forms the basis for computing the allowance for depreciation and obsolescence, such value must be substantiated by evidence satisfactory to the commissioner. No appraised value as of any other date than March 1, 1913, may be used as the basis for computing the allowance."

The taxpayer's claim, as noted above, is based on an appraisal as of January 1, 1916. The claim is, therefore, not set up in accordance with the regulations.

The second point to consider is that the information available inadequately supports the claim—a number of elements remaining unexplained. Among the pertinent points of this case that remain to be supported or explained the following may be mentioned:

(*a*) It is noted that the blowing engines are 50 years of age—unless otherwise stated, it is reasonable to consider that the plant is near the same age.

(*b*) When the facility was originally acquired, together with dates of extensions, betterments, replacements, etc., should be given.

(*c*) It is noted that the taxpayer stated that it was aware of the "definite fact of obsolescence" on January 1, 1918—proof is lacking that this fact was unknown at dates several or many years prior to this date.

(*d*) Was the Lawrence furnace plant properly depreciated in prior years; and if not, for what reasons?

(*e*) If the cost of the Lawrence plant was not depreciated throughout its life, on what reasonable and equitable grounds can the taxpayer presume to deduct obsolescence in lieu of untaken depreciation and, furthermore, undertake to deduct the so-called obsolescence in 1918 and 1919, only high-tax years?

(*f*) In the submitted information it is stated that the furnace had a maximum production of 150 tons, but in the later years the best production that could be obtained from it was 125 tons, or an efficiency of 83 per cent. The information is not given as to what general period of the furnace's life that this inefficiency became evident.

The engineer notes that the appraised depreciated book value of $373,950 as at January 1, 1916, is practically double that of the actual book value as of that date. At January 1, 1916, the plant had reached 40 years of age, whereas the normal life is usually taken at about 25 years, which life was also estimated by the taxpayer by using a depreciation rate of 4 per cent. It would appear, then, that the actual life of the plant had reached 160 per cent of the expected life; it is also reasonable to consider that after 40 years of age the furnace would have reached practically a scrap basis, or a condition approximating that status.

The depreciation rate of 4 per cent is considered to be exclusive of replacements, which with respect to a facility of this kind is a comparatively large annual expenditure. After 40 years of life it is reasonable to consider that the owner of such a plant must necessarily be aware of the fact that the plant would not have many more years to exist.

It is furthermore considered reasonable to consider that the plant probably would not have survived competition in 1918, 1919, and 1920 except for the abnormal war conditions or abnormal conditions growing out of the war. The fact remains that it was scrapped in 1923 for $20,000, or about one-twentieth of its appraised value as of January 1, 1916, and the point is not clear that it was not, to a certain extent, in the same condition in 1916.

ENGINEER'S FINDINGS

The claim for obsolescence to be deducted in the years 1918 and 1919 is disallowed for the following reasons:

(*a*) That the claim is not set up according to existing regulations.

(*b*) That full details are lacking to support the claim.

(*c*) That the claim appears unreasonable, as it operates to deduct obsolescence in 1918 and 1919 in lieu of depreciation on an old plant that would normally be written off as depreciation during a period of time beginning a number of years prior.

Summary

Cost on which obsolescence is claimed	$194,471.06
Cost on which obsolescence is disallowed	194,471.06
Cost on which obsolence is allowed	----------
Obsolescence claimed	143,908.59
Obsolescence disallowed	143,908.59

It is recommended that no obsolescence be allowed the Marting Iron & Steel Co. Lawrenceburg plant. All costs and rates of depreciation are subject to

check by the auditor or revenue agent assigned to the field investigation of this case.

C. B. WATKINS, *Engineer.*

Submitted November 15, 1923.

L. E. LUCE, *Reviewing Engineer.*

Approved:

J. T. KEENAN,
Acting Chief of Section.

EXHIBIT B

OFFICE REPORT ON REEXAMINATION ON OBSOLESCENCE CLAIM OF MARTING IRON & STEEL CO., IRONTON, OHIO

The original field examination of the claim for obsolescence of the above-named taxpayer was made June 12, 1923, by Engineer L. L. Thwing, of the amortization section. This engineer severed his connection with the Income Tax Unit before completion of report on this case, and subsequently the case was assigned to Engineer C. B. Watkins for office examination. The report of Engineer Watkins was submitted November 15, 1923, in which a total disallowance of the claim was recommended for reasons specifically stated in said report.

The taxpayer protested this action of the Unit in the diasallowance of its claim for obsolescence by letter and in person before the appraisal section, and as a result the case was assigned to the writer for reexamination in the field.

The writer visited the taxpayer's office in Ironton, Ohio, May 3 and 4, 1924, and discussed the claim with the taxpayer's attorney, Mr. A. R. Johnson, as suggested by the taxpayer. Mr. Johnson stated that the case had just been placed in his hands, and on that account was not familiar with its details and suggested a time extension in order to become conversant with all the features of the case. Mr. Johnson stated during this conference that an additional time extension to June 24, 1924, had been granted in a letter signed by Deputy Commissioner J. C. Bright.

The writer continued the discussion of this claim with the taxpayer's representatives at its office in Ironton. At this conference the taxpayer was represented by Miss Margaret M. Reif, secretary, and Mr. H. E. Frazier, accounting officer.

The taxpayer during the war period and for many years prior operated three blast furnaces producing malleable and foundry pig iron. One of these units, known as the Lawrence Furnace, was acquired by the Marting Iron & Steel Co. September 30, 1912. This furnace was operated regularly as necessary until July 1, 1920, when it was indefinitely shut down after having been in service for over 60 years. The furnace was sold as scrap August 1, 1923, for a price said to be $19,477.11. It is claimed that the depreciated book value of this abandoned furnace as of the date of sale less sale price amounts to $143,908.59, which amount is claimed as a deduction for obsolescence and of which 50 per cent, or $71,954.29, is claimed as a deduction in the year 1918 and the balance, $71,954.29, is claimed as a deduction in the year 1919.

Engineer C. B. Watkins, in a report on this case referred to above, discusses the claim of the taxpayer in detail and as this report is readily available in the files of the case, it is not deemed necessary to repeat this analysis in the present report. The taxpayer's representative, Mr. A. R. Johnson, advised the writer that a copy of the engineer's report had not been received by the taxpayer and for that reason no specific written exceptions were as yet submitted by the taxpayer. The files of the case show that a copy of the engineer's report in question was furnished the taxpayer May 6, 1924.

The writer in conference with Mr. H. E. Frazier at the taxpayer's office pointed out the information and data required by the department in support of its claim and in order that there might be no misunderstanding on the part of the taxpayer in this respect, a set of written instructions were prepared and given to the taxpayer by the writer.

The taxpayer's representative, Mr. Frazier, agreed to prepare the data required and forward same to the writer in the field within 15 days' time or on approximately May 21, 1924. Almost two months have elapsed since that date and nothing has been heard from the taxpayer and no additional information has reached this office in further support of this claim.

The writer agrees with Engineer Watkins that on the basis of the information available there is nothing that can be done under the regulations but to recommend a total disallowance of the claim. It is, therefore, recommended that the report of Engineer C. B. Watkins, submitted November 15, 1923, in which the total disallowance of this claim was recommended, be sustained.

M. WILLIAM NOLAN, *Engineer.*

Approved:

J. T. KEENAY, *Chief of Section.*

Submitted July 17, 1924.

A. T. PAGTER, *Reviewing Engineer.*

EXHIBIT C

TAXPAYER'S CONFERENCE

Taxpayer: Marting Iron & Steel Co.
Address: Ironton, Ohio.
Taxpayer's representatives: Mr. Carmi Thompson, chairman board of directors: Mr. A. R. Johnson, attorney; Mr. H. E. Frazier, accountant.
Government representatives: Mr. C. C. Griggs, assistant head, engineering division; Mr. A. R. Shepard, engineer, engineering division.
Matter presented: Additional evidence in support of its claim for obsolescence.

The above representatives of the taxpayer appeared to-day in conference before the above-named Government representatives and submitted further written and oral evidence in support of claim for refund based on the obsolescence of a blast-furnace plant abandoned in July, 1920, and salvaged in 1923, and sundry other deductions from income for the taxable years 1917, 1918, and 1919.

Claim for obsolescence was originally examined by Engineer C. B. Watkins and disallowed in its entirety, as the information available was not sufficient in substantiation of the claim. In May, 1924, the writer visited the plant and made a complete examination of the remaining property and advised the taxpayer's representatives as to what specific evidence was required in support of this claim. In order that there would be no misunderstanding, the writer placed this advice in writing for the taxpayer, who agreed to submit a supplemental brief to the writer in Pittsburgh, Pa., about May 9 or 10, 1924. Nothing further was heard from the taxpayer, and on July 17, 1924, in the absence of any new evidence in support of the claim, it was recommended that the original report of Engineer Watkins be allowed to stand without any modification. Nothing further was heard from taxpayer until November 12, 1924, when the above-named representatives appeared in this office for the purpose hereinbefore mentioned.

A revised claim submitted in conference November 12, 1924, is exhibited in tabular form herewith:

Cost of furnace plant (in stock)		$198,300.00
1917 additions, stock bins and trestle	$47,825.00	
No. 4 hot blast stove	10,679.42	
		58,504.42
Total cost claimed		256,804.42
Less:		
Amount received from sale of abandoned plant	$12,385.00	
Salvage value of 150 horsepower water tube boiler	100.00	
Salvage value of Hassman hot-blast stove	100.00	
Salvage value stock bins and trestle	2,500.00	
Total	15,085.00	
Less—		
Depreciation—1913 to 1917, inclusive—5 years at 6 per cent—$198,300	59,490.00	
Depreciation, 1 year at 6 per cent—$58,504.42	3,510.27	
		78,085.27
Total amount claimed as obsolescence		178,719.15
Amount allocated to year 1918, 50 per cent		89,359.57
Amount allocated to year 1919, 50 per cent		89,359.57

The taxpayer acquired the property of the Lawrence Furnace Co., consisting of one 150-ton blast furnace complete with all accessories, for its operation on September 30, 1912. Payment for this property was made in stock of the Marting Iron & Steel Co. It is claimed the value of the property as of date of sale was $206,700, which, owing to a defective system of accounts, was not reflected by the books of the Lawrence Furnace Co.

The taxpayer was therefore requested to either establish the market value of its stock as of the date of this purchase or establish the fair value of the property as of March 1, 1913, by appraisal. Obviously the writer could not even begin the analysis of this claim until the cost of the property in question was established.

The Lawrence furnace operated regularly from date of acquirement, September, 1912, to July, 1920, when it was blown out and remained idle until August, 1923, when the furnace plant, with the exceptions as noted below, was sold to a junk dealer, and the amount realized in the transaction was $12,385. The property not sold to the junk dealer consisted of the following:

	Cost	Salvage value claimed by taxpayer
1 14 by 80 foot Hassman 2-pass hot blast stove	$10,679.42	$100.00
1 150 horsepower Rust water tube boiler	Not stated.	100.00
Stock trestle and stock bins	47,825.00	2,500.00
Total	58,504.42	
Cost of boiler (estimated by writer)	7,500.00	
Total	66,004.42	2,700.00

The above Hassman 2-pass hot blast stove was dismantled by the taxpayer and moved to its Aetna blast furnace plant, to be held there for erection or sale; a similar disposition was made of the water tube boiler. The stock bins are of modern steel construction, and are held by the taxpayer pending sale or removal for use at one of its other blast-furnace plants. The writer accordingly questioned the reasonableness of the above-claimed salvage values of those three items, amounting to $2,700, on costs amounting to approximately $66,004.42.

The furnace plant in question operated up to and including July 1, 1920, when it was blown out and abandoned. The writer contended that the obsolescence allowable, if any, should be apportioned over the period January 1, 1918, to July 1, 1920, the date when the furnace was blown out. This statement and contention may be verified by reference to Income Tax Bulletin F, Depreciation and Obsolescence, page 13.

The taxpayer submitted evidence showing that in respect to the acquisition of the Lawrence Furnace property the transaction was a transfer of stock having equal face values from one company to the other, and accordingly it appears that the value of the assets in question was not increased or decreased by such transfer, and accordingly the cost as claimed was accepted by the Government conferees.

In respect to the disputed salvage values the taxpayer has furnished a statement in affidavit form signed by Mr. Carmi Thompson, chairman of the board of directors, which states that those facilities have been abandoned and scrapped, and accordingly the conferees in charge of this conference accept the salvage values as claimed.

Further discussion was held in respect to land values and the apportionment of the allowance, if any, and also to the question as to whether the claim is properly one of obsolescence or of loss of useful value, after which the conference adjourned with the understanding that the case would receive prompt attention and be disposed of at an early date.

C. C. GRIGGS,
Assistant Head, Engineering Division, Conferee.
A. R. SHEPHERD,
Division Conferee, Conferee.
M. WILLIAM NOLAN,
Engineer.

Approved November 12, 1924.

J. T. KEENAN, *Chief.*

EXHIBIT D

ENGINEERING DIVISION, INCOME TAX UNIT,
November 15, 1924.

TAXPAYER'S CONFERENCE

Date of conference: November 12, 1924.
Taxpayer: Marting Iron & Steel Co., Ironton, Ohio.
Represented by: Carmi Thompson, chairman of the board of directors; A. R. Johnson, general counsel; H. E. Frazier, accountant.
Representing the Government: C. C. Griggs, assistant head of division; A. R. Shepherd, division conferee; W. C. Gordon, valuation engineer (metals section); M. W. Nolan, appraisal engineer; Miss Heft, auditor, corporation audit.

MATTER PRESENTED

This case has been in the appraisal section several times and there have been three appraisal memoranda prepared as well as two field investigations, and taxpayer's claim denied on the grounds that the necessary information could not be secured.

It was thought that the only question involved was the question of obsolescence which had been referred to the appraisal section, but in conference it developed that it was a question of establishing the value at acquisition of all the assets acquired by the company for stock, this value to be for invested capital purposes as well as to furnish the value for the equipment on which obsolescence was claimed. On this account, the auditor from corporation audit was invited to attend the conference, as well as Mr. Gordon, valuation engineer from the metals section, who is familiar with the plant and equipment necessary for the production of iron.

The auditor requested the engineering division to pass upon the rate for depreciation, stating that the audit would accept the engineer's decision in this respect.

The taxpayer submitted evidence to indicate that the stock at the time of acquisition was worth more than par, as shown by the assets acquired, and also by the department accepting the value of the stock at $139 a share in computing the profits for one of the individual stockholders at the time he sold the stock in 1920.

CONCLUSIONS

The question of obsolescence was referred to Mr. Nolan in the appraisal section for him to prepare his report. The question of the value of the assets as at acquisition was referred to Mr. Gordon, of the metals section, who was to confer with Mr. Frazier at subsequent dates, and he will report upon this question and the depreciation sustained and allowed.

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

EXHIBIT E

REPORT ON REEXAMINATION OF OBSOLESCENCE CLAIM OF MARTING IRON & STEEL CO., IRONTON, OHIO

First report: By Engineer C. B. Watkins, submitted November 15, 1923. Claim was totally disallowed, as same was not substantiated.

Second report: By Engineer M. William Nolan, submitted July 17, 1924. The taxpayer failed to furnish the evidence requested by the examining officer and it was recommended that the findings of Engineer Watkins be sustained.

A conference on this case was held November 12, 1924, in the office of Mr. C. C. Griggs, assistant head engineering division. The taxpayer was represented by Mr. Carmi Thompson, chairman board of directors; Mr. Adna R. Johnson, attorney at law; Mr. H. E. Frazier, accountant.

The conference was conducted by the following representatives of the income-tax unit: Mr. C. C. Griggs, assistant head engineering division; Mr. A. R. Shepherd, engineer, engineering division.

In this conference, a complete report of which will be found in the files of the case, the taxpayer submitted a revised claim for obsolescence of the Lawrence blast furnace plant, which is supported by schedule, brief, and affidavit, all of which evidence may be found in the files of the case. A summary of the claim is given herewith, as follows:

Revised claim for obsolescence on Lawrence blast-furnace plant

Cost of plant—September 20, 1912 (by stock transfer)		$198,300.00
1917 additions, stock bins and trestle	$47,825.00	
1917 additions, Hassman hot-blast stove	10,679.42	
		58,504.42
Total cost of plant and additions up to January 1, 1918		256,804.42
Plant operated to July 1, 1920, and was then blown out. Sold to junk dealer as scrap in August, 1923.		
Sale price received for portion of plant sold	$12,385.00	
Salvage value of 150-horsepower boiler retained by taxpayer	200.00	
Salvage value of steel stock bins and trestle retained by taxpayer	2,500.00	
		15,085.00
		241,719.42
Depreciation:		
6 per cent for five years on $198,300	$59,490.00	
6 per cent for one year on $58,504.42	3,510.27	
		63,000.27
Amount claimed as obsolescence		178,719.15
Amount claimed as obsolescence, allocated to year 1918, 50 per cent		89,359.57
Amount claimed as obsolescence, allocated to year 1919, 50 per cent		89,359.57

The plant of the Lawrence Furnace Co., consisting of one 150-ton capacity blast furnace, complete with accessories, was acquired by the taxpayer in September, 1912 by merger of three companies, namely: Marting Iron & Steel Co., Ironton Furnace Co., and Lawrence Furnace Co.

It is claimed that the value of the plant account of the Lawrence Furnace Co. as of the date of merger was $198,300, which amount was paid for in stock in the taxpayer company. An equal amount of stock was surrendered to the taxpayer by the owners of the Lawrence Furnace Co. The stock of both companies was claimed to have a face value of $100 per share at the time of this transaction and accordingly, it appears that the book value of the Lawrence furnace plant was neither increased nor decreased by the merger. The actual cost of the Lawrence furnace plant, owing to defective accounting methods, is not reflected by the books of that company. As it is evident that the transaction was but a merger of the three companies, it appears that the actual value of the plant account in question is established by the face value of the stock exchanged, amounting to $198,300 and it is the opinion of the conferees that this stock should be accepted in lieu of an appraisal as of March 1, 1913, or a value based on actual sales of stock in the Marting Iron & Steel Co. as of the date of this merger. The writer, therefore, accepts the value $198,300 as the cost of the property to the taxpayer in September, 1912.

The Lawrence blast furnace operated almost continuously from the date of the merger to July, 1920, when the furnace was blown out and remained idle until August, 1923, when the entire plant with the exceptions noted below was sold to a junk dealer and the amount, $12,385, was recovered as salvage. In February, 1923, Mr. Carmi Thompson and associates acquired a large interest in this company by purchase of about 33⅓ per cent of its outstanding stock; the company was reorganized and Mr. Thompson since has held the office of chairman, board of directors.

The plant facilities retained by the taxpayer after abandonment and scrapping of the plant were as follows:

	Cost	Salvage value claimed
Stock bins and trestle	$47,825	$2,500
Hassman hot-blast stove—14 by 75 feet	10,679	100
150-horsepower Rust water-tube boiler	[1] 4,000	100
	62,504	2,700

[1] Estimated by the writer.

The writer objected to the extremely low salvage values shown above on the grounds that those facilities were not sold as scrap with the plant, but were admitted on the date of the field examination as retained for sale or possible use in other plants of the company. The taxpayer at the request of the writer supports this claim by affidavit, which states that the above noted facilities have been scrapped and will not be again used at any of its operations. The conferees accordingly accepted this affidavit and the salvage values as claimed.

The difference between the total amount paid for the Lawrence furnace property, $206,300, and $198,300 claimed as the value of the plant account, represents a valuation placed on 392 acres of land, which amounts to $8,400. The land in question is located in an extremely isolated place, distant about 12 miles from Ironton, Ohio, and appears to have no possible value other than for farming purposes. Based on evidences of sales of land in that district submitted by the taxpayer, it appears that the above value of the land in question is reasonable, and it is therefore accepted by the conferees. The claim for obsolescence does not include the cost of land.

The Lawrence furnace plant operated regularly as warranted by conditions in the pig-iron trade from the date of acquirement up to July, 1920. The production by years as submitted by the taxpayer is given herewith:

Lawrence furnace production, tons

1914	49,696	1918	39,621
1915	17,189	1919	51,986
1916	45,198	1920[1]	19,407
1917	57,097		

The original claim of the taxpayer for obsolescence in respect to this blast furnace plant was received in this office in December, 1922. In support of the claim a letter in affidavit form, signed by Mr. Carmi Thompson, chairman board of directors, states in part as follows:

"It was operated at a profit during the war period but can not be successfully operated under ordinary conditions. The signing of the armistice indicated that by the end of 1919 this unit would be worthless as an income producing factor so that the plant was known during 1918 and 1919 to be approaching a complete loss in 1920. Operations were permanently discontinued in July, 1920. On account of its small capacity, operations could not be continued on a profitable basis."

In reply to a letter from the commissioner dated September 4, 1923, to the taxpayer requesting further evidence in support of its claim for obsolescence, there was submitted a letter in affidavit form dated October 3, 1923, signed by Mr. Carmi Thompson, which states in part, as follows:

"The determination of the approximate date when the Lawrence furnace began to be obsolete was based upon economic factors. As we have heretofore advised your office, our company operated three fully equipped blast furnaces in separate units. The Lawrence furnace was located 12 miles from the other furnaces and due to this isolated location, it became apparent that a profitable operation of this plant could not be maintained upon diminution of the abnormal demand for our product occasioned by the World War.

"Therefore, upon the formal signing of the armistice and cessation of hostilities, the basic cause of the existing extraordinary demand for pig iron

[1] Blown out in July.

was removed and the officials of this company faced the very definite fact that the Lawrence plant would have to be abandoned. The limited capacity (125 tons per day) of this plant and the increased efficiency of plants of later construction preclude the possibility of operating this furnace on a profitable basis under postwar conditions and such inadequacy was known in 1918."

In the conference herein referred to, held in this office November 12, 1924, the taxpayer's representatives submitted verbally in general terms substantially the same facts as outlined in the above-quoted affidavits in support of their contentions that this claim is properly one of "obsolescence" and not one involving "loss of useful value," allowable only in the year in which the actual abandonment took place. The conferees in charge are of the opinion based on the evidence submitted in the conference and again substantially reviewed by the writer in this report that the claim may be properly allowable as "obsolescence" rather than "loss of useful value."

The beginning of the period during which obsolescence may be allowed as a deduction from income for tax purposes is January 1, 1918, and Income Tax Bulletin F, page 13, defines the end of the obsolescence period as the date when the property ceased to function and was actually discarded. This blast furnace operated continuously up to July, 1920, when it was blown out and discarded. It appears, therefore, that the obsolescence allowable, if any, should be apportioned over the period January 1, 1918, to June 30, 1920.

It was agreed in conference that all disputed points involved in this claim have been satisfactorily explained and such explanations have been accepted by the conferees in charge of this case and the writer submits a recommendation in accordance therewith as shown on the summary attached hereto.

This report supersedes and cancels all previous reports in respect to obsolescence claimed and the allowances herein recommended are in lieu of all prior allowances.

SUMMARY

Cost on which obsolescence is claimed	$256,804.42
Cost on which obsolescence is disallowed	None.
Cost on which obsolescence is allowed (net residual value as herein allowed)	256,804.42
Salvage value plus depreciation to Jan. 1, 1918 ($15,085 plus $63,000.27)	78,085.27
Obsolescence allowed for tax purposes	178,719.15
Obsolescence claimed for tax purposes	178,719.15

It is recommended that obsolescence in the amount of $178,719.15 be allowed the Marting Iron & Steel Co. on property costs indicated above. All costs are subject to check by the auditor or revenue agent assigned to the field investigation of this case.

The obsolescence allowance, $178,719.15 recommended, should be apportioned by the auditor over the period January 1, 1918, to June 30, 1920, in accordance with the regulations, Income Tax Bulletin F.

This report supersedes and cancels all previous reports and the allowances herein recommended are in lieu of all prior allowances.

M. WILLIAM NOLAN, *Engineer.*

Approved:

J. T. KEENAN, *Chief of Section.*

Submitted November 17, 1924.

A. H. WELLENSICK,
Reviewing Engineer.

EXHIBIT F

NOVEMBER 22, 1924.

REPORT BY METALS SECTION, RE MARTING IRON & STEEL CO., IRONTON, OHIO, YEARS 1917 TO 1920, INCLUSIVE, FOR INVESTED CAPITAL

In 1898 H. A. Marting acquired the Aetna furnace situated at Ironton, Ohio. In February, 1899, he organized the Marting Iron & Steel Co., of which he became the principal stockholder and to whom he transferred the furnace. The capital stock issued was $140,000.

The taxpayer claims that as of that date the capital stock was only nominal and that there was a paid-in surplus. To support the claim affidavits have been submitted showing that prior to the furnace being acquired by H. A. Marting trust deeds had been issued against it to a total of $1,100,000 and also that E. S. Harper had offered to pay off the entire amount of the trust deeds and to pay all expenses that had been incurred by H. A. Marting and Marting Iron & Steel Co. if they would deed the property to him. Engineering division recognizes that the property was worth in excess of the $140,000 issued for it but is not in possession of information to determine its exact value. The only figure the division has is the $1,100,000 mentioned in the affidavit.

While engineering division recognizes that there was no value beyond the par value of the stock it makes no recommendation relative to allowing a paid-in surplus, because the allowing or disallowing of the claim is wholly an audit question.

In the year 1912 the Marting Iron & Steel Co. absorbed the Ironton Iron Co. and the Lawrence Furnace Co. The physical assets of the three plants were appraised in September, 1912, and valued as follows:

Marting Iron & Steel Co	$768,000
Ironton Iron Co	675,000
Lawrence Furnace Co	206,700
Total	1,649,700

Stock was then issued to the stockholders of the three plants as follows:

Marting Iron & Steel Co	$628,000
Ironton Iron Co	675,000
Lawrence Furnace Co	206,700
Total	1,509,700

At the time of the transaction the capital of the Marting Iron & Steel Co. was raised from $140,000 to $2,000,000.

Based upon the record of earnings submitted by the Marting Iron & Stee Co. and upon other information placed before it, engineering division considers that the new issue of stock was worth par and that the cost of the two plants acquired was the value placed upon them by the appraisal.

The taxpayer claims that a further payment of $13,300 was made because of liabilities on the part of the Lawrence Furnace Co. unknown to the appraisers. If audit determines that such amount was paid by Marting Iron & Steel it is recommended that it also be allowed.

The capital invested in the Aetna plant can not be determined accurately because the taxpayer can not produce complete records covering the period 1899 to 1912. It is known that the two furnaces that existed in 1899 whose combined capacity was 250 to 275 tons per day had been replaced by one furnace with a daily capacity of 375 tons as of 1912. It appears then that as of 1912 little if any of the 1899 plant remained, that is the 1912 plant represented almost wholly investments made between 1899 and 1912. Since the depreciated value of these investments can not be determined and since the appraisal value as of 1912 is not an unreasonable investment for a plant of that capacity, it is recommended that $768,000 be allowed for capital invested in the Aetna furnace as of September, 1912.

SUMMARY OF INVESTED CAPITAL

It is recommended that the following amounts be allowed as capital invested in physical assets as of 1912:

Aetna plant	$768,000
Ironton Iron Co. plant	675,000
Lawrence Furnace Co. plant	220,000
Total	1,663,000

DEPRECIATION

Engineering division has considered that data submitted by the taxpayer and recommends the following:

For the years 1912 to 1916, inclusive, 4 per cent per annum. (This is an average for all plants. It is recognized that depreciation on individual plants

may have been greater or less. The Lawrence plant was greater.) For the years 1917 to 1920, inclusive, 6 per cent per annum.

Taxpayer set up a reserve for furnace relining at the rate of 50 cents per ton. It is recommended that the charge be allowed.

Taxpayer set up a charge in 1918 of $18,736.11 for incidental expenses, but has not supported the charge from an engineering point of view. Engineering division can not recommend that it be allowed.

W. C. GORDON,
Valuation Engineer.

Approved:

JOHN ALDEN GRIMES,
Chief of Metals Section.

Mr. GREGG. May I ask one question with reference to that case?

Mr. MANSON. Certainly.

Mr. GREGG. In your opinion there was nothing which happened from 1900 to 1920, when this machinery was scrapped, which changed the situation with reference to this particular machinery?

Mr. MANSON. No. I have had that matter carefully investigated. It appears that the 500-ton blast furnace became standard construction about 1900 or between 1895 and 1900. It appears that that is still standard construction. The basis of this obsolescence claim was inadequacy of size for economical operation. Of course there has been a good deal of development in the auxiliaries, but those auxiliaries are applied to old blast furnaces. There is no question but what this furnace was obsolete. There is no doubt that it was obsolete at the time it was acquired.

In this connection I refer to the brief history of the development of the blast furnace which I have previously offered as a part of the record and which can be easily verified.

Mr. GREGG. I am perfectly willing to accept the conclusion of counsel for the committee on that point. May I answer the case now?

The CHAIRMAN. Yes.

Mr. GREGG. In a good many of these cases that have been brought up lately we have been answering by going back a little and explaining how the different practices and questions arise in the bureau and sometimes explaining how the different sections of the act affect these matters, which is necessary to be done in this case.

Under the acts prior to the 1918 act there was no allowance for obsolescence. The allowance was for depreciation, or, in the words of the act, exhaustion, wear and tear of assets used in the trade or business. The method of computing the depreciation is this: The cost of the asset is determined. The estimated future life of the asset is determined; that is, the physical life of the asset is determined. The cost is then ratably spread over the number of years in the estimated future life, and that pro rata part of the cost is deducted as depreciation each year. To make that perfectly clear, assume a taxpayer buys in 1915 for $10,000 a machine the estimated physical life of which is five years. Of course, he does not deduct the $10,000 expended in the year in which he purchased the machine, but deducts each year as depreciation on that machine $2,000.

The CHAIRMAN. Do you mind if I interrupt you?

Mr. GREGG. No, sir.

The CHAIRMAN. Suppose that machine were junked in the third year instead of waiting until the end of the fifth year.

Mr. GREGG. I was just coming to that point. The theoretical computation of depreciation is as I have just given it. It is spread over the life of the machine. Very obviously that does not all work out——

Senator WATSON. Just what is your distinction between depreciation and obsolescence?

Mr. GREGG. I am coming to that in just a moment, if I may do so. Depreciation is based entirely on the physical life. Here it is estimated that this machine will last in use for five years. Therefore the taxpayer is entitled to get back free of taxes the capital which he invested in this machine.

The CHAIRMAN. At the rate of $2,000 a year?

Mr. GREGG. Yes; at the rate of $2,000 a year, so that at the end of five years he has gotten back the $10,000 of capital free of tax. Under the regulations prior to 1918 cases arose where, let us say in the second year, it became apparent at the end of the second year that the machine was then going to be good for only one more year in that business—not that its physical life was limited to the one remaining year, but that it could only economically be used by that taxpayer in his business for another year.

The CHAIRMAN. Because of a better development in the art?

Mr. GREGG. Possibly because of a better development in the art, yes; possibly because of change of business methods on the part of the taxpayer. There are many things which might occasion that. We have no right under the law as counsel brought out, or at least we had no right prior to 1918, to consider that fact, although at the end of the second year it could be definitely determined that at the end of one more year it would be useless. We had to give the taxpayer in the third year his depreciation of $2,000.

Mr. MANSON. But you could give him——

Mr. GREGG (interrupting). I am coming to the loss of useful value. For the three years he would have had the deduction of $6,000 as depreciation. He scraps the machine at that time, which has no salvage value, and he still has $4,000 remaining invested in the machine. When he scraps it he has lost the $4,000. Under the old regulations we gave that loss in the year in which he scrapped it, which was perfectly proper.

It became apparent under that practice that in those cases where it could be determined that the property could not be used by this particular taxpayer in his business for its full physical life, that the taxpayer, instead of getting all of his loss dumped into the last year, should be allowed to spread the remaining capital over the remaining life. For example, suppose an asset cost $10,000 and had a life of 10 years. The taxpayer takes the deduction of $1,000 a year for the first three years. That leaves him $7,000 remaining invested in the machine. It then becomes apparent that it is only going to be useful to him for two more years in his particular business, and then it is going to have to be scrapped, although its physical life is still 10 years. Obsolescence, which came into the act for the first time in 1918, permits the remaining capital of $7,000 to be spread ratably over the remaining two years of the life of the property. He takes in each of those years a deduction of one-half of the $7,000.

The CHAIRMAN. You are using seven years in this example?

Mr. GREGG. Yes. It has become apparent that he can only use it for two more years, although the remaining physical life is seven years. He takes his remaining capital under the obsolescence deduction and spreads it over the remaining life.

Will counsel for the committee agree with that statement?

Mr. MANSON. I will agree if you will qualify it to this extent. If it becomes apparent to the taxpayer that he is not going to be able to use this facility because the facility is obsolete, then it is a proper case for the application of the obsolescence provision of the law. But I do not think that the obsolescence provision of the law was ever intended to cover cases of loss of useful value because the taxpayer no longer had any use for the equipment. I am supported in that by your regulations and the solicitor's opinions. In other words, obsolescence is intended to cover that loss which is due to the development of the art.

Mr. GREGG. I do not think obsolescence is limited to that.

Mr. MANSON. The solicitor has so defined it, and I think if we will go outside to find a definition of obsolescence, either by the courts or in general works on accounting, we will find that the term obsolescence has a technical meaning which means that depreciation which is due to the fact that something better has been developed for that particular purpose.

The CHAIRMAN. It seems to me counsel's contention on that point is correct.

Senator WATSON. I understand that depreciation means natural wear and tear, but obsolescence means a thing has become obsolete and something else better has been discovered. That is the reason why I asked in this particular case for a distinction between depreciation and obsolescence.

Mr. GREGG. The point I was trying to make on that was this. I agree with that entirely, but obsolescence may be due to many factors, while depreciation——

Senator WATSON. Depreciation—suppose a machine wears out?

Mr. GREGG. That is depreciation.

Senator WATSON. And suppose that it is very manifest, or it becomes evident that it will be good for another year. That is not obsolescence; that is depreciation.

Mr. GREGG. Absolutely; and that shows that in the first estimate of the remaining useful life they made an error; but that is not obsolescence.

Senator WATSON. Suppose at the end of two years it is found that another machine that has been invented which will do the work that this machine has been doing, and do it very much better, but he thinks he can run it another year and then be compelled to install the new machine. That is obsolescence?

Mr. GREGG. Yes; that is obsolescence, and exactly the distinction I was trying to make. I am not going to stop to argue with counsel over what constitutes obsolescence, because I do not think it is necessary in this case.

Mr. MANSON. I think the regulations are very fair. In Bulletin F, which is issued for the guidance of the taxpayer, it is stated:

Obsolescence means the gradual reduction in the value of property due to the normal progress of the art in which the property is used or to the property becoming inadequate to the growing needs of the trade or the business. Obsolescence, a gradual lessening of value, must be distinguished from "loss of useful value," which contemplated an abrupt termination of usefulness.

In other words, we have three elements instead of two—depreciation, due to wear and tear, due to the wearing out of the facility; obsolescence, due to the development of something that is better or to the inadequacy of the facility. Loss of useful value, which is still a third sort of loss, which is due to the fact that the taxpayer no longer has any use for a facility which may have a physical life remaining, and which may not be obsolete. There are those three elements.

Mr. GREGG. There are those three elements, but I think you incorrectly defined the last one. From the definition which you have just read of "obsolescence" from the bulletin, it stated that it included loss of value of the property through the progress of the art or through the article becoming inadequate to the taxpayer's trade or business. That is included in obsolescence. I do not think we are at odds on that point. Depreciation is physical wear and tear. Obsolescence is the deduction to take care of the fact that the property, although it may not be physically worn out, can not be economically used by this taxpayer, either due to the growth of his trade or business, or to the progress of the art. Loss of useful value is something we can leave out.

Mr. MANSON. Let me use another illustration. Suppose we have need for 500 kilowatts of power. We put in a 500 kilowatt generator. Two or three years later we need some more power. This 500 kilowatt generator is not obsolete, but the growth of our demand for current is such that if we will abandon it and put in a larger generator we will save money . Now, while that particular piece of machinery can not be said to be obsolete, it is obsolete from the standpoint of the taxpayer.

Mr. GREGG. Absolutely; and that is a proper case of obsolescence.

Mr. MANSON. Yes.

Mr. GREGG. We are absolutely together on the difference between depreciation and obsolescence. I have got to restate it to this point, that it is a proper allowance for obsolescence if it becomes apparent at a given time that a given piece of property will, at the end of a specified period, be no longer useful to this particular taxpayer in his business, either because of the changes or the progress of the art, or because of the growth or change in his business, which makes it useless to him.

Mr. MANSON. I do not accept that definition.

Mr. GREGG. I think that is the example just given.

The CHAIRMAN. I think it is the example given by counsel just now, because I do not agree with counsel that the 500-kilowatt machine is obsolete because a particular taxpayer wants to increase his unit to 5,000 kilowatts.

Mr. GREGG. In answer to that, it seems to me the matter of obsolescence should be looked at from the point of view of the particular taxpayer. Assume, in the case which has been suggested, that at the end of two years it becomes apparent that the 500-kilowatt power

plant can no longer be used economically by this taxpayer and that a larger power plant is what he needs, and he has got to scrap this one. So far as he is concerned, this 500-kilowatt power plant which he has been using has become obsolete.

The CHAIRMAN. What is the attitude of the bureau with respect to the market value of the 500-kilowatt unit, generally speaking, for the industry that did not require the 5,000-kilowatt or larger unit? What I mean is whether the 500-kilowatt unit is not just as valuable in the market?

Senator WATSON. That is to say, it does not become a total loss because the taxpayer has to have a larger unit.

Mr. GREGG. I think that clears up the chairman's point, decidedly. Remember that the value of the property on the market, or the market value of the property, when scrapped by this particular taxpayer is deducted from the capital sum on which he computes his obsolescence. For example, assume in the case given that the 500-kilowatt unit cost $10,000. It has a physical life of five years. It is used for two years, and the taxpayer takes the deduction of $2,000 a year, so he has taken a $4,000 deduction and still has a $6,000 investment. It becomes apparent that he is going to have to scrap it. If the value of it in the market is $4,000, we subtract that $4,000 from the $6,000, because he will get that back, and his entire obsolescence is $2,000.

The CHAIRMAN. That was the practice previously?

Mr. GREGG. Yes.

Mr. MANSON. I think this is the difference between the case of the blast furnace and the case of the electrical unit.

Mr. GREGG. May I come to that next?

Mr. MANSON. I do not want to confuse it with my illustration with regard to the generators. In the case of the blast furnace, a 150-ton blast furnace reached the point where it was not economical for anybody under the conditions. In the case of the 500-kilowatt generator, a 500-kilowatt generator may be more economical for a certain taxpayer's use than a larger generator would be. That depends upon his demands. The difference is this:

Regardless of the taxpayer's demands, if a piece of equipment becomes obsolete, then the obsolescence is due to the changes in the art and not to the taxpayer's situation That is the case with reference to boats. The case I have presented this morning is exactly parallel with the case of the boats relied on by the solicitor. The development of shipping on the Great Lakes was such that the man with the 10,000-ton boat could put out of business the fellow with the 5,000-ton boat. The same thing is true in the production of iron. The man with the 150-ton blast furnace could not compete with the man who had a 500-ton blast furnace.

The CHAIRMAN. At this point I would like to ask Mr. Gregg if he concedes that the case presented this morning is analogous with the boat case referred to in the solicitor's opinion?

Mr. GREGG. No, sir; I do not. I would like to come to this case separately.

The CHAIRMAN. In that case you disagree with counsel?

Mr. GREGG. Yes, sir; and on the case which he took up, too. I thought he had almost conceded that the bureau was right by his power-unit illustration.

Mr. MANSON. The difference there is that in the one case, the case of the power plant, a 500-kilowatt generator is not necessarily obsolete by reason of progress of the art unless you need more power. But in the case of the blast furnace or in the case of the vessel, it is obsolete, because he can not compete with units of larger size. We had had a fine illustration of that in the case of some of the ships built for the Shipping Board, particularly the wooden ships. They were so small that it did not make any difference how good they might be, they could not be economically operated.

Mr. GREGG. We have come to the point, I think, where the committee understands the practices of the bureau on the general matter of obsolescence. When it is determined that a given asset will, after a given date, be no longer fit for economical use by the taxpayer, the remaining capital which has not yet been returned through depreciation, less the salvage value of the property at the end, is spread over the remaining useful life to that taxpayer. Having arrived at that point, let us apply that principle to this case.

Counsel for the committee said that nothing happened from 1900 to 1920 affecting the value of the blast furnace, so we have this situation——

Mr. MANSON (interrupting). I said there was not progress in the art.

Mr. GREGG. That is what I meant to say. We have this situation: This blast furnace was purchased in 1912 by the taxpayer for the sum of $200,000. We must assume, in spite of counsel's statement, that when the taxpayer paid $200,000 for that furnace, it had some value to him and was worth something to him. He paid $200,000 for it in 1912. He took depreciation on the basis of the physical life of the blast furnace until January 1, 1918. It then became apparent that he was going to have to scrap it, although he had been using it from 1912 to 1918. It became apparent that he was going to have to scrap it in 1920.

Senator WATSON. Why?

Mr. GREGG. Because of the fact that it could no longer be economically used by him in his business. Therefore, he took the depreciation which had been previously taken by him from his $200,000. I do not know the figure, but assume the depreciation taken was $60,000. He then estimated the salvage value of the property when he would have to scrap it in 1920. Suppose that was $40,000. Therefore, he would have gotten out of his original investment of $200,000 a scrap value of $40,000, and a depreciation return of $60,000, or $100,000 in all. He therefore still had invested in the property $100,000 which he was entitled to have returned to him free of tax.

The bureau did what seems to me the obviously correct thing, since the law recognizes it. We took the remaining $100,000 which he had invested in the plant and spread it over the remaining life from January 1, 1918, to June 30, 1920, and gave the deduction so that at the time when it was scrapped, on June 30, 1920, the taxpayer had received through salvage, through depreciation up to 1918, and through obsolescence from January 1, 1918, to June 30, 1920, $200,000, or the amount he had invested. He got back his return on invested capital. It seems to me that for once the special conferees gave the right answer.

Mr. MANSON. That does not agree with the ruling in the case of the Great Lakes boats case, does it?

Mr. GREGG. I do not see the conflict between them.

Mr. MANSON. Here is the conflict: You have confused the loss of useful value with obsolescence. It might be profitable for this taxpayer to operate this plant over a period of years. For instance, the price of iron and the supply of iron during the period from 1912 to 1920 might have been such that he could operate this plant and make a profit, even though during all of that time the state of the art was such that by the use of a larger unit he could have made more profit. My point is that the minute that there is a change in the art which produces a facility under which more profit can be made than can be made by the use of a then existing facility the old facility becomes obsolete. You may use it; you may use an obsolete truck; you may use an obsolete automobile for a long period of time after it becomes obsolete. The time finally comes when you have to scrap it.

The regulations here are very clear and very sound. The regulations say, and the rulings, that from the time it appears that the thing is obsolete you shall begin to charge off.

My point is that in the case of the boats the minute that they developed the 10,000-ton steamer and changed the docks so that the 10,000-ton steamer could be operated more economically than the 5,000-ton steamer the old boats became obsolete, and that obsolescence, according to the rule laid down by the solicitor, should be spread over the period of time that the 10,000-ton boat was developed until the time the 5,000-ton boat was abandoned.

In the case of the blast furnace, it was somewhere between 1895 and 1900 that the 500-ton blast furnace was developed and accepted as the most economical unit. From that time until the time that this 150-ton furnace was blown out, in 1920, that company was operating an obsolete facility, and the obsolescence or loss due to the obsolescence, under the regulations, was properly spread over that entire period.

The view accepted by the special conferees and expressed by Mr. Gregg here is that it is not until you reach the point where you know that you are going to abandon that thing that the obsolescence begins to run, and therefore all of this obsolescence which had accrued from 1910 up to 1918, is dumped onto the high tax years of 1918 and 1919, and a part of 1920.

I can see no distinction whatever between the boats and the blast furnaces. In both cases it was found profitable to operate them after they became obsolete.

The very regulations contemplate that facilities are going to be operated after they become obsolete, because they provide that the obsolescence loss shall be spread over the period from the time they become obsolete until their use is abandoned.

The CHAIRMAN. That distinction is perfectly clear to me, Mr. Gregg.

Mr. GREGG. It is not to me.

Senator KING. Let me say that I do not quite agree with the definition of "obsolete." We usually attribute to the word "obsolete" the meaning that it ceases to be usable.

Senator WATSON. We were discussing that phase of it before you came in, Senator.

Senator KING. That is all right, then.

The CHAIRMAN. The regulations do not put that interpretation on it.

Senator KING. Take the case of ships. Many of them do not have a Diesel engine, and you might say that sailing vessels as compared with steam vessels are obsolete, measured by this standard that you have been applying here.

Mr. MANSON. Yes.

Senator KING. And yet the sailing vessels serve a very useful purpose to-day. They are operated far more economically per ton carried, in some instances, than are the other vessels. The Diesel engines have not put them out of the running, and the other engines will be employed for years and years, and yet by the standard that you have accepted here they would be obsolete.

The CHAIRMAN. The standard that you spoke about, Senator, is not the standard which the decision of the solicitor, as just read by counsel, adopts.

Senator WATSON. I think the whole thing depends on the distinction between "depreciation" and "obsolescence." He says that obsolescence was spread over the whole period from 1895——

Mr. MANSON. I say it should be.

Senator WATSON (continuing). To 1920. I do not see how you can do that. You can spread depreciation over that period, because each year it would depreciate in its value for effective use. But it may be that the word "obsolescence" has a meaning in a tax sense that it does not have in any other sense.

Mr. MANSON. I am accepting the meaning as defined by the regulations here.

Mr. GREGG. May I answer that point, Senator?

Senator WATSON. Yes.

Mr. GREGG. Let us look at this specifically for a minute, before going into generalities.

The contention of counsel for the committee is that this article was obsolete when purchased by this taxpayer in 1912 for $200,000. We have to accept this; it had some value to this particular taxpayer.

Senator WATSON. To him it was not obsolete.

Mr. GREGG. To him it was not obsolete at that time. That is it exactly. He was spending $200,000 for it.

Mr. MANSON. You might buy an obsolete automobile.

Senator WATSON. But to the purchaser it is not obsolete.

Senator KING. I do not agree with you that it is not obsolete.

Mr. GREGG. May I finish my statement?

The CHAIRMAN. Yes.

Mr. GREGG. Look at the purpose of the obsolescence and depreciation deductions, the two of them together. The idea is that when a taxpayer expends money for acquiring assets, those assets are going to produce income while they are used in his business, and the capital which he expended for the assets should be returned to him and taken as a deduction against income which that facility is producing while it is producing income. In other words, he has to get back as a deduction what he expended for that asset over the period that the asset is used by him.

Just to bear that out, I would like to read the definition of "obsolescence" contained in the regulations.

This is article 166, regulations 65:

With respect to——

Mr. MANSON. That regulation has just been adopted.

Mr. GREGG. It is under exactly the same law. It is verbatim:

With respect to physical property, the whole or any portion of which is clearly shown by the taxpayer as being affected by economic conditions that will result in its being abandoned at a future date prior to the end of its normal useful life, so that depreciation deductions alone are insufficient to return the cost (or other basis) at the end of its economic term of usefulness, a reasonable deduction for obsolescence, in addition to depreciation, may be allowed in accordance with the facts, etc.

Prior to 1918 this taxpayer took a deduction for actual physical wear and tear, and from then on it became apparent that although this taxpayer paid $200,000 for the best blast furnace in 1912, and although it would not be physically worn out for several years to come, nevertheless, in the middle of 1920, it would be necessary for him, due to conditions in the business, to abandon it prior to the expiration of its normal useful life, to quote the regulations. Therefore, the department did what seems to me the proper thing. They took the remaining capital that he had invested, subtracted from it the salvage value, and spread it over that period, in accordance with the regulations.

The CHAIRMAN. I think that is true in connection with those regulations that you have just read, but it is certainly not true in connection with the ruling of the solicitor on the question, on the basis of what counsel read into the record a while ago.

Mr. GREGG. Let me make this distinction between the two cases, Mr. Chairman.

There something happened while the asset was owned by the particular taxpayer to make it obsolete and to lessen materially its useful life to him.

In the case we have under consideration the events which counsel contends made this blast furnace obsolete happened before this taxpayer ever purchased his article, and therefore when he purchased it he purchased an obsolete article for $200,000 on the theory that it would be valuable to him in his trade or in his business, because he used it up to 1920; but when the time came that it became no longer useful to him in his trade or business, then obsolescence began.

Senator WATSON. Yes.

The CHAIRMAN. The opinion of the solicitor as read by counsel makes no reference to the fact that the owner owned that during the period when the art changed. Under the regulations, as read, a person might have bought the boat under the same conditions or under the same circumstances that this taxpayer bought the blast furnace.

Mr. GREGG. May I answer you there?

Mr. MANSON. Certainly, and——

Mr. GREGG. May I answer that, Mr. Chairman, as the inquiry was put to me?

The two cases stand, I think, on absolutely different grounds, for this reason, although it may not be brought out in the opinion of the

solicitor: In the boat case, the cost which the taxpayer was put to for the boat was decreased due to these events which happened which made it become obsolete at a later date. In the blast furnace case——

The CHAIRMAN. That is the point that I do not admit—that the solicitor's opinion shows that this became obsolete at a later date.

Mr. GREGG. It may not show it, but if it does not, it is unsound; it is not based on that assumption, because in this case when the taxpayer bought it, under the contention of counsel, it was already, as a general matter, obsolete.

The CHAIRMAN. Yes.

Mr. GREGG. But, obviously, it was not obsolete. In his business it was useful to him, or he would not have paid $200,000 for it; so he continues to have his spread of depreciation until it appears even to him that he is going to have to abandon it prior to the expiration of its useful life.

Senator WATSON. Wherein will that differ from the boat case?

Mr. MANSON. It strikes me that Mr. Gregg, for the purpose of defending the bureau's action in this particular case, is arguing against a sound policy which has been adopted by the bureau in the differentiation between the loss of useful life, which is the loss which is sustained by a taxpayer when he abandons the property, and obsolescence, which is the loss defined by the regulations to be that gradually accruing loss that begins to run when the art changes and that terminates when the thing is abandoned.

Senator WATSON. Are there any more cases in which this thing is involved?

Mr. MANSON. I do not know yet, and I stated here in the opening that I believed this to be an exceptional case, but from Mr. Gregg's strenuous defense of it I am beginning to believe that, instead of the bureau following this sound policy laid down by the solicitor's opinion, they have abandoned that policy and have gone over to a very unsound policy.

Mr. GREGG. I think the policy in that respect is perfectly sound, and I do not think it is in conflict with the solicitor's opinion. I think if you will keep in mind always the purposes of the two allowances the whole thing is made clear. The two allowances are to return to the taxpayer his investment in the property over its life, over the period of its use by him. In this case, that was done through a combination of obsolescence and depreciation after the obsolescence became apparent.

In the boat case——

Mr. MANSON. Does not obsolescence become apparent as soon as there is a change in the art, which you know at some future time is going to compel you to abandon that facility?

Mr. GREGG. Not obsolescence to the person who purchases it after that happens, because he purchases it with that in mind. He purchases an article for use in his own particular business. To him it must have had some use. It could not be obsolete or he would not have purchased it.

Mr. MANSON. I know, but he gets a reduction in price by reason of that.

Mr. GREGG. That is all right.

Mr. MANSON. A man may buy something that, because of the existence of a better thing at the time he buys it, he knows is going to have a shorter life than it would have if it was the last word in the facilities along that line.

Mr. GREGG. That is perfectly true, but that——

Mr. MANSON. Then the regulation is very clear, and the opinion of the solicitor is very clear, that as soon as the change in the art takes place from that minute the obsolescence begins to run and begins to accrue.

Mr. GREGG. There is no argument but that obsolescence accrued to the previous owner when the change in the art occurred, but to this one who purchased it after that event it was not obsolete to him or he would not have purchased it.

Now, something else must have happened to make it become obsolete to him. That may happen either through some additional change in the art or through the ascertainment of the fact that at a definite future date it is going to be no longer economically useful to this particular taxpayer. That is what happened in this case, and that is what distinguishes it from the boat case. This case would be comparable to the boat case if we were considering the person from whom this particular taxpayer purchased the property, considering his condition back in 1895 or 1900, when these developments in the art occurred.

Mr. MANSON. Taking that view of this thing, here are two owners of boats, one of whom bought a 5,000-ton boat prior to 1910. The other bought his 5,000-ton boat after 1910. According to your statement, the man who suffers the loss because he bought a 5,000-ton boat prior to 1910 must spread his loss over the full period from 1910 up to the time that he abandons the boat, while the man who bought subsequent to 1910 can charge off his entire loss in the high-tax years of 1918, 1919, and 1920.

The point is that in both instances the boats, from the standpoint of their usefulness for transportation purposes and profitableness for the purposes of transportation, are in identically the same position.

Mr. GREGG. That is the point that I do not concede. Let us take that case to see where it leads us. I think we have gone a little far afield in the argument, but let us take it.

Assume that A owned one of those Great Lakes boats before the development made it obsolete. When it became obsolete its obsolescence was spread over the remaining life that that boat would be useful to him. He determines that to be three years, for example, in his particular business. All right. He should spread his remaining capital over those three years; but after that happens another person comes in who does not want to use the boat, possibly, for the same thing. He wants to use it for some short freight haul, say, where it can be profitably used. He purchases it. Of course, he purchases it at a reduced price, because the value of that boat is lessened. Now, he uses it for, say, three or four or five years less than its actual physical life; but it then becomes apparent that even in the work that he is using it for it is no longer economically useful. Then obsolescence starts to him on his reduced cost, and I think that is perfectly sound.

Mr. MANSON. That is when the loss of useful life starts. That is a third element that you have here, recognized by the regulations.

Mr. GREGG. The regulation that I read absolutely justifies this.

Mr. MANSON. The regulation you read was not adopted until long after this case was decided. I read to you the regulation under which this case was decided.

Mr. GREGG. The regulations are under the same statute.

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

Senator WATSON. Yes; have you anything fresh?

Senator KING. Mr. Gregg or Mr. Nash, I will be very glad, for my own benefit, for a little further explanation of this proposition later. I have just asked my secretary to look up your income-tax returns or your statistics for income for 1922.

Mr. GREGG. Yes, sir.

Senator KING. I find that you allowed in that year deductions, just on corporations, for depreciation, amortization, obsolescence, and depletion of $2,889,067,298, and you allowed for interest—a deduction, you see—$3,069,112,305. Then, you further allowed $501,780,287 on account of alleged losses sustained by these same corporations for the preceding year; so that there were deducted from their earnings that stupendous sum of more than $6,400,000,000, and they paid taxes on $4,200,000,000, plus. That is what first attracted my attention to this subject.

Mr. GREGG. I do not see what the information is that you want, Senator.

Senator KING. How is it that there can be such enormous allowances for interest and deductions, measured by the amount which finally becomes subject to taxation?

Mr. GREGG. I think we can explain that now just as well as we can after study of the matter.

Senator KING. It seems to me that there must be allowances or deductions, depletion, amortization, and interest that are entirely disproportionate to the amount upon which taxes are paid, and that if the law permits that, and you have administered it properly—and I am not saying that you have not—the law ought to be amended. It seems to me that it is unjust to the Government to permit such enormous deductions for those purposes.

Mr. GREGG. Well, Senator, I do not see how you can possibly reach any conclusion from a gross total of that sort.

Senator WATSON. You have to take each case.

Mr. GREGG. I do not see how it proves anything. Take the matter of interest. The way we compute that is perfectly simple. The interest which corporations pay on their borrowed money is deductible. That is the biggest item there, of approximately $3,000,000,000.

Senator KING. Some of these corporations put capital in, and some do not. The latter borrow money to put it into the business, and then you allow them upon capital investment deductions for interest.

Mr. GREGG. Yes, sir; that is in the law. We can answer that just as well now as we can after going over it. The law allows deductions of interest on borrowed money. That is the biggest single item you have there. In other words, there is more than $3,000,000,000 paid by corporations as interest on money borrowed by them.

The CHAIRMAN. No; I think that is a mistake.

Senator WATSON. Yes; that is not right.

Senator KING. $3,000,000,000 on interest and $501,000,000 were allowed for alleged losses in the preceding year.

Mr. GREGG. Well, net losses from one year are carried over to the subsequent year.

Senator KING. That is to say, they have allowed by way of interest, obsolescence, depreciation, and depletion, but still there was over $501,000,000 carried over to the next year to be subtracted from their earnings before you computed the taxes.

Mr. GREGG. The law allows net losses to be carried over to the subsequent year. That is in the law, and there was considerable discussion as to whether that should be done.

The CHAIRMAN. For my own information I would like to know about this: Suppose a corporation puts in a million dollars in capital or elects to borrow a million dollars. Does it get any deduction for the capital investment, the same as it does for the money borrowed?

Mr. GREGG. No, sir.

The CHAIRMAN. So it is advantageous, then, for these corporations to borrow money rather than——

Mr. GREGG. To issue stock.

The CHAIRMAN (continuing). To issue stock; yes.

Mr. GREGG. Yes, sir.

The CHAIRMAN. I think that is wrong.

Senator KING. And I insisted, when we had the tax bill up for consideration, to strike out the interest in cases of that kind.

The CHAIRMAN. I think it is unfair to the man who puts a million dollars of capital in as against the man who borrows a million dollars.

Mr. GREGG. There is a little offsetting fact there. Interest is allowed as a deduction to the corporation, but it is subject to normal stock in the hands of the stockholders. The dividends of a corporation on stock are not allowed as a deduction by the corporation, but they are not subject to the normal tax in the hands of the stockholders. It is not quite a wash transaction.

Senator KING. Suppose Senator Watson puts $1,000,000 into a business to make it a going concern, and that Senator Couzens puts $500,000 into his business and then he borrows $500,000. In that event Senator Couzens would get the deduction on the capital that he borrows?

Mr. GREGG. Yes, sir.

Senator KING. An interest deduction?

Mr. GREGG. Yes, sir.

Senator KING. Have you any other case ready, Mr. Manson?

Senator WATSON. I remember that we discussed that matter at some length, Senator King.

Senator KING. Of course, if we were to abolish these things that are the subject of so much controversy we could cut the rate of taxation in half. Is that your judgment, Mr. Gregg?

Mr. GREGG. If you levied the tax on the gross income, possibly you could certainly cut the rate.

The CHAIRMAN. It would save a lot of difficulty in all of these cases.

Senator KING. No; I mean just the profits from operation.

Mr. GREGG. I do not think that the Congress that did that would be very popular all over the country.

Senator KING. No; I do not mean gross income, but profits from operation.

Mr. GREGG. I do not know whether you would take into consideration interest payments or all the losses.

Senator KING. No; I mean deducting those losses, wages, operating expenses, etc.

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

Mr. MANSON. Yes; and I will make this one as brief as I can.

This has to do with the allowance for depletion and leasehold of the Houston Coal & Coke Co.

The facts are quite simple.

The Houston Coal & Coke Co. had an old lease under which they were paying a royalty of 10 cents per ton. It has been agreed between the coal valuation section and the Pocahontas operators that the prevailing royalty in 1913 was 17.9 cents per ton. This lease was valued by the coal valuation section by capitalizing the difference between the 10 cents a ton and 17.9 cents per ton; in other words, a difference of 7.9 cents, reducing that to its present value, and upon that they got a depletion rate of 4.966 cents per ton.

That valuation was set aside by the chief of the section, Mr. Tait, and a value was arrived at by capitalizing the prospective earnings of the company, reducing them to a present value, which gave a depletion rate of 21.3 cents per ton.

The Houston Coal & Coke Co. was one of several affiliated companies, and just for the purpose of comparison, before discussing the merits of this proposition, I would call attention to the fact that while they got on this basis 21.3 cents per ton, the Keystone Coal & Coke Co., an affiliated company, got 3.4 cents, the Thatcher Coal & Coke Co. got 2.4 cents, and the Houston Colleries Co., under its Maitland lease, got 2 cents.

Senator WATSON. By way of depletion?

Mr. MANSON. By way of depletion.

I call attention to those allowances to show how completely out of line this allowance is with the other allowances given to the affiliated companies of the same concern.

The CHAIRMAN. Almost ten times as much.

Mr. MANSON. Yes. In the first place, I maintain that the value of a lease can not exceed the difference between the royalty rate paid on that lease and what you could get another lease for. In other words, if they were buying coal under this lease at a royalty of 10 cents per ton and coal could be produced for 17.9 cents per ton, the value of that lease could not exceed the value of the difference of 7.9 cents per ton, which gave a depletion rate, as I say, of nearly 5 cents.

In making this valuation, the valuation allowed here, there are included profits that are made out of the selling ability of the taxpayer, and out of their entire business organization, which is in no way affected by the depletion of a lease which can be replaced at a slightly higher royalty rate, and the value can not exceed that difference.

I would call attention also in this case to the fact that this property had reached a point where all that was left was pillars of coal in the mine, and yet in valuing the remaining term of that lease it was assumed that the profits from operation to the company would remain constant right up to the very termination of operation, while it is an established fact that is not open to dispute that when a coal mine once reaches that point its profits taper off to the conclusion of the term.

The CHAIRMAN. Over how long a period did the profits of this lease extend?

Mr. MANSON. Twelve years.

The CHAIRMAN. In spite of the fact that there were only the pillars left?

Mr. MANSON. That was the state of the mine at the time.

The principal objection to this is the valuation of the entire anticipated profits of the company, as distinguished from the valuation of the lease itself, which could have been replaced at a definite price.

The CHAIRMAN. Who settled this case—what conferees?

Mr. MANSON. It was settled by the chief of the section.

Mr. PARKER. It was settled by Mr. Tait, no longer an employee.

Senator KING. And that would make, of course, a greater difference in the amount of the tax, relatively.

Mr. MANSON. Oh, yes; it makes a difference in the depletion rate of slightly less than 5 cents and 21 cents.

The CHAIRMAN. Have you computed what difference that made in the tax?

Senator KING. On that little property?

Mr. MANSON. $24,727.21 for the year 1918 only.

Senator WATSON. Do you know anything about this case, Mr. Gregg?

Mr. GREGG. No, sir; I will have to look it up.

Senator KING. Is that case settled?

Mr. MANSON. Is this case closed?

Mr. PARKER. It is closed, as I understand it.

The CHAIRMAN. But it has not been closed for subsequent years?

Mr. PARKER. No.

The CHAIRMAN. So that it may be open for settlement as to subsequent years?

Mr. MANSON. Oh, yes; this same depletion rate is being applied to subsequent years.

The CHAIRMAN. I think the bureau ought to take notice of this incorrect basis and change it for subsequent years, even though it can not be reopened for the old years.

Mr. GREGG. We will go into it.

The CHAIRMAN. Of course, I appreciate the fact that you can not open it for old years now, since you have established a new policy.

Senator KING. Mr. Manson, have your associates had sufficient time to make examinations of other coal companies to ascertain whether there is that same great disparity in the allowances for depletion as has been exhibited in this case?

Mr. MANSON. I do not think it is a general rule. I would say that the work of the coal valuation section, under its present administration, is on a pretty sound basis.

In connection with this case, I wish to submit the report of the investigating engineer, as follows:

This case is one where a rate of depletion was allowed without gathering the data required by regulations. It never went to appeal as the chief of the coal valuation section settled the valuation in conference with the taxpayer, and is an instance of what can happen when depletion rates are based on present earnings and no reckoning is made of probable future state of the industry or company, nor any contrast made to the situation of any other company in like situation in the industry. The review of the case was apparently perfunctory.

The original rate of depletion was undoubtedly low and the taxpayer consequently took it higher up, when the pendulum swung the other way and too high a rate was allowed on insufficient information.

The law and the regulations call for the use of information whose gathering requires a large amount of effort and engineering and statistical work. It is outside of this particular case and worthy of note that the organization of the Income Tax Bureau has not specifically included provision for gathering or dissemination of this information. In the meantime a best guess requiring large experience has to be used.

History of company (memorandum, March 7, 1921, IT:SA:NR:C LWA): The Houston Coal & Coke Co. is a lessee organized 1887 and operating on a lease of 1,069 acres of coal lands at 10 cents per gross ton royalty from the Crozier Coal Land Association. The capital stock of the company is $300,000. * * *

The coal is the Pocahontas No. 3 seam from 6½ to 7½ feet thick.

Nothing was paid for this lease.

(From brief of taxpayer: No date, but from associated papers assumed date April 8, 1919:)

"The company was incorporated August 8, 1887, under the laws of the State of West Virginia for the purpose of mining coal, making coke, as well as the marketing of both products. The mine operated by the company is located at Elkhorn, McDowell County, W. Va. (on the Norfolk & Western Railroad).

"The company was originally incorporated by Charles D. Houston, David F. Houston, and E. J. Houston, with a paid-in capital of $30,000. On July 26, 1889, this capital was increased to $100,000, and on October 29, 1901, it was increased to $300,000. In addition to these increases, the investment was also increased by the amount of earned surplus from year to year. The ownership of the company subsequently passed into the possession of T. E. Houston and H. H. Houston, the two sons of Mr. C. B. Houston, who have owned and operated it continuously since the death of their father.

"From the above facts it can plainly be seen that this company is decidedly a family affair."

History of case: July 3, 1920, the Houston Coal & Coke Co., through Lewis, Murphy & Co., filed a brief requesting relief for their 1917 taxes under section 210 of the act of 1917.

November 1, 1920, the resident auditor submitted a memorandum suggesting that the case be sent to the natural resources division for the determination of the items of depreciation and depletion.

November 18, 1920, the Houston Coal & Coke Co. was requested to file Form E that an audit might be made of their returns.

January 11, 1921, a letter from chief of section (G. M. S. Tait) to the Houston Coal & Coke Co. suggested that the taxpayer "arrange to send a representative to interview the coal valuation section of the Bureau of Internal Revenue in order that you may benefit from any deductions to which you are entitled."

The taxpayer accepted this invitation as disclosed by memorandum of taxpayer's conference and by copies of letters.

March 7, 1921, there is a memorandum, IT:SA:NR:C, Louis W. Atkinson, valuation engineer, approved by chief of section, G. M. S. Tait, setting forth the calculations for depletion and comments upon valuation of the Houston Coal & Coke Co. and its subsidiaries. The calculations for the Houston Coal & Coke Co. were later crossed out with a pen. The depletion which was here calculated was $0.04966 per ton. (Exhibit A.) Except for the Houston Collieries Co., one of the subsidiaries, the depletion rates here calculated are still in force.

Various taxpayers' conferences followed.

Until there appears another memorandum by another valuation engineer, F. L. Clemens, allowing a depletion rate of 21.5 cents a ton of coal produced by the Houston Coal & Coke Co. This memorandum was approved June 2, 1921, by Godfrey M. S. Tait, chief of coal valuation section; was initialed R. A. S.; and was stamped approved, June 4, 1921, head, natural resources subdivision. (Exhibit B.)

Depletion for a bituminous coal mine at the rate of 21.3 cents per ton of coal produced is high on the face of it.

The Houston Coal & Coke Co. is the parent company with five subsidiary companies, three of whom are companies operating mines and for whom depletion was calculated.

These subsidiary companies have a comparative situation to the parent company and yet the rate of their depletion allowance is not at all comparable to that enjoyed by the parent company. The allowances are as follows:

	Depletion allowance
The Houston Coal & Coke Co. (parent)	$0.213
The Houston Coal Co. (nonoperating).	
The Keystone Coal & Coke Co	.03409
The Thacker Fuel Co. (nonoperating).	
The Thacker Coal & Coke Co	.0243
The Houston Collieries Co.:	
Maitland lease	.02
Carswell lease	.0047
Laurel Creek	.0007

(NOTE.—Depletion allowed, objection taken to depletion and new value of lease returned under amortization.)

In relative order of rates of depletion, the companies come in order with the Houston Collieries lowest and the Houston Coal & Coke Co. enjoying the highest rate. The actual order of rates is ($0.0007, $0.0047, $0.02, $0.0243, $0.03409, $0.213). The rate of the highest is over six times larger than the next highest.

The order of rates is quite in contrast to the claims of the taxpayer. In a brief filed May 6, 1924, nearly three years after the memorandum of June 2, 1921, the taxpayer asserts, "The Houston Coal & Coke Co. owned one of these leaseholds. The Keystone Coal & Coke Co. owned a still more valuable leasehold. The Houston Collieries Co. owned a larger and probably a still more valuable leasehold." The taxpayer here values his leases in reverse order to the rates of depletion; and though the leasehold of the Keystone Coal & Coke Co. is stated to be more valuable than the Houston Coal & Coke Co., its depletion rate is less than one-sixth of the latter.

In the original calculations of the rate of depletion which resulted in an allowance of $0.04966 per ton the valuation engineer arrived at this figure by only considering the present value of the annual savings due to the differential between the actual royalty paid by the taxpayer and the common royalty on such coal as of March 1, 1913. The taxpayer, possessing an old lease, was paying only 10 cents per gross ton, whereas the common royalty on March 1, 1913, was 17.9 cents. The valuation of this difference of 7.9 cents gave a depletion rate of 4.966 cents. The increase amounted to 16.344 cents.

The figure for the common royalty of 17.9 cents was an amount which had been agreed upon by the coal valuation section and the Pocahontas operators as representing the prevailing royalty rates in 1913. It is a figure on which 90 per cent of the Pocahontas cases have been settled, according to a statement of the chief of the coal valuation section.

Regulations 45 (sec. 206 b, p. 80) promulgated January 28, 1921, and governing at the time the memorandum of June 2, 1921, was made, specifies that certain "essential factors must be determined for each deposit." The memorandum of June 2, 1921, discloses that a number of these factors were not determined, while other facts for which a determination was made are probably incorrect. There is no record of the expected percentage of recovery, the unit operating cost, nor the expected selling price per unit, as called for by regulations. In calculating the life of the mine the past average output was divided into the total tons in place. The life of a mine does not end squarely. Full output can not be maintained until the date the mine is finished. Cost, and consequently profits, are dependent upon output. As the life of a coal mine is dragged out, output declines and costs mount and profits decrease.

The calculation of the probable profits as set forth in the memorandum of June 2, 1921, would seem to be an exaggeration and not to represent the value as would be calculated by a willing buyer.

In this case depletion was calculated contrary to the method recommended in the regulations and, in addition, without taking into account factors which the regulations state "must be determined."

EXHIBIT A

MARCH 7, 1921.

Houston Coal & Coke Co., 19751143 (parent); McDowell Co., W. Va., consolidated with Houston Coal Co., 19751145; Houston Collieries Co., 19751144; Keystone Coal & Coke Co., 19751155; Thacker Fuel Co., 19501019; Thacker Coal & Coke Co., 19751221, lessees.

COMMENT ON VALUATION

1. The question involved in the depletion rate on the recoverable coal en bloc as of March 1, 1913.

2. The claims and deductions of the several companies are given below and treated separately as follows:

3. Houston Coal Co. is the selling agent for the coal and coke produced by the affiliated companies and, having no depletable assets, is not considered in this valuation.

* * * * * * *

HOUSTON COLLIERIES CO.

This corporation operates two leaseholds with shaft mines, one known as the Maitland lease of 1,150 acres, acquired prior to 1913 from the Watson Coal Co., without other payment than 9 cents per gross ton on coal as mined.

The seam operated on this lease is the Pocahontas No. 4, averaging 5 feet thick with a 190-foot shaft. In and prior to 1913 the prevailing royalty rate in this section was not over 10 cents per ton, and it is believed that * * *.

EXHIBIT B

Houston Coal & Coke Co., McDowell County, W. Va., lessee.

COMMENT ON VALUATION

1. Valuation is required as of March 1, 1913, for depletion purposes.

2. This corporation acquired its leaseholds prior to March 1, 1913. The recoverable coal remaining on that date is estimated to have been 4,031,500 tons.

3. The following figures show operating conditions and results for years 1911–1914, inclusive, and are used as a basis for determination of value as of March 1, 1913:

Average annual production----------tons--	359,150
Average annual operating profit----------	$167,988.40
Average investment in plant and equipment----------	$308,341.97
Average life of depreciable assets----------years--	10
Total replacement cost 12 years, life of mine----------	$61,668.40
Annual replacement cost----------	$5,139.03
Net annual realization----------	$162,849.37
Total realization 12 years' life----------	$1,954,182.44
$1,984,182.44 discounted at 8 per cent for 12 years----------	$1,227,226.57
Less average investment in plant and equipment----------	$308,341.97
Value reflected for 4,309,800 tons coal----------	$918,884.60
Value reflected for 1 ton coal----------cents--	21.3

4. It is therefore recommended that the March 1, 1913, value of coal be placed at 21.3 cents per ton and that depletion be allowed at that rate after January 1, 1918.

F. L. CLEMENS,
Valuation Engineer.

Approved.

GODFREY M. S. TAIT,
Chief, Coal Valuation Section.

JUNE 2, 1921.

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The CHAIRMAN. I suppose that is all you have this morning, Mr. Manson?

Mr. MANSON. Yes, sir; that is all I have this morning.

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

Mr. GREGG. No, sir.

The CHAIRMAN. Have you, Mr. Nash?

Mr. NASH. No, sir.

The CHAIRMAN. We will adjourn, then, until 10 o'clock on Monday morning.

(Whereupon, at 11.40 o'clock a. m., the committee adjourned until Monday, March 23, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, MARCH 25, 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 call of the chairman.

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

Present also: Mr. L. C. Manson, counsel for the committee; Mr. L. H. Parker, chief engineer for the committee; Mr. Raleigh C. Thomas, investigating engineer for the committee; Mr. J. M. Robbins, assistant engineer 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. R. Marrs, attorney, Office of Solicitor of Internal Revenue; and Mr. W. S. Tandrow, appraisal engineer, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. I am going to present for consideration some features of the amortization allowance of the J. I. Case Threshing Machine Co.

In order to bring out the real significance of this case I deem it important to call attention to some of the proceedings which have already been had before this committee. It will be recalled that when we were considering the United States Steel case, counsel for the committee took exception to the method of determining the amortization allowance of the United States Steel Co. upon the ground that instead of determining the usefulness of the war facilities to the taxpayer, what was determined was the use made of all the facilities including the war facilities, and it was then assumed that the war facilities had no greater value in use to the taxpayer than the percentage of the use of all the facilities, thus ignoring the element of life, the element of efficiency, and the salvage value of the facility. At that time I called to the attention of the committee a ruling by the Solicitor of Internal Revenue construing the amortization statute, in which ruling the solicitor held, among other things, that to determine the amortization allowance under this law it was necessary to determine the usefulness of the particular facility upon which amortization was claimed to the taxpayer, and that if it was found that the taxpayer had 100 per cent use for that facility he was entitled to no amortization upon that facility regardless of what other facilities he might have.

The same question was raised in the case of the Aluminum Co. of America. The same question applies to all of the amortization cases which have come to the attention of the committee.

In the United States Steel case Mr. Hartson presented a reply, the answer of the bureau. I wish to direct particular attention of the committee at this time to the fact that that reply did not represent Mr. Hartson's personal views solely, but that it was a prepared written document presented as the answer of the bureau, and that in that answer it was conceded that the determination of amortization in that case was not in accordance with the solicitor's ruling, but that because of the expense involved and because of the time it would take, it was impossible to determine amortization in accordance with the method laid down in the solicitor's ruling.

The case to which I direct the attention of the committee this morning is the case which called forth that ruling of the solicitor, the ruling referred to in the United States Steel case, in the Berwin-White case and in the Aluminum Co. case.

Before going into this case there are some facts which stand out to which I wish to direct the attention of the committee. In the matter of the J. I. Case Co. they presented their claim for amortization. In presenting their claim they based the amount they claimed upon the use of all of their facilities determined upon the man-hour basis of employment. As I called to the committee's attention in the Steel case, there is no essential difference in principle between a determination based upon the number of hours men were employed and a determination based upon production, because man hours of employment are readily translated into production, so that the principle upon which these two claims were based is identically the same.

An allowance was made upon that basis wherein all of the facilities of the plant were considered to have the same value in use. This case came to the solicitor. The solicitor held that such a determination was contrary to the law. The commissioner ordered a redetermination of amortization. The same engineer who had made the original determination made the redetermination.

Senator KING. You are speaking now of the J. I. Case case?

Mr. MANSON. Yes. He made a redetermination and his report shows that he made that redetermination in accordance with the solicitor's opinion. It took him five days. He determined the particular use of each of the facilities upon which amortization was claimed. Having determined amortization in accordance with the opinion of the official legal adviser of the department, in accordance with the only published interpretation ever given to the amortization provision of the law, the taxpayer made a protest, the determination made in accordance with the solicitor's opinion was junked. and a redetermination was made which eliminates some of the objectionable features to which the solicitor called attention, but which still determines amortization by considering all of the facilities of the taxpayer, both old and new, as having the same value in use, which lumps them all together for determination in this last determination instead of by the whole plant. But the principle is identically the same. There is a lumping together of the old facility which is 10 per cent worn out and 50 per cent worn out and 90 per cent worn out, with the new facility which was installed during the

war, and the value in use of the new facility is correspondingly decreased.

This case is important for this reason, not only for what was done in making the allowance to the taxpayer very much in excess of the allowance based upon the solicitor's opinion but it is important for the reason that it throws considerable doubt upon the sincerity of the department's answer in the steel case and in the aluminum case wherein they claimed that they can not make proper determination of amortization for the reason that it costs too much. In this case the expense had already been incurred. In this case the work had already been done. After the expense had been incurred to make a determination in strict accordance with the solicitor's ruling, that determination was rejected.

When the taxpayer made his protest against that determination, the gravamen of the protest was that the solicitor's opinion was unsound—not that the engineer had erred in determining that this machine had been in continuous use or that machine had been in continuous use, not that the engineer had erred in these particulars, but that the whole theory upon which the allowance was made in accordance with the solicitor's opinion was unsound. But there was no reference to the solicitor. The solicitor was not called upon to reconsider his ruling. The solicitor did not reconsider his ruling. That ruling stands to-day as the day it was made, the only ruling there is upon the subject.

Senator KING. Then the tax was settled, if settled up to date, upon a basis different from the ruling of the solicitor?

Mr. MANSON. It was. It has not been finally settled; that is, amortization has been finally determined. The case is still in audit in the bureau. As far as the amortization feature is concerned it has passed out of the engineering section.

Senator KING. And that deduction for amortization you contend is in violation of the opinion of the solicitor and in contravention of the law, and allows entirely too much?

Mr. MANSON. It does; but I call attention to the fact that the ruling of the solicitor which, as I have said, is the only ruling by the bureau to which publication has ever been given, has not been followed in the particular case in which it was made, although a redetermination of amortization in accordance with the ruling was ordered. That is why this case, in my opinion, is most important from the standpoint of the principles involved, the most important amortization case which has been brought to the attention of the committee, although the amount of actual cash and in actual tax is nowhere near as great as in some other cases to which the attention of the committee has been directed.

Senator KING. In your opinion, is the ruling of the solicitor in conformity to the law, and is it sound?

Mr. MANSON. It is absolutely sound.

Senator KING. Is it just to the taxpayer and just to the Government?

Mr. MANSON. It is absolutely sound. It is just to the taxpayer, and it is just to the Government. I have discussed that ruling and the grounds upon which it is based many times in the presentation of the United States Steel Co. case and of the Aluminum Co. of

America case and of the Berwin-White case. I have gone into the soundness of the ruling and have discussed it upon its merits. I take the position at this time that the public, the Congress, the taxpayers generally have a right to know what yardstick is used in measuring these deductions from income. It will be recalled that at the time the resolution to continue this investigation was before the Finance Committee the chairman of the committee made a statement in which he asserted that it was only through the making of such an investigation as is being made that Congress had the opportunity to ascertain how the income tax law is being construed and applied. At that time Mr. Gregg called attention to the published rulings of the department as refuting the position of the chairman and took the position that the public had, through these published rulings, all of the information that was necessary for the purpose of determining how the law is interpreted, how deductions may be measured, and how the law is applied in particular cases.

I call attention to the fact that this ruling was made in August, 1923. It was never published until November, 1924. There is a period of over a year that this ruling was supposed to be in force. If the solicitor occupies any useful position whatever, if Congress has accomplished anything by the establishment of his office, this ruling should have been in force and should have been followed.

The CHAIRMAN. And should have been published?

Mr. MANSON. Yes; it should have been published; but during that entire period of time the ruling was not published.

The CHAIRMAN. Just at that point let me ask another question. You say the ruling was made in August, 1923.

Mr. MANSON. Yes; August 19, 1923.

The CHAIRMAN. What was the procedure in the department prior to that ruling?

Senator KING. On the question of amortization?

The CHAIRMAN. Yes; that is what we are discussing.

Mr. MANSON. I am just coming to that.

Senator KING. And when you answer that also answer, if you can from your investigation, whether after that ruling, the amortization feature of which had been settled prior to that time, a rechecking of the case which had been settled was made with a view to ascertaining whether that conformed to the ruling or not, and also whether you have investigated sufficiently to determine whether the ruling has been followed since or whether it has been ignored, or at least departed from, in the J. I. Case case.

Mr. MANSON. When I was before the Finance Committee Senator Reed of Pennsylvania asked me whether I knew of any cases in which amortization had been determined since this ruling was made which did not conform to the ruling. I told him that I did not. In making that reply to Senator Reed of Pennsylvania I assumed that this ruling had been published within reasonable length of time after it had been promulgated. I had no knowledge of how cases in which amortization had been determined between November, 1924, and the present time had been determined. When I learned that the ruling had been made away back in August, 1923, which fact did not come to my attention until after the hearings before the Finance Committee, I caused an investigation to be initiated to determine whether any attention had been paid to the

ruling since August, 1923. Of course, it is impossible to review all of the cases. I instructed the engineers to start in with the cases in which the amortization allowance exceeded $500,000 and to review them only to the extent necessary to determine the basis upon which the allowance had been made, whether it had been made in accordance with the ruling or whether it had been made in accordance with the practice followed in the United States Steel case and other cases. We so far have been unable to locate any such case determined in that period of time in which the ruling has been followed.

Senator KING. That is to say, in the cases you have discussed it has not been applied?

Mr. MANSON. Yes. I do not mean to say that our work is completed along that line by any means, but I say up to the present time we have located no case in which it has been followed.

It will be recalled that when Mr. Hartson read into the record the answer of the bureau in the United States Steel case I asked him whether the ruling was followed in cases in which it was practical to do so. I called the committee's attention again to the fact that the answer of the bureau was that it was impractical to follow the ruling because of the expense. Mr. Hartson's answer was that it was being followed where practical.

The CHAIRMAN. I may say at this point that I think the committee would invite the bureau to tell us of any cases where it was followed so as to offset what appears to be the conclusion of counsel.

Mr. MANSON. At that time Mr. Hartson read into the record—I am not sure whether it was at the time Mr. Hartson presented the United States Steel case or the Aluminum case, but upon one of those two occasions he read into the record a communication signed by a man by the name of De La Mater, addressed to the solicitor, and protesting against the ruling. That communication stated that the redetermination would be made in the J. I. Case case in accordance with the ruling. I assumed, until the J. I. Case case was investigated, that the ruling had been followed at least in the case which gave rise to it. I now find that although this was a small case and although in this case they had already made the engineering investigation in accordance with the ruling and had already incurred the expense and had already done everything necessary for the purpose of determining amortization and had determined amortization in accordance with the ruling, that yet it was again redetermined upon the basis I have described of generally considering all of the facilities of the taxpayer as being of equal value in use regardless of the fact that some facilities may have twice as long to live and therefore twice as great usefulness to the taxpayer as other similar facilities.

The CHAIRMAN. In this case and like cases it is the opinion of counsel that that is absolutely wrong?

Mr. MANSON. Oh, yes; it is absolutely wrong. I am frank to say that I am now "up in the air" as to whether it has been followed at all. I doubt very much whether the ruling has been followed at all, although I can not assert that. I have not found a case in which it has been followed and I assume from the fact that it was not followed even in the case in which it was made, even after they had incurred the expense of making the kind of investigation that was

necessary to apply it to, that they certainly have not followed it in any other case.

In the J. I. Case Threshing Machine Co. amortization allowance the second revised claim of the taxpayer was filed in June, 1922, in which amortization was claimed amounting to $468,884.72. An allowance was made in October, 1922, amounting to $259,268. That is the determination which went to the solicitor. Upon the redetermination in accordance with the solicitor's ruling it was found that the taxpayer's amortization computed in accordance with the solicitor's ruling was $131,992.13.

The taxpayer then filed another claim amounting to $486,778.51, or at least a revised claim upon which an allowance of $350,879.95 was made. I take it that the difference between those two allowances represents the difference between the application of the formulas to which your counsel has repeatedly urged objections and the application of the method of determining amortization laid down by the ruling of the solicitor, although it has been repeatedly asserted by the bureau before this committee that the results to be arrived at by the use of the formula applied in the Steel case, and, with certain modifications, in all of these cases are approximately the same as the results which would be arrived at if the solicitor's ruling were followed.

In that connection I desire to call the attention of the committee to the fact that in the United States Steel case there was an investigation made which did conform to the ruling of the solicitor and the facilities upon which amortization was allowed and to which allowances your staff took exception were found upon that investigation by the bureau's engineers to be 100 per cent in use; so that in the United States Steel case the failure to follow the ruling about doubled the allowance upon the particular items. In this case it more than doubles the allowance. The allowance in this case is almost three times what the allowance was determined to be when the engineers of the bureau made their investigation in accordance with the ruling of the solicitor. The difference in the tax in this case amounts to $174,000.

Senator KING. Is that for just one year?

Mr. MANSON. It is spread over two years—1918 and 1919. This is an amortization allowance.

The CHAIRMAN. Let me ask Mr. Gregg if they will reexamine this case to see whether it is too late to collect the tax?

Mr. GREGG. We will look into the case; yes.

Mr. MANSON. All of the pertinent details are set forth in the report of our engineers, which covers the matter as follows:

> We are submitting Exhibit A which contains a complete memorandum of the engineering staff on this case. The amortization claim of this taxpayer was selected for study because it was the one which called forth the solicitor's only published ruling covering the method of determining amortization on August 19, 1923, although it was 15 months later on November 3, 1924, that this ruling was published and made available to all taxpayers. This ruling has been continually quoted and read into the record in the presentation of our other amortization cases. It is also shown in Exhibit B, which is likewise submitted, as rendered in this particular case.
>
> We had not originally intended to present this taxpayer's claim in detail to the committee, but investigation shows that it reveals an astounding condition in the amortization section, and it becomes, therefore, of an interest

reaching far beyond this individual case, in that it brings out the general condition existing in amortization determinations.

The following amounts of amortization are involved in this case:

Taxpayer's original claim as per return	$251,677.57
Allowed by engineers	
Revised claim, April, 1921	751,653.78
Allowed by engineers	
Second revised claim, June, 1922	468,884.72
Allowed by engineers October, 1922	259,268.00
Allowed by engineers on basis of solicitor's ruling January 2, 1924	131,992.13
Taxpayer's final claim based on his brief of April, 1924	486,778.51
Final allowance by engineers August, 1924	350,879.95
Estimated proper maximum allowance (committee's engineers)	131,992.13
Approximate difference in tax	174,000.00

We shall attempt to show from the record in this case the following:

(1) That after the solicitor's ruling setting forth in detail sound principles for the determination of amortization, a determination of amortization based on said principles was made following an actual field examination of five days. This determination was in practical accordance with the solicitor's memorandum, and while values in use were not always mathematically determined they were determined after careful investigation and were substantially correct if reasonable exercise of judgment is conceded to the engineer.

(2) That taxpayer having protested this determination, a revised determination was made in the amortization section, which did not agree with the solicitor's rulings and that the case is now closed in the section and is in audit on this basis. In other words, the section has seen fit to disregard the interpretation of the meaning of the law on this question by the solicitor, and has, by means of camouflaging its original methods somewhat, really gone back and determined amortization in this case practically under the same method originally used and specifically condemned by the solicitor in the very case on which the ruling was made specifically to apply. This redetermination nearly triples the proper allowance made on the basis of the solicitor's ruling.

(3) From this evidence and a general survey of engineering reports made since August 19, 1923, as well as verbal statements by the engineers of the unit, we believe that the ruling of the solicitor, obviously sound in its general principles, is consistently and wilfully disregarded by the amortization section.

The J. I. Case Threshing Machine Co. was incorporated in 1880 and is engaged in the manufacture of threshing machines, steam engines, gasoline tractors, and agricultural machinery. It has two principal works—the main works, which produce mainly threshers and steam engines, and the south works, which produce mainly oil and gas tractors.

The claims for amortization and reports on same are fully described in your engineers' memorandum under Exhibit A, which is submitted herewith; a brief résumé of same will be found substantially as follows:

The original claim for amortization by the taxpayer was included in his 1918 tax return, and was determined by simply charging off 20 per cent of the cost of the facilities installed during the war as amortization. This claim was disallowed by the unit's engineer in August, 1920, as he found the facilities of the taxpayer to be 100 per cent in use at this time.

In April, 1921, taxpayer submitted a revised claim for amortization based on lowered value in use. This claim was disallowed in separate reports by Engineers Reel and Bowling on the basis that facilities had been in full use in 1919 and 1920 and that amortization could not be granted on the basis of a temporary business depression as probably existed at that time.

Under date of June 14, 1922, taxpayer made a second revised claim based on lowered replacement costs and lowered value in use. The unit's engineer allowed $259,268 of this claim of $468,884.72. The method of arriving at replacement costs will not be criticized here. The method used in arriving at value in use of the main works facilities was based on a comparison of the monthly average of man-hour worked for six months in 1918 with the monthly average of man-hours worked in the post-war period down to June, 1922. This basis was specifically condemned in solicitor's memorandum dated August 19, 1923. The same basis was also used for the south works.

Following the solicitor's ruling, shown in its entirety in Exhibit B, submitted, a field examination lasting five days was made of the taxpayer's war facilities. The engineer, while exercising a proper judgment in absence in some cases of absolutely definite facts, arrived at a determination practically in accord with the solicitor's ruling. The engineer took account of the prima facie evidence given by the taxpayer in the purchase of facilities similar to those installed during the war in post-war years. The gross plant expenditures of taxpayer are given at this point to show that disallowance of value in use on this point must have been considerable:

Plant additions, Apr. 6 to Dec. 31, 1917	$197,244.00
Plant additions, Jan. 1 to Nov. 11, 1918	810,082.00
Plant additions, Nov. 12, 1918, to Dec. 31, 1919	873,155.02
Plant additions, year 1920	1,690,083.95

Under Exhibit F, submitted, are shown extracts from the engineer's report, dated January 2, 1924, which shows that he took into account not only the above feature but also practically all the features covered in the solicitor's memorandum.

In April, 1924, the taxpayer submitted a brief protesting the above determination, pertinent quotations are made from this brief on pages 21 and 22 of Exhibit A, herewith submitted. The main contention of taxpayer is an attempt to contradict the ruling of the solicitor. The intent of this protest is to claim that the purchase of facilities in 1919 and 1920 of a like or similar nature to those installed during the war does not show that the taxpayer needed these facilities in his post-war business. The taxpayer admits he did purchase similar facilities. By the statement, "It is apparent that the solicitor's office has overlooked * * * conditions which we are advised have been recognized by the department," it is obvious that the taxpayer is still contending for the average methods of production or man-hours the uses of which the solicitor as well as counsel and engineers for the committee have condemned. It must not be overlooked that the main point of attack in the taxpayer's brief is on the solicitor's memorandum. The only criticism of the engineer's determination was a very vague statement on method of arriving at post-war replacement cost and an unsubstantiated claim that his figures for value in use were arbitrary.

On August 22, 1924, engineer for the unit made a revised determination of taxpayer's amortization without a field examination. This determination raised the allowance from $131,992.13 to $350,879.95. The method employed is described fully in Exhibit E, submitted. Briefly, it allows amortization on basis of man-hours worked during the war, cutting out overtime, compared with an estimate of normal postwar hours. This latter estimate is arrived at through an average of actual hours worked in 1923 and adjusted hours for 1921 and 1922, this adjustment being made by applying a ratio determined by a comparison of the number of men employed in 1921 and 1922 with the number of men employed in 1914 and 1915. In other words, to all practical purposes the engineer has used a modification of the very method the solicitor condemned in his ruling.

From the foregoing statement and from Exhibits A to F it is clearly shown that taxpayer had full use of his war facilities in the years 1919 and 1920. it is further provided that he made enormous expenditures for plant expansion in 1919 and 1920 of the same character as made in 1917 and 1918. His total war expenditures were $1,007,326, while his postwar expenditures in 1919 and 1920 amounted to $2,563,238.97, or over double the war costs.

We contend that the engineer made a determination in practical accordance with the solicitor's memorandum after a field survey and found an amount of amortization allowable of $131,992.13. Even this determination was high in the opinion of your staff, as it disregarded the fact that in the case of certain items full use of said items was necessary in 1919 and 1920 and according to our views should not have had a lowered value in use. However, as this point is not covered by solicitor's memorandum we pass it over here as of relatively small importance in this particular case.

We condemn in the strongest terms the action of the amortization section in allowing a subsequent office determination of this claim to be made directly contrary to the solicitor's ruling. This last determination ignores, as we have shown in previous cases, the salvage value of the items, the relative value of the new war equipment, and the wornout or at least partly wornout pre-war equipment, and also the fact that the taxpayer's postwar

expenditures furnish prima facie evidence that his facilities purchased during the war were not amortizable on the basis of lowered value in use.

We submit that the solicitor's ruling in this case was a very proper one. It did not attempt to hand down an arbitrary figure fixing the amortization but properly left that to the engineers, but it did, and correctly so, properly interpret the law on the case and lay down principles which should be used in the determination of amortization in order that such determinations might be legal and just.

We condemn the general policy of the amortization section in ignoring this solicitor's ruling, and we suggest that some method of administration be devised that a proper check may be had on the activities of individual sections to keep them within the legal bounds laid down by the law, regulations, and legal advise of the bureau.

We point out also that the taxpayer's brief of April, 1924, based mainly on objections to the solicitor's ruling in this particular case, should not have been given any consideration by the amortization section, but that this matter should have been referred to the solicitor. In other words, we condemn the engineers for usurping the functions of the legal department, as we would condemn the legal department for usurping the functions of the engineers.

Before closing this case, we wish to call attention to one more fact which is a general criticism of this section as well. In the determination of post-war replacement cost, the unit established a tentative (so marked) list of ratios purporting to show the difference in pre-war and post-war prices. (See Exhibit G, submitted.) While we will later prepare a detailed report on these ratios, we wish at this point to call attention to the fact that study should have been made on this matter and the tentative supplanted by a final list of ratios on or soon after March 3, 1924, the legal date for limiting facts in reference to amortization. Over one year has now elapsed since that date, and the tentative list first used in May, 1922, is still in use although it is known to be inaccurate.

Senator KING. Who were the engineers who made the reappraisal to which you referred?

Mr. MANSON. It was the same engineer who made the original determination, Mr. Wellensiek.

The CHAIRMAN. Almost the same amount of plant additions were made from November 12, 1918, to December 31, 1918, as when put in the plant during the war period?

Mr. MANSON. Yes; almost.

Senator KING. Why do you call them war-plant facilities? I suppose their business called for an expansion of their plant?

Mr. MANSON. Yes. This taxpayer engaged in no special war business. This taxpayer continued to manufacture identically the same things during the war period that it manufactured before the war and has manufactured since the war. There was a considerable enlargement in its activities in the manufacture of tractors, but there was no special equipment designed for the purpose of manufacturing something for which the taxpayer had a war demand only. There was no equipment installed that was not an increase in the general manufacturing capacity of the taxpayer along the same lines.

I call attention to the fact that while expenditures during the war period for plant extension were approximately a million dollars, the expenditures during the two years succeeding the war were approximately $2,500,000 for plant extensions.

I made a statement in connection with the consideration of the United States Steel case which I wish to repeat here. I took the position in the steel case, and I wish to take the same position now, that it strikes me as being manifest that the judgment of the responsible officers of the corporation as to what facilities they need in their

business is far better than the judgment that any engineer of the income-tax unit can possibly have, no matter with what formula he may be armed.

Senator WATSON. Who disputes that?

Mr. MANSON. In effect the whole policy of the bureau disputes it, for the reason that in all of these cases where the management of these corporations have since the war supplemented their facilities they installed during the war by the installation of additional facilities, which I say is conclusive that in their judgment they not only needed what they already had but even more, and that any taxpayer who installed subsequent to the war additional units of the same kind as those installed during the war is certainly estopped from asserting that he does not need the facilities which he installed during the war for his peace-time business.

The CHAIRMAN. And therefore under no possible conception could he be entitled to amortization.

Mr. MANSON. That is correct; therefore under no possible conception could he be entitled to amortization.

Senator KING. And yet the bureau engineers have proceeded upon the theory that these are so-called war facilities, though units of the same character have been constructed after the war and have assumed to state that they were not needed or at least they were subject to amortization and have allowed amortization?

Mr. MANSON. Yes.

Senator WATSON. Would it make any difference whether the facilities constructed during the war were continued in use after the war?

Mr. MANSON. I do not think so.

Senator WATSON. Even though they had abandoned them and built new ones?

Mr. MANSON. If it is a special facility that is not useful in peace-time business, that is a different thing. I do not question that.

Senator WATSON. I understand that.

Mr. MANSON. I have had reference only to amortization allowances upon special facilities which were not useful to the taxpayer in his peace-time business. The point I am making is that if during the war a taxpayer installs a 15,000 kilowatt capacity electric generator and subsequent to the war installs another one, that the taxpayer is certainly estopped from asserting that he does not need the one which he installed during the war.

Senator WATSON. Even though he does not use it?

Mr. MANSON. Even though he does not use it, because if he has an increased capacity it is not due to war investment, but it is due to increase in capacity which had been brought about by the installation of additional facilities since the war.

Senator WATSON. But suppose he does not use the one installed during the war and it is not really a question of additional capacity. There would have to be some other reason for it—that it was of a different character or type, for instance?

Mr. MANSON. Then, of course, it is not fit for use and comes under another head entirely.

Senator WATSON. That is what I am trying to get you to do—to differentiate. That is a broad statement you are making.

Mr. MANSON. I do differentiate in this, and I say now that I have at no time taken exception to any allowance which has been made

by the bureau upon facilities installed during the war which were found to be of a type or for a use which was peculiar to war conditions.

To repeat briefly, the taxpayer admits that he did purchase similar facilities. By the statement, "It is apparent that the solicitor's office has overlooked conditions which we are advised have been recognized by the department," it is obvious that the taxpayer is still contending for the average methods of production or man-hours, the uses of which the solicitor as well as counsel and engineers for the committee have condemned. It must not be overlooked that the main point of attack in the taxpayer's brief is on the solicitor's memorandum. The only criticism of the engineer's determination was a very vague statement on the method of arriving at post-war replacement costs and an unsubstantiated claim that his figures for value in use were arbitrary.

At this point I wish to call attention specifically to the report of this engineer made subsequent to the solicitor's opinion, that is, the one that was made when the redetermination in accordance with the solicitor's opinion was ordered. I will call attention now to certain portions of that report which are pertinent for the purpose of showing the character of investigation made and of showing the character of investigation required to be made to conform to the opinion, and for the purpose of showing that there is no foundation for the position repeatedly taken here by the bureau that the kind of investigation called for by the solicitor's opinion can not be made within a reasonable cost. I call attention now to the engineer's report.

The CHAIRMAN. What is the engineer's name?

Mr. MANSON. Wellensiek.

The CHAIRMAN. The same one, is it?

Mr. MANSON. Yes. He said:

In accordance with instruction from the commissioner a reinvestigation of the above case was made at the office and plant of the taxpayer October 21 to 25, 1923, by the undersigned engineer.

This investigation and report has been made to conform as closely as possible with the solicitor's memorandum regarding this case.

Under the heading "For postwar replacement cost" the engineer then discusses the difference between the war cost and the replacement cost, which I will pass over. Then under the heading "Solicitor's memorandum":

The present reinvestigation and reconsideration of the claim of the above taxpayer is made to comply with the solicitor's memorandum to the deputy commissioner, dated August 21, 1923, which deals specifically with this case.

The solicitor's criticism deals only with that portion of the amortization allowed on the basis of value in use. Objections are made to—

1. Applying the ratio of postwar activities to wartime activities of the entire plant to specific facilities or units in the plant as a measure of usefulness.

2. Not considering overtime hours during war period.

3. Allowing amortization on war facilities when reduction of value in terms of use was apparently caused by the overexpansion in postwar years.

It will be noted in Table IV that the capital expenditures in 1917 and 1918 together represent little more than might be expected to be expended for replacements in a plant of the size indicated which has been in operation for a great many years.

The additional facilities installed in each year were used on the average only approximately six months during that year. It is evident, therefore, in

view of the production records and pay-roll hours that the pre-war facilities were used far more during the war period than normally used.

The present reinvestigation was made, furthermore, in conformity with the solocitor's memorandum. The engineer made special inquiry with regard to each item or group of items shown in the schedule. Interviews were held with superintendents and foremen in direct charge of the facilities in the plant and with men in charge of the cost department to which the engineer was directed for detailed information with regard to production, etc.

According to the information secured from these men the war facilities, with the exception of specific items to be considered separately, are in actual and economic use and will be used in postwar years to the capacity ordinarily expected or for which designed. They are needed in the business to this extent. The excess capacity, except with regard to those specific items disclosed in the following paragraphs, is found to be due principally to post-war additions.

No amortization is accordingly allowed on the basis of value in use except on those items specifically mentioned in the following paragraphs. These specific facilities will probably not be used in the postwar period to the extent such facilities are ordinarily employed or they are not needed in the taxpayer's business. Their use value is not effected by similar postwar additions.

The taxpayer does not claim to have totally discarded any of the war facilities. The war facilities comprise only a small portion of its excess equipment. To sell all excess equipment would, according to the taxpayer's statement, bring a very small cash return and would result in a heavy loss in case its volume of business should increase to a point where this equipment would be required.

Operation as a war facility ceased on the date of the armistice, November 11, 1918. Expenditures showing a later date are excluded from consideration in connection with the claim.

For the purpose of showing the character of investigation that was made and the character and kind of investigation that is required to be made to determine amortization in accordance with sound principles I will quote some extracts from the report dealing with specific items:

The engineer requested and received a list of all plant facilities constructed or installed during the fiscal years ending October 1 from 1919 to 1923, inclusive. This list is filed with the papers in the case. It shows account numbers, a brief description of each facility, and location in the plant. In the case of items received prior to the armistice, November 11, 1918, the actual date received is given.

The engineer has compared the above-mentioned list with those items in the taxpayer's amortization schedule which, according to statements of superintendents and officials, are excess facilities and not needed or not employed to ordinary capacity.

In the above-mentioned comparison it was found that in most cases where there is excess equipment of a certain class that this excess is due entirely to post-war additions. In other cases it is partially due to post-war additions.

In comparing electric motors, for instance, it was found that the post-war additions to motor equipment exceed the idle or excess motors. No amortization is accordingly allowable on motors except on the basis of replacement cost.

The conditions with respect to minor equipment and patterns are similar to a large extent to that of electric motors. Most of the excess is due evidently to post-war additions. While a portion of this class of equipment may be obsolete or not usable for postwar work, it is impossible to determine from the information at hand how much of this is properly amortizable on the basis of value in use. This portion of the claim is accordingly disallowed for the reason that it is not clearly set forth as required in article 189, Regulations 62.

In regard to facilities classified under construction, it is found that the post-war construction exceeds the excess construction now claimed. The same condition holds for the remainder of the classifications. There are some items, however, of construction and other facilities which are idle or not usable to ordinary capacity because of improper design, size, or location. These will be disclosed in the following paragraphs.

He then takes up the items which he finds require special consideration, as follows:

Item No. 1. No amortization is allowed. This item is a 1917 expenditure on which no reduction in value is shown on the basis of replacement cost nor is there shown a reduction in value based on value in use.

Items 2 and 3. These are post-war additions.

Items 4, 5, and 6. In regular use. Amortization is allowed on basis of replacement cost only.

Items 22 and 30. Amortization is allowed on 1918 expenditures on the basis of replacement cost only. No amortization is allowed on 1917 and 1919 expenditures. There is similar equipment in the list of post-war additions.

Item 117. This item offers a portion of total minor equipment erroneously allocated to building F–8 in 1918. Amortization is allowed on basis of replacement cost only.

I am not going to read all the way through that report. I believe I have gone far enough to show that in making that determination the engineer determined in the first place whether they had more of any particular kind of facilities than they required, and if they did have more whether that excess was due to postwar conditions or to war investment, and he determined the use which was being made of those particular facilities. It strikes me as being manifest that the only way we can determine whether the taxpayer has lost money because he has made a plant investment is to determine the use he can get out of that plant investment—not the use he can get out of some other plant investment, but of that particular plant investment. In conclusion on that case I wish to repeat that in view of the fact that in this particular case, after the solicitor's ruling made applicable to this case and condemning this system of averaging all facilities, after they had made the investigation required to be made and had spent the money for that purpose, it does not seem to me that the bureau can be heard to say that the reason why they did not follow the solicitor's ruling is that it is impractical because it is too expensive. In this case they had already incurred the expense.

I now formally offer Exhibits A, B, C, D, E, F, and G of the engineer's report.

(The exhibits submitted by Mr. Manson in the J. I. Case Threshing Machine Co. case are as follows:)

EXHIBIT A

SENATE COMMITTEE INVESTIGATING BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT,
March 24, 1925.

To: Mr. L. H. Parker, chief engineer.
From: Mr. J. M. Robbins, assistant engineer.
Subject: Amortization.
Taxpayer: The J. I. Case Threshing Machine Co., Racine, Wis.

Figures involved	Costs	Amortization
Original claim in 1918 return	$1,145,007.83	$251,677.57
Revised claim submitted April, 1921	1,138,869.35	751,653.78
Second revised claim submitted June 14, 1922	1,217,654.04	468,884.72
Allowance (engineer's report of Oct. 1, 1922)	1,032,545.99	259,268.00
Redetermination ordered by commissioner: Allowance (engineer's report of Jan. 2, 1924)	688,760.75	131,992.13
Present claim, resulting after taxpayer's protest	1,217,654.04	486,778.51
Final allowance		350,879.95
Estimated proper maximum allowance		131,992.13
Approximate difference in tax		174,000.00

SYNOPSIS OF CASE

From an examination of the records in the case, it appears—

1. That the Income Tax Unit has allowed this taxpayer amortization on its war-time facilities and upon facilities installed subsequent to the end of the amortization period but contracted for during the war, and that these facilities were not only 100 per cent in use for a considerable period of time subsequent to the war, but were totally insufficient to take care of the post-war business of the taxpayer. Inasmuch as these facilities and facilities subsequently installed were necessary to enable the taxpayer to enjoy the enormous business prosperity of the years 1919 and 1920, it is held that these war-time costs are not amortizable, except as to the difference between war and postwar costs. It is recognized that the taxpayer expanded its plant facilities to an abnormal extent and that when the slump came in the fall of 1920 it was left with a plant much more extensive than was justified by its business needs, but it is held that this abnormal expansion and the subsequent lowered value in use are the result of faulty judgment of business conditions rather than to expansion deemed necessary to the prosecution of the war.

HISTORY OF CASE—GENERAL

The J. I. Case Threshing Machine Co. was incorporated February 25, 1880, under the laws of the State of Wisconsin, for the purpose of manufacturing threshing machines, steam engines, gasoline tractors, plows, automobiles, and other agricultural machinery.

The taxpayer's plants located in Racine, Wis., may be separated into three distinct groups—main works, south works, and motor works. Inasmuch as no amortization was claimed on the facilities located in motor works, no further mention of this plant will be made in this report. On pages 11 and 12 of taxpayer's schedule, the following information appears relative to the articles produced at the main works and the south works.

"*Main works.*—The principal products produced at the main works are threshers and steam engines. On the basis of sales this constitutes approximately 61 per cent of the production of this plant. The balance comprises in the main feeders, stackers, and thresher and engine attachments, which are necessary attachments, and the sales of which are normally proportionate to the sales of the two main lines. In other words, a thresher sale will ordinarily include the sale of a feeder and stacker, so that a fair measure of the activity at this plant would be the production statistics of engines and threshers. This plant also produces baling presses, rock machinery, and some road machinery, but the volume of this business is so small that it can be disregarded in the preparation of this report. There are no separate departments for the production of these last-named products, and the factor of increased demand during the war period was so inconsequential as to obviate any necessity for plant additions.

"*South works.*—The south works is primarily a tractor plant, the main product being gas and oil tractors. A few tractor parts are made at the main works and motor works, but this will in no way affect the consideration of the activity of this plant. At the south works will also be found a large gray iron foundry which produces nearly all the castings for the company."

During the war period the business of this taxpayer increased very materially, it's war-time products being identical with the normal lines, though the production of different types of machinery expanded in far different proportions. The gasoline-tractor line especially expanded out of all proportion to the remainder of the business.

The period of war expansion commenced in the year 1915, and from that time on the taxpayer sold large quantities of tractors to the British, French, Italian, and Greek Governments. None of its products were sold directly to any of the departments of the United States Government.

The taxpayer claimed that amortization was properly allowable on its plant facilities inasmuch as it produced articles contributing to the prosecution of the war, such as tractors, threshers, and their accessories. It claimed that those products were required to offset the shortage of farm laborers as well as horses and mules in maintaining the high production rate of foodstuffs necessary during the war. In view of the fact that the taxpayer was given priority freight ratings on its products, and from certain other data submitted by the taxpayer, it appears that the Government recognized that the taxpayer's

products contributed to the prosecution of the war, and in this respect, at least its plant facilities are subject to amortization.

On account of the increased demands for its products during the war period, the taxpayer constructed extensive additions and installed a large amount of additional machinery and equipment. The South Works, due to the large increase in manufacture of gasoline tractors, was expanded to extremely abnormal proportions.

Following the armistice the taxpayer's sales did not fall off, but, in fact, they increased to an extent unknown even during the war, and the taxpayer continued to add during the years 1919 and 1920 productive facilities greatly in excess of those added during the war. It was not until September, 1920, that the demand for the taxpayer's products fell off to any marked extent. The production during the years 1921 and 1922 was very low, but since the latter year the production figures have increased and are beginning to approach the pre-war level.

The following tabulation, taken from Schedule A–18, filed with the 1918 tax return, indicates the extent of the war-time and postwar additions:

Book value of manufacturing plants		$6,173,448.44
Additions:		
Apr. 6 to Dec. 31, 1917	$197,244.00	
Jan. 1 to Nov. 11, 1918	810,082.00	
		1,007,326.00
Nov. 12, 1918, to Dec. 31, 1919	873,155.02	
Year 1920	1,690,083.95	
		2,563,238.97

ORIGINAL CLAIM AND REPORT

In its original 1918 tax return the taxpayer claimed amortization in the sum of $251.677.57 on facilities costing $1,157,101.98. The taxpayer admitted at the time that his facilities were in full use and that the replacement cost of such facilities was even greater than the war-time cost of the same. He felt, however, that normal postwar replacement costs would be considerably less than the actual war-time cost of his facilities and filed claim for amortization in the amount of 20 per cent of the original cost except on the item of machine tools, where a deduction of 25 per cent was claimed. His sole purpose was to reduce prices to what would probably constitute normal postwar values.

Under date of August 21, 1920, a report on this case was submitted by an engineer of the Income Tax Unit, in which the claim was disallowed in its entirety. The engineer found that at the time of his investigation the war-time facilities of the company were in full use; that these facilities had not been sufficient to take care of postwar business; and that consequently the taxpayer had made extensive additions since the armistice; and that the replacement cost of the facilities was equal to, if not greater than, the original cost. In view of these general conditions then obtaining, he had no recourse but to disallow the claim.

FIRST REVISED CLAIM AND REPORTS

In September, 1920, the business of the taxpayer, which, owing to the high price of wheat and other foodstuffs, had become in the years subsequent to the war, enormously inflated, fell off sharply, due to the economic reaction and depression which began about that time and which continued through the year 1921. Under these conditions the war-time and postwar facilities became far in excess of the demands of those required by business conditions.

In view of the decreased value in use of its plant facilities, the taxpayer conferred with the Income Tax Unit's engineer and was advised to submit a formal application for a redetermination based upon the new conditions. As a result the taxpayer filed a revised claim in April, 1921. In this schedule the taxpayer claimed amortization of $635,147.45, deductible from 1918 income, and $116,506.33, deductible from 1919 income, on plant facilities costing $1,138,669.35.

The taxpayer based its claim upon a lowered value in use, arriving at a value in use of 34 per cent by a rather abstruse computation, which is indicated on pages 3 to 5 of Engineer Reel's report.

Under dates of June 24, 1921, and July 1, 1921, the separate reports on this claim were submitted by Engineers Reel and Bowling, of the Income Tax

Unit. Both of these reports disallow the claim of the taxpayer in full. In regard to the reasons for disallowing this claim, the following is quoted from Engineer Reel's report.

"The attending circumstances as compared with other taxpayers claiming amortization should be clearly noted. In the first place the taxpayer has not deviated in any way from its regular business.

"The facilities which it has acquired are in no way special to war work but are useful in the regular business of the company.

"This taxpayer kept right at its usual business, and as a consequence did not lose its regular customers and business affiliations since its efforts were along customary lines and not devoted to new and strange undertakings, and hence it did not find itself isolated after the signing of the armistice, but on the contrary the year 1919 was the greatest in its history.

"The taxpayer had the advantage of Government preferences and priorities in the conduct of a profitable and enormously expanded business during the war. After the war the business instead of letting up continued to expand and there was no serious break until September, 1920. Had the business of the company continued as in August, 1920, the situation would have been as reported by Mr. Wheeler at that time. While the present business of the company is momentarily slightly less than that of 1917 the very exceptional year of 1919 must not be lost sight of. The present business depression is perhaps only momentary, and certainly 1921 has not progressed sufficiently far to warrant any such amortization deduction as the taxpayer now claims.

"Ordinary common sense and judgment must control, and while it would be inequitable to deny a taxpayer amortization simply because at the exact moment of the engineer's visit all of the facilities would be in full use, similarly it would be absurd to allow an inordinate amount of amortization simply because a momentary depression in business had temporarily put war facilities out of use. Any definite recommendation at the present time would necessarily have to be predicated upon the foregoing considerations, and the writer, in view of the year 1919 and even 1920, is not persuaded that it is in order to make favorable recommendation at this time, but feels that the year 1921 should be allowed to run along somewhat further, which is, after all, only reasonable in view of the extraordinary activity in 1919.

"In taking this position the engineer has in mind the best interests of both the taxpayer and the Government. No amortization will be recommended at this time."

SECOND REVISED CLAIM

Under date of June 14, 1922, the taxpayer filed a second claim for amortization in connection with its 1918 and 1919 income-tax returns, in which deduction is claimed in the amount of $433,042.46 on costs of $938,313.44 incurred in 1918 and $35,842.26 on costs of $82,096.60 incurred in 1919. This claim was based on both a decreased replacement value and a decreased value in use. Inasmuch as this is the final claim of the taxpayer, it will be discussed quite fully.

The following extract is taken from page 37 of taxpayer's brief:

"The company keeps its property record subdivided into the seven following classifications: (1) Construction; (2) building equipment: (3) power equipment; (4) machine tools; (5) machinery equipment; (6) minor equipment; (7) patterns.

"Under 'construction' will be found buildings, bridges, fences, offices, yard paving, partitions, platforms, sidewalks, tunnels, and all other items of similar nature.

"'Building equipment' comprises, in the main, pipe and fittings for hot-air heating, steam heating, water service, plumbing and sewerage, air supply, sprinkler system, and in addition, such items as elevators, fire apparatus, toilets, and electric lighting.

"'Power equipment' includes transmission equipment, exhaust and blower systems, boilers, compressors, generators, pumps, engines, dynamos, motors, transformers, and pipe and fittings for power service.

"Under 'machine tools' will be found all stationary power-driven machines which are direct earners to production, such as lathes, shapers, planers, drill presses, boring machines, grinders, screw machines, etc.

"'Machinery equipment' comprises punches, dies, forms, jigs, special tools, and such facilities as cranes, hoists, etc.

"Under 'minor equipment' are classified the multitudinous facilities which can not be allocated to the major groups.

"The classification 'Patterns' readily indicates the type of equipment included."

To indicate the method used by the taxpayer in computing a lowered replacement cost the following information in regard to the item "Construction" is taken from the taxpayer's brief.

"The chart following was compiled from data taken from the monthly statement of Commerce Reports, published by the United States Department of Commerce. This chart gives the cost index of construction from 1913 to January, 1922, and was computed by the Engineering News Record, based upon the cost of steel, cement, lumber, and the rates paid common labor, weighted to properly give an equitable measure of the fluctuating cost of building.

"The figures are percentages, the year 1913 being taken as 100 per cent. Up until 1921 only the monthly averages are plotted, but thereafter the fluctuating cost index is shown by month.

"It will be seen from this chart that the cost of construction has been steadily declining since June, 1920, and the trend is rapidly toward the pre-war level. Consequently, it would be unfair to assume that building costs, as indicated by the latest monthly cost index figure, are normal. An average of the latest cost index and the 1913 cost index gives a fairly representative figure of 134 per cent. When compared to 1916 average of 137 per cent, which is the latest pre-war figure, it will be seen that this percentage appears to be fair and equitable. Therefore, for the purpose of this report it will be assumed that 134 per cent represents a normal return to postwar construction costs.

"The amortization deduction in terms of percentages can therefore be determined as follows:

Year	Cost index	Estimated normal cost	Amortization
			Per cent
1917	189	134	29.1
1918	203	134	33.9
1919	208	134	35.5

"These are the percentages applied to the cost of the facilities which come under the classification 'Construction.'"

The amortization percentages for the other headings are based on similar data and are as follows:

2. Building equipment.
   Costs:
   1917 ---- 24.4
   1918 ---- 28.0
   1919 ---- 32.6

3. Power equipment.
   Costs:
   1917 ---- 33.1
   1918 ---- 32.8
   1919 ---- 34.1

4. Machine tools.
   Costs:
   1917 ---- 12.8
   1918 ---- 26.6
   1919 ---- 35.1

5. Machinery equipment.
   Costs:
   1917 ---- 15.6
   1918 ---- 27.3
   1919 ---- 34.5

6. Minor equipment.[1]
   Costs:
   1917 ---- 19.6
   1918 ---- 28.8
   1919 ---- 34.4

7. Patterns.
   Costs:
   1917 ---- 06.3
   1918 ---- 25.7
   1919 ---- 36.3

The taxpayer also claims amortization on the basis of decreased value in use. The statement and figures regarding this feature of the claim, as given in the taxpayer's brief, is as follows:

"In the preceding pages the amortization percentages were computed on the basis of replacement costs under normal postwar conditions. It is now proposed to determine the value in use of the amortizable property which will indicate the percentages of amortization applicable on this basis.

"The property units under consideration are the main works and the south works. Each will be treated separately.

"The major products manufactured at the main works at the present time are threshers and necessary attachments, such as feeders and stackers. In

[1] Percentages for minor equipment are taken as the averages of the percentages of the previous five items.

addition, steam tractors and certain parts for gas and oil tractors are produced, but the steam tractor business has been steadily on the decline for a number of years, while the tractor parts referred to above form only a small output of this plant. Only occasional schedules for baling presses, road machinery, rock crushers, straw bruisers, etc., are received, so that this business will not receive material attention.

"The south works is primarily a gas and oil tractor plant. This plant produces nearly all the necessary parts for the tractors, but the forgings are made at the main works, as are a few minor parts and repair parts for obsolete types of tractors. Some sheet metal parts are made at the motor works which is not considered in this claim.

"Production figures are ordinarily a good gauge of the activity of a plant. In the case of the J. I. Case Threshing Machine Co., however, it would not be equitable to use production figures, as there is a certain flexibility and interchangeability of operations which destroy the value of such data in a comparison of activity during successive periods. Frequent changes in models, and occasional changes in product, contribute to this situation. In addition, certain parts or products may be made at one plant for a period of time and then transferred to another plant. Again, if the demand for a certain product is abnormal, the other plants may be called upon to assist and carry part of the load.

"The postwar expansion is another factor which must be considered. (This is discussed in detail in another chapter of the report.) Of course, it would not be right to compare the average postwar production with the capacity at present existing, as this was materially increased after the war. Then, again, to compare the average postwar production to the capacity during the war period would not be fair, as a large portion of the postwar output was obtained on facilities acquired after 1918. Thus the value in use determined by the usual method would not reflect the true value of the amortizable property.

All these factors show that it would be difficult to apply the amortization percentages determined by a comparison of production to capacity, and that some more representative measure of activity must be used. In a business of this sort, the total hours of labor is an excellent way to determine plant activity during successive periods. Changes in model, changes in product, changes in method of manufacture, all are more or less absorbed in a study of data of this nature. Hours of labor truthfully reflect the use to which the equipment is being put without regard to the kind of work done. Consequently, hours of labor are a fair measure of utility and will be used in the computation which follow.

"Undoubtedly a large percentage of the work on post-war output was obtained on facilities purchased and installed after the armistice. The hours in which these facilities were in use should, therefore, be subtracted from the total hours of labor recorded by the pay roll department of the company. However, it is proposed to treat this determination in a conservative way. Consequently, the average post-war hours of labor thus far obtained will be compared to the activity indicated by these statistics during the war years. This method will give percentages which undoubtedly indicate a much higher value in use for the amortizable property than should rightfully be the case, but there is no way of segregating the property and applying measures of activity to the facilities under consideration; consequently, it is necessary to proceed as explained above.

"It may be argued that the year 1921, being a subnormal year, has an abnormal effect on the determination of amortization, and materially reduces the value in use of the facilities under consideration. But, on the other hand, it must be remembered that 1919 and 1920 were years of unusual prosperity. The officials of the company do not expect the same volume of business for a good many years. All that can be hoped for is a return to the pre-war volume which, it is interesting to note, compares very favorably with the average business for the three postwar years. Consequently, in determining the amortization deduction, if any consideration is given the year 1921, allowance should be made for the unusual conditions existing in 1919 and 1920."

In determining the value in use of the facilities at the main works, the taxpayer filed statistics showing the monthly hours of labor for six consecutive months during the war period, and compared the average to the average monthly post-war hours. The value in use of the facilities computed on this basis is 90 per cent, which gives as an amortization deduction 10 per cent of the cost of the war-time conditions at the main works.

The value in use of the facilities at the south works was computed on the same bases, a value in use of 82.5 per cent be obtained. This gave an amortization deduction of 17.5 per cent of the cost of the facilities at the south works.

FIRST REPORT ON SECOND REVISED CLAIM

Under date of October 18, 1922, Engineers Wallensiek and Donnelly, of the Income Tax Unit, submitted a report on this claim in which amortization in the amount of $259,268 was allowed on cost totalling $1,032,545.99. This report allowed amortization in part on decreased replacement costs and in part on a lowered value in use.

In respect to the determination on lowered replacement cost, the engineers used the ratios of postwar to prewar cost as used by the bureau rather than the index figures computed by the taxpayer. As an example of their treatment of this phase of the claim, the following, in respect to the item of construction, is included:

"It will be noted that the taxpayer uses an index number which is an average between that of December, 1921, and that of the year 1913, taken from the commerce report (chart A). The ratio of this average index number to the index for each of the years 1917, 1918, and 1919 is then applied to costs to compute the replacement costs.

"The taxpayer's chart shows construction costs steadily declining during the first 11 months of 1921, and it apparently assumes that they will continue to fall steadily until the 1913 level is reached. The same index, compiled by the Engineering News Record for 1922, however, shows that the lowest point to date since the war was 162, reached in March, 1922, and that prices are now again increasing, the index number for September, 1922, being 185.

"The 1922 index figures of the Engineering News Record are reported as follows:

January	169	June	167
February	169	July	170
March	162	August	173
April	165	September	185
May	165		

"When it is considered that the year 1921 and the early months of 1922 was a period of extreme business stagnation it would be reasonable to assume, in view of the revival of business generally, that prices will not further approach the 1913 level for some time to come.

"The average index number for the year 1921 in the data referred to by taxpayer is 202, or only 1 point lower than the average for 1918. The average for the first nine months of 1922 is 170. Since there has been a steady increase in recent months it may be reasonable to assume that the average for 1922 and 1923 will approach that of 1921. From the above it is evident that the taxpayer's claim in this instance is not tenable.

"Investigation of the details classified under 'Construction' shows that the principal facilities at the main plant consist of wooden partitions and bins, a brick and concrete building for housing an oxygen and hydrogen plant, a gas holder, and a railroad switch track.

"The facilities in this class located at the south works consist principally of additions to core room, sand-storage building, machine shop, restaurant, fire department building, and a railway switch track. These facilities at the south works are constructed principally of brick, steel, and concrete.

"Detailed costs and quantities of various classes of material entering into the construction of the facilities in this class have not been presented and are not readily available at this time.

"In order to apply the bureau's ratios it would be necessary to make a segregation of various classes of materials in order to secure the approximate percentage of the costs on each class to use in compiling a weighted composite ratio. In the absence of details to make such a segregation, the engineers estimate that the percentages of each class are approximately as shown in the first column of the following table. The second column shows the bureau's ratios, and the third column shows the product of the figures in the first and second columns, the total of which gives an estimated composite ratio of 157:

	Estimated per cent of construction	Bureau's ratios	Product of first and second columns
	Per cent		
Lumber	10	175	17
Structural steel	15	60	9
Other building materials	25	225	56
Labor	50	150	75
Total	100		157

"The composite ratio derived above applied to the 1916 index figure presented in the chart results in an index of 215 for postwar cost of replacement. This figure compared with the index figures for 1917, 1918, and 1919 would indicate that the postwar cost of replacement is greater than the costs for the above years.

"The engineers have recently investigated the postwar cost of replacement based on the bureau's ratios of very similar facilities involving practically the same relative percentages of various materials and labor. In all of this class of construction, taken as an average, it was demonstrated that the postwar cost of replacement based on the bureau's ratios is higher than the 1917 and 1918 costs. Since the 1919 construction was contracted for in 1918, the costs on it will be considered as 1918 costs.

"In view of the conditions outlined above, the engineers recommend that the portion of the amortization claim based on replacement cost of "Construction" be disallowed."

In this case no allowance was made on the basis of lowered replacement costs. On the other items of the taxpayer's facilities no amortization was allowed on this basis for costs incurred in 1917. The following percentages were, however, allowed on costs incurred in 1918 and 1919:

Item	Replacement cost, 1918	Replacement cost, 1919
Power equipment	10	8
Machine tools	13	9
Machinery equipment	13	9
Minor equipment	7	5
Patterns	9	0

In respect to the amortization allowable on the basis of value in use, the engineers found that the data presented by the taxpayer in support of its claim for a value in use fairly indicated the activities in the taxpayer's plant, and that the percentage value in use claimed on each plant was fair and reasonable. They accordingly recommended that amortization be allowed on the basis of 90 per cent value in use of the main works and 82½ per cent value in use of the south works.

SOLICITOR'S DECISION

Under date of August 19, 1923, the Solicitor of the Bureau of Internal Revenue submitted a decision on this case in which it was held that the value in use percentage should not be computed by consideration of general production data, but should be determined in so far as possible by a consideration of the actual value to the taxpayer in his going business of each individual facility. Furthermore, it was denied that the taxpayer could claim amortization on certain costs incurred subsequent to the amortization period on plant facilities which had been commenced previous to the end of the amortization period where no attempt had been made to cancel the contracts for the erection of such facilities and where it seemed likely that such contracts could have been canceled without loss to the taxpayer. In cases where it was necessary to decide between cancellation or completion, and where it was decided for business reasons to complete the contracts, it was held that amortization could be allowed only in the amount which cancellation would have cost the taxpayer if such cost was less than the actual cost necessary to complete the contract. In accordance with this decision, a copy of which is attached as Exhibit B, the case of this taxpayer was returned for reconsideration.

SECOND REPORT ON SECOND REVISED CLAIM

Accordingly, a reinvestigation of this case was made at the office and plant of the taxpayer and a report on this redetermination was submitted by Engineer Wellensiek, under date of January 2, 1924.

In so far as the previous award on the basis of postwar replacement costs was concerned, no change as to the percentage of amortization allowed was made in this investigation. It was found, however, that a portion of the costs submitted were not amortizable. The net allowance based on replacement costs was, therefore, slightly reduced. Although the percentages allowed on the various subdivisions of the taxpayer's plant were the same as those shown on page 14 of this report, the percentages were applied to individual items rather than to a general group of facilities, as had been previously done.

In regard to the determination based upon the value in use, the engineer requested from the taxpayer records showing production, sales, hours of labor, overtime, plant additions, etc., by months or by years, up to the end of the fiscal year, September 30, 1923. From a study of these data the engineer determined that none of the production records gave a fair index of plant activities as a whole during fixed periods, and that sales records could not be used because of the large amount of finished parts carried in stock at various times.

The engineer found that the taxpayer's plant had been rearranged from time to time and that war and postwar facilities were interspersed with those purchased in pre-war years throughout the entire plant. No records were available that would show actual use of individual or specific facilities. The nearest approach to such data was a comparison of war and postwar activities within various departments, but even these records were incomplete.

In view of this situation, the engineer found it necessary to base his determination of amortization on the results of inspection and personal interviews with the operators in regard to the value in use of each facility. According to information secured from the operators, many of the items were found to be in full use and found to be required in the business of the taxpayer to the extent of the capacity ordinarily expected or for which they were designed. The excess capacity, except in a few specific cases, was found to be due principally to postwar additions. Consequently, no amortization on the basis of value in use was allowed except on those facilities specifically shown to be not in full use in the going business of the taxpayer.

On those items which were found to be of decreased value in use the engineer allowed amortization based on his personal inspection and apparently assigned reasonable percentages to the individual items.

FINAL REPORT

Subsequent to the preparations of the foregoing report, the taxpayer submitted a protest accompanied by supplementary information and data. This supplementary data indicates that the taxpayer claimed amortization in the sum of $486,778.51 on costs totaling $1,217,654.04. Under date of August 22, 1924, a report on this supplementary claim and protest was submitted by engineer Wellensiek.

In this report amortization is allowed under three general headings, namely, lowered replacement cost, decreased value in use and sale for estimated salvage value. Amortization is not, however, allowed under more than one of these headings on any one facility, for a definite rule had been established by the unit at the time of this report that amortization was not allowable on more than one basis.

This ruling reverses in part at least the engineer's previous recommendations on this case. In another feature, too, namely, the determination of value in use, the engineer reverses his previous recommendations, for his statement in regard to this phase is as follows:

"On account of the great number of items in the schedule it would be impracticable, if not impossible, to determine the specific use value of each individual facility. No records are presented, and none are probably available by which this could be shown. The most practicable segregation is that of facilities by departments, the use value being determined by activities in each productive department.

"In taxpayer's claim the use value of facilities outside the productive departments is based on a weighted average of the use value of facilities in productive departments. This method of arriving at the use value of facilities in nonproductive departments is considered reasonable."

In accordance with this opinion the engineer determined value in use on a comparison of average monthly pay-roll hours in war and postwar years in the various productive departments of the taxpayer.

The taxpayer's computations of value in use, based on the activities of separate departments, showed that the percentages applying to certain departments were lower than reasonable estimates of sales or salvage values plus depreciation due to postwar use. The engineer, in respect to these items, estimated that, taken as a whole, the sale or salvage value plus postwar depreciation on these facilities would average 45 per cent of cost. He accordingly recommended that amortization be allowed in 55 per cent of the cost of these items. In this case it is evident that he proceeded contrary to the recommendations of the solicitor's decision, for he admitted that certain items would have a much higher sale price than 45 per cent of the cost, and that he had simply estimated the average sale price of all facilities concerned.

In regard to amortization allowed on a replacement cost basis, the engineer again used the percentages as determined in his previous reports, but in this case they were applied only where the allowable percentage on this basis exceed the percentage of amortization allowable on a basis of lowered value in use.

This final report allowed amortization in the amount of $346,129.35 on cost of $1,049,611.81 incurred in the year 1918, and amortization in the amount of $4,750.60 on cost of $14,489.49 incurred in the year 1919.

In the above report, the end of the amortization period for this taxpayer was considered as the date of the armistice and no amortization was allowed on facilities completed subsequent thereto when it was deemed that cancellation could have been effected without loss to the taxpayer.

The records of the Income Tax Unit show that this case is closed in the amortization section, but is still in audit.

DISCUSSION OF CASE

In considering this case it is well to bear the following facts in mind:

1. In its war work the taxpayer did not deviate in any way from its regular business.

2. Its war work commenced in 1916 with contracts for foreign governments which may be considered as a development of the normal business of the taxpayer and from which the taxpayer undoubtedly received a reasonable profit.

3. The taxpayer had no direct contract with the United States Government.

4. The facilities which the taxpayer acquired for use in war production are in no way special to war work, but are of value in the regular business of the company, either for regular work or as replacements of worn-out facilities.

5. The taxpayer, as a result of its work, did not lose its regular customers and business affiliations, since it worked along normal lines and did not embark upon new and strange undertakings. Consequently it did not find its business affiliations broken after the armistice, but on the contrary in the years 1919 and 1920 the taxpayer enjoyed the greatest period of prosperity in its history.

6. The taxpayer had the advantage of Government preferences and priorities in the conduct of a profitable and enormously expanded business during the war.

7. The taxpayer found that its war-time facilities were insufficient to take care of postwar demands and consequently it expanded its plant to an extent far beyond the war-time expansion. Its war-time facilities were therefore necessary to the taxpayer in its enjoyment of the enormously increased and profitable volume of postwar business.

8. Assuming that the taxpayer was operating at 100 per cent capacity during the war, which assumption is borne out by statememnts of the taxpayer, it appears from the produtcion figures that the capacity of the plant in the war years of 1917 and 1918 was not greatly in excess of that required for its normal peace-time business requirements, and that the excess capacity at the present time is due almost entirely to the postwar expansion.

9. The taxpayer has discarded or sold but five small items of its war facilities and according to the taxpayer's statement the sale of excess equipment would bring in a very small cash return and would result in a heavvy loss in case its volume of business should increase to a point where this equipment would be required. This statement indicates that while the plant may be temporarily excessive, it is felt that the equipment may be required in the near future.

10. The slump in the taxpayer's business in the fall of 1920 was due primarily to the general economic situation and was augmented still further by the taxpayer's general policy of expanding its plant to take care of any

increase in business which appeared to be in sight, whether or not such business seemed likely to long continue.

11. Business conditions in general have improved greatly during the last two years, and in many industries the volume of business now greatly exceeds that obtaining in war years, while in others the present volume is rapidly approaching that of the war period.

From a consideration of the above items it appears that this taxpayer did not in any way whatsoever suffer from the effect of its efforts toward the prosecution of the war. On the contrary, it enjoyed an extensive and profitable business in the years 1915 through 1920. It expanded enormously during this period but this expansion was not due to the necessities of war, but was the acknowledged policy of the taxpayer whenever it appeared that increased business was in prospect. The taxpayer expanded its plant considerably in 1915 and 1916, continued its expansion during the war, and subsequent to the armistice pursued this policy with an ever-increasing vigor until economic conditions made it apparent that further expansion would be suicidal.

It is recognized that the present business of the taxpayer does not require a 100 per cent use of the war-time plant, but there is no evidence to indicate that stable war-time conditions have come about in this industry. Statements by the engineers as to the value in use of the plant are somewhat conflicting; for example, in one report the following appears:

"It was considered that even if the post-war facilities should be discarded that there would be a reduced use value on war facilities for several years to come."

In direct contradiction to this statement, the following appears in a subsequent report:

"At the present time (January, 1924) business is much improved over a year ago and prospects are much more encouraging. Sales and plant activities are still below those experienced in 1917 and 1918, but there are indications that the war-time additions, at least, will be required in its future business."

There is no question in the point that the war-time facilities of the taxpayer were 100 per cent in use during the years 1919 and 1920; that the taxpayer earned enormous profits on those facilities during these years; and that these facilities were essential to it for the enjoyment of the increased business of these years. From a consideration of this point alone the writer is forced to the conclusion that amortization is not allowable on most of the war-time facilities of this taxpayer, except for the allowance between war and postwar cost. Such an allowance was not contemplated by the statute or the regulations made pursuant thereto.

In support of this statement the following is quoted from the memorandum of the Solicitor of the Income Tax Unit in regard to this case.

"It also appears in this case that the taxpayer constructed additions to its plant in 1919 and 1920 which were more extensive than its war-time addition. The business during these two postwar years exceeded the war business. It is the opinion of this office that in such cases in determining the value in use of facilities or equipment that those acquired during the war years shall not be considered to have been reduced in value in terms of use where the taxpayer acquired in postwar years additional facilities- and increased capacity of its plant unless it can be satisfactorily shown that the facilities acquired during the war years were not of proper type or as capable of economic use in postwar times as the new facilities. In other words, when a taxpayer has and uses in postwar years not only the facilities acquired during the war but additional facilities subsequently acquired for the same uses and purposes and of substantially the same character as those acquired during the war years it is prima facie evidence that any reduction of value in terms of use of the war facilities were caused by the overexpansion in postwar years and not as a result of facilities not being useful and needed to full, normal capacity for postwar business. In such cases it could not be said that the war-time facilities were reduced in value in terms of use. If a taxpayer has a warehouse which he erected durin gthe war years, the postwar business demands required the erection of another warehouse of similar kind and capacity, and the one erected during the war times was not used to full capacity after the amortization period solely because of the subsequent erection of the other buildings no reduction in value in terms of use is shown. Such a situation was not contemplated by the statute or the regulations made pursuant thereto. The fact that additions to plant and facilities of substantially the same kind, character, and use were made in postwar years to a greater extent than during the war years prima facie establishes the fact that the war facilities were just as valuable

in terms of use for postwar business as during the war. Unless it be shown that after the amortization period the war facil ties were to a certain extent not needed no reduction in value in terms of use is shown."

Referring to the final sentence of the above quotation, the writer wishes to point out that it may be shown and is admitted by the taxpayer, that the war facilities were in full use for a very considerable period "after the armistice."

In a brief dated April 19, 1924, the taxpayer takes exception to this point of view and offers a statement in rebuttal. To quote from this brief:

"The position taken by the solicitor's office, as revealed in the above, is that facilities acquired during the war period which are in use or maintained for future use, are not subject to amortization based upon their relative present use as compared with their use during the war period because we did during the years 1919 and 1920 install additional equipment (thereby increasing our departmental and works capacities to an extent equal to, if not greater than during the war period) and that this postwar expansion showed the inadequacy of the war capacity and indicates that the war facilities were of 100 per cent use value to us.

"It is apparent that the solicitor's office has overlooked, or at least has not given due consideration to conditions which we are advised have been recognized by the department and which are to wit:

"1. That many industries throughout the country did not experience the business depression which was more or less general during the first eight months of 1919, and that their operations continued throughout the years 1919 and 1920 on even a larger scale than during the war period and that this prosperity is recognized by the department as having been brought about due to a reflex action of the war. Conditions in 1919 and 1920 were abnormal, and should not be considered in any way reflecting normal postwar conditions or be used in a comparison of pre-war or postwar activity to the activity of the war period.

"2. We admit that in order to meet the abnormal demand for our products during the years 1919 and 1920 we did use our war capacity to 100 per cent and installed additional facilities (some of a similar character to those installed during the war period) and thereby increased our capacity to one greater than that existed at the end of the war period; but this postwar expansion was made by us to meet abnormal post war demands due entirely to the war. We wish to emphasize the fact that the facilities acquired during 1919 and 1920 can be considered a liability inasmuch as their use value is so low that the judgment exercised by the executive in authorizing this postwar expansion can be termed fundamentally unsound from an economic standpoint.

"It is submitted that the postwar expansion does not effect the use value of war expansion except during the years 1919 and 1920 and that the 'value in use' of the war facilities should be determined by comparing the normal postwar activity to the war activity. Regardless of what expansion took place in our plants after the war, the capacity in existence at the close of 1918 when compared to the average postwar activity for normal years, is a true measure of the value of the facilities we had in our plant at the close of the war. For example, let us assume that a plant or department capacity prior to the war period was X, and that during the war this capacity was increased to X plus 2, and that during the years 1919 and 1920 it was further increased to X plus 4, then a comparison of normal postwar operations (1921, 1922, and 1923) to X plus 2 would determine the use value of those facilities acquired during the war period, but it would not be correct to compare the average postwar activity to the capacity X plus 4. The above example we believe is correctly stated and should apply when the question of use value is considered in determining the amount of amortization which our company is rightfully entitled to by virtue of the 'value in use' theory."

In regard to the first point, the contention of the writer is, that this taxpayer earned great profits throughout the war and during 1919 and 1920 as shown in the following table which gives the earnings of the company from 1915 to 1922; that no loss to the taxpayer can be shown to be due to the necessity of war; that the intent of the law was to reimburse taxpayer for losses which were incurred due to the war; that the case of this taxpayer does not fall within the meaning of the law and the company's amortization claim should therefore be disallowed except as to the difference between war and postwar costs and in the case of a very few specific items which were discarded.

Year	Gross income	Net income	Year	Gross income	Net income
1915	$8,190,241.09	$2,017,672.84	1919	$17,502,290.94	$5,023,654.80
1916	7,483,310.63	1,686,096.51	1920	17,919,148.60	3,992,385.01
1917	19,418,687.11	2,655,451.78	1921	6,680,507.14	[1] 2,825,268.91
1918	14,807,915.57	3,255,611.73	1922	8,016,593.72	[1] 93,800.40

[1] Loss.

In its second point the taxpayer states "* * * this postwar expansion was made by us to meet abnormal postwar demands due entirely to the war. We wish to emphasize the fact that the facilities acquired during 1919 and 1920 can be considered a liability inasmuch as their value is so low that the judgment exercised by the executives in authorizing this postwar expansion can be termed fundamentally unsound from an economic standpoint."

The writer wishes to point out that the fact that this taxpayer's expansion has become a liability is not due to a reflex action of the war, but is, as the taxpayer himself states, due to the lack of sound business judgment on the part of the executives of the company. The Government may assume some responsibility for conditions resulting from the war, but can not assume responsibility for conditions which are the result of an unsound judgment of economic conditions.

It is well to point out that the taxpayer has not been disposed to sell the excess facilities of either the war or postwar plant. The only inference to be drawn from this is that these facilities are valuable to the taxpayer as replacements or that the taxpayer expects the business to grow to such a point that the facilities will again be required. The following table of production figures of castings in the Grey Iron Foundry, which may be said to reflect the general trend of the taxpayer's business, well indicates that the war-time production was not greatly in excess of the pre-war output and that the business conditions are rapidly improving following a period of extreme depression in 1921 and 1922:

Manufacturing season—	Net tons produced	Manufacturing season—	Net tons produced
1910	12,195	1917	14,439
1911	13,446	1918	16,142
1912	15,688	1919	18,232
1913	15,617	1920	18,969
1914	7,306	1921	3,940
1915	8,729	1922	2,901
1916	16,828	1923	7,665

From a thorough consideration of all the data available on this case the writer can come to no other conclusion but that the claim of this taxpayer was handled approximately according to the solicitor's ruling in the engineer's report of January 2, 1924, but that the final determination is in contradiction thereto, and that the amortization section has deliberately violated the solicitor's ruling.

Respectfully submitted,

J. M. ROBBINS,
Assistant Engineer.

Approved:

RALEIGH C. THOMAS,
Investigating Engineer.

EXHIBIT B

In re: J. I. Case Threshing Machine Co., Racine, Wis.
Deputy Commissioner BRIGHT.
(Attention Mr. De La Mater, chief amortization section.)

In determining the value in use for the purpose of the amortization deduction in the case of the above-named taxpayer the Income Tax Unit has used as a basis the hours of labor or machine hours in the entire business, on the theory that such a method truthfully reflects the use to which the equipment is being put. This basis, however, does not determine the value in use of particular assets or equipment. If none of the facilities or equipment are, under postwar conditions, useless but are in actual and economic use to their ordinary, normal capacity in postwar times, the value in terms of use is not reduced.

It is not necessary, however, that such facilities or equipment be operated for the number of hours per day or be operated to the full capacity by overtime work of continuous shifts, as was required during the war in order to hold that such equipment or facilities are being fully used or required under postwar conditions. If, however, facilities required for the purpose of producing articles contributing to the prosecution of the war are being used to the capacity ordinarily expected or for which designed and are needed in the business to that extent, no reduction in value in terms of use is shown. Even if the value in use of certain facilities could properly be determined by the number of hours of labor, this method could only apply to particular facilities affected. The number of hours employees worked on certain machinery or equipment would have no bearing or connection with the value in use of other facilities or of warehouses, buildings, or other specific facilities where employees did in fact work full time or have longer hours and which were being used to full, normal capacity, although throughout the entire enterprise the hours of labor were reduced.

In determining the value in use it is necessary to determine such value as to the specific facilities erected or acquired for production of articles contributing to the prosecution of the war, and in doing so it must be determined, first, whether the specific facilities are being used to their full, normal capacity; and, second, whether such capacity is needed for the postwar business. If all of the property is required to be used to its ordinary, normal capacity in postwar times, certainly, merely because peace-time business did not require the long hours and overtime, as were required under war conditions, it could not be held that the facilities did not have as great a value in use as during the war period. In such cases, however, article 184 of Regulations 62 provides that in no case the value in use shall be greater than the replacement value. The value in use being 100 per cent in such cases, the deduction should be based upon the replacement value of such facilities.

It also appears in this case that the taxpayer constructed additions to its plant in 1919 and 1920 which were more extensive than its war-time addition. The business during these two postwar years exceeded the war business. It is the opinion of this office that in such cases in determining the value in use of facilities or equipment that those acquired during the war years shall not be considered to have been reduced in value in terms of use where the taxpayer acquired in postwar years additional facilities and increased capacity of its plant, unless it can be satisfactorily shown that the facilities acquired during the war years were not of proper type or as capable of economic use in postwar times as the new facilities. In other words, when a taxpayer has and uses in postwar years not only the facilities acquired during the war but additional facilities subsequently acquired for the same uses and purposes and of substantially the same character as those acquired during the war years, it is prima facie evidence that any reduction of value in terms of use of the war facilities were caused by the overexpansion in postwar years and not as a result of facilities not being useful and needed to full, normal capacity for postwar business. In such cases it could not be said that the war-time facilities were reduced in value in terms of use. If a taxpayer has a warehouse which he erected during the war years, and postwar business demands required the erection of another warehouse of similar kind and capacity, and the one erected during the war times was not used to full capacity after the amortization period solely because of the subsequent erection of the other buildings, no reduction in value in terms of use is shown. Such a situation was not contemplated by the statute or the regulations made pursuant thereto. The fact that additions to plant and facilities of substantially the same kind, character, and use were made in postwar years to a greater extent than during the war years prima facie establishes the fact that the war facilities were just as valuable in terms of use for postwar business as during the war. Unless it be shown that after the amortization period the war facilities were to a certain extent not needed, no reduction in value in terms of use is shown. Clearly this is what Congress had in mind in enacting the amortization provision. In cases, however, where the value in terms of use has not been reduced, the regulations provide that the value in use shall not be greater than the replacement value. The deduction would, therefore, be confined to the difference between the cost of the facilities acquired during the war years and the replacement value thereof. Since the taxpayer had no Government contracts or subcontracts, and neither produced or sold articles to the Government or for the use of the Government, it must be held that it was producing articles contributing to the prosecution of the war only from April 6, 1917, to November 11, 1918. The

Income Tax Unit has properly so held in the adjustment of this case. However, it appears that a portion of the equipment or facilities was erected or acquired by the taxpayer after the expiration of this period. In cases where the taxpayer had not commenced the erection of such facilities during the above period and had incurred no actual expense in connection therewith, he should be limited in his amortization deduction, if any, in so far as such additions, equipment, or facilities are concerned to the liquidated or compensatory damages he would have been required to pay in the case of the cancellation of the contract or contracts for such additions or facilities. He had the option to carry out the contracts and acquire or erect such facilities or pay damages for cancellation thereof. If he chose the former, he should not be allowed any greater deduction than the actual amount he would have been required to pay under the latter alternative. Other expenses over that amount were not of necessity incurred. This does not apply to cases where the taxpayer had carried such equipment or facilities to such a degree of completion that it would have been an economic waste not to complete them or where amounts had actually been paid out or work progressed to such a state that good business judgment would have required carrying the contract to completion.

In view of the foregoing, the claim of the above-named taxpayer is returned for reconsideration in connection with the views herein expressed.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT C

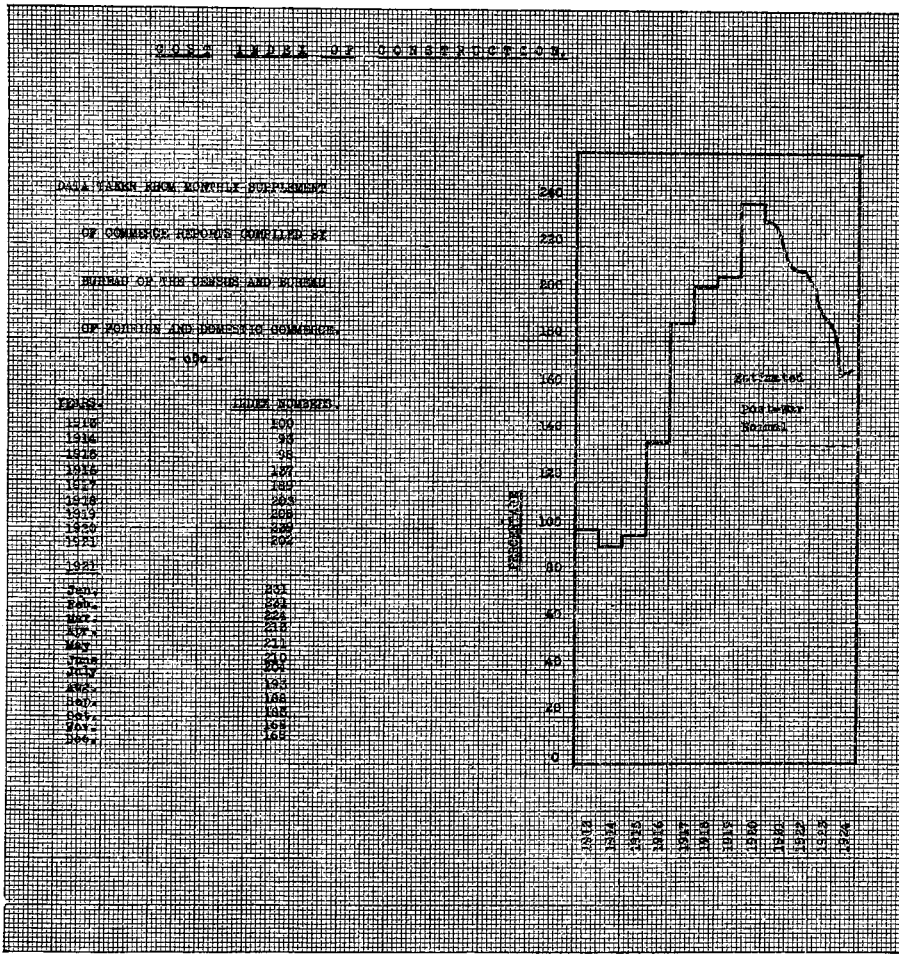

EXHIBIT D

TABLE IV.—*Expenditures for plant, J. I. Case Threshing Machine Co. (main and south works combined)*

	Book value, Oct. 1, 1916	Capital additions, manufacturing year basis					
		1917	1918	1919	1920	1921	1922
Construction	$2,489,911.04	$23,577.70	$175,889.63	$92,569.56	$522,783.91	$73,735.72	$823.90
Buildings equipment	483,388.60	5,782.46	23,638.56	31,583.92	143,509.76	17,513.01	808.16
Power equipment	524,309.11	10,630.04	39,637.05	56,251.33	59,352.76	15,508.74	
Machine tools	918,856.74	92,914.34	353,301.09	263,905.01	310,803.91	137,803.33	888.65
Machinery equipment	818,403.80	66,551.93	107,241.73	155,202.30	120,141.15	89,850.48	57,326.06
Minor equipment	545,131.50	46,794.21	89,267.98	107,703.26	177,247.01	64,948.11	7,386.10
Patterns	374,240.96	35,196.21	45,441.71	59,099.31	47,214.73	32,663.78	16,638.45
Total	6,154,241.75	281,446.89	834,417.75	766,314.69	1,381,053.23	437,023.17	83,871.34

EXHIBIT E

METHOD OF DETERMINATION OF AMORTIZATION ALLOWANCE IN FINAL ENGINEER'S REPORT OF AUGUST 22, 1924

SECTION 1. VALUE IN USE DETERMINATION

In the determination of the value in use of the taxpayer's facilities, the engineer followed, in general, the method as outlined in the data which the taxpayer submitted on April 28, 1924.

The taxpayer admits that the Government engineers' position is correct in stating that the taxpayer's operations during 1921 and 1922 were abnormally low, and that therefore the use of average monthly pay-roll hours of the various departments for the years 1921, 1922, and 1923, as compared with those of the war period, does not indicate a true comparison of normal post-war activity to war activity.

With this point in mind, the taxpayer has endeavored to adjust the man hours for 1921 and 1922 to a degree which would reflect normal operations more correctly. The average men employed for the seasons of 1914, as well as for the years 1921 and 1922, at the main and south works will be found in the table on page 3176.

A comparison of the average men employed at the main works shows that the employment in the years 1921 and 1922 was 81 per cent of the employment for the years 1914 and 1915. A similar comparison at the south works shows the 1921 and 1922 employment to be 83 per cent of the employment for the years 1914 and 1915.

In Table III–A following, taken from the taxpayer's brief, the value in use computations are shown in this table. The taxpayer takes the average monthly pay-roll hours by departments for the years 1921 and 1922 and divides these by the percentages obtained above, namely, 81 per cent, for the main works and 83 per cent for the south works, to obtain an adjusted figure, indicating more nearly what normal monthly pay-roll hours would amount to in the postwar period.

These adjusted figures for the years 1921 and 1922 are averaged with the actual figures for 1923, and this average is compared to the monthly hours of day work of the war period. This comparison gives the value in use as shown in column 10.

In connection with this computation, it may be considered doubtful whether postwar activities will normally be limited in volume to the activity of pre-war years. Many factors which enter into production, including competition, marketing problems, and items of similar character, have brought about changes. There can be no doubt, however, but that the figure arrived at by this computation approaches more nearly to a figure representing normal postwar conditions than did the actual production figures and it is evident that the taxpayer is sincere in its efforts to present a fair basis for determination. The taxpayer, in column 7 and 9 of Table III–A, has not considered that work was carried on more days per year during the war than during a normal period. It is not probable, however, that this point is of sufficient importance to greatly change the computations. Moreover, this error is partially offset in that all war facilities were not in use during the entire war period. Taking all these points into consideration, the engineer adopted the basis of the taxpayer's computations, though he made slight modifications as indicated below.

The engineer reviewed the schedule and disallowed amortization on such items installed after the armistice which, apparently, could have been canceled.

SECTION II. REPLACEMENT COST BASIS

The postwar replacement cost of the facilities was computed in this report on the basis of the percentages which were given in the engineer's previous report of October 18, 1922. Amortization was allowed on the basis of lowered replacement cost where such allowance was greater than that computed on the value in use basis and vice versa.

SECTION III. SALVAGE VALUE BASIS

The taxpayer's computation of value in use based on activities of separate departments and indicated in Table III–A, shows that the percentages applying to certain departments are lower than reasonable estimates of sale or salvage value plus depreciation for postwar use. The engineer, after reviewing the list of facilities involved in this class estimated that, taking these items as a whole, the sale or salvage value plus postwar depreciation would average 45 per cent of cost. Certain items had a much higher sale value, but the engineer considered 45 per cent to be a fair average. He accordingly recommended that amortizat on be allowed in the amount of 45 per cent of cost of these items. In this allowance he clearly failed to act within the intent of the solicitor's decision, for he should have estimated the salvage value of each of these items separately. The items were few in number and such an individual estimate would not have been difficult.

On five Class I items the engineer disallowed amortization on a gear cutter which was shipped, received, and paid for a long time after the armistice; on the other four items the engineer recommended that the allowance be limited to 50 per cent of cost on the basis of insufficient data, inasmuch as the taxpayer did not offer any explanation in regard to the disposal of those items, and the date of discard and the amount of pre-war use were not shown. It appears to the writer that the engineer having no information in regard to these items, should not have attempted to make any allowance, but should have called for additional information, and if he failed to obtain this from the taxpayer, should have disallowed all amortization on these items. As it is, his 50 per cent allowance is nothing more or less than a rank guess.

SUMMARY

Amortization was allowed this taxpayer on the three bases as outlined above. On any given item, however, amortization was only allowed on a single basis, that basis which would give the greatest allowance being used.

J. I. Case Threshing Machine Co., Racine, Wis., men employed, south works, incorporated, foundry

	Season of 1914	Season of 1915	Season of 1921	Season of 1922		Season of 1914	Season of 1915	Season of 1921	Season of 1922
October	447	295	1,071	231	May	626	787	412	650
November	655	641	1,013	248	June	459	613	357	793
December	758	924	805	245	July	385	657	283	823
January	947	1,012	825	259	August	306	592	239	919
February	858	1,067	763	356	September	281	580	238	984
March	739	989	571	449					
April	703	925	437	567	Average	597	757	585	543

J. I. Case Threshing Machine Co., Racine, Wis.—Men employed at main plant

	Season of 1914	Season of 1915	Season of 1921	Season of 1922		Season of 1914	Season of 1915	Season of 1921	Season of 1922
October	1,184	382	1,071	377	May	972	934	1,065	745
November	1,363	462	1,215	367	June	1,026	839	961	802
December	1,385	776	1,199	355	July	920	831	620	814
January	1,327	968	1,211	380	August	709	780	414	798
February	1,142	967	1,263	519	September	409	702	407	743
March	1,072	978	1,222	616					
April	1,036	953	1,189	717	Average	1,043	798	984	603

TABLE III–A.—*Summary of actual pay-roll hours, J. I. Case Threshing Machine Co., Racine, Wis.—Average monthly pay-roll hours*

	1921, actual (1)	1921, adjusted (2)	1922, actual (3)	1922, adjusted (4)	1923, actual (5)	Average, 2 and 4 and 5 (6)	War (7)	Per cent day-work (8)	War, adjusted (9)	Value in use (per cent) (10)	Amortization (per cent) (11)
MAIN WORKS											
26. Blacksmith	12,757	15,740	6,584	8,104	15,150	13,001	18,000	98.5	17,730	73.33	26.67
27. Boiler	5,822	7,188	5,087	6,280	10,032	7,833	17,500	99	17,325	45.21	54.79
37. Tank	3,302	4,077	3,275	4,043	6,000	4,707	6,130	98	6,007	78.36	21.64
28. Engine erecting	7,883	9,732	5,107	6,305	13,135	9,724	27,400	98	26,852	36.21	63.79
34. Separator erecting	19,066	23,538	7,000	8,642	15,490	15,890	14,750	98	14,455	109.93	0
29. Engine machine shop	11,348	14,010	6,000	7,407	12,500	11,306	45,200	83	37,516	30.14	69.86
35. Separator machine shop	19,924	24,598	8,360	10,346	20,000	18,315	18,000	98.5	17,730	103.30	0
36. Sheet metal	14,983	18,498	6,220	7,679	15,000	13,726	16,500	97.5	16,088	85.32	14.68
38. Wood	5,006	6,180	3,045	3,759	6,463	5,467	6,600	99	6,534	83.67	16.33
SOUTH WORKS											
225. Radiator	753	907	1,323	1,594	1,752	1,418	5,250	100	5,250	27.01	72.98
226. Heat treat	2,454	2,957	2,280	2,747	6,240	3,981	6,550	80	5,240	75.97	24.03
228, 239. Engine erecting	5,747	6,924	13,200	15,904	19,250	14,026	24,300	97	23,571	59.51	40.49
240. General mechanic	4,091	4,929	4,103	4,943	9,093						
241. Automatic	1,605	1,934	2,141	2,580	6,000	22,246	29,850	95	28,358	78.45	21.55
250. Gear cutters	1,287	1,551	1,411	1,700	3,630						
254. Cylinder and frame	4,652	5,605	8,112	9,775	15,000						
248. Drill and mill	3,607	4,346	7,300	8,795	13,000	8,714	23,800	88.5	21,063	41.37	58.63
251. J. & L. lathes	3,139	3,782	5,830	7,024	9,700	6,835	23,700	86	20,145	33.93	66.07
255. Rough grind	400	482	1,661	2,001	3,120	6,530	10,500	89	9,345	69.88	30.12
257. Finish grind	2,880	3,470	3,250	3,916	6,600						
242, 245. Foundry	26,900	32,410	21,301	25,664	48,550	35,541	104,200	92	95,864	37.07	62.93

EXHIBIT F

EXTRACTS FROM REPORT ON REDETERMINATION OF AMORTIZATION OF THE J. I. CASE THRESHING MACHINE CO., RACINE, WIS.

In accordance with instructions from the commissioner, a reinvestigation of the above case was made at the office and plant of the taxpayer, October 21 to 25, 1923, by the undersigned engineer.

This reinvestigation and report has been made to conform as closely as possible with the solicitor's memorandum regarding this case.

The percentage allowed in the engineer's previous report, submitted October 18, 1922, are shown in the following table. These same percentages are again used in computing the amortization to be allowed on the basis of replacement costs in this report.

Amortization percentages allowed based on replacement values, also depreciation during amortization period

	1917		1918		1919
	Replacement cost	Depreciation	Replacement cost	Depreciation	Replacement cost
Construction	0	0	0	0	0
Building equipment	0	5	0	2½	0
Power equipment	0	0	10	3	8
Machine tools	0	7	13	5	9
Machinery equipment	0	7	13	5	9
Minor equipment	0	5	7	5	5
Patterns	0	0	9	10	0

SOLICITOR'S MEMORANDUM

The present reinvestigation and reconsideration of the claim of the above taxpayer is made to comply with the solicitor's memorandum to the deputy commissioner, dated August 21, 1923, which deals specifically with this case.

The solicitor's criticism deals only with that portion of the amortization allowed on the basis of value in use. Objections are made to:

1. Applying the ratio of postwar activities to war-time activities of the entire plant to specific facilities or units in the plant as a measure of usefulness.
2. Not considering overtime hours during war period.
3. Allowing amortization on war facilities when reduction of value in terms of use was apparently caused by the over-expansion in postwar years.

It will be noted (in Table IV) that the capital expenditures in 1917 and 1918 together represent little more than might be expected to be expended for replacements in a plant of the size indicated which has been in operation for a great many years.

The additional facilities installed in each year were used on the average only approximately six months during that year. It is evident, therefore, in view of the production records and pay-roll hours that the pre-war facilities were used far more during the war period than normally used.

The present reinvestigation was made, furthermore, in conformity with the solicitor's memorandum. The engineer made special inquiry with regard to each item or group of items shown in the schedule. Interviews were held with superintendents and foremen in direct charge of the facilities in the plant and with men in charge of the coast department to which the engineer was directed for detailed information with regard to production, etc.

According to the information secured from those men the war facilities, with the exception of specific items to be considered separately, are in actual and economic use and will be used in postwar years to the capacity ordinarily expected or for which designed. They are needed in the business to this extent. The excess capacity, except with regard to those specific items disclosed in the following paragraphs, is found to be due principally to postwar additions.

No amortization is accordingly allowed on the basis of value in use except on those items specifically mentioned in the following paragraphs. These specific facilities will probably not be used in the postwar period to the extent such facilities are ordinarily employed or they are not needed in the taxpayer's business. Their use value is not affected by similar postwar additions.

The taxpayer does not claim to have totally discarded any of the war facilities. The war facilities comprise only a small portion of its excess equipment. To sell all excess equipment would, according to the taxpayer's statement, bring a very small cash return and would result in a heavy loss in case its volume of business should increase to a point where this equipment would be required.

Operation as a war facility ceased on the date of the armistice, November 11, 1918. Expenditures showing a later date are excluded from consideration in connection with the claim.

GENERAL STATEMENT REGARDING VALUE IN USE

The engineer requested and received a list of all plant facilities constructed or installed during the fiscal years ending October 1 from 1919 to 1923, inclusive. This list is filed with the papers in the case. It shows account numbers, a brief description of each facility, and location in the plant. In the case of items received prior to the armistice, November 11, 1918, the actual date received is given.

The engineer has compared the above-mentioned list with those items in the taxpayer's amortization schedule which, according to statements of superintendents and officials, are excess facilities and not needed or not employed to ordinary capacity.

In the above-mentioned comparison it was found that in most cases where there is excess equipment of a certain class that this excess is due entirely to postwar conditions. In other cases it is partially due to postwar additions.

In comparing electric motors, for instance, it was found that the postwar additions to motor equipment exceed the idle or excess motors. No amortization is accordingly allowable on motors except on the basis of replacement cost.

The conditions with respect to minor equipment and patterns are similar to a large extent to that of electric motors. Most of the excess is due evidently to postwar additions. While a portion of this class of equipment may be obsolete or not usable for postwar work, it is impossible to determine from the information at hand how much of this is properly amortizable on the basis of value in use. This portion of the claim is accordingly disallowed for the reason that it is not clearly set forth as required in article 189, Regulations 62.

In regard to facilities classified under construction, it is found that the postwar construction exceeds the excess construction now claimed. The same condition holds for the remainder of the classifications. There are some items, however, of construction and other facilities which are idle or not usable to ordinary capacity because of improper designs, size, or location. These will be disclosed in the following paragraphs:

ANALYSIS OF SCHEDULE—MAIN WORKS

Item No. 1. No amortization is allowed. This item is a 1917 expenditure on which no reduction in value is shown on the basis of replacement cost (see table, p. 4), nor is there shown a reduction in value based on value in use.

Items 2 and 3. These are postwar additions.

Items 4, 5, and 6. In regular use. Amortization is allowed on basis of replacement cost only.

Items 22 and 30. Amortization is allowed on 1918 expenditures on the basis of replacement cost only. No amortization is allowed on 1917 and 1919 expenditures. There is similar equipment in the list of postwar additions.

Item 117. This item offers a portion of total minor equipment erroneously allocated to building F–8 in 1918. Amortization is allowed on basis of replacement cost only.

Item 123. This item is a 5-ton Warner truck trailer purchased in 1917 and used until January 1, 1923. The taxpayer states that, although its use was not entirely satisfactory, the reasons for not using it this year is because of slack business and on account of the high costs of licenses in Wisconsin for such truck. This item is not discarded and taxpayer states that it will probably be again put in use.

There was some trucking equipment purchased after the war.

Considering ordinary depreciation on trucks and the time this one has been used, the engineer estimates that the residual value at this time is fully equal to cost less ordinary depreciation.

Item 124. This item consists of two 6,000-gallon steel cylinder oil tanks, which were used in connection with tractor testing. They are approximately 6 feet in diameter by 30 feet long. They have not been used since 1919. Taxpayer states that no effort has been made to dispose of these.

The list of postwar additions contains similar equipment. Any excess of these facilities is, therefore, considered to be due to postwar additions. The

1919 expenditure is not explained, hence amortization is disallowed entirely on this portion of costs.

SOUTH WORKS

Items 1 and 2. In regular use and needed in the business. Amortization is allowed on the basis of replacement cost in percentages shown in table with this report.

Item 3. This is a second-story core-room addition constructed during the war rush to provide a separate place for women workers. The war conditions made it imperative to employ women in the core room. This had not been done previously. This room has not been used since 1920. Taxpayer claims that there is little prospect of again using this addition except in case of another war emergency.

A wash room in one corner is used to a small extent by two women still employed but working in the main core room. Most of the equipment is still in place and is immediately available in case it should be again needed.

Items 7 to 12. Taxpayer claims excess capacity on these items. The engineer finds similar equipment shown on the list of postwar additions. The description, however, is incomplete. It appears that the entire excess capacity is due to postwar additions. Amortization is accordingly disallowed on value-in-use basis but allowed on replacement-cost basis.

Item 23. The sand-storage space is apparently in regular use and required. The ladies' core room extends over a portion of this building, and this is little used. No segregation in costs is shown between sand-storage and the core room, both, of course, being partially under one roof. The engineer estimates 20 per cent of total cost of the additional construction as an equitable allowance as amortization.

Items 25 to 29. This equipment is allocated in the second-floor core room, referred to above. It has been idle since 1920. Its value is reduced in about the same proportion as item 3 above. The engineer estimates 40 per cent of cost as an equitable allowance on account of amortization.

Item 42. This item covers two No. 24 53-inch heavy disk grinders. Taxpayer states that it has four of these machines, two of which were on hand prior to the war. It claims that only two are needed now. Inspection showed that two had been idle for a long time. They are evidently retained on account of their potential value as replacements. No postwar additions offset this group. The engineer recommends that amortization be allowed in the amount of 40 per cent of cost.

Item 51. This item covers 14 No. 2–A universal hollow hexagonal turret lathes. Taxpayer claims that five of these constitute excess machines, not needed except eventually as replacements. The engineer finds, however, that the list of postwar additions contains 10 similar machines. It is evident, therefore, that any excess capacity in this group is due to the postwar addition. That portion of amortization claimed on the basis of value in use is accordingly disallowed. Amortization is allowed on the basis of replacement cost.

Item 198. This item is not in use, and taxpayer claims it will probably not be again needed. It is not claimed to be discarded. The engineer recommends that amortization be allowed on value-in-use basis in the amount of 50 per cent of replacement cost.

Summary—J. I. Case Thrashing Machine Co., Racine, Wis.

	1917–18 costs	1919 costs	Total
Cost on which amortization is claimed	$1,137,991.49	$82,096.60	$1,220,088.09
Cost on which amortization is disallowed	449,230.74	82,096.60	531,327.34
Cost on which amortization is allowed	688,760.75	00.00	688,760.75
Contractural amortization and depreciation for 1917 on cost on which amortization is allowed:			
Depreciation	8.00		8.00
Contractu ral amortization			
Reduced cost on which amortization is allowed	688,752.75		688,752.75
Net residual value as herein computed	556,760.62		556,760.62
Amortization allowed for tax purposes	131,992.13		131,992.13
Amortization claimed for tax purposes			468,884.72
Amortization disallowed for tax purposes			336,892.59

It is recommended that the J. I. Case Threshing Machine Co. be allowed amortization in the sum of $131,992.13 on property costs indicated above. All costs, sales, and contractural amortization are subject to check by the auditor or revenue agent assigned to the field investigation of this case.

Depreciation has been deducted in respect to property acquired between April 6 and December 31, 1917.

The date of cessation of operation as a war facility was November 11, 1918.

The amortization allowance on cost of property used in war producton, $131,992.13, on 1917–18 costs, should be apportioned with regard to income as provided for in the second paragraph of article 185 (a), regulations 62.

This report cancels and supersedes all previous reports and the allowances herein made are in lieu of those previously made.

Submitted.

A. H. WELLENSIEK, *Engineer.*

Approved:

J. N. BRIGGS,
Chief of section, J. T. K.
W. S. TANDROW,
Reviewing Engineer.

EXHIBIT G

Pursuant to article 184 of regulations 62 the commissioner has determined and publishes the following ratios of estimated post-war cost of replacement for use by taxpayers in computing claims for tentative allowance for amortization.

The purpose of establishing these ratios is to facilitate the preparation and examination of claims and to bring about, to such extent as may be practicable, uniformity as to the basis of claims. The allowances based thereon will be purely tentative and subject to redetermination in accordance with the provisions of the law.

These ratios, condensed as they are to cover 16 groups, are necessarily composite figures, arrived at by an examination of many items entering into the respective groups, and it is realized that in some cases where only a limited number of items in the group are involved the ratios given may not fairly be applicable to a particular case. In such cases the claim for amortization should be made in accordance with the ratios published, but the taxpayer, along with his claim, should submit a statement showing in detail the reasons why and the extent to which such ratio is not properly applicable to his claim, so that such cases may receive special consideration; in like manner there may be cases where the ratios as applied to the particular claim would give the taxpayer more than a reasonable allowance, and in such cases the ratio properly applicable will be determined on the examination of the claim and the taxpayer given notice thereof.

All ratios are expressed in percentages based on prices as of June 30, 1916.

A. Ratios for computing estimated post-war cost of replacement of buildings, vessels, cars, tanks, blast furnaces, open-hearth furnaces, annealing furnaces, electric furnaces, coke ovens, and construction of all kinds:

	Per cent
1. Lumber—	
(a) Hard	240
(b) Soft	175
2. Structural steel	60
3. Building materials other than lumber and structural steel	225
4. Steel (other than structural steel) and steel products	90
5. Building equipment	150
6. Labor (all classes)	160

B. Ratios for computing estimated post-war costs of replacement of machinery and equipment:

7. Electrical machinery and equipment	130
8. Engines, turbines, compressors, and similar facilities	175
9. Pumps	135
10. Boilers	160
11. Transmission equipment—	
(a) Shafting, pulleys, hangers, etc	135
(b) Belting	100

B. Ratios for computing estimated post-war costs of replacement of machinery and equipment—Continued.

	Per cent
12. Machine tools and small tools (machine tools are considered as that class of metal-working machinery which can be used on both cast iron and steel)	130
13. Woodworking machinery	155
14. Textile machinery	155
15. All other machinery (including cranes)—	
(a) Machinery the cost of which did not exceed 10 cents per pound as of June 30, 1916	120
(b) Machinery the cost of which did exceed 10 cents per pound as of June 30, 1916	130
16. Office furniture and equipment	125

The CHAIRMAN. I would like to ask Mr. Manson this question: I recall that in presenting this case you said the taxpayer, at the time of operating his plant during the war, did nothing more than his normal business?

Mr. MANSON. He did not do a different kind of business. They did increase their output of tractors very materially, but they were manufacturers of tractors before the war and since the war. The fact I mean to bring home is that they did not engage in the manufacture of cannon or helmets or rifles or shells or anything of that sort which required the installation of special equipment useful for war purposes only.

The CHAIRMAN. During that time did they increase their production because of the demands of the war?

Mr. MANSON. Oh, yes; their production was increased.

The CHAIRMAN. Because of the demands of the war?

Mr. MANSON. Oh, yes.

The CHAIRMAN. Does the production record show that the production was materially reduced after the war?

Mr. MANSON. The production in 1919 and 1920 was higher than it was during the war.

The CHAIRMAN. That is the point I am trying to develop. In view of that fact I do not see why every manufacturer of anything used during the war might not be entitled to amortization on the same theory that amortization was granted in this case.

Mr. MANSON. If he made any plant installations during the war of any description, he would be entitled to amortization, because I doubt whether there is a manufacturer in the country that did the business in 1921 and 1922 that he did during the war period.

The CHAIRMAN. Am I to understand then that no matter what the manufacturer might be manufacturing, if he increased his production during the war he would be entitled to amortization?

Mr. MANSON. No. The law limits that to articles useful for war purposes, in substance. In this case it was a manufacturer of agricultural implements and tractors.

Senator KING. Take a case like this, if the Senator from Michigan will pardon me. Suppose I am engaged in the shoe business and I have large factories. I get a contract during the war with the Government to furnish several million pairs of shoes for soldiers and I add to my units to meet the increased demand. After the war is over I use those same units. There is a subsidence for a little while, as there was generally throughout the United States during the years 1920 and 1921, but that was quite awhile after the war. But in 1923 and 1924 my business is as great as or even greater than it was during

the war, and I use the same facilities. Do you mean to say there should be amortization for those units?

Mr. MANSON. As far as my own views are concerned, I have taken the position right along that in determining that question plant investment does not represent a loss because that is the real question here. It can not be said that investment which is required to meet the demand of a peak year during the postwar period is a loss. Every progressive manufacturer attempts at least to keep his equipment to the point where he can take advantage of peak years, because it is in the peak year that prices are highest and profits are greatest.

Senator KING. Then your answer would be that in the case I put, getting down to the concrete case, there ought not to be any allowance for amortization?

Mr. MANSON. I do not think so.

The CHAIRMAN. I would like to ask at this point why you concede that amortization would be allowable for difference in cost. I believe that is what you said?

Mr. MANSON. Yes.

The CHAIRMAN. Why? For example, if you concede that point, it seems to me that is conceding more than the law contemplated, or at least more than the law should have included. For example, there was a great shortage of labor during the war. Suppose I was a manufacturer of women's skirts, for instance. Because of a shortage of help I put in some more machinery with which to make skirts. Because of the shortage of labor and the general demand for machinery I paid a higher price, and yet I got advantage of all those higher prices during that period even for skirts. I can not conceive that I am entitled to amortization on my machinery to make skirts, sewing machines, etc., just because we were engaged in war and because all prices were high at that particular time. Why should I receive any amortization there for excess equipment or for difference in prices?

Mr. MANSON. I think, in the first place, you made an income during that period of time, but the theory of the law is that you paid taxes on that income also. When you come to readjust your property account subsequent to the war the purpose of the act, as I construe it, is to protect you and write off from your property account that loss which you have incurred by reason of the fact that you are carrying in your property account property for which you paid more than it represents in value for postwar purposes.

The CHAIRMAN. Then that proposition would apply to every manufacturer, whether he were manufacturing medicines, perfumes, skirts, shoes, or what not?

Mr. MANSON. Yes.

The CHAIRMAN. And your understanding is that amortization is allowed and should be allowed on all those manufactures?

Mr. MANSON. No; I take the position that amortization should not be allowed unless it can be shown that the manufacturer is manufacturing something that was useful for prosecution of the war. In discussing this matter I hope it will be understood that I am discussing my construction of the act. I am not discussing the general question of whether the provision was justified. Here we have a provision in the law which provides that the taxpayer shall

be permitted to amortize that portion of the cost of those facilities which has been borne by him. Construing that provision, as I said before, in the light of other provisions of the income tax law, my construction is that it was intended to permit him to charge off the loss that he has suffered by reason of his investment in facilities which either are of no use to him after the war or to charge off facilities which have cost him more than their postwar value represents.

Senator KING. Take the case of the farmer. I know many farmers who during the war went out and purchased land at greatly increased values over pre-war values, expecting that the war was going to last a considerable length of time, and they produced food supplies, cotton—long staple cotton of Arizona, for instance—for which the needs of the war, and our allies as well as ourselves, brought about a very great demand and high prices.

When the war was over some of those lands went down in value.

Mr. MANSON. Most of them did.

Senator KING. Yes. What is your view of that under the law—that they are to write off that depreciation in value?

Mr. MANSON. I have never considered this law from the farmer's standpoint. I would not want to give a snapshot opinion on it. I have not the exact language in mind.

Senator KING. I have heard of many cases where sheepmen bought sheep and cattlemen bought cattle, the sheep at $18 or $20 apiece and the cattle at double the pre-war prices; but soon after the war sheep went down to $5, and in some places lower than that, and cattle went down to $40 and lower than that. There were great losses sustained in the depreciation in value.

Mr. MANSON. There is no doubt about it.

Senator KING. But they made enormous profits in some instances through the rise in prices, and they purchased because they expected to make profits. What does the law, as you understand it, provide, and what is the practice of the department, in determining what the tax shall be?

Senator WATSON. That would not apply to farmers in Indiana. I do not know of any farmer in Indiana that has ever made any income-tax return since 1920.

Senator KING. Did he before?

Senator WATSON. I think they did during the war, because their receipts justified it.

The CHAIRMAN. There was one thing that I wanted to clear up, because I see Mr. Gregg is about ready to begin.

Mr. MANSON. Yes; in answer to the Senator's question——

Senator WATSON. And the reason they did not make any returns was because they did not have receipts to justify returns. They did not have anything to pay an income tax on. Of course, in Iowa, the reason that that land got so high was that it was a matter of speculation. It was not a matter of legitimate investment. It was in the hands of brokers, and it just went from one to another.

Senator KING. There were many farmers who made purchases.

Senator WATSON. There were a great many farmers who made purchases, of course.

Senator KING. As they said, they rounded out their farms.

Senator WATSON. Yes; they did that.

Senator KING. And made very large extensions in their farming activities.

Senator WATSON. They did, like the manufacturers, hoping to make money out of it.

Senator KING. Yes; surely.

Mr. MANSON. This act reads this way.

Senator KING. Which act are you referring to now?

Mr. MANSON. I am referring now to the amortization part of the income tax law.

Senator KING. Of 1920 or 1922?

Mr. PARKER. This happens to be the 1918 law.

Mr. MANSON. This happens to be the 1918 law, but so far as the general scope of it is concerned it has not been amended since, as I understand it.

I am reading from section 214, subdivision 9 of regulations 45, page 72:

> In the case of buildings, machinery, equipment, or other facilities constructed, erected, installed, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war, and in the case of vessels, etc.

The CHAIRMAN. Of course, that would not include land and cattle, like Senator King referred to?

Mr. MANSON. No; it would not.

The CHAIRMAN. No.

Mr. MANSON. I would say that if a farmer erected a granary to meet an additional supply of grain, such as many of them doubtless did, such building would come within this provision of the law. I would say that if a farmer purchased harvesting machinery or purchased tractors or plows for the purpose of meeting the requirements of a greater acreage, as many of them doubtless did, in the wheat fields of the West, such equipment would come within the provisions of this act.

Senator WATSON. There is no doubt about that, I think.

Mr. MANSON. I have never considered that before.

The CHAIRMAN. I want to get one point cleared up.

Does anyone here know whether amortization was allowed to manufacturers of women's wearing apparel, shoes, perfumes, or pharmaceutical goods, or manufactures of that kind?

Mr. GREGG. I think I can answer that, Senator. As I understand your whole question now is not with reference to Mr. Manson's contention about the amount of amortization allowable, but with reference to the type of manufacturer who is entitled to any allowance for amortization, which involves a question of whether he acquired the equipment for the production of articles contributing to the prosecution of the war.

When that language was put into the 1918 act, Congress had just passed one of their war-control acts, which used the same language, giving control to certain governmental agencies of industries producing articles contributing to the prosecution of the war. It was very thoroughly debated at the time, and from the debates on that act we could get a fair idea of what Congress meant by the same language in the revenue act, and what it came down to was this; that almost anyone manufacturing essentials, which were subject to

control by, I think, the War Industries Board, is entitled to amortization on capital expenditures during the war, but it did not apply to such things as the manufacture of women's wearing apparel. It did apply to the manufacture of men's shoes. We have very recently had a case in which the question was up as to whether it applies to the manufacture of macaroni. We held that it did. We also had the question up in connection with the production of sugar, and we held that it applied there. It really applied to anything which was subject to control by the War Industries Board.

Mr. MANSON. You could apply it to the purchase of land, for instance, for raising sugar?

Mr. GREGG. No, sir; we have ruled specifically that it does not apply to land.

Mr. MANSON. Suppose you had land that needed improvement, that was covered with underbrush and things of that kind. Would it apply to the money spent for improving the land so as to render it fit for the production of sugar?

Mr. GREGG. You are getting on ground that I do not know the answer to now. I doubt it seriously. Where the question arose it was in connection with the production and refining, or whatever it is that is done to sugar.

Mr. MANSON. I would doubt it myself, because I would consider that as land for agricultural purposes.

Mr. GREGG. I would say so, and I do not think amortization applies to any of the cost of land. I think the language just referred to "buildings, machinery," etc., acquired for the production of articles, eliminates land.

The CHAIRMAN. There were some claims, though, for amortization on the price of land?

Mr. GREGG. Yes, sir.

The CHAIRMAN. Claiming that those prices were excessive during the war period?

Mr. GREGG. Yes, sir.

The CHAIRMAN. There were claims made for allowances in those cases?

Mr. GREGG. Yes, sir.

The CHAIRMAN. Are allowances made in such cases?

Mr. GREGG. No, sir. They have never been allowed. The claim was also made, as I remember it, in some coal case, where the coal property was bought during the war at an excessive price, and it was not allowed there. The allowance is really limited to manufacturing facilities and plants. We have never limited it, however, to the production of war facilities in the sense of munitions, but we have applied it to any essential article subject to regulation.

The CHAIRMAN. It would not include women's shoes?

Mr. GREGG. No; it would not include women's shoes.

The CHAIRMAN. Nor would it include pharmaceutical goods.

Mr. GREGG. No, sir.

The CHAIRMAN. Are you through with that case, Mr. Manson?

Mr. MANSON. Yes, sir.

The CHAIRMAN. Have you anything to say in reply to that case at this time, Mr. Gregg?

Mr. GREGG. No.; I would rather wait and look into it.

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

Mr. MANSON. Yes, sir; I have another small case here.

Senator KING. Mr. Chairman and Mr. Manson, would it not be a good idea if Mr. Nash and Mr. Gregg could tell us, without too much trouble, to what extent this ruling of the solicitor has been followed or has been departed from? It would appear from Mr. Manson's statement that scarcely has been observed at all.

Mr. GREGG. It looks to me, Senator, rather as if, in answering Mr. Manson's statement this morning, we have got to.

The CHAIRMAN. Answer yours.

Mr. GREGG. Yes.

Senator KING. Well, I thought so, too.

Senator WATSON. You do not mean that they should make an immediate inquiry?

Senator KING. Oh, no.

Mr. GREGG. No; you will have to give us time to look it up.

Mr. MANSON. I would say that for some time we have been conducting an investigation to determine that fact, and we started with the big cases. I requested the engineers to start with cases involving allowances in excess of $500,000, knowing, of course, that we could not cover the field. I desire to cover the field in the amount of allowances, to as great an extent as possible.

Mr. PARKER. There are some cases which, of course, are determined on a salvage value. We are not discussing those.

Mr. MANSON. No.

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

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, MARCH 30, 1925

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

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

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

Present also: Mr. L. C. Manson, counsel for the committee; Mr. Raleigh C. Thomas, investigating engineer for the committee; and 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. J. G. Bright, Deputy Commissioner of Internal Revenue; and Mr. A. R. Marrs, attorney, office of the solicitor, Bureau of Internal Revenue.

The CHAIRMAN. Mr. Gregg, have you anything to present this morning?

Mr. GREGG. Mr. Bright has a statement in reference to the United Verde Mining Extension Co.

The CHAIRMAN. Very well; you may proceed, Mr. Bright.

Mr. BRIGHT. At the hearing of this committee held on March 26, 1925, the case of the United Verde Extension Mining Co. was presented by Mr. Manson. It was said by counsel for the committee during his presentation of the matter that this was a "clear case of fraud." (Transcript, p. 4018.) No individual is named in connection with this charge of fraud, although the chairman remarked that he gained from the statement of counsel that the fraudulent acts were particularly applicable to the taxpayer in his presentation of the case in his brief. (Transcript, p. 4056.) Under these circumstances and because my action in recommending to the commissioner that this case remain closed for the year 1917 has been the subject of severe criticism by counsel for the committee, I deem it proper to make a full and complete statement as to the circumstances surrounding my action.

This case first came to my attention during May, 1923, upon the protest of the taxpayer against the bureau's proposal to assess an additional tax of $721,260.82. There were two conferences held in my office at which the taxpayer was represented and at which two representatives of the natural resources division and one representative of the audit division were present. It was my effort to consult and advise with all of those in the bureau who had knowledge of this case in order that I might have the benefit of such information

as the several individuals possessed and because I believed they should be informed of the action under consideration.

On September 11, 1923, I addressed a memorandum to Mr. Blair containing my conclusions and making a recommendation that the taxes of this company for the year 1917 remain undisturbed and that the assessment letter proposing to assess an additional tax of $721,260.82 be withdrawn. I made this recommendation after full consideration of all the circumstances, and I believe with the complete knowledge, if not approval, of the several individuals in the Income Tax Unit who had handled the case. Mr. Greenidge, the chief of the natural resources division, recommended that the case remain closed for 1917 and based his opinion on the proposition that a further determination of taxes for that year after the usual procedure had been followed would not result in a material difference from the tax theretofore paid.

It is unfortunate that paragraphs numbered 3 and 4 of my memorandum to the commissioner of September 11, 1923, were included as reasons for my recommendation, because upon further consideration of the matter I realize that the statements therein made are erroneous and misleading. I can only account for this error by reason of the great volume of work that was passing across my desk at the time and my consequent inability to study the files and records in this case with that degree of care that no doubt should have been exercised in such an important matter. I can only say that the memorandum was prepared in the utmost good faith, believing that the statements therein made were fully borne out by the facts. Upon further consideration I am still convinced that the result of my memorandum was and is correct and proper and that the case should have remained closed, although some of the reasons on which I based my original recommendation to the commissioner might well have been eliminated.

Mr. Enes, a conferee in the consolidated returns subdivision, had been specially designated by me to review this case prior to my recommendation to the commissioner, and Mr. Volney Eaton, chief of the special assessment section in the natural resources division, had also reviewed the case, and it seemed clear from recommendations made to me by these men that a lower rate was justified by the use of comparatives of other representative copper companies. While an additional tax might be found due for 1917 by throwing out the original basis used in arriving at the depletion deduction and using the lower rate of 15.81 per cent, this would have been seized upon by the taxpayer as a basis for consistent use in the following year, the result of which would have been to substantially decrease the tax for 1918, with the net result for the two years remaining approximately the same. In the meantime a vast amount of work would be performed by the bureau and the company put to considerable expense, with no material change so far as the Government is concerned in the net result. For this reason and for the further reason that my effort was and is to get the work of the bureau current and allow cases that were tentatively settled by my predecessors to remain closed where subsequent investigation clearly shows substantially the same result as the tentative settlement, in the absence of fraud or gross error, neither of which, in my judgment,

was present in this case, I recommended to the commissioner that the matter be not reopened.

I desire to emphasize a fact that must already be apparent. My action was taken with the full knowledge of everybody concerned, and my memorandum of September 11, 1923, was included in the files and must have come to the attention of Mr. Grimes and Mr. Donahue. If erroneous statements were made in this memorandum, I had a right to expect that these individuals would point out my error to me and give me an opportunity to correct what was obviously a mistaken idea of the facts. In any event, I believe my conclusion was correct and that the Government has in no way suffered by reason of my action. I shall be glad to answer any questions that the members of the committee desire to ask.

Mr. MANSON. I would like to examine Mr. Bright on this matter to-morrow. I have not the files here and I would like to refresh my recollection as to some of the facts.

The CHAIRMAN. In view of what Mr. Bright just said I want to emphasize what I think is the contention of counsel, at least it is my view of it, that this is dwelt on particularly for the reason that it seems to be an erroneous settlement. It seems to be the impression of the bureau that we are only interested in getting cases where the Government has failed to collect enough tax. That is not a correct conclusion. The committee is just as anxious to help straighten out errors or policies of the bureau where the taxpayer gets the worst of it as it is to take similar action in cases where the Government gets the worst of it. While, as Mr. Bright has stated, the net result in this case may have been the same to the Government, I can not conceive of the bureau indorsing a policy which permits one case to be settled because it balances another case.

Mr. GREGG. I do not think Mr. Bright meant to give that impression.

The CHAIRMAN. He emphasized that in his statement, Mr. Gregg, because he said the outcome was the same to the Government as though they had opened up the 1917 case.

Mr. GREGG. He was referring entirely and solely to this case, and his idea was, as I understood him, that if he reopened the case and revised the depletion deduction, it would have necessitated the use of different comparatives which, with reference to this taxpayer, would have given the same result.

The CHAIRMAN. That is true, and he was taking into consideration other factors than the factors which seemed to be in error. I think every case and every factor should be settled on its merits regardless of some other factor. If an official of the bureau can approve an incorrect factor with a mental or even a stated reservation that some other factor will be disturbed by the correcting of this factor, it seems obvious to me that that is an incorrect procedure.

Mr. GREGG. In this case, Mr. Chairman, it appeared that the case was reopened and the one error corrected, there will be another error which will also have to be corrected at the same time, with the net result that it means no difference in the tax liability of the taxpayer. Is not the question of primary importance how much tax this particular taxpayer owes, and there is no necessity to go through a reworking when the two items are going to offset.

The CHAIRMAN. As a practical proposition in the settlement of that particular case I think you are entirely correct, but you know that the establishment of these precedents goes on for years and years and they should be corrected at the time they come up and not be allowed to run so that the taxpayer may use them for 10 or 15 or 20 years thereafter as precedents established by the bureau.

Mr. GREGG. I do not think that is done. An erroneous action on one point which may be allowed to stand because it will not affect the tax liability of a taxpayer is not allowed to remain for subsequent years when it may affect the tax liability of other taxpayers. It is not considered as a precedent in any respect.

Mr. MANSON. In this particular case there were two factors. One was the question whether a depletion allowance of over $2,000,000 should be allowed and the other one was the question of a proper comparative rate. There is no relationship between the two. The matter of the comparative rate is a question that is determined by comparing the rates of this taxpayer with the rate paid by the other taxpayer engaged in the same industry.

The CHAIRMAN. In this particular case a properly organized board established this comparative rate without regard to any other factor.

Mr. MANSON. And the taxpayer took no exception to it.

The CHAIRMAN. Yes; the taxpayer took no exception to it.

Mr. BRIGHT. I would not say that the board did not take into consideration any other factor. The factor of depletion allowance I think is considered at the same time that the invested capital is considered. Income and invested capital are both considered in applying special assessment. It is so stated under the law.

The CHAIRMAN. But under what rule did you or your associates assume, other than on the statement of the taxpayers, that the rate would be questioned if you disagreed with the taxpayer on the matter of depletion?

Mr. BRIGHT. By disallowing to this taxpayer the total depletion or any portion of it, its income would be disproportionate to that of other taxpayers to whom it should rightfully be compared.

Mr. GREGG. If I may amplify that a bit, I think the point is that the income factor is one of the important factors in determining special assessments. Through the disallowance of deduction for depletion, it would entitle the taxpayer to deduction. The act I think justifies that interpretation and forces that conclusion, and that has been done in cases by the department. An adjustment of income may be the sole factor which entitles the taxpayer to a special assessment and by readjusting the income account and throwing out all depletion that would affect the comparatives under the special assessment section.

The CHAIRMAN. Are these comparatives used in all succeeding years?

Mr. BRIGHT. Each case is closed on the basis of the rates of the several companies considered in that particular year, so the rates used in one year do not necessarily apply all through all years.

The CHAIRMAN. What rate was used in the succeeding years in the case of this taxpayer?

Mr. BRIGHT. It has not been closed.

The CHAIRMAN. For 1918 and subsequent years it has not been closed?

Mr. BRIGHT. No.

The CHAIRMAN. Has any rate been established by the bureau for those succeeding years?

Mr. BRIGHT. That I can not say.

The CHAIRMAN. The establishment in 1917 of the invested capital on which depreciation or depletion is figured fixes that factor for all years, does it not?

Mr. GREGG. As to depletion, yes. Of course it is not in this case, because they are entitled to discovery depletion for years subsequent to 1917. So the only year affected by the depletion allowance is 1917 in this case. A depletion basis once set continues throughout. A special assessment basis once set does not, however.

The CHAIRMAN. In this case you fixed the valuation as of March 1, 1913, which would be a fixed valuation for succeeding years, would it not?

Mr. GREGG. No, sir; not in succeeding years, because in succeeding years the taxpayer takes depletion on the basis of discovery.

The CHAIRMAN. In all cases, whether there is discovery or not?

Mr. GREGG. No, sir; just in this case; in this particular case.

The CHAIRMAN. In fixing any 1917 taxes on March 1, 1913, value, of course you have no right to consider subsequent years or subsequent discoveries, because you were not looking forward but were dealing with conditions prior to the use of the discovery depletion. You then had a right to assume or at least any investigator had a right to assume that you were using that March 1, 1913, valuation in subsequent years. I mean to imply by that that it is a dangerous precedent loosely to establish a March 1, 1913, value when that March 1, 1913, value must continue throughout the subsequent years in making the taxpayer's return.

Mr. GREGG. That is true if it continues throughout the subsequent years.

The CHAIRMAN. That is one of the criticisms in this case, that a careless March 1, 1913, value was allowed and an incorrect one was allowed which might exceed perhaps the discovery value if it had been continued throughout subsequent years.

Mr. GREGG. Of course, in this particular case it could not continue because in subsequent years depletion was on discovery value.

Mr. MANSON. Did you make a set-up as to what companies you would apply in determining the rate in case you excluded this?

Mr. BRIGHT. The set-up was made on that basis, Mr. Manson, and these data sheets were in the files of the case. The allowance on depletion was based primarily on——

Mr. MANSON (interrupting). No; I am not asking that.

Mr. BRIGHT. Just a minute. The allowance of depletion to this taxpayer took into consideration the probability of showing a $4,000,000 value and not a $40,000,000.

Mr. MANSON. Do you mean the allowance made was based on a $4,000,000 value?

Mr. BRIGHT. And not a $40,000,000 value; yes, on the data sheets.

Mr. MANSON. Upon what theory can you justify an allowance for one year for depletion in excess of $2,000,000 on a $4,000,000 valuation?

Mr. BRIGHT. My statement to that effect was erroneous, as I stated this morning. I was not justifying an allowance of depletion in excess of that claimed by the taxpayer. The statement that I had reference to was a statement made to me by Mr. Donahue that this taxpayer probably could prove a March 1, 1913, value of $4,000,000 based on the capitalizations of the two predecessor companies.

Mr. MANSON. Assuming a $4,000,000 valuation as being correct as of March 1, 1913, the depletion allowance was predicated on a $40,000,000 valuation.

Mr. BRIGHT. Yes.

Mr. MANSON. So that your depletion allowance on a $4,000,000 valuation would be approximately one-tenth of the depletion actually allowed; in other words, that would give you somewhere in the neighborhood of $200,000 as depletion instead of $2,000,000.

Mr. BRIGHT. As claimed.

Mr. MANSON. On the basis of the $2,000,000 valuation you used comparisons in which you compared companies with tax rates ranging from 12 to 34 per cent.

Mr. BRIGHT. May I state right there that the rate of 34 was since changed by special assessment. In fact, that information was available to Mr. Eaton at that time. They had applied for a special assessment and had been granted an 18 rate.

Mr. MANSON. Suppose you applied an 18 rate to this case and cut down the depletion from $2,000,000 plus to $200,000 plus, do you mean to say you would get a result in taxes of approximately what you actually made in this case?

Mr. BRIGHT. They arrived at a tax in this case of approximately $150,000 by only allowing $200,000 plus depletion with a 15.81 rate.

Mr. MANSON. Do you mean that there was an extra tax of $158,000 in addition to what had already been paid?

Mr. BRIGHT. $154,000.

Mr. MANSON. After you cut the depletion down from $2,000,000 to a depletion basis on a $4,000,000 valuation and after you reduced your rate from 21 per cent plus to 15 per cent plus?

Mr. BRIGHT. Yes.

Mr. MANSON. And there were still $158,000 more due the Government after you had made those adjustments? Is not that true?

Mr. BRIGHT. That is correct by that data sheet.

Mr. MANSON. Did you contemplate further increasing the depletion over a $4,000,000 valuation, which is the highest one to which you could give any consideration?

Mr. BRIGHT. No, sir.

Mr. MANSON. Did you contemplate reducing the rate below 15 per cent?

Mr. BRIGHT. No. According to a statement made by Mr. Eaton, which was part of the record and which I would like to read—and that will answer your question——

Mr. MANSON (interrupting). I want to know whether you contemplated reducing the rate of approximately 15 per cent.

Senator ERNST. You may explain it in your own way, Mr. Bright.

Mr. BRIGHT. I did not contemplate reducing that rate below 15.81.

Mr. MANSON. On that basis, even though you had made all the changes that you contemplated might be necessary, the taxpayer still owed the Government $158,000, did it not.

Mr. BRIGHT. By that data sheet, yes.

Mr MANSON. In spite of that fact you recommended that the case be closed?

Mr. BRIGHT. On this statement of Mr. Eaton, chief of the special assessment section:

> By allowing the previous rate and settlement for 1917 to stand instead of the rate and tax as determined by the new audit sheet and corrected income allowing $4,000,000 March 1, 1913, value, the Government will lose approximately $154,000, but at the same time the unit is placed in a better position to equalize in 1918 any inequalities inadvertently favoring the taxpayer as a result of this settlement made in 1917.

The CHAIRMAN. That is just the statement I was going to read. I had in mind that very point which I raised with Mr. Gregg previously, that the adjusting of rates and taxes in subsequent years is a bad policy. I am questioning the policy in this case. I think if the bureau is going to allow the taxpayers to get off, or even charge the taxpayers rates for taxes in excess of what that particular year showed were just and equitable because of some opportunity in later years to adjust it, it is pursuing an unsound policy.

Mr. BRIGHT. It was based on the fact that this taxpayer would apply for special assessment in subsequent years. It would be entitled to relief under special assessment.

The CHAIRMAN. Let the taxpayer do it. I am not objecting to the taxpayer getting relief in subsequent years under a proper rate, but I think this is a very bad policy to adjust a case on any such principle as that, on the assumption that the taxpayer is going to do something in some subsequent year that the bureau would rather he would not do. Let him take his chances. Let the subsequent years' taxes be arrived at on a proper basis, regardless of the particular year. I am not finding fault with this case because of this particular case, but I hope the department will change its policy.

Mr. MANSON. On that point, as to a special assessment in 1918, this taxpayer in 1918 was allowed some $36,000,000 as a discovery value, was it not?

Mr. BRIGHT. I think so.

Mr. MANSON. Do you think they would be entitled to a still lower rate? If you allowed them depletion based upon their $36,000,000, do you think they would be entitled to a lower rate than the 21 per cent?

Mr. GREGG. May I answer that question? The matter of depletion of discovery value does not affect the invested capital at all.

Mr. MANSON. I understand it does not.

Mr. GREGG. The rate of tax to which they are entitled depends upon invested capital entirely.

Mr. MANSON. You have just stated a few moments ago that it depended to some extent upon depletion allowance.

Mr. GREGG. That is true, but the rate of tax is determined by invested capital. The abnormality affecting their invested capital would exist in subsequent years regardless of the fact of the abnormality of their——

Mr. MANSON (interrupting). You mean the question of whether or not they are entitled to consideration under section 210 depends upon the amount of invested capital?

Mr. GREGG. Not solely. Their income on invested capital may affect the question whether they are entitled to a special assessment.

Mr. MANSON. I wish to call attention on the record at this time that the facts in this case show that in 1912 the capitalization of this company was reduced from $4,000,000 to $750,000 and that there was an actual sale of $450,000 out of $750,000 of stock, and that the value as fixed by that actual sale of this property was $525,000. Under those conditions, when the further fact is taken into consideration that the company was not operating—I say it was not operating. It was not producing any minerals. It was a mere prospect at that time. To fix a $4,000,000 valuation on a company the value of whose entire stock was fixed by actual sale in 1912 is certainly stretching valuation to the breaking point, and even after you stretch it to the breaking point of $4,000,000 and even after you reduce the tax rate to the minimum contemplated by the bureau there was still a difference of $154,000 plus in the tax .

The CHAIRMAN. There is another element entering into this case that runs through several cases, and that is the allowing of the taxpayer to get away with misstatements, either intentional or otherwise. For instance, it runs all through the case that the taxpayer insisted the 1917 case was closed when every employee of the bureau denied that statement. In the letters which Mr. Bright refers to in his communication to the commissioner he uses these two statements as reasons for closing the case——

Mr. BRIGHT. Oh, no!

The CHAIRMAN. I beg your pardon. Just a moment until I finish. In your letter to Mr. Blair you said, on September 11, 1923——

Mr. BRIGHT (interrupting). Paragraph No. 1 covers that, Mr. Chairman.

The CHAIRMAN. In the last paragraph you said, in view of the fact as set forth in the memoranda prepared by Mr. Enes and Mr. Eaton, and in these memoranda to which you made reference in your letter to the commissioner, they both emphatically denied that the case was closed in 1917. For instance, Mr. Enes in his memorandum to you dated September 4, 1923, said:

> With reference to the taxpayer's claim that the case may be opened under provisions of section 1313 of the 1921 revenue act * * * it appears that the taxpayer has a good claim if he can show that the case was closed. The information in the files does not support his claim.

That is referred to in a number of references here, that he kept on contending that his case was closed when all of the testimony and all of the communications show there was no such basis for claim. I submit that when a taxpayer can appear before the bureau and make misstatement after misstatement and have the bureau swallow them it is wrong. The same thing was done in the Agwi case, where the taxpayer on several occasions tried to defraud the Government and still got away with it. I submit the Government is not protected if they can get away with that sort of thing. I believe the bureau should use every effort to resist that sort of thing and that a taxpayer ought to be punished for attempting to mislead the Government in that matter.

Mr. BRIGHT. I only want to state that the main point in this case that impressed me was that this was a special assessment case which had been closed by the old advisory tax board; that is, tenta-

tively closed, allowing special assessment. As time was going on and the settlement of the case had been made, an investigation of comparatives of similarly situated companies to this company would not show a material change in the rate of tax, nor would the Government lose any great amount of money taking 1917 and 1918 into consideration, and that was my main purpose in trying to permit cases once closed to remain closed and not be continuously reopened if that was the case.

The CHAIRMAN. Please remember, so far as the chairman may speak about it, that I am not objecting particularly to the fact that the case was closed, but to the methods under which it was closed and the conclusions reached for closing it. In other words, if this case was closed publicly, no such basis for closing it would be stated, or if it was stated then every other taxpayer could close his case on the same theory. In other words, there must be justice and equity between taxpayers, and no taxpayer, because of secrecy of a settlement, must receive any favor nor must other taxpayers be unjustly treated.

Coming back to the question of the tax rate itself, I do not see any basis yet anywhere for reaching a conclusion that it may be reduced below 21 per cent; and yet offhand and without any substantiating evidence at least that appears in the record, there originates in the mind of some official of the bureau a thought, perhaps put there by the taxpayer, that he may get a lower rate. I think that is absurd.

Mr. BRIGHT. The data sheet as given to me by Mr. Eaton, chief of the special assessments section, showed this rate of 15.81, and it was a better data sheet than that used by the section in arriving at or trying to perfect a rate of 21.

The CHAIRMAN. All right, Mr. Bright, we will concede that. In justice to the taxpayer we will concede that he ought to have had a rate of 15 plus and not 21 plus per cent. I am not here to contend that the bureau should squeeze the taxpayer to the limit. I am endeavoring to help the taxpayers as well as the Government to get justice. It is not the theory of the committee that in all cases the bureau has been negligent in supporting the Government's claim and collecting the Government's claims, but the committee believes that the bureau should see that the taxpayers are not unfairly and unjustly treated in any cases. That can only be arrived at by an investigation and comparison between taxpayers.

While on this point I want to mention a part of the record that was not read by Mr. Manson, although it was placed in the record. As long as Mr. Bright is here perhaps he would like to comment on it.

Mr. MANSON. I call the chairman's attention to the fact that in the communication to which I believe he refers Mr. Donahue repudiates the statement that has just been attributed to him that a $4,000,000, 1913, value could be fixed on this property.

The CHAIRMAN. That is not what I was going to refer to.

Mr. BRIGHT. Mr. Donahue I think has reference to my memorandum where I said that the taxpayer probably could prove a greater 1913 value than that allowed in the letter of June 10. Mr. Donahue did not make that statement. I do not think Mr. Donahue will repudiate the fact that he did state that the taxpayer could probably prove a $4,000,000 March 1, 1913, value.

The CHAIRMAN. In the communication to the commissioner dated February 18, 1925, however, Mr. Grimes said this:

I believe the portion of the documentary record comprising the attached exhibits fully substantiate my statement that both Mr. Greenidge and Mr. Bright violated their oath of office in recommending that this case be settled on the basis of the initial tax paid and further violated the trust which was conferred upon them by their superior officers in recommending the final settlement of the case by 1312 agreement. Such an agreement has been signed by the Secretary of the Treasury.

Mr. BRIGHT. That is an awful charge for anybody to make.

The CHAIRMAN. Yes. I was going to say that that is a very serious matter and it appears in the records of the bureau and is taken from the records of the bureau by the investigators of the committee. I think it was of sufficient seriousness to have instigated some sort of inquiry and some sort of conclusion being reached by the officials of the bureau.

Mr. GREGG. I can answer that statement. This case was called to no one's attention until about a month ago. As a matter of fact, the fact that the investigation was going on is the reason that it was ever brought to our attention. Mr. Grimes's conscience seems to have remained quiet for a couple years after settlement until the committee got into the case, and then he brought it up and wrote his memorandum to the commissioner, which was his way I think of bringing it up to the investigating committee. The case was turned over, I understand, by him to the committee and their attention was called to it by him. It seems that it is another instance where Mr. Grimes has taken it upon himself to criticize the conduct of other people without knowing what he was talking about.

The CHAIRMAN. I am not substantiating Mr. Grimes's statement nor am I dealing with it upon its merits. I am not competent at this time to pass upon the justification for the memorandum. I am bringing it up particularly to ask if the commissioner has taken any action in connection with it.

Mr. GREGG. That is the reason why I said what I did. It was not called to our attention until about the time it was brought to the attention of the committee. We are going into it at one time for the committee and for the bureau.

Mr. NASH. With reference to the United Verde Extension Co. case, Mr. Grimes called me at my house one Sunday several weeks ago, and wanted to come to my house to see me. He said he had some things that he would like to talk over with me. I told him that I was coming down town that afternoon, and that I would come into the office and he could come in then and tell me whatever he had to say. I tried to get in touch with both Mr. Blair and Mr. Hartson, to see if they would come down to the office with me, but I could not get either one of them; so I went down and listened to Mr. Grimes's story alone.

He cited a number of cases wherein he had differed with the settlement that had been reached, and among them was the United Verde Extension Co. case.

The next morning I went in to see Mr. Blair and repeated to him as nearly as I could everything that Mr. Grimes had said.

That afternoon Mr. Blair called Mr. Grimes up to his office and Mr. Grimes repeated to Mr. Blair substantially what he had said to me the day before, and Mr. Blair asked him to put in writing for his information the criticisms that he had of these various cases. As I recall it, there were 8 or 10 of them. That is what brought about the writing of the memorandum from which you have just read.

The original of that memorandum came up to the commissioner and he asked for certain papers in the file of the United Verde case, and sent them to the solicitor's office for the solicitor to immediately go into the case.

Just about that time, I believe, the committee called for the files in the case and the solicitor had not completed his work.

That is the status of the United Verde case, as far as the commissioner is concerned.

The CHAIRMAN. You may proceed with your case now, Mr. Manson.

Mr. MANSON. On March 25 we were discussing the question of whether amortization applied to land, and the statement is made on page 3968 of the record by Mr. Gregg that it does not apply to land. I have a memorandum of several cases in which amortization has been allowed upon land.

In this connection I wish to be distinctly understood as not questioning Mr. Gregg's good faith in making this statement on the record on the 25th.

The CHAIRMAN. In that connection I might say that I have in mind one particular case where I understood amortization had been allowed on land, and that was the reason I asked Mr. Gregg if that was the practice or the law, which resulted in Mr. Gregg's statement.

Mr. MANSON. But I want to state on the record as positively as I can that I am not questioning the good faith of Mr. Gregg, but merely the reliability of his source of information, and knowing, as I do, the general confusion in which the whole subject of amortization is involved, there being no adequate regulations, no written instructions, and no ruling, with the exception of one which has been shown here time after time as not adhered to, I call these cases to the attention of the committee more for the purpose of showing this general confusion than for any other purpose, in addition to showing the fact that not even the responsible officers of the bureau are informed as to how the amortization section of the statute is being applied.

The cases to which I will refer are the Todd Shipyards Corporation and the Todd Dry Dock & Construction Corporation, treated as one company. In that case amortization is allowed on real estate, dredging, and filling, and on dredging, filling, and bulkheading. Real estate is included but is not separated by the engineers in making their allowance. The allowance under all of those headings involves $74,723.70. The Todd Dry Dock & Construction Co. also had an allowance of $184,363.51.

In the case of the Trojan Powder Co. amortization is allowed on real estate, surveying, and recording, amounting to $16,093.05.

In the case of J. H. Williams & Co. amortization is allowed on real estate, surveying, recording, and improvements, of $16,681.27.

In the Guantanamo Sugar Co. amortization is allowed for real estate, clearing, planting, and fencing, amounting to $10,088.98.

In the case of the Federal Shipbuilding Co. amortization is allowed on real estate amounting to $200,847.71.

In the South Porto Rico Sugar Co. case amortization is allowed for clearing pastures and cane fields, which I take it is an improvement of real estate for the purpose of rendering it fit for raising sugar, amounting to $114,086.83.

In the case of the Pacific Coast Shipbuilding Co. amortization is allowed on real estate amounting to $80,500.

I will submit the following as showing some examples of what I refer to:

Taxpayer	Item	Amortization claimed	Amortization allowed
Todd Shipyards Corporation [1]	Real estate, dredging, filling	$190,096.11	$74,723.70
Todd Dry Dock & Construction Corporation.[1]	Dredging, filling, and bulkheading	270,399.81	184,363.51
Trojan Powder Co	Real estate, surveying, and recording.	23,951.85	16,093.05
J. H. Williams & Co.[2]	Real estate, surveying, recording, and improvements.	25,271.83	16,681.27
Guantanamo Sugar Co.[2]	Clearing, planting, fencing, and real estate.	15,665.12	10,088.98
Federal Shipbuilding Co	Shipyard site and east side real estate.	392,331.32	200,847.71
South Porto Rico Sugar Co	Clearing pastures and cane fields	216,137.60	114,086.83
Pacific Coast Shipbuilding Co	Real estate at town of Clyde	80,500.00	80,500.00

[1] Treated as one company.
[2] For itemized "breakdown" of this case, see table following.

Taxpayer	Date acquired	Amortization claimed	Amortization allowed
Guantanamo Sugar Co., New York City:			
Station Rio Seco, clearing and planting	January, 1919	$472.95	$472.95
111.2-acre section, Rio Seco	December, 1917	2,060.82	1,222.52
Purchase of Colonia M. Savon	October, 1917	414.12	245.77
66.7 acres, Rio Seco	April, 1918	1,342.70	796.52
180 acres, Rio Seco	June, 1919	3,907.53	2,318.03
54.51 acres, section P. A	October, 1917	975.02	578.42
60.61 acres, section Q	November, 1917	1,040.23	617.08
Purchase of Colonias—contracts completed	October, 1917	1,626.28	965.09
24.7 acres, section O	April, 1918	242.44	143.82
152.11 acres, section P. A	November, 1918	2,100.04	1,245.79
Making pasture—128.44 acres	August, 1918	1,262.08	1,262.08
Fencing for pasture	do	220.91	220.91
Total		15,665.12	10,088.98
Amortization period ended Dec. 31, 1919.			
J. H. Williams & Co., Brooklyn, N. Y.:			
Land, surveying and recording		23,951.85	16,093.05
Fences and road pickets		1,319.98	588.22
Total		25,271.83	16,681.27

Mr. GREGG. In referring to the amortization on land Mr. Manson beat me to it by a few minutes.

After the meeting the other day, Mr. Marrs looked into the question for me and found that they had allowed amortization on land; but I do want to correct now the impression that Mr. Manson left by his statement that when I referred to that subject I was attempting to say what the bureau did. I remember the conversation, and

I said I did not think that amortization did apply to land, and then I read the statute which said buildings, plants, machinery, etc. I said I did not think land came within that term. I still do not. That is one thing in which the bureau does not happen to agree with what I think is a proper interpretation of the law; but I was not attempting at that time to say what the bureau did. I had not looked into it, and I would not have said that.

Mr. MANSON. The statement that I refer to on page 3185 is as follows:

Mr. GREGG. No, sir: we have ruled specifically that it does not apply to land.

Mr. GREGG. I think we have. I have not looked into it to see whether we have or not. I remember the question arising, and I remember very distinctly that it arose with reference to coal property; but we can find out about that.

The point I do want to make is that I do not know, and do not pretend to, without looking into it, exactly what the bureau has ruled on a particular question that has arisen. If the committee wants to ask me about a matter of that kind and gives me time to look it up, I can find out, but I can not carry the rulings on all subjects in my head.

The CHAIRMAN. I would like to ask Mr. Nash if he has looked up the case of the Lincoln Motor Car Co. That was one of the cases in which I understood amortization was allowed or claimed for real-estate extensions.

Mr. NASH. I spoke to Mr. Hartson about the case when he came back, and Mr. Hartson has prepared a memorandum, which he asked me to hand you to-day. If you want it in the record, I will be glad to read it.

The CHAIRMAN. You may read it if it is not too long.

Mr. NASH. This is dated March 28, 1925, in re Lincoln Motor Car Co. It is addressed to Mr. Nash and is signed by Nelson T. Hartson, Solicitor of Internal Revenue:

Senator Couzens asked me some time ago regarding the adjustment of the Lincoln Motor Car Co. taxes for the year 1918. Since that time I understand he has also asked you for information on this matter. I find from the office files that the Income Tax Unit made an additional assessment against the Lincoln Motor Car Co. of $4,505,681.23 for the year 1918 on account of the disallowance of part of the amortization claim by the company, and on account of the assessment made under the provisions of sections 327 and 328 of the revenue act of 1918 at the rate of 70.01 per cent of the net income.

It appears that the Lincoln Motor Car Co. at the request of the Government constructed a new plant in order to increase production of Liberty motors. Building operations were commenced September 21, 1917, at a time when material, machinery, and labor were all secured at very high prices. After the assessment of the additional tax above referred to a reorganization was attempted and which proved unsuccessful. Efforts to obtain further capital failed and on November 5, 1921, the Detroit Trust Co. was appointed receiver of the company. Immediately thereafter the district court appointed appraisers, who submitted a report showing a minimum or liquidating value as of November 7, 1921, of $2,730,784.42. The buildings cost $4,014,168 and have been appraised at a liquidating value of $1,120,000. The machinery, etc., cost $3,978,960.40 and have been appraised at a minimum or liquidating value of $824,212.76. No loss was claimed by the receiver on the land. The case was referred to the committee on appeals and review by the commissioner and after a thorough consideration of all the circumstances the amortization allowance based on appraisals made under order of the court was fixed at $6,048,915.69. The committee recommended that the action of the Income Tax

Unit in fixing the amortization allowance for 1918 at $1,944,385.38 be reversed and that an amortization allowance of $6,048,915.69 be allowed against the net income of the corporation for 1918 and 1919, to be spread upon the basis of the number of motors completed in each year, and the net loss sustained in 1919 be allowed against 1918 income in the final adjustment of the taxes for that year, and that an excess-profits tax rate of 65.67 per cent be assessed in place of the 70.01 per cent used by the unit.

This recommendation was signed by the chairman of the committee on appeals and review, Mr. N. T. Johnson; was noted by Mr. Mapes, Solicitor of Internal Revenue, and accepted for the guidance of the Income Tax Unit by Commissioner Blair. The effect of this recommendation was to reduce the assessment from $4,505,681.23 to $610,274.43, which was paid by the receiver for the company and the case closed. Senator Couzens apparently has the impression that this matter was compromised by the bureau. From the foregoing it is apparent that no compromise under section 3229, Revised Statutes, was made, but that further consideration of the company's tax liability reduced the assessment from the figure originally determined to be due.

He mentions the land here in just one place, where he says:

No loss was claimed by the receiver on the land.

The CHAIRMAN. I might have been somewhat confused by the assessment made by the Department of Justice, I think, in the fraud case and the Income Tax Unit assessment. As I recall it, there was some discussion in the House of Representatives about the fraud case against the Lincoln Motor Car Co., and I recall that when I was director of the Trust Co. the fraud case was settled for $1,500,000, if I remember correctly. I might have gotten somewhat confused between the fraud case and the Internal Revenue Bureau tax matter.

(At 11.55 o'clock a. m. the committee adjourned.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

FRIDAY, MAY 8, 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 the call of the chairman.

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

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. You may proceed, Mr. Nash or Mr. Gregg.

Mr. GREGG. Mr. Chairman, we thought we should call the attention of the committee to one thing. You will remember the wording of the resolution explaining the work of the committee. We now have requests from members of your staff for photostats of a very large number of cases, the representatives of the committee stating that they were wanted before May 15, so as to work on this summer. We wanted to make sure whether that was in accordance with the desire and intention of the committee, that we give them photostats of complete cases for them to work on this summer.

Senator ERNST. That is the first I heard of that.

The CHAIRMAN. I do not see how we can get along without it. I mean, under the resolution, we have got to get out of the bureau. Another thing is that one of the greatest questions raised in Congress and in the minds of the public is why there are these enormous appropriations for refund. I said to Mr. Manson the other day that this committee has got to answer that question. Otherwise, what was the use of getting into the bureau if we could not answer, perhaps, the biggest question raised in Congress and in the public mind as to the reason for the refunds. I asked Mr. Manson to prepare a questionnaire which I thought would cover the ground, but, as you know, he is ill. We want enough information, and I am willing to discuss that, or have Mr. Manson discuss with the representatives of the bureau as to how it is that that has come about and why. I think I understand it fairly well from my own contact with the work, but it is not a question of my understanding it. It is a question of making Congress and the public understand it, as to why these enormous appropriations for refunds are called for.

Senator ERNST. Are these photographs of original records that are requested?

Mr. GREGG. As I understand it, the requests were for photostats of the entire files in these various cases that have been called for.

Senator ERNST. No action in that connection has been taken by the committee, so far as I am aware. I want to go on record now as saying that I am opposed to it, so that if it should be called up at a meeting of the committee when I am not here I want my position to be known.

Mr. GREGG. May I take up a case now, Senator?

The CHAIRMAN. Yes.

Mr. GREGG. There are a couple of things that I wanted to take up with the committee.

The first is on amortization of land. The members of the committee will remember that I stated once in a committee meeting that amortization, in my opinion, was not allowable on land, and I said that the bureau had so held. Subsequently, I found out, and so did the representatives of the committee, that in various cases amortization on land had been allowed. There had been a published ruling of the solicitor on the point covering the developments of coal mines, and holding that inasmuch as these developments were an addition to the realty, they were not subject to amortization. I thought it was perfectly clear from that ruling that lands were not subject to amortization. The question arose in that connection, and we have now ordered all of these cases held up which involve amortization of land, and have had the question referred to our office for an opinion. That is the present status of the matter. It is over there, and none of the cases will be disposed of until we pass on the question as to whether it is permissible.

The CHAIRMAN. At this point, let me ask you if we are to understand that no amortization claims on land have been allowed up to date?

Mr. GREGG. I think some have been allowed. I think there were four or five on which it has been allowed, and we have asked that these cases be held up until we pass on the question.

The CHAIRMAN. Do you yourself understand, Mr. Gregg, that it is debatable? There must have been some debate on it.

Mr. GREGG. To be perfectly frank, I can not see any doubt about it. It seems to me perfectly clear that land is not subject to amortization, but I don't wish to decide the question against the taxpayer before it gets to me.

The CHAIRMAN. No; I am not asking you to do that.

Mr. GREGG. I think our published rulings are open to just one interpretation; that land is not subject to amortization.

I have some notes of some matters that I want to take up here this morning.

The next case is that of the Los Angeles Shipbuilding Co. That was a case of contractual amortization, if you will remember, and the question arose whether, in this case, the taxpayer had included the amortization allowance from the Shipping Board as income. We got in touch with the representatives of the taxpayer to find that out, and were advised by them that the claim had been assigned, with permission of the Comptroller General, and that the amount for which it had been assigned had been included as income. We wanted to check that more carefully, and have sent to the collector at the dis-

trict to have an investigation made of it, and to advise us on it. Of course, as soon as we get the report on that, I will take it up.

I also have here a note as to the Slim Jim Oil Co. I was trying to get the brief, giving the reasons for the compromise, which is included in every compromise case, from our file, and I was told the entire file was up here. So, until we can get the file, we can not answer that.

The CHAIRMAN. Mr. Carson, has Mr. Box got that file?

Mr. CARSON. No; I do not think he has the file at all. It may be down in Mr. Box's office, but we have none of the files up here.

The CHAIRMAN. We do not bring any original files up here, do we?

Mr. GREGG. But I meant it was out of our office.

The CHAIRMAN. You mean it may be down in the bureau, in some of the sections there?

Mr. GREGG. Yes.

Mr. CARSON. The instructions were that none of the papers should be taken out of the bureau, even over night; so they are all down there.

Mr. GREGG. I think that covers all of the comments that I have. Have you anything else, Mr. Nash?

Mr. NASH. There is the J. I. Case case.

Mr. GREGG. That is the case, you will remember, in which the opinion of the solicitor was written on the computation of amortization, and the whole subject is so big that we have one man going into it and trying to work out a rule that will be workable in connection with the engineers. We hope in that way to be able to get something that we can approve as to principle but which, at the same time, is not so theoretical that it can not be applied. Mr. Williamson, who was up here with us before the committee on several occasions, is working on that at the present time.

The CHAIRMAN. Do you understand that that also applies to the United States Steel Corporation?

Mr. GREGG. Mr. Williamson is working on the United States Steel Corporation matter also.

The CHAIRMAN. I have had some correspondence with Mr. Nash about that, and I understand that that is not settled as yet. Is that correct?

Mr. NASH. No, sir. That case is still pending in the solicitor's office. The lawyers in Mr. Gregg's office and the engineers are working jointly on it.

Senator ERNST. If there is any action to be taken by the committee, I want to go on record as opposing the request for photostatic copies of these original records to be taken from the files and introduced here.

Senator JONES of New Mexico. On what ground, Senator?

Senator ERNST. I do not think those original records ought to be photographed and bandied about. I think that would be an unwise thing. I think it is an entirely wrong thing to have copies of those records on file where anybody can get hold of them. I think if there are any records they want they ought to go right there and consult them. We are to be through by June 1, and the records could be examined, everything that is necessary, and have it all closed up. I think that ought to be done, but I do not think the original records

from the office of the Bureau of Internal Revenue should be taken away.

Senator WATSON. Let us see what the resolution says about that.

The CHAIRMAN. We just discussed that before you came in, Senator. Down to line 8 it is substantially the same as the old resolution. The resolution reads:

Provided, however, That the representatives of this committee shall be withdrawn from the offices of the bureau by June 1, 1925, and hearings shall cease on or before that date and no original files shall be withdrawn after said date—

That has reference to the original files.

* * * But any papers or files requested by the agents of the committee on or before May 15, 1925, shall be available to the agents of the committee for examination for two weeks after the same are furnished.

Senator ERNST. In my judgment, this is a violation both of the letter and the spirit of this provision of the resolution—"and no original files shall be withdrawn after said date." If they can take those original papers from the files and have photostatic copies made of them it would be an unwise thing to be done at this time, or any time.

Senator JONES of New Mexico. Senator Ernst, do you not believe that the committee could request the bureau to furnish those now with all of those original papers?

Senator ERNST. No; we could not do that. The work is over under this resolution by June 1. They can not do anything further.

Senator JONES of New Mexico. Well, this is not June 1.

Senator ERNST. I know; and up to that time I want everything done that this resolution authorizes.

Senator JONES of New Mexico. Can we not ask that those original papers be brought over here to-day?

The CHAIRMAN. Yes.

Senator WATSON. It says up to May 15, 1925, the original files may be produced.

The CHAIRMAN. Yes.

Senator WATSON. I agree with Senator Ernst in this, Senator: I do not see any difference between going in and taking out the original files and taking photostat copies. It is all the same thing.

The CHAIRMAN. Oh, no.

Senator JONES of New Mexico. Does not that clearly contemplate that we can ask for all the original files that we want up to May 15, 1925?

Senator WATSON. That is my understanding of the resolution.

Senator JONES of New Mexico. Yes.

The CHAIRMAN. The difference is that in securing the photostatic copies we will be out of the bureau, and will not interfere with the work of the bureau.

Senator WATSON. That is quite true, but, after all, as far as scattering information abroad and all of that is concerned, if these copies are to be made and bandied about the result is the same.

The CHAIRMAN. The result is the same prior to that date.

Senator WATSON. Yes; before the 15th of May under that resolution you have a right to go in there and take those original files.

The CHAIRMAN. Yes; and we have a right to two weeks after they are furnished, no matter when they are furnished.

Senator ERNST. Here is the language of the resolution:

* * * But any papers or files requested by the agents of the committee on or before May 15, 1925, shall be available to the agents of the committee for examination for two weeks after the same are furnished.

In other words, according to this resolution, you are entitled to the original records or copies of them for two weeks, and after that time they have to be returned. That is the meaning of this resolution.

The CHAIRMAN. We will return all of the original files, according to the resolution.

Senator JONES of New Mexico. It seems to me it is a question of what we want. We have full power to do that thing if we want to do it.

Senator WATSON. How many cases have you yet in. mind, Senator?

The CHAIRMAN. Before you come in, Senator, when Mr. Gregg raised the question——

Senator WATSON. Oh, if you have been over it, never mind, then.

The CHAIRMAN. I want to say this for your benefit.

Senator WATSON. Thank you.

The CHAIRMAN. Mr. Gregg raised the question as to whether the committee backed up the request made by one of our staff for photostat copies of the records. Just how was it you put that, Mr. Gregg?

Mr. GREGG. The representative of the committee's staff asked that photostats of some several hundred cases be furnished the committee, as he put it, for them to work on this summer. Now, I wanted to be sure that that was in accordance with the wishes of the committee before we furnished the photostats of these cases to him.

The CHAIRMAN. I might say in that connection, so far as my instructions were concerned, there was no reference made to the matter of working on them during the summer. It was a part of the request that I made of Mr. Manson to get this information for the committee prior to the limitation placed on it by the resolution. We can get off enough information within the two weeks, if necessary, to cover our purposes, perhaps, but if we did not have any of the original records, and we wanted to get them out of the bureau, I would not consider that we were violating the resolution.

Senator WATSON. Under the terms of that resolution, you have a right to go in and withdraw original minutes up to the 15th of May. Then they must all be returned within two weeks.

The CHAIRMAN. From the time they are furnished.

Senator WATSON. No.

The CHAIRMAN. No.

Senator WATSON. But, Senator, you can not go in there after the 15th of May and get anything.

The CHAIRMAN. Oh, yes.

Senator WATSON. What is your resolution?

The CHAIRMAN. We can ask for anything up to the 15th of May, and Mr. Gregg's understanding is that if there is any delay in furnishing the records, we would have two weeks after they are furnished to analyze the records.

Mr. GREGG. As I understand the resolution, the committee has authority to ask for original records in any case up to May 15.

Senator ERNST. That is right.

Mr. GREGG. But not after that date.

The CHAIRMAN. Oh, I do not understand it that way.

Senator WATSON. Let me read you this, Senator:

That the representatives of this committee shall be withdrawn from the office of the bureau by June 1, 1925, and hearings shall cease on or before that date and no original files shall be withdrawn after said date——

The CHAIRMAN. Yes: after June 1.

Senator WATSON (reading further):

* * * But any papers or files requested by the agents of the committee on or before May 15, 1925, shall be available to the agents of the committee for examination for two weeks after the same are furnished.

But it shall not run after the 1st of June, 1925.

The CHAIRMAN. Oh, no.

Senator WATSON. Yes.

The CHAIRMAN. Because if they were furnished on May 29, we must have two weeks after that.

Senator WATSON. No; but you must withdraw all you want by May 15.

The CHAIRMAN. Oh, no: we must make the request; that is all.

Senator JONES of New Mexico. We must make the request. They may be furnished later.

Mr. GREGG. As I understand it, that was put in so that if there was any delay on the part of the bureau in furnishing the cases, the committee would still have the case for two weeks after we furnished it.

The CHAIRMAN. Yes.

Mr. GREGG. So that the committee can, up to May 15, call for any records, but it can keep them only two weeks after the receipt of them.

The CHAIRMAN. Yes; but if we should go in on May 20 and ask to see a record and we got it on May 21, there is nothing in the resolution that would prohibit that.

Senator WATSON. What would be your construction of that, Mr. Gregg, if we were to come in and ask for a hundred original files?

Mr. GREGG. I would say they would have to return them.

Senator WATSON. At the present time, before May 15?

Mr. GREGG. They would have to get them back to us either by June 1 or, if that date was so early that they had not had them two weeks, they would have to be returned to us at the end of two weeks. That is my construction of it.

The CHAIRMAN. The chairman agrees with that entirely.

Senator WATSON. You will put a more liberal construction on it than I would put on it; but I am entirely willing to accede to your construction. What I was asking is this: Suppose we ask for a hundred copies and took those original files out before May 15 and had photostatic copies made of them.

Senator ERNST. I have to take the 11 o'clock train to New York and will not be back until Monday. It is not expected that there will be anything done to-morrow, as I understand it from the chairman and the secretary.

Mr. NASH. Another point that we were discussing, Senator Watson, before you came in was that if we furnished these photostats to the committee, and they are to be worked on sometime during the summer and the criticism of some of these cases enters into the report of the committee, the bureau thought they should have the opportunity of making a reply to be incorporated in the report of any such criticisms. The chairman stated that such criticisms should be submitted to the bureau in writing, and that we would be permitted to reply in writing.

Senator WATSON. Oh, I think so, to be fair, of course.

The CHAIRMAN. Yes; I have no objection to that. I agree to it.

Senator WATSON. It will be no advantage to do otherwise. A committee of investigation does not go in and make an ex parte statement, without the other side having an opportunity to be heard, of course. That is not investigating.

Senator JONES of New Mexico. The matter which I understand is concretely before us relates to a number of cases where refunds have been either claimed or allowed in excess of $200,000, and the chairman, just before you came in, stated that that had been one of the biggest criticisms in the public press against the bureau, and that this committee ought to be able to give the reasons why.

Senator WATSON. I have no objection to that, on Mr. Gregg's construction of this resolution, Senator Jones, which I think would give you the latitude.

Mr. GREGG. The point I have in mind is, if you agree to that construction, which I think is the correct construction, how does that apply to the photostats?

Senator JONES of New Mexico. When we framed the provisions of the resolution that was distinctly discussed.

The CHAIRMAN. I think Mr. Gregg, Mr. Manson, Senator Jones, and Senator Reed and myself discussed this matter, and we all agreed upon it in principle.

Senator JONES of New Mexico. Yes.

Senator WATSON. Of course I had nothing to do with the preparation of the resolution.

The CHAIRMAN. No; I mean after the resolution was pointed out to the committee.

Senator WATSON. Yes; I understand.

The CHAIRMAN. Senator Reed was delegated to agree with us on the resolution, and we did agree and reported back from the Finance Committee, which committee reported it as we agreed upon it.

Mr. GREGG. Let us straighten out the remaining one point on this matter. It seems to me that there is just one question remaining. Everyone agrees as to the construction of the resolution except on this point. Does the construction that we have just discussed apply to photostats as well as to original records? I think that is the question.

The CHAIRMAN. It particularly emphasizes original records, and that was put in for the purpose of preventing our interfering with the work of the bureau after June 1, and we will not interfere with the bureau after June 1 if we get these photostat records, because we can go on and study them afterwards, just the same as we are going on and studying the statistics after June 1. Those statistics

will not be furnished by June 1 and can not be furnished by June 1, but we will have to have those to study for our report.

Mr. GREGG. I am not arguing the other side of it. I just want to get the instructions clearly from the committee.

The CHAIRMAN. If it is agreeable to the other members of the committee, it is agreeable to the chairman if in lieu of at least some of these photostat copies requested the bureau furnishes us the total amount of tax refunded on these court decisions, and eliminate from these lists those that were refunded on court decisions. On those it will not be necessary to furnish a photostat copy.

Mr. NASH. It would be much easier to furnish you all of the photostats than to go through our files and try to pick out the ones that have been refunded on court decisions. There can be no separation of them. I have not any scruples about furnishing those photostat copies, but may I ask what disposition is to be made of these photostats after the committee completes its work? They are confidential records of the bureau, and under the law can not be made public. Some consideration should be given to the disposition of these things, so that they will not be made public in any way after the committee finishes its work.

The CHAIRMAN. So far as I am concerned, I am in favor of returning them to the bureau.

Senator WATSON. Oh, yes; the committee has no desire to violate the law.

The CHAIRMAN. No; not a bit.

Senator WATSON. No.

The CHAIRMAN. Do I understand now that it is the consensus of the committee that we get these photostat copies, as requested by our auditor?

Senator JONES of New Mexico. I think we should have them, and especially in view of Mr. Nash's statement that the work in furnishing them is comparatively nominal. The statement was made that it would take only two or three days.

Mr. NASH. That is, for this present list.

Senator JONES of New Mexico. Yes; I understand it is for the present list.

Senator WATSON. Do I understand, Mr. Nash, that you and Mr. Gregg acquiesce in that procedure?

Mr. NASH. Yes, sir. What Mr. Gregg and I were principally concerned in, Senator Watson, was an opportunity to reply to any criticism that the committee might raise on cases after June 1, if any such criticism is raised, so that the record would show both sides of the story.

Senator WATSON. Yes; of course. An investigating committee investigates both sides of the question.

The CHAIRMAN. Oh, absolutely. I said, before you came in, Senator, that so far as the chairman was concerned he has been trying to conduct this investigation in a wide-open way as regards the bureau, and wishes to give the bureau every opportunity to reply to any criticism that the committee's staff has made.

For the record, I would like to have a reply at this time, and if we can not have it now, I would like to have it replied to when Mr. Manson returns, and I am raising this question now largely because of Mr. Manson's absence.

Take the Sinclair Oil & Gas Co.'s case. It appears from the record that none of their taxes have been actually settled. From a chronological order of the correspondence and records that we were able to obtain, it appears that beginning with February, 1918, and dealing with the 1916 taxes and those of subsequent years, that from February 16, 1918, correspondence, conferences, and interviews took place up to May 1, 1924, during which time additional assessments were made by the bureau by the issuance of the regular additional assessment letter, aggregating $5,094,439.36.

Senator WATSON. When was the last assessment on that, Senator?

The CHAIRMAN. The memorandum that I have here says:

"Additional taxes per letter of February 8, 1924"—and it lists them by years, amount to the aggregate that I have previously mentioned—"during which time the Sinclair Oil & Gas Co. paid in taxes $1,222,127.96," making a difference of nearly $4,000,000, and none of which has been paid. What I wanted to ask the bureau was that, inasmuch as these taxes have been pending through all of these years, whether or not the Government loses interest on those assessments?

Mr. NASH. If assessments have been made, they are drawii g interest, Senator, under the 1918 law, at the rate of 1 per cent a month, and under the other law at the rate of 6 per cent per annum.

The CHAIRMAN. So that if all of these additional assessments are collected, aggregating, as I say, and including only up to 1918, in other words, the years 1916, 1917, and 1918, the Sinclair Oil & Gas Co. would have to pay interest thereon?

Mr. NASH. From the date of the 10-day notice that they received from the collector. The collector under the law must give them a notice, giving them 10 days in which to pay or to file an abatement claim.

The CHAIRMAN. Then, as I understand it, even though the letter was not sent out according to this memorandum until February 8, 1924, for all of the time between 1916, 1917, and 1918 up to that time no interest would be collected?

Mr. NASH. There is no provision of the law under which we could collect interest. The 1921 act is, I believe, the first law that has enabled us to collect interest on a delinquency that had been discovered when final adjustment of a case was being made.

The CHAIRMAN. So that the interest is all lost to the Government on those?

Mr. GREGG. Up until the date of assessment. I might add on that, Senator, that the 1921 and 1924 acts both provided for interest on additional assessments for the year 1921 and subsequent years. At the time that that was put in the matter was discussed in the Ways and Means Committee, and I am not sure about the Finance Committee, of making this interest apply to the prior acts, retroactively. It was decided not to, the principal reasons being that the delay was the fault of the bureau in collecting these additional taxes, and that we should not charge interest on them, but that we should start with 1921 and charge interest from then on, but under the old act the only interest to be charged was from the date of the 10-day notice following the assessment.

Senator WATSON. Are those Sinclair taxes under dispute?

The CHAIRMAN. I understand they are.

Senator WATSON. I did not know.

The CHAIRMAN. I want to emphasize there that it is apparent from a reading of this record, which I went over yesterday, that it is to the advantage of the taxpayer all along the line to delay settlement on those years that are referred to; and such being the case, it seems to me that the bureau has been exceptionally lenient in its failure to push these cases when they knew all the time that the Government was losing interest on this money and it was to the taxpayer's benefit to delay the settlement. In other words, it seems to me that this enormous amount involved in the Sinclair cases has, through delays, caused a loss of hundreds of thousands of dollars of interest to the Government.

Mr. GREGG. I may say on that, Senator, that it is very true that the bureau has been very liberal in allowing additional hearings and extensions of time for the submission of data, but the feeling has been that when you are dealing with taxes so large as these the taxpayer should be given every opportunity to present his case. That is the reason we have been as liberal as we have in the matter of hearings, extensions, and postponements.

The CHAIRMAN. That has been very expensive to the Government, has it not?

Mr. GREGG. Yes, sir; on the matter of interest it has.

The CHAIRMAN. I would like to ask the bureau if, in reply to the Sinclair case after it has been submitted by Mr. Manson more in detail, they think the tactics of the Sinclair Oil & Gas Co. have not been dilatory. The records as I have them here indicate that they have been exceptionally dilatory, and of course it is to their interest to do that.

Senator WATSON. When was the first assessment made?

The CHAIRMAN. I do not have a record of when they were first made, Senator. The only thing I have found in the record here is that they were made on February 8, 1924.

Senator WATSON. Were there any prior assessments?

Senator JONES of New Mexico. Was not that on assessments for the years 1916 and 1917?

The CHAIRMAN. Yes; on all of those prior years, but whether they were made all at one time or at different periods——

Senator WATSON. That is what I am trying to find out.

The CHAIRMAN. I am not quite sure from a reading of the records.

Senator WATSON. Yes; that is what I was trying to find out.

Mr. GREGG. I do not know anything about this particular case, but, talking generally, in these very large cases it is very difficult to settle one year without settling them all. For example, the adjustment of the 1916 taxes will change invested capital down to 1921. You can not settle 1918 until 1917 is settled. When you get to a point in a case where it is giving you a great deal of difficulty, you have to let the whole case remain open until that is settled.

Mr. NASH. Another thing is that when we send our auditors or engineers into work on a case, we try to bite off one year at a time, but we wish to make an examination cover just as many years as we can to bring it up to as nearly current as possible. We do try to

work 1917, 1918, and 1919 all together, when we go in a case where the three years are pending, so as not to disturb their taxpayers too much, and do the three years' job at one visit.

The CHAIRMAN. I do not find any particular fault with that procedure, but it does seem to me that in view of the fact that 1916, 1917, 1918, and 1919 have not been settled, of course 1920, 1921, 1922, 1923, and 1924 could not be settled. In that way the taxpayer goes on for several years with no settlement at all, and it is to his advantage that no settlement be made.

Senator WATSON. Has he not paid any interest at all during that time?

Mr. NASH. He is paying interest from the date of that assessment, and under the 1921 law for the years from 1921 down he would pay interest on any delinquency. Up until the time the 1924 law was passed, to offset that, we did not pay any interest on refunds. On many overpayments in 1917, 1918, and 1919 we did not make any refunds until 1922 or 1923, and the taxpayers did not get any interest on the money that the Government had use of for four or five years.

The CHAIRMAN. Well, the fact that those who paid got no interest does not offset the advantage that the people got in not having to pay interest. You are going back again to the average, which helps the fellow out who gets an advantage from the underside of the average.

Senator WATSON. Making one hand wash the other.

The CHAIRMAN. I mean making one hand wash the other, as between taxpayers.

Mr. NASH. That is the way the law worked.

The CHAIRMAN. Yes; but the assistant to the commissioner stated that one hand washed the other. In other words, we are getting back to Mr. Greenidge's contention that you could average taxpayers.

Mr. NASH. No; I did not mean that. I meant that the Government did not lose out entirely by this interest proposition. Of course, there is more interest due on additional assessments than there is interest due on refunds. Yet it was the agitation of the taxpayers claiming that they should have interest on these refunds which brought about that provision in the 1924 act.

Senator WATSON. What was the rate of interest up to 1921 on assessments actually made?

Mr. NASH. One per cent a month.

Senator WATSON. Twelve per cent?

Mr. NASH. Yes, sir.

The CHAIRMAN. Another very large case which involved a great deal of interest is the Standard Oil Co. of California, which case has not been settled, and I think it is opportune to say that something ought to be done to expedite the settlement of all of these cases, so that the Government will not only be out all of this interest but that the cases may be settled and the Government get the taxes.

Senator WATSON. You are quite right about that. How long has that matter been pending; do you know?

The CHAIRMAN. Which?

Senator WATSON. The Standard Oil Co. of California.

The CHAIRMAN. It has never been settled. I do not think any of the years have been settled.

Senator WATSON. Beginning with 1916 and from then on?

The CHAIRMAN. Yes; and I do not know how many other cases there are, but I understand that there are a great many others that have not been settled. I understand that some of the anthracite coal cases have been settled. We have gone into some of the anthracite coal cases to analyze the method of arriving at depletion and could reach no conclusion, because the cases have not been settled. Therefore you can not tell just what policy the bureau has elected to adopt on the matter of depletion of anthracite coal mines.

Mr. GREGG. I think you will find, Mr. Chairman, we are very much behind on our natural-resources cases, much more so than on anything else.

The CHAIRMAN. What does the bureau propose to do to clean up these natural-resources cases? In other words, from our examination we can not find a single thing being done to expedite these old cases.

Senator WATSON. Is that due to a lack of disposition to do it? That would be one thing, of course, to just let them drift along and pay no attention to them, but I do not suppose there is any disposition of that kind on the part of the department. Or is it because here is a fight on or a contest about the thing, with new hearings, new evidence, and all that sort of thing?

Mr. GREGG. Contests on dozens of points on all of these big cases.

The CHAIRMAN. Is there nothing that can be done to end these contests?

Mr. NASH. Mr. Chairman, the Bureau of Internal Revenue was called upon, under the revenue acts since 1918, to value every natural resource in the country—timber, oil, and metals. We are also called upon, under the amortization sections, to value a great many of the large industries that were engaged in the manufacture of articles used in the prosecution of the war. It was not until 1921 that we were able to perfect anywhere near an efficient organization to undertake this work. Up until 1921 very little work had been done on the natural-resources cases. I think we had a very good instance of what was done when for a few days the committee considered the copper cases, showing how hurriedly Mr. Graton attempted to value the copper industry in order to get taxes from the copper companies when the Government needed money. The work that was done in 1918, 1919, and 1920 had to be largely done over again. We have never had a very large force of engineers, and it has been very difficult for us to get good engineers at the salaries that the Government will pay. We had a tremendous turnover of men that we did get. Very seldom did an engineer stay with us to exceed one year, especially if he was a good one. We paid those men $3,000, $3,600, and $4,000. It was rarely that we could pay a man $5,000, and usually, as soon as he got acquainted with the work and gained some knowledge of taxes, some taxpayer would come along and pay him three or four or five times as much as we could, and he was gone. That is what we had to contend with. Mr. Gregg has just stated these cases involve many questions that are contested, tooth and nail, from start to finish. One hearing leads on to another hearing, and it takes months to settle such cases.

To-day, in proportion to the number of cases filed, we do not have so many cases pending. I think in natural resources there are less than 300 cases involving 1917.

The CHAIRMAN. That represents a lot of money, though, does it not?

Mr. NASH. Of course, it represents, as I believe, the larger cases, the ones that have been contested hardest, and fought over the hardest. I have not looked at the figures recently, but for 1918, as I recall it, there were six or seven hundred the last time I saw them.

Senator WATSON. Let me ask you this: Are those cases gradually being appealed to the new tax board?

Mr. NASH. Many of them are pending to-day before the Board of Tax Appeals.

Senator WATSON. This new board?

Mr. NASH. Yes, sir.

Senator WATSON. And are all of those other cases likely to get there eventually?

Mr. NASH. I presume they will all get there eventually, because the taxpayer usually, as has been pointed out, contests as far as he can before he pays any money.

Senator WATSON. How do they stand with their work now?

Mr. NASH. The Board of Tax Appeals last month received 900 cases, and that is about three or four times as many as they can turn out in the same period. I understand there are from 2,500 to 3,000 cases over there now.

Senator WATSON. "Three to four times as many as they can turn out." Turn out in what length of time?

Mr. NASH. In the same period.

Senator WATSON. Yes.

Mr. NASH. In the solicitor's office we are confronted with the same proposition. It is almost impossible to get lawyers. Mr. Gregg is begging for lawyers, good lawyers, to come in and handle our work, and with no criticism whatever on the solicitor's office, it sometimes takes six months, just in ordinary procedure, to get a case through there. All of these larger cases have to be referred back and forth to the solicitor's office for decisions on legal points that are involved.

It has been a most difficult proposition, and I know we at the head of the bureau are straining every effort we can to expedite these cases and get them closed. We have a great many difficulties to contend with.

The CHAIRMAN. You see, you say it is four years since you say you started in with the organization for valuing these natural resources. Is it going to take four years more or six years more, or what is the situation, because, as I said, we can not find any evidence that there is any effort made to speed up these cases.

Mr. NASH. I will say, Senator, that in less than two years we will have these cases very well cleaned out. The other cases are moving rapidly, and I think up through 1919 to date we have less than 40,000 cases pending. That is all through the bureau, and that record looks fine compared with what it was a year or two ago. Our men in the other sections are now working on 1920 and 1921, because the statute of limitations expires on both of those years on March 15, next. We are working more of our cases in the field, because we find that we can close them faster. We have sent a great many of

our engineers to the field for this summer, and I think we will get rid of more cases in that way than we would by keeping them in the bureau.

This copper valuation that we are working on is reopening a great many cases that have previously been closed. There are constant issues coming up that do reopen cases. We had an example of that the other day when we were discussing this estate tax decision, and the chairman said we ought to keep tab on such decisions, so that we could reopen the cases and refund the money to the taxpayers when a decision came through that was favorable to them. I mentioned the fact that the Alworth Stevens decision is going to reopen thousands and thousands of cases that have already been closed.

The CHAIRMAN. Let me ask you at this point if you are going to do nothing except when the taxpayer himself will apply for relief under that decision.

Mr. NASH. I do not see that we can do anything else, Senator. We could not comb our files and pick out every case that this decision touched or affected. We receive, Senator, an average of over 20,000 claims a month affecting cases that are already closed, and every one of those cases immediately becomes active when the claim is filed within the statutory period.

Mr. GREGG. And may I point out this fact, that there are thousands of cases which are opened under the Alworth Stevens decision for the years 1916 and 1917.

The CHAIRMAN. And they will only be opened in case the taxpayer applies to have them opened?

Mr. GREGG. Yes; but it goes back to 1916 and 1917. It does not affect later years.

The CHAIRMAN. In making these additional assessments, such as referred to in the Sinclair case, do I understand that in like cases, no matter how many there are, the Government will lose the interest until the bureau makes the assessment?

Mr. NASH. That is true.

The CHAIRMAN. Then, does not the bureau think it should expedite, perhaps more than any other work, the matter of making these assessments, so that the taxpayer can not avoid the payment of interest by dilatory methods?

Mr. NASH. Senator, I do not believe there is a case prior to the year 1920 that is not in process somewhere. There are none of them that are inactive in the files. They may be in the protest file, they may be in process of work, or in process of field examination, or in the solicitor's office waiting for opinions on legal points, or there may be engineering examinations being made for valuation, etc., but they are all active. None of them are inactive.

The CHAIRMAN. I may not have all of the records, but I do not find anything being done in the case of the Sinclair Oil & Gas Co. in the past year.

Mr. NASH. I think the Sinclair oil and gas cases are all in one room over in the solicitor's office, and they are being worked on. They have been worked on continuously since the Teapot Dome investigation started.

The CHAIRMAN. I want to make a correction of the record here as to my reference to the date of May 1, 1924, by saying that the committee record shows this:

Field audit ordered, and during the past 10 months two to seven auditors have been engaged continually 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.

It may be inferred from my previous remarks that nothing has been done during the year, but I find in reading the complete note that they have been working on it during that time; but it does seem to me that six or seven auditors on that case for a year ought to be able to settle it.

We will adjourn now until 10 o'clock on Monday morning.

(Whereupon, at 11.25 o'clock a. m., the committee adjourned until Monday, May 11, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

THURSDAY, MAY 14, 1925

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

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

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

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

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; and Mr. A. W. Gregg, solicitor, Bureau of Internal Revenue.

The CHAIRMAN. You may present your other matter now, Mr. Manson.

Mr. MANSON. I wish to call attention to determinations of value for depletion and invested capital purpose for three sulphur companies and will consider them together. They are the Union Sulphur Co., the Freeport Texas Sulphur Co., and the Texas Gulf Sulphur Co.

I might say that these sulphur mines are all located near the Gulf of Mexico, in Texas and Louisiana.

The sulphur lies about 900 feet from the surface of the ground. The geological formation in the case of all three deposits is identically the same, the quality of the sulphur is identically the same, and the method of mining or recovering the sulphur in all three cases is identical.

The method may be briefly described as this: Superheated water, water heated to 300 degrees or more, is pumped down a well. This water melts the sulphur, and the molten sulphur is then brought up by air pressure.

Up to the time of the development of this process, which was discovered by a German who came to this country, there was no practical way for the recovery of this sulphur.

Senator WATSON. How deep do they have to go for it?

Mr. MANSON. About 900 feet—between 900 and a thousand feet.

The Union Sulphur Co. was first organized. At the time of the organization of the Union Sulphur Co. the process, which was patented, was considered by the promoters and organizers of the Union Sulphur Co. as of the same value as the deposit. Each one of them was turned in for a hundred thousand dollars of stock.

Senator KING. Each company?

Mr. MANSON. No; that was in the case of the Union Sulphur Co., but at the time the process, which was a patented process, was considered to be of equal value.

Senator KING. I understand.

Mr. MANSON. I bring that out here for the purpose of emphasizing the fact that the process is a material factor in the value of the property as a whole.

All three of these valuations are determined by discounting future expected profits. As I have stated, all three companies are operating by the same method, and operating under identical conditions.

In the case of the Union Sulphur Co., a 15 per cent discount factor was used, resulting in a depletion made of $2.80 per ton.

In the case of the Freeport Texas Co., a 10 and 4 per cent rate was used.

The CHAIRMAN. What is the difference between a 15 per cent rate and a 10 and 4?

Mr. MANSON. The 15 per cent is a flat rate. The 10 per cent is 10 per cent for the use of the money, and the 4 per cent is the sinking fund accumulated on a compound-interest basis.

The CHAIRMAN. In other words, that would take 25 years, then, to have a profit on the 4 per cent basis?

Mr. MANSON. It would not take that long, because it is accumulated by compound interest.

The CHAIRMAN. I mean, less the amount of compound interest.

Mr. MANSON. Yes.

In the Shreveport Texas case, the depletion unit was $3.86 a ton.

In the case of the Texas Gulf Sulphur Co., a 7 and 4 per cent rate was used, resulting in a depletion rate of $4.86 a ton.

Now, here are three companies doing business under the same conditions, having deposits in the same geological formations—not in identical formation, but in similar geological formations, using the same process, where every risk of the business in the one case is identical with the risk of the business in the other, with three different rates applied here, resulting in a depletion unit of $2.80 in one case, of $3.86 in another case, and of $4.86 in the third case.

Before going into the details of these cases, there are two unusual outstanding features to which I desire to call the committee's attention.

In the case of the Texas Gulf Sulphur Co., the existence of the sulphur had been determined in drilling for oil back in 1903. The fact that the sulphur was there was demonstrated. The sulphur was brought to the top of the ground; it was capable of examination, showing the thickness of the deposit, the geological conditions under which the deposit existed, the extent of the deposit, and the quality of the deposit, were known in 1903.

The process for the recovery of this sulphur had been successfully applied in the case of the Union Sulphur Co. as early as 1896.

Senator ERNST. How far apart are these three deposits?

Mr. MANSON. The Texas Gulf Co., I believe, is also located in Louisiana. They are not very far apart. They are all right there together on that coastal plain.

So here we have a known deposit, recovered through a known process, yet a discovery value was allowed on that property as of

1919 upon this theory, that it was not known that this particular process could be operated on this particular property.

I now wish to call the committee's attention to the fact that if the discovery statute is to be given that sort of an interpretation, it is to lead to discovery valuations being allowed beyond the wildest dream of the most fanciful tax expert.

Senator KING. We knew that salt was in Salt Lake, impregnating the water there, as soon as the people went there in 1847, but they did not discover the method of evaporating it in commercial quantities until along in the nineties, and I suppose that would be discovery value.

Mr. MANSON. Well, this is going a step further than that, if the Senator please.

In this instance we knew this process as early as 1896. We knew that sulphur was there in 1903. This is not the case of a discovery of a new process. This is a case of applying a known process to a known mineral deposit.

Senator WATSON. When was this process first applied in this case?

Mr. MANSON. In 1896, it was testified by the Union Sulphur Co.

Senator WATSON. That is, this German process?

Mr. MANSON. This German process.

I wish to call attention to what can be done under the discovery statute, if this principle is to stand.

Under our usual process of recovering oil, petroleum oil, we get about 10 per cent on the oil that is in the ground—not to exceed 15 per cent. We know in every exhausted oil field—that is, in every oil field that is exhausted under our present method of recovering—the depth of the sand; we know the existence of the sand; we know the porosity of the rock, if it is a case of a rock deposit. In other words, we can determine almost within a barrel the amount of oil that is still in the old Spindle Top field in Texas, near Beaumont.

In Alsace-Lorraine they are mining oil. We do not mine oil in this country, because we have so much of it that can be recovered by a much cheaper process, but in Alsace-Lorraine they are mining oil. In the first place, they put down a shaft similar to any mine shaft, in which the perimeter of the shaft is far larger than the perimeter of an ordinary oil well; the area for seepage is greater, and you can recover a much greater percentage of the oil. When you have recovered all that you can recover through seepage into the shaft, they then drive laterals, which give another large area for seepage, and when the precipitation of the salts, due to the action of the atmosphere upon the oil, stops the seepage in those laterals, then they use diamond drills and run further laterals out in all directions. In that way they can recover about 50 per cent of oil.

When they have gone that far and have taken out all that they can get by seepage, they then proceed to mine the rock or the sand and bring it to the surface, where they extract the balance of the oil.

There is a process that is known; there is nothing new about it.

Our exhausted oil fields are known; the exact quantity of oil in them can be readily ascertained.

When the time comes, as it probably will in the future, when we will be compelled to resort to methods of recovering oil which will recover some of these reserves that are not recoverable by our present

methods, under the principle of this case, a new discovery can be set up upon the theory that you have not ascertained yet—that in any particular field you know the process, you know the oil is there, but you have not demonstrated yet that the application of that process to that particular field is going to be successful.

Senator KING. May I interrupt you there, Mr. Manson?

Mr. MANSON. Yes, sir.

Senator KING. This is important, in view of the enormous shale deposits in Utah, Idaho, Colorado, California, and Nevada—billions of tons. They have processes now, one of which is by putting the shale into a large tank and forcing superheated steam to it. In that way you eliminate the oil.

Mr. MANSON. Yes.

Senator KING. You can get from one-half a barrel to a barrel or more out of each ton of some of these shales. They know the oil is there, and the title to many of these deposits has been acquired by corporations and by individuals. If this theory be true, as I understand it, then they could claim a discovery upon those properties, some of which they have had the title to for 10 or for 15 years, and they located under the placer act those claims, and took them up for the purpose of getting the oil out when the oil sands were pretty generally exhausted.

Mr. MANSON. I would now call attention to another fertile field for the application of discovery valuations. Under the principle laid down in this case, as I have said, it is not necessary that you discover a new mineral deposit; it is not necessary that you discover a new process. Around every copper mine there are thousands of tons, millions of tons in some instances, of tailings that are of such low-grade ore that under old processes it was not profitable to attempt to extract ore. You could set up a plant for the recovery of the copper in those tailings with the oil-flotation process. We have a known mineral deposit, and we have a known process, but we simply set up a plant, and we can claim a discovery under this principle on every pile of tailings there is lying around the copper mine.

Now, it might seem far-fetched, and I do not mean to be facetious; I am absolutely serious when I say it, that by setting up a plant to boil the salt out of water you could actually claim a discovery on the Atlantic Ocean as a salt mine under this principle.

There is still another point in these cases to which I wish to direct your special attention.

In the Freeport Texas case the property was bought for $450,000 cash.

The CHAIRMAN. When?

Mr. MANSON. It was bought in 1912 for $450,000 cash and a royalty or a payment of 75 cents a ton upon sulphur recovered.

The solicitor held that those payments of 75 cents a ton were not royalty payments, but were deferred payments upon the purchase price of the property.

Taking $450,000 plus the present value as of 1913 as of these deferred payments of 75 cents a ton, it gives you a total of $1,285,177 cash purchase price in 1912; and within four or five months of that time, as of the 1st of March, 1913, the value is allowed of $13,375,857

for gross invested capital as of the date of acquisition, just a few months before, and for depletion purposes.

In connection with that valuation I would call the committee's attention to the fact that in 1913 the Union Sulphur Co. had a monopoly upon the production of sulphur. It was producing at least twice as much sulphur as this country could consume; yet in arriving at this valuation in 1913 for the Freeport Texas Co. it is assumed that that company can produce and sell sulphur to the full capacity of their plant, even though a company then in existence and which had been in existence and had a selling organization in existence since 1896 was unable to dispose of half of its product.

Subsequent events, of course, gave that property a great deal of value. The war came on in Europe in 1914, and in 1915 the world was short of sulphur, and these sulphur mines had a tremendous value; but as of 1913 this company went into business with a competitor that controlled the entire market and which competitor was producing a supply twice what the market called for.

Senator KING. And it valued that property at $100,000 in the corporation?

Mr. MANSON. The original company.

Senator KING. But not this one?

Mr. MANSON. No; the original company had determined this process to be worth $100,000.

Senator KING. Yes.

Mr. MANSON. That is the Union Sulphur Co.?

Senator KING. Yes.

Mr. MANSON. That was organized in 1896.

Senator KING. Did this company have to pay a royalty for the use of this patent?

Mr. MANSON. No; that is another thing that I am coming to in connection with this Freeport valuation.

The CHAIRMAN. Can you tell us briefly how that Freeport valuation was arrived at?

Mr. MANSON. That Freeport valuation was arrived at by assuming that this company would sell at a profit and get $10 upon the entire output; that it would sell the sulphur up to the entire capacity of its plant.

The CHAIRMAN. Until the exhaustion of the deposit?

Mr. MANSON. Until the exhaustion of the deposit.

Senator ERNST. When was that valuation made?

Mr. MANSON. Oh, it was made subsequent to that; it was made along in 1924; I can not give you the exact date.

There is another feature in connection with the Freeport company in 1913.

The Union Sulphur Co. claimed to have a patent on this process, and every man who invested a dollar in the Freeport company was sure of a lawsuit; and they did get into a lawsuit, and they were required for several years to refrain from paying dividends and were required to set aside their net earnings pending the result of that lawsuit.

Senator KING. How did that lawsuit terminate?

Mr. MANSON. I think the patent finally expired.

We now get to the next point in this connection.

As I have stated, the solicitor held that the 75 cents a ton that was agreed to be paid was not a royalty. If it was a royalty then, of course, it should not be capitalized as part of the invested capital of the company. If it was not a royalty but used as a deferred payment upon the purchase price, then the vendor had disposed of his interest in the property; yet, while they hold that it is not a royalty in the Freeport case, in the case of the vendor they hold that the vendor is entitled to depletion of 56 cents a ton as against that 75 cents upon royalty.

So here you have a situation where, with respect to the operating company of that mine, the purchaser, they hold they bought it outright, and that the vendor has no interest in it, and they permit the capitalization for invested capital purposes of the total amount. On the other hand, with respect to the vendor, they hold that the vendor still has an interest in that property which permits the allowance to him of a depletion of 56 cents a ton upon the sulphur thereafter taken out.

The CHAIRMAN. Can you tell us briefly on what basis the solicitor determined that this was a deferred payment rather than a royalty?

Mr. MANSON. No; I have not gone into that. I have not attempted to pass on that question. You have to take one horn of the dilemma or the other.

If that was a purchase, then the vendor lost all interest in the property. He had nothing to deplete; he had sold his property, and the allowance of depletion to the vendor was improper.

Senator KING. May I inquire of you or Mr. Gregg whether in any of these oil leases—and nearly every one carries in addition to some purchase price a royalty of from 10 to as high as 33 per cent—they consider that part of deferred payments, or do they not consider it a royalty, and the person receiving a royalty has to account for it in his income?

Mr. GREGG. They consider it a royalty.

Senator KING. Of course, I can not see any difference. If you accept this as a deferred payment, you have to do it in all of your oil cases.

Mr. GREGG. No; I think it turns on the wording of the instrument in question. I do not know anything about this particular instrument. In the case of oil leases there is no doubt but that it is a royalty.

Mr. MANSON. I did not attempt to examine the instrument. I did not have it before me nor did I attempt to pass on that question. The question I have now raised is an entirely different question, and that is that they are wrong in either one instance or the other.

Senator KING. It seems to me that it would be a subterfuge in one case or the other. If you can do it in one, just by a twist of the instrument, or by the language of the transaction, you can do it in all.

Mr. GREGG. Of course, it is impossible, by the language of the instrument, to change a lease into a sale.

Senator JONES of New Mexico. That affects materially the tax that the vendor pays, does it not?

Mr. MANSON. Yes. Instead of paying a tax on 75 cents a ton, he gets a depletion allowance of 56 cents off that 75 cents, so that he

pays an income tax on 19 cents, assuming that to be his entire income. I believe it figures out 19 cents instead of 75 cents.

Senator KING. On a part of the purchase price he did not pay any income tax.

Senator JONES of New Mexico. It goes to the question of the profit that he made on the original purchase.

Senator KING. Yes.

Senator JONES of New Mexico. The question of the capital gain that was derived.

Mr. GREGG. I think, as a matter of fact, the result would be the same, either way it was decided, since, if it was treated as a sale, he would be entitled to set up the March 1, 1913, value of his expected future profits, and would be allowed a return of capital as an offset against the payments as he received them.

Mr. MANSON. Yes; but the Freeport Texas Sulphur Co. would not be entitled to set up as a part of invested capital future payments that it is going to claim in the shape of royalties.

Mr. GREGG. I was just speaking of a vendor.

Mr. MANSON. Yes. Those are the salient features of this case. I do not think it is necessary to read all of the facts involved here, but I do wish to call attention to the difference between these values.

The cost of the property of the Union Sulphur Co. was a hundred thousand dollars. Mind you, this is the old, the original company, and it is given a value of $3,000,000 as of date of acquisition.

The Freeport Texas Co., by capitalizing these royalty payments, or these payments which may be in the nature of royalty, has a cost of $1,285,177, and is given a March 1, 1913, value, which is only a few months subsequent to the date of acquisition, of $13,375,857.

The Texas Gulf Sulphur Co. acquired its property for $250,000 in 1917, and is given a discovery value in 1919 of $5,100,340.35.

The CHAIRMAN. Let me ask you at this point, what was the depletion rate allowed those companies for the removal of the sulphur?

Mr. MANSON. $2.80 for the Union Co., which was the original company; $3.86 for the Freeport Texas Co.; and $4.86 for the last company.

Senator JONES of New Mexico. Did they estimate the output of one as greater than the other?

Mr. MANSON. Oh, yes. The tonnage estimated in the Union Sulphur Co. is 6,000,000 tons; in the Freeport Texas Co., 3,359,000; and in the Texas Gulf Co., 8,000,000 tons; but that difference in tonnage is eliminated when you come to get back to the depletion rate, because your value is divided into tons, and the real difference between these values is shown up in the difference in the depletion rate. That is very largely accounted for by the difference in the discount factors used.

In the earliest company, the one that had been in business as of March 1, 1913, was an established business since 1896, about whose patent rights there was no question, and about whose market there was no question. That company's expected profits were discounted 15 per cent.

The Freeport Texas Co., which was a new company, just starting in business at that time, had its profits discounted at 10 and 4 per cent, and the Texas Gulf Co., which did not go into business until

March, 1919, is allowed a discovery value, discounting its expected profits at 7 and 4 per cent.

Senator JONES of New Mexico. What are those two concerns capitalized at and what is the market value of the property?

Mr. MANSON. The outstanding capital of these companies is not given in the report of the engineer here. I do not know what it is.

Mr. GREGG. I think it states that one of them is a hundred thousand dollars.

Mr. MANSON. That is the original capital.

Mr. GREGG. Yes.

Mr. MANSON. The original capital was a hundred thousand dollars, par stock given for the land, and a hundred thousand dollars par stock was given for the patent; that is, the process.

The CHAIRMAN. Was the same method used in arriving at the amount of the deposit in each case?

Mr. MANSON. Yes; the deposits, I think, were pretty well established. The area of the deposits appears to have been substantiated by drilling, and it was not a difficult process to arrive at the area.

Senator ERNST. Were objections made by the companies to these valuations?

Mr. MANSON. I think all of those valuations were the subject of a great deal of discussion between the bureau and the companies.

Senator KING. Have the taxes been settled?

Mr. MANSON. All of them.

The CHAIRMAN. The depletion rate, of course?

Mr. MANSON. Applies in the future. I think in the case of one of these companies the deposit is played out.

The CHAIRMAN. I think the Union Sulphur Co. has played out.

Mr. MANSON. I am not sure whether it is the Union company or one of the others.

Senator WATSON. I think we had that up before the Finance Committee, and my recollection is that it was the Union Sulphur Co.

The CHAIRMAN. That is my recollection.

Senator WATSON. That the Union Sulphur Co. had exhausted its supply.

The CHAIRMAN. But the bringing up of this matter in this way may still draw the bureau's attention to the fact that this condition exists and a correction made in the future depletion.

Mr. MANSON. Oh, yes. There is no possible justification for the difference in the basis of appraisal there, which leads to the vast difference in the depletion allowances for those three companies, and there is certainly no justification in principle, in my opinion, for any discovery value for the last of those companies. I have pointed out the result of the application of that principle; and if the discovery can be so construed, and if this case is to be accepted as a precedent, there is no limit to what discovery can be applied to.

Senator JONES of New Mexico. If you apply the regulation of the department to this discovery, it seems that discovery is certainly permitted on each one, unless they are within 160 acres.

Mr. MANSON. This is a sulphur deposit.

Senator JONES of New Mexico. I understand; but I can not make a distinction between a discovery on a sulphur deposit and on an oil well.

Mr. MANSON. Well, that is another question.

Senator JONES of New Mexico. It is a question of discovery, and the extent of the area as included within each discovery, and if you are going to arbitrarily limit an oil discovery to 160 acres, why should you not limit this to 160 acres, and allow discovery here for each 160 acres?

The CHAIRMAN. In that connection, I would like to ask this question: Assuming that a condition exists as stated by counsel, did this condition arise through one set of engineers or one set of members of the staff of the bureau not knowing that depletion was allowed on the 75 cents upon royalty or deferred payments, while knowing that it was allowed on the corporations?

Mr. GREGG. I do not see how it could have been. Of course, I do not know how it happened, if it happened as stated.

The CHAIRMAN. Would it in all probability be due to that fact? I could not conceive how the bureau could do that if the same staff of engineers knew that that situation existed.

Mr. GREGG. It should be handled in the same subdivision of natural resources, and they should know what was done in the other cases.

Mr. NASH. The nonmetals section is one of the smallest sections that we have in the engineering division. There are only about 10 engineers in that section, and the head of that section ought to have a fair idea as to what happened in cases of this kind.

Senator KING. Who is the head of that section?

Mr. NASH. Mr. Briggs was the head of it until recently. Mr. Grimes is now the head of it. It is now a part of the metals section.

Senator KING. If erroneous calculations have been made here, which have resulted in losses to the Government in taxes, is it too late to recover?

Mr. NASH. It is certainly not too late to correct the years that are not yet closed. If the statute of limitations has run on the years that are already closed, of course it is too late.

Mr. MANSON. At this point I wish to submit the report which has been prepared in connection with there sulphur-mining companies.

(The report submitted by Mr. Manson consisting of Exhibits A to P, inclusive, is as follows:)

EXHIBIT A

MAY 13, 1925.

Mr. L. C. MANSON,
General council, Senate Committee Investigating Bureau of Internal Revenue.

Taxpayer: Union Sulphur Co., Freeport Texas Co., Texas Gulf Sulphur Co.
Subject: Depletion and invested capital allowed on sulphur in the ground.

Figures involved

DEPLETION

Company	Hoskold's rate	Depletion rate per ton	Tonnage	Valuation	As of date
Union Sulphur Co.	15 per cent	$2.80	6,000,000	$16,838,423.00	Mar. 1, 1913
Freeport Texas Co.	10 per cent and 4 per cent.	3.86	3,459,000	13,375,857.00	Do.
Texas Gulf Sulphur Co.	7 per cent and 4 per cent.	4.86	8,000,000	[1] 38,920,000.00	Mar. —, 1919

[1] Discovered.

Figures involved—Continued

INVESTED CAPITAL

Company	Cost of property	Allowed for invested capital	As of date
Union Sulphur Co	[2] $100,000.00	$3,000,000.00	1896
Freeport Texas Co	[3] 1,285,177.00	13,375,857.00	1913
Texas Gulf Sulphur Co	[4] 250,000.00	5,100,340.35	1919

[2] 1896. [3] Equivalent, 1912. [4] 1917.

SYNOPSIS OF CASE

It appears from the record in the above-mentioned sulphur case:

First. That the Union Sulphur Co. is allowed an invested capital of $3,000,000, as of date of acquisition in 1896, for the value of the sulphur in the ground, this in spite of the following facts:

(*a*) One hundred thousand dollars for par value of stock was given to the land.

(*b*) One hundred thousand dollars in par value of stock was given for the patent.

(*c*) It was unknown whether this patent was practical for extracting the sulphur from the ground as of date of payment.

(*d*) The extent of the deposit of sulphur was not fully known.

We contend that no willing buyer would have given a willing seller anywhere near the value allowed by the bureau, and this is what determines the market value of the property as of date of acquisition.

Second. That the Freeport Texas Co. (Freeport Sulphur Co., subsidiary) was allowed a value of $13,375,857 for both invested capital and depletion purposes as of March 1, 1913. This was granted in spite of the following facts:

(*a*) Four hundred and fifty thousand dollars in cash and a royalty of 75 cents per ton was paid for the sulphur, which was equivalent to the present worth value of $1,285,177.

(*b*) This property was bought only eight months prior to March 1, 1913, and there is nothing in the record to show why this property should increase in value over 1,000 per cent in eight months.

(*c*) A depletion rate of $3.86 per ton was allowed, although the Union Sulphur Co., for what the engineers considered a more available and better deposit of sulphur, was only allowed $2.80 per ton as of the same date.

(*d*) The solicitor's office ruled in 1920 that, in spite of the 75 cents per ton royalty clause referred to above, this was a bona fide sale and that the 75 cents was not royalty, but deferred payments.

(*e*) In spite of this, the American Sulphur Co., the lessor, has been allowed to deduct depletion at the rate of $0.5675 per ton.

(*f*) The taxpayer in going into this venture was buying a lawsuit, because it was necessary, in order to exploit the property, to use certain processes, patents for which were held by the Union Sulphur Co.

We contend that there is no basis for any such increase in value as is shown between July, 1912, and March 1, 1913, amounting to 1,000 per cent. We contend further, that if this was a bona fide sale there should be no such thing as giving the American Sulphur Royalty Co. depletion as a lessor. It is also evident that the rate of $3.86 allowed the Freeport Sulphur Co. is disproportionate to the rate of 56 cents allowed the American Sulphur Royalty Co.

Third. That the Texas Gulf Sulphur Co. has been allowed in 1919 a discovery value on sulphur in the ground amounting to $38,920,000, in spite of the following facts:

(*a*) It was known that sulphur existed on this property as early as 1903.

(*b*) An engineer's report, made in 1909, showed the definite existence of sulphur in the ground, predicted the quality thereof, and showed the thickness of the deposit.

(*c*) The company was incorporated in 1909 and the value of the property containing the sulphur, which was taken in for stock, had an agreed valuation as of that date of only $2,000. The total par value of the stock issued at this time was $250,000.

(*d*) Discovery value was allowed on the ridiculous proposition that a discovery is not a discovery until the extent of the deposit and the quality of the deposit are fully known and until it is known that the processes which it is proposed to use in extracting this deposit is practical or not.

(*e*) A depletion unit of $4.86 has been allowed the Texas Gulf Sulphur Co. against a rate of $3.86 for the Freeport Texas Co. and against a rate of $2.80 for the Union Sulphur Co.

(*f*) The valuation in this case has been determined by using the very low rates of 7 per cent and 4 per cent (Hoskold's formula), whereas the valuation for the Freeport Texas Co. was determined with rates of 10 per cent and 4 per cent, and the Union Sulphur Co. with a straight rate of 15 per cent.

We contend that the allowance for a discovery value in this case is absolutely contrary to the intent of the law, providing for the right of taxpayers to set up a discovery value. We contend, further, that the rates used in making the valuation are entirely inadequate to express the hazard incident to this business, which hazard the taxpayer himself admits.

HISTORY OF THE UNION SULPHUR CO. CASE

The Union Sulphur Co. was incorporated in 1896. The company was formed to exploit certain deposits of sulphur in the State of Louisiana which had been discovered in 1867 in a well being drilled for oil. No means of exploiting these deposits were devised until 1896, when Herman Frasch patented a process of pumping superheated water into the strata containing the sulphur through drilled wells. This was a new industry in the country at this time.

On January 23, 1896, the Union Sulphur Co. obtained control of these sulphur deposits, paying therefor $100,000 par value of stock. The patents covering the process were purchased of Herman Frasch for $100,000 par value of stock, who thus became the principal stockholder. The total par value of stock issued was $200,000. In addition to the above, a mortgage indebtedness of $165,000 was assumed.

On November 10, 1920 (see Exhibit B) a fair market value of this sulphur deposit was made as of date of acquisition amounting to $3,000,000. The March 1 value was set at $16,838,423, based on the remaining tonnage of 6,000,000 tons, a remaining life of 20 years, and a discounted profit rate of 15 per cent. This gave a depletion rate of $2.80. This valuation was confirmed in reports by the nonmetals section, dated November 23, 1922, and May 31, 1923, respectively. (See Exhibits C and D.)

As further reference in this case, Exhibit E is submitted, containing certain pertinent facts brought out by Mr. W. E. Hix, chief of review section. It is noted in this exhibit that the taxpayer has contended in contesting his taxes with the State of Louisiana that at least one-half of the value of the property should be assigned to the patents. This has not been done in arriving at the values as of date of acquisition or as of March 1, 1913.

HISTORY OF FREEPORT TEXAS CO. CASE (FREEPORT SULPHUR CO. SUBSIDIARY)

The Freeport Sulphur Co. was incorporated July 12, 1912, acquiring in that month certain sulphur deposits in Texas for $450,000 cash and royalty of $1.75 per ton for the first 200,000 tons, and $0.75 per ton for the remainder, until exhaustion of deposit. The solicitor on March 27, 1920, ruled this was a bona fide sale, the 75 cents per ton being construed as a deferred payment and not as royalty. The fee owner, the Freeport Sulphur Co., was ruled to have right to a March 1, 1913, value. The Freeport Texas Co. (a holding company) was organized in October, 1913, and took over the stock of the Freeport Sulphur Co. in exchange for its own stock.

The valuation allowed for March 1, 1913, is based on a tonnage of 3,459,000 tons at an expected profit of $10 per ton, discounted by Hoskold's formula at 10 per cent and 4 per cent over a 17-year life. The value of March 1, 1913, is set at $13,375,857, and the depletion rate allowed for both invested capital and depletion is $3.867 per ton. The same valuation is allowed for invested capital.

The above valuation was set up as per orders of the division conferee, Mr. A. R. Shepherd. (See conference report dated November 10 and 11, 1924, Exhibit F.) The valuation report was made under date of December 12, 1924. (See Exhibit G.) The valuation was agreed to in spite of the fact that in a very exhaustive memorandum dated May 3, 1924 (Exhibit H), the valuation

engineer, Mr. Boalich, after completely reviewing the data in the case, apparently came to the conclusion that the valuation as of March 1, 1913, should be $2,500,000 instead of over $13,000,000, and that the depletion rate should be 42 cents per ton instead of $3.85 per ton. It is also shown in this memorandum that the solicitor ruled that this property had been purchased in fee at a bona fide sale, and that the 75 cents per ton should be considered as a deferred payment and not royalty. It is also stated, however, that the American Sulphur Royalty Co., original owners of this property, had been allowed to deduct depletion at the rate of 56 cents per ton. There is no explanation in the record for the enormous increase in value in the eight months between date of acquisition and March 1, 1913. The production during this period was only 752 tons of sulphur.

HISTORY OF THE TEXAS GULF SULPHUR

The Gulf Sulphur Co. was incorporated December 23, 1909, under the laws of the State of Texas. When this company was incorporated it had an authorized capital of $250,000 par value of stock. A part of the stock was given for 200 acres of land in Matagorda County, Tex. The value placed on the land at the time was $2,000. A report on this property by Mr. J. M. Allen (see Exhibit I), made in April, 1909, shows that sulphur was discovered on this hill, when oil was drilled for, about 1903. He states, "All or nearly all the wells on the hill found sulphur. Reports * * * show that from 10 to 12 feet of good sulphur was encountered in every well at depths varying from 900 to 1,000 feet." An examination of the log records given by Mr. Allen shows sulphur to have existed in thicknesses of from 56 to 96 feet. Mr. Allen concludes his report of April, 1909, on this property by the following statement: "I do not know of such a favorable and seemingly sure investment for capital to-day as this field offers, and the showing already made justifies, in my opinion, the installation of a pumping plant."

In September, 1917, the company had not yet started exploiting this property, but began on this date a further drilling program which was completed in 1919. The pumping plant was also completed in March, 1919.

On July 22, 1918, the company's capital stock was increased to $750,000, and its name was changed from Gulf Sulphur Co. to Texas Gulf Sulphur Co. Other stock issues were later floated, bringing invested capital in 1919 up to about $5,000,000. (See extract from taxpayer's brief, Exhibit I.)

On presentation of brief by taxpayer the bureau engineers on July 8, 1921, set up a valuation exactly like that submitted by the taxpayer, and this valuation has been allowed. This valuation covers the 200 acres of land originally purchased for $250,000.

The basis of this valuation is as follows:

1. A discovery value as of March, 1919, is allowed.
2. Tonnage allowed, 8,000,000 tons.
3. Life, 12 years.
4. Profit per ton, $9.
5. Present value, Hoskold's.
6. Formula at 7 per cent and 4 per cent, $43,920,000; estimated cost of plant, $5,000,000.
7. Valuation of sulphur in ground, $38,920,000. (See Exhibit K.)

The above valuation was confirmed by nonmetals section report, dated July 2, 1924. (See Exhibit L.)

DISCUSSION OF THE CASE

It appears from the facts and history given above and the information contained in the exhibits referred to that those three sulphur cases have all received treatment not in accordance with the law or even in accordance with sound engineering principles.

First. Consider the matter of depletion. On valuations both made as of March 1, 1913, the Union Sulphur Co. is granted a depletion rate of $2.80, while the Freeport Texas Co. has been granted a rate of $3.86. The Texas Gulf Sulphur Co. has been granted a depletion rate of $4.86 for 1919 on the basis of discovery value, whereas it should have been compelled to have based its depletion on the March 1, 1913, value at a rate comparable with the others. A more proper rate of depletion for all these companies, as of March 1, 1913, would have been closer to 42 cents. (See report of Engineer Boalich, Exhibit H.)

Second. Consider the matter of valuations of March 1, 1913. The Union Sulphur Co., with a tonnage on hand of around 6,000,000 tons, has been allowed a valuation of $16,838,423, while the Texas Co., with a tonnage of only 3,459,000 tons, has been allowed a valuation of $13,375,857. It is seen that there is a large discrepancy in these values, and this, according to the engineer's reports, is not accounted for by any great difference in the nature of the deposits or in the difficulty of extracting same. If either of these figures, however, be compared with the valuation as of March, 1919, for the Texas Gulf Sulphur Co., amounting to over $38,000,000 on a tonnage of 8,000,000, a more astonishing difference is seen.

In the report of Henry Krumb, geologist, to Mr. W. H. Aldridge, president of the Texas Gulf Sulphur Co., dated April 9, 1921 (Exhibit M), it is admitted that sulphur was discovered on this property in 1903, that information was obtained as to the thickness of the deposit in 1909, and that drillings were made by this company in 1917. It is also admitted that there was a process known as the steaming process, which would be available to use in extracting sulphur from the ground. It is claimed, however, that in spite of these facts the discovery was not made until the steaming plant was put in and it could be proved that this steaming plant would profitably extract the known sulphur in the ground at a profit.

We also desire to put in the report the copy of a letter to the Texas Gulf Sulphur Co. from Mr. Aldridge, its president, dated June 22, 1920. (Exhibit N.) The letter shows that the valuation submitted by Mr. Aldridge is exactly the same as the valuation made by Mining Engineer Spencer C. Brown on this same property. (Exhibit O.) We include an extract from a pamphlet on "Pyrites and Sulphur Industry," a Bureau of Mines publication. (Exhibit P.)

Third. Consider now invested capital. The invested capital of the Union Sulphur Co., as of date of acquisition in 1896, was fixed at $3,000,000 by the bureau, although at this time the property had been bought for $100,000 par value of stock, and the patents for $100,000 par value of stock. At this date of acquisition it was obviously impossible for any willing buyer to know the profits that could be derived from this business, whether or not the patented processes would be successful, the extent of the recovery of the sulphur, the profit that could be made on the enterprise. We can not follow the process of reasoning by which the bureau fixes the market value of this property at $3,000,000, when the stock paid therefor was only $100,000. In the case of the Freeport Texas Co. an invested capital of $13,375,857 is allowed. This is the same as the March 1, 1913 value, and while it is not definitely so stated, we must assume that this is really the value as of date of acquisition eight months previous, inasmuch as March 1 valuations are for depletion purposes and not for invested capital purposes. We do not understand by what process of reasoning the bureau is able to deduce that this property for which was paid the equivalent of $1,285,177 (based on the maximum value obtainable by capitalizing royalties) increased in value over 1,000 per cent between July, 1912, and March 1, 1913. It is still more remarkable if this property could be considered to be worth over $13,000,000 as of date of acquisition in July, 1912, when only about $1,200,000 was paid therefor. The Texas Gulf Sulphur Co., due to being in the hands of stock promoters, did not require invested capital relief necessary to the other companies. They made frequent issues of stock and were therefore able to establish an invested capital principally on the basis of their stock as of 1917 of something in excess of $5,000,000.

Fourth. Consider now discovery value. Discovery value was allowed to the Texas Gulf Sulphur Co. only. We have shown in the exhibits attached, fully substantiated, the fact that the sulphur was discovered on the property of this taxpayer in 1903. We have also shown, and it is fully substantiated in the exhibits, that an engineer's report was made on this sulphur deposit in 1909, giving detailed information as to the existence of sulphur on the property, the thickness of the deposit, and other pertinent facts. Notwithstanding this, the taxpayer claims that the sulphur can not be said to be discovered until the extent of the ore body is known, until the quality of the ore body is known, and until it is known that a certain specific process for extracting the sulphur is known to be successful on the specific sulphur deposit in question. The bureau has accepted this fallacious argument. If this argument be admitted, there is no reason why a known bank of gravel can not be said to be discovered if a new and perfected process of washing the gravel is invented, which will make the commercial operation of this gravel bank profitable. If this argu-

ment be admitted, there is no reason why salt in the ocean should not be considered to be discovered if a new process can be invented to extract this salt and purify it so that it can be sold at a profit. We are very much mistaken in the intent of the discovery clause of the revenue acts if any such interpretation as this can be placed on them.

Fifth. Considering the matter of discount rates (Hoskeld's formula), the Union Sulphur Co. has to stand for the fairly high rate of 15 per cent in determining its valuation. The Freeport Texas Co. gets the more favorable rates of 10 per cent and 4 per cent, while the Texas Gulf Sulphur Co. gets the unreasonable rates of 7 per cent and 4 per cent. The latter taxpayer in his brief admits that the sulphur industry is hazardous, and still his property is valued on a basis of an expected return of only 7 per cent on his investment. It is obvious that in 1919 investment could be made in perfectly sound bond issues, bearing 7 per cent rate of interest. We do not consider these rates to be equitable between the taxpayers and at least in the later case we consider the rate to be out of all proportion to the hazards in the industry.

We believe the foregoing matters to be so important and to so illustrate the unsound principles which have been practiced by the unit that we will not cloud the issue by going into detail in the many minor points which could be developed in this case, among which might be mentioned the decision of the solicitor's office, claiming that the payment of 75 cents a ton was a deferred payment and not a royalty and that the parties who received this 75 cents per ton could nevertheless receive depletion on these deferred payments.

We have been unable to definitely fix the responsibility for the bureau's action in these cases. Each of the three cases, however, has been the subject of at least two engineer's reports, the latter of which, in each case, is dated either in 1923 or 1924. We understand from verbal statements made by members of the nonmetals section that Mr. C. C. Griggs, now assistant head of the engineering division and formerly chief of the nonmetals section, signified his approval of these valuations, and this in spite of the fact that verbal protests were made. We have not gone further with this phase of the subject and do not know whether or not Mr. Griggs received orders from higher authorities.

We desire to state in closing that we believe these valuations to have been determined on unsound principles, that they have not provided for any rate of profit on plant investment, and that the discovery value allowed in one case is absolutely without foundation. We have examined, in connection with these cases, a paper on "Taxation of mines by States," by W. R. Ingalls, consulting engineer of New York. Mr. Ingalls was an engineer, we understand, obtained by the Union Sulphur Co. in its taxation fight in the State of Louisiana, in which the taxpayer tried to minimize the value of sulphur in the ground and place at least half of the value to the patents. He lays great stress to the fact that a mining company "may enhance profits, based primarily upon its mine, by its organization for carrying on its business. By virtue of its knowledge and experience (intangible assets) vessels, distributing depots, etc., it may increase the net return for its product f. o. b. mine above what other operators might be able to realize, and the State in assessing valuation upon such a basis might tax what in truth did not belong to it." It is to be noted, however, that these sulphur companies did not hesitate to throw the value of all their intangible assets into the sulphur in the ground when they want a high valuation for depletion purposes instead of a low valuation for State taxation purposes.

Respectfully submitted.

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

MINING AND MARKETING SULPHUR

SECTION OF MISCELLANEOUS NONMETALS,
Washington, D. C., November 10, 1920.

UNION SULPHUR CO.,
New York, N. Y.

A very brief history of this company is as follows:

The occurrence of sulphur in Louisiana has been known since 1867, when a deposit of this substance was encountered in a well being drilled for oil.

This discovery was followed by sporadic attempts to develop the property. At one time Belgian engineers came to this country for the purpose of installing special apparatus to freeze the water-bearing quicksands overlying the deposit, thus enabling them to sink a shaft. After expending over $100,000 this attempt ended in failure and the company went into the hands of receivers. The Union Sulphur Co. was formed for the purpose of exploiting these deposits by means of a process devised and patented by Herman Frasch, who developed the idea of pumping superheated water to the sulphur horizon by means of drilled wells sunk by the rotary process.

The Frasch patents proved more successful than the most sanguine expectations and the company made plans to develop the deposits on a large scale, necessitating a huge plant with almost unlimited steaming capacity. So much for a very brief outline of what was at the time a new industry in America.

1. The Union Sulphur Co. obtained control of these deposits January 23, 1896, the total consideration being $265,000, made up of $100,000 in stock (1,000 shares at $100 per share) and $165,000 in mortgage notes assumed by them. The value of the deposits at date of acquisition and subsequently determined is, of course, out of all proportion to the purchase price. This matter was given full consideration when the affairs of the company were investigated by the Income Tax Unit. The company not only made tremendous profits but its success was derived from a unique process applied to an entirely new industry in this country. This being the case, such men as Capt. A. F. Lucas, an expert on sulphur; Mr. J. Park Channing, of the Bureau of Mines; Mr. R. C. Allen, of the Board of Tax Review; Mr. Ralph Arnold, oil geologist and tax expert; and other high officials under the direction of Mr. Daniel C. Roper, reached definite conclusions as to the tax liability of the Union Sulphur Co. After a careful study of the entire case I can only say that I find nothing that in any way modifies their conclusions. I believe these conclusions to be fair to the company and to the Government.

ACTION TAKEN

Fair market value date of acquisition, January, 1896, $3,000,000.
Total recoverable sulphur reserves date of acquisition, 9,388,000 tons.
Sustained depletion rate, $0.31956.
This figure may be written as 32 cents.

Table of productions

Year	Production (long tons)	Shipments (long tons)		Total	Stock (long tons)
		Rail	Water		
Previous to 1905	119,739	72,761	36,737	109,498	----------
1905	218,950	43,467	117,026	160,495	----------
1906	288,560	40,119	138,400	178,519	----------
1907	185,772	53,699	215,054	268,753	----------
1908	362,896	46,123	158,802	204,925	----------
1909	270,725	51,538	203,407	254,945	----------
1910	246,510	52,560	197,809	260,369	----------
1911	304,220	46,879	205,070	252,949	----------
1912	786,605	62,145	242,115	304,260	----------
1913	478,565	52,811	265,276	318,087	----------
1914	374,470	39,993	274,720	314,715	----------
1915	379,885	44,325	165,543	209,862	----------
1916	383,065	159,507	339,154	498,661	----------
1917 (9 months)	382,600	199,713	284,143	483,856	----------
Total Oct. 1, 1917	4,682,562	965,640	2,844,258	3,809,898	872,654

Fair market value March 1, 1913 based upon gross earnings at $15 per ton over a life of 20 years amortized at 15 per cent per annum ---------- $16,838,423.00
Depletion rate per ton for allowed depletion ---------- 2.80

Table of sustained and allowed depletion

Year	Tons sold	Depletion sustained	Depletion allowed	Year	Tons sold	Depletion sustained	Depletion allowed
Prior to 1905	109,498	$35,039.36		1912	304,260	$97,363.20	
1905	160,495	51,358.40		1913	318,087	101,737.84	$890,643.60
1906	178,519	57,126.08		1914	314,713	100,708.16	881,196.40
1907	268,753	86,000.96		1915	209,862	67,155.84	587,613.60
1908	204,925	65,576.00		1916	498,661	159,571.52	1,396,250.80
1909	254,945	81,582.40		1917	595,130	190,441.60	1,666,364.00
1910	260,369	83,318.08		1918	918,700	293,984.00	2,572,360.00
1911	252,949	80,943.68					

It is possible that some slight variation will be found in the figures appearing above and the amounts deducted for depletion on the various income-tax returns of the Union Sulphur Co. The figures on the returns are somewhat lower due to the fact that the record of "tons sold" is more or less subject to interpretation. I am assured however that the company has followed the practice of basing its allowed depletion on $2 per ton.

WM. H. KOBBE,
Valuation Engineer.

EXHIBIT C

PRODUCTION AND SALE OF SULPHUR

SECTION OF INORGANIC NONMETALS,
November 23, 1922.

UNION SULPHUR CO.,
New York, N. Y.

Under date of November 10, 1920, a valuation of the sulphur properties of this company was made by this section.

The case was resubmitted by the review division to this section for further consideration of the valuation of the properties determined by this section.

A conference was held with the review division at which time the review division decided to reconsider their memorandum to this section.

Under date of August 10, 1922, the review section submitted a memorandum to this section, covering the American Sulphur Royalty Co. of Texas, the Texas Gulf Sulphur Co., and the Union Sulphur Co.

The memorandum covering the latter company follows:

"UNION SULPHUR CO.

"Review division memorandum dated December 14, 1921, covers several minor points sufficiently clearly and these are recommended for consideration.

"The major points (the $3,000,000 valuation of paid-in surplus) is considered in the memorandum at length, and the argument against the value allowed is further strengthened by the record of the Louisiana tax case wherein it is noted taxpayers plead that the patents should be assigned a value one-half the total value of the combined property. This valuation, therefore, is a matter of exceeding difficulty to which there is every indication it has already been given careful attention, deep thought, and exhaustive debate with the taxpayers. A decision by competent representatives of the bureau was reached to allow $3,000,000, and it is the reviewer's understanding the taxpayers have agreed thereto. It appears proper, therefore, to recommend that this valuation be allowed to stand."

Accordingly original valuation, dated November 10, 1920, stands approved and the case is returned to audit for action on claims now pending.

J. H. BRIGGS, *Valuation Engineer.*

EXHIBIT D

CONSOLIDATED SECTION OF INORGANIC NONMETALS,
May 31, 1923.

(Union Sulphur Co. (parent), West and Rector Streets, New York City. Brimstone Railroad & Canal Co. (subsidiary). Incorporated 1896. Taxable years 1918 to 1921, inclusive.)

See valuation memorandum dated November 10, 1920. Depletion rates have been established by conference agreement. No evidence has been submitted to change these rates.

Taxpayer filed a claim dated December 29, 1922, embodying depletion on the rates agreed upon for all years referred to above. Depletion as claimed therein is hereby approved and allowed.

ACTION TAKEN

Invested capital allowed

For sulphur deposits $3,000,000
Sulphur arising from readjustment of ore value March 1, 1913 13,573,423

	Depletion, reserve deductible from invested 32 cents	Allowed as deduction from annual income at $2.90	Reserve deducted from Mar. 1, 1913, surplus at $2.48
Dec. 31, 1918	$1,066,570.88	$1,851,802.40	$3,193,835.76
Dec. 31, 1917	1,278,205.44	1,851,802.40	4,834,003.60
Dec. 31, 1918	1,553,930.43	2,412,593.70	6,970,872.31
Dec. 31, 1919	1,665,954.96	980,426.90	7,839,274.68
Dec. 31, 1920	1,911,318.17	2,146,928.09	9,740,839.56
Dec. 31, 1921	2,045,898.87	1,177,581.08	10,783,839.94

S. L. SHONTZ,
Valuation Engineer.

EXHIBIT E

AUGUST 10, 1922.

Re: American Sulphur Royalty Co. of Texas, Houston, Tex.; Texas Gulf Sulphur Co., 41 East Forty-second Street, New York City; Freeport Texas Co., 61 Broadway, New York City; Union Sulphur Co., 17 Battery Place, New York City.

Mr. C. C. GRIGGS,
Chief Nonmetals Valuation Section.
(Through Mr. A. H. Fay, head Natural Resources Division.)

In response to memorandum dated July 25, 1922, the following comment is offered:

AMERICAN SULPHUR ROYALTY CO. OF TEXAS

In the opinion of the reviewer, the solicitor was right in recognizing a depletable value as of March 1, 1913, for the royalties receivable, and it is questionable whether or not a resubmission would result in a reversal.

In determining the present worth, rates of 6 and 4 per cent were used. This appears very low to the reviewer, as the royalties were subject to large risks and uncertainties.

TEXAS GULF SULPHUR CO.

It is noted this case was approved by the review division on March 27, 1922, therefore, the file has been merely briefly surveyed.

In answer to the request for comment applicable:

It appears to the present reviewer that the discount rates of 7 and 4 per cent used in the discovery valuation for 1919 are somewhat low if the detailed and voluminous descriptions by the taxpayer of the uncertainties and risks in this form of mining enterprise are given credence. The resulting rate for computation of the depletion deduction is quite high in comparison with the

other sulphur companies, and it is questionable whether the difference in basic dates will satisfactorily account for the difference in event that the taxpayers compare valuations. Possibly it may be considered less difficult to handle the taxpayers in this regard than it would be to reopen this case.

UNION SULPHUR CO.

Review division memorandum dated December 14, 1921, covers several minor points sufficiently clearly and these are recommended for consideration.

The major point (the $3,000,000 valuation of paid-in surplus) is considered in the memorandum at length, and the argument against the value allowed is further strengthened by the record of the Louisiana Tax Case, wherein it is noted taxpayers plead that the patents should be assigned a value one-half the total value of the combined property. This valuation, therefore, is a matter of exceeding difficulty, to which there is every indication has already been given careful attention, deep thought, and exhaustive debate with the taxpayers. A decision by competent representatives of the bureau was reached to allow $3,000,000, and it is the reviewer's understanding the taxpayers have agreed thereto. It appears proper, therefore, to recommend that this valuation be allowed to stand.

W. E. Hix, *Chief Review Section.*

Depletion schedule showing depletion on original paid-in surplus on March 1, 1913, valuation

Years	Total tons consumed	Depletion sustained on invested capital at 32 cents per ton	Depletion at $2.80 sustained on Mar. 1, 1913, value	Total depletion sustained
Prior to 1905	$109,498	$35,039.36		$35,039.36
1905	160,495	51,348.40		51,358.40
1906	178,519	57,126.08		57,126.08
1907	268,753	86,000.96		86,000.96
1908	210,837	67,467.84		67,467.84
1909	238,830	76,425.60		76,425.60
1910	258,114	82,596.48		82,596.48
1911	268,622	85,959.04		85,959.04
1912	306,849	98,191.68		98,191.68
Total	2,000,517	640,165.44		640,165.44
January-February, 1913	44,680	14,297.60		14,297.80
Total sustained to Mar. 1, 1913				654,463.04
March-December:				
1913	259,029	82,889.28	$725,281.20	725,281.20
1914	306,177	97,976.64	857,295.60	857,295.60
1915	215,041	68,813.12	602,114.80	602,114.80
1916	507,590	162,428.80	1,421,251.00	1,421,252.00
1917	661,358	211,634.56	1,851,802.40	1,851,802.40
Total	3,994,392	1,278,205.44	5,547,740.00	6,112,209.04

Original cost, $3,000,000. Tonnage, date of acquisitions, 9,388, equal 31.95 cents per ton; use 32 cents.

Value March 1, 1913, $16,423. Tons in mine, 6,000,000. Average figure per ton to be used for depletion, $2.80.

EXHIBIT F

CONFERENCE REPORT

ENGINEERING DIVISION, NONMETALS SECTION,
November 10 and 11, 1924.

Taxpayer: Freeport Texas Co., New York, N. Y.

Represented by: Geo. B. Furman and Messrs. Munson, Miller & Cummings, of the staff of Robertson, Furman & Murphy.

Credentials: Verified.

Matter presented: Brief dated June 18, 1924, covering valuation and depletion of sulphur in deposit at Freeport, Tex.; also obsolescence in 1918. This

is a protest in regard to adjustment of tax liability of the Freeport Texas Co. and its subsidiaries for the years 1917 and 1918 as established by the Income Tax Unit.

Issues discussed: Exhaustive data is on file in the nonmetals section relative to the engineering features of this case. It was claimed by taxpayer that valuation as of March 1, 1913, should be determined on theoretical basis of discounting expected profits. This method was accepted in principle, and the discussion centered about the factors which must be used in calculating values in this manner.

Final agreement: 1. It was agreed that the following factors would govern in valuation of taxpayer's sulphur deposit on the "present worth" method: Total estimated tons at March 1, 1913, 3,459,000; estimated life, 17 years; discount rate (Hoskold's formula), 10 per cent and 4 per cent; estimated net profit per ton, $10; estimated value of plant and equipment required, $660,000; depreciation rate on plant and equipment, 10 per cent.

2. It was also agreed that the "royalties" which taxpayer has deducted on all his tax returns as expense shall be restored to income. These amounts are in reality deferred payments and therefore not deductible.

These are capital items, part of the purchase price of the sulphur property, but they are taken care of in the cost value of mineral allowed in valuation report of November 12, 1924, and should not be again capitalized.

Valuation report just mentioned indicates final action as taken on basis of this conference agreement.

3. Taxpayer's representatives agreed to have new waivers filed as soon as possible covering 1917, 1918, and 1919.

4. It was agreed that audit items as shown in schedules attached to brief of June 18, 1924, shall govern in calculating tax for all years.

E. S. BOALICH,
Subsection Chief.
A. R. SHEPHERD,
Division Conferee.
FRANK H. MADISON,
Conferee, Nonmetals Section.
W. T. CARDWELL,
Conferee, Audit G.

Noted:

J. H. BRIGGS,
Chief Nonmetals Valuation Section.

EXHIBIT G

ENGINEERING DIVISION, NONMETALS SECTION,
November 12, 1924.

(Freeport Texas Co. (parent), Freeport Sulphur Co. (subsidiary), New York, N. Y. Mining and selling of sulphur. Organized October 10, 1913 (parent). Valuation report for 1917–1923, inclusive. Returns in case, 1917–1921, inclusive (fiscal).)

PROTEST CASE—HISTORY

Many of the early records in this case are missing.

From available data it appears that numerous conferences were held between taxpayer and the review board in 1920, and that 1917 and prior years were closed as a result of those conferences allowing taxpayer a depletion rate of $2.80 per ton for income-tax purposes, and fixing invested capital under the provisions of section 210 of the 1917 law.

The Freeport Sulphur Co. acquired sulphur properties in the latter part of 1912 for $450,000 cash, and a "royalty" agreement calling for addit onal payments of $1.75 per ton for the first 200,000 tons of sulphur removed, and 75 cents for the remainder until the exhaustion of the deposit.

Taxpayer submitted evidence supporting his claim that this deal was a bona fide sale, and not a lease agreement, and on November 27, 1920, the solicitor upheld taxpayer's claim. The so-called "royalties" are therefore deferred payments on the purchase price.

As fee owner, therefore, the Freeport Sulphur Co. was entitled to set up a fair market value as of March 1, 1913.

In October, 1913, the Freeport Texas Co. (a holding company) was organized and took over all the stock of the Freeport Sulphur Co. in exchange for its own stock.

The ownership is therefore in the Freeport Texas Co., which has previously been allowed by the bureau the right to set up a March 1, 1913, value of mineral as paid-in surplus for invested-capital purposes.

FIRST ACTION RELATIVE TO 1918 TAX

When case was submitted to the nonmetals section for valuation report covering 1918 tax return a memorandum was written on June 8, 1923 (SIS) indicating that no engineering basis could be found to establish the unit value of $2.80 per ton.

However, that rate had been allowed a competitive company which had no deferred payments to meet, and in the endeavor to take action which would be equitable the engineer deducted the "present value" of the deferred payments and allowed taxpayer a unit value of $2.2325 per ton. Accepting the March 1, 1913, tonnage, based on the estimate of a "war" sulphur commission of the Bureau of Mines—3,459,000 tons—this gave a March 1, 1913, value of $7,722,217.50.

After the 1918 return had been audited on the above basis taxpayer filed a protest, dated February 19, 1924, claiming a valuation of mineral for invested-capital purposes, and as of March 1, 1913, of $17,220,000, and a depletion rate of $5.74 per ton.

1917 CLAIM FOR REFUND

On April 7, 1924, a 1917 claim for refund was filed, and this was supported by a brief dated June 17, 1924, superseding the protest of February 9, 1924, and claiming:

Mar. 1, 1913, mineral value	$20,051,161.14
Total units, Mar. 1, 1913 (tons)	3,459,000
Depletion rate ($5.7962 less present value of "royalties" or)	$5.3698
Obsolescence, 1918	$18,730.04

CONFERENCE AGREEMENT, NOVEMBER 10 AND 11, 1924

On above dates a conference was held with taxpayer's representatives (conference report in case), in which agreement was reached, as follows:

1. It was agreed to use the "present worth" method of valuing the sulphur deposit in question, based on these factors:

Total estimated units in deposit March 1, 1913, 3,459,000 tons.
Estimated life of deposit, 17 years.
Discount rate (Haskold's formula), 10 and 4 per cent.
Estimated net profits per ton, $10.
Estimated cost of plant to be deducted, $660,000.
Estimated life of plant, 10 years.

2. It was agreed that all "royalty" items which taxpayer has deducted as expense on his tax returns shall be restored to income. These amounts are deferred payments and are not deductible from income.

Inasmuch as valuation for invested-capital purposes is allowed far in excess of cost, these "royalty" items should not be capitalized in the audit of this case.

3. It was agreed that audit items as shown in schedules attached to brief of June 17, 1924, shall govern in calculating taxes for all years, where differences exist between those items and the figures originally used by taxpayer in the returns.

4. The obsolescence claimed by taxpayer in brief of June 17, 1924, was not discussed in detail in conference, but it has been reviewed and found acceptable and is allowed.

ACTION TAKEN

Valuation of mineral for invested-capital and income-tax purposes as of March 1, 1913:

Claimed in brief of June 18, 1924	$20,051,161.14
Allowed on basis of conference agreement (total units, 3,459,000 tons):	
Total expected profits, 3,459,000 by 10	34,590,000.00
Less estimated cost of second plant	660,000.00
	33,930,000.00
Haskold's factor, 10 and 4 per cent over 17 years	.413671
	14,035,857.00
Less estimated cost of first plant	660,000.00
Valuation allowed	13,375,857.00

(Actual plant costs are shown on schedule attached to brief of June 17, 1924. An average depreciation rate of approximately 10 per cent should be used.)

The above mineral value, $13,375,857, divided by total units in deposit at the basic date, 3,459,000, equals $3.867, depletion rate sustained on cost value and allowed for income-tax purposes.

Depletion Schedule

Years ending Nov. 30—	Output (tons)	Depletion claimed		Sustained and allowed, rate $3.867
		In protest	On returns	
1913–14	53,012	$284,663.83		$204,997.40
1915	128,995	692,667.35		498,823.67
1916	230,815	1,239,430.38		692,561.61
1917	544,803	2,925,483.14	$4,745,836.35	2,106,753.20
1918	422,509	2,268,788.82	1,238,700.40	1,633,842.30
1919	318,465	1,710,093.35	992,044.20	1,231,505.16
1920	276,182	1,483,042.10		1,067,995.79
1921	85,570	459,493.78		330,899.19
1922	138,064	741,376.06		533,893.50
1923	334,870	1,798,184.92		1,294,942.29

Obsolescence claimed and allowed, fiscal year ended November 30, 1918, $18,730.04.

"Royalties" deducted by taxpayer on his returns under heading of expense are disallowed for all years and should be restored to income, as set forth in body of this memorandum and in conference report of November 10 and 11, 1924.

E. S. BOALICH,
Subsection Chief.

Noted:

J. H. BRIGGS,
Chief Nonmetals Valuation Section.

EXHIBIT H

MAY 3, 1924.

Memorandum for office reference.

In re: Protest of February 19, 1924. Freeport Sulphur Co. (subsidiary of Freeport Texas Co.).

VALUATION AND DEPLETION OF SULPHUR DEPOSIT

Year involved (fiscal) ending November 30, 1918.

Additional assessment in dispute, $2,124,341.89.

Items contested: (1) Valuation and depletion; (2) amortization; (3) invested capital.

	Claimed by taxpayer	Allowed in report of June 8, 1923 (SLS)
Valuation of mineral for invested capital as of Mar. 1, 1913	$17,220,000.00	$7,722,217.50
Tonnage, estimated total at acquisition	$3,000,000.00	$3,459,000.00
Depletion rate, sustained and allowed----cents	5.74	2.2325

HISTORY

The Freeport Sulphur Co. acquired sulphur properties in July, 1912, for $450,000 cash, and "royalty" agreement calling for payment of $1.75 per ton for first 200,000 tons of sulphur removed, and 75 cents per ton for remainder until exhaustion of the deposit.

March 27, 1920, the solicitor ruled that this was a bona fide sale, the 75 cents being deferred payment and not royalty.

As fee owner, therefore, the Freeport Sulphur Co. was entitled to set up a fair market value as of March 1, 1913.

In October, 1913, the Freeport Texas Co. (a holding company) was organized and took over all the stock of the Freeport Sulphur Co. in exchange for its own stock.

The ownership is in the Freeport Texas Co., which has previously been allowed the right to set up a March 1, 1913, value of mineral as paid in surplus for invested capital purposes.

ACTION RELATIVE TO VALUATION PRIOR TO 1918

It appears that numerous conferences were held between taxpayer and the review board (in 1920 and 1921), and that 1917 and prior years were closed as a result of those conferences, allowing taxpayer a depletion rate of $2.80 per ton and fixing invested capital under the provisions of section 210 of the 1917 law.

No definite record of those conferences is to be found in the case.

VALUATION FOR 1918

For 1918 the case was resubmitted to the nonmetals section with the request that in view of the fact that there was no data showing how the rate of $2.80 had been arrived at, the valuation engineer should confirm this rate or establish a new one.

The 1918 valuation report (SLS June 8, 1923) states that the above rate was allowed because it was the figure determined for the Union Sulphur Co., the only sulphur producer of any consequence in the United States in 1913.

The engineer who wrote that report does not indicate that he consulted with taxpayer, but states that the Union Sulphur Co. deposit is thicker and more valuable than the Freeport and that the Union owns its deposits without any due deferred payments (as is the case with the Freeport Co.).

Furthermore, the American Sulphur Royalty Co., which receives the 75 cents per ton deferred payments from the Freeport, has been allowed to deduct depletion at rate of $0.5675 per ton.

His decision was that the Freeport to be on a proper basis with the Union, should be allowed depletion rate equivalent to $2.80 less $0.5674, or $2.2325.

As to tonnage available in March 1, 1913, he takes the figure of 3,459,000 tons which was found by a war-time sulphur commission reporting to the United States Bureau of Mines November 4, 1917.

The valuation, upon which basis the 1918 return was audited, was obtained by multiplying 3,459,000 by $2.2325, or $7,722,217.50.

DISCUSSION OF PROTEST AND PROPOSED ACTION BY THE NONMETALS SECTION

Inasmuch as the unit allowed the depletion rate of $2.80 for 1917, and this was done under a previous administration, it is understood to be the policy of the bureau to make no attempt to go below that figure for 1918 and subsequent years.

A review of taxpayer's claims, which follows in detail, appears to provide ample reason to believe that not only the claimed rate of $5.74 is excessive but that $2.60 is much too high.

However, it is proposed by this section to settle the case as follows:

Tonnage, Mar. 1, 1913	3,459,000
Depletion rate sustained and allowed	$2.80
Valuation for invested capital and income-tax purposes, 3,459,000×$2.80	$9,685,200.00

The following simply indicated the unreasonableness of taxpayer's claims for rate in excess of $2.80:

ANALYSIS OF TAXPAYER'S CALCULATION OF VALUATIONS OF MINERAL AS OF MARCH 1, 1913, BY WHICH HE REACHES A TOTAL VALUE OF $17,220,000, OR $5.74 PER TON

Taxpayer uses a method of determining the present worth of expected profits over an estimated life of property. Such a method is approved in principle, but decided exception is taken to some of the factors used, which follow:

Estimated reserves—tons	3,000,000
Estimated annual production—do	270,000
Estimated life—years	11
Estimated selling price, f. o. b. mine	$17.50
Estimated total cost of production	$6.82
Estimated net realization per ton	$10.68
Deduction to cover unforeseen contingencies	$2.67
Average realization over life of 11 years	8.01
Discount factor, 6 per cent compound interest	0.717
Present value of 1 ton of sulphur (Mar. 1, 1913)	$5.74
3,000,000×$5.74	$17,220,000

In the first place, the valuation of a mineral property should be calculated on the basis of a formula such as Haskold's which provides for a fund which, placed at 4 per cent interest, will return the capital invested, at the exhaustion of the deposit.

This feature applies to a wasting asset such as the sulphur deposit under consideration, and Haskold's formula has been approved and adopted by leading mining men throughout the world.

Use of this formula gives the present value of any amount in accumulated earnings of equal annual installments, over a given period of years on the basis of a rate of interest commemorate with the hazards involved, with return of capital at 4 per cent.

In report by Fisher and Lowrie, accompanying protest, upon which taxpayer sets up his claim for a depletion rate of $5.74 he states that using Haskold's formula and rates 8 and 4 per cent that the March 1, 1913 value of a ton of sulphur would be $6.30, and that he has adopted the former figure because it is "more conservative."

In the report of H. W. C. Prommel, December, 1920, it is shown that estimated reserves by company's experts, from 1911 to 1920, varied between 3,000,000 tons and 15,000,000 tons.

The estimated reserves at basic date will be taken as 3,459,000 tons. Taxpayer states in his protest that he has no objection to that figure.

Selling price f. o. b. mine stated by taxpayer to have been $17.50 per ton is not questioned by this section.

It is not accepted, however, that valuation be discontinued, profits method should be based on cost of product on of $6.82, as claimed by taxpayer.

As will be shown later the experience of Union Sulphur Co., in 1909, 1910, 1911, and 1913 indicated that production costs varied inversly with output, with production of 204,000 tons in 1911, the costs to this old established concern were $9.48 per ton.

In 1910 with output of 240,000 tons this figure was $6.09.

These data were brought out in tariff hearings of June, 1918, by officials of the Union Sulphur Co.

Taxpayers actual experience show per ton cost of production to have been (about) $25 in 1913; $14.70 in 1914; $9.33 in 1915; $11.25 in 1916. (See fig. 2, attached.)

There can be discerned no justification for the belief that a "willing buyer," in studying this proposition in March, 1913, would have paid a "present value"

based on a production cost $6.83. He would have observed a plant with a rated capacity of 120,000 tons per year, as yet in the experimental stage.

Even assuming that its full capacity had been reached, it would appear that an estimate of $10 per ton, production cost, would have been too low.

It is held that $7.50 is a much fairer figure to use as prospective net realization per ton than the figure of $10.68 claimed by taxpayer.

There then remains to analyze the factors:

(*a*) Expected annual output.
(*b*) Life of property.
(*c*) Proper risk rate to use in Haskold's formula.
(*d*) Value of requisite physical assets, plant, etc.
(*e*) Proportion of remaining value to be allocated to mineral.

ESTIMATED ANNUAL OUTPUT AND CONSEQUENT LIFE OF DEPOSIT BASED ON TOTAL CONTENT OF 3,459,000 TONS (SEE FIG. 1)

Prior to 1913 there was but one real sulphur producer in the United States, the Union Sulphur Co. of Louisiana.

Using all their accumulated knowledge and ability in a market where they stood alone, they sold around 300,000 tons in 1912, although they actually mined 786,000 tons. This excess output was placed in storage preparatory to an active extension of the company's foreign trade.

This was brought out in hearings before the United States Tariff Commission, reported in United States Tariff Commission Bulletin 348, June 29, 1918, where W. R. Ingalls, consulting engineer of the Union Co., testified, under oath, that the output and costs of the Union Sulphur Co., were:

1909, 270,000 tons costs per ton	$4.98
1910, 240,000 tons costs per ton	6.09
1911, 204,000 tons costs per ton	9.48
1912, 786,000 tons costs per ton	2.98

Taxpayer maintains that the life of his property at March 1, 1913, should be based on an estimated output only slightly less than the entire sales of the U. S. (the Union Sulphur Co.) during their best previous year, 1912.

Mineral Industry for 1913, published early in 1914, says "the Union Sulphur Co. continues to be the dominant factor in the production to sulphur in the United States, the developments at Bryan Heights Dome in Texas not having come up to expectation."

Actual output by taxpayer for 1913 was 10,747 tons.

The above authority continues: "The Freeport Co. was pumping at the rate of about 100 tons per week at the end of 1913. The first well had to be repiped and operations were not steady during the year.

"The first unit—operating in 1913—had a rated capacity of 120,000 tons annually and consisted of four 750-horsepower Sterling water-tube boilers."

In K. W. C. Prommel's report to the taxpayer in December, 1920, he states:

"On March 1, 1913, production at Bryan Heights had just begun, only one well, No. 103, having been steamed for a period of 30 days, during which period the well produced 1,261 long tons of sulphur. * * * the steaming of well * * * was still at the experimental stage.

"There is therefore no available data other than the physical occurrence of sulphur and the richness of the deposit, on which to base calculations for the actual recovery of sulphur which might be expected from the Bryan Heights deposit." (Ref. U. S. G. S., M. R. 1916, Pt. II, p. 403.)

The following extract from a letter published privately by the Freeport Sulphur Co. under the title "Freeport (Tex.) Harbor and its importance in the plan of national defense" may be of interest as an estimate of the domestic consumption of sulphur in 1916:

"The consumption of sulphur in this country for all purposes was approximately 300,000 tons in normal times. * * * The entire consumption in the United States during 1916 for normal uses plus the requirements for war munitions totaled approximately 900,000 tons."

In the Engineering and Mining Journal of September 7, 1912, there appeared an article by Richard H. Vail entitled "A new sulphur operation in the South."

He says, "The monopoly enjoyed by the Union Sulphur Co. will, it is expected, be broken by the commencement of operations of the Freeport Sulphur Co. * * *

"The first unit of a plant to have a capacity of 120,000 tons annually is now being constructed * * * under the direction of C. M. Chapman (who is still consulting engineer).

"Since 1904 the requirements of the United States have been easily met by the Union Sulphur Co."

It is held that no "willing buyer" would pay cash for a property in an amount based on discounted expected profits and an estimated annual production two and one-half times the rated capacity of equipment which had not yet been demonstrated capable of approaching its rated capacity, particularly under the above-described conditions of national production and consumption.

One hundred and twenty thousand tons were 40 per cent of the total sulphur business done in 1912; 46 per cent in 1911; 48 per cent in 1910.

But for the war demand for sulphur, which was undreamed of in 1913, it is highly questionable as to what the production history of the Freeport Co. would have been. Total figures furnished by taxpayer are:

	Tons		Tons
1912	726	1919	318,465
1913	10,747	1920	276,182
1914	41,539	1921	85,570
1915[1]	128,995	1922	138,064
1916	230,815		
1917	544,803	Total	2,198,415
1918	422,509		

The estimated life of deposit as of March 1, 1913, should be allowed as (about) 25 years.

This assumes an annual output of 138,000 tons, which was:

1. Considerably in excess of plant capacity at date of valuation.
2. Approximately half the available business which was already well in the hands of an established competitor.
3. Not equaled in actual practice until the unlooked-for war demand set in.
4. Greatly in excess of 1921 productions and the same as 1923 output.

In addition, experience has shown that the 11 years estimated by taxpayer have expired and the actual output, including the big war years, has only been 2,198,415 tons.

PROPER RISK RATE TO BE USED IN SELECTING A FACTOR IN HASKOLD'S FORMULA—FISCAL HAZARDS OF THE SULPHUR INDUSTRY

In taxpayer's valuation data, prepared by Fisher and Lowrie and dated February 17, 1919, it is stated that 8 per cent and 4 per cent should govern if Haskold's formulas were used.

In other words, a "willing buyer" would have put his money into the Freeport Sulphur project at March 1, 1913, expecting but 8 per cent interest on his money.

An investment to be rated close to a first mortgage as far as safety is concerned.

In this connection it is interesting to consult some of the views publicly stated by leaders in the sulphur industry.

An industry of such importance as the sulphur operations of the gulf coastal region, in the hands of but three production companies (one up to 1913, two up to 1919, and three since) has attracted wide attention and has been discussed in all its angles by geologists, engineers, and economists.

Technical literature from the nineties onward contains hundreds of references to this subject, and necessarily, to the individual affairs of the three companies mentioned above.

The commercial output of sulphur from the gulf coastal deposits depends absolutely on the "Frasch process" of pumping superheated water into the sulphur beds.

The inventor of that process was one of the organizers of the Union Sulphur Co. His process was patented and his rights on the main patent expired in 1908, but a number of later patents regarding various details were still in force in 1913.

[1] War demand started.

The plans of the Freeport Co. precluded accusation by the Union Co. of patent infringements.

As a matter of fact there was controversy from the beginning, as the Union Sulphur Co. protested against the taxpayer's use of these processes at the outset of their operations.

A lawsuit resulted in 1915 which was not terminated finally until May, 1919. In April, 1918, a court injunction restrained taxpayer corporation from paying further dividends until final settlement was reached.

Physical difficulties to be overcome constitute further "fiscal hazards."

Even after drilling results have determined the approximate tonnage of sulphur present, and have indicated something of the purity of that element and the porosity of the formation, the drilling does not determine the availability of the sulphur to the heating and pumping process, and it is, therefore a pure gamble (in advance of actual operations) as to what amount of money will be required to bring in production.

The yield of a particular well depends entirely upon the condition of the sulphur bed and overlying formation at the point where it is tapped. There is great lack of uniformity in the sulphur bed, itself.

Wells are lost through coving or running ground, sudden irruptions of underground water, etc.

Corrosion of well equipment is a most serious item, both from the superheated, impure water pumped in and the hot sulphur removed.

Other conditions met with are the pollution of sulphur with oil or clay from the known deposits above it; inability to recover the molten sulphur from fissures and cavities in the formation; and access of too large quantities of underground cold water to the sulphur bed, requiring an uneconomical amount of hot water from the steaming plant.

It is peculiarly true of sulphur deposits of the dome type that practical extraction tests can not be made with a small experimental plant on account of the large dimensions of the deposit that have to be heated.

Before it is known that sulphur can be extracted at a profit it is necessary to risk, in advance of complete justification, the investment required for a plant large enough for commercial operation.

Summarizing the fiscal hazard, an unusually high return should have been hoped for by the theoretical "willing buyer" of the Freeport deposit in 1913:

1. Because of "buying a lawsuit," the result of which could not be foretold.
2. Because of the extraordinary physical difficulties to be faced and fought.
3. Because of the peculiar situation requiring an immense outlay of money for a plant of large capacity before it could be positively known that the entire project would not result in complete loss.

A "reasonable" risk rate for such an investment would assuredly be not less than 15 per cent.

COST OF PHYSICAL ASSETS NECESSARY FOR SULPHUR PRODUCTION

In his theoretical calculations taxpayer throws the entire discounted value of expected profits to mineral in the ground, no account is taken of necessary expenditures for boilers, heaters, pumps, sulphur wells and equipment, water wells and other water supply and storage, fuel-oil storage, fuel-oil pipe lines, air compressors, water purification plant, buildings, roads, bridges, docks, etc.

Not only must the cost of such assets be deducted, but their rate of depreciation must be determined, and if their life is less than the estimated life of the deposit, the cost of duplicating them must also be considered.

Approximate figures from balance sheet of 1917 indicate values:

Buildings	$500,000
Machinery	2,000,000
Total	2,500,000

Depreciation is taken at about 10 per cent.

"When the valuation of a mine has been determined by the capitalization of expected earnings the value of its equipment, like the cost of its development, have been included therein, for both of those elements contribute to its earning capacity." (W. R. Ingalls, 25th Trans. Am. Min. Cong.)

This brings up the question of what should be deducted as development. In this case it would undoubtedly run into big figures most of which was probably written off as operating expense.

PROPORTION OF VALUE WHICH SHOULD BE ALLOCATED TO MINERAL AND PROPORTION TO INTANGIBLES

Whatever the discounted earnings may be it is an unquestionable fact that the entire sum is not ascribable to mineral in the ground, as the taxpayer was incorrectly shown it.

In a paper entitled "Taxation of Mines by States," presented by W. R. Ingalls before the annual convention of the American Mining Congress in 1922 he covered this ground exhaustively with direct reference to the sulphur industry along the gulf coast.

He states that the Gulf coastal dome sulphur deposits were known for many years but were unreachable by any known method of mining, although the best skill was exerted in the effort.

By the successful application of the Fraesch process a profitable business was developed. (In the organization of the Union Sulphur Co. half the stock was allotted for the property and half for the patent rights.)

Organization, knowledge, experience, distributing depots are mentioned as intangibles which should be listed at their proper worth.

He proceeds, "In the valuation of mines for taxation purposes discrimination should be made between tangible and intangible property.

"In other words there is a difference between the value of the shares of a corporation and the physical property that it owns, which difference is sometimes very large. This is the difference between physical valuation and fiscal valuation."

The present problem is to arrive at a physical valuation of sulphur in the ground, not the value of a going business.

One of the greatest paying mines in the United States where only a portion of the value can be attributed to the deposit is the Franklin Mine of the New Jersey Mine Co., which had a relatively small value until the magnetic separation process was invented. Many similar cases could be cited.

The ingenuity of the operator directly in charge of the plant is another intangible asset, peculiarly applicable to sulphur mining as practiced by taxpayer.

After the sulphur is melted in place it runs in a downward direction until it is trapped in the fissures at some point where it can be drained through the well and pumped to the surface and recovered, or until it congeals in cool ground waters or is trapped at some point where it can not be drained through the well, and is lost.

A thorough understanding of what is going on underground on the part of the operator in charge and this resourcefulness and ability to make the most of the varying conditions encountered, can most assuredly be translated into greater or lesser profits from any given well.

Summary of factors involved in valuation, as claimed by taxpayer, and as might be reasonably taken after giving due weight to the foregoing discussion

	Claimed by (as acceptable to) taxpayer	Suggested by this section
Estimated reserves Mar. 1, 1913 ---------- tons	3,459,000	3,459,000
Estimated annual output ---------- do	270,000	126,000
Life ---------- years	11	28
Risk rate (Haskold's) ---------- per cent	8 & 4	15 & 4
Factor ----------	$0.58975	$0.23
Net valuation per ton ----------	$10.68	$7.50
Value of physical assets ----------	----------	$2,500,000
Depreciation of physical assets rate [1] ---------- per cent	----------	8
Per cent of discounted profits ascribable to mineral ---------- do	----------	50

[1] Should be 10 per cent.

Taxpayer claims that a per ton value of $6.30 is correct, based upon his figures as shown above.

The calculation on office assumptions is approximately as follows:

Total tonnage	3,459,000
Profit per ton	$7.50
	$25,942,500
Less cost of second plant	$2,500,000
	$23,442,500
Haskold's factor 15 and 4 per cent, 25 years	$0.23
	$5,391,775
Less cost of first plant	$2,500,000
	$2,891,775
Less 50 per cent applicable to process and intangibles	$1,445,687
Value of mineral deposit	$1,445,888

$$\frac{1,445,888}{3,459,000}=\$0.42 \text{ per ton value.}$$

This does not take into account development items, and allows for two plants instead of two and one-half (3).

This checks with surprising closeness the actual cost of the mineral deposit, the purchase of which extended over the last months of 1912 and first two months of 1913.

Cash, $450,000 was paid=$113 per ton.

Additional payments to be $1.75 for the first 200,000 tons, and $0.75 per ton for the balance.

200,000×$1.75×$0.78=$273,000 present worth.

3,459,000—200,000×$0.75×$0.23=$562,177 present worth.

$$\frac{\$73,000+562,177}{3,459,000}=\$0.24 \text{ additional cost per ton}$$

$0.13+$0.24=$0.37 cost value to taxpayer.

Why should the March 1, 1913, value differ in any great degree from cost, a few months prior to that date, as agreed upon between a "willing buyer and a willing seller"?

EXHIBIT I

TEXAS GULF SULPHUR CO.—REPORT OF SULPHUR PROPERTY AT MATAGORDA, TEX., BY J. M. ALLEN, APRIL, 1909

I reached Matagorda at noon Thursday, April 15, 1909. The town is on the bay at the terminus of the G., C. & S. F. R. R.; very old town, population about 700. No industries other than rice mills and oyster and fish shipping. Country open, level, and healthful. Fine hunting and fishing. Oyster reefs here finest on the Gulf.

Sulphur field is on what is known as Big Hill, about 5 miles northeast of Matagorda and three-fourths mile from bay.

Six years ago this hill was prospected extensively for oil. A few big producers were brought in. The hill was divided into small lots, excitement ran high, as in all oil booms, and ground sold at $1,000 per acre and more. Many transfers were made, many leases and corporations controlling the field. Many wells were put down, some getting oil and many getting nothing. The oil in the big wells failed suddenly while the excitement was highest. The general belief prevails that water flooded the oil. At any rate the boom ended as quickly as it had formed. The field was practically abandoned except two or three wells, which continue to pump 10 or 15 barrels per day. To-day there are three wells being pumped with above results, the product being sold to rice farmers for fuel at $1 per barrel at the well.

All, or nearly all, the wells put down on the hill found sulphur on the hill, reports which are, of course, confirmable at this late date—but which are borne out to some degree by the actual sulphur now to be found at these wells—show

that from 10 to 12 feet of good sulphur was encountered in every well at depths varying from 900 to 1,000 feet.

Mr. Culver, of Matagorda, one of the leading citizens and very reliable, confirms this. He was personally interested in the field and in the Lane well, to which I shall refer later. He tells me he knows of his own knowledge they passed through over 60 feet of sulphur and that "it came out of the pipe and flowed off with a scum like heavy cream"; that the ditch was "yellow" with it and that they caught bucketfuls.

I asked him why nothing was done with it at the time. He said everyone was wild about oil and the sulphur was found by everyone, and no attention was paid to it because oil men knew, or did at the time, very little about sulphur.

I have talked to more than a dozen good men and all confirm these statements.

Coming down to more recent operations, the work done by Mr. Middlebrook and the reports thereon are, in my judgment, accurate and thoroughly reliable. I will add now that I was most favorably impressed with the rugged honesty and the simple, truthful statements of Mr. Middlebrook. I made most careful inquiry about him at Matagorda and Bay City, and he is noted for his homely, rugged integrity and good horse sense. He is a successful horse and cattle man and has been working in oil development for six years, and can, I believe, get more and better results in drilling wells, closing options, and in other ways dealing with his "home people" than any other man in the community.

I attached hereto a map and have located thereon the wells, designated by numbers, as follows:

No. 1: Drilled by R. O. Middlebrook and Robert Stevens, Devers, Tex. (head driller), in August, 1908, for Matagorda Oil Co.; depth, 1,028 feet; found sulphur at 940 to 948 feet, and both Middlebrook and Stevens report the log as practically identical with No. 2; about 500 feet of 4-inch pipe pulled off and still in this hole.

No. 2: This is the well which was being drilled when I arrived; begun April 9, 1909: finished April 19, 1909. Days actual drilling, 20.

Cost (approximately), exclusive of pipe, use of rig, and freight, $700. Depth, 1,009 feet.

Log: Eighteen feet surface, 232 feet sand and shale, 185 feet gumbo and shale, 45 feet gumbo, 20 feet soft shale, 50 feet soft gumbo, 15 feet water sand, 35 feet gumbo, 4 feet rock, 6 feet gumbo, 90 feet slate, 3 feet rock, 25 feet hard shale, 102 feet gumbo, 6 feet hard rock, 109 feet gumbo, 8 feet rock and gypsum—953 feet: 16 feet medium soft sulphur, 3 feet gypsum and sulphur, 3 feet soft sulphur, 1½ feet gypsum, 2 feet soft sulphur, 1 foot hard rock, one-half foot rock, 14 feet soft rock sulphur, 8 feet medium, 7½ feet soft sulphur—56 feet; total, 1,009 feet.

Sample of gumbo, of which 200 feet overlays cap rock above sulphur, submitted herewith.

This stuff has the tenacity of rubber and drillers say it will hold steam perfectly.

After reaching the cap rock at 945 feet a 4-inch casing was set in the rock to cut off the flow of muddy water which had been used above to hold up the wells. The well was pumped out and 3⅞-inch drill was used to go through the sulphur, with the result that the product was much cleaner and the showing doubtless more marked than in former wells drilled where the mud was forced through the bit or point of the drill by the pumps to hold up the wells.

I skimmed the sulphur marked "Sample No. 1" from the top of the water. When the drill would strike what is designated as "soft" sulphur in the log the return would be a cream color, and the sample marked "No. 2" was recovered at the bottom of the trough after settling. The sample marked "No. 3" shows the product designated as "gypsum and sulphur" and "medium soft sulphur."

The collar above the drill was flush $3\frac{13}{16}$ inches, a new collar, and bound so tight at times as to hold the entire line of pipe suspended so that the product, particularly when going through "soft sulphur," was finely pulverized. The 14 feet of soft sulphur referred to (judging from the uniform rapid movement of the drill, the statement of the driller, Stevens, and the product that was recovered) must be very rich in sulphur.

No. 3: Drilled by R. O. Middlebrook in October, 1908; struck cap rock at 1,140 feet; 4-inch drill, cap rock, 6 or 8 feet of sulphur; struck hard rock; lost water and quit. No. 3 is 240 feet northwest of the Lane well.

No. 4: Drilled by R. O. Middlebrook November and December, 1908. Went down 906 feet; struck cap rock at 896 feet; set in 6-inch pipe on cap rock; left it and quit in the rock. Derrick still standing.

Lane well: Drilled by Sutherland and Lane in 1903; claim went down about 1,400 feet; claim went through 96 feet of sulphur at 1,140 feet; paid no attention to it.

Emery, now with the Union Sulphur Co., says (Doctor Lyons), "I am sure they went through this sulphur."

Mr. Culver and Mr. Sutherland verify it.

Old sulphur well: Shows sulphur on the dump, as does the "Johnson," "Santa Fe," and a well directly west of No. 2.

Topography: Lot No. 70 (see map) or 69 is about the apex of what is called "The Hill"; the elevation at this point is probably 15 feet higher than the surrounding land. The lowest level on the land covered by the option is on lot No. 102, south end, and is about 10 feet above sea level at mean tide.

Recommendations: I consider the showing of sulphur covered by option to be sufficient to warrant further development as permitted up to September 15, 1909. I therefore recommend as follows:

First. That we pay Mr. Pickett's order, the $1,500, as provided, for drilling well No. 2.

Second. That we temporarily employ Mr. Middlebrook to take charge of future developments; that he be instructed to at once put down another well at a point we may select. My selection would be near the Lane well, probably 100 feet north, on the same lot, or directly east of well No. 2, about 200 feet at the foot of the hill.

The Matagorda Oil Co. owns leases (covering oil and minerals) on about 1,200 acres of this field. These leases will become void September 15, provided they discontinue operations in the field.

I recommend that we secure an assignment of these leases covering lands other than are included in our option and keep these leases alive by complying with their provisions.

I recommend that Mr. Middlebrook be authorized to secure options on additional lands surrounding us, particularly 100 acres east of us, owned by Zefflyn; 18 acres within our boundaries owned by Mr. Norton; three lots west of us owned by the G. C. & S. F. R. R. Co.

I believe all of these lands can be secured in such manner as to require little or no cash outlay, except possibly the 18 acres of Norton's, who I believe is working closely with the Union Sulphur Co., and who only acquired his title after he learned that we were beginning operations. The lease of the Matagorda Oil Co. covers Norton's land, and Middlebrook's lawyer says can be used to hold it.

Estimate of cost.—I submit the following approximate estimate of cost to further develop this property up to the date when we must buy it or let it go:

Salary of Middlebrook, May 1 to Sept. 1, at $160 per month	$720
Putting down two more wells, 1,000 feet each	2,000
Pipe and lumber	1,300
Loss on boarding men	250
Equipping boarding house	250
Attorney's fees	500
Amount due Pickett	1,500
Traveling expense	300
Incidentals	250
Total	7,070

Transportation.—The G. C. & S. F. R. R. is now within 1 mile of the field and will build a switch. A town site is already laid out and can be secured at acreage price. We must board our men during development work.

The south end of lots are about three-fourths mile from the bay. A canal to the land would be inexpensive and would provide water for light-draft vessels only. To get deep water it would be necessary to dredge the bay 12 feet a distance of 5 miles to the peninsula and 1 mile through the Gulf. The proposed intercoastal canal would bring the Mississippi River boats to our land.

Fuel.—It is claimed by competent authority that this field will without doubt provide sufficient oil for gas and fuel.

Water supply.—Plenty of artesian water excellent for boilers on the land. Good drinking water scarce.

Conclusion.—No undue excitement has attended the development work so far, and no trouble should be met in getting what we want at fair prices. The original land owners have been in many instances badly dealt with, but I found the better and more substantial citizens desirous of assisting any company who would show an inclination to develop the property. If we want a promising sulphur field, I think we should not let it get away from us. I do not know of such a favorable and seemingly sure investment for capital to-day as this field offers, and the showing already made justifies in my opinion the installation of a pumping plant.

Respectfully submitted.

J. M. ALLEN.

The BOARD OF DIRECTORS,
St. Louis, Mo., April 23, 1909.

EXHIBIT J

HISTORY OF PROPERTY

The Gulf Sulphur Co. was incorporated December 23, 1909, under the laws of the State of Texas. The company was organized for the purpose of mining sulphur, and to this end representatives of the incorporators of the company prospected for sulphur in various parts of the States known to have sulphur deposits, finally acquiring considerable acreage in Matagorda County, Tex.

When the Gulf Sulphur Co. was incorporated it had an authorized capital stock of $250,000, consisting of 25,000 shares of the par value of $10 each, all of which the company issued at that time, and it received in payment therefor $463.57 in cash and property consisting of approximately 200 acres of land in Matagorda County, Tex.

While the company's mineralized land was reported to contain sulphur, no regular and extended drilling for sulphur was begun nor had there been any systematic or extended explorations for sulphur until September, 1917, and at that time a complete exploration of the deposit was begun and was continued until March, 1919, when the great wealth of the field was ascertained. In September, 1917, this country had entered the World War and a great scarcity of sulphuric acid needed for war purposes developed. It became imperative that vast supplies of sulphur should be obtained, and with this end in view, despite the fact that it was well-nigh impossible to procure building materials and the necessary force of men, it was determined by the Texas Gulf Sulphur Co. that the field in Matagorda County should be developed to the utmost. Therefore, early in 1918 the engineering and construction work was entered into under a contract with the J. G. White Engineering Corporation of New York, and the field work was started in July, 1918. Nine months later, or, to be precise, March, 1919, the entire plant being almost completed, was turned over to the Texas Gulf Sulphur Co., operations beginning immediately.

When the J. G. White Engineering Corporation began its construction work in July, 1918, the entire property consisted of undeveloped prairie, the nearest village being 6 miles away, and the nearest city 90 miles farther on. It became necessary to construct a village to house 1,000 men, with all the ramifications that would accompany such a project, such as water, lighting, sanitary, and fire protection systems. Next a 3-mile railway spur was constructed, and at the end of nine months after the J. G. White Engineering Corporation had begun work a flourishing village with modern equipment and conveniences stood where formerly there had been uncultivated prairie land.

The sulphur is mined in a manner similar to that followed by the late Herman Frasch, which consists of pumping into the well water which has been heated to a temperature of 300° to 325° F. at a pressure ranging as high as 300 pounds per square inch, depending upon the character of the well. This hot water on reaching the sulphur melts it, and the sulphur is raised to the earth's surface by air-lift pumps. The water supply is obtained largely from the Colorado River, but due to the fact that a shortage from this source may be frequently expected, it became necessary to drill wells for an emergency supply.

The water from the driven wells is discharged through a wood stave pipe line 1½ miles long to a 15,000,000-gallon reservoir. An open concrete conduit from this reservoir leads to the pumping station. Paralleling this open trench is a tile pipe conduit which will carry water from the main reservoir to the pumping station, the pipe at the pumping station being so arranged that the water may be drawn from either of these two conduits.

The steaming plant was designed with the idea of procuring the greatest possible economy in value. This plant consists of a building of approximately 280 feet long by 100 feet wide, containing 10,000 horsepower of boilers, with oil-fired furnaces; two 500-kilowatt General Electric steam turbo-generators for supplying power for the deep wells and for general power and lighting purposes, and four steam-driven air compressors for 700 pounds air pressure, together with the usual station auxiliaries. The water for mining purposes will be taken from one of the two hydraulic systems and discharged to the feed-water heaters. The exhaust steam for all power units is discharged to these heaters, raising the water from 150° to 200° F. Seventeen 10 by 6 by 16 inch duplex pumps are installed to receive this water and discharge it to eight mine water heaters, in which the water is heated by live steam to the required temperature. An equal number of 12 by 7 by 12 inch duplex pumps receive this water from the mine water heaters and discharge it to the wells. It is not expected that all of these pumps will be required at any one time, the exact number varying with the character of the wells.

Practically everything in the construction of this plant is duplicated so that in case of accident to any part it may be quickly replaced and in no way hinder production.

A complete oil unloading and storage system has been installed. This includes two steel storage tanks, 114 feet 6 inches in diameter by 30 feet in height, of 55,000 barrels capacity each, a track unloading system permitting of the unloading of 12 tank cars without shifting cars, an unloading pump house, and service pump house.

There is also a warehouse, 60 by 175 feet, and a machine shop, 75 by 116 feet, with machine-shop equipment.

About 1 mile south of the pumping station is located the town site, and here the entire force of the plant is housed with every convenience and comfort.

On July 22, 1918, the company's capital stock was increased to $750,000 and its name was changed from Gulf Sulphur Co. to Texas Gulf Sulphur Co. The increased stock, namely, $500,000, was all issued and fully paid for in cash at par.

On November 19, 1918, the company's capital stock was increased to $3,000,000, and thereafter the increased capital stock, namely, $2,250,000, was all issued and paid for in cash at par.

On April 1, 1919, the company's capital stock was increased to $5,000,000, and the increased capital stock, namely, $2,000,000, was thereafter all issued and paid for in cash at par.

On November 29, 1919, the company's capital stock was increased to $7,600,000, and $100,000 of said increased capital stock was issued in December, 1919, and paid for at par in property, namely, lands in Matagorda County, Tex., and the remaining $2,500,000 of said increased capital stock was subscribed for at par; and during 1919, 50 per cent of said subscription, namely, $1,250,000, was paid in cash.

Up to December 31, 1919, the company had purchased in all about 1,922 acres of land in Matagorda County, Tex. All of this land is practically contiguous. Systematic drilling was continued from September, 1917, to March, 1919, and at that date it indicated that there were about 11,000,000 tons on sulphur on the company's property. Of this it is estimated that about 8,000,000 tons will be recovered.

In the month of July, 1917, George S. Hessenbruch, an engineer and a vice president of the company, assumed immediate supervision of the working of the mine.

In August, 1918, Charles Biesel, an engineer of wide experience, superseded Doctor Hessenbruch in authority at the mine, holding at present the position of general manager in Texas.

There have been no accidents or any changes of operating methods since the inception of the company.

EXHIBIT K

SECTION OF INORGANIC NONMETALS

WASHINGTON, D. C., *July 8, 1921.*

Re Texas Gulf Sulphur Co., 50 East Forty-second Street, New York, N. Y.

1. This case has been under investigation for nearly 12 months by the valuation section, many conferences having been held during this period and much time and consideration having been given to various matters connected with the case. In spite of this long lapse of time there has been no particular delay, since the first return made by the company is for the year 1919. The importance of the case justifies the time spent in carefully studying its various aspects. Several reports have been rendered by the best engineering authorities on sulphur in the United States, among them being Mr. Spencer C. Brown and Mr. Krumb.

2. Of particular consequence is a claim for discovery in 1919 and whether the profits were in any part due to a combination in restraint of trade. Such profits naturally would not reflect expected earning possibilities of a natural resource, due to its inherent qualities or worth.

3. After reviewing all reports and other evidence which the company appeared always willing and anxious to furnish, the conclusion has been reached to allow discovery as of March, 1919, the date of the completion of their drilling campaign which was initiated in September, 1917. At the earlier date the Matagorda Big Hill was undoubtedly a prospect, and prospect only. In 1917 it was not known that there was any large body of commercial sulphur underlying this dome, although all saline domes of the Gulf coastal region were known to contain some evidence of sulphur.

4. The foregoing is a very brief outline of the case. All reports and other documents are available for reference and are transmitted herewith.

Action taken: In view of the company's substantiation of facts necessary in the premises, the following valuation is recommended:

Company's sulphur deposit, approximately	tons	11,000,000
Containing recoverable sulphur	do	8,000,000
Annual extraction	do	667,667
Life of deposit	years	12
Profit per ton		$9.00
Estimated profit per year		$6,000,000
"Present-value" factor to yield 7 per cent interest with amortization of principal in 12 years by installments reinvested at 4 per cent		$7.32
Present value of $6,000,000 per annum for 12 years		$43,920,000
The estimated net cost of plant and equipment is		5,000,000
Net present value of sulphur body		38,920,000
Dividing by 8,000,000, the tonnage of recoverable sulphur, gives depletion unit per ton		4.865

Depletion claimed, 1919, $721,695.46. Allowed, number of tons sold by $4.865.

5. Attention is called to the fact that Mr. Henry Krumb, of Salt Lake City, Utah, the well-known engineer, reported on this deposit and determined a depletion rate of $5.46 a ton, based upon a total recoverable tonnage of 8,225,000 long tons, valued at $44,922,400.

6. All the foregoing report, together with statements and figures herein, is rendered with the express understanding that all statements, figures, affidavits, as submitted by the taxpayer, are true and correct. This provision applies particularly to the affidavit from Mr. W. H. Aldridge, president of the Texas Gulf Sulphur Co., to the effect that the sulphur industry is an open, competitive business with normal profits based upon usual methods of barter and trade; that his profits are not derived from or dependent upon either restraint of trade, control of the industry, or open-price methods.

7. In conclusion it is recommended that this case be audited with the greatest care.

WILLIAM H. KOBBÉ, *Valuation Engineer.*

Approved.

ORR R. HAMILTON,
Chief, Metals Valuation Section.

EXHIBIT L

ENGINEERING DIVISION—NONMETALS SECTION

JULY 2, 1924.

Texas Gulf Sulphur Co., New York, N. Y.
Organized December 23, 1909.
Valuation report for 1919 to 1921, inclusive.
Return in case, 1919 and 1921 only.

SUPPLEMENTING VALUATION MEMORANDUM OF JULY 8, 1921

Status of case is not exactly clear. A–2 letter of January 22, 1922, covering 1919 and 1920, has apparently never been replied to. At the same time the 1919 return on its face appears to be "open."

In any event, this report will apply to all years. Mineral production began in March, 1919; taxpayer's claims for discovery value and depletion were allowed by former action of this section, and taxpayer has adhered to the depletion rate allowed in calculating his taxable income for the years under review.

Former valuation made no reference to valuation of mineral land at acquisition.

Conference report in case dated January 6, 1922, states that the company is willing to accept a value of $10 per acre, for the purpose of computing invested capital, on the 200 acres of sulphur land originally acquired for stock in 1909.

According to Exhibit A attached to Form F, it appears that other purchases of land were all paid for in December, 1919, when $100,000 in stock was issued for additional land, bringing the total up to 1,922 acres, the inference being, however, that the sulphur was contained in the original 200 acres only.

As large amounts of stock were sold for cash at part in 1918 and 1919, the cash value of the property acquired in 1919 was undoubtedly equal to the par value of the stock paid.

ACTION TAKEN

Value at acquisition:	
1909, sulphur land, depletion negligible	$2,000
1919, land, not depletable	100,000
	102,000

Discovery value and depletion rate for income-tax purposes, as allowed by action of July 8, 1921:

Value		$38,920,000
Total units	tons	8,000,000
Depletion rate	per ton	$4.865

Depletion schedule claimed and allowed for income-tax purposes

Output in tons:	Value
1919, 148,344.4	$721,695.46
1920, 506,533.7	2,464,286.55
1921, 366,180.9	1,781,470.06

E. S. BOALICH, *Subsection Chief.*

Noted:
J. H. BRIGGS, *Chief, Nonmetals Valuation Section.*

EXHIBIT M

APRIL 9, 1921.

Mr. W. H. ALDRIDGE,
President Texas Gulf Sulphur Co., New York City.

DEAR SIR: In response to your request, I have made an examination of the property of the Texas Gulf Sulphur Co. located in Matagorda County, Tex., to determine the following facts:

1. The date of discovery of the sulphur deposit in accordance with the regulations on depletion of the Internal Revenue Bureau of the Treasury Department.

2. The quantity and grade of ore developed on the date of discovery as above determined.

3. The value of the ore on that date.

The history of the deposit is well known to you but I will briefly outline its salient points in order to make clear the reasons for my conclusions as to the date of discovery.

In prospecting for oil in 1903 and 1904 some sulphur was noticed in the slush from the drilling. Sulphur had been found in other salt domes and little attention was paid to it as oil and not sulphur was the object of the drilling. However, some St. Louis men hearing these reports of the finding of sulphur in various parts of Texas, formed the Gulf Sulphur Co. in 1909 and began drilling at the Matagorda Big Hill dome to determine the extent of the sulphur deposit. In this early drilling the same methods were used as in drilling for oil. While some information was obtained as to the thickness of the sulphur deposit, practically nothing definite was learned as to the grade of the ore.

Other interests obtained control of the company and in September, 1917, drilling was resumed. This drilling was carried on more systematically with the object of determining the richness of the deposit and if possible to obtain information in regard to the occurence of the ore, its physical character and the porosity of the enclosing formations. Special methods were introduced so that accurate samples of the ore were obtained which were carefully assayed. I have gone over the records of this drilling and discussed the methods of sampling and assaying with the engineers in charge of the work and am convinced that the results are reliable as the work was done probably as accurately and conscientiously as it was possible to do it.

During the war there was a large demand for sulphur. To take advantage of this demand and at the earnest solicitation of Van H. Manning, Director of the Bureau of Mines, the directors of the company in April, 1918, decided to erect a steaming plant to produce sulphur. At this time it could not have been known that the venture on the whole would be a profitable commercial success. There were many unknown factors. The working of a sulphur deposit of this type differs radically from that of the ordinary metal or coal mine. When a metal mine is developed and the quantity and grade of the ore are known, a small quantity of the ore can be tested in the laboratory or in a small testing plant to determine if and to what extent the values can be extracted. With the data then available, the engineers can very closely estimate the cost of production and, given the average selling price, the approximate profit can be estimated.

In the case of a sulphur deposit located at great depth, which has been developed by drilling only, and which must be worked by the steaming process, no estimate of cost of production can be made. In fact, it can not be definitely predicted that any great quantity of sulphur will be produced and the profitable success of the enterprise is in doubt until a full size plant is erected and the production of sulphur is actually under way.

To enumerate only a few of the unknown factors which may cause the complete or partial failure of the enterprise, the following may be mentioned.

In the first place, a deposit such as that of the Texas Gulf Sulphur Co., situated at a depth of roughly 1,000 feet below the surface can not be worked by the ordinary mining methods of sinking shafts and stopping the ore, on account of the large quantity of poisonous and obnoxious gases present in the deposit. The steaming process has been developed to work a deposit of this type. This process consists essentially of forcing water at a temperature of about 330° F. through pipes into the deposit. Sulphur melts at 238° F. The liquid sulphur collects at the bottom of wells from which it is pumped to vats on the surface by compressed air. If there are many open channels in the deposit the hot water will run off before it has a chance to melt much of the sulphur, and the

liquid sulphur itself may be carried off with the water or run into cracks and crevices instead of collecting at the bottom of the wells.

If there is a continual influx of large quantities of cold water, the hot water pumped down will be chilled below the temperature at which sulphur melts or at least much larger quantities of hot water will be required and this, of course, greatly increases the cost of production. In fact, it may increase the cost of production to such an extent that the deposit can not be worked at a profit. It has now been proved, but it could not have been predicted, that the deposit of the Texas Gulf Sulphur Co. is a much more favorable deposit to work than the other two deposits worked by this method and for this reason the cost of producing sulphur is lower than at the other deposits.

Another very important point which can not be determined except by actual operation is the purity of the sulphur that will be produced. The sulphur pumped from the wells might be contaminated with oil or clay. The drilling had shown the sulphur deposit to be overlain by hundreds of feet of gumbo. Some of this gumbo or clay might be held in suspension by the molten sulphur and the sulphur produced might be so impure as to command a very low price. More serious than clay would be even a very small percentage of oil, as sulphur will not satisfactorily burn when it is contaminated by more than a small fraction of 1 per cent of oil.

In the manufacture of sulphurous or sulphuric acid sulphur with from 0.10 to 0.30 per cent of oil, depending on the type of burner employed, can be used only with the greatest difficulty, and for some purposes, as, for example, in the manufacture of paper, would be useless. It was known that oil occurred in the Matagorda Big Hill dome, but only actual production of sulphur would prove how successfully this oil could be excluded from the sulphur horizon.

Therefore, while the existence of some sulphur was mentioned by oil drillers as early as 1903, little was known as to the quantity and grade of the ore until some time in 1918, and it was not known until March, 1919, when the steaming plant began to produce sulphur, that the deposit could be worked at a profit. According to the regulations on depletion of the Internal Revenue Bureau, this date, namely, March, 1919, is therefore the date of discovery of the deposit.

Very complete and detailed records of the drilling have been kept. I have carefully gone over these records and estimate that in March, 1919, the date of discovery, there were developed on the property then owned by Texas Gulf Sulphur Co. ore having a gross sulphur content of 12,263,696 short tons, or 10,967,585 long tons. I have arrived at this estimate by the usual methods employed by engineers in estimating the ore reserves of copper mines developed by drilling.

As previously stated, before actual production began it would have been impossible to make any estimate as to what percentage of the sulphur in the ground would be recovered by the steaming process. However, as soon as the hot water was pumped into the deposit production of sulphur commenced within a few hours and continued so smoothly and regularly that I believe it could have been very conservatively estimated within the 30 days allowed by the regulations that the ultimate recovery of sulphur would be at least 75 per cent, or approximately 8,225,000 long tons of sulphur.

In order to arrive at the value of this sulphur it is necessary to estimate the cost of production and assume some average selling price. The best guide as to the future selling price of sulphur is probably the average price received by the mines for the 10-year period previous to the war. The most accurate and complete statistics on sulphur are probably those in the "Mineral resources of the United States," published by the United States Geological Survey. Copy of these statistics are shown in an appendix to this report, as are also some statistics compiled by the "mineral industry" and published in volume 20, page 641. From these statistics it will be seen that the average selling price of sulphur at the mines for the 10-year period preceding the war was about $18 per long ton. There does not appear to be any reason why, when conditions again become normal, the price of sulphur should not be about the same as it was before the war. This is especially true in view of the fact that no new sources of competition are likely to enter the market and some of the old sources of supply give indications of becoming exhausted.

As to the cost of production, I estimate it may be safely assumed that the average cost over the life of the mine, excluding depreciation but including all general and administration expenses, will not exceed $5 per long ton of sulphur produced. This cost was obtained from the beginning of operations in spite of the usual extra expenses incidental to starting up a new plant. During the second year of operation the costs were materially lower than

above estimated and it must furthermore be taken into consideration that during both of these years the cost of labor and supplies was abnormally high. In view of what has actually been accomplished the estimate of $5 is really too high.

In view of the facts above presented as to average selling price of sulphur and the estimates of the cost of production, it may safely be assumed that the average profit over the life of the mine will be at least $10 per ton of sulphur produced.

If we assume a life of the mine of 12 years the average annual production would have to be 682,000 long tons. The plant at the mine is capable of producing twice this amount and there should be no difficulty in disposing of this amount as soon as conditions are again normal especially as the demand for sulphur in this country is increasing at a very rapid rate, due to the great expansion of chemical industry in this country as a result of the war.

The company now has contracts extending over a period of years calling for the requirements of various fertilizer, chemical, paper, and other companies, who estimate their requirements for the current year at 650,000 tons. This fully justifies the assumption that the company will be able to dispose of the amount estimated.

The annual profit on sales of 682,000 tons at $10 per ton is $6,820,000. The "present value" of $6,820,000 per annum for 12 years, using Hoover's tables for a 7 per cent yield and a sinking fund invested at 4 per cent to amortize the investment, is $49,922,400. From this figure should be subtracted the estimated net cost of plants necessary to extract the sulphur, which is $5,000,000, leaving as the net "present value" of 8,225,000 long tons of sulphur $44,922,400, or $5.46 per ton.

Respectfully submitted. HENRY KRUMB.

APPENDIX

Marketed production of sulphur in United States

[Mineral resources of the United States for 1914. Published by the United States Geological Survey
Copied from page 131]

Year	Quantity (long tons)	Value		Year	Quantity (long tons)	Value	
		Total	Per ton			Total	Per ton
1904	127,292	2,663,760	20.93	1911	265,664	4,787,049	18.02
1905	181,677	3,706,560	20.40	1912	303,472	5,256,422	17.32
1906	294,153	5,096,678	17.33	1913	311,590	5,479,849	17.59
1907	293,106	5,142,850	17.55				
1908	369,444	6,668,215	18.05	Total and average	2,641,244	47,838,560	18.11
1909	239,312	4,432,065	18.52				
1910	255,534	4,605,112	18.01				

Copied from Mineral Resources of the United States for 1913, page 23:

"By production is meant actual sales of sulphur which enter and affect the market. The unsold sulphur stocked at the mines is not included."

Copied from Mineral Resources of the United States for 1912, page 931:

"In determining the value of most of the sulphur produced in 1912 the current market prices at New York were taken from which the mine values were computed."

[Mineral Industry for 1919, vol. 28. Copied from page 641]

Year	Shipped		
	Quantity (long tons)	Approximate value	Value per ton
1909	258,283	$4,783,000	$18.52
1910	250,919	4,522,000	18.02
1911	253,795	4,573,000	18.02
1912	305,390	5,289,000	17.32
1913	319,333	5,614,000	17.58
1914	341,985	6,214,000	18.17
Total and average	1,729,705	30,995,000	17.92

EXHIBIT N

TEXAS GULF SULPHUR CO.,
New York, June 22, 1920.

TEXAS GULF SULPHUR CO.,
New York City.

GENTLEMEN: As our operations commenced in March, 1919, and as the first year's operations are necessarily subject to many adjustments, experiments, and changes, the costs and profits for that period are at best only of slight assistance in estimating what the company's costs and profits will be for the next 12 years.

The experience of the other two large sulphur producers (which use substantially the same methods of production) over a period of years should be of greater assistance in making this estimate, and in this connection I submit the following information regarding their sulphur production, its value, costs of production, and profits.

Sulphur production United States and the value thereof for the years 1904 to 1914, inclusive, according to Mineral Resources of the United States, reprinted in Information Concerning the Pyrites and Sulphur Industry, prepared by the United States Tariff Commission for use of Committee on Ways and Means, House of Representatives, is as follows:

Year	Long tons	Value	Per ton	Year	Long tons	Value	Per ton
1904	127,292	$2,663,760	$20.926	1910	255,534	$4,605,112	$18.022
1905	181,677	3,706,560	20.402	1911	265,664	4,787,049	18.019
1906	294,153	5,096,678	17.327	1912	303,472	5,256,422	17.321
1907	293,106	5,142,850	17.546	1913	311,590	5,479,849	17.587
1908	369,444	6,668,215	18.049	1914	327,634	5,954,236	18.173
1909	239,312	4,432,066	18.520				

The report of the Federal Trade Commission, published in the Official Bulletin, No. 348, June 29, 1918, contains the following statements on the cost of producing sulphur in the United States, and it is reproduced in Information Concerning the Pyrites and Sulphur Industry, prepared by the United States Tariff Commission for use of Committee on Ways and Means, House of Representatives:

"The cost of the Freeport Co. in 1917 was $6.15 per ton; in 1918 it is estimated that increases will bring the cost up to not over $9.50 per ton. In the first half of 1917 the Union Co.'s costs were $5.73 per ton. The average realization of the Union Co. in the first half of 1917 was $18.11 per ton, making a margin of $12.38 per ton."

It is reported that Mr. W. R. Ingalls, formerly editor of the Engineering and Mining Journal and now acting in a consulting capacity for the Union Sulphur Co., testified under oath to the following production and costs of the Union Sulphur Co. for the years 1909 to 1912, inclusive, namely:

1909, 270,000 tons were produced at a cost of $4.98
1910, 240,000 tons were produced at a cost of 6.09
1911, 204,000 tons were produced at a cost of 9.48
1912, 786,000 tons were produced at a cost of 2.98

It is also reported that Mr. Horace H. Craig, auditor of the Union Sulphur Co., testified under oath to the following relating to selling prices of sulphur, namely:

"In the old days the company received $18 per ton for sulphur at the mines. During the submarine campaign pyrites ceased to come here from Spain and the price of sulphur advanced. The company was getting $20 per ton when the National Council of Defense raised the price to $22.

"That the profits of the Union Sulphur Co. in 1917 averaged $9.67 per ton, and in 1918 $12.38 per ton."

Following are the approximate shipments, profits, and profits per ton of the Union Sulphur Co. for the years 1909 to 1917:

	Shipments	Profits	Profits per ton		Shipments	Profits	Profits per ton
1909	258, 283	$3, 150, 000	$12. 1959	1914	316, 061	$4, 034, 846	$12. 7660
1910	250, 919	3, 326, 480	13. 2571	1915	213, 614	2, 669, 712	12. 4978
1911	253, 795	3, 079, 765	12. 1348	1916	503, 500	6, 613, 842	13. 1357
1912	305, 390	4, 285, 792	14. 0338	1917	660, 378	8, 872, 146	13. 4349
1913	319, 333	4, 111, 092	12. 8739				

I have compiled these figures from the sworn testimony reported to have been given by Mr. W. R. Ingalls, consulting engineer for Union Sulphur Co., and Mr. Joseph A. Skinner, of New Orleans, expert accountant, in the tax case of the State of Louisiana *v.* Union Sulphur Co., pending in the United States District Court for the Western District of Louisiana, June, 1920. In arriving at the shipments for the years 1914 to 1917 the approximate shipments made by Freeport were subtracted from those given by Mr. W. R. Ingalls as total United States shipments.

It is difficult to predict accurately the average selling price for sulphur throughout the world during the next 12 years. It is equally difficult to predict the average cost of production at the mines due to changing conditions, taking into consideration the past history of the industry, the recent large increase in sales of sulphur, the many new prospective uses; and it is my opinion that it is fair to assume an average selling price during the next 12 years of $15 per long ton and a $6 cost, leaving a net profit of $9 per long ton. These prices and profits are based on estimated average sales of over 666,000 tons per year.

In assuming this sales price and cost you will note that the average sales price of $15 per ton is approximately $3 per ton less than the average sales price for sulphur over a period of 10 years prior to the war and that the average profit of $9 is materially less than figures which have been given as the average profit made by the Union Sulphur Co.

The estimate of $6 as a fair average cost of producing sulphur during the next 12 years is probably high, because the sulphur deposit of this company is much more uniform than that of the Freeport Sulphur Co., making its operating cost per ton of sulphur lower than Freeport; also because of the nature of this company's deposit and the methods of operating, it can be made to produce sulphur for a less cost per ton than can Union Sulphur Co. The fact should also be considered that the costs of labor and practically all supplies have been excessive during the year 1919.

While this company's profits for 1919 were less than $9 per ton, yet we believe we can conservatively assume this figure, because the costs of water transportation were and are abnormally high. For example, prior to the war the costs of transportation from the mines of Union and Freeport to Atlantic ports were approximately $4 per ton; the average costs to this company during 1919 were approximately $9 per ton. Any reduction obtainable in these costs of water transportation will materially lessen the cost to this company of making Atlantic seaboard deliveries and will increase the average net profit per ton of sulphur.

We are also contemplating improvements in the handling of sulphur which we believe will reduce production costs.

The entry of this third large sulphur producer in the sulphur markets during 1919 tended to demoralize market conditions. As a result sulphur was selling during 1919 at lower prices than for many years. The Texas Gulf Sulphur Co. having now established its position in the markets of the world, it is fair to assume that there will be greater stability in the markets and that there will be an upward tendency in sulphur prices during the next few years.

I therefore believe a fair valuation for depletion purposes of the Texas Gulf Sulphur Co.'s property at Gulf, Matagorda County, Tex., to be as follows:

Company's sulphur deposit, approximately (tons)	11, 000, 000
Containing recoverable sulphur (tons)	8, 000, 000
Annual extraction (tons)	666, 667
Life of deposit (years)	12
Profit per ton	$9
Estimated profit per year	$6, 000, 000
"Present value" factor to yield 7 per cent interest with amortization of principal in 12 years by installments reinvested at 4 per cent	$7. 32

Present value of $6,000,000 per annum for 12 years	$43,920,000
The estimated net cost of plant and equipment is	$5,000,000
Net present value of ore body	$38,920,000
Dividing by 8,000,000, the tonnage of recoverable sulphur, gives depletion unit per ton	$4.865

Yours very truly,

TEXAS GULF SULPHUR CO.,
W. H. ALDRIDGE, *President.*

EXHIBIT O

JUNE 28, 1920.

Mr. W. H. ALDRIDGE,
President Texas Gulf Sulphur Co., New York.

DEAR SIR: In accordance with your request I am sending you my discussion of the history of development, discovery, tonnage, and valuation of your company's sulphur deposit, as required for its income-tax statement.

As you know, I first became familiar with this deposit and visited it in 1910, and have remained in touch with it and familiar with its condition of development ever since. From September, 1917, until March, 1919, during the campaign of development, I was employed by the company as consulting engineer to advise and direct the methods of development. Since March, 1919, I have had no connection with the company except through my holdings of a small number of its shares.

SUMMARY

In view of the history of the development of the company's property and its progress as I have known it, there is no doubt that the "date of discovery" of the deposit, as contemplated in the Treasury Department's regulations, was in March, 1919, when discovery was completed by a successful pumping test.

At the date of discovery you had developed approximately 11,000,000 long tons of sulphur, of which I believe you are justified in assuming 8,000,000 long tons recoverable in mining.

You have submitted a statement establishing a value of the deposit for the purpose of your income-tax return of $43,920,000. I believe that according to the intent and regulations of the Treasury Department $43,920,000 is a fair and reasonable figure for you to claim, and one that you will be able to defend.

LOCATION AND EXTENT

The Matagorda Big Hill is at Gulf, Matagorda County, Tex., 5 miles east of the town of Matagorda. The hill itself covers some two or three hundred acres, rising gradually 10 to 20 feet above the level of the surrounding coastal plain. One mile to the south is the Bay of Matagorda, a shallow arm of the Gulf of Mexico, which is separated from the latter by a long, narrow sand spit some 6 or 8 miles farther to the south. Gulf is reached by a spur of the Matagorda branch of the Santa Fe Railroad.

The property of the Texas Gulf Sulphur Co., comprising about 2,900 acres, covers practically the entire hill and most of the flats immediately surrounding it.

GEOLOGY

The structure of the Matagorda Big Hill is similar to that of many other "saline domes" in the Texas-Louisiana coastal plain. The surface is composed of unconsolidated muds, sands, and clays of recent geological age. These formations, with occasional beds of water sand, shell, hard shale, and limestone, constitute the upper 700 to 1,200 feet of the formation at the top of the mound. Below these is the first "cap rock," a bed or series of beds of limestone about 80 feet thick. Below this are other layers of clay, and then the real capping of the sulphur horizon, a recrystallized vesicular limestone containing cavities filled with salt water, oil, gas, or sulphur crystals. In some places there is a considerable amount of cap rock above the sulphur; in others the sulphur occurs at the top of the formation and even penetrates a little way into the clay above it.

The sulphur horizon itself is composed almost entirely of calcite and sulphur crystals for a thickness of 60 to 200 feet. The sulphur appears to have formed later than the calcite or during a stage of recrystallization of the latter and occurs largely in the nature of a filling or lining of cavities in the lime. The proportion of sulphur is large throughout considerable thicknesses, amounting to 75 per cent of the formation in some places.

Below the richer sulphur horizon the formation consists principally of gypsum, with subordinate and unimportant amounts of calcite and sulphur. The gypsum formation is 50 to 100 feet thick or more and is underlain by a deposit of rock salt of unknown thickness.

This same sequence of formations is found in other saline domes of the coastal plain, notably at Beaumont, Freeport, Damon Mound, and many others, but as a rule the sulphur horizon, where found at all, is thin and low grade and of no such importance as at Gulf.

The shape of the Big Hill dome, like most of the others, is that of an open umbrella, its apex being under the higher part of the surface elevation, fairly flat at the top and sloping off steeply at the sides.

The origin of the saline domes and their relation to sulphur and oil deposits have long been topics of geological discussion; several interesting theories have been advanced to account for them, but as yet no theory has been granted general acceptance.

CHARACTERISTICS OF SULPHUR DEPOSITS

Sulphur deposits of the saline dome type (which include the three producing deposits of the Union, Freeport, and Texas Gulf companies have a number of peculiarities not met with in other better-known types of mineral deposits.

The sulphur occurs as an incomplete filling of fissures and cavities in a porous mass. The interstices are filled with a plentiful supply of warm salt sulphurous water and poisonous sulphurous gas.

On account of the water and gas it is impractical to sink a shaft and open mine workings as is done with other mineral deposits. The only direct information that it is practical to obtain of the character of the deposits must come through the drilling of wells into the deposit or through the extraction of sulphur from such wells.

On account of the extremely porous nature of the sulphur formation the ordinary methods of drilling do not yield adequate information regarding its richness or character. The cuttings made by the ordinary methods are usually lost in the cavities or interstices of the deposit and are seldom brought to the surface; consequently wells so drilled have rarely given any reliable evidence of what was penetrated. To obviate this difficulty the writer developed a process of drilling that delivers the cuttings of the drill at the surface. This process has been used successfully at Freeport and at Gulf and has been proved at both places to yield reliable information regarding the quantity of sulphur in the ground, provided proper methods are used for sampling the cuttings.

After the sulphur deposit is drilled and the content of sulphur determined there remains the problem of extracting it. By pumping into the wells large quantities of water superheated to 330 or 350° F., sulphur can be melted for a variable distance around the well, the distance depending upon the porosity of the formation, the amount and temperature of the salt water already there, the direction and character of the cavities and water courses in the formation, and the imperviousness or permeability to water of the underlying material. All these conditions and many others make it impossible to predict accurately, in advance of actual pumping, just how the hot water will act and how much of it will be required.

After the sulphur is melted it must run in a general downward direction until it congeals in the cooler waters below or until it is trapped in the fissures at some point that either can or can not be drained through the well. The part that can be drained through the well can be pumped to the surface by means of a jet of compressed air. The part that can not be so drained may remain to be drained by some other well, or may never be recovered. It is manifestly impossible to predict accurately how much of the sulphur can be recovered by any well, and the ingenuity of the operator may be a large factor.

The cuttings recovered during drilling usually show the sulphur pure and crystalline. But at times sulphur when extracted has been found to be con-

taminated with oil from the formation above or below; this was a great trouble at the Union property during its early days, and to a lesser extent was noted at Gulf when production first began. By proper precautions the oil was successfully excluded at both places and sulphur produced free from injurious impurities.

On the whole, these sulphur deposits may be likened to natural retorts a thousand feet below ground containing very large tonnages of sulphur in porous masses of gangue.. On account of their great dimensions they can not be worked on a small scale, for it is necessary to heat a considerable part of the retort to extract sulphur from it.

EARLY HISTORY OF MATAGORDA BIG HILL

Following the discovery of the Spindletop oil dome near Beaumont wildcat drilling operations for oil were quickly started on most of the recognizable elevations on the Texas coast. A number of wells were drilled on the Matagorda Big Hill in 1903 and 1904, and until 1908 a small amount of oil was produced from moderately shallow wells near the higher part of the elevation. While drilling in some of the deeper of these oil wells crystals of sulphur were occasionally brought to the surface, but on account of the peculiar porous character of the sulphur formation the cuttings from the drill were usually lost in the fissures and not seen by the drillers.

The sulphur shown in the drilling of these oil wells was interesting in that it appeared to be somewhat greater in amount than at other saline domes, but the drillers were interested only in getting oil and the reports of the occurrence of sulphur carried no evidence of its thickness or extent or quantity.

Messrs. John W. Harrison and J. M. Allen, of St. Louis, were attracted by the reports of the occurrence of sulphur in these oil wells at Matagorda Big Hill and succeeded in interesting Messrs. A. C. Einstein and Theodore F. Meyer in the prospect. They gathered together some 200 acres of land covering the east side of the hill, and in 1909 formed the Gulf Sulphur Co. and began a campaign of drilling to determine the extent and richness of the sulphur deposit.

During 1909–10 the Gulf Sulphur Co. drilled six holes shown as holes A to F on company's maps. Holes A to E, inclusive, were sunk by inadequate methods and without competent supervision and their records can not be considered of much value except as an indication of the depth and thickness of the sulphur horizon. Hole F was more carefully drilled than the others, but proper methods were not used for recovery of the drill cuttings and representative samples were not obtained. Consequently the record of hole F, which suggested 13 per cent of sulphur in 59.5 feet of horizon, was not reliable. The thickness of the sulphur formation as found in this early drilling was reported as follows:

Hole	Thickness	Per cent sulphur
	Feet	
A	56.0	Undetermined.
B	85.6	Undetermined; said to be richer than A or C.
C	54.5	Undetermined.
D	35.0	Undetermined; very low grade.
E	41.0	Do.
F	59.5	About 13 per cent; not reliably sampled.

In July, 1910, while in the employ of clients now interested in the Texas Gulf Sulphur Co., I heard of the foregoing results of drilling and visited the Matagorda Big Hill and reported favorably regarding its prospects. Through a visit to St. Louis I became acquainted with Messrs. Einstein, Allen, and Harrison, and with the details of their exploration work at Big Hill; and while on this visit I persuaded Messrs. Einstein and Allen to come to New York to confer with my clients. As a result of these conferences, and in the light of further information regarding sulphur that we developed during our exploration of the Bryan Heights deposit in 1910 and 1911, my clients gradually acquired the controlling interest in the Gulf Sulphur Co. during the next few years.

In 1916, under the direction of the Gulf Sulphur Co., the Producers Oil Co. drilled two holes in the area north of the sulphur deposit. Neither of these holes found any deposits of interest.

Up to this point the Matagorda Big Hill had been shown to be underlain, in part at least, by a deposit of sulphur of undetermined richness, extent, or quantity but of considerable prospective value. In no respect had it been shown to be workable at a profit.

RECENT DRILLING CAMPAIGN

In September, 1917, drilling was begun by the Gulf Sulphur Co. (soon renamed the Texas Gulf Sulphur Co.) to determine the actual sulphur content of the Big Hill deposit and to decide whether or not it could be exploited profitably.

The drilling and sampling of the wells was done according to methods prescribed by and under the guidance of the writer. Test holes were sunk at frequent and fairly uniform intervals, as shown on the map. The drilling was done very carefully with constant attention to obtain representative cuttings. The cuttings were sampled according to a plan developed by me that had been found both at Freeport and at Gulf to yield reliable and representative results. All the coarse cuttings brought up by the drill were saved, and a representative proportion of the coarse sands, fine sands, and slimes. Cores were occasionally taken. Samples of each class of material were kept separately for each 3 to 5 feet drilled and assayed for sulphur in the company's laboratory. Occasional check samples were also assayed by custom chemists in New York. The percentages of sulphur reported for each sample were properly combined, and an average percentage calculated for the full thickness of sulphur formation penetrated in each hole. This average was checked by means of composite samples and corrected, if necessary, for any dilution of the samples with extraneous matter, such as pipe scale or clay. From the average percentage finally adopted and the corresponding thickness of the formation there was then calculated for each hole the thickness of an equivalent bed of solid sulphur.

The results from all the drill holes may then be combined, according to standard methods, to give the developed tonnage of sulphur. The total tonnage as reported thus represents, not sulphur ore but the content of solid, pure sulphur, which is the actual product of the mine.

The methods used in drilling, sampling, and estimating the tonnage of sulphur at Gulf have been the most careful and accurate ever used for any sulphur deposit, and they are worthy of the greatest reliance.

On December 27, 1917, after completion of the first test well, I reported that the deposits appeared to be thick enough and rich enough to be exploited very profitably and recommended that you continue the drilling campaign vigorously to develop the extent and sulphur content of the deposit. I also recommended the preparation of plans for a steaming plant to produce sulphur.

In April, 1918, after completion of five wells, I reported a probable content of 3,982,000 tons of sulphur, with development yet insufficient to establish this figure definitely. On account of the great demand for sulphur during the war, I recommended beginning expenditure of $2,000,000 for the erection of a steaming plant without waiting to establish the tonnage more definitely, as normal conservative practice would have suggested. The erection of the plant was actively prosecuted.

On August 11, 1918, I reported that the company had reasonable assurance of 8,692,000 tons of sulphur, with considerable prospect of large additional tonnage. This was the last detailed report on tonnage made by me, although the drilling campaign was continued with the same methods under the company's local staff until and after production began. Estimates of the developed tonnage of sulphur were made from time to time by the company's staff according, in general, to my method of calculation; and while I have not checked over these later estimates in detail, I have no reason to doubt their essential reliability. The staff estimated a developed quantity of 10,955,000 long tons of sulphur within the company's property in March, 1919, with some additional tonnage likely because the limits of the deposit were still undetermined in two directions.

In March, 1919, the heating and pumping plant was sufficiently completed to permit pumping a well to test the practicability of extracting the sulphur. The drilling results had determined the tonnage of sulphur present and had indicated something of the purity of the sulphur and the porosity of the formation; but the drilling had not determined the availability of the sulphur

to the heating and pumping process. Various possible difficulties were anticipated, chiefly because the Union and Freeport companies had met serious unforeseen troubles in getting started. It was therefore a matter of intense satisfaction that the operation of the Texas Gulf Sulphur Co.'s plant was successful immediately from the start, producing a highly satisfactory daily tonnage of sulphur over 99.5 per cent pure, and finally demonstrating that there were no natural conditions seriously detrimental to the production of sulphur of marketable quality.

DATE OF DISCOVERY

For its income-tax statement, the company is interested in the question of date of discovery, and tonnage and valuation as of that date.

Form D of schedules for valuation, depletion and depreciation says "The date of discovery is the date upon which it was ascertained that sufficient ore has been blocked out to justify the installation of equipment for operation on a commercial scale."

There is no question in my mind that the intent of this ruling means the date upon which sulphur was first successfully mined by the Texas Gulf Sulphur Co., which was in the month of March, 1919.

The occurrence of sulphur at Gulf was first reported in 1903–4 in wells drilled for oil—but this in no way constitutes legal discovery of a commercially valuable deposit for nothing was discovered of its richness or extent or workable character.

The drilling of 1909–10 added but little to the previous information regarding richness or workable character, though it suggested a fairly large areal extent of the deposit.

It remained for the careful drilling of the campaign of 1917–1919 to demonstrate the richness and extent of the deposit, and for the actual successful pumping of sulphur in March, 1919, to prove the absence of possible detrimental conditions that could not be determined by drilling alone. Such conditions might have involved, for instance, the pollution of the sulphur with oil or clay from the known deposits above it, or inability to recover the melter sulphur from the fissures and cavities in the formation, or the access of too large quantities of colder water to the formation, requiring an unduly excessive amount hot water from the steaming plant. These and other troubles were serious during the starting of operations at the only other two similar deposits that have been exploited, and the facts regarding these conditions could not be determined in any other way than by actual pumping of hot water into the ground and extraction of marketable sulphur from it.

The operation of a heating and pumping plant is thus an integral and necessary part of the development of a sulphur deposit of the dome type. A parallel example is in the case of oil lands which can only be tested by actual production through wells. Another comparison is in the development of metalliferous deposits; to justify the erection of equipment for mining ores and producing metal a metallurgical test is always required to show that the metal can be extracted from the ores.

It is a peculiar characteristic of sulphur deposits of the dome type that practical extraction tests con not be made with a small plant or on less than a commercial scale, on account of the large dimensions of the deposit that has to be heated underground. To prove that sulphur can be extracted at a profit it is necessary to risk, in advance of complete justification, the investment required for a plant large enough for commercial operation.

It was not before the success of the company's first pumping operations in March, 1919, that the final facts were demonstrated to justify the installation of its equipment, and I am therefore firm in the opinion that your legal discovery as understood by the Treasury Department, was completed in March, 1919, and not before that time.

TONNAGE

My own figures and reports to August 11, 1918, as supplemented by the figures of the company's staff on subsequent drilling, justify you in adopting the figure for developed and probable sulphur in the company's property of 11,000,000 long tons of sulphur at the date of completion of the discovery in March, 1919.

The actual amount of sulphur that can be profitably extracted depends on many conditions concerning which little can be predicted. From my own

experience in the sulphur industry and my knowledge of the results of operations at other places. I believe that, of the 11,000,000 long tons gross content of the company's property, the amount of 8,000,000 long tons, or 72 per cent, should be readily recovered by mining, without undue difficulty or excessive cost. The figure of 8,000,000 long tons is a reasonable and a properly conservative one for you to adopt as the content of available sulphur in the mine at the date of discovery.

VALUATION

You have submitted to the Treasury Department a valuation as of March, 1919, of $43,920,000 for the fully equipped deposit. This you have calculated as follows:

Available sulphur ---------- tons	8,000,000
Estimated annual production ---------- do	667,000
Years life ----------	12
Estimated profit per ton (before charging depreciation) ----------	$9.00
Estimated profit per annum ----------	$6,000,000
"Present value" factor to yield 7 per cent with amortization of principal in 12 years by installments reinvested at 4 per cent ---	7.32
"Present value" of $6,000,000 per annum for 12 years ----------	$43,920,000

In your letter of June 22 to the company you have discussed the basis of this estimate in considerable detail.

Because of the richness of the sulphur deposit at Gulf, its uniformity, and its freedom from unfavorable mining conditions, I believe you can mine the greater part of your sulphur at very low cost—considerably under $5 per ton, exclusive of transportation and depreciation charges.

The normal price of sulphur before the war was $18 per ton at the mine. It is difficult to estimate closely how great a reduction of price below this level will be necessary to maintain the large consumption you have estimated. You have apparently already achieved the practical exclusion of forcing pyrite from the American market and are now producing and selling nearly as much sulphur as you have estimated for your annual average throughout the whole life of the Gulf deposit. And due to the normal growth of the requirements of this country as well as Europe the demand for sulphur will undoubtedly increase largely during the next 12 years.

With low costs that can be expected at Gulf, your estimated profit of $9 per ton leaves a large margin for reduction in price below the pre-war average. This is a smaller profit than your competitors have normally made from similar deposits, and I believe it is sufficiently conservative for your estimate.

In accordance with the attitude and regulations of the Treasury Department, I therefore believe you are justified in claiming the valuation of $43,920,000 for purposes of depletion and depreciation in your tax statement.

Very truly yours,

SPENCER C. BROWNE.

EXHIBIT P

[Extracts from Pyrites and Sulphur Industry]

Texas Gulf Sulphur Co., production in United States

[Figures from Mineral Resources of the United States]

Years	Quantity	Value	Years	Quantity	Value
	Long tons			*Long tons*	
1900	3,147	$88,100	1911	265,664	$4,787,049
1904	127,292	2,633,760	1912	303,472	5,256,422
1905	181,677	3,706,560	1913	311,590	5,479,849
1906	294,153	5,098,678	1914	327,634	5,954,236
1907	293,106	5,142,850	1915	410,000	----------
1908	369,444	6,668,215	1916	900,000	----------
1909	239,312	4,432,066	1917	1,350,000	----------
1910	255,534	4,605,112			

COST OF REDUCTION

The report of the Federal Trade Commission to the President on profiteering, in response to Senate Resolution 255, which was published in the Official Bulletin, No. 348, June 29, 1918, contains the following statements on the cost of producing sulphur in the United States:

"Two companies produce all the sulphur in this country—the Freeport Sulphur Co. and the Union Sulphur Co.

"The cost of the Freeport Co. in 1917 was $6.15 per ton; in 1918 it is estimated that increases will bring the cost up to not over $9.50 per ton. In the first half of 1917 the Union Co.'s costs were $5.73 per ton. The average realization of the Union Co. in the first half of 1917 was $18.11 per ton, making a margin of $12.38 per ton. The manufacturers of sulphuric acid are paying in the neighborhood of $25 per ton to sulphur companies. The Freeport Co.'s balance sheets show an operating profit for the 11 months ending October 31, 1917, of $4,301,310, or 236 per cent on investment. On November 30, 1918, the company's balance sheets show dividends declared of $925,000; on July 31, 1917, $1,850,000; and October 31, 1917, $2,600,000. Its surplus increased from $1,254,000 in November, 1918, to $2,543,000 in October, 1917.

"These companies may be said to have a natural monopoly of sulphur. Since they have placed their operations upon an established basis they have always made large earnings. They have taken advantage of the existing situation to raise their price."

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

Mr. MANSON. I have not.

Senator KING. I assume, Mr. Nash, that this matter will receive attention?

Mr. NASH. Yes, sir.

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

(Whereupon, at 11.55 o'clock a. m., the committee adjourned until to-morrow, Friday, May 15, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

FRIDAY, MAY 15, 1925

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

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

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

Present also: Mr. L. C. Manson, counsel for the committee, 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; and Mr. A. W. Gregg, solicitor Bureau of Internal Revenue.

The CHAIRMAN. Do you want to take up the timber matters now, Mr. Manson? I understood you to say you had something on that.

Mr. MANSON. Yes; I have a timber matter here that can be taken up. It will take some little time. I do not know whether the committee will care to hear it all now or not.

Senator KING. Can we not run until 1 o'clock?

The CHAIRMAN. Can you finish it by that time?

Mr. MANSON. Oh, yes; in less time than that.

I have a general report here, made by one of our engineers who investigated the work of the timber section of the engineering division of the Income Tax Unit, and I am going to offer this as an exhibit in the record; but I wish to say at this time that there is nothing in it that criticizes in any way the work of the timber section. In fact, it is commended.

He does call attention to the fact, however, that there is considerable conflict between the timber section and the auditing divisions on the matter of depreciation.

It appears that the timber section has been given jurisdiction by the commissioner over the matter of the determination of depreciation units; in other words, the rates of depreciation. It is, in my judgment, proper that they should have jurisdiction over the determination of what is a proper rate of depreciation, whether it applies to a sawmill or to a paper mill, or whether it applies to any industry, that being necessarily a matter involving a knowledge of the machinery and equipment used in that industry, the methods of its use, and the life of it, etc.

There has been some difficulty due to the fact that the auditing divisions have refused to recognize the rates established by the engineering division.

The CHAIRMAN. From reading that report I got the impression that this division of authority was creating considerable disturbance among taxpayers, and that the question of authority had not yet been determined by the commissioner. It has not yet been apparently satisfactorily determined. In other words, there is a communication there from one department to the other which criticizes the turmoil——

Mr. MANSON. Yes.

The CHAIRMAN. And ask that the matter be settled, and I find no evidence in the report that the matter has been settled.

Mr. MANSON. The fact is that the matter has not yet been settled. Although, in the first instance, the timber section was given the authority to do this work, evidently the auditing sections have not yet been required to accept the work done by the timber section with reference to the determination of depreciation rates.

The matter is called to the attention of the committee not especially as a timber matter for the reason that this is a question of first general application to the whole subject of depreciation. The whole subject of depreciation is now in the hands of auditors, except to the extent that the auditors may call upon the engineers for advice as to depreciation rates; but there is nothing in the procedure requiring that they do so, and there is no special machinery set up in the engineering division whose function it is to establish these depreciation rates.

Senator KING. You mean the auditors has none?

Mr. MANSON. No; there is no machinery set up in the engineering division which can be utilized for the purpose of determining depreciation rates to be applied by the auditor. That has led to a rather ridiculous result in the case of Dill & Collins Co., paper manufacturers.

I am going to offer this report on the Dill & Collins Co. as an exhibit in the record, but I will briefly call the committee's attention to the facts.

The Dill & Collins Co. are paper manufacturers. It so happens that there was an engineer in the timber section who had actually constructed a part of this Dill & Collins plant and had superintended its operation. I call attention to that fact to show that here was a case where there could be no question about the familiarity of the engineer not only with paper manufacturing generally but with this particular piece of property.

The company in its returns claimed either 6 or 6½ per cent depreciation rate on its machinery as a composite rate. I believe the engineers, in conference with the taxpayer, agreed to a 6½ per cent rate as was claimed by the taxpayer, on the machinery, and 2 per cent on the buildings.

Subsequently, in a conference with Mr. Alexander, the head of the audit section having jurisdiction over this case, Mr. Alexander overruled the engineers, although he conceded that he had no knowledge of paper manufacturing machinery, and allowed them 10 per cent on the machinery.

The CHAIRMAN. I understood you to say that the taxpayer claimed only 6½ per cent.

Mr. MANSON. The taxpayer claimed only 6½ per cent in his original return. He afterwards amended his claim in that respect.

The CHAIRMAN. What did the taxpayer claim in its amended return?

Mr. MANSON. Ten per cent on the machinery and 3½ per cent on the buildings.

The CHAIRMAN. Were both of those allowed by Mr. Alexander?

Mr. MANSON. Both of those were allowed by Mr. Alexander, upon the theory advanced by the taxpayer that his plant had worked double shift. It is contended by the engineer, by the very man who built that plant, that in that kind of business it is customary for the plant to work continuously, and that the 6½ per cent rate was predicated upon continuous operation.

I call attention to this matter because it illustrates the situation with respect to depreciation generally not only in the lumber industry and not only in the paper industry but throughout all industries. Depreciation deductions, so far as the future is concerned, amount to more than any other one class of deductions, and it is highly important that the subject of depreciation be handled upon a scientific basis. It never can be handled upon a scientific basis until the determination of the rates which are to be applied throughout the industries is left to engineers who have knowledge of the industries to which those rates are to be applied.

The CHAIRMAN. Is that the same Alexander that settled the William Boyce Thompson case?

Mr. MANSON. Yes.

The CHAIRMAN. Was he a special conferee or a special adjuster?

Mr. MANSON. No; he is the head of the section, and he just arbitrarily, after the engineers had been authorized by the commissioner to consider this matter and to determine depreciation rates in the paper and pulp and timber industries—after the commissioner had authorized that branch of the service to determine depreciation rates—Alexander arbitrarily made an allowance here of nearly double what the engineers had determined was the proper rate; and it illustrates, to my mind, a bad condition of organization with respect to that problem, which is also one of the largest problems before the bureau.

The CHAIRMAN. It also typifies, in my opinion, what I think has been shown right along, and that is the enormous power that is reposed in these section heads.

Senator KING. That was not the subject of review by a board or by a committee, but it was just done by himself?

Mr. MANSON. He just did that himself, and although the assistant head of the engineering division, the head of the timber section, and the engineer, who, as I said, was not only an expert in pulp mills but had actually built this plant, after they had protested, and Alexander had told them that even though an auditor could not name a single machine in the plant or what it was used for, he considered it to be a proper matter for auditors to have exclusive jurisdiction over, that he would not recognize their determination, and the case was settled on that basis.

Senator KING. Mr. Gregg, is there any action under contemplation by the department, assuming that the heads of the sections have this power, to subject their action, whether just or arbitrary, to review?

Mr. GREGG. A great deal of the work of the different sections of the unit is subject to review. A great many claims come through the solicitor's office. Of course, all of it can not be reviewed.

Senator JONES of New Mexico. You have to repose authority somewhere.

Mr. GREGG. Somewhere; yes, sir.

The CHAIRMAN. But the point that I want to bring the committee's attention to is that when the section head agrees with the taxpayer there is not anything to review, because the taxpayer then makes no claim. That does not go to the solicitor's office.

Mr. GREGG. Well, it may involve a refund.

The CHAIRMAN. Yes; but the section head has authority to handle anything.

Mr. GREGG. That is true. A case may get to the solicitor's office, and we have to decide it; somebody has to decide it.

The CHAIRMAN. I bring that out not for the purpose of criticizing the fact that they do have to settle it but for the purpose of pointing out to Congress that something should be done with the law when there is all of that enormous responsibility placed in so few hands.

Mr. GREGG. You are certainly going to get thorough cooperation from the bureau in any attempt to take away these questions of judgment from us.

Mr. MANSON. My criticism here is that this is a highly technical subject; the determination of proper rates for depreciation is a highly technical subject, requiring special engineering knowledge, and that it is a matter upon which the judgment of the engineers should not be subject to being overturned by an auditor.

Senator JONES of New Mexico. Is not that true with respect to all depreciations?

Mr. MANSON. Yes; I do not say it is confined just to this. I have just used this case as an illustration of what happens when an auditor sees fit to overrule an engineer on a matter that the auditor does not know anything about.

Senator KING. Is there any rule in the department, Mr. Gregg, and if there is not, should there not be, in a case like this, and in analogous ones, which would impose the duty on an employee, if he were in the position of this clerk or auditor here, of appealing it to somebody higher, without being chastised for insubordination?

Mr. NASH. That is what should have been done in this case.

The CHAIRMAN. But they are chastised, Mr. Senator. You can not get away from that fact. They are fired and disciplined for taking appeals above, and that has been demonstrated here time and again.

Mr. MANSON. I understand that this is a part of the function of the head of the engineering division, as defined by the commissioner. This is not the only case that has arisen. There are 10 or 12 out of the timber section. I have not had the others prepared for presentation, because this case will illustrate the situation as well as a dozen; but it is a part of the record here that the head of the engineering division protested against this sort of procedure and asked that his authority be clearly defined. That was done seven months ago, and no action has been taken on it yet.

Mr. GREGG. I must say, for the sake of the record, in answer to the chairman's statement, that any engineer or any man in the bureau who is overruled in a matter is at liberty to take it up with his superiors. They do take them up with the commissioner many times. Of course there must be some dividing line. Every man who is overruled can not run to the commissioner and say, "I do not agree with what the man above me said." That is perfectly obvious. We can not permit that; but if it is on a big matter, and he feels that the one who overruled him was in the wrong, or that the manner of handling it was irregular, he not only may, but it is his duty, to take that up with somebody until he gets his point considered.

The CHAIRMAN. I want to draw attention, Mr. Gregg, to the records here, which show that Greenidge letter, threatening anybody that dared to take a matter over his head.

Mr. GREGG. I think that goes a little further than Mr. Greenidge's letter, which letter I do not approve of, but people from Mr. Greenidge's section have taken that up, and nothing has happened to them. Mr. Grimes has taken up plenty.

The CHAIRMAN. And he has been promoted?

Mr. GREGG. He has been promoted.

The CHAIRMAN. I want to be fair to the bureau by showing that some may be promoted and some may be fired.

Mr. NASH. Mr. Chairman, I would like to know who has been fired for appealing a case.

The CHAIRMAN. Would you like to put some of those in the record?

Mr. NASH. I have been assistant commissioner for nearly two years, and it has never come to my attention that any man has ever been fired for appealing on a decision.

The CHAIRMAN. Of course, your records will not show that. It is perfectly obvious. You do not have to put that in the record any time you punish a subordinate. I recognize that, because I have handled organizations myself. If you have anyone that you do not want or approve of, or who annoys you, you can easily get rid of him without putting in the records the actual reason for getting rid of him; but there are cases which show clearly that a man who has been energetic and vigorous in defense of what he considers a correct policy in the interest of the Government has been punished.

Mr. NASH. I would like to know such a case, Mr. Chairman.

The CHAIRMAN. We will present some. We have not gone into the personal equation very much, because we have felt that we would rather deal with principles, but since the assistant commissioner wants some of these in the record we will do so, and then he can reply, if he wants to.

Mr. NASH. Very well.

The CHAIRMAN. But I know that our staff and some of the members of the committee are convinced that what I have said is correct, and if you want them in the record we will submit them for the record.

Mr. MANSON. I will submit the report covering this case for the record.

(The report submitted by Mr. Manson is as follows:)

MAY 8, 1925.

Mr. L. C. MANSON,
General Counsel Senate Committee
Investigating Bureau of Internal Revenue.

Office report No. 41.
Taxpayer: Dill & Collins Co., 140 North Sixth Street, Philadelphia, Pa.
Subject: Tax reduction. Revised allowance for depreciation for taxable years 1917, 1918, and 1919.

Amounts involved—Tax as determined

Year	By original returns	By revenue agent	By bureau audit (final)
1917	$61,676.88	$95,599.11	$57,718.61
1918	18,169.85	20,302.95	9,431.79
1919	13,011.07	12,970.80	4,877.33
Total	92,857.80	128,872.86	72,027.73

STATUS OF CASE

Closed for the years 1917, 1918, and 1919 on the basis of final audit, allowing overassessments. Tax for 1920 determined by revenue agents and now in bureau audit.

SYNOPSIS OF CASE

The records in this case reveal that the bureau first assessed the taxpayer for an additional liability of $48,156.11 for the year 1917. This letter of assessment was dated January 27, 1923. Next, on March 8, 1924, the bureau reduced the tax for 1917 by crediting the taxpayer with an overassessment of $3,958.27, making a difference of $52,114.38 with the former determination. The taxes for 1918 and 1919 were also reduced by overassessments credited to taxpayer, as revisions to the tax liability as determined previously by the revenue agent and by the taxpayer himself in his original returns.

HISTORY OF THE COMPANY

This company was organized under the laws of the State of Pennsylvania, March 9, 1903, as manufacturers of paper and pulp. Its plant, known as the Delaware Mills, was acquired by Dill and Collins as a partnership in June, 1895. On July 1, 1918, the Dill & Collins Co. acquired an additional plant known as the Flat Rock Mills in exchange for $950,000 preferred capital stock.

The company owns no timberland or standing timber in fee or equity or leased.

HISTORY OF THE CASE

The revenue agent's report to the commissioner, dated August 23, 1921, covers his investigation of the taxpayer for the taxable years 1917 to 1920, inclusive. His findings recommend the assessment of $116,516.52 as the sum of additional taxes for those four years, composed as follows:

Year	Recommended additional tax	Overpayment
1917	$33,922.23	
1918	2,133.10	
1919		$40.27
1920	80,501.46	
Total	116,556.79	
Less	40.27	
Net result	116,516.52	

A valuation report by the timber section was made December 14, 1922, covering the taxable year 1917. This recommends that no change be made in the amount of invested capital or depreciation set up in the 1917 return. It also calls attention to an abnormal charge for ordinary and incidental repairs of close to $500,000 for 1917, as compared with $150,000 for 1916, and recommends a tentative adjustment of these repair charges allowing 35 per cent of the amount to repairs and the balance disallowed and to be added to net income. This is tentative, subject to a field examination.

A 30-day assessment letter, dated January 27, 1923, notifies taxpayer that the examination of his income-tax return and books of account and records disclose additional tax liability for the year 1917 of $48,156.11. The additional tax due is explained as resulting from adjustment of invested capital for excess-profits tax purposes. Invested capital has been reduced by the disallowance of items of good will, $400,000; appreciation of machinery, $1,540; and the proration of Federal tax $11,454.88 for 1916, and dividends $60,000 in excess of earnings less accrued Federal tax.

From this the taxpayer appealed, February 27, 1923, taking exceptions as follows:

No. 1–A. The rates and amounts of depreciation allowed by the revenue agent are not adequate.

No. 1–B. The revenue agent is in error in refusing to accept the value of the plant and equipment as appraised January 1, 1913, for the purpose of computing depreciation.

No. 2. The amount of excessive depreciation to be restored to invested capital is $86,835.79 instead of $23,106.33 allowed by the revenue agent.

No. 3. The 10 per cent commission, amounting to $5,101.39 on the work of William Steele & Sons Co., disallowed by the revenue agent, is a duplication.

No. 4. The revenue agent is in error in disallowing the total amount of invoices of William Steele & Sons Co. Claim is made for a deduction of 50 per cent or $25,560.97.

No. 5. The Income Tax Unit is in error in disallowing as invested capital, the proportion of the value of good will.

The appeal ends with a request for a conference which is granted and held March 15, 1923. The taxpayer was represented by five persons, including the vice president and the treasurer of the company. The unit's conferee being W. Robertson, valuation engineer of the timber section, and an auditor.

The following issues were discussed:

1. Good will acquired by the taxpayer from his predecessor in exchange for $400,000 par value capital stock.
2. Repair charges properly applicable to the items of replacements and expense.
3. The appraisal of the property made January, 1913, by other parties.
4. The depreciation rates on depreciable property.
5. Propriety for allowing excess cost of improvements and expenses.

Following this, a visit to the taxpayer's plant was made on April 2, 1923, by Mr. W. Robertson, valuation engineer of the timber section. May 4, 1923, the deputy commissioner addressed a letter to the taxpayer reporting the findings and recommendations resulting from the engineer's examination of the taxpayer's plant.

A valuation report, dated November 30, 1923, next follows.

This treats the matters discussed in the conference of March 15, 1923, and makes specific recommendations concerning them. Another taxpayer's conference took place January 3, 1924, at which the basis of the taxpayer's protest was the bureau's assessment letter of January 27, 1923, by which the taxpayer was advised of additional tax liability of $48,156.11 for the year 1917. The issues were depreciation, commissions, repairs and renewals, invested capital, and good will. The conclusions reached were:

1. Depreciation: The taxpayer's claim unsubstantiated and denied. Bureau's previous decision sustained.
2. Commission: Claim that $5,101.39 had been included in income twice by revenue agent not substantiated. Will be deducted, however, if taxpayer established the fact.
3. Repairs and renewals: Claim for deduction for $25,506.97 as cost of repairs and renewals made under adverse circumstances allowed taxpayer as a deduction from gross income.
4. Invested capital: Claim for $86,825.79 to be restored to surplus instead of $23,106.33, allowed by revenue agent, decided to be an accounting question.

The true amount will be revealed by the audit of the case, and that amount will be allowed the taxpayer.

5. Good will: Taxpayer's claim will be allowed, subject to limitations provided by the statute.

The above findings are acceptable to the taxpayer with the exception of the question of depreciation. At this conference the taxpayer was represented by C. T. Haynes. The unit's conferee was E. R. McCarthy.

Following this is a report on the taxpayer's conference, dated January 23, 1924, and marked "Supplement to report dated January 3, 1924," by Conferee E. R. McCarthy.

The issues are commissions and depreciation left over from the previous conference. The conclusions reached allowed taxpayer his claims on both these items, closing the case.

Next in order is the assessment letter to taxpayer mailed March 8, 1924, which advises tax liability for the years 1917 and 1918 as overassessments amounting to $3,958.27 and $8,737.86, respectively.

The next assessment letter sent to taxpayer is dated December 6, 1924, and advises that examination of his accounts discloses an overassessment of $40.27 for the year 1919. This is followed by an assessment letter dated January 30, 1925, which changes the tax liability for the year 1919 to $8,133.74 overassessment.

DISCUSSION

Beginning with the subject of depreciation of physical property, the taxpayer reported in his returns of 1917, 1918, and 1919 depreciation totaling for the three years $351,770, computed on the basis of March 1, 1913, value, at rates of 2 per cent for buildings and 6 per cent for machinery, with the exception of a minor unit of the plant known as the bleach plant, on which 10 per cent was used for the machinery, owing to its recognized shorter life. These rates used by the taxpayer are annual rates of depreciation based upon the estimated life of the properties, the same as are found in the taxpayer's report in Form T–P, special forest industries questionnaire, for the pulp and paper industry for the taxable years prior to 1920, in which the taxpayer reports the basis for depreciation of physical property as 2 per cent annual rate for buildings and 6 per cent for machinery for both the Delaware mill and the Flat Rock mill. The Form T–P was submitted by the taxpayer in May, 1920. The matter of depreciation, as well as other matters of an engineering nature, were gone into in the examination of the taxpayer's return for 1917 by the valuation engineer of the timber section having jurisdiction over the pulp and paper cases. In his valuation report, which is dated December 14, 1922, recommendations were made as follows:

(1) The amount of invested capital and depreciation set up in the 1917 return should remain unchanged so far as fixed assets is concerned.

(2) The charge for ordinary and incidental repairs set up at $430,099.43 was not, in the opinion of the timber section, entirely chargeable to repairs, but that it included a large amount of replacements and betterments which should, under the law, be charged to increased capital.

The taxpayer, in order to prove his contentions, invited a field examination of his plant, which was duly made by Mr. W. Robertson, valuation engineer of the timber section, to whom all matters pertaining to the pulp and paper industry coming to that section are assigned and who is the timber section's specialist in this particular line, having had many years' experience in the design, construction, and operation of pulp and paper plants. Incidentally, it might be mentioned that Mr. Robertson was superintendent on the construction and for awhile in charge of the operation of the Flat Rock Mills acquired by the taxpayer in 1918.

The taxpayer claims for the year 1917 a higher rate of depreciation for the reason that his plant, under the stress of the times, was obliged to operate 24 hours of the day. According to Mr. Robertson it is customary in the pulp and paper industry to run the plants continuously, and the machinery is designed and built to perform such service.

In the taxpayer's conference held January 3, 1924, which was attended by Mr. C. T. Haynes, representing the taxpayer; Mr. E. R. McCarthy, conferee; Mr. E. N. Brewster, auditor; and Mr. W. Robertson, engineer, representing the unit, the conclusion reached respecting depreciation was that the taxpayer's claim was not consistent with the recognized mortality of this class of industry. Further, that the taxpayer's method of taking the appraisal made as of

January 30, 1913, and depreciating the same only 2 per cent and 4 per cent to obtain the sound values as of the taxable year, and then to claim depreciation of 10 per cent from then on, is not a true reflection of the actual economic waste. Further, the department has gone into the matter rather exhaustively, as shown by the valuation report, and has accepted the appraisal as of January 30, 1913, as being representative of the reproductive value, and has depreciated same over the recognized physical life of the items involved, due consideration being given for all questions of obsolescence, abnormal depreciation, and extensive repairs made during the taxable years.

The taxpayer's conference of January 23, 1924, is reported by E. R. McCarthy, conferee: E. M. Brewster, auditor: and noted by E. E. H. (Hensinger), chief of section. This report does not mention the name of the representative of the taxpayer appearing in the case nor that any representative of the timber section was in attendance. I learned from other sources that no member of the timber section was present. Attention is particularly invited to the report of this conference, especially to the second, third, and fourth paragraphs, which read:

"That, due to the claim of the taxpayer of extraordinary depreciation incurred in the years 1917, 1918, and 1919, and in order to close the case, it was decided to allow the taxpayer an additional depreciation of 3½ per cent on machinery over the 6½ per cent recommended by the department.

"The rate of 3 per cent on buildings is waived by the taxpayer and the rate of 2½ per cent, as determined by the department, is acceptable.

"The above findings of the department are satisfactory to the taxpayer, and the case is closed."

The assessment letter, mailed March 8, 1924, to the taxpayer, signed by S. Alexander, head of division, shows in the statement attached to it how the amount of tax is computed, which results in the overassessment and carrying out the conclusions reached in the conference of January 23, 1924.

Attention is next invited to the letter dated March 1, 1924, from Robert P. Smith, chief of review section, to E. E. Hensinger, chief, Section F, referring to the adjustment made in this case as above mentioned. In this letter Mr. Smith protests the action of the unit in concluding upon the above adjustment on the ground that the case falls under A. R. R. 6099.

Attention is next invited to office conference memorandum, dated April 3, 1924, by the chief of the timber section, and memorandum on the same conference, dated April 2, 1924, made by W. Robertson, valuation engineer, both concerning the conference held on April 1, 1924, in the office of Mr. Alexander, head of natural resources division. Besides Mr. Alexander there were present Mr. C. C. Griggs, assistant head of the engineering division; N. B. Tanner, chief of timber section; and Mr. Robertson. The object of this conference was to make known to Mr. Alexander the functions of the timber section with respect to tax matters involving capital assets of pulp and paper companies as a natural part of the timber section's work, and to learn the reason for Mr. Alexander's office disregarding the recommendations of the timber section. The answer may be given as is expressed in one of these memorandums, which is: "Mr. Alexander stated that he was personally responsible for increasing the rate on machinery mentioned above, as one of the reasons therefor was that the property during the two years in question operated double shift," to which may be added another statement which is to the effect that it is Mr. Alexander's opinion that auditors, even though they are not sufficiently familiar with such operations as to name one of the machines used in paper making, are, nevertheless, competent to determine the question of depreciation in this class of property.

CONCLUSIONS

Your engineers, after a fair and impartial analysis of the case, have reached the following conclusions:

1. That the taxpayer's claim for increased allowances for depreciation of physical property, particularly the 10 per cent rate on machinery, is not justified by the reasons he has offered in the case.

2. That the engineer's recommendations, made after a thorough study, including a personal inspection of the property in question, appear to have been made upon a sound basis.

3. That the natural resources division were in thorough accord with the engineers' recommendations up to and including the taxpayer's conference January

3, 1924, with specific reasons given therefor, and that 20 days later reversed itself, granting the claims of the taxpayer without making known any reason for its sudden change of opinion other than that "in order to close the case it was decided to allow the taxpayer an additional depreciation of 3½ per cent on machinery over the 6½ per cent recommended by the department."

Further, that at this conference no member of the engineering division was present, nor does the report of the conference state by whom the taxpayer was represented. Therefore it is apparent that the regular procedure governing taxpayers' conferences was not followed in this instance, and the record of the conference is lacking in such essential data as to carry conviction that the decision reached therein was irregular.

4. That the objection raised by Robert P. Smith, chief of review section, to the adjustment made in the conference, in his letter to E. E. Hensinger, chief of Section F, had merit, and warranted a reply which the files in the case do not disclose having been made.

5. That the interdepartment conference held in Mr. Alexander's office April 3, 1924, between the engineer and himself, as reported by the chief of the timber section and W. Robertson, April 2 and 3, 1924, reveals a vast difference of opinion held by the two departments as to which is the better qualified and whose opinion should prevail in the case. Further, that Mr. Alexander's statement that he was personally responsible for making the change, and in view of the amount of tax lost to the Government according to the engineers' stand in the matter, the chief of the engineering division was negligent in not bringing the matter before the commissioner for a ruling.

Respectfully submitted.

C. D. VASSAR, *Investigating Engineer.*

Approved:

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

VALUATION REPORT BY TIMBER SECTION

DECEMBER 14, 1922.

Re: Dill & Collins Co., 140 North Sixth Street, Philadelphia, Pa.
Subject: Return for year 1917.

This company organized under the laws of the State of Pennsylvania on date of March 9, 1903, and entered into the manufacture and sale of pulp and paper.

No change is recommended in the amount of invested capital or depreciation set up in the 1917 return in so far as the value of the fixed assets is concerned.

One important feature, however, is the charge for ordinary and incidental repairs set up at $430,089.43 in 1917, as compared with $149,464.49 in 1916.

The sum claimed in 1917 of close to a half million dollars could not in the opinion of this office have been spent without it included a large amount of replacements and betterments that should not under the statutes and regulations properly be charged to expense.

Until such time as a careful field examination is made of the repair charges for 1917, the following tentative adjustment is recommended:

Repairs, ordinary and incidental (amount charged)	$430,089.43
Amount allowed (subject to field examination)	150,000.00
Amount disallowed and to be added to net income	280,089.43

As a new plant was acquired by the taxpayer on July 1, 1918, in exchange for $950,000, preferred capital stock, the case should be returned to this section for a valuation report for 1918 and subsequent years.

Recommended by—

_____,
Valuation Engineer.

Approved.

_____,
Chief, Timber Section.

EXHIBIT C

JANUARY 27, 1923.

DILL & COLLINS CO.,
140 North Sixth Street, Philadelphia, Pa.

SIRS: An examination of your income-tax return and of your books of account and records for the year 1917 discloses an additional tax liability for the year 1917 of $48,156.11, as shown in detail on the attached statement.

An examination of your income-tax returns and those of your affiliated company (or companies), together with the information heretofore submitted, has been made, and the results thereof are outlined in the attached schedules.

In accordance with the provisions of section 250 (d) of the revenue act of 1921, you are granted 30 days within which to file an appeal and show cause or reason why this tax or deficiency should not be paid. No particular form of appeal is required, but if filed it must set forth specifically the exceptions upon which it is taken, shall be under oath, contain a statement that it is not for the purpose of delay, and the facts and evidence upon which you rely must be fully stated. The appeal, if filed, must be addressed to the Commissioner of Internal Revenue, Washington, D. C., for the specific attention of IT:NR:G-4-EMB-1162, and will be referred to the Income Tax Unit before transmittal to the agency designated for the hearing of such appeals.

You may, if you desire, request a conference before the Income Tax Unit in connection with the appeal, to be held within the period prior to the expiration of five days after the time prescribed for the filing of the appeal. If the Income Tax Unit is unable to concede the points raised in your appeal, it will be transmitted, together with the recommendation of the Income Tax Unit, to such agency as the commissioner may designate for final consideration.

In view of the limitation of time for making additional assessments as provided in the revenue act of 1921, together with the desire of the Income Tax Unit to make additional assessments only after careful consideration of all the facts in the case, it will be necessary, if an appeal is filed as outlined above, to execute and return the inclosed form of waiver with such appeal.

Where a taxpayer has been given an opportunity to appeal and has not done so, as set forth above, and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement of the assessment will be entertained.

Payment should not be made until a bill is received from the collector of internal revenue for your district, and remittance should then be made to him.

Respectfully,

E. W. CHATTERTON,
Deputy Commissioner.

1917

Net income as reported on return		$393,879.11
Add capital items disallowed as expense		99,282.54
Total		493,161.65
Less:		
Depreciation allowed	$104,053.20	
Depreciation reported	100,236.44	
		3,816.76
Adjusted net income		489,344.89
Invested capital as adjusted		1,900,657.99
Excess profits tax		174,059.22
Excess profits tax		85,608.83
Net income	$489,344.89	
Less profits tax	85,608.83	
Balance	403,736.06	
Normal tax at 2 per cent and 4 per cent		24,224.16
Excess profits tax		85,608.83
Total tax		109,832.99
Tax previously assessed		61,676.68
Additional tax due		48,156.31

The additional tax due results from the adjustment of invested capital for excess profits tax purposes. Invested capital has been reduced by the disallowance of items of good will $400,000, appreciation of machinery $1,540, and the proration of Federal tax $11,454.88 for 1916, and dividends $60,000 in excess of earnings less accrued Federal tax.

EXHIBIT D

TAXPAYER'S CONFERENCE,
NATURAL RESOURCES DIVISION, TIMBER SECTION,
March 15, 1923.

Taxpayer: Dill & Collins Co.
Address: Philadelphia, Pa.
Represented by: Messrs. N. W. Taylor, vice president; D. W. Bond, treasurer; F. E. Hare; H. H. Steinmeyer; and C. G. McGuire.

MATTER PRESENTED AND ISSUES DISCUSSED

(*a*) Good will was acquired by the taxpayer from the predecessor in exchange for $400,000 par value capital stock.

The revenue agent's report indicates that a portion of the good will was written off and later restored to invested capital.

The restoration was allowed in the revenue agent's report but disallowed in letter of assessment of January 27, 1923.

Taxpayer submits evidence in support of restoration of good will to invested capital on basis of earnings before and after date of its original acquisition.

On account of the tax involved it is advisable to examine and, if necessary, to adjust such book earnings before permitting the inclusion of good will in the capital account.

A supplemental report by a revenue agent appears necessary to a final determination of this feature of the case.

(*b*) The revenue agent wrote down the assets by $100,000 accred depreciation in addition to amount on books as at December 31, 1918.

As a manufacturer's appraisal as at January 1, 1913, indicated value in excess of book value, the taxpayer claims its surplus can not be disturbed and cites A. R. M. 106 as authority in support of such claim.

As the taxpayer originally acquired the greater portion of its properties at what it states in its appeal as a bargain price, it follows that original cost less depreciation would be less than sound value as evidenced by appraisal in 1913.

The indications are that the revenue agent was justified in finding additional accrued depreciation on a cost basis.

But taxpayer presents counter evidence in addition to A. R. M. 106, based on practice of charging replacements to expense, and states that if anything too much depreciation was charged off under such policy in the early years.

An examination of the detailed appraisal as at 1913 as compared with cost values appears necessary and the appreciation over cost eliminated and disallowed as invested capital.

(*c*) The 1913 appraisal value and confirmation by G. F. Hardy will be examined; and if found acceptable, will be used as a basis for determining March 1, 1913, value and subsequent depreciation.

The rates of depreciation as claimed by the taxpayer in its appeal (3 per cent on buildings, 10 per cent on equipment) appear excessive if applied to gross reproductive costs as at 1913. Rates will have to be adjusted through field examination of the depreciable property.

This is an important feature of the case, as the taxpayer now claims $235,372.64 depreciation in year 1917, as compared with $104,053.20 recommended in revenue agent's report and with $100,236.44 set up in the original 1917 returns.

(*d*) The taxpayer submits evidence to show that the cost of improvements and replacements made in 1917 was excessive, due to the work being done under adverse conditions, chief of which was that the taxpayer continued to operate while new work was under construction.

The excess over normal cost is claimed as an operating expense in year 1917 and the normal cost a capital addition.

Affidavits as to the amount of excess cost will be submitted by taxpayer.

The propriety of allowing excess cost of improvements as expense will be made subject to further discussion within the unit.

W. ROBERTSON,
Timber Section, Conferee.

Noted:

E. B. TANNER,
Chief Timber Section.

EXHIBIT E

NOVEMBER 30, 1923.

VALUATION REPORT BY TIMBER SECTIONS

(Extension of report dated December 14, 1922.)
Re: Dill & Collins Co., Philadelphia, Pa.
Report on appeal and protest of additional assessments, year 1917 taxes.
Report on depreciation of physical properties, years 1917–18.
Returns attached: Years 1913 through 1919.
Data attached: R. A. R. for years 1917 through 1920, dated August 23, 1921. Appraisal January 1, 1913. Claim for abatement 1917, No. 509310. Waiver for year 1917. Appeal re additional assessment 1917. Protest re additional assessment 1917.
Attention of IT: NR: F–4: EMB in re action on 1918 returns.
Attention of Committee on Appeals and Review in re 1917 appeal.

GOOD WILL (EXCEPTION NO. 5, APPEAL FEBRUARY 27, 1923)

Prior to January 1, 1917, good will acquired from the predecessor in exchange for $400,000 par value capital stock of the taxpayer was reduced by a $200,000 write-off in year 1908, but restored by the taxpayer in computing its 1917 invested capital.

The restoration of the above $200,000 is made in the R. A. R., dated August 23, 1921, but the limitation of 20 per cent of the outstanding capital stock was applied in setting up the value of good will in making invested capital adjustment.

In office letter of January 27, 1923, good will was disallowed in its entire amount.

It is suggested that the merits of the taxpayer's claim to "good will" as part of the invested capital should be examined in the light of the provisions contained in article 843, regulations 45, with respect to the treatment of other intangible assets and also rulings A. R. M. 34; 68; 145 and A. R. R. 252.

Depreciation—Delaware Mills general property exclusive of bleach plant

(Exceptions No. 1–A and No. 1–B—Appeal February 27, 1923)

The taxpayer computed its depreciation prior to January 1, 1917, and also in its 1917 original return on a reducing balance basis of 2 per cent on buildings subsequent to year 1909, with nothing taken prior to that time; also 10 per cent on machinery from 1901 to 1910 and 6 per cent on machinery starting in 1910 and subsequently, both rates on machinery being applied on a reducing balance basis.

In pages 13 and 15 of the R. A. R. the examining officer computed depreciation on the straight-line method, using 2 per cent on buildings and 5 per cent on machinery, applying on all years from the start of the taxpayer's operations.

It is the opinion of this office that this adjustment, while protested by the taxpayer on the basis of A. R. R. 106, is property in so far as the depreciation reserve as at January 1, 1917, is concerned as the taxpayer's method of constructing such reserve is generally reputed to be unsound.

In the taxable period starting January 1, 1917, it is held by this office that the taxpayer may be given the benefit of higher rates than those recommended in the revenue agent's report.

During the high-tax years repair labor was less efficient than in former years, repair materials were not of as good quality, the mills were forced to higher productive capacity and the general maintenance in consequence being less effective, the depreciation became higher.

It is furthermore the opinion of this office that the taxpayer should be allowed depreciation on the basis of properly adjusted rates applied to reproductive values as of March 1, 1913, as indicated in the taxpayer's insurance appraisal as of January 1, 1913.

This opinion is based on the fact that part of the property may have been originally acquired at a bargain price, as claimed in the taxpayer's appeal of February 27, 1923, and further that in the taxpayer's accounting policy in the earlier years neglect may have been made in charging all of the capital items into their proper account.

It is fully recognized that with respect to the appraisal used by the taxpayer as evidence of March 1, 1913, value that the net or depreciated values therein set up are not dependable and can not be considered as competent evidence in support of book value or invested capital determination.

It is held by this office that whereas the reproduction values, or value as of new property, shown in the appraisal may be considered as proper and allowable as a basis for computing depreciation subsequent to March 1, 1913, the sound or depreciated values are in all cases too high, the reason therefor being that an insufficient amount of depreciation is set up against all items whereof the ages are shown at date of the appraisal.

On the second page of the photostat report of the appraisal buildings known to have been acquired 10 years prior to the appraisal are depreciated a total of 5 per cent, or one-half of 1 per cent each year.

The average total for machinery is set up at 7⅛ per cent, which is not a yearly rate, but the total rate for all years on the machinery on hand at the time of the appraisal.

The ages as at date of the appraisal are given for a large number of the machinery items, and by dividing the total percentage of depreciation by the number of years the machine was in use the annual rate may be found.

This annual rate is in many cases lower than 2 per cent a year, and in the case of very few machinery items is an annual rate as high as 4 per cent used by the appraiser.

The taxpayer has attempted to establish annual rates of 3 per cent on buildings and 10 per cent on machinery of all classes, both in its appeal and protest, in determining current-year depreciation allowances after December 31, 1916.

It is held by this office that these rates are unwarranted and could not have been applied in the years prior to that date without wiping out all but a very small part of the depreciable assets.

One of the chief arguments used by the taxpayer is that whereas all replacements as well as repairs made prior to 1917 had been charged to operating expense, the accounting policy was changed in 1917; when it was compelled to capitalize replacements so that depreciation charges should be increased to provide for the cost of making replacements.

It is held by this office that if replacements of depreciable property as well as repairs were charged in all years to expense of operations and that the plant was thus renewed out of profits over an indefinite period of time, then the entire amount of depreciation would be covered by charges to operations and no additional depreciation could be claimed.

On the other hand, when replacements are capitalized the annual depreciation should be cost divided by number of years of the normal life of the machine, whether it be a replacement or an original installment.

A physical examination of this property made in April, 1923, indicated that there was no basis for the claim of a 10 per cent depreciation rate on machinery irrespective of the fact that replacements are disallowed as expense for the reason that in no department of the mill except the bleach plant is there a 100 per cent replacement of the entire machinery in every 10-year period, nor is there a 100 per cent replacement of the buildings in every 33⅓-year period.

The examination of this and many similar properties indicates that the average life of the buildings is not less than 40 years and the average life of the machinery is from 10 to 15 years for the light-weight machines, wood-stock chests, and equipment subject to chemical action, and from 20 to 30 years for the heavy-weight paper-making machinery; the heavy machinery having the longest life constitutes at least 60 per cent of the total cost of all machinery.

It is recommended that rates of 2½ per cent on buildings and 6¼ per cent on machinery be allowed in the instant case for years 1917 through 1920, which are sufficiently above normal rates, for those years to allow for the extraordinary conditions that then existed.

These rates, however, should be applied to the reproductive or gross cost value as indicated by the taxpayer's appraisal as of January, 1913, and to the cash costs of subsequent additions as shown in the revenue agent's report, pages 13 and 15.

Articles 161 and 166, regulations 45, provide for the applications of rates based on length of life remaining after March 1, 1913, to the sound or depreciated value as of that date.

But a strict adherence to these provisions in the case of a property, the life of which is to be maintained over an indefinite future period through additions made from time to time, and on which replacements of machines had been made at various times prior to March 1, 1913, is found to be impractical of application.

Rates ordinarily the same on similar machines would become variable when based on remaining life and applied to remaining value as at March 1, 1913.

Three like machines, for example, having a normal useful life of 20 years, but two being 5 and 10 years old, respectively, and one installed in 1913, would have remaining lives as of March 1, 1913, of 15, 10, and 20 years, requiring the application to March 1, 1913, fair market value of three different rates, namely, 6⅔ per cent, 10 per cent, and 5 per cent.

The results, however, would be just the same as if the 5 per cent rate indicated by the full term of life were applied to the undepreciated gross value as March 1, 1913, and the calculations are thus simplified in the case of a property containing many items of the same class but installed at various times prior to the basic date of March 1, 1913.

DEPRECIATION—DELAWARE MILLS BLEACH PLANT

Reference is made to R. A. R., page 19, wherein depreciation rates on this property are set up at 2 per cent on buildings and 7 per cent on machinery.

It is recommended that in the case of this portion of the property that 3 per cent on buildings and 12 per cent on machinery subsequent to December 31, 1916, be allowed.

The physical examination of the property indicated that the bleach plant was the only portion of the Delaware mill property wherein rates as high as are claimed by the taxpayer on all of its property, might be justified.

DEPRECIATION—FLAT ROCK MILLS PROPERTY

This property was acquired from the Martin and William H. Nixon Paper Co. on date of July 1, 1918, at a cost of $950,000 par value of the taxpayer's preferred capital stock.

This purchase price included current assets as well as physical property, and an allocation of cost to the various classes of assets that comprise the total property is set up in the taxpayer's questionnaire Form T–P as follows:

(*a*) Real estate (land)	$50,000.00
(*b*) Buildings	263,507.09
(*c*) Machinery	365,879.27
(*d*) Current assets less liabilities	270,613.64
Total	950,000.00

This was a second hand property, when acquired by the taxpayer, that had been in existence many years prior to 1918 but had undergone extensive remodeling and additions in year 1914.

The proper method of depreciating this property is held to be the cost of the depreciable assets as originally set up by the taxpayer as in above items (*b*) and (*c*) spread over their remaining years of useful life.

The average remaining life of the buildings as at July 1, 1918, was indicated by the examination to have been approximately 33 years.

The average remaining life of the machinery, a large portion of which had been installed new by the predecessor in year 1914, is held to have been 12½ years after date of acquisition.

The depreciation on this property for the six months' period from July 1, 1918, to December 31, 1918, would therefore be one-half of 3 per cent by $263,507.09, plus one-half of 8 per cent by $365,789.27.

The rates applicable to additions to this property subsequent to the original purchase are recommended to be 2½ per cent on buildings and 6½ per cent on machinery.

These rates are in excess of those used in the taxpayer's questionnaire from T–P both for the old property and the additions subsequent to its purchase.

The questionnaire rates are 2 per cent on buildings and 6 per cent on machinery applied to the same capital sums as above, but in the taxpayer's appeal and protest its rates have been increased on all properties.

The depreciable capital sums set up on page 20 of the R. A. R. for the Flat Rock hills property indicate both book value as at July 1, 1918, under the prior ownership and cost to the taxpayer as at date of purchase.

Since the cost as at date of purchase represents property that had already undergone depreciation, the rates set up by the examining officer, of 2 per cent on buildings and 5 per cent on machinery, are held to be inadequate.

EXCEPTION NO. 2, APPEAL FEBRUARY 27, 1923

The inadequacy of the accrued depreciation set up in the January 1, 1913, appraisal indicates the incompetency of such evidence submitted in support of the taxpayer's claim under A. R. M. 106, that the revenue agent was unwarranted in adjusting the depreciation reserve as at December 31, 1916.

In the revenue agent's report this reserve is shown to have been computed in the taxpayer's records on an erroneous basis, as heretofore mentioned under the subject of depreciation.

The evidence cited on page 3, viz, report by G. F. Hardy, in the taxpayer's appeal (exception No. 1–B) in support of its right to use of the appraisal for depreciation subsequent to March 1, 1913, is held to be in some degree competent but inadmissible with respect to sound value for invested capital purposes as based on cost less depreciation.

Property originally acquired at a bargain price in year 1903 and properly depreciated to date of January 1, 1913, would undoubtedly show less book value than sound appraised value as at the latter date.

It is held that the above fact does not constitute admissible evidence under A. R. M. 106, that cost value as at date of acquisition should not be made subject to properly computed depreciation as based on normal life of the assets.

Otherwise appreciation becomes an element in determining January 1, 1917, sound value as based on original cost less depreciation in invested capital calculations.

For the reasons above cited this office is out of agreement with the taxpayer's exception No. 2 in appeal February 27, 1923.

Reference is made to T. D. 3367 and confidential mimeograph recommendation No. 2810, which are thought to have a corroborative bearing on this finding.

While all of the provisions contained in T. D. 3367 may not be considered as pertinent with respect to an appraisal submitted to confirm a book value, it is nevertheless held that where an appraisal is shown to be a mere estimate of property value as at a date considerably later than the dates at which the properties were acquired, and that it also contains a statement to the effect it is only approximate and intended for insurance purposes, its value becomes doubtful as evidence with reference to statutory invested capital determination.

Confidential mimeograph recommendation No. 2810 describes a case wherein it was manifest that depreciation set up during the earlier life of the property was inadequate and inconsistent with the large amounts claimed as allowances in the high tax years. Therefore the taxpayer was denied the application of A. R. M. 106 and the depreciation reserve was made subject to adjustment by the Income Tax Unit.

The necessity for a similar adjustment, substantially as made in the R. A. R., is held to be evident in the instant case.

EXCEPTION NO. 4, APPEAL FEBRUARY 27, 1923

The evidence cited by the taxpayer that the costs of replacements of floors and roofs were excessive on account of the work being done under handicap and in the manner set forth in the appeal, and that 50 per cent of such cost should be allowed as operating expense in the year 1917, the balance being treated as a capital expenditure recoverable through future depreciation allowances, is considered by this office to be sound from a property-accounting standpoint in this kind of business.

A depreciation reserve built up in the ordinary method would not properly cover costs of replacements when such costs were shown to be excessive.

But the statutory provisions with respect to a charge of this kind should no doubt govern in the instant case irrespective of the soundness of the business policy.

GENERAL

It is held by this office that the matter contained in the taxpayer's protest of November 13, 1923, with respect to the subjects contained in this report presents nothing of importance over what is contained in the appeal of February 27, 1923.

The theoretical matter on depreciation is not considered applicable in the instant case wherein the facts with regard to the operations are familiar to the valuation engineers.

Twenty-four-hour operation during six days a week is universal in the taxpayer's business, and the buildings, machinery, and materials used in the business are designed to meet such operating conditions.

The conditions in the industry are such that when parts of the plants are shut down the depreciation is higher than when operating normally at 24 hours a day.

Seventy-five per cent of the increased wear and tear that occurs when the production of the mill is accelerated above its normal capacity of output is sustained on replaceable parts of the machines that are chargeable to repair expense whenever such parts are replaced.

Recommended by:

W. ROBERTSON,
Valuation Engineer.

Approved:
E. B. TANNER,
Chief, Timber Section.

EXHIBIT F

TAXPAYER'S CONFERENCE,
NATURAL RESOURCES DIVISION, SECTION F,
January 3, 1924.

Taxpayer: Dill & Collins Co.
Address: Philadelphia, Pa.
Represented by C. T. Haynes.
Credentials: Power of attorney and enrollment verified.
Previous conferences: One.
Basis of protest: Assessment letter dated January 27, 1923.
Years and amount involved: 1917 ($48,156.11).
Brief filed: November 15, 1923.
Issues: (1) Depreciation, (2) commissions, (3) repairs and renewals, (4) invested capital, (5) good will.

FACTS

1. Taxpayer engaged in the manufacture and sale of paper and pulp, and due to the nature of their industry, which resulted in operating time being above normal, lack of maintenance, and obsolescence, contend that they should be allowed a depreciation of 10 per cent on machinery and 3 per cent on buildings.

2. The taxpayer had certain machinery installed by William Steele & Sons Co. on a cost-plus basis, which they had charged off to expense. Revenue agent's report, dated August 23, 1921, disallowed charges as expenses, as same were considered capital expenditures. The contention of the taxpayer is that the commission of 10 per cent, amounting to $5,101.39, had been included in the cost of material, and that when the revenue agent added the 10 per cent over the cost he had virtually disallowed this item twice.

3. Taxpayer contends that in the alterations and repairs made by William Steele & Sons Co. it was necessary to do same while the mill was in full operation. This arrangement resulted in an additional cost that the company would not have incurred if said alterations and repairs could have been made when the plant was shut down. They contend that 50 per cent of such cost should be charged off as expense due to operation.

4. Taxpayer contends that the depreciation, amounting to $86,835.79, which was written off its books from January 1, 1913, to December 31, 1916, was based on increase in value of machinery, viz, $401,540.49, which was an appreciated value of the property as of March 1, 1913, over cost, and that this realized appreciation should be added to surplus, claiming that the amount of $23,106.33 as representing the difference between cumulative depreciation of $752,056.44 and depreciation reserve of $775,162.77 which was restored by the revenue agent, is incorrect.

5. Taxpayer claims good will to the amount of $400,000, and supports their contention on the basis of net tangibles and earnings in accordance with method laid down by A. R. M. 34, C. B. 2, page 31.

Mr. W. Robertson, valuation engineer sitting in conference, will render separate report for the engineering division.

CONCLUSIONS

1. That the taxpayer's claim for depreciation is not consistent with the recognized mortality of this class of industry.

That the taxpayer's method of taking the appraisal made as of January 30, 1913, and depreciating same only 2 per cent and 4 per cent to obtain sound values as of the taxable year and then to claim depreciation of 10 per cent from then on is not a true reflection of the actual economic waste. The department has gone into the matter rather exhaustively, as shown by valuation report, and has accepted the appraisal as of January 30, 1913, as being representative of the reproductive value, and has depreciated same over the recognized physical life of the items involved, due consideration being given for all questions of obsolescence, abnormal depreciation, and extensive repairs made during the taxable year. The taxpayer's representative was not in position to say whether the conclusions of the department would be acceptable to his client, as they had never been advised as to the department's position as contained in the aforementioned report before filing their brief. Taxpayer's representative was given a copy of this report and requested that he submit same to the company for their examination. The department was of the opinion that, as this was a fair and liberal adjustment of the entire question based upon their own appraisal value, the taxpayer would recognize the justice of the department's conclusion.

Taxpayers given 10 days to advise their acceptance of the above conclusion.

2. That as the revenue agent's report did not disclose that commissions had been deducted twice taxpayer has been requested to submit the record of the actual total payment made to William Steele & Sons Co., which would definitely establish the facts in the case; and if it was found that payment had been made twice, the commissions of $5,101.39 would be allowed as a deduction from income.

3. That as the repairs and replacements were made under adverse circumstances, due to the mill being required to operate while same were going on, the additional expense could be considered as an expense item chargeable to operations. This proportion of the amount chargeable to operation was estimated at 50 per cent. The taxpayer was allowed a deduction of $25,506.97 from gross income.

4. Invested capital. That the claim of realized appreciation amounting to $86,835.79 being restored to surplus as compared to $23,106.33 allowed by the revenue agent would be simply a question of accounting, and whatever this would be when the case had been audited would be allowed to the taxpayer.

5. That the taxpayer's claim for good will would be allowed in accordance with A. R. M. 34, C. B. 2, page 31, subject to 20 per cent limitation provided by the statute.

The above findings of the department are acceptable to the taxpayer with the exception of the question of depreciation, which the taxpayer's representative will present to the company for approval.

Interviewed by:

E. R. McCarthy, *Conferee.*
E. N. Brewster, *Auditor.*

Noted:

E. E. H., *Chief of Section.*

EXHIBIT G

TAXPAYER'S CONFERENCE,
NATURAL RESOURCES DIVISION, SECTION F,
January 23, 1924.

Taxpayer: Dill & Collins.
Address: Philadelphia, Pa.

SUPPLEMENT TO REPORT DATED JANUARY 3, 1924

Issues: (1) Commissions, (2) depreciation.

CONCLUSIONS

1. On presentation by the taxpayer of information requested in conference of January 3, 1924, showing that the item of $5,101.39 represented a duplicate charge on account of commissions, same was allowed the taxpayer.
2. That, due to the claim of the taxpayer of extraordinary depreciation incurred in the years 1917, 1918, and 1919, and in order to close the case, it was decided to allow the taxpayer an additional depreciation of 3½ per cent on machinery over the 6½ per cent recommended by the department.

The rate of 3 per cent on buildings is waived by the taxpayer, and the rate of 2½ per cent as determined by the department, is acceptable.

The above findings of the department are satisfactory to taxpayer and case is closed.

Interviewed by:

E. R. MCCARTHY, *Conferee,*
E. N. BREWSTER, *Auditor.*

Noted:

E. E. H., *Chief of Section.*

EXHIBIT H

MARCH 8, 1924.

DILL & COLLINS CO.,
140 North Sixth Street,
Philadelphia, Pa.

SIRS: Reference is made to your appeal dated February 26, 1923, from the action taken by this office as shown in its letter dated January 27, 1923, disclosing an additional tax liability against you of $48,156.11 for the year 1917.

In accordance with agreement made at conference January 3, 1924, between your representatives and this office, an adjustment of tax liability has been made, which is shown in detail in the attached statement. As this agreement embraces the year 1918, an adjustment of tax liability for that year is also included.

Adjustment of tax indicated will be made directly and certificates of overassessment will be issued in due course, which will reach you through the collector of internal revenue for your district and will be applied by that office in accordance with the provisions of section 252 of the revenue act of 1921.

Respectfully,

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

92919—25—PT 16——16

Statement

In re: Dill & Collins Co., 140 North Sixth Street, Philadelphia, Pa.

SCHEDULE 1

[Year ended December 31, 1917]

(Waiver on file)

Net income:		
Net income as shown by the return		$393,879.11
As corrected		375,456.22
Net deductions		18,422.89
Additions—		
Repairs capitalized, buildings	$2,633.27	
Repairs capitalized, machinery	39,049.56	
Expenses capitalized	1,484.39	
Repairs charged to depreciation—		
Reserve $51,013.94		
Repairs allowed as expense 25,506.97		
	25,506.97	
Depreciation reported	100,236.44	
Total additions		168,910.63
Deductions—		
Depreciation allowed (Exhibit 1)	187,333.52	
Total deductions		187,333.52
Net deduction as above		18,422.89

SCHEDULE 2

Invested capital:		
Invested capital disclosed by books (Exhibit 1)		$2,309,109.33
As corrected		2,189,276.91
Net reductions as explained below		119,832.42
Additions—		
Good will restored	$400,000.00	
Excessive depreciation charged off prior years, restored	23,106.33	
Total additions		423,106.33
Reductions—		
Good will excessive	100,000.00	
Appraisal increase	401,540.49	
Prior years income tax paid 1917	12,675.88	
Dividend adjustment	28,722.38	
Total reductions		542,938.75
Net reductions as above		119,832.42

SCHEDULE 3

Total credit at 9 per cent $200,034.92

Commutation of tax

	Income	Deduction	Balance	Rate	Tax
				Per cent	
15 per cent	$328,391.53	$200,034.92	$128,356.61	20	$25,671.32
Balance	47,064.69		47,064.69	25	11,766.17
Total	375,456.22	200,034.92	175,421.30		37,437.49

Income tax

Taxable net income, Schedule 1		$375,456.22	
Deduct:			
Excess-profits tax, Schedule 3	$37,437.49		
Taxable at 1 per cent (dividends 1913, 1914, 1915)	None.		
		37,437.49	
Taxable at 2 per cent		338,018.73	$6,760.37
Taxable at 4 per cent		338,018.73	13,520.75
Total tax liability			57,718.61
Previously assessed			61,676.88
Overassessment			3,958.27

EXHIBIT 1.—*Analysis of depreciable assets, machinery account*

Cost plus additions to May 1, 1913		$1,118,155.66
Depreciation taken as shown by books to May 1, 1913		446,222.88
Net cost May 1, 1913		671,932.78
Actual additions from May 1, 1913, to Dec. 31, 1916		323,940.26
Excess value shown by appraisal		401,540.49
Value as at Dec. 31, 1916		1,397,413.53

Items December 31, 1916

	Credit	Depreciation
Machinery (cost) per books (Exhibit A) (R. A. R. p. 36)	$1,397,413.53	
Pump station (Exhibit D)	25,961.74	
Bleach plant (Exhibit E)	70,000.00	
Total	1,493,375.27	
Depreciation at 10 per cent		$149,337.53
Additional depletion, bleach plant, 2 per cent		1,400.00
Machinery disallowed as expense during year (R. A. R. p. 1)	39,049.56	
Additions per examination of books (Exhibit A)	125,690.86	
Total	164,740.42	
Bleach plant (Exhibit E) at 12 per cent	2,647.86	
Total	167,388.28	
Depreciation 10 per cent, prorated one-half year		8,369.41
Additional depletion, bleach plant, 2 per cent		26.48
Total depreciation, machinery account		159,133.42

BUILDINGS

Buildings; cost, books, balance sheet December 31, 1916 (R. A. R. p. 36, Exhibit B)		725,819.88	
Pumping station (Exhibit D)		87,499.05	
Bleach plant (Exhibit E)		114,647.03	
Total		927,965.96	
Depreciation at 2½ per cent			23,199.15
Additions (Exhibit B)	$42,506.96		
Repairs capitalized	2,633.27		
		45,140.23	
Bleach plant (Exhibit E)		6,559.44	
Total		51,699.67	
Depreciation at 2½ per cent, one-half year			646.25
Total depreciation, buildings			23,845.40

TRUCKS

	Credit	Depreciation
Trucks, electrical (Exhibit E)	$16,633.06	
Depreciation at 10 per cent		$1,663.31
Addition 1916 gasoline	1,200.00	
Depreciation at 20 per cent (Exhibit C)		240.00
Additions 1917, gasoline	24,513.97	
Depreciation at 20 per cent (one-half year effective)		2,451.39
Total depreciation, trucks		4,354.70

Summary

Machinery (exhibit)	$159,133.42
Buildings (exhibit)	23,845.40
Trucks (exhibit)	4,354.70
Total depreciation	187,333.52

Year ended December 31, 1918—Schedule 1, net income

Net income as shown by the return		$154,213.70
As corrected		81,398.23
Net deductions		72,815.47
Additions:		
Repair items, capitalized, buildings	$8,605.43	
Repair items, capitalized, machinery	12,418.20	
Expense items	3,000.00	
Depreciation shown by books	119,291.29	
Total additions		143,314.92
Deductions: Depreciation allowed (Exhibit 1)	216,130.39	
Total deductions		216,130.39
Net deductions as above		72,815.47

Schedule 2—Invested capital

Invested capital disclosed by books unadjusted	$2,564,062.56
Excess profits credit	208,125.00

Computation of total tax

	Income	Tax
Excess-profits tax:		
Net income for taxable year (Schedule 1)	$81,398.23	
Less excess-profits credit (Schedule 2)	208,125.00	
Balance	None.	
War-profits tax:		
Net income for taxable year (Schedule 1)	81,398.23	
Less war-profits credit (Schedule 2)	259,406.26	
Taxable at 80 per cent	None.	
Income tax:		
Net income for taxable year (Schedule 1)	81,398.23	
Less:		
War profits and excess profits tax	None.	
Interest United States obligations	$798.30	
Exemption	2,000.00	
	2,798.30	
Taxable at 12 per cent		$9,431.99
Total tax		9,431.99
Previously assessed		18,169.85
Overassessed		8,737.86

Analysis of depreciation

MACHINERY

	Credit	Depreciation
Machinery—cost-plus additions as at Mar. 1, 1913 (books, Exhibit A)	$1,121,563.90	
March 1, 1913, additions	401,540.49	
Disallowance 1917 expense	39,049.56	
Total	1,562,153.95	
Depreciation at 10 per cent		$156,215.40
Machinery disallowed, 1918	12,418.20	
Additions 1918 (Exhibit A)	64,246.72	
Total	76,664.92	
Depreciation at 10 per cent (one-half effective)		3,833.25
Bleach plant (Exhibit E)	72,647.86	
Depreciation at 12 per cent		8,717.74
Additions to bleach plant 1918 (12 per cent, one-half effective)	1,094.23	65.65
Pump plant (Exhibit D, 10 per cent)	25,961.74	2,596.17
Flat Rock property		9,146.98
Total		180,575.19

BUILDINGS

Buildings—cost—books (Exhibit B)	768,326.84	
Pumping station (Exhibit D)	87,499.05	
Bleach plant (Exhibit E)	121,206.47	
Repairs capitalized, 1917	2,633.27	
Roof disallowed as expense, 1917 ($51,013.94 one-half applicable)	25,506.97	
Total	1,005,172.60	
Depreciation at 2½ per cent		25,129.32
Flat Rock property		2,635.07
Total		27,764.39
Additions (Exhibit B)	$18,423.30	
Repairs capitalized, 1918	8,605.43	
Additions (Exhibit E)	1,544.00	
	28,572.73	
Depreciation at 2½ per cent (one-half applicable)		357.16
Total		28,121.55

TRUCKS

Balance	$16,633.06, at 10 per cent	$1,663.31
Additions 1917	15,766.10, at 20 per cent	3,153.22
Total	32,399.16	
New York office	9,947.87, at 20 per cent	1,989.57
Total	42,347.03	
Additions, 1918	$6,275.50	
Depreciation at 20 per cent (one-half applicable)		27.55
		7,433.65

Summary

Machinery	$180,575.19
Buildings	28,121.55
Trucks	7,433.65
Total depreciation	216,130.39

EXHIBIT I

BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT, NATURAL RESOURCES AUDIT DIVISION,
March 1, 1924.

Mr. E. E. Hensinger, Chief, Section F.
In re: Dill & Collins, Philadelphia, Pa.

Attention is called to the adjustment made in conference with respect to depreciation on machinery and equipment.

It appears that the taxpayer, agent, and department are in agreement as to the apparent values to be used. It is noted, however, that the taxpayer's attorney has skillfully set up the value in a way that he gets approximately $700,000 in values more than are actually disclosed by the facts.

The taxpayer has asked the department to accept an appraisal as of 1910 and 1913, which appraisal disclosed appreciated values on machinery to the extent of approximately $400,000 in excess of book values. This we are willing to accept, but he does not use the book value as of March 1, 1913; he adds the appreciation on to the accumulated cost value. Depreciation under the law must be computed under the March 1, 1913, value, the taxpayer's value as of March 1, 1913, admitting the appreciation of $400,000 will be the cost of all assets and additions, less depreciation which he has charged off his books, and to this should be added the increased value by appraisal and the cost of additions subsequent to 1913. This, as shown in Exhibit A attached, amounts to $1,397,413.53.

Thus admitting that the taxpayer is entitled to the accelerated rate of depreciation claimed, the maximum amount that he could get on this value would be approximately $60,000 less than that shown in the proposed A–2 letter.

It seems to me that the rate in this case is a little excessive and that the case probably falls under the committee's A. R. R. 6099. This recommendation contains very valuable observations on the point involved in this case, and should be given consideration. I do not claim that the taxpayer is not entitled to an accelerated rate of depreciation for the years in question if he has been working his plant overtime, but such claim should be clearly substantiated.

It will be noted that a large amount of repairs, $300,000 or $400,000 has been deducted in each of the years in question. All these points should be taken into consideration in arriving at the result in this case.

But even by allowing him the increased rate proposed if figured on the correct basis as indicated in the aforementioned schedule, the result will not be greatly different from that arrived at in the prior conference.

It is, therefore, recommended that with suitable explanation, that adjustment be made as indicated above.

ROBT. C. SMITH,
Chief, Review Section.

EXHIBIT J

APRIL 3, 1924.

Conference memorandum:
In re: Dill & Collins Paper Co., Manayunk, Philadelphia, Pa.

We were unable to agree with the taxpayer as to the value of physical property as of March 1, 1913, and the rate at which depreciation should be written off. It was, therefore, deemed expedient to send Mr. Robertson, pulp and paper engineer (who incidentally had built at least a portion of the plant and was superintendent for operation of the same plant) to inspect the property on the ground, which examination was made during the early part of last year. After this thorough and detailed examination a depreciation rate of 6½ per cent on machinery was decided upon, but not until after a conference with the taxpayer, which conference was held subsequent to the examination and the analyses of the accounts. A valuation report was accordingly made recommending a rate of 6½ per cent for the machinery. Subsequent to the date of the valuation report, the audit section held a conference with representatives of the taxpayer and the rate on machinery was increased to 10 per cent, an increase of approximately 54 per cent over that allowed by the timber section, such increase being allowed without consulting the timber section.

In view of the fact that a conference was to be held in the afternoon of April 1, with a neighboring paper company, it was deemed advisable to ascertain

from the audit section the basis for the increase in order that we would be in possession of the facts when discussing the same subject with the neighboring corporation. At the suggestion of Mr. Greenidge, who had an appointment and could not attend the conference, the writer and Mr. Robertson accompanied Mr. Griggs and discussed the case with Mr. Alexander.

The writer was unavoidably delayed and was not present at the full conference with Mr. Alexander. The following, therefore, only covers that portion of the conference after my participation therein.

Mr. Alexander stated that he was personally responsible for increasing the rate on machinery mentioned above and one of the reasons therefor was that the property during the two years in question operated double shift.

Mr. Robertson stated that it was a universal custom of the pulp and paper industry to work 24 hours a day and that the machinery was designed for that purpose.

Mr. Alexander stated that he considered the question of depreciation one of judgment and that in order to handle it intelligently one had to analyze conditions and he felt that it was purely an audit matter.

I pointed out to him that I agreed with him to the extent that it was necessary to be familiar with all of the facts and conditions in order to equitably adjust depreciation, but, however, it occurred to me that an engineer trained and experienced in that business was best qualified to analyze the situation.

Mr. Alexander stated that the question seemed to be one of administration, which should be taken up with him by the head of the division and the deputy commissioner. I informed him that it was not my purpose to discuss questions of administrative policy but rather the reason leading up to the conference was to ascertain specific advice with respect to the depreciation allowed by the audit section in the case of the Dill & Collins Lumber Co. I further informed Mr. Alexander that we had no desire to take on additional work nor usurp any authority in the matter, but that we were working under specific instructions from the commissioner with respect to the pulp and paper valuation.

A copy of this correspondence is attached to one of the memoranda submitted herewith.

_____ _____,
Chief of Section.

The above is in substance the same as a memorandum prepared by me but considered unnecessary to have typed and to submit.

W. ROBERTSON.

EXHIBIT K

APRIL 2, 1924.

Memorandum on conference held in Mr. Alexander's office Tuesday, April 1, 1924.

Re: Audit section adjustments of depreciation on cases valued in timber section.

In conference on case of Dill & Collins Co., Manayunk, Pa., between Mr. S. Alexander, head natural resources division; Mr. C. C. Griggs, assistant head of engineering division; Mr. E. B. Tanner, chief, timber section; and W. Robertson, valuation engineer, it was represented to Mr. Alexander that the timber section arranged in year 1920 under advices of the deputy commissioner to have its work include the determination of all questions of valuation of pulp and paper plants whose operations were dependent upon the utilization of timber as the chief raw product.

The necessity for valuation of pulp and paper properties grew out of the fact that many of the present owners of pulp and paper plants originally acquired properties that embraced timberlands, riparian land, and water rights and mill-site land that made an allocation necessary in order to determine the relative values of such properties for purposes of determining invested capital in the excess-profits tax years, and further to properly assign values as of a pertinent basic date to the depreciable plant facilities for purposes of computing depreciation allowances.

Frequently the original properties embracing a large amount of real estate of the kind above named were acquired for considerations that included stocks and bonds.

Fifty million dollars worth of timberlands, depreciable plant properties, and nondepreciable waterpower and real estate were acquired in this manner by

one of the larger consolidated companies for a small amount of cash and bonds and the balance in common and preferred stock, with no segregation made as between the various classes of property thus acquired.

Frequently the life of the pulp and paper plant properties are limited by the supply of available timber so that the factor of obsolescence in addition to depreciation entered into the determination of taxable income in the years subsequent to 1917.

In order to bring the entire pulp and paper industry under the administration of one section of the unit and thereby to arrive at uniformity of treatment of questions affecting tax liability the pulp and paper industry appointed a committee of arrangements for the purpose of constructing a questionnaire in collaboration with the timber section.

The questionnaire in its final form and the history of the proceedings that led up to its issue by the Bureau of Internal Revenue to all taxpayers in the pulp and paper industry are attached.

This information was available for Mr. Alexander's inspection in conference, but his position in the matter of depreciation and obsolescence is that such questions are functions of the natural resources audit sections.

* * * * * * *

(Pages 5 and 6 missing.)

* * * The machinery employed in paper making is especially constructed to meet the demands imposed by such operations.

The questionnaire data clearly shows that many of the machines of this kind have been in actual operation from 25 to 35 years, so that a 4 per cent rate on all of the large paper-making units would be a sufficient allowance except under the stress of abnormal conditions for which the timber section always made liberal allowance in increased rates.

Granting that the less expensive auxiliary units would have a shorter life of from 10 to 15 years, it has been carefully ascertained that the weighted average rate (except under special circumstances that might tend toward a high rate of obsolescence) should not be over 6½ per cent on general equipment. While this question is only one of several embraced in the questionnaire, it is nevertheless a very important one, since one paper machine alone in a modern plant of high capacity, such as shown in the attached illustration, may have a cost of $1,000,000, and the machinery in one plant frequently runs to several million dollars.

On account of the expensive and intricate features in connection with pulp and paper properties the compilation of questionnaire data was undertaken at considerable cost to the taxpayers.

It was held in conference by the valuation engineers that adjustment or approval of depreciation and obsolescence allowance are bound up by economic factors in the operation of such properties that can best be determined by means of the questionnaire data filed by the taxpayers for such purposes, when analyzed by a competent engineer, and that the valuation section in which the questionnaire was constructed is the one designated to pass upon the merits of such claims since its personnel includes engineers that were engaged on account of their previous training in the pulp and paper industry.

This is the opposite view to the one held by Mr. Alexander which is that auditors (that are not sufficiently familiar with such operations as to be able to name one of the machines used in paper-making) are nevertheless competent to determine the question of the depreciation in this class of property.

The timber section has always contended that no change should be made by the audit section in findings recommended in any valuation report without calling some representative of the valuation section making such report into conference.

Otherwise it may be impossible to arrive at an equitable basis of adjustment with respect to the valuation in similar cases.

_____,
Assistant Head Engineering Division.

_____,
Chief, Timber Section.

_____,
Valuation Engineer.

(Copy of pencil memorandum by Mr. W. Robertson, valuation Engineer, pulp and paper region, timber section.)

EXHIBIT L

DECEMBER 6, 1924.

DILL & COLLINS CO.,
Philadelphia, Pa.

SIRS: An audit of your income and profits tax return for the year 1919 in connection with an examination of your books of account and records disclosed an overassessment of $40.27 as shown in detail in the attached statement

Should further correspondence be necessary reference should be made to IT: CA: 2224–14

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.

EXHIBIT M

JANUARY 30, 1925.

DILL & COLLINS CO.,
Philadelphia, Pa.

SIRS: A reaudit of your income and profits-tax return for the year 1919, in connection with an examination of your books of account and records and on the basis of the information contained in your letter dated December 13, 1924, disclosed an overassessment of $8,133.74.

In the event that further protest is made you are advised that a claim be filed at once on the inclosed Form 843.

Should further correspondence be necessary, reference should be made to the symbols IT: CA: 2224–14.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.
By F. R. CLUTE,
Head of Division.

STATEMENT

Overassessment, 1919

Net income shown by return		$132,110.70
As corrected		50,773.33
Net deductions		81,337.37
Repair items capitalized	$10,969.92	
Depreciation shown by books	134,232.13	
		145,202.05
Depreciation allowed (Exhibit 1)		226,539.42
Net deductions as above		81,337.37

INVESTED CAPITAL

Profits tax not applicable	None.
Net income	$50,773.33
Less exemption	2,000.00
Balance subject to tax	48,773.33
Original tax	13,011.07
Amount of tax at 10 per cent	4,877.33
Overassessment	8,133.74

In the foregoing computation, depreciation has been computed on the same basis as for the year 1918.

The overassessment will be made the subject of a certificate of overassessment which will reach you in due course through the office of the Collector of Internal Revenue for your district, and will be applied by that official in accordance with the provisions of section 281 of the revenue act of 1924.

Inasmuch as the overassessment shown above is greater than the amount mentioned in registered office letter dated December 6, 1924, said letter is hereby annulled.

Analysis of depreciation, December 31, 1918

	Credit	Depreciation
Machinery cost plus additions as at Mar. 1, 1913 (books)	$1,121,563.90	
Mar. 1, 1913, additions	401,540.49	
Disallowance, 1918 expense	12,418.20	
Total	1,535,522.59	
Depreciation, 10 per cent		$153,552.26
Additions, 1919	81,929.14	
Depreciation at 10 per cent (one-half effective)		4,096.46
Bleach plant (Exhibit E)	73,742.09	
Depreciation at 12 per cent		8,849.05
Addition, 1919 (12 per cent depreciation, one-third effective)		10.16
Pump plant (Exhibit D, 10 per cent)	$25,961.74	2,596.17
Flat Rock property (Exhibit F)		19,014.14
		188,118.24
Bulidings, cost (books) (Exhibit B)	786,750.04	
Pumping station (Exhibit D)	87,499.05	
Bleach plant (Exhibit E)	122,750.47	
Repairs capitalized, 1918	8,605.43	
	1,005,604.99	
Roof disallowed as expense, 1917 ($51,013.94, one-half applicable)	25,506.97	
Depreciation at 2½ per cent	1,031,111.96	25,777.80
Flat Rock property (Exhibit F)		5,502.57
Total		31,280.37
Additions (Exhibit B)	10,875.58	
Repairs capitalized, 1919	10,969.92	
Additions (Exhibit E)	833.82	
Total	22,679.32	
Depreciation at 2½ per cent (one-half applicable)		283.49
		31,563.86

Inasmuch as the overassessment shown above is greater than the amount mentioned in registered office letter dated December 6, 1924, said letter is hereby annulled.

Trucks

Date	Item	Debit	Credit	Depreciation
Dec. 31, 1918	Balance	$32,399.16	[1] 10	$3,239.92
	Additions, 1918	6,275.50	[1] 20	1,255.10
	Total	38,674.66		
	New York office	7,958.29	[1] 20	1,591.66
	Total	46,632.95		6,086.68
	Additions, 1919 (Schedule E)		$7,706.40	
	Depreciation at 20 per cent (one-half applicable)			770.64
	Total			2,857.32

[1] Per cent.

SUMMARY

Machinery	$188,118.24
Buildings	31,563.86
Trucks	6,857.32
Total	226,539.42

Mr. MANSON. It was not my intention to call any more amortization cases to the attention of the committee, but the Westinghouse Air Brake Co. claim presents a situation which is so novel I deem it proper to present it.

The Westinghouse Airbrake Co. during the war built a lot of houses to house their workingmen. The houses were not completed until after the war, when they were turned over to a subsidiary corporation.

The bureau, in examining their claim for amortization, determined that the houses were worth more at the close of the war than they cost; in other words, that the cost of reproduction after the war was greater than it cost them to build them. So there was no claim there for a loss of value because of loss in the cost of reproduction, but a claim was allowed for amortization based upon this theory: The houses had no greater extent of vacancy than could normally be expected, but the company had difficulty in collecting the rents; so the amortization was determined by comparing the rents collected during the postwar period with the rents they collected during the war period.

It seems to me that any further comment on that is unnecessary.

The CHAIRMAN. What was the amount involved? Have you the figures there?

Mr. MANSON. About $250,000. I will put the report in the record.

Senator KING. Has that matter been settled?

Mr. MANSON. Yes.

(The report submitted by Mr. Manson in connection with the Westinghouse Airbrake Co. is as follows:)

SENATE COMMITTEE INVESTIGATING
BUREAU OF INTERNAL REVENUE,
May 4, 1925.

To: L. C. Manson, general counsel.
From: L. H. Parker, chief engineer.
Subject: Transmittal of report, Westinghouse Air Brake Co.

Herewith is submitted in triplicate office report No. 36, covering amortization in the case of the Westinghouse Air Brake Co.

Please note that the unit has entirely lost sight of the fact that in determining amortization on the housing project, the question was the difference between war cost and the value as of July 1, 1919, when the Westinghouse Air Brake Home Building Co. purchased their property. We contend that a parent company, who manufactures an article contributing to the war, can not claim amortization on facilities of a company whose stock it owns, but which latter company does not produce an article contributing to the war. In this case the parent company is claiming amortization on the basis of rents that the subsidiary can not collect in the years 1921, 1922, and 1923, long after the sale of property to the subsidiary took place.

Respectfully submitted.

L. H. PARKER, *Chief Engineer.*

EXHIBIT A

APRIL 23, 1925.

Mr. L. C. Manson, counsel Senate Committee for Investigating Bureau of Internal Revenue.
Office report No. 36.
Taxpayer: Westinghouse Air Brake Co., Pittsburgh, Pa.
Business: Air brakes, signals, etc.
Years: 1917–18 and 1919.
Subject: Amortization.
Amounts involved: Amount claimed, $2,403,968.71; amount allowed, $1,471,369.24.

SYNOPSIS OF CASE

From an examination of the record in this case it appears that—

1. In establishing the "value in use" allowances upon which amortization was based the Income Tax Unit's engineer did not comply with the decision of the solicitor governing such cases, as handed down in the J. I. Case Threshing Machine Co.'s claim, in that the individual facilities concerned were not considered separately but were treated in groups. It will be noted that the engineer's report in this case was dated March 1, 1924, which was subsequent to the solicitor's opinion above referred to.

2. Although the taxpayer admitted in its brief that certain housing facilities which has been installed for war-time purposes were nearly in full use during the post-war period, the unit's engineer allowed amortization on the basis of decreased "value in use." This allowance being computed from a comparison of actual rentals received on the housing project to the theoretical number of rental months possible. That is to say that the taxpayer was reimbursed for its inability to collect rentals.

3. The "value in use" of the several facilities in the plants of the taxpayer was arrived at by comparing the production figures in each department for approximately the peak six months of the war period to the average production figures for the three postwar years 1921, 1922, and 1923.

HISTORY OF CASE

The Westinghouse Air Brake Co. at Pittsburgh, Pa., was organized on September 26, 1869, under the laws of the State of Pennsylvania for the purpose of manufacturing air brakes. At various times the company developed or acquired a number of other industries engaged in the railroad supply industry. These included the Union Switch & Signal Co., the American Air Brake Co., the National Brake & Electric Co., the Western Pacific Coast Brake Co., the Western Traction Brake Co., and the Safety Car Device Co. In addition to these, the Westinghouse Air Brake Co. organized the Westinghouse Air Brake House Building Co., which was organized in 1919 for the purpose of handling the housing developments built by the parent company during the war period to provide living quarters for its workmen.

This taxpayer submitted a claim for amortization in the sum of $2,403,968.71 on a cost of $4,429,433.55. This claim was divided into three parts, as follows:

Part 1. Westinghouse Air Brake House Building Co.

Part 2. Westinghouse Air Brake Co., Wilmerding, Pa.

Part 3. Union Switch & Signal Co., Swissvale, Pa.

The following is a table showing the amounts claimed and the amounts allowed under each part of the taxpayer's claim:

	Claimed	Allowed
1. Home Building Co	$317,349.77	$165,846.68
2. Westinghouse Air Brake Co. (Wilmerding)	255,132.82	173,954.17
3. Union Switch & Signal Co. (Swissvale)	1,831,486.12	1,131,568.39
	2,403,968.71	1,475,869.24

DISCUSSION OF THE CASE

Copies of the engineer's report together with the taxpayer's schedule are attached hereto for reference.

1. It is apparent from the engineer's report and from the taxpayer's brief that the solicitor's opinion covering the determination of allowable amortization based upon "value in use" as handed down in the case of the J. I. Case Threshing Machine Co. has been entirely disregarded in this instance. This is only one of a great many cases in which this ruling of the solicitor's office has been entirely set aside. As a matter of fact the writer has yet to discover a single case among the many which he has investigated in which the solicitor's ruling has been adhered to.

2. In determining the amount of recommended amortization covering the housing facilities, the unit's engineer has made an allowance on an item which can in no wise be construed as being subject to amortization.

This taxpayer constructed certain housing facilities to take care of its employees and in this work incurred a cost amounting to $995,000. This housing project was operated by the taxpayer through the war period and up until July 1, 1919. On January 6, 1919, the Westinghouse Air Brake Home Building Co. was organized under the laws of the State of Pennsylvania for the purpose of purchasing, selling, and leasing real estate. The authorized capital stock was $1,000,000, consisting of 20,000 shares of common stock with a par value of $50 each. The Westinghouse Air Brake Co. turned over to the Westinghouse Air Brake Home Building Co. certain real estate, buildings, etc., and in lieu thereof took over the entire issue of common stock amounting to $1,000,000. The property thus transferred by the taxapyer to the Home Building Co. amounted to $995,000, the remaining $5,000 representing certain "costs." These figures are shown on the balance sheet at the time of acquisition of the property in question.

The transfer of this property to the Home Building Co. was not actually made until July 1, 1919; therefore operation under the new company did not begin until that time. From the above it will be seen that this taxpayer owned and operated its housing project during the war period and until July 1, 1919, and subsequent to this date it was owned and operated by the Home Building Co. The question might arise which company under these conditions would be entitled to amortization, if amortization in any sum was allowable. It is contended that the Home Building Co. would not be entitled to any allowance for amortization even though its capital stock was entirely owned by the parent company for the reason that it did not produce an article or articles necessary for the prosecution of the war and was and is a separate entity.

Further it is not believed that the parent company is entitled to amortization even though it owns the entire stock issue of the housing company and regardless of the fact that it was engaged in war work, so that amortization in this case is limited to the loss incurred up to the time of the transfer of the parent company's housing properties to the Home Building Co., and from the conditions surrounding this transfer it is evident that same was made on the basis of 100 per cent of the cost of the facilities involved. Assuming this transfer to be a bona fide sale the parent company is unable to show that any actual loss was involved.

However, the main point at issue is not so much the question of which company should be allowed amortization; rather, whether or not any amortization is allowable. The taxpayer in presenting its claim for amortization for housing facilities computed same on two different bases.

1. Difference in replacement cost.
2. Value in use.

The unit's engineer disallowed the claim on the first basis for the reason that the replacement cost was shown to be as great as the initial cost. He, however, recommended an allowance in the sum of $165,846.68 based on "value in use."

In submitting its claim on this basis, the taxpayer states in its brief (see pp. 69 and 70) the following:

"It is therefore proposed to determine the value in use of the dwellings by comparing the total number of rental months to the number of rental months for which rent has been actually received. For the boarding houses and lodges, of course, this method does not hold, as no delinquencies are permitted. In that case the comparison will have to be between the available occupancy and the actual occupancy."

On pages 68 and 69 the following appears:

"As previously stated, the statistics of actual occupancy show that the houses have been occupied almost continuously during the postwar period, and particularly during the years which must be used in the computation of the value in use. But this occupancy means nothing. The delinquent rental list shows conclusively that the houses have a low 'value' to the company."

From the above it would seem that the taxpayer is in effect making a claim for rentals which it failed to collect. It is the writer's opinion that if the taxpayer sustained a loss by reason of its failure to collect rentals a deduction in its tax return may be permissible under some other heading such as "bad debts," but it is difficult to conceive that a loss of this character could in any way be considered as an allowable deduction under "amortization." In his recommendation for allowance of amortization for housing facilities the engineer did not allow the full amount claimed by the taxpayer but assumed that

a 10 per cent vacancy in its housing was to be expected in the general run of this line of business and accordingly made such a deduction from the taxpayer's claim.

It must be borne in mind, however, that the taxpayer admits that these housing facilities were "occupied almost continuously during the postwar period, and particularly during the years which must be used in the computation of the value in use." This would practically fix the value in use at 100 per cent which would necessarily estop any allowance for amortization, but the taxpayer maintains that "this occupancy means nothing. The delinquency rental list shows conclusively that the housings have a low 'value' to the company." The writer can not agree with the taxpayer in its construction of the term "value in use."

From the above it is the writer's opinion that under no conditions should amortization be allowed this taxpayer on his housing facilities.

3. As formerly stated under the heading "Synopsis of case," the allowable amortization on class 2 property was computed by the engineer by comparing the production figures in each department for what appears to be approximately the peak six months of the war period and the average production figures for the three postwar years, 1921, 1922, and 1923, except in a few departments where salvage value governs the allowance, in which cases the salvage values were deducted from the actual cost and the difference was allowed as amortization. An examination of these data seems to indicate that aside from selecting what was approximately the peak six months period during the war period for comparison the same six months was not taken for all of the departments operating, but that the six months selected by the engineer appears to be the maximum six months production in each case. For example, in one department it might be from May to October, inclusive, while in another department the period might cover from January to June, inclusive.

While there is much to be said in favor of a period of six months in cases where the production did not approach its maximum until the end of 1918, there appears to be little to recommend it in the present instance, and there surely can be no justification for the comparison of peak production for a period of only six months in 1918 to the average production over the three postwar years.

The taxpayer's production, according to its own figures, exceeded in 1919 and 1920 the war-time production in many of its departments. The writer is of the opinion that if the peak production for six months during the war period is taken as a basis of war-time production it is only fair that the period of production in postwar times, which would fairly represent the postwar production, should be the peak six months' period of postwar period. However, this method of computation may be open to criticism, so the writer has computed the "value in use" in this particular case on four different bases, as follows:

1. A comparison of the average production statistics for the years 1921, 1922, and 1923 and the production statistics for the peak six months of 1918.

2. A comparison of average production figures for 1921, 1922, and 1923 to the average figures for the war period. This period extended from April, 1917, through February, 1919, inasmuch as February 28, 1919, has been considered as the date of cessation of war activity.

3. A comparison of average production statistics for the years 1919, 1920, 1921, 1922, and 1923, with the average production of the war period.

4. A comparison of production figures for the peak postwar year to the production figures for the year 1918.

The above-referred-to computations are set forth in detail on the attached schedule. There is also attached hereto tabulation showing allowable amortization on class 2 facilities of the taxpayer's plant of Wilmerding, Pa.; also the plant of the Union Switch & Signal Co., a subsidiary company, at Swissvale, Pa.

This table gives the cost on which amortization is allowable and the allowable amortization by each of the four methods by which the value in use of the taxpayer's facilities was computed. The table also shows the amortization as allowed so as to indicate the difference between amortization as allowed and the amortization allowable under each of the four methods.

No class 1 property is included in this table nor is the class 2 property of the Westinghouse Air Brake Home Building Co. taken into consideration, inasmuch as this last item has been treated separately.

In the case of the signal manufacturing departments and buildings Nos. 1 and 2 of the Swissvale plant of the Union Switch & Signal Co., the salvage

value is greater than the value in use computed by any of the methods as shown, and the amortization allowed, which was computed on a salvage value basis, should stand.

In conclusion it develops in this case that the examining engineer's report was approved by both the chief of section, Mr. Briggs, and the reviewing engineer, Mr. Diemer. However, upon investigation the writer was advised that during the period in which Mr. Briggs was acting chief of section it was the custom for Mr. Keenan, then assistant to Mr. Briggs, to affix Mr. Briggs's name to the reports and initial same. Further, that with few exceptions these cases were not even submitted to Mr. Briggs for his approval.

Respectfully submitted.

RALEIGH C. THOMAS,
Investigating Engineer.

Approved.

L. H. PARKER,
Chief Engineer.

EXHIBIT B

The following is a tabulation of figures indicating the value in use of the class 2 property of the Wilmerding (Pa.) plant of the Westinghouse Air Brake Co. and the various departments of the Union Switch & Signal Co., of Swissdale, Pa., a subsidiary of the Westinghouse Co. These computations are in accordance with the following four general methods:

1. A comparison of the average production statistics for the years 1921, 1922, and 1923, and the production statistics for the peak six months of 1918.
2. A comparison of average production figures for 1921, 1922, and 1923 to the average figures for the war period. This period extended from April, 1917, through February, 1919, inasmuch as February 28, 1919, has been considered as the date of cessation of war activity.
3. A comparison of average production statistics for the years 1919, 1920, 1921, 1922, and 1923 with the average production of the war period.
4. A comparison of production figures for the peak postwar year to the production figures for the year 1918.

The first method was that used by the taxpayer in computing its claim for amortization and except as noted in the following computations this method was allowed by the Income Tax Unit's engineers. The fourth method gives perhaps the best determination of the value in use of the taxpayer's facilities taken by plants or departments. It does not conform with the solicitor's memorandum of August 19, 1923, in that it does not determine the value in use of each individual facility. If, however, computations are to be based on average plant or departmental statistics, this method gives results which conform more closely to the true conditions than the first. It conforms with the position which we took in the case of the Aluminum Co. and other companies.

Each of the four methods is applied to the entire plant at Wilmerding and to each of the following departments at the Swissvale plant:

1. Foundry department.
2. Forge department.
3. Heat-treating plant.
4. Signal-manufacturing department.
5. Buildings No. 1 and No. 2.
6. General plant.

WESTINGHOUSE AIR BRAKE PLANT, WILMERDING, PA.

The value in use of this plant is computed from a study of the production figures of the Grey Iron Foundry, together with the figures of castings purchased, inasmuch as the number of casting used is considered to fairly represent the activities of the plant as a whole.

METHOD 1

	Production	Purchases
Year:	*Pounds*	*Pounds*
1921	27,909,210	1,743,900
1922	43,609,064	26,155
1923	66,401,819	9,695,039
	137,920,093	11,465,094
Total production and purchases		149,385,187
Average production per month		1,149,588
Month:		
July (1918)	5,104,918	2,188,656
August	4,646,835	2,117,331
September	4,826,773	3,083,742
October	5,090,711	3,256,884
November	3,343,223	2,975,385
December	4,342,609	2,890,235
	27,355,069	16,512,233
Total production and purchases		43,867,302
Average per month		7,311,217

Value in use as computed by taxpayer, 4,149,588 divided by 7,311,217=56 per cent.

The unit's engineer changed this figure slightly inasmuch as he found that only 83 per cent of the six months' peak production of 1918 went through the shop on day shifts, and inasmuch as actual instead of estimated production figures for the last three months of 1923 indicated the average postwar production to be 4,219,953 pounds per month instead of 4,149,588. His figures are as follows:

7,311,217×0.83=6,068,310 pounds per month.

Value in use=4,218,593÷6,068,310=70 per cent.

METHOD 2

Average postwar production 1921, 1922, and 1923, 4,219,593 pounds.

War-time production

Year	Month	Production
		Pounds
1917	April	4,066,802
	May	4,352,629
	June	4,310,415
	July	4,255,126
	August	4,389,904
	September	3,959,208
	October	5,515,306
	November	5,202,830
	December	4,615,805
1918	Entire year	55,407,644
1919	January	4,727,212
	February	3,740,972
Total		104,543,853

War-time purchases

	Pounds
1917, ¾×7,726,713	5,795,034
1918	22,898,169
1919, 16×3,059,048	509,841
Total	29,203,044

Total purchased and produced, 133,746,898.

Average per month, 5,815,083.

Value in use=4,219,593÷5,815,083=72½ per cent.

METHOD 3

Average postwar production

Year	Production	Purchases
1919 (less January and February)	47,455,001	2,549,207
1920	64,211,596	6,972,534
1921	27,909,210	1,743,900
1922	43,609,064	26,155
1923	71,420,159	9,195,854
	254,605,030	20,487,630

Average per month, 4,743,977.
Average war production, 5,815,083.
Value in use=4,743,977÷5,815,083=81.6 per cent.

METHOD 4

Production and purchases during peak postwar year (1923), 76,096.858.
Production and purchases, 1918, 78,305,813.
Value in use=76,096,858÷78,305,813=98.2 per cent.

UNION SWITCH & SIGNAL CO.

(*a*) Foundry department.

METHOD 1

Postwar production

	Pounds
1921	3,603,438
1922	5,114,542
1923	11,880,202
Total	20,598,182

Average per month, 572,171 pounds.

Production for peak six months, 1918

	Pounds
May	1,092,644
June	987,661
July	966,553
August	1,023,003
September	1,037,727
October	1,237,409
Total	6,344,997

Average per month, 1,057,499 pounds.
Value in use=572,171÷1,057,499=54 per cent.
This percentage value in use was accepted by the unit's engineers for this department.

METHOD 2

Average postwar production 1921, 1922, and 1923, 572,171 pounds per month.

War-time production

	Pounds
Year 1918	12,238,203
January, 1919	678,831
February, 1919	394,964
Total	13,311,998

Average per month, 95,857 pounds.
Value in use=572.171÷950,857=60.2 per cent.

METHOD 3

Postwar production

	Pounds
1919 (less January and February)	6,212,595
1920	11,067,503
1921	3,603,438
1922	5,114,542
1923	11,880,202
Total	37,878,280

Average per month, 653,074.
Average war-time production, 950,857.
Value in use=653,074÷950,857=68.7 per cent.

METHOD 4

Production for peak postwar year (1923), 11,880,202.
Production 1918, 12,238,203.
Value in use=11,880,202÷12,238,203=96.9 per cent.

For this department and all other departments of the Union Switch & Signal Co. it has been necessary to consider the war period as extending from January, 1918, through February, 1919, inasmuch as production figures for the year 1917 are not shown on the taxpayer's brief.

(*b*) Forge department.

METHOD 1

Production peak six months, 1918

	Production in hours
January	31,046
February	30,815
March	32,981
April	33,089
May	30,675
June	28,808

Average, 31,236 hours per month.

Postwar production

	Production in hours
1921	105,819
1922	392,646
1923	419,663

Average, 25,503 hours per month.
Value in use=25,503÷31,236=82 per cent.
This percentage value in use was allowed by the Income Tax Unit's engineer.

METHOD 2

Average postwar production 1921, 1922, and 1923, 25,503 hours per month.

War production

	Production in hours
Year 1918	343,117
January, 1919	35,173
February, 1919	31,135

Average per month, 29,245 hours.
Value in use=25,503÷29,245=87.3 per cent.

METHOD 3

War production, 29,245 hours per month.

Postwar production

	Production in hours
1919 (less January and February)	348,676
1920	391,724
1921	105,819
1922	392,646
1923	419,663

Average per month, 28,595 hours.
Value in use=28,595÷29,245=97.7 per cent.

METHOD 4

Peak postwar production (1923), 419,663.
Production, 1918, 343,117.
Value in use=419,663÷343,117=100 per cent.
All postwar years, with the exception of 1921, show over 100 per cent value in use.

(*c*) Heat-treating department.

METHOD 1

Postwar production

	Production in hours
March, 1918	2,556
April	3,081
May	3,284
June	3,838
July	3,717
August	3,493

Average, 3,328 hours per month.
Value in use=1907÷3,328=57 per cent.
This value in use was allowed by the unit's engineer.

METHOD 2

Average postwar production, 1921, 1922, and 1923, 1,907 hours.

War production

	Production in hours
Year 1918	29,453
January, 1919	2,658
February, 1919	1,441

Average per month, 2,581 hours.
Value in use=1907÷2,581=73.8 per cent.

METHOD 3

War production, 2,581 hours per month.

Postwar production

	Production in hours
1919 (less January and February)	21,132
1920	43,884
1921	10,660
1922	29,581
1923	28,433

Average, 2,305 hours per month.
Value in use=2,305÷2,581=90 per cent.

METHOD 4

Postwar peak production (1920), 43,884.
Production, 1918, 29,453.
Value in use=43,884÷29,453=100 per cent.
(*d*) Signal division.

METHOD 1

Peak six months' production, 1918

	Production in hours
January	216, 442
February	223, 977
March	263, 748
April	226, 979
May	229, 891
June	210, 394

Average, 228,572 hours per month.

Postwar production

	Production in hours
1921	421, 230
1922	783, 857
1923	1, 123, 411

Average, 64,680 hours per month.
Value in use = 64,680 ÷ 228,572 = 29 per cent.
The taxpayer did not, however, use this figure, inasmuch as he computed the salvage value of the plant facilities to be 40 per cent. The Income Tax Unit's engineer computed the value of these facilities as 55 per cent of cost and used this percentage in the allowance.

METHOD 2

Postwar production for years 1921, 1922, and 1923, 64,680 hours per month.

War-time production

	Production in hours
Year 1918	2, 322, 611
January, 1919	149, 462
February, 1919	108. 432

Average, 184,322 hours per month.
Value in use = 64,680 ÷ 184,322 = 35.1 per cent.

METHOD 3

War-time production, 184,322 hours per month.

Postwar production

	Production in hours
1919 (less January and February)	717, 913
1920	925, 238
1921	421, 230
1922	783, 857
1923	1, 123, 411

Average, 68,480 hours per month.
Value in use=68,480÷184,322=37.2 per cent.

METHOD 4

Peak post-war production (1923), 1,123,411 hours.
Production, 1918, 2,322,611 hours.
Value in use=1,123,411÷2,322,611=48.3 per cent.
(*e*) Buildings 1 and 2.

METHOD 1

Postwar production

	Production in hours
1921	519,073
1922	956,760
1923	1,392,740

Average, 79,683 hours per month.

War-time production, 1918

	Production in hours
May	424,000
June	450,835
July	471,524
August	429,571
September	406,759
October	412,759

Average, 432,641 hours per month.
Value in use=79,683÷432,641=18 per cent.
The taxpayer did not use this low value in use percentage, inasmuch as the salvage value of the buildings and facilities were estimated to be 35 per cent. The Income Tax Unit's engineer made an estimate of the value in use of these buildings and their contents as a result of an inspection and found the value in use to be 70 per cent, as shown in the computations on page 14 of the engineer's report. This percentage was used in the allowance.

METHOD 2

Average postwar production, 79,683 hours per month.

War-time production

	Production in hours
Year 1918	4,474,153
January, 1919	278,590
February, 1919	127,070

Average, 334,272 hours per month.
Value in use=79,683÷334,272=23.8 per cent.

METHOD 3

War-time production. 334,272 hours per month.

Postwar production

	Production in hours
1919 (less January and February)	574,451
1920	875,470
1921	519,073
1922	956,760
1923	1,392,740

Average, 74,457 hours per month.
Value in use=74,457÷334,272=22.2 per cent.

METHOD 4

Peak postwar production (1923), 1,392,740 hours.
Production, 1918, 4,474,153.
Value in use=1,392,740÷4,474,153=31.2 per cent.
(*f*) General plant.
In computing the value in use of the general plant facilities the taxpayer has taken the average postwar hours of labor for 1921, 1922, and 1923 and has determined the percentage of the total hours which were taken up by the

foundry, forge shops, heat-treating departments, and signal divisions. These percentages are as follows:

	Per cent
Foundry	16.6
Forge	17.6
Heat treating	1.4
Signal divisions	64.4
Total	100

These percentages have been multiplied by the percentage value in use of each department for each of the four methods and the weighted value in use of the general plant facilities obtained in this manner.

METHOD 1

Department:	Per cent of total	Value in use percentage
Foundry	16.6×54=	9.0
Forge	17.6×82=	14.4
Heat treating	1.4×57=	8.0
Signal division	64.4×29=	18.7
Weighted value in use percentage	100	=50.1

The computations for the other three methods are similar and the value in use allowed was also obtained in a similar manner, except that the engineer used his values for each of the above departments rather than those of the taxpayer. These values are as follows for the other methods:

	Per cent
Method 2	49
Method 3	53.9
Method 4	66.4
Engineer's determination	60

A summary of the above computations is given in the table which follows. It will be noted that the value in use percentage governs the amortization allowance in all but three cases as allowed by the engineer and in all but two cases as determined by method 4. In these cases the salvage value governs.

Summary—Value in use table

Plant	Department	Value in use by method—				Value in use as allowed
		1	2	3	4	
		Per cent	*Per cent*	*Per cent*	*Per cent*	*Per cent*
Wilmerding	All	56	72.5	81.6	98.2	70
Swissvale	Foundry	54	60.2	68.7	96.9	54
Do	Forge	82	87.3	97.7	100	82
Do	Heat treating	57	73.8	90.0	100	57
Do	Signal manufacturing	29	35.1	37.2	48.3	55
Do	Buildings 1 and 2	18	23.8	22.2	31.2	70
Do	General	50.1	49.0	53.9	66.4	60

Amortization table

Plant	Department	Cost of facilities	Amortization by method—				Amortization as allowed
			1	2	3	4	
Wilmerding	All	$579,847.22	$255,132.78	$159,457.99	$106,691.89	$10,437.25	$173,954.17
Swissvale	Foundry	48,966.90	22,524.77	19,489.63	15,326.64	1,517.97	22,524.76
Do	Forge	221,378.96	39,848.21	28,115.13	5,091.72	0.00	39,848.24
Do	Heat treating	29,637.85	12,744.28	7,565.12	2,963.79	0.00	12,744.28
Do	Signal manufacturing.	811,730.32	576,328.46	526,812.91	509,766.64	419,664.57	365,278.64
Do	Buildings 1 and 2.	1,540,902.45	1,263,540.01	1,164,167.67	1,198,822.11	960,140.89	462,273.74
Do	General	313,815.34	156,593.85	160,045.82	144,668.72	105,441.95	125,526.13

Mr. GREGG. May I make a statement, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. GREGG. I wish to make this statement before we adjourn: I think the bureau should be given an opportunity to answer any cases which are presented to the committee so late that we are unable to answer before June 1.

Senator KING. Oh, surely.

Mr. GREGG. We should be allowed to prepare a written statement in reference to any of these cases submitted, and have that go into the record.

The CHAIRMAN. Just so long as our counsel and staff are permitted to put a reply in the record to your statement.

Mr. GREGG. Yes.

Mr. MANSON. I wish to say this; that I had planned, on any matters that were developed after June 1, and submitted in reports that are made to me by engineers and auditors, to submit that to the bureau for their criticisms and reply.

Mr. GREGG. That will be very agreeable to us.

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

(Whereupon, at 12.35 o'clock p. m., the committee adjourned until to-morrow, Saturday, May 16, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, MAY 26, 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, and King.

Present also: Mr. L. C. Manson, counsel for the committee, and Mr. Raleigh C. Thomas, investigator for the committee.

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; and Mr. A. W. Gregg, solicitor, Bureau of Internal Revenue.

Mr. MANSON. I have a report here dealing with 17 small amortization cases. They are all summarized in this one report. As I say, these are small cases, the 17 cases, the largest amount allowed being $23,266.20. The aggregate amount claimed in the 17 cases is $204,843.45. The aggregate amount allowed is $196,793.45.

The report of Mr. Thomas, our engineer, with respect to the general handling of these 17 cases is very brief, and I will read it into the record:

In the investigation of the numerous cases involving amortization which have been examined by the writer and which have been acted upon by the unit attention has been directed to several—17 in number—in which allowances for amortization have been recommended by the production committee of the engineering section.

Before going into the discussion of these allowances it might be well to briefly state the functions of this committee, in so far as passing on taxpayers' claims for amortization is concerned, as told to the writer by one of the members of this committee.

It seems that in October, 1924, there was quite an accumulation of comparatively small cases pending in the appraisal section and it was recommended by Mr. Raleigh, head of the production committee, to Mr. Greenidge, chief of engineering division, that in order to expedite these cases and in order to relieve the regular engineers of the appraisal section of a considerable amount of work the production committee be authorized to pass judgment in the matter of amortization allowances.

The cases to be handled by the committee were divided into three classes, as follows:

1. Cases where allowances were made in full amount of claim.
2. Cases where total disallowances were made.
3. Cases which would be turned over to the appraisal engineers for final recommendation.

This suggestion was approved by both Mr. Keenan, head appraisal section, and Mr. Greenidge, and the committee began to consider cases.

It is unknown to the writer how many cases were disposed of by this committee, but the following list includes all that he has laid before him:

Indiana Rubber & Insulated Wire Co.
Porter Bros. & Collins.
Lyons Manufacturing Co.

Giant Furniture Co.
Milwaukee Stamping Co.
Massillon Foundry & Machine Co.
Sharon Coal & Coke Co.
Wabash Canning Co.
Buffalo Pressed Steel Co.
Western Grain Co.
Cobb Preserving Co.
Elkhorn Coal & Coke Co.
Essmueller Mill Furnishing Co.
Early & Daniel Co.
Interlake Engineering Co.
Keystone Manufacturing Co.
Tregoning Boat Co.

Attached hereto is a tabulated list of the above cases, showing the amounts claimed, amounts allowed by the committee, the appraisal engineer's recommendation (in cases which were referred for action), and date of action of the committee.

While it may have been an excellent idea to expedite the settlement of cases in which only small sums of money were involved and to relieve the appraisal engineers of a considerable amount of work, it seems that a reasonable amount of investigation on the part of the committee would not have been amiss, and it further seems that in recommending allowances to the several taxpayers, the established rules and regulations of the unit, which are supposed to be adhered to in cases where amortization is involved, should have governed the action of the committee to some extent.

An analysis of the attached tabulated list shows conclusively that the 17 cases investigated were acted upon by the committee in a haphazard way and it appears that the one thought of the committee was to settle the cases regardless of their respective merits. For instance, of the 17 cases just mentioned, we find that in 7 instances no investigation had been made by the appraisal engineers prior to the committee's action. Further, we find that in one case, that of the Tregoning Boat Co., the committee acted during the period in which an engineer's report was being prepared and entirely ignored the taxpayer's claim for 1919. We also find that in 10 instances there was no report submitted by an appraisal engineer and in 6 cases, where the appraisal engineer had made an investigation and submitted a report, making certain allowances, these reports were either entirely ignored or arbitrarily rejected.

Possibly it is interesting to note that on October 7, 1924, there were eight cases passed upon by the committee which have been brought to the writer's attention, and on October 14, there were six cases disposed of. How many more is not known to the writer, nor is it known to what extent the committee's actions have affected the actual amount paid in taxes by various taxpayers for the reason that it is not known whether the committee confined its action to amortization claims or handled cases of other kinds.

In closing, it may be stated that a careful study of the 17 cases in hand develops the following facts:

1. That the committee allowed amortization in direct opposition to the recommendation of the appraisal engineers who had made a careful study of the cases after first having made a thorough investigation in the field. That these allowances were made by the committee without any apparent explanation.

2. That this committee allowed amortization on facilities which according to the engineer's report, were 100 per cent in use during the postwar period. This determination of value in use by the engineer having been made only after a thorough investigation and a thorough survey of the facilties in question at the taxpayer's plant by the engineers.

3. That this committee allowed amortization without first having either a field investigation or report, or even an office report submitted by an appraisal engineer, and so far as the records show, based the allowance solely upon the "say-so" of the taxpayer and without any evidence to substantiate its claim.

4. That this committee, without explanation and without apparent justification, overruled both the recommendations of the appraisal engineers and the action of conference committees, which committees met for the specific purpose of determining amortization questions and before which both the taxpayer's and unit's representatives were present to present their respective sides of the cases and to thoroughly discuss the merits of same.

5. That this committee allowed amortization in cases where the data submitted by the taxpayer were not in accordance with the requirements of the

unit. In many instances the writer has noted that other taxpayers' claims for amortization have been disallowed for failure on the taxpayer's part to submit data in accordance with the requirements of the unit; so it would seem that action under these conditions by the committee constituted the most flagrant discrimination against other taxpayers.

In fact, the outstanding features of the committee's actions, in so far as the 17 cases in hand are concerned, would indicate that it was only necessary for a taxpayer who had presented a reasonably small claim for amortization to arrange to have the committee act upon same in order that he may receive the full amount of amortization claimed.

Name	Amount claimed	Amount allowed	Engineer's recommendation	Date of action
Indiana Rubber & Insulated Wire Co	$17,261.10	$17,261.10	No investigation	Oct. 14, 1924
Porter Bros. & Collins	15,425.12	15,425.12	No report	Oct. 7, 1924
Lyons Manufacturing Co	3,948.81	3,948.81	do	Do.
Giant Furniture Co	8,414.06	8,414.06		Do.
Milwaukee Stamping Co	16,256.32	16,256.32	No investigation; no report.	Oct. 14, 1924
Massillon Foundry & Machine Co	9,305.87	9,305.87	$219.64	Oct. 9, 1924
Sharon Coal & Coke Co	5,610.41	5,610.41	No investigation; no report.	Oct. 14, 1924
Wabash Canning Co	19,890.64	19,890.64	do	Do.
Buffalo Pressed Steel Co	16,315.17	16,315.17	$3,234.08	Oct. 7, 1924
Western Grain Co	2,141.31	2,141.31	No investigation; no report.	Oct. 14, 1924
Cobb Preserving Co	6,091.27	6,091.27		Oct. 20, 1924
Elkhorn Coal & Coke Co	7,225.01	7,225.01	No investigation; no report.	Oct. 14, 1924
Essmueller Mill Furnishing Co	[1] 2,000.00	No action.	$1,355.89	Oct. 7, 1924
	[2] 3,152.50	3,152.50	No report	
Early & Daniel Co	23,266.20	23,266.20		Do.
Interlake Engineering Co	11,787.93	11,787.93	$11,787.93	Jan. 6, 1925
	19,829.37	13,779.37	No report	Oct. 7, 1924
Keystone Manufacturing Co	5,479.51	5,479.51	No investigation or report.	Oct. 9, 1924
Tregoning Boat Co	11,442.85	11,442.85	Report not submitted until after committee's action.	Oct. 7, 1924
Total	204,843.45	196,793.45		

[1] Original. [2] Final.

Mr. MANSON. I will now call specific attention to several of these cases.

Buffalo Pressed Steel Co., Buffalo, N. Y.: During the war this taxpayer was engaged in the manufacture of silencers, machine-gun tripods, adapters, and small fittings for airplanes. For its war-time production additional facilities were required.

Taxpayer submitted claim for amortization in the sum of $16,315.17 on cost of $24,424.42.

Mr. M. F. Kahn, engineer of the appraisal section, made a field investigation of the case and submitted a report thereon under date of August 28, 1920. In this report Mr. Kahn recommended an allowance of $3,234.08 and a disallowance of $13,081.09. This recommendation was based on the following facts:

After the cancellation of war contracts the taxpayer sold certain of the facilities upon which amortization is claimed to the United States Government, at a price equal to 74 per cent of the original cost. Subsequently some of these facilities so sold to the Government were repurchased by the taxpayer from the Government at a price equal to 55 per cent of their original cost. The original cost to the taxpayer of the facilities sold to the Government and repurchased by the taxpayer was $11,985.67, while the original cost to the taxpayer of the facilities sold to the Government and retained by the Government was $12,438.75. There were certain other facilities in a small amount which are included in the taxpayer's claim,

amortization on which was disallowed by Mr. Kahn for the reason that they were retained by the taxpayer to be used in its business and were 100 per cent in use in the postwar years.

Mr. Kahn, in figuring his amortization, considered that the sale of certain facilities to the Government was a bona fide one and that the maximum loss, which the taxpayer could have possibly sustained, was the difference between the cost to the taxpayer of these facilities and the amount realized by the sale of 26 per cent of $12,438.75 equals $3,234.08, the amount allowed. Mr. Kahn further figured that inasmuch as the taxpayer had sold the other facilities to the Government at a net loss of 26 per cent, and had repurchased them from the Government for 55 cents on the dollar, that there was a net gain of 19 per cent to the taxpayer. Therefore no allowance for amortization should be made and it was so recommended.

With this information in hand the production committee on October 7, 1924, entirely disregarded Mr. Kahn's report and allowed the taxpayer's claim in full for $16,315.17.

Regardless of what system of computation the committee may have used in reaching this conclusion, we are unable to understand for what rhyme or reason this claim should have been allowed in full.

Under the rules and regulations governing amortization allowance, where there is a bona fide sale of the facilities involved, the maximum amount of amortization allowable is the difference between the actual cost and the amount realized by the sale. It certainly may not be rightly held that this sale was not a bona fide one and it must be accepted as establishing the "fair" value of the facilities. As to those facilities which were repurchased by the taxpayer, the figures as shown in Mr. Kahn's report prove beyond all peradventure that there was no loss incurred by the taxpayer, but, rather, that there was an actual profit made by it, assuming the depreciation is not taken into account. But even waiving this for the sake of argument, it can not be disputed that the maximum loss which the taxpayer could have incurred by the sale of these facilities was the difference between the cost of same to it and the amount realized by it in its original sale to the Government. Hence the net maximum loss of both allowances of facilities to the taxpayer could have been not more than 26 per cent of the original cost of same or $6,350.35 as against $16,315.17 allowed by the committee.

I would add to what the engineer states in connection with this case that the fact that the taxpayer bought these facilities back from the Government after it had disposed of them to the Government establishes the necessity for them in the taxpayer's business.

Western Grain Co., Birmingham, Ala.: There is nothing in the engineering files as submitted to our engineers indicating that this case was ever considered by the appraisal section. On October 14, 1924, production committee allowed amortization in sum of $2,141.31 for 1918 expenditures and disallowed taxpayer's claim for additional amortization (no amount mentioned) owing to the fact that the facilities in question were "apparently" made during 1919.

It would seem that the production committee acted in this case without having sufficient information at hand to permit of an intelligent recommendation and without first having had an investigation made by one of the appraisal engineers.

Early & Daniel, Cincinnati, Ohio: This company was incorporated in 1904 under the laws of the State of Ohio for the purpose of engaging in a general brokerage and warehouse business and grain, hay, and other feed products. It had never been a manufacturer and was not engaged in manufacturing during the war.

During the amortization period, however, the company was engaged in recompressing hay for the United States Government under (*a*) "Contract for miscellaneous services."

This taxpayer submitted a claim for amortization of certain facilities purchased and installed in 1917 and 1918 in the sum of $23,266.20. Included in the facilities upon which amortization was claimed is a building costing $7,357.68, also a hay compressor costing $17,753.91, the hay compressor having been installed in 1917 and the building having been constructed in 1918. This building was of cheap construction and replaced a former building in which the compressor was installed and which was destroyed by fire. The taxpayer's claim is based upon the fact that since the completion and cancellation of its Government contract—final cancellation occurring in May, 1919—it has made no use of the building or the compressor, and contends that amortization should be allowed in an amount equal to actual cost, less 1917 depreciation and estimated salvage values, which are put at $400 for the building and $140 for the hay compressor.

An office investigation of a brief and schedule prepared by Ernst & Ernst, certified public accountants, and submitted by the taxpayer under date of May 15, 1923, together with the report thereon, was handed down by unit's engineer, Newburg, in which a total disallowance was recommended on the ground that the taxpayer was not engaged in the production of articles contributing to the prosecution of the war. Further, that its claim does not come within the scope of the amortization provision of the revenue acts of 1918 and 1921. This recommendation was concurred in by S. T. De La Mater, chief of section, and W. J. Jennings, reviewing engineer, and was dated July 5, 1923.

The taxpayer demurred from the recommendation of Engineer Newburg and appealed in the form of a brief and dated January 5, 1924.

On January 24, 1924, Deputy Commissioner Bright addressed a communication from the engineering division, Income Tax Unit, to the committee on appeals and review, in which the following appears:

> The facilities were not for the production of articles but were for the performance of service only. It is contended that the phrase production of articles relates to some form of manufacturing (see L. O. 1074, 45–21–1909, C. B. No. 5, page 159), and that the purpose of the taxpayer's facilities is clearly shown to be related to transportation. (See taxpayer's claim and brief.)

From the record it would seem that this case remained dormant from the date of the letter just quoted until October 7, 1924, when the production committee acted in the case and recommended that amortization be allowed in the full amount of claim ($23,266.20) as being reasonable. There is not a word of explanation as to why the engineer's report, together with the letter of deputy commissioner, were either ignored or overruled, neither was there any statement in substantiation of the allowance made. The writer has been advised that this recommendation of the production committee has been passed as being final.

The CHAIRMAN. Do the records show of whom that production committee was composed?

Mr. THOMAS. Yes, sir.

Mr. MANSON. State who they were.

Mr. THOMAS. Mr. Rashleigh and Mr. Shepherd.

The CHAIRMAN. There were only two members of this production committee?

Mr. THOMAS. Yes, sir.

Mr. NASH. Pardon me at this point. Was Mr. Shepherd on that committee last October, when these cases were going through?

Mr. THOMAS. He signed all of the reports; yes, sir. The reports were also signed by Mr. Greenidge.

Mr. MANSON. Elkhorn Coal & Coke Co., Mayberry, W. Va.: This taxpayer submitted claim for amortization on certain coal-mining facilities in the sum of $7,225.01. This claim was based on actual production.

In support of this claim the taxpayer submitted a sworn statement giving certain production figures as follows:

Year	Total net tons coal produced	Total net tons coke produced	Year	Total net tons coal produced	Total net tons coke produced
1915	271,820	16,856	1919	207,739	13,501
1916	231,828	32,845	1920	199,594	57,262
1917	242,455	29,222	1921	275,894	None.
1918	208,043	55,670	1922	235,775	None.

This case was not referred to the unit's engineers in the usual way. Consequently no field investigation or report was made thereon.

However, on October 14, 1924, the production committee recommended an allowance of the full amount claimed, or $7,225.01. The writer is of the opinion that this allowance is beyond all reason and believes that the entire claim should have been disallowed for the reason that the average production of coal in the postwar years was greater than the average in war years, that the average combined production of both coal and coke in the postwar years nearly equaled that of the war period, and that during 1921 and 1922 the production of coal exceeded the production of both coal and coke during the war period (1917 and 1918).

Massillon Foundry & Machine Co., Massillon, Ohio: Taxpayer claimed amortization during 1918 in the sum of $9,305.87.

Engineer L. E. Luce submitted report, dated July 26, 1921, recommending an allowance of $219.64.

Amortization was based on "value in use"; almost all facilities were necessary in taxpayer's business during 1919 and 1920 and were 100 per cent in use.

On October 9, 1924, the production committee allowed amortization in the sum of $9,305.87 as per following action:

> Amortization claimed on original 1918 return of $9,305.87 is allowed in full as reasonable. This recommendation voids amortization report dated July 26, 1921.

There is nothing in the engineering files to show why the engineer's original recommendation was overruled; neither was there any explanation why the full amount claimed by the taxpayer was allowed by the production committee.

It is difficult to understand why the committee allowed the claim in full in the face of the engineer's statement that the facilities were necessary in the taxpayer's regular postwar business and were nearly 100 per cent in use.

This engineer made a field examination of the case and was necessarily familiar with existing conditions at the time of his visit to taxpayer's offices. Surely a field investigation and report of this character should not be overruled or ignored without some good and valid reason for so doing.

The next is the Giant Furniture Co., High Point, N. C.: Taxpayer claimed amortization in the sum of $8,414.06.

Taxpayer made no deduction in returns for amortization, but wrote off cost of machinery upon which he asked amortization ($15,099.36) to expense in 1918.

Taxpayer received $6,923.39 as a payment by Bureau of Aircraft Production and included same in 1919.

This action on taxpayer's part was approved by revenue agent in July, 1923.

On December 10, 1923, Engineer Pagter submitted report in which he disagreed with the revenue agent and recommended that the write off of $15,099.36 be disallowed, but that the $6,923.39 paid by Bureau of Aircraft Production be taken out of income in 1919 and written off against asset value restored as above.

On March 7, 1924, an auditor on amortization submitted a memorandum on the case in which he agreed with the engineer and recommended as follows:

> It is therefore recommended that the entire case be transferred, with transmittal Form 1932, to the engineering division, appraisal section, for determination of the amount of amortization, if any, that is allowable. * * *

In the face of the above the production committee, on October 7, 1924, allowed the total claim of the taxpayer in the sum of $8,414.06.

This is another case where a recommendation of the engineer who has investigated the case and who has set forth valid reasons for disallowance has been set aside by the committee for no apparent reason and without any explanation.

The next case is that of the Sharon Coal & Coke Co., Sharondale, Ky.: Taxpayer claimed amortization on housing facilities in the sum of $5,610.41.

Conference was held July 16, 1924, at which taxpayer was represented. At this conference the taxpayer was requested to submit certain information in accordance with Form 1007–M, together with other supporting data.

On August 19, 1924, engineering division was requested by Mr. Kensel, assistant head of division, to give the case early attention.

On October 14, 1924, production committee approved claim in full ($5,610.41).

There is nothing in the record as delivered to the writer to indicate that the data requested of the taxpayer at the above-mentioned conference was ever furnished, nor is there any indication of the engineering division having examined the case or having submitted a report thereon.

The next is that of the Keystone Manufacturing Co., of Elkins, W. Va.: In May, 1924, taxpayer filed claim for amortization in the sum of $5,479.51 for war-time facilities used in the manufacture of wood treenails for Government ships. This case was sent to head,

engineering division, attention of appraisal section, on July 9, 1924, for proper action.

Certain additional information was asked for by Deputy Commissioner Bright in communication dated August 20, 1924. Taxpayer replied to this request on August 26, 1924, supplying additional data. On August 28, 1924, Mr. Bright acknowledged receipt of this data and stated:

> Your letter has been referred to the engineer assigned to the case for his prompt attention.

Our engineer was unable to find anything in the record of this case indicating that the case was ever considered in the regular way by one of the unit's engineers. However, on October 9, 1924, the production committee acted in the matter and allowed the claim in full, as follows:

> Amortization originally claimed in brief received May 8, 1924, for $5,479.51 is allowed in full as reasonable.

Milwaukee Stamping Co., West Allis, Wis.: Taxpayer made claim for amortization in the sum of $16,256.32, as follows: 1918, $11,890; 1919, $4,366.32; total, $16,256.32.

This claim for amortization was not investigated in the usual way by an appraisal engineer of the unit, but was reported upon by a revenue agent in report dated April 19, 1920. Recommendation in this report was for an allowance of $841.40. This revenue agent was not an engineer but an auditor.

The case was acted upon by the production committee, when on October 14, 1924, said committee, without any explanation of its action or without comment, approved the claim in full amount of $16,256.32.

Lyons Manufacturing Co., Framingham, Mass.: This taxpayer, together with Porter Bros. & Collins, the two companies being managed as one, submitted two claims for amortization for war facilities purchased in 1918, as follows:

Lyons Manufacturing Co., $3,948.81; Porter Bros. & Collins, $15,425.12.

Detailed data in connection with the several facilities upon which amortization was claimed was not available owing to a fire which destroyed certain of the taxpayer's records.

Conferences were held in the cases, with the result that Porter Bros. & Collins submitted certain data through their representatives, Grimes, Clarkson & Co., C. P. A., giving a partial list of the facilities purchased by the taxpayer together with a list of facilities sold after the war period. A part of the letter transmitting these lists reads:

> This list is not necessarily complete, since the company suffered a severe fire in 1920, as explained in the conference, and all the records of the company were lost at that time. However, we believe that the list comprises a large majority of the invoices rendered but we can not say definitely which invoices are applicable to the Lyons Manufacturing Co. and which to Porter Bros. & Collins as all the purchasing at that time was done on the credit of the latter company and invoices were practically invariably rendered to Porter Bros. & Collins.

According to these lists of facilities the cost of those purchased during 1918 was $25,282.16 and the amount realized by the scale of a part of the facilities was $10,146.42, or a difference of $15,135.74.

The taxpayer further states in its letter:

After the armistice this machinery was partly used in peace-time business and partly sold.

This would indicate that at least a part of the machinery was being used in the taxpayer's regular post-war business, and therefore had some residual value. There is nothing in the record which indicates that this case was reported on by the unit's engineer in the usual way. There is, however, in the files, a penciled memorandum carelessly scrawled on a piece of wrapping paper and unsigned, which reads:

Records destroyed Zolzer exam early in 1923 never write report waiting for data.

Data such as is finally came in not believed can allow any original costs & shown. Sold some but can't identify with costs * * *.

I, by the way, have seen that memorandum. There is a crumpled-up piece of wrapping paper that you would ordinarily think would be a piece of waste paper that had gotten into the file. It is hard to decipher just what is written on it. It is written in lead pencil and scuffed into that file.

The CHAIRMAN. It is signed?

Mr. MANSON. No; it is not signed.

The CHAIRMAN. Is there any record in the file as to whether there was any insurance on this property which was destroyed by fire?

Mr. THOMAS. No, sir; none that I know of.

The CHAIRMAN. No inquiry was made as to whether there was any insurance on it or not?

Mr. THOMAS. I can not say that.

The CHAIRMAN. There was no inquiry indicated?

Mr. THOMAS. It was not indicated in the file that I saw.

Mr. MANSON. It should be noted that the taxpayer's claim is for $15,425.12 and by its own statement the cost of facilities was $25,-282.16. Further, that certain of these facilities were sold for $10,-146.42, which would make the taxpayer's maximum loss $15,135.74, not taking into consideration the facilities which were retained by the taxpayer and which carried with them a certain value.

It is true that the actual costs of facilities as listed in the taxpayer's letter are not complete, owing to the destruction of the records. However, this letter is the only data upon which an allowance by the unit could be based.

The production committee, on October 7, 1924, recommended an allowance in the full amount of the claim, or $15,425.12, several hundred dollars more than the maximum, even if the taxpayer had retained none of them in use.

The CHAIRMAN. And apparently without any evidence that it was not insured?

Mr. MANSON. Yes; and no consideration given then to the fact that he had retained a part of these facilities in use.

Mr. THOMAS. I might say that there is nothing in the record to show that any of the facilities were destroyed in the fire. The only reference made to destruction in the fire was of the records.

The CHAIRMAN. Oh, I see.

Mr. MANSON. While our engineer does not question the fact that some deduction for amortization is proper, he maintains that an allowance of the total amount of the claim is excessive; further, that there was not sufficient data presented to the production committee to permit of an intelligent allowance being made.

The claim of the Lyons Manufacturing Co. was acted on by the production committee on October 7, 1924, by which action the full amount of claim ($3,948.81) was "allowed in full as reasonable."

The same question of lack of sufficient data applies in this case.

Our engineer adds that in the investigation of the several amortization cases which have come to his attention there have been many cases in which amortization has been disallowed in full for the reason that the taxpayer was unable to furnish sufficient data to support his claim, whereas in these two claims allowances for the full amount claimed have been made.

Cobb Preserving Co., subsidiary of New York Canners (Inc.), Rochester, N. Y.: Taxpayer claimed amortization in its 1919 returns in sum of $6,091.27. Unit's engineer, William F. R. Griffith, submitted a report on April 4, 1921, recommending disallowance in full for reason that taxpayer held no war contracts and that amortization period should end November 11, 1918. Further, for the reason that taxpayer advised him that all facilities would be used in the taxpayer's normal postwar business and that practically all were erected or installed in 1919, or after the amortization period. Conference with taxpayer was held on August 27, 1924, at which taxpayer stated it had not been notified of the disallowance by Engineer Griffith; conferees advised taxpayer to submit further data in support of claim; conference report states that there is nothing in the record to show that taxpayer had been notified of engineer's disallowance.

Taxpayer entered a protest against disallowance and conference committee decided to reopen case.

On October 13, 1924, taxpayer submitted affidavit setting forth the expenditures prior to November 11, 1918, which are given as "none."

This affidavit states that in July, 1918, taxpayer entered into a verbal contract on a cost-plus basis for the construction of the buildings upon which amortization is claimed.

Instead of referring this case back to the engineer who made the field examination and report and who was thoroughly familiar with the case, the case was settled by the production committee on October 20, 1924, by allowing the total amount claimed, or $6,091.27.

It would seem that inasmuch as the verbal contract for the facilities was on a cost-plus basis, which could have been canceled at any time, and inasmuch as the taxpayer advised the engineer that the facilities would be used in its regular business, the engineer was correct in his disallowance.

In order to recapitulate that situation, during the war period the taxpayer entered into an oral contract, on a cost-plus basis, for construction of certain facilities. The work was not done until after the war period. Under any cost-plus contract, of course, it could have been canceled.

The CHAIRMAN. At this point I would like to ask if there was any confirmation received from the concern which was the other party to the cost-plus contract?

Mr. THOMAS. No, sir.

The CHAIRMAN. In other words, they just took the taxpayer's statement, without any attempt at verification.

Mr. MANSON. Wabash Canning Co., Wabash, Ind.: This taxpayer was engaged in the business of canning peas, corn, etc.

The taxpayer did not deduct amortization in its return for any year.

On July 31, 1924, a brief was submitted by taxpayer in support of an amortization claim in the sum of $19,890.64 on claimed costs of $57,406.74.

No engineer's report has been submitted in this case, but on September 2, 1924, a conference was held with taxpayer's representatives. The unit's engineer was present at this conference and examined taxpayer's brief on amortization. The question arose as to whether or not the taxpayer should be allowed amortization under the statute regarding the production of articles contributing to the prosecution of the war. Additional detailed data was requested of the taxpayer in substantiation of its claim. At this conference Mr. Watkins, the unit's engineer, after having asked the taxpayer to submit additional data, requested the conferees to withhold final action in the case until a field report could be submitted by him. This request was granted by the conferees and the conference adjourned after having approved the following:

The case will be held in the section pending receipt of the amortization engineer's report.

On October 14, 1924, the production committee, without waiting for Engineer Watkins's report and apparently without regard to the action taken by the conferees, approved taxpayer's claim in full ($19,890.64) as being "reasonable."

Indiana Rubber & Insulated Wire Co., Jonesboro, Ind.: This taxpayer was engaged in the manufacture of automobile tires, bicycle tires, and insulated wire and cables. It had no Government contracts, but during the war period the demand for its products increased sufficiently to warrant certain extensions being made to its plant and equipment.

A claim for amortization in the sum of $17,261.10 was submitted in the form of a sworn statement. This claim was based on "value in use."

The taxpayer also claimed depreciation over and above that usually claimed and allowed on facilities of a similar character for the reason that it was compelled to operate its plant "double time" during 1918 and 1919.

The normal depreciation claimed varied from 3½ per cent on buildings to 20 per cent on reels and vulcanizing pans, while the additional or overtime depreciation claimed varied from 6 per cent on "machinery" to 10 per cent on reels and vulcanizing pans.

The case was not referred to the appraisal section of the unit for investigation and report. Consequently no field report was submitted. Instead, the production committee acted in the case on October 14, 1924, and allowed the claim in the full amount, $17,261.10.

As far as can be learned by a careful study of the record in this case, as submitted to our engineer, the production committee had no data upon which to base its recommendation other than the taxpayer's brief.

It is our engineer's opinion that the case was of sufficient importance and involved questions of a sufficiently debatable character to warrant a field investigation, or at least a "regular" detailed report by one of the unit's engineers. As the case now stands (in so far

as the record shows) the only explanation of the allowance by the production committee is the following recommendation above referred to:

Recommended that taxpayer's claim for amortization of $17,261.10 be allowed in full as reasonable, the spread to be made according to regulations.

The CHAIRMAN. Just a moment there. What is the name of the concern you reported on ahead of that one?

Mr. MANSON. That was the Wabash Canning Co.

The CHAIRMAN. In reading that report you refer to the fact that in all of the taxpayer's returns he made no claim for amortization. I wondered what suggested to him to make a claim at that late hour, after having made no claim in his returns.

Mr. THOMAS. I could not answer that, Senator. I have no idea. I suppose, for instance, taxpayers talk things over among themselves, and possibly he had heard that some one else received amortization under similar conditions.

The CHAIRMAN. Then, after all these tax returns have been made, and no claim made in them for amortization, the taxpayer makes a claim for amortization, going back over the period for which he had made returns, and during which he had made no claims, and had received an allowance.

Mr. THOMAS. Yes, sir.

Mr. MANSON. Esmueller Mill Furnishing Co., St. Louis, Mo.

This taxpayer was engaged in the business of manufacturing flour-mill machinery and supplies. According to a report of the unit's engineer, the taxpayer in 1918 purchased an additional facility in the shape of a boring and milling machine in order that it might take care of its war-time business and it is upon the cost of this machine that it based its claim for amortization in the sum of $2,000.

A field investigation of this case, together with a report, was submitted by Engineer A. J. Henriques of the appraisal section. Mr. Henriques recommended an allowance of $1,355.89, which allowance was based on the replacement cost of a machine of the same type. The engineer further states that from the data furnished by the taxpayer at the time of the investigation, it was apparent that the machine in question was in full use; further, that the taxpayer made no claim for amortization based on a reduced value in use and it was for that reason that he used the replacement cost basis in his computations.

There is found in the record of this case a pencil memorandum dated August 5, 1924, but unsigned, in which the following appears:

The base of claim was lower replacement value but taxpayer used as basic date April 6, 1917, instead of June 30, 1916, and did not apply bureau's ratios. The information furnished by the taxpayer was not in accordance with article 189, regulations 62.

Also:

A–2 letter sent taxpayer on August 7, 1923. * * *

Also:

Taxpayer submitted protest dated August 31, 1923.

Also:

In its protest taxpayer states that the engineer's amortization allowance is wholly inadequate and at the same time submits different costs, i. e., $6,340, cost of Lewis boring and milling machine, plus $400 for cost of freight and installation, making a total of $6,740, against the cost figure $6,350 submitted

by taxpayer with its original claim and against the cost figure "stated to have been $6,270," which the engineer has used in his computation of amortization.

The taxpayer does not protest the engineer's allowance on the original basis of its claim, i. e., lower replacement value, but on a different basis, lower value in use.

During the war taxpayer was engaged in manufacturing mill machinery and doing general repair work for powder and munition manufacturers, flour and cotton mills, and others, as stated in revenue agent's report dated June 20, 1922.

The taxpayer states in a brief dated March 31, 1924, that the company makes a friction-clutch pulley, grain and flour mixers, and a quite extensive line of flour-mill machinery and supplies.

In consideration of the character of the taxpayer's business, such as general repair work, etc., it is suggested that this case be assigned for reexamination in the field.

In its letter dated September 18, 1924, the taxpayer submitted a revised claim for amortization in the sum of $3,152.50.

On September 22, 1924, Deputy Commissioner Bright addressed a communication to the taxpayer, in which he stated:

Receipt is acknowledged of your letter dated September 18, 1924, and the inclosed amortization schedule in duplicate, which have been referred to the engineer assigned to the case for the necessary attention.

On October 2, 1924, the production committee acted on the case and recommended an allowance for the full amount claimed, or $3,152.50, as is usual in cases of this character which were handled by the production committee. No reason whatever was given for the overriding of the unit engineeer's report, but the total amount claimed was allowed without any explanation.

The next is the Interlake Engineering Co., of Cleveland, Ohio: Taxpayer filed claim for amortization in the sum of $11,787.93 on facilities costing $23,575.86, as follows:

One Ingersoll T and Imperial type, No. 10, air compressor, motor driven, W. E. and M. Co., 3-phase, 60-cycle, 220-volt, 251 amperes, cost $3,163.80.

One Beatty, No. 6, punch and shear, 48-inch, cost $7,410.09.

Miscellaneous tools, air rivets, hammers, caulkers, etc., cost $13,001.97, making a total cost of $23,575.86.

A field examination of this claim was made by unit engineers H. F. Coombs and J. P. Moore, and as a result a report was submitted signed by both Mr. Coombs and Mr. Moore in which amortization was allowed in the sum of $11,787.93. Subsequently, or on November 10, 1923, the taxpayer protested this allowance and to all intents and purposes made claim for additional amortization in the sum of $19,829.37, made up as follows:

Fencing yard, $1,800.40; electric lights, $4,478.97; track extensions, $2,250; grading yard, $800; and building mold loft and office, $10,500; making a total of $19,829.37.

There is nothing in the record to indicate that a regular investigation was made on this additional claim. There is, however, a copy of an A–2 letter which was sent to the taxpayer on November 6, 1924, to which is attached the computation of the taxpayer's tax liability. In this computation the total allowance for amortization is shown in the sum of $25,567.30. This includes the $11,787.93 above referred to as having been allowed by the unit's engineers.

On October 7, 1924, the production committee acted on this case and adopted the following recommendation:

Recommended that amortization be allowed as follows based on the additional information furnished by the taxpayer in its protest: Fencing yard,

$1,800.40; electric lights, $4,478.97; track extension, $2,250; grading yard, $0; mold loft and office building, $5,250; total, $13,779.37. This recommendation voids report dated August 8, 1922. The above amount should be spread according to regulations.

From the above it would seem that the intent of this recommendation was to disallow the allowance made by the engineers in their report of August 8, 1922. However, the case was finally closed by an allowance of both amounts, or a total of $25,567.30.

On January 6, 1925, the production committee evidently realized that an error had been made in the recommendation of October 7, 1924, and made a supplemental recommendation, as follows:

Recommended that amortization be allowed as follows based on the additional information furnished by the taxpayer in its protest to R. A. R., which disallowed writing off cost of buildings and improvements, $19,829.37. Fencing yard, $1,800.40; electric lights, $4,478.97; track extension, $2,250; grading yard, $0; mold loft and office building, $5,250; total, $13,779.37. This allowance is in addition to amortization allowed in engineer's report dated August 8, 1922. The above amount should be spread according to regulations, as was done with the former allowance.

Our engineer has carefully investigated the taxpayer's additional claim in this case and has noted the reasons given in support of the several items involved. The record shows that an allowance was made in the full amount claimed on the "fencing of the yard," "electric lights," and "track extension," whereas the cost of "grading the yard" was disallowed in full and the cost of "mold loft and office building" was allowed in the sum of $5,250, or 50 per cent. It is not clear how the total cost of the first three items mentioned above may be allowed as amortization, as from the very nature of the facilities involved there must have been some residual value of same, even if it was estimated as low as scrap value, and while our engineer is not in a position to state what he considers to be a fair allowance on these facilities he is of the opinion that a field investigation should have been made by the appraisal section in order that an intelligent recommendation could have been made.

It must be apparent that a fence around a yard will be useful as long as the yard is in use.

Tregoning Boat Co., Seattle, Wash.: This taxpayer was engaged in the business of manufacturing metail life boats, life rafts, and similar articles. In its original return for 1918, the taxpayer claimed amortization in the sum of $18,825 and also claimed a deduction of the same amount in its 1919 return, making a total claim for amortization of $37,650.

In September, 1924, Mr. J. M. Clack, appraisal engineer, visited the taxpayer's office and investigated the claim. Subsequently, Mr. Clack submitted a report in which he recommended an allowance in the sum of $11,144.85.

From the record it would appear that this taxpayer made an amended return in which amortization was claimed in the sum of $11,442.85.

On October 7, 1924, the production committee, without waiting for a report from Mr. Clack, and so far as the writer has been able to ascertain, without any first-handed information upon which to base a recommendation, recommended an allowance in the full amount claimed, or $11,442.85. This recommendation reads as follows:

Amortization claimed on amended returns of $11,442.85 is allowed in full as reasonable.

There appears in the file a copy of engineer Clack's report which bears his signature, to which is attached a pencil memorandum as follows:

Tregoning Boat Co.: Taxpayer's claim for 1918 allowed in full as reasonable before this report was submitted.

Taxpayer also claimed amortization in 1919, this being covered in this report. J. M. C.

From the above-quoted memorandum it would seem that the committee had entirely ignored the taxpayer's claim for 1919 amortization.

Mr. GREGG. In connection with that last case, the difference in the two allowances was only $1.05.

Mr. THOMAS. They made a similar claim for both 1918 and 1919. Mr. Clack made a field examination and recommended an allowance of eleven thousand and odd dollars for 1919. The committee, without first having received the tax report, recommended an allowance in full for 1918, and did not consider at all the claim for 1919. You see, the total amount was the sum of the two claims for 1918 and 1919.

Mr. GREGG. But they just allowed the one amount?

Mr. THOMAS. They allowed just the one amount, but they did not consider the other. The amount they allowed they allowed in full before Mr. Clack reported on the other amount.

Mr. NASH. But there has been no recommendation for 1919, so far as this production committee is concerned.

Mr. THOMAS. No; no action by the committee, so far as the record shows.

The CHAIRMAN. Is there any record in the bureau to show how many cases this production committee closed, Mr. Nash?

Mr. NASH. I did not know there was such a committee until this morning.

Senator WATSON. I was wondering what the production committee is.

Nr. NASH. That is, I knew there was a production committee, but I did not know it was functioning in this way.

Senator WATSON. What is the production committee?

Mr. NASH. There is a production committee in each audit division who are supposed to be the representatives of the deputy commissioner, and their function is to keep in touch with the cases that are going through, and see that they keep moving, and then report to the deputy commissioner each day the number of cases that go through a division, the number received, the number closed, etc.

The CHAIRMAN. It is not intended, then, that they should actually pass upon cases?

Mr. NASH. No, sir; I never understood that to be part of their function at all.

Mr. MANSON. I had always supposed that their function was to expedite business.

Mr. NASH. Yes, sir; to push the cases along, so to speak, and to see that the business keeps moving.

Mr. MANSON. Yes.

Senator WATSON. They have nothing to do with production of an industry?

Mr. NASH. They are not technical men.

Senator WATSON. They are to get production in the department, as I understand it; that is, to produce results.

Mr. NASH. Yes, sir.

Senator WATSON. I was wondering where they got any authority to pass on cases.

Mr. THOMAS. I might say, Senator, that I had a talk with Mr. Rashleigh, who is the head of the production committee, which functions as Mr. Nash has just explained. It seems that at that time, as I stated in my report, there were quite a number of small cases, under $25,000, hanging fire in the engineering unit. Mr. Rashleigh, in his capacity of trying to push cases along through the department, recommended to Mr. Greenidge that this production committee be allowed to pass on small claims for amortization. That was approved by Mr. Keenan and by Mr. Greenidge. Then they started to function.

Mr. MOSS. Is that in the form of any written memorial of any kind?

Mr. THOMAS. I have never seen anything to indicate that it was.

Mr. MANSON. Did you ask for it?

Mr. THOMAS. I asked Mr. Rashleigh how the committee started to function in this procedure, and he told me of the approval by Mr. Greenidge and Mr. Keenan on his recommendation.

The CHAIRMAN. How long did that committee function?

Mr. THOMAS. So far as I can find, from the first part of October and through November. Mr. Rashleigh was rather vague.

Mr. NASH. May I ask if there is anything in the record to show whether Mr. Bright had knowledge of this work, or whether he approved it?

Mr. THOMAS. No, sir; nothing whatever.

Mr. MOSS. I think, Mr. Chairman, Mr. Nash will want to inquire about this work of the so-called production committee.

Mr. THOMAS. I do not know whether this committee confined its work to amortization cases or not. I do not know whether they attempted to do anything in the oil and gas section, the metals section, or the nonmetals section. Mr. Parker or Mr. Manson, I think, wrote to Mr. Bright, under date of May 14, asking him for a complete list of all cases handled by that committee, giving the amount allowed, the amount claimed, the date of allowance, and I think whether or not it was acted on by an engineer, and if so, what the engineer's recommendation was. We have received no answer to that.

The CHAIRMAN. Did you see that letter, Mr. Nash, that Mr. Thomas refers to?

Mr. NASH. No, sir.

Mr. MANSON. That letter was signed by Mr. Parker, with my approval.

The CHAIRMAN. And delivered to Mr. Bright?

Mr. MANSON. Yes, sir.

Mr. THOMAS. Mr. Greenidge had it, because he came to me either yesterday or Saturday and asked me if he could have another copy of it, and I supplied him with another copy of it.

Senator WATSON. How many cases did that production committee actually deal with, Mr. Thomas?

Mr. MANSON. That is just the information that we have asked for.

Mr. THOMAS. I have only had 17 of them before me.

Mr. MANSON. Mr. Thomas's work, outside of some general duties, has been confined to amortization.

(At 1.10 o'clock p. m. the committee adjourned.)

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