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 18, 23, 25, 26, 30, MAY 4, 5, 11, 12, 16, 20, AND 29, 1925

PART 17

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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

WEDNESDAY, MARCH 18, 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) and Watson.

Present also: Mr. L. C. Manson, of counsel for the committee; 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. James M. Williamson, attorney, office of solicitor, Bureau of Internal Revenue; and Mr. F. T. Eddingfield, engineer, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. This is the matter of the settlement of the tax of the corporation known as George Bros., of Pittsburgh, for the years 1917 to 1921, inclusive.

The amount of tax involved in the difference between the additional tax assessed by the bureau, or proposed to be assessed by the bureau, according to certain A-2 letters which will be offered in the record, and the amount actually assessed, is $158,137.23.

The point involved is the matter of deductions for the compensation of the officers of this corporation.

It appears that all of the stock of this corporation was held by five salaried officers. These officers had fixed salaries, which ranged from $2,000 a year to $4,200 a year. These salaried officers had an arrangement with the corporation, under which the corporation was to distribute 10 per cent of its net earnings as dividends.

Senator WATSON. What is the business of this taxpayer, may I ask you?

Mr. MANSON. The real estate business—real estate brokers, rentals, etc.

Senator WATSON. And where are they located?

Mr. MANSON. Pittsburgh, Pa.

Senator WATSON. All right.

Mr. MANSON. Their arrangement provided that 10 per cent of the earnings of the corporation should be distributed as dividends and that the balance, the 90 per cent of the earnings, should then be distributed among these four officers in proportion to the amount of stock that each of the officers held.

It was claimed by the corporation that this distribution of 90 per cent of the earnings constituted additional salaries or compensation for the officers of the corporation, and, as such, was deductible expense, which would have the earnings of the corporation only 10 per cent of the actual net earnings, with the result that for the year 1917 they returned an income upon which a tax of $238 was levied, and for the years 1918, 1919, 1920, and 1921 they returned no taxable income.

The facts are stated in a memorandum prepared by Mr. Box, chief auditor——

The CHAIRMAN. Of the committee?

Mr. MANSON (continuing). Of the committee. This memorandum is brief, and I will read it:

MARCH 12, 1925.

In re: George Bros., Pittsburgh, Pa.

This taxpayer is a corporation, organized under the laws of the State of Pennsylvania in 1902, and is engaged in the real estate and renting business.

It submitted an income-tax return for the year 1917 which showed a tax liability of $238.

On August 18, 1922, Revenue Agents A. H. Toothman and G. W. Pitts, of the Pittsburgh (Pa.) district, submitted a report of their investigations of 1917 recommending an additional tax of $4,852.72. The items involved which resulted in this additional tax were a donation to the Red Cross of $300 (not allowable as a deduction to a corporation) and payments aggregating $35,055.21 to four officers of the corporation, who were its only stockholders.

The records indicate that in 1910 the taxpayer agreed with its officers that it would pay them salaries in stated sums, and after payments of 10 per cent of the earnings of the corporation were distributed at the end of each quarter of each year as dividends the balance, or 90 per cent, would be paid to them as additional compensation in proportion to the stock owned by them at that time.

The agents decided that these payments were dividends and not additional compensation, and that, therefore, the corporation was taxable on all of such payments as income. They also reported that in their opinion, in view of the fact that the corporation did not buy or sell or deal in real estate and no invested capital was needed except for contingencies, that it was entitled to the benefit of personal service classification under section 209 of the revenue act of 1917.

This feature of the revenue agents' report was overruled by the bureau, and is set forth only to explain the large disparity between the amounts of additional taxes recommended by the agents and by the bureau. The report in question was forwarded by the revenue agent in charge at Pittsburgh and received in the public utilities and personal service section of the personal audit division of the Internal Revenue Bureau on November 6, 1922. On January 11, 1923, an A–2 letter was mailed to the taxpayer notifying him of a proposed additional assessment of $21,760.97.

This A–2 letter is marked "Exhibit A" and is offered as a part of our presentation of this matter.

In this letter the bureau advised the taxpayer that its claim for assessment at the 8 per cent rate under the provisions of section 209, revenue act of 1917, was denied, and the taxes were computed at the rate provided by the 1917 act for corporations having invested capital.

The taxpayer requested a conference, which was arranged for February 13, 1923, at which time Mr. L. E. Rusch appeared as the taxpayer's representative. The conferees reported that Mr. Rusch stated that owing to the limited amount of time he had had he had not been able to furnish a brief, but that he would submit one

prior to March 12, 1923, and he was advised a conference would be arranged for 11 o'clock on that date.

The minutes of this conference are offered as Exhibit B.

On March 5, 1923, the brief was filed in this case by the taxpayer.

Mr. Rusch, who represented the taxpayer in this case, was formerly assistant chief of the consolidated returns subdivision of the special audit division in the Income Tax Unit, from which position he resigned on November 15, 1922.

It will be noted that that was just a short time before Mr. Rusch appears as this taxpayer's representative, and the power of attorney is offered as one of the exhibits, which shows that within two weeks after Mr. Rusch retired as the assistant chief of the consolidated returns subdivision he had a power of attorney as representative of the taxpayer in this case.

The file of the case contains a power of attorney executed by the taxpayer in favor of William A. Seifert; Reed, Smith, Shaw, and McClay; and Louis E. Rusch, on November 28, 1922 (see Exhibit C), 13 days subsequent to the latter's resignation from the Bureau of Internal Revenue.

The records fail to show that the March 12, 1923, conference was held, but on that date Mr. Rusch addressed a letter to the Commissioner of Internal Revenue requesting that the entire file of the taxpayer be forwarded to the consolidated returns division (of which he was formerly assistant chief), as there was a question of affiliations for consideration. (See Exhibit D.) On the same date D. W. Bell, chief of the public utilities and personal service section, referred the file to the head of the consolidated division by letter (see Exhibit E), and also advised the collector of internal revenue at Pittsburgh that additional facts had been presented since the additional assessment of $21,687.96 was sent for schedule to the list, and that he would be advised of the final decision at an early date. (See Exhibit E.)

Shortly thereafter, and prior to March 30, 1923, a certificate of overassessment (the file copy of which was undated) was sent to taxpayer notifying it that the assessment of additional taxes made in bureau letter of January 11, 1923, was not on the proper basis; that its tax liability would be redetermined, and that they found an overassessment of $21,760.97, the amount which had been assessed on March 5, 1923. (See Exhibit G.)

The effect of that was to reverse the former action in levying this additional assessment, and the additional assessment was based upon the determination that the allowance of 90 per cent of earnings as additional compensation to the officers was not a proper deduction.

On March 30, 1923, the collector of internal revenue at Pittsburgh was advised by Deputy Commissioner Chatterton that a certificate of overassessment had been issued for $21,760.97 for the purpose of cancellation in entirety of the additional assessment of that amount. (See Exhibit H.)

The auditor, Mr. C. F. Pollock, who handled the case in the consolidated returns section, was advised by his chief (Mr. H. L. Robinson, chief of section B) to allow the salaries as deductions from income, and in forwarding the case to the reviewer, attached a memorandum in pencil to indicate his authority for arriving at the deduction. (See Exhibit I.)

By allowing this additional compensation as a deduction from income nothing remained on which to assess additional tax except the $300 disallowed by revenue agent on account of donations, and accordingly on July 17, 1923, an A–2 letter was mailed to the taxpayer advising him of additional tax of $18 (6 per cent of the last above-mentioned item), and the case for the year 1917 was closed on that basis. (See Exhibit J.)

Under date of June 28, 1922, Revenue Inspector Pitts, of the Pittsburgh, Pa., district submitted a report of his investigation of the taxpayer for the years from 1918 to 1921, recommending assessment of additional taxes in the following amounts:

1918	$21,590.54
1919	35,395.75
1920	46,980.52
1921	38,518.61

There were no taxes paid by the corporation for any of these years on submission of its original returns. The agents state:

> The books of the company show no profit in any of the taxable years. This is caused by the fact that when the quarterly profits are arrived at 10 per cent is distributed as dividends and the remaining 90 per cent distributed as increase in compensation to the stockholders who are also the officers of the company. This distribution is disallowed as expense throughout this report and classed as dividends. (See Exhibit K.)

He also invites the attention of the bureau to the fact that the salaries of the officers are low and are regarded by them as drawing accounts chiefly, and recommends that an adjustment be made on this account.

Notwithstanding the fact that the payment of the 90 per cent of the profits of the corporation for the year 1917 to its officers (who are the only stockholders) was decided by the bureau to be additional compensation and not dividends, prior to July 17, 1923, the bureau advised the taxpayer by A–2 letter, dated November 21, 1923, that these items were considered as a distribution of profits and proposed additional tax aggregating $142,584.36. (See Exhibit L.) That is, as to the years after having determined that this extra compensation was a deductible salary for the year 1917, for the years 1918, 1919, 1920, and 1921 the bureau determined that they were not deductible salaries and proposed an additional tax of $142,584.36, based upon a disallowance of that deduction.

The taxpayer filed a brief under date of December, 1923, protesting the proposed assessment of additional tax above mentioned, and submitted copies of agreements of officers dated June 3, 1910, indicating that the corporation agreed to pay them an annual compensation consisting of a fixed salary and a percentage of the net earnings of the corporation. The inspector's report failed to show the fixed salaries of the officers, although he refers to the low salaries paid them.

The copies of agreements attached to the brief indicate that the fixed salaries for 1910 were as follows:

W. D. George, president	$4,200
C. S. Chubb, vice president	3,000
W. A. Feltyberger, secretary	3,300
F. S. Guthrie, treasurer	3,000
W. L. Davis, renting agent	2,000

A conference was granted the taxpayer on January 29, 1924. Among other things, the conferees stated in their report that the taxpayer claimed that its agreements were entered into from year to year in relation to salaries taken, and were granted the privilege of presenting further information relating to this matter. This report contains a note, evidently written subsequently, to the effect that the taxpayer could not furnish copies of new contracts, as promised, and recommended "that salaries be allowed as taken in view of the personal element in the income."

A-2 letters were written on March 10 and 15, 1924, which allowed the payments of 90 per cent as additional compensation to the officers, and proposed assessment of additional taxes as follows:

1918	$376.30
1919	1,678.69
1920	2,383.86
1921	1,751.26

By deciding that these payments were additional compensation instead of dividends, this taxpayer saved $158,137.23 in taxes, as shown by the following statement:

Year	Original tax	Additional tax proposed by A-2 letters	Additional tax collected
1917	$238.00	$21,760.97	$18.00
1918	None.	21,590.44	376.30
1919	None.	35,395.39	1,678.68
1920	None.	46,980.52	2,383.86
1921	None.	38,618.01	1,751.26
Total		164,345.33	6,208.10

A statement is attached (see Exhibit M) showing the percentage of stockholdings by the different officers, and the amounts paid from 1917 to 1921, inclusive, to each of them.

W. D. George, president, transferred 7½ shares of stock on July 1, 1918, to W. A. Feltyberger, secretary-treasurer. On July 1, 1920, the former transferred 5 shares of stock to G. W. Feltyberger, assistant secretary. The amount of earnings paid to these three officers changed in the same proportion as their stockholdings.

There is nothing in the records to indicate whether or not the officers performed a greater or less amount of services after the transfers, but this fact is evidence that the payments called additional compensation, based entirely upon the stockholdings of the officers, were in reality distribution of profits or dividends and not compensation for services rendered.

The taxpayer claimed that the agreements with its officers were made long before the excess profits tax law was thought of, and therefore could not have been made with a view of evasion of the taxes provided for by that law; however, the first agreement, made under date of January 3, 1910, was subsequent to the corporation excise tax law of June 5, 1909, which provided for a tax of 1 per cent on corporation income.

Senator WATSON. What reason is given by the department for holding one way in two or three years and another way in the other years?

Mr. MANSON. The final outcome of that as to all of these years is that they hold this distribution of 90 per cent was a payment of salaries, and as such is deductible from income instead of a distribution of earnings. That is held as to all the years.

Senator WATSON. As to all of the years?

Mr. MANSON. Yes.

The CHAIRMAN. But they did rule two ways?

Senator WATSON. Yes; and I was wondering what the reason was.

Mr. MANSON. I pointed out that it was proposed to assess the 1917 tax and that action was reversed, but after that conclusion had been reversed it was then proposed to assess the 1918, 1919, 1920, and 1921 taxes, and that subsequently that action was reversed, so that the same action was taken with respect to all of the years. I submit that if the law with respect to the deduction for salaries of corporate officers is to receive the construction that has been given in this case it is optional with any corporation whose stock is held by its officers as to whether it pays any corporate tax or not. Any corporation whose stock is held by a small group can make an arrangement with the stockholders whereby such stockholders will receive compensation, which shall consist of 100 per cent of earnings. I can see no particular reason in this case why they did not take the whole thing. If 90 per cent of the earnings can be distributed, as they were in this case, and thereby the payment of a tax is evaded, it is very easy to distribute 100 per cent of the earnings.

Senator WATSON. Have you stated anywhere, Mr. Manson, what this made these salaries to these people?

Mr. MANSON. Yes; I did state that the salaries ranged up to $4,200.

The CHAIRMAN. No; Senator Watson asked you what it made after adding all of these distributions.

Senator WATSON. Yes.

Mr. MANSON. I did not state that, but the exhibits show it here.

Mr. Box. That is the last exhibit, Exhibit M, I think. That is just the distribution of dividends.

The CHAIRMAN. Which would be added, of course?

Mr. MANSON. Yes. In 1917 the dividends distributed to W. D. George amounted to $16,651.23; to F. S. Guthrie, $9,640.18; to W. A. Feltyberger, $7,011.04; and to W. L. Davis, $1,752.76.

Senator WATSON. That is the distributive share of each in addition to their salary?

Mr. MANSON. In addition to the fixed salary.

Senator WATSON. What was the capitalization of that company?

Mr. MANSON. I think it was $16,000, was it not?

Mr. Box. I believe it was. It was very small.

Mr. MANSON. $16,000.

Senator WATSON. And what was the volume of business transacted?

Mr. MANSON. I do not know the volume of business, but in 1921 the total amount of earnings distributed was $84,054.86.

The CHAIRMAN. Which represented 90 per cent of the earnings?

Mr. MANSON. Well, these payments made to the officers represented the balance of earnings made by the corporation after the distribution of 10 per cent dividends.

The net income in 1917 was $39,321.89. In 1918, 90 per cent of their net earnings was $33,926.41; in 1919, 90 per cent was $77,743.14; in 1920, 90 per cent was $100,409.72; and in 1921, 90 per cent was $84,054.86.

The CHAIRMAN. In your examination, Mr. Box, have you found any policy with respect to treating these distributions of earnings in this manner?

Mr. BOX. I have not, Mr. Chairman, but the usual procedure in the field is where a distribution is made by a corporation on a certain percentage, if it is in the same proportion as the stocks held by the officers in a close corporation it is held as dividends and not additional compensation.

The CHAIRMAN. Mr. Gregg, do you want to say something at this time?

Mr. GREGG. Yes, sir. I want to ask several questions if I may.

What is the criticism, if there is a general criticism based on this case?

Mr. MANSON. My criticism of this case is that it is manifest from the statement of facts that this is a distribution of earnings among stockholders, and not salaries.

Mr. GREGG. Without conceding that, does that amount to a general criticism of the bureau, or is it a criticism of the settlement of this one particular case? I mean, is it claimed that this represents what is usually done in the settlement of similar cases? Does counsel for the committee claim that, under the rulings, the general rulings of the bureau, the general precedents—and there are hundreds on this very point—that a close corporation may, by paying out its earnings as salaries, evade the corporate income tax?

Mr. MANSON. It is manifest, in any case where the rule is applied that was applied in this case, they can evade the tax by this method of distributing their earnings. To what extent this practice has been permitted by the bureau I am unable to say.

Mr. GREGG. Well, Mr. Chairman, I think I can show very conclusively that it is not possible for a corporation, by the payment of its earnings as salaries, to evade the income tax.

I would like at this time to give you a brief statement of the history of this question in the bureau.

The CHAIRMAN. Let me ask you at this point, Mr. Gregg, whether, in view of that general statement of yours, you think this case was properly settled?

Mr. GREGG. I do not know, sir. I can not tell without going into the facts more fully. I will get to this case in just a moment, if I may.

The CHAIRMAN. Yes.

Mr. GREGG. I would like to give you the general procedure.

The CHAIRMAN. All right.

Mr. GREGG. When the 1917 excess-profits tax was passed, this question for the first time became an acute one. The act provided for the deduction by a corporation, in computing its net income, of salaries paid to officials and employees of the corporation. We held that this meant only true salaries, and that if, in fact, the amount so distributed was not true salary but a distribution of earnings and profits, it was not deductible by the corporation and should be treated as a dividend.

We had very slim legal grounds for our ruling, under the 1917 act, and we went to court on it. In the Philadelphia Knitting Mills case, the circuit court of appeals held with us. That court sustained our position and certiorari was denied by the Supreme Court, the circuit court holding that, under the 1917 act, we had no right to question the reasonableness of a salary in a given instance; that that was a matter entirely within the jurisdiction of the board of directors of the corporation; but if, as a matter of fact, it was not a salary, but a distribution of earnings and profits, and we could so show by the facts, then it was not deductible.

As a result of that difficulty under the 1917 act, we came to Congress when the 1918 act was under consideration and asked them to put in the act specifically a provision that the only salaries deductible by a corporation were a reasonable allowance for the compensation of officers and employees. That gave us a right for the first time to test the reasonableness of a given allowance.

Senator WATSON. Was that incorporated in the 1918 act?

Mr. GREGG. Yes; that was incorporated in the 1918 act, and has been continued in every act since then in the corporation provisions.

One of the most troublesome questions that we have had in administering the excess-profits tax law has been this question, more particularly under the later acts, as to the reasonableness of salaries in a particular case. You can appreciate the difficulty of our sitting here in Washington and passing judgment on the reasonableness of salaries paid in every type of business and industry.

The usual procedure was this: If the salary was increased in 1917 or 1918, when the question first became important, the increase would be entirely disallowed in the field if it bore any relation at all to stock ownership. It would be disallowed in its entirety as a distribution of earnings and profits. Then, in Washington, we would examine it to see whether or not we could sustain our position that it was a distribution of earnings and not salary.

I do not think there has been a single point that the committee on appeals and review has been called upon to pass upon more frequently than upon that particular question, and it has come down to approximately this point in our general rulings, and I will be prepared to cite to the committee probably a hundred precedents on this in decisions of the committee on appeals and review: If the salaries are paid to nonstockholders, we allow them, unless it is to the wife of a majority stockholder, or something of that sort. If it is to any person entirely outside of the corporation, we allow it as salary. If it is salary paid under a contract entered into prior to the income tax laws, we almost always allow it. Sometimes we do not. If, however, there is an increase voted to the stockholders after the rates became high, when it became to the advantage of the corporation to do so, and if that increase bears any relation whatever to stock ownership, then we disallow it in full.

That is a statement of the general attitude of the bureau, and I can cite you hundreds of cases showing it.

I have just one case in mind now where, on January 1, 1917, a corporation—as I remember it, it was the New York Talking Machine Co.—had permitted the purchase of its stock by its employees. They continued as fixed salaries for 1917, they voting their own

salaries, and they were the same salaries which had been paid in the previous year when the stock was owned by outsiders. At the end of the year they voted themselves a bonus in proportion to stockholding, which was in some cases as much as five times the salary they had been receiving. They claimed that that was a deduction. We disallowed it. I handled the case personally, and that is the reason I remember it so distinctly. We disallowed it in full, on the theory that there we had a test of the value of their services by what was paid in the preceding year, and there was nothing to show that their services were any more valuable in 1917, when they were paying their own salaries, than in 1916, when the stock was held by outsiders.

That has been the general attitude of the bureau on this entire question. I wanted to bring that out to show that, if there is a criticism here it is a criticism of the settlement of this particular case, rather than a criticism of the settlement based on the general attitude of the bureau on this question.

The CHAIRMAN. In that connection I would like to say that this occurs to me, not only in the discussion that has taken place here, but in my contact with the work as it has been going along, that notwithstanding that this may not be a general criticism of the policy of the bureau with respect to this kind of cases, I think it clearly indicates the possibilities of individuals ruling differently in specific cases from what the general policy of the bureau is.

Mr. GREGG. Yes, sir; that is quite true; it is very possible.

The CHAIRMAN. I think it is equally important, Mr. Gregg, that the bureau and the public, if you please, should know that these particular things can be done and are done; and I do not think the answer to Mr. Gregg's question was conclusive as to the reasons for the reporting of this particular case. In other words, you inferred that we may not be devoting our time to an investigation of the policy of the bureau, but trying to find fault with a specific case, and even if the latter were so it would be justifiable to investigate the administration of a particular case and show the possibilities in a particular case, even though it was an exceptional instance.

Mr. MANSON. There is one other thing that I wanted to bring out here.

Senator WATSON. When was this case decided?

Mr. MANSON. The A-2 letters here are dated March 10 and 15, 1924.

There is one other fact that I want to call particular attention to here, and that is the fact that an assistant chief of the consolidated returns sections resigned. Thirteen days later he appeared with a power of attorney for this taxpayer. This case was pending in another division. His first act was to request that it be transferred to the division of which he had been assistant chief, and that the first action reversing the——

Senator WATSON. Was the transfer made?

Mr. MANSON. Yes; that the first action reversing the policy with respect to the treatment of this kind of a reduction in reference to this particular case took place immediately after that.

The CHAIRMAN. I would like to ask Mr. Gregg if he does not think that there is some justification for a criticism of this particular case, in view of the history surrounding it?

Mr. GREGG. I was just coming to that.

Is there anything to indicate that Mr. Rusch, who handled the case after he got out of the department, had any personal knowledge of the case while he was in the department?

Mr. MANSON. I do not know anything about that.

Mr. GREGG. I think that is quite material.

Mr. MANSON. I do not consider it at all material.

Mr. BOX. There is not.

Mr. GREGG. There is not, Mr. Box?

Mr. BOX. No.

Mr. GREGG. Then you come to this, Senator—and it is something you know exists, and we all know exists, that men who get out of the department are permitted to appear in cases if they have had no personal knowledge of the case while it was pending in the department, and if they are not, when they take the case, handling a claim for refund against the Government. That is the situation at the present time. If Congress wants to remedy that, of course it can do so.

The CHAIRMAN. I understand, but do you place any significance in the fact that the record was transferred to the division that he had formerly been assistant chief of, and where he was in close touch and familiar with all of the employees?

Mr. GREGG. Not as I heard the statement made by counsel for the committee. It was said that the case involved a question of affiliation.

Mr. MANSON. Well, it was ruled that it did not.

Mr. GREGG. He got the transfer on the ground, as he alleged, that a question of affiliation was involved.

Mr. MANSON. The department ruled that it was not, but instead of then transferring the case back to the division where it originally was, the division which secured jurisdiction on the ground that the question of affiliation was involved retained jurisdiction after it had been determined that the question of affiliation was not involved.

Mr. GREGG. Was it determined that there was no question of affiliation involved, or was it determined that there was no affiliation involved?

Mr. MANSON. Well, that is a distinction without a difference.

Mr. GREGG. I do not think so. Here is my point, Mr. Chairman: If there was a question of affiliation involved in that case, no matter how the question was subsequently decided, there was only one section in the bureau that had authority to pass on that question, and that is the consolidated returns section. If such a question was involved, it was entirely proper and necessary that the case go to that section. When it gets there for the determination of the question of affiliation, the section takes jurisdiction over it and disposes of the case.

Senator WATSON. Whether there be affiliation or not?

Mr. GREGG. Yes, sir. So I think it was material whether there was a question of affiliation involved in the case.

I now want to answer what the chairman said to me. I did not state what I did say with any intention of implying that there was no reason for the committee investigating individual cases which were incorrectly settled. What I did want to bring out was that that

criticism was a criticism of an individual case, and not a criticism of the general policy of the department. This particular case is entirely new to me. I did not know that the case was coming up this morning, and I thought we were to have another case, and I have nothing on it except what has been stated here.

Is there anything in the files showing why this stock was transferred between these different officers of the company, which I think you said was in 1917 and 1918?

Mr. MANSON. Not that I know of.

Mr. GREGG. May I ask Mr. Box as to that?

Mr. BOX. There is nothing in the files showing why the transfer was made.

Mr. GREGG. Was there anything shewing a consideration for the transfer?

Mr. BOX. No; it shows that the transfer was made about the 1st of July; that is, the income changed from the different officers in the third quarter of each year. There were two transfers, one of seven and a half shares and one of five shares, and each time the transfer was made the income for the succeeding quarter changed in proportion.

Mr. MANSON. We merely cite that to show that this distribution was in no way based upon the services rendered by these officers, but that the slightest change in stock holdings, even in a case of five shares in one instance and seven and a half shares in the other, was immediately reflected in the distribution.

The CHAIRMAN. I think the committee understood that.

Mr. GREGG. We will go into this case thoroughly and submit a reply to the committee, but these facts occur to me right now, to which I would like to draw attention:

This company earned a net income, as counsel for the committee says, of approximately $90,000 in one year—ranging from $35,000 up to $90,000. The company had practically no capital. The revenue agent has classified it as a personal service corporation, one using no capital. The salaries of the officers had been the same since 1910—that is, the basic salaries—the president getting $4,000 a year. The services of five officers who without capital can produce up to $90,000 a year income are, I think, on the face of things, worth much more than $4,000 a year.

Going back to 1910, when the excise tax of a corporation was a thing that no one paid any attention to, the company had adopted the policy of basing salaries, in addition to these drawing accounts, which were practically nominal, on the earnings of the company—something that is not at all unusual in a case where the income of a company is attributable almost entirely to the activities of its stockholders and officers. This policy was continued up through the tax years. There was no change made after the high tax years in connection with this policy. I think it is obvious from that statement of the facts that they had paid salaries before the high tax years in excess of these basic nominal salaries and that they were entitled in the high tax years to a deduction for salaries in excess of those amounts. Now, whether they were entitled to the entire 90 per cent is a different question; but it seems to me that if that was a reasonable salary for the services rendered by those men, they were probably entitled to it.

That is a question that we will have to go into to see whether the salaries were reasonable, considering the services that they performed. But I do not think the case, on its face, shows that it is wrong. The thing that I think is hardest to explain is as to the transfers of the stock in 1917, and that is the reason I asked Mr. Box the question. Unless there is some explanation of that, it is a very weak point; but I do not think the fact that the salaries were based on earnings affects the case materially, when the earnings of the company were attributable almost entirely to the activities of these stockholders and officers.

Mr. MANSON. On that point I would like to say if the compensation of the officers is to be increased and decreased in proportion to earnings, as occurs sometimes, that that policy can be justified. There your basic salary determines the increase or decrease, or the basis of your increase or decrease. In this instance, however, the basic salaries have nothing whatever to do with the increase or decrease, that having been predicated entirely upon the stockholding. For instance, if these officers received a bonus of 25 per cent or 30 or 50, or may be a hundred per cent, in addition to their basic salaries, when the earnings permitted it, that is one thing; but to have the earnings of the company distributed in identically the same way and in identically the same proportions as they would be distributed were they denominated dividends is a clear evasion of the law.

My point is that if this practice, or if the rule followed in this case, could be generally applied, you might just as well repeal the corporation tax.

The CHAIRMAN. I think there is a difference there, Mr. Manson. I think Mr. Gregg's point is well taken; that if, prior to the income tax act, these same percentages of distribution occurred, and have continued to occur after the excess-profits tax and other taxes have been made effective, that is a different case than if it was as you stated, only adopted for the purpose of tax evasion.

Senator WATSON. I think so, too, Mr. Chairman.

The CHAIRMAN. Yes.

Senator WATSON. That line of demarcation seems very clear.

The CHAIRMAN. But we ought to get the facts in the case.

Senator WATSON. Yes.

Mr. GREGG. We will look into the case and see whether the salaries paid these people were reasonable as compared with the services performed.

The CHAIRMAN. Yes; I think we ought to have the facts.

Mr. GREGG. Yes; we will get that for you.

Mr. MANSON. In that connection, we have $35,000 in one year and $100,000 in another.

The CHAIRMAN. Have you anything else to-day, Mr. Manson?

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

Senator WATSON. Have you concluded, then, not to treat this as a personal-service corporation?

Mr. MANSON. Yes.

Senator WATSON. They got away from that idea; they had originally treated it on that basis?

Mr. MANSON. The field agent's recommendation that the claim be treated as a personal-service corporation was rejected.

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

EXHIBIT A

STATEMENT IN RE GEORGE BROS., PITTSBURGH, PA., 1917

Additional tax, $21,687.96.

After careful consideration of the facts submitted, your claim for assessment of the 8 per cent rate under the provisions of section 209, revenue act of 1917, is denied, since the department, under the law, deems that your business is one in which the use of capital is essential and the profits can not be ascribed primarily to the personal services of the principal owners.

NET INCOME

Net income reported		$3 966.68
Plus:		
Donations disallowed		300.00
Distribution of profits		35,055.29
Net income adjusted		39,321.89

Donations, gifts, gratuities, etc., are held not to be operating expenses, and therefore are not allowable deductions from gross income.

Net earnings for the year		$39,321.89
Less tentative tax		21,237.30
Earnings available for dividend payments		18,084.59

ADJUSTMENT TO INVESTED CAPITAL FOR EXCESS DIVIDEND PAYMENTS

Dividend paid Mar. 31		$9,987.84
Available earnings to date		4,472.53
Dividend paid in excess of available earnings		5,515.31
$5,515.31 prorated for $9\frac{1}{3}\frac{1}{7}$ months		4,151.31
Dividends paid June 30	$9,987.84	
Available earnings from March 31 to June 30 (3 months)	4,521.15	
Dividends paid in excess of available earnings	5,466.69	
$5,466.69 prorated for $6\frac{1}{3}\frac{1}{0}$ months		2,748.53
Dividends paid Sept. 30	9,987.84	
Available earnings from June 30 to Sept. 30 (3 months)	4,521.15	
Dividends paid in excess of available earnings	5,466.69	
$5,466.69 prorated for 3 $\frac{1}{6}$ months		1,381.86
Dividends paid Dec. 31	9,987.84	
Available earnings from Sept. 30 to Dec. 31 (3 months)	4,521.15	
Dividends paid in excess of available earnings	5,466.69	
$5,466.69 prorated for $\frac{1}{7}$ month		14.70
Total deduction for dividends		8,296.40

INVESTED CAPITAL

Capital stock and surplus		$25,000.00
Deductions:		
1916 income tax prorated	$38.41	
Adjustment for dividend payments	8,296.40	
		8,344.81
Invested capital		16,665.19
7 per cent of invested capital		1,166.56
Exemption		3,000.00
Total deduction		4,166.56

Rate per cent capital	Income	Excess-profits credit	Balance	Rate	Amount
				Per cent	
15	$2,499.78	$2,499.78		20	
5	833.26	833.26		25	
5	833.26	833.26		35	
8	1,333.22	.26	$1,332.96	45	$599.83
Balance	33,822.37		33,822.37	60	20,293.42
Total	39,321.89	4,166.56	35,155.33		20,893.25

Total excess profits tax		$20,893.25
Net income	$39,321.89	
Less excess profits tax	20,893.25	
Amount subject to 4 per cent and 2 per cent	18,428.64	
Tax at 2 per cent		368.57
Tax at 4 per cent		737.15
Total tax liability		21,998.97
Tax previously assessed		238.00
Total		21,760.97

EXHIBIT B

TAXPAYER'S CONFERENCE

Taxpayer: George Bros.
Address: Pittsburgh, Pa.
Represented by: Mr. E. R. Rusch, Washington, D. C.

Mr. Rusch appeared for the taxpayer and requested that the conference arranged for February 13 be deferred to March 12, 1923. The representative was requested to furnish further evidence relative to the various items in the taxpayer's return, specifically, deduction for taxes, $245.75, bills and notes receivable and payable, interest paid and the connection of this taxpayer with the partnership, Edwards, George & Co.

Representative stated that owing to the limited amount of time he had had he had not been able to furnish a brief for the conference, but that subsequently, prior to March 12, 1923, he would submit a brief signed by the taxpayer.

The representative was advised that a conference would be arranged for 11 o'clock March 12, 1923.

Interviewed by:

ALBERT E. MILLER,
Auditor.
A. J. BAKER, *Conferee.*
D. W. BELL,
Chief P. U. and P. S. Section.

FEBRUARY 13, 1923.

EXHIBIT C

Know all men by these presents, that George Bros., a corporation of the State of Pennsylvania, having its domicile in the city of Pittsburgh, county of Allegheny, in said State, has made, constituted, and appointed, and by these presents does make, constitute, and appoint, William A. Seifert, Reed, Smith, Shaw & McClay, and Louis E. Rusch true and lawful attorneys for it and its name, place, and stead to appear before the Treasurer of the United States, the Commissioner of Internal Revenue, the committee on appeals and review, and/or the Income Tax Unit of the Internal Revenue Bureau in connection with any and all matters appertaining to or having to do with the 1916 and 1917 income and profits taxes of this company, hereby giving and granting unto

our said attorneys full and whole power and authority in and about the premises; and generally all and every act and acts, thing and things, device and devices, in the law whatsoever needful and necessary to be done in and about the premises, fo us and in our name to do, execute, and perform as large and amply, to all intents and purposes, as we might or could do, if personally present; and an attorney or attorneys under them for the purpose aforesaid, to make and constitute, and the same to remove and revoke at their pleasure, hereby ratifying and confirming as good and effectual, in law and in equity, all that our said attorneys or their substitutes shall lawfully and legally do by virture hereof.

In witness whereof we have hereunto set our hands and seal the 28th day of November in the year of our Lord one thousand nine hundred and twenty-two.

Recorded March 19, 1923, Income Tax Unit, administrative division.

Sealed and delivered in the presence of—

GEORGE BROS.,
By W. D. GEORGE,
President.

Attest:
[SEAL.]

W. A. FELTYBERGER,
Secretary.

EXHIBIT D

WASHINGTON, D. C., *March 12, 1923.*

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

SIR: Inasmuch as the public-utilities section raised a question of affiliation in connection with George Bros., a corporation in Pittsburgh, Pa., with Edwards, George & Co., it is respectfully requested that the entire file be forwarded to the consolidated returns subdivision for consideration of the question of affiliation.

Yours respectfully,

L. E. HUSCH.

EXHIBIT E

MARCH 12, 1923.

Head, consolidated division: In re George Bros., 307 Fourth Avenue, Pittsburgh, Pa.

Inclosed herewith is the file of the above-named corporation for the year 1917. The 1917 return was sent for schedule to collector's list, March 5, 1923.

The file is transferred to you for consideration at the request of the taxpayer, and with this return should be considered the return of Edwards, George & Co.

After careful consideration of the facts submitted the claim of this corporation to assessment under the provisions of section 209 of the revenue act of 1917 is denied, since the department under the law deems that their business is one in which the use of capital is essential and the profits can not be ascribed primarily to the personal services of the principal owners.

Your attention is directed to the carbon copy of a letter forwarded to the collector under date of March 12, 1923.

F. R. CLUTE,
Head, Corporation Audit Division.
By D. W. BELL,
Chief of Section.

EXHIBIT F

MARCH 12, 1923.

COLLECTOR OF INTERNAL REVENUE,
Pittsburgh, Pa.:

Reference is made to the return of income of George Bros., 307 Fourth Avenue, Pittsburgh, Pa., for 1917.

You are informed that the additional assessment of $21,687.96 was sent for schedule to the list, under date of March 5, 1923. Since then additional facts have been presented in form of a brief and are now being considered.

You will be advised at an early date of the final decision of the bureau.

If you desire to take up the matter further, same will be expedited by referring to IT:CA:PU-2306.

R. W. CHATTERTON,
Deputy Commissioner.
By D. W. BELL,
Chief of Section.

EXHIBIT G

GEORGE BROS.,
307 Fourth Avenue, Pittsburgh, Pa.

SIRS: This certificate is prepared for the reason that careful consideration of additional information submitted by you reveals that the assessment of additional corporation income and excess profits taxes for 1917 made in bureau letter, dated January 11, 1923, was not on the proper basis. Your tax liability will therefore be redetermined.

This action is not to be construed as preventing the assessment of any tax found due upon redetermination of your tax liability.

Amount of overassessment (assessed March 5, 1923), $21,760.97.

(The file copy of above certificate is undated and unsigned, but the following appears in pencil at the upper right corner "To Schedule 4/14/23.")

EXHIBIT H

MARCH 30, 1923.

COLLECTOR OF INTERNAL REVENUE,
Pittsburgh, Pa.:

Reference is made to return of income of George Bros., 307 Fourth Avenue, Pittsburgh, Pa., for 1917.

You are informed that a certificate of overassessment has been issued for the amount of the additional assessment of $21,760.97 sent for schedule to the list under date of March 5, 1923.

This is for the purpose of cancellation in entirety of the additional assessment mentioned, as additional information has been submitted which reveals that the assessment was not made on the proper basis and the tax liability will therefore have to be redetermined.

E. W. CHATTERTON,
Deputy Commissioner
By WM. P. BIRD,
Chief of Subdivision

EXHIBIT I

REVIEWER:

Advised by chief of section B to allow salaries.

C. F. POLLOCK.

JUNE 19, 1923.

EXHIBIT J

JULY 17, 1923.

GEORGE BROS.,
307 Fourth Avenue, Pittsburgh, Pa.

SIRS: An examination of your income-tax returns and of your books of account and records for the year 1917 discloses an additional tax liability for the year 1917 aggregating $18, as shown in detail in the attached statement.

In accordance with the provisions of section 250(d) of the revenue act of 1921 you are granted 30 days within which to file an appeal and show cause or reasons 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:SA:CR:B-CFP, and will be referred to the Income Tax Unit before transmittal to the agency designated for the hearing of such appeals.

You may, if you desire, request a conference before the Income Tax Unit in connection with the appeal, to be held within the period prior to the expiration of five days after the time prescribed for the filing of the appeal. If the Income Tax Unit is unable to concede the points raised in your appeal, it will be transmitted, together with the recommendation of the Income Tax Unit, to such agency as the commissioner may designate for final consideration.

Where a taxpayer has been given an opportunity to appeal and has not done so, as set forth above, and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement of the assessment will be entertained.

Payment should not be made until a bill is received from the Collector of Internal Revenue for your district, and remittance should then be made to him.

Respectfully,

J. G. BRIGHT, *Deputy Commissioner.*
By L. T. LOHMANN, *Chief of Subdivision.*

Schedule 1—Net income

Net income as disclosed by revenue agent's report, dated Aug. 18, 1922	$39,321.89
As corrected	4,266.68
Deduction	35,055.21

(*a*) Distribution of earnings, $35,055.21.

REASON FOR CHANGE

(*a*) The action of the unit in disallowing salaries, as shown in bureau letter dated January 11, 1923, is hereby reversed.

Schedule 2—Computation of total tax, 1917

Net income (schedule 1), $4,266.68.

	Tax
Taxable at 2 per cent ($4,266.68)	$85.33
Taxable at 4 per cent ($4,266.68)	170.67
Total tax	256.00
Previously assessed	238.00
Additional tax to be assessed	18.00

As the credit for excess-profits tax is in excess of the taxable net income, the computation of invested capital is not shown.

Statement of returns examined and resulting tax liability

Returns examined:	
George Bros., Pittsburgh, Pa.—	
Year	1917
Form	1031
Tax Liability:	
George Bros., Pittsburgh, Pa.—	
Year	1917
Additional tax	$18

The revenue agent's report dated August 18, 1922, and your brief dated March 15, 1923, have been made the basis of adjustments which are fully explained in attached Schedules 1 and 2.

EXHIBIT K

Pittsburgh, Serial No. 735C.

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
OFFICE OF INTERNAL REVENUE AGENT IN CHARGE,
Pittsburgh, Pa., June 28, 1923.

In re: George Bros., 307 Fourth Avenue, Pittsburgh, Pa.

Examining officer, George W. Pitts; examination commenced June 16, 1923; examination completed, June 27, 1923.

INTERNAL REVENUE AGENT IN CHARGE
Pittsburgh, Pa.

An examination of the books and records of the above-named corporation for the calendar years 1918 to 1922, inclusive, and period ending February 28, 1923, disclosed the following in connection with its income and excess-profits tax liability:

Summary

Year	Form No.	Schedule No.	Additional tax
1918	1065	4	$21,530.54
1919	1065	6	35,395.75
1920	1065	8	46,989.52
1921	1065	10	38,418.01
1922	1120	12	11,632.70
1923	1120-A	14	1,687.21
Total additional tax			155,704.73

Kind of business: Real estate brokers and agents.
Authority for examination: Authority of agent in charge.
No affiliations.

This company was incorporated under the laws of the State of Pennsylvania in July, 1902. It operates as brokers and renting agents. When first incorporated the company operated an insurance department. In 1905 the insurance department of George Bros. and the insurance business of Ogden Edwards were consolidated and the partnership of Edwards, George & Co. was organized. The capital of this concern was furnished by Messrs. Edwards, George, Guthrie, and McKelvey. O. Edwards and H. M. McKelvey withdrew from the business later on and W. D. George and F. S. Guthrie became sole owners.

The stockholders of George Bros. have a working agreement to turn over to the company all outside earnings for distribution. There is also an agreement which gives the company the right to purchase the stock of any stockholder upon the death or retirement from active participation in the business. This agreement, however, could not be enforced against the interest of Mr. George and Mr. Guthrie in Edwards, George & Co., and income now received by the corporation would, therefore, be diverted to other channels. It is evident, therefore, that Edwards, George & Co., regarded by George Bros. as their insurance branch, is a separate and distinct organization.

During the years examined the books of the corporation show dividends from Edwards, George & Co. as income. This income, however, is in reality income of W. D. George and F. S. Guthrie, turned over to the corporation in accordance with the working agreement before mentioned, and with article of trust executed by George and Guthrie, although regarded by George Bros. as income from their insurance department.

In the same class also is salary received by W. D. George as receiver for the Pittsburgh Street Railway Co., as follows:

1920	$10,000.00
1921	35,000.00
1922	36,250.00
January and February, 1923	3,333.34

This money is turned over to the corporaton by Mr. George, and is treated as income to the corporation and distributed in the same manner as ordinary income. It is so treated in this report.

The books of the company show no profit in any of the taxable years. This is caused by the fact that when quarterly profits are arrived at 10 per cent are distributed as dividends and the remaining 90 per cent distributed as increase in compensation to the stockholders, who are also the officers of the company. This distribution is disallowed as expenses throughout this report and classed as dividends.

Note, however, that salaries of the officers are low and are regarded by them as drawing accounts chiefly. It is recommended that an adjustment be made on this account.

The corporation filed returns for 1918, 1919, 1920, and 1921 as a personal-service corporation. Department letter IT:CA:PU 2306, dated January 11, 1923, disallowed a personal service rating.

The tax for 1918, 1919, 1920, 1921 falls under section 302, regulations 45 and 62. Consequently no invested capital schedules for the year 1919 on are included.

It is recommended that the corporation be granted relief under section 327 (d) (1) or section 328.

All changes in this report fully discussed with Mr. Seifert, of Reed, Smith, Shaw & McClay, attorneys for the corporation.

Respectfully submitted.

GEORGE W. PITTS,
Internal Revenue Inspector.

EXHIBIT L

STATEMENT

Mailed November 21, 1923, J. G. Bright, Deputy Commissioner.
In re: George Bros., 307 Fourth Avenue, Pittsburgh, Pa.

	Additional tax
1918	$21,590.44
1919	35,395.39
1920	46,980.52
1921	38,618.01
Total	142,584.36

After a careful consideration of the facts submitted, your claim for classification as a personal-service corporation under the provisions of section 200 of the revenue act of 1918 is denied, since the department, under the law, deems that your business is one in which the use of capital is essential and the profits can not be ascribed primarily to the personal services of the principal owners.

Inasmuch as your profits tax for 1918, 1919, 1920, and 1921, as computed under section 301, is in excess of the profits tax as computed under section 302, your profits tax has been computed under the latter section.

1918

Net income reported		$4,407.59
Plus:		
Donations	$400.00	
Income tax	238.00	
Distribution of profit	33,288.41	
		33,926.41
Total		38,334.00

Less Liberty bond interest			$200.00
			38,134.00
Profits tax under section 302			19,607.20
Net income		$38,134.00	
Less:			
Profits tax	$19,607.20		
Exemption	2,000.00		
		21,607.20	
Taxable at 12 per cent		16,526.80	
Tax at 12 per cent			1,983.22
Total tax			21,590.44
Tax previously assessed			None.
Tax due			21,590.44

1919

Net income reported			$8,638.13
Distribution of profits			77,743.14
Net income			86,381.27
Profits tax under section 302			29,952.51
Net income		$86,381.27	
Less:			
Profits tax	$29,952.51		
Exemption	2,000.00		
		31,952.51	
Balance		54,428.76	
Tax at 10 per cent			5,442.88
Total tax assessable			35,395.39
Tax previously assessed			None.
Tax due			35,395.39

1920

Net income reported			11,156.64
Distribution of profits			100,409.72
Net income			111,566.36
Profits tax under section 302			40,026.54
Net income		$111,566.36	
Less:			
Profits tax	$40,026.54		
Exemption	2,000.00		
		42,026.54	
Balance subject to tax at 10 per cent		69,539.82	
Tax at 10 per cent			6,953.98
Total tax assessable			46,980.52
Tax previously assessed			None.
Tax due			46,980.52

1921

Net income reported			8,897.35
Distribution of profits			84,496.93
Total			93,394.28

Liberty bond interest		$442.07
Net income		92,952.21
Profits tax under section 302		32,580.88
Net income	$92,952.21	
Less profits tax	32,580.88	
Balance	60,371.33	
Tax at 10 per cent		6,037.13
Total tax assessable		38,618.01
Previously assessed		None.
Tax due		38,618.01

EXHIBIT M

Payments made to officers of George Bros., Pittsburgh, Pa., as additional compensation for the years from 1917 to 1921, inclusive. These payments represent the balance of earnings made by this corporation after a distribution of 10 per cent dividends.

	Mar. 31	June 30	Sept. 30	Dec. 31	Total
1917					
W. D. George, president, 47½					$16,651.23
F. S. Guthrie, vice president, 27½					9,640.18
W. A. Feltyberger, secretary-treasurer, 20					7,011.04
W. L. Davis, assistant treasurer, 5					1,752.76
Total					35,055.21
1918					
W. D. George, 47½ (6 months), 40 (6 months)	$5,011.44	$5,454.23	$3,852.80	$904.57	15,223.04
F. S. Guthrie, 27½	2,901.35	3,157.71	2,648.81	621.89	9,329.76
W. A. Feltyberger, 20 (6 months), 27½ (6 months)	2,110.08	2,296.51	2,648.80	621.89	7,677.28
W. L. Davis, 5	527.52	574.13	481.60	113.08	1,696.33
Total	10,550.39	11,482.58	9,632.01	2,261.43	33,926.41
1919					
W. D. George, 40	4,027.74	9,327.48	2,588.78	15,153.26	31,097.26
F. S. Guthrie, 27½	2,769.06	6,412.64	1,779.79	10,417.86	21,379.35
W. A. Feltyberger, 27½	2,769.06	6,412.64	1,779.79	10,417.87	21,379.36
W. L. Davis, 5	503.47	1,165.94	323.60	1,894.16	3,887.17
Total	10,069.33	23,318.70	6,471.96	37,883.15	77,743.14
1920					
W. D. George, 40 (6 months), 35 (6 months)	7,491.73	18,017.42	5,651.06	7,171.83	38,332.04
W. A. Feltyberger, 27½	5,150.56	12,386.97	4,440.13	5,635.02	27,612.68
F. S. Guthrie, 27½	5,150.56	12,386.97	4,440.12	5,635.02	27,612.67
W. L. Davis, 5	936.47	2,252.18	807.29	1,024.55	5,020.49
G. W. Feltyberger, 5 (6 months)			807.29	1,024.55	1,831.84
Total	18,729.32	45,043.54	16,145.89	20,490.97	100,409.72
1921					
W. D. George, 35	12,335.47	5,719.62	3,358.50	8,005.61	29,419.20
W. A. Feltyberger, 27½	9,692.16	4,493.99	2,638.82	6,290.12	23,115.09
F. S. Guthrie, 27½	9,692.16	4,493.99	2,638.82	6,290.12	23,115.09
W. L. Davis, 5	1,762.21	817.09	479.78	1,143.65	4,202.73
G. W. Feltyberger, assistant secretary, 5	1,762.21	817.09	479.78	1,143.66	4,202.75
Total	35,244.21	16,341.78	9,595.71	22,873.16	84,054.86

The CHAIRMAN. I thought there were some statistics that you were going to give us this morning, Mr. Manson, as to some of the findings with reference to the statistical work of the bureau.

Mr. MANSON. I did not bring them down here this morning, and I am not prepared to discuss them myself this morning.

The CHAIRMAN. Has the bureau any reply to the last cases that we had up for consideration?

Mr. GREGG. We have not a thing this morning; no, sir. We will be prepared to-morrow morning, however.

The CHAIRMAN. Then we will adjourn until to-morrow morning at 10 o'clock.

(Whereupon, at 11 o'clock p. m., the committee adjourned until to-morrow, Thursday, March 19, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, MARCH 23, 1925

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

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

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

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

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

The CHAIRMAN. Let the record show that Mr. Manson is absent this morning because of illness in his family. Mr. Box, one of the auditors of the committee, will present the case this morning. You may proceed, Mr. Box.

Mr. GREGG. Before you start with that case we have a couple of matters we would like to put in the record.

The CHAIRMAN. Very well; you may proceed.

Mr. GREGG. At the last meeting of the committee the chairman stated that in connection with the settlement of several of the cases which the committee had criticized the names of a few of the officials and employees of the bureau, whom he named, occurred repeatedly. He stated that it was the feeling on the part of at least some of the members of the committee that there might be either irregularity or fraud in their settlements or in their actions with reference to some of these cases. In this connection he stated that the committee might desire that those officials be brought before the committee.

The statement rather took me by surprise at the time, particularly because of some of the names which were stated by the chairman in that connection, and I made no answer. But I do want to refer to the matter now briefly. The record as it now stands contains only the statement by the chairman, which indicates the possibility of irregularity or corruption on the part of those officials of the bureau whom he named in the settlement of some of their cases. Those men, like most people who spend their time in the Government service, have nothing but their good names and their reputations, and as it now stands that statement is a black spot on both.

The CHAIRMAN. On both of what?

Mr. GREGG. Both their reputation and their good name. It seems to me that the committee should go into the matter specifically to determine the question one way or the other. I think in justice to those men that that should be done, that it is owing to them that this

statement, without the citation of facts or evidence on which it is based, should not remain alone in the record, and it is due them to have the charges investigated to determine whether there was any irregularity in their action or was not.

I am not making this statement for the bureau, but for the men themselves, because I feel very sincerely that an injustice has been done the men, that the record with this statement questioning their integrity should not go to the public without the charges being investigated and their accuracy determined. If it is released to the public, it will be a lasting stain on their records and reputations. I think they are entitled to have it cleared up.

The CHAIRMAN. I do not think that the statement of the chairman at the hearing on Saturday, March 21, is quite as broad as Mr. Gregg has made it. What the chairman said was as follows:

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 conclusion 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 happened and how they reached some of their conclusions.

Then further on the record shows this further statement by the chairman:

It seems to run through a number of these cases that this group that I have just mentioned is involved, and I say very frankly that some of the members of the committee have had 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 those men down here without them knowing about it.

I do not see anything in that statement which charges fraud or graft.

Mr. GREGG. I did not mean to misquote the chairman.

The CHAIRMAN. I think you did misquote me in that respect, because I did not use that language at all.

Mr. GREGG. No, sir; you did not, but I think the inference from the statement which you just read is that the committee thinks that there may have been some irregularity on the part of those men whose names have occurred in connection with the various cases taken up by the committee.

The CHAIRMAN. Of course, Mr. Gregg can read anything he likes into it or can reach his own conclusions, but I submit there is nothing in the statement of the chairman that either mentioned the word fraud or graft or dishonesty.

Mr. GREGG. No; but the chairman said exactly this:

I say very frankly that some of the members of the committee have had a very definite conviction that all is not right with some or all of these employees.

Now, the words "graft" or "corruption" were not used, but I think the inference from that statement is fairly plain. I do not think it is necessary to place an interpretation on it. I think the record as it exists with that statement in it is a very decided reflection upon the integrity of those men.

The CHAIRMAN. The members of the committee who discussed it did not have any definite conviction as to either fraud or graft. With those members of the committee who discussed it there was a definite conviction, as I said, that there was something peculiar about some of those settlements. In view of the fact that no reply has yet been put into the record on the Thompson case and some of the quotations from Special Conferee Shepherd sounded peculiar and did not seem to be cleared up at least in the minds of some of the members, this statement was suggested to the chairman the other day. The statement was not a prepared statement, but was just an expression of opinion of some of the members of the committee who had, you might say, unofficially discussed it at times. In line with what I said at that time, I expect before we get through that we will probably ask some, if not all, of those men who have been mentioned to come down here and help straighten out the things that seemed peculiar to members of the committee.

Mr. GREGG. That is what I wanted to ask that the committee do, in order that any reflection of that kind either be substantiated or removed.

The CHAIRMAN. There was no desire on the part of members of the committee to whom I had reference——

Senator ERNST (interposing). Who are the members of the committee to whom you have reference?

The CHAIRMAN (continuing). To forestall the men who had been mentioned here from making any statement or explanation they may desire to make.

Senator ERNST. Was the matter discussed by the committee?

The CHAIRMAN. No. What I said in my earlier statement of last Saturday was that some of the members of the committee had discussed it. I say now for the benefit of Senator Ernst that he was not one of them, but it was among some other members of the committee informally.

Mr. GREGG. I just wanted to get that statement in the record.

The CHAIRMAN. You may proceed, Mr. BOX.

Mr. BOX. The case which is about to be presented is that of the Phelps-Dodge Corporation, a corporation incorporated in the State of New York March 14, 1917, with a capitalization of $50,000,000. It took over the assets of several companies which were owned by Phelps, Dodge & Co. (Inc.), a holding corporation. Phelps, Dodge & Co. (Inc.) was incorporated in 1908 under the laws of the State of New York and took over the assets of the Phelps, Dodge & Co. partnership, which owned the Copper Queen Consolidated Mining Co., the Moctezuma Copper Co., the Detroit Copper Mining Co., and the Stag Cannon Fuel Co. properties in Arizona and New Mexico.

The 1917 return of the Phelps-Dodge Corporation showed a tax liability of $2,666,821.36. Upon examination of the income of this corporation the bureau prepared an A–2 letter under date of December 11, 1919, proposing an additional tax of $2,101,114.95. This tax was reduced and an overassessment found of $44,051.54. Shortly after this overassessment was found a mistake was found in the computation of the invested capital—that is, a mathematical error in the bureau—slightly in excess of $8,000,000. After considerable correspondence in regard to whether the case had been closed or not

closed an additional tax of $131,116.33 was assessed, which closed the 1917 case.

Under 1918 an overassessment of $125,580.45 was found in June, 1920. Subsequent to that time, upon recomputing the tax, an additional tax of $4,303,195.76 was found due on January 1, 1924. After a conference this tax was reduced to $1,796,547.20 on September 2, 1924. The proposed assessment of this additional tax was protested by the taxpayer and the question is now before the solicitor on several different points for decision, so that the 1918 tax matter remains open at the present time.

Senator KING. Was that additional tax of $4,303,195.76 on one year or on all years?

Mr. Box. On the year 1918.

Senator KING. 1918 alone?

Mr. Box. Yes.

Senator KING. Have settlements been made for the years 1920, 1921, 1922, and 1923?

Mr. Box. No. March 2, 1925, an additional tax of $236,197.23 was found on 1919, and there is no record of any protest having been made as to that.

Senator KING. That has not been paid?

Mr. Box. No; the tax was only assessed; that is, the letter was sent out this month. The whole question in this case, outside of the error that I spoke of, the mathematical error of $8,000,000 in the bureau, has centered on the matter of valuation of these properties that were taken over in 1908.

The taxpayer in this case, the Phelps-Dodge Corporation, was incorporated March 14, 1917, under the laws of the State of New York, at which time it acquired the assets of the Phelps, Dodge & Co. (Inc.), a holding company which was incorporated under the laws of the State of New York under date of December 31, 1908. On the latter date Phelps, Dodge & Co. (Inc.) acquired the assets of the Phelps, Dodge & Co. partnership, which owned the stock of the Copper Queen Consolidated Mining Co., Moctezuma Copper Co., Detroit Copper Mining Co., and the Stag Cannon Fuel Co.

Both the taxpayer and the Phelps Dodge Co. (Inc.) were capitalized at $50,000,000, which comprises 500,000 shares of capital stock at the par value of $100 each.

On December 31, 1908, the Phelps Dodge & Co. (Inc.) issued $45,000,000 of its stock in exchange for stock of subsidiary companies formerly owned by Phelps Dodge & Co., the partnership, in the following amounts:

Copper Queen Consolidated Mining Co	$27,000,000
Moctezuma Copper Co	8,000,000
Detroit Copper Mining Co	6,000,000
Stag Cannon Fuel Co	4,000,000
Total	45,000,000

The values represented by the stock issued were made up of the following items:

VALUE OF MINES

Copper Queen Consolidated Mining Co	$12,385,213.66	
Moctezuma Copper Co	4,356,173.82	
Detroit Copper Mining Co	1,057,306.51	
Stag Copper Mining Co	2,412,732.54	
		$20,211,426.53

VALUE OF PLANT AND EQUIPMENT

Copper Queen Consolidated Mining Co	$4,974,866.77	
Moctezuma Copper Co	3,046,384.32	
Detroit Copper Mining Co	2,158,106.00	
Stag Cannon Fuel Co	3,226,488.42	
		13,405,845.51
Net value of liquid assets		11,382,727.96
Total		45,000,000.00

The CHAIRMAN. Do your records show what the liquid assets were?

Mr. BOX. No; they do not. They show the excess liquid assets over the liabilities were $11,382,727.96. They were lumped.

Senator KING. Were they notes or cash?

Mr. BOX. There was no reference at all to what they were.

The CHAIRMAN. They were just an amount to even up the $45,000,000 of stock issued, were they not?

Mr. BOX. It would seem so. There is nothing to show what they were made up of. You will note the value of mines was $20,211,426.53.

Under date of June 15, 1911, Phelps, Dodge & Co. issued a circular which it sent to its stockholders (see Exhibit A) advising them that since the law relative to the excise tax on corporations became effective it was essential that the actual values of mines and mining claims should be recorded in their books and accounts, and that they had written up the values of mines and mining claims so that the total values shown on the books "will equal the total estimated values at the time of the sale of Phelps, Dodge & Co. on December 31, 1908." This write-up was from a book value of $2,579,041.48 to $24,114,045.73.

Mr. GREGG. May I ask a question just at that point to clear up as we go along?

Mr. BOX. Yes.

Mr. GREGG. I do not understand the items which were written up from $2,000,000 to $24,000,000.

Mr. BOX. It was the value of the mines and mining claims.

Senator KING. The property?

Mr. BOX. Yes.

Senator KING. Copper Queen was valued at $12,385,213.66.

Mr. BOX. Yes. In the statement I have just made, under "valuation of mines," the value is given at $20,211,426.53. Those figures are taken from the engineer's report in the case. While there is a difference of four million and odd dollars between the two items, that is the only record we have as to the value of the mines in the Bureau of Internal Revenue outside of the Phelps-Dodge figures.

Mr. GREGG. Then the figures which have been given showing the value of the mines as twenty million and odd dollars were not put on the books until 1911?

Mr. Box. Yes.

Mr. GREGG. That is a point I wanted to clear up.

Senator KING. They just wrote them up to make the aggregate amount of the new capitalization?

Mr. Box. The items were written up on the books of the separate companies. The holding company itself then issued the stock of $45,000,000 without, I suppose, any segregation of assets, but I do not know about that.

On December 11, 1919, as a result of an audit of the net income of the taxpayer for the year 1917 based on a revenue agent's report of his field investigation the assessment of an additional tax of $2,101,114.95 was proposed. This was based on an invested capital of $55,532,524.48. The taxpayer protested against the assessment of this additional tax and claimed that its invested capital was greatly understated. It submitted the argument that the value of the assets acquired by Phelps-Dodge & Co. (Inc.) from the partnership of Phelps, Dodge & Co. in 1908 for which $45,000,000 par value in stock was issued, was in reality $90,000,000, and the Internal Revenue Bureau, after the submission of a report by one of its engineers, named L. C. Graton, agreed to consider the value of the assets acquired at the above-named date for invested capital purposes at $90,000,000 instead of $45,000,000, the additional $45,000,000 being considered as paid-in surplus. This action was authorized by article 63 of regulations 41. There is no complaint to make about the write-up if the values were there, because the regulations provide for it.

Senator KING. I am somewhat familiar with some of the properties in Arizona. When they incorporated and took over the assets of the Phelps-Dodge partnership, and it is presumed that they started out on a fair and legitimate basis, why should they put in assets of the value of $90,000,000 at only $45,000,000? Is there anything to indicate it?

Mr. Box. Nothing whatever.

Senator KING. Very well; go ahead.

Mr. Box. As a result of this change in invested capital it was found that an overassessment of $44,051.54 had been made and certificate issued therefor, under date of April 15, 1920.

On April 26, 1923, the case was reopened for 1917 and an additional tax of $131,116.33 found due.

Senator KING. I want to go back for just a moment. Is Mr. Graton's report here?

Mr. Box. Yes; it is here.

Senator KING. Did he state of what this property consisted? Did he itemize it to show its value?

Mr. Box. No. He shows four items of different mining properties en bloc.

Senator KING. Did he mention the $11,000,000 of so-called liquid assets?

Mr. Box. I think not.

Senator KING. Or state what that consisted of?

Mr. Box. No, sir.

Senator KING. Very well.

Mr. Box. As article 63 of regulations 41 grants authority for considering the excess of the actual value of an asset over the amount of the stock issued in exchange therefor, as paid-in surplus the only question in this case is one of fact as to the actual value of the assets acquired by the corporation from the partnership in 1908. In this connection the following information taken from the records as evidence that the value of the assets did not exceed $45,000,000 on December 31, 1908, is submitted.

On May 14, 1919, Revenue Agents G. W. Huntington and Charles W. Murphy stated in the report of their investigation for the year 1917 of this taxpayer in regard to the value of the property of the various companies concerned in the transfer of Phelps, Dodge & Co. (Inc.), in 1908, that they visited the surrogate's court of the county of New York, with the object in view of obtaining information bearing on the value of the property taken over by Phelps, Dodge & Co. (Inc.), upon its formation.

D. Willis James, one of the partners of the old partnership of Phelps, Dodge & Co., died on September 13, 1907. On March 6, 1908, the appraisers filed a report recommending that tax be assessed on part of his personal property as follows:

Copper Queen Consolidated Mining Co. stock, par value $10 per share, appraised at $50 per share.
Moctezuma Copper Co. stock, par value $100 per share, appraised at $75 per share.
Detroit Copper Mining Co. stock, par value $25 per share, appraised at $35 per share.

Inheritance tax was paid on the above valuation.

It appears that subsequently the State comptroller had been informed that the shares of stock mentioned above might have been undervalued, which information rested upon data submitted to the New York Stock Exchange in connection with the application of Phelps, Dodge & Co. (Inc.), to have its stock listed. The contention was made that the stocks should have been appraised at the value at which they were exchanged for the stock of Phelps, Dodge & Co. (Inc.), in December, 1908, as follows:

Copper Queen Consolidated Mining Co., par $10, exchanged at $135 per share.
Moctezuma Copper Co., par $100, exchanged at $307.69 per share.
Detroit Copper Mining Co., par $25, exchanged at $150 per share.

A reappraisal was ordered, and ex-Governor Charles F. Whitman, of New York, was appointed special appraiser. Hearings were held at which both sides were represented by counsel, and much testimony was submitted. It was contended that the exchange of stock for the stock of Phelps, Dodge & Co. (Inc.), in no way represented a fair measure of the market value of the stocks of the other companies.

On December 27, 1910, Mr. Whitman submitted a report to Judge Blanchard of the Supreme Court of New York State to the effect that no error had been made in the original assessment and that the property in question was valued fairly, as follows:

Copper Queen Consolidated Mining Co	$50
Moctezuma Copper Co	75
Detroit Copper Mining Co	35

The par value, the September 13, 1907, value, arrived at by ex-Governor Whitman for the New York State inheritance tax, and the value at which it was exchanged on December 31, 1908, for stock of Phelps, Dodge & Co. (Inc.), is as follows:

Name of company	Total par value of stock	Value Sept. 13, 1907	Stock of Phelps, Dodge & Co. (Inc.) issued therefor
Copper Queen Consolidated Mining Co	$2,000,000	$10,000,000	$27,000,000
Montezuma Copper Co	2,600,000	1,950,000	8,000,000
Detroit Copper Mining Co	1,000,000	1,400,000	6,000,000
Total	5,600,000	13,350,000	41,000,000

This is exclusive of the coal company, which was put in at $4,000,000, making the total $45,000,000. This is their agent's report.

Senator KING. You mean Huntington's report?

Mr. BOX. Yes.

As the stocks were judicially declared on September 13, 1907, to be worth only one-third of the figure at which they were taken over by Phelps, Dodge & Co. (Inc.) in December, 1908, "and as far as we can ascertain nothing happened in the meantime to materially affect their value, we consider it very doubtful whether they were worth the $45,000,000 and consider the claim of their value at $90,000,000 to be absolutely beyond reason. It is only on account of the clause in the law (section 207 (a) of the revenue act of 1917) allowing appreciation to January 1, 1914, to be considered in this case that prevents our decreasing the original $45,000,000 very materially."

From the valuations just stated it appears that the value placed on these properties on September 13, 1907, was less than one-third of the value at which exchange was made with the corporation on December 31, 1908.

Senator KING. Then, in brief, the situation is this: Phelps, Dodge & Co. as a partnership had property which they assembled and put into a corporation at $45,000,000. The surrogate's court found, as did Governor Whitman, after a contest, that part of that property was put in to Phelps, Dodge & Co at grossly excessive prices to make up the $45,000,000?

Mr. BOX. Yes, sir.

Senator KING. Then in the face of that fact Mr. Graton and the Bureau of Internal Revenue raised that valuation to $90,000,000 for invested capital purposes?

Mr. BOX. Yes; for invested capital purposes.

Senator KING. Why did they not make it $190,000,000?

Mr. BOX. The representatives of some of the companies claimed that it should have been $150,000,000.

Attached to the 1909 excise-tax returns of the Moctezuma Copper Co., the Detroit Copper Mining Co., and the Stag Cannon Fuel Co., and the excise-tax return for 1910 of the Copper Queen Consolidated Mining Co. are statements setting forth that the fair and just valuation of the mines and mining claims of the respective companies are

represented by the values at which they were determined in the exchange of stock between the said companies and the Phelps-Dodge Co. (Inc.) on December 31, 1908. These returns are sworn to by its officers and all statements submitted with them are covered by their oaths. See Exhibits B, C, D, and E.

When this case was audited in the bureau the reviewer, Mr. Robert P. Smith, under date of December 13, 1922, attached a statement to the case stating that "The letters have been signed by the reviewer merely as a matter of form, in order that the case may go through regular channels." He stated that the case is handled absolutely erroneously and that his signature is a matter of form only. Exhibit F is a copy of the letter in question, and states:

> The letters have been signed by the reviewer merely as a matter of form, in order that case may go through regular channels. The case is handled absolutely erroneous even from the standpoint of allowing paid-in surplus. Basis used to determine depletion for invested capital is groundless even should the figures be approximately correct (which is not admitted). The depletion should be figured on each grade of copper separately, based on a suitable production life. (This is possible.) There is also allowed reserves for bad debts and taxes, $850,000, which is in no way substantiated, nor was it claimed by taxpayer on his own amended return. My signature is therefore a matter of form only and I shall in no way be responsible for the inaccuracies in this case.

Senator KING. That is, he questioned the allowance of the $90,000,000?

Mr. BOX. The allowance of the additional $45,000,000.

Senator KING. Mr. Smith is questioning that and claiming that it is erroneous?

Mr. BOX. Yes.

Senator KING. Was he criticizing then Mr. Graton's report?

Mr. BOX. He was criticizing the allowance of the $45,000,000 additional paid-in surplus. That letter was signed "Robert P. Smith," December 13, 1922.

In another memorandum which he attaches to this case he states that the possible value for invested capital is $45,000,000, to which should be added acquisitions for cash between the dates of acquisitions and January 1, 1914, and that it is understood that the metals valuation section is not allowed to make a revaluation in the case on the ground that it is a closed incident. He also states that a revaluation of the coal property shows a large reduction in the original value and that it is not clear why a valuation is permitted on coal lands and not for metals. He states that he thinks should this case be closed in its present deplorable condition the department would not be able to retract its position, as this is a paid-in surplus allowance and not a January 1, 1914, value.

I sub. it the memorandum in full as Exhibit G.

The CHAIRMAN. All of those exhibits will be set forth in the record.

Mr. BOX. Yes.

Senator KING. That memorandum merely supports his position?

Mr. BOX. Yes. The reason why a revaluation was not allowed for copper mines is because, under date of December 11, 1922, the commissioner wrote a memorandum to Deputy Commissioner Batson,

in which he decided that the value of the ore bodies of copper mines for 1919 and subsequent years should be revised. As the memorandum submitted to the commissioner, to which this was an answer, referred to the years 1917 and 1918 also, the fact that he authorized the revised valuations for the later years and did not mention 1917 and 1918 was accepted as final that the valuations for those years were not to be disturbed. Exhibit H is a copy of the letter of the commissioner referred to.

Senator KING. Do you understand that the valuation of $90,000,000 was for 1917 and for 1918 and has not been justified?

Mr. BOX. It has not been justified.

Senator KING. The tax was paid upon that basis?

Mr. BOX. The 1918 tax has not yet been paid, but the tax has been computed on that basis.

Senator KING. But 1919 and subsequent years have not exceeded the valuation of $90,000,000?

Mr. BOX. No; they have made a reduced valuation for 1919.

The CHAIRMAN. Do you know what it is?

Mr. BOX. It is claimed at $45,000,000.

Senator KING. It is returned at $45,000,000?

Mr. BOX. Yes; with cash acquisitions.

Senator KING. It would be interesting to know where it got the cash to make those cash acquisitions. Was it out of dividends which it did not distribute? Was it undistributed earnings? Or was it real cash that it put in as an addition to capital? Did you discover?

Mr. BOX. Of course, if it was cash left in the treasury undistributed, it would be available for invested-capital purposes. I did not go into that matter, however.

Senator KING. It was $170,348 at that time in 1922, and they made no returns of net income for taxation and stated they did not earn anything, and yet paid cash dividends amounting to $253,849,119.

The CHAIRMAN. I would like to ask Mr. Gregg at this point, as long as Mr. Box is referring to these cases as closed incidents, whether there is any ruling of a court saying that when a case is closed by one commissioner it may not be opened by another commissioner?

Mr. GREGG. That is a much-disputed point. There is a great deal of argument on both sides of it. The department, of course, has never accepted the theory that we can not reopen, although it has been urged before us in a great many cases. The copper cases will form one of the first cases to test the question, because they say they are going to take it to the courts, and they have prepared some very excellent briefs on the question.

The CHAIRMAN. Has any court ever decided that question, either a lower court or an appellate court?

Mr. GREGG. Not since the income tax law was enacted. There were a great many decisions back under the old internal revenue tax law prior to the income tax law to the effect that we can not reopen such cases, but we have always contended that they stood on a different basis than the income-tax returns. There are a good many different points involved. The question is very complicated and very involved. The precedents arise as a result of cases in other departments of the Government to the effect that where an offi-

cial of the Government who, in accordance with acts of Congress authorizing him to exercise judgment and discretion, does so exercise his judgment and discretion that action can not be subsequently revised by his successor. It arose primarily, I think, in the Department of the Interior in land cases, patent matters, locations, etc.

Senator KING. Not having in mind these particular cases, let us assume that an assessment were made for $25,000,000 for capital investment by the representatives of the Government in 1917 and subsequently and before the tax was paid it was raised to $50,000,000 through the representations of the taxpayer, and those representations were wrong; that court investigation showed in a collateral case which involved questions of the value of the property that it was just doubling the value, and settlement was made on the basis of that incorrect valuation superinduced by representations of the owner which were false: in fact, either constructive or actual fraud in the representations. Do you mean to say they could not be reopened?

Mr. GREGG. Exception is always made of fraud cases. Even in the decisions with reference to other departments of the Government they except cases where fraud is discovered. They can be reopened unquestionably.

Senator KING. When Mr. Smith said this was erroneous, so erroneous that he disapproved of it, why did not the department then refuse to settle on the basis of that valuation?

Mr. GREGG. I do not know enough about the case to know. That may have represented the individual opinion of Mr. Smith and there may have been 15 others who differed from Mr. Smith.

The CHAIRMAN. Proceed, Mr. Box.

Mr. BOX. Under date of May 28, 1923, a letter was written to the commissioner signed "J. G. B., deputy commissioner," referring to a mathematical mistake in the computation of invested capital for the year 1917, in which he recommended that "although the year 1917 was mathematically incorrect and the invested capital allowed the corporation was considerably in excess of the proper allowance, it should be considered closed."

In this connection I think it would be well to present that letter in full.

The CHAIRMAN. What is the date of the letter?

Mr. BOX. It is dated May 28, 1923, and addressed "To the commissioner," and states:

A conference was held in my office this morning with representatives of the above-named corporation—

That is, the Phelps-Dodge Corporation—

to discuss the proposal of the Income Tax Unit to reopen the 1917 audit because of an erroneous computation of the invested capital in office letter dated June 10, 1920.

Mr. Matthew C. Fleming and Mr. Sterling, who represented the corporation, exhibited a copy of a valuation report dated December 1, 1919, signed by Mr. L. C. Graton, valuation engineer, and Mr. J. C. Dick, head metals valuation section, in which the total valuation of the mineral property was said to be in the neighborhood of $110,000,000 as of 1908, the date of the organization of the company. A subsequent memorandum, undated, signed by Mr. J. L. Darnell, then head of the natural resources subdivision, states that it was agreed that the company should be permitted to include a paid-in surplus of $45,-

000,000 in the invested capital since it was clearly shown that the properties had a value in 1908 in excess of $90,000,000.

Acting upon the recommendation of Mr. Darnell the consolidated returns subdivision prepared a letter dated March 3, 1920, in which it was stated that the invested capital for the year 1917 should be $110,756,190.37.

An audit was made shortly thereafter and the tax liability for the year 1917 determined. The auditor, in preparing a letter setting forth this tax liability stated "your invested capital has been fixed as agreed in conference at $110,765,190.37." This letter is written in longhand preparatory to typing but was never typed, as a request was made by the corporation at this time that the audit be extended to cover the year 1918. The final letter, dated June 10, 1920, contained schedules 1 to 30, setting forth the tax liability for the years 1917 and 1918, and was made "subject to amendment by a field examination which may later be made if deemed necessary by the bureau." It appears that the change in wording of the final assessment letter from that proposed by the auditor has some significance, and the inference is that the audit for the year 1917 was considered by all concerned to have been complete, but when in compliance with the request of the corporation the year 1918 was included in this audit, it was thought best to make such audit for the year 1918 subject to a field examination since no revenue agent's examination had been made for that year.

Therefore I wish to recommend that, although the year 1917 was mathematically incorrect and the invested capital allowed the corporation was considerably in excess of the proper allowance, it should be considered closed, but the unit should be allowed to reopen the audit for 1918 on all points other than the actual valuation of the property to determine the correct tax liability.

That letter is signed "J. G. B., Assistant Deputy Commissioner."

Senator KING. The erroneousness of which this man complains was in raising it from $90,000,000 to $110,000,000 plus. He did not complain of the $90,000,000 at all being erroneous.

Mr. BOX. It was not that, Senator. It was an item of eight million and odd which had been computed the wrong way and made the invested capital of $110,000,000 about $8,000,000 too much. It should have been revised from one hundred and ten million dollars to one hundred and two million and odd dollars. He did not object to the $45,000,000 paid in surplus at all.

The CHAIRMAN. Who did not object to that—Mr. Smith?

Mr. BOX. This was Mr. Bright.

The CHAIRMAN. Mr. Smith objected to the $45,000,000 paid in surplus?

Mr. BOX. Yes.

Senator KING. He does not object to the so-called $45,000,000 and also the additional $12,000,000 for some purpose which I do not know——

Mr. BOX. That was acquisitions.

Senator KING. That made a total of $102,000,000.

Mr. BOX. Yes.

Senator KING. It was settled, then, for 1917 on the basis indicated. In 1918 on what basis was it settled?

Mr. BOX. It was not settled on this basis. There is more correspondence that reverses Mr. Bright's recommendation. That $8,000,000 was afterwards thrown out.

Senator KING. And $110,000,000 allowed?

Mr. BOX. $102,000,000 allowed.

Senator KING. But it was not reduced down to $45,000,000 at any time?

Mr. BOX. No: that was never taken out for 1917.

Mr. GREGG. As I understand it, the question of the valuation of this property is not under consideration or discussion in Mr. Bright's memorandum?

Mr. BOX. No.

Mr. GREGG. He is referring solely to the so-called mathematical error and has no reference to the question of valuation, which he considers settled?

Mr. BOX. Yes.

The CHAIRMAN. Would you agree that he was right in ignoring the mathematical error?

Mr. GREGG. No, sir; and the bureau did not do so in that case.

The CHAIRMAN. That is perhaps one of the peculiar things to which I had reference in my statement of Saturday.

Mr. BOX. By letter of June 29, 1923, Acting Secretary of the Treasury S. T. Gilbert, jr., advised the Commissioner of Internal Revenue that the error in the computation of invested capital raised a sufficiently serious question as to tax liability to warrant the reopening of the case for both 1917 and 1918. (Exhibit J.)

Senator KING. And that letter there just confirms your statement, does it?

Mr. BOX. Yes, sir; it confirms the statement that I have made.

Senator KING. I ask that to save the time of reading the letter.

Mr. BOX. On January 19, 1924, Matthew C. Fleming, Esq., counsel for the taxpayer, wrote the Secretary of the Treasury, protesting against a proposed additional assessment of approximately $131,000 for 1917, and $4,300,000 for 1918 (Exhibit K), in which he states that it is a fact:

> * * * that we made a bargain with the department in 1920, whereby, in consideration of our obtaining an invested capital figure of $110,000,000, irrespective of how it was made up, we accepted a very large reduction in the depletion figures which our engineers claimed, and agreed to a reduction of about $40,000,000 in the March 1, 1913, value of our mines.

The mathematical error referred to in the correspondence above mentioned is one amounting to $8,109,572.49 in computing invested capital, and results in reducing the invested capital that amount below that allowed by the bureau in its computations of June 10, 1920. (Exhibit L.)

The letter of the Secretary of the Treasury, dated March 6, 1924, in reply to the last above-mentioned letter, reveals the circumstances in regard to the mathematical error and the decision to allow the provisional valuation of the copper mines to remain undisturbed. (Exhibit M.)

There is one paragraph of this letter of the Secretary of the Treasury that I think should be read. It says:

> Inasmuch as a decision was reached to allow the original or provisional valuations to govern the audit of returns for 1917 and 1918, but to make new valuations for invested capital and depletion for the audit of returns for 1919 and subsequent years, the values which you state were the result of a "bargain with the department in 1920," have not been altered for 1917 or 1918.

Mr. GREGG. May I bring this fact out there, Mr. Box? This mathematical error of $8,000,000 was corrected, however, was it not?

Mr. Box. Yes, sir. I just wanted to read that to show a little conflict between that letter and the following one, from the commissioner, on that point.

The commissioner advised counsel for the taxpayer, under date of March 28, 1924, that the case (1917 and 1918) would be carefully reconsidered by the Income Tax Unit, and that conference would be arranged at an early date at which any additional evidence and arguments presented would be considered.

This letter of the commissioner is dated March 28, 1924, and is addressed to Mr. Fleming. It reads:

> Reference is made to your letter dated March 10, 1924, in regard to the income-tax liability of the Phelps-Dodge Corporation for the years 1917 and 1918, involving the depletion values established for these years as well as the invested capital.
>
> Inasmuch as the figures arrived at by the bureau as to the determination of the March 1, 1913, values for the purpose of depletion and the amount of invested capital to which the taxpayer is entitled for the years 1917 and 1918 are not satisfactory to the taxpayer and in view of the misunderstanding as to certain adjustments in these values, the entire case will be reconsidered.
>
> Referring to your statement in regard to any bargain which may have been made by the bureau's representative with respect to depletion values and invested capital, you are advised that these matters are questions of fact to be established by the best evidence available, and the bureau's representative in the particular audit case is not vested with authority whereby such values may be established through bargaining with the taxpayer's representative. The cases will, however, be carefully reconsidered by representatives of the Income Tax Unit. The conference will be arranged at an early date, at which you may present any additional evidence and arguments which you desire to be considered.

The CHAIRMAN. The conflict that you speak about is that your understanding of the Secretary's decision was that there would be no reconsideration of valuations only.

Mr. Box. Of the revaluation for invested capital purposes, and this letter has seemed to raise a little doubt in the minds of some of the officers as to whether the 1918 revaluation should be made, which will appear a little later on.

Mr. GREGG. However, there was nothing to revoke the order of the commissioner, as approved by the Secretary, which was previous to that date.

Mr. Box. Of December 11, 1922?

Mr. GREGG. Yes; saying that they—those provisional valuations, so called—would not be reopened.

Mr. Box. Only this letter.

Under date of January 27, 1925, Deputy Commissioner Bright advised Mr. Greenidge by letter (Exhibit O) that he was returning the latter's memorandum of January 10, 1925 (Exhibit P), addressed to the commissioner, which had been sent to him for signature, and stated that:

> * * * It appears to me that this case is open to the Government only for the purpose of correcting the error in invested capital and to the taxpayer to permit it to prove a high valuation on the basis of evidence and facts in its possession.

By memorandum of the chief of the metals valuation section, dated January 23, 1925, he recommends that the case be revalued for 1918 on the basis of the valuation methods approved by the commissioner in his memorandum of December 11, 1922, authoriz-

ing the unit to revalue the copper and silver mining industries. (Exhibit Q.)

This is a memorandum from Mr. John Alden Grimes, dated January 23, 1925:

In re letter of January 10, 1925, addressed to the Commissioner of Internal Revenue bearing symbols IT:EN:M:F.T.D. and copies of letters attached hereto.

About January 20, 1925, Mr. Greenidge, head of engineering division, stated verbally that the commissioner had instructed him that the case was to be audited in conformity with the statements of his letter of March 28, 1924, directed to Mr. M. C. Fleming, attorney for the above corporation.

In view of the questions of this office directed to the commissioner in the letter of January 10, 1925, this office can read the commissioner's letter in but one way, and therefore recommends that the case be revalued for 1918 on the basis of the valuation methods approved by the commissioner in his memorandum of December 11, 1922, authorizing and instructing the Income Tax Unit to revalue the copper and silver mining industries.

The valuations of the properties of the taxpayer are therefore being sent to audit on this basis.

The CHAIRMAN. I want to ask Mr. Gregg if he does not think there is some conflict between the Secretary and the commissioner there, where the commissioner's letter, as interpreted by Mr. Greenidge, indicates that 1918 was to be reopened in this taxpayer's case?

Mr. GREGG. By Mr. Grimes. I think Mr. Grimes interpreted that as he wished to interpret it. I happened to be present at a good many of the conferences with reference to this case. I was present at the conference in Mr. Gilbert's office, when it was decided to reopen and correct the mathematical error of $8,000,000. It was never the thought of anyone that this case would be made an exception, however, to the general letter of the commissioner, as approved by the Secretary, to the effect that Mr. Graton's valuations of copper properties would stand for 1917 and 1918, and that the revaluations would be effective only for subsequent years, and Mr. Grimes, when he put that memorandum in the files, was perfectly familiar with this previous order of the commissioner and the Secretary, and knew that it had never been modified.

The CHAIRMAN. From a reading of the commissioner's letter, do you not think there has been some conflict as to just what it means?

Mr. GREGG. Yes. The commissioner's letter is not very clear.

The CHAIRMAN. Yes; that is what I mean.

Mr. GREGG. Yes, sir.

The CHAIRMAN. To my mind, it would seem that there is a conflict between the two.

Mr. GREGG. It is not clear at all. I can understand how anyone would have difficulty in getting exactly what was meant by it.

The CHAIRMAN. You may proceed, Mr. Box.

Senator KING. Just a moment. Mr. Gregg, are we to understand that the unit has accepted as a finality the valuation for invested capital at $90,000,000?

Mr. GREGG. Yes; for 1917 and 1918.

Senator KING. Yes; for 1917 and 1918?

Mr. GREGG. There is no question about it.

The CHAIRMAN. Why do you say $90,000,000? I thought it was $110,000,000, less $8,000,000.

Mr. BOX. $102,000,000.

Mr. GREGG. $102,000,000 was the final figure.

Senator KING. I had reference to the transfer.

Mr. GREGG. The original transfer in 1908; yes, sir.

Senator KING. Of course, they claimed there were some additions, bringing it up to $102,000,000 or $110,000,000?

Mr. GREGG. Yes, sir.

Senator KING. But that $45,000,000 of water was legalized.

Mr. GREGG. Well, that all depends on what you call it.

Senator KING. Yes.

Mr. GREGG. If the value was there as of 1908, they were entitled to it. Mr. Graton determined that that value was there. Subsequently we differed with Mr. Graton.

The CHAIRMAN. And when you did, you still had the valuation as presented to the Surrogate Court of New York, had you not?

Mr. GREGG. Yes, sir.

The CHAIRMAN. What has the department valued in 1919 and 1920?

Mr. GREGG. I do not know from my personal knowledge, but Mr. Box said they valued it at $45,000,000.

Mr. BOX. $45,000,000 paid in surplus had been eliminated.

Senator KING. They eliminated that $45,000,000?

Mr. BOX. They eliminated that $45,000,000.

Senator KING. So that it would be the $45,000,000 plus any subsequent capital investment?

Mr. BOX. Yes, sir.

Senator KING. What would be the amount of the tax on that $45,000,000? Taking all of the other factors into consideration, and allowing that increase of $45,000,000 for capital purposes, what would be the tax?

Mr. BOX. That would involve a great deal of computation, because it would mean figuring the depletion from 1908 down and the revaluation on March 1, 1913, for depletion purposes; but this will give you an idea:

For 1917, the additional tax, as proposed by the bureau at first, before the $45,000,000 was considered, was $2,201,000, and the final payment was $131,000, after taking off $44,000 which had been refunded, leaving $87,000.

Senator KING. Tax?

Mr. BOX. Yes, sir.

Senator KING. Do you mean to say that that corporation, then, was taxed only $87,000?

Mr. BOX. $87,000 additional tax. The original tax was $2,666,000.

Senator KING. Oh, yes.

Mr. BOX. But an additional tax over that $2,666,000 was proposed originally, of $2,101,000. That was the final settlement on the basis of about $87,000 additional tax.

The CHAIRMAN. In considering those figures roughly, the use of $90,000,000 instead of $45,000,000 would save the taxpayer approximately $2,000,000. Is that correct?

Mr. BOX. Yes, sir.

Under date of January 21, 1925, a revised valuation report for 1918 and 1919 was submitted, placing the values of the assets of the Copper Queen Consolidated Mining Co., the Detroit Copper Mining Co., and the Moctezuma Copper Co. at the amounts at which they

were originally taken over by the Phelps & Dodge Co. (Inc.), on December 31, 1908. The Stag Canon Fuel Co. value had been revised heretofore, as it was not a copper company and therefore not subject to the commissioner's ruling referred to above.

The valuation of the Stag Canon Fuel Co., which was taken in at $4,000,000 in 1908, was revised, and the revised valuation was made at about $1,400,000.

Senator KING. More?

Mr. BOX. Reduced.

Senator KING. It was reduced?

Mr. BOX. Yes. It was increased to $8,000,000 when the paid-in surplus of $45,000,000 was allowed, and then under revaluation it was valued at $1,400,000, approximately.

The recommendation of the chief of the metals section in regard to the revaluation for 1918 resulted in a letter from the head of the consolidated returns division (Exhibit R) calling attention to the fact that the interpretation of the commissioner's letter of March 28, 1924, arrived at by the chief of the metals section would be in conflict with the letter of the Secretary of the Treasury of March 6, 1924, and stating that he felt the personal approval of the head engineer should be secured before a reaudit upon the revised valuation is commenced.

In regard to the taxes for the years 1918 and 1919, an A–2 letter was mailed January 1, 1924, proposing an additional tax of $4,303,195.76, to which protest was made by the taxpayer. On September 2, 1924, an additional tax assessment of $1,796,547.20 in lieu of the above was proposed. Protest has been made to this assessment, and the question of tax liability for that year is still unsettled. The tax for 1919 is also unsettled. On March 2, 1925, A–2 letter was mailed proposing an additional tax of $236,197.23. The invested capital was reduced by $45,000,000, in accordance with the revised valuation, but with this reduction the income was not sufficiently large to exceed the excess-profits credit, and therefore the additional tax is comparatively insignificant as compared with that which would be due for 1917 and 1918 if the invested capital for those years was adjusted on the same basis as that for 1919.

The CHAIRMAN. Does that complete your presentation of this case, Mr. Box?

Mr. BOX. That completes my presentation of the case, Mr. Chairman.

Mr. GREGG. May I say just one word on the case? I do not want to put in an answer now. I am not prepared to do that, but the case is rather complicated and I would like to boil the criticism down as much as I can. The case is complicated by reason of this mathematical error which was under consideration for so long.

Senator KING. Still that cuts a small figure in the aggregate amount of the tax.

Mr. GREGG. True. The mathematical error was actually corrected, the $8,000,000 mathematical error.

Mr. BOX. Yes; and an assessment of $131,000 additional tax made.

Mr. GREGG. That is correct; yes. The sole criticism of the action of the bureau is the acceptance of the valuation as of 1908 as of $90,000,000 for the years 1917 and 1918?

Mr. Box. Yes.

Mr. GREGG. In other words, this case is given as a specific illustration of the effect of the action of the bureau with reference to copper cases as a whole, which has been considered so much by the committee.

Mr. Box. This case is given as an illustration of the amount of the tax which was lost by allowing a write up of $45,000,000, and calling it paid in surplus, when the valuation from outside sources was shown at $45,000,000 and was probably too high a valuation to be placed in 1908 on property taken over by the corporation.

Mr. GREGG. But it is just an illustration; it is just one of the cases which Mr. Graton valued, which have been, in general, already criticized by the committee. I just wanted to make that clear. I think that is accurate.

The CHAIRMAN. I think, if the chairman might interpret it, it is more than that. It involves the question of the write up of assets on the taxpayer's books to 100 per cent in excess of what the taxpayer's books showed, and allowed it to be included as paid in surplus, when the evidence in the New York courts showed that it was probably worth one-third of the original book figures of $45,000,000.

Mr. GREGG. Well, it seems to me that it comes back to the same general point. If the properties were worth $90,000,000 when they were paid in, the taxpayer is entitled to include that amount in invested capital, regardless of the par value of the stock issued for it, or regardless of the valuation placed upon this property on the books of the taxpayer. If the property was not worth $90,000,000 it was not entitled to that. The evidence that should be considered determining the value of the property is a different matter; but the case really boils down to the question of the value of this property in 1908, when taken over by the corporation.

The CHAIRMAN. In part, yes; but aside from that I think it is apparent that the taxpayer's own statements, or at least some statements of the original partnership before the surrogate court of New York, indicated that they did not place any such value as that on the property.

Mr. GREGG. Yes, sir; but that is just evidence in determining what the value of the property was in 1908.

The CHAIRMAN. Oh, yes.

Senator KING. I think you are right, Mr. Gregg.

Mr. GREGG. But I just want to make this one point, that the property which was valued in 1908 for inheritance tax purposes was not the identical property which we have to value for tax purposes. The property which was valued for inheritance-tax purposes was the stock of these subsidiary companies.

Senator KING. Which had been surrendered, and they had taken stock in the new company?

Mr. GREGG. Yes, sir; but what we have to value is not the stock of these subsidiary companies, but we have to go back of the stock to the assets. Of course, the valuation of the stock may be evidence of the value of the assets back of it, but it is certainly not conclusive evidence.

Senator KING. That is true.

The CHAIRMAN. Is it not quite competent evidence, though?

Mr. GREGG. Yes, sir.

Senator KING. I was wondering whether the president of the company or any of the officers of the company; and if so, what officers testified in the hearing before Governor Whitman. For my own information I should be very glad if we could get that report, because the officers of the company, knowing that that question was to be the basis of the value of the property, went before Governor Whitman and testified to the value of the property, and then turned around and doubled it for the purpose of escaping taxation in dealing with the Federal Government. I would like to know about that.

Mr. BOX. I will try to get something on that.

Senator KING. I wish you would get that.

Mr. BOX. Of course, you will remember that there are exhibits in this case which I submitted, which were copies of the sworn statements attached to their excise-tax return for 1909 and 1910 by these different officers, to the effect that these values taken over were fair and just at that time.

Senator KING. That is important. Did you make that statement?

Mr. BOX. Yes, sir; that is in the case.

Senator KING. When the corporation was formed?

Mr. BOX. Yes; the excise-tax returns for 1909 and 1910 had these statements attached to the front of the returns. They were sworn to by the vice president and secretary, I think, or at least two of the principal officers in each case. They swore that the valuation at which these mining properties were taken over by the corporation on December 31, 1908, was a fair and just valuation.

Senator KING. And that was how much?

Mr. BOX. That was the valuation of $45,000,000.

The CHAIRMAN. Then the same officers swore to the claims before the bureau? I think that is what Senator King wanted to find out, if they were the same officers?

Senator KING. What I wanted to find out was whether the same officers who made this claim for a tax reduction on the basis of $90,000,000 capitalization testified before Governor Whitman in that investigation.

The CHAIRMAN. And it would be equally interesting to ascertain whether they testified at any other place.

Senator KING. Surely.

The CHAIRMAN. Differently than they testified before the bureau.

Senator KING. I might say that, usually, in the case of corporations, where you take over properties, the incorporators swear as to the actual cash value and the market value of the property taken over.

Mr. GREGG. Mr. Box, did you say that that affidavit was one of the exhibits that you submitted?

Mr. BOX. Yes.

Mr. GREGG. Which exhibit is it, please?

Mr. BOX. Exhibits B, C, D, and E, I think.

Mr. GREGG. I do not find it here. Maybe it is Exhibit B.

Mr. BOX. B, C, D, and E are the exhibits.

The CHAIRMAN. I wish you would just read that particular exhibit into the record at this point.

Mr. Box. This is Exhibit B.

The CHAIRMAN. What is Exhibit B?

Mr. Box. Exhibit B is as follows:

The following is a statement attached to the return of annual net income of the Copper Queen Consolidated Mining Co. for the year 1919, sworn to by James Douglas, president, and George Nottman, treasurer.

COPPER QUEEN CONSOLIDATED MINING CO.—DEPRECIATION

In fixing "a fair and just estimate of the actual amount of depreciation" this company has considered that its plant and real estate would be obsolete or worthless in approximately eight and one-third years, and therefore for a number of years has been writing off 12 per cent per annum covering such depreciation.

The books of the company do not definitely show "the amount actually invested" representing the value in mines and mining claims, but in making up this report of annual net income we desire to clearly indicate that we believe we are making a fair and just estimate when we assume that 12 years will approximate the life of the mines, and therefore the annual rate of depreciation of mines and mining claims will be one-twelfth of their total estimated value, being, say, $13,967,242.74.

This depreciation is based upon the fair and just valuation of said mines and mining claims as determined December 31, 1908.

The plant investment and real estate is carried on December 31, 1910, at $2,152,424.04, an eighth of which is $269,053.

The mine value as per valuation of December 31, 1908, is $13,967,242.74, on which the depreciation of one-twelfth annually is $1,163,936.90. The depreciation on both plant and real estate and mines and mining claims aggregating $1,432,989.90.

Senator KING. Is that the Copper Queen Consolidated Mining Co. that is referred to?

Mr. Box. That is the Copper Queen Consolidated Mining Co.; yes, sir.

Senator KING. I am interested to know this: Going down 13 years from the date when he swore to that, what valuation was put on that mine, which he said would be exhausted absolutely in 13 years?

Mr. Box. Each of the other exhibits——

Senator KING. The 13 years have elapsed, and I venture to state that there is a very high value attributed to that property still.

Mr. GREGG. Of course, his basis of depletion based upon an estimated life of 12 years was not accepted by the bureau. The depletion was taken not on the basis of the years but on the basis of the units produced.

Senator KING. I was interested to know, in view of his sworn statement. I would like to see if they have reduced every year the valuation pursuant to that or whether they have not augmented it.

Mr. GREGG. Of course, an increase in the price of copper would increase the value of the mine, although some of the ore had actually been produced, or the value of the mine might be increased by extensions.

Can you tell me, Mr. Box, just what portion of the valuation of $90,000,000 was allocated to the mines of the Copper Queen Consolidated? The amount that we have arrived at here in this statement that taxpayer returned for 1910 is $13,000,000.

Mr. Box. No; I can not tell you what the bureau considered was the value of the mines of each company. The value of the mines as taken over was $12,385,213.66 for the Copper Queen. I do not

know whether that was just doubled or how it was figured in the report.

The CHAIRMAN. Can you look up, Mr. Box, and find out what the price of copper was in 1910, and whether this sworn statement that you have just read into the record is at great variance with the value placed on that property in the various claims that the taxpayer has made?

Senator KING. From year to year.

The CHAIRMAN. Yes; from year to year, and also whether the same officers made these statements.

Senator KING. As I understand it, the bureau now is considering 1919, 1920, 1921, and 1922, etc.

Mr. GREGG. Yes, sir; we have revalued for those years, and have cut the value as of the date of 1908 to $45,000,000.

The CHAIRMAN. Do I understand that the law does not permit you to reduce those valuations below the par value of the stock?

Mr. GREGG. No, sir; we reduce them below the par value every day.

The CHAIRMAN. Just what was the reason for taking the $45,000,000 in this case?

Mr. GREGG. On the revaluations. I suppose Mr. Grimes's revaluation, in accordance with the Secretary's order, for 1919 and subsequent years gave $45,000,000. I did not know what it was until Mr. Box gave it this morning.

Mr. BOX. You mean the revaluation?

Mr. GREGG. Yes.

The CHAIRMAN. You have not got the revalution here?

Mr. BOX. I have not a copy of it here.

The CHAIRMAN. I wish you would give it to the committee, because I got the impression that the revaluation accepted was $45,000,000, and it seems to me that even that was excessive in view of the testimony given before Governor Whitman.

Mr. GREGG. I should rather imagine——

Mr. BOX. That is so. The value of the property taken over in 1908 in this revaluation is $45,000,000. I can not tell you how much has been added for subsequent acquisitions.

Mr. GREGG. I rather imagine the committee will find that since the revaluations in 1919 were made by Mr. Grimes, it is plenty low.

Senator KING. I would like to know whether those acquisitions have been paid for by just issuing additional stock or whether there has been new capital added.

Mr. GREGG. I think you will find, Senator, that surplus has been invested in new property.

The CHAIRMAN. Is that the only case you have to present this morning, Mr. Box?

Mr. BOX. That is the only one, sir.

(The exhibits submitted by Mr. Box are as follows:)

EXHIBIT A

PHELPS, DODGE & CO.,
New York, June 15, 1911.

To the stockholders of Phelps, Dodge & Co.:

At the time of the purchase by Phelps, Dodge & Co. of the Copper Queen Consolidated Mining Co., Detroit Copper Mining Co. of Arizona, Moctezuma Copper Co., and the Stag Cannon Fuel Co. the values of the mines and mining

claims of these companies were carried on the respective books at nominal figures only, following out an established policy of years' standing.

Since the law relative to excess tax on corporations became effective we have found that to avail ourselves of its provisions as to deductions from annual gross income for depreciation on mines and mining claims it is essential that the actual value of mines and mining claims shall be recorded in our books and accounts because of the following ruling of the United States Internal Revenue Department, viz: "No system of bookkeeping or accounting will be required by the department. However, the business transacted by corporations, etc., must be so recorded that each and every item therein set forth may be readily verified by an examination of the books and accounts where such examination is deemed necessary."

To meet these conditions and establish our right to deductions for depreciation we have, under authority of the board of directors of the several companies mentioned, written up the values of mines and mining claims as follows, so that the total values shown on the books will equal the total estimated values at the time of the sale to Phelps, Dodge & Co., December 31, 1908:

	From book value of—	To—
Copper Queen Consolidated Mining Co	$500,286.45	$13,967,242.74
Detroit Copper Mining Co. of Arizona	585,984.23	2,821,569.35
Moctezuma Copper Co	992,770.80	3,846,201.71
Stag Canon Fuel Co	500,000.00	3,479,031.95

PHELPS, DODGE & CO.,
W. F. CRANE, *Comptroller.*

EXHIBIT B

The following is a statement attached to the return of annual net income of the Copper Queen Consolidated Mining Co. for the year 1910 sworn to by James Douglas, president, and George Nottman, treasurer:

COPPER QUEEN CONSOLIDATED MINING CO.—DEPRECIATION

In fixing "a fair and just estimate of the actual amount of depreciation" this company has considered that its plant and real estate would be obsolete or worthless in approximately eight and one-third years, and therefore for a number of years has been writing off 12 per cent per annum covering such depreciation.

The books of the company do not definitely show "the amount actually invested" representing the value in mines and mining claims, but in making up this report of annual net income we desire to clearly indicate that we believe we are making a fair and just estimate when we assume that 12 years will approximate the life of the mines, and therefore the annual rate of depreciation of mines and mining claims will be one-twelfth of their total estimated value, being, say, $13,967,242.74.

This depreciation is based upon the fair and just valuation of said mines and mining claims as determined December 31, 1908.

The plant investment and real estate is carried on December 31, 1910, at $2,152,424.04, an eighth of which is $269,053.

The mine value as per valuation of December 31, 1908, is $13,967,242.74, on which the depreciation of one-twelfth annually is $1,163,936.90, the depreciation on both plant and real estate and mines and mining claims aggregating $1,432,989.90.

EXHIBIT C

The following is a statement attached to the return of the Stag Cannon Fuel Co. for the year 1909, which was sworn to by A. C. James, vice president, and George Notman, treasurer:

BASIS OF ARRIVING DEPRECIATION FOR REPORTING AND RETURN OF NET INCOME FOR 1909, STAG CANNON FUEL CO.

This company is the Operating Fuel Co. at Dawson, N. Mex., for the Dawson coal fields, and is operating under lease the mines and plant of the Dawson Fuel Co. in connection with its own plant.

In fixing "a fair and just estimate of the actual amount of depreciation" upon the plant and real estate, not including the mines, of the above-named properties, would say that the only charge so far set up against this class of company property is to cover the ordinary wear and tear which is not made good through maintenance and repairs.

In making this report of annual net income we desire to clearly indicate that we believe we are making a fair and just estimate when we assume that 20 years will approximate the life of the plant, and therefore the annual depreciation will be one-twentieth of the total value of the plant as of December 31, 1909, apportioned as follows: Dawson plant $2,327,159.53, and Stag Cannon plant $129,346.09. Total depreciation will be $122,825.28 annually.

EXHIBIT D

The following is a statement attached to the return of the Moctezuma Copper Co. of New York for the year 1909, which was sworn to by A. C. James, vice president, and George Notman, treasurer.

BASIS FOR ARRIVING AT DEPRECIATION AND VALUE OF MINES FOR REPORTING DEPRECIATION FOR RETURN OF NET INCOME FOR 1909, MOCTEZUMA COPPER CO.

Balance sheet December 31, 1908

Plant investment and real estate (not including mines and mining claims	$3,090,480.82
Other assets	1,063,317.47
Estimated value of mines	3,846,201.71
Total	8,000,000.00

In fixing "a fair and just estimate of the actual amount of depreciation" this company considers that its plant and real estate will be obsolete and practically valueless in approximately eight and one-third years, and will therefore depreciate this class of its property, say, by an annual deduction of one-eighth of $3,090,480.82, equalling $386,310.10.

The books of this company do not definitely show the "amount actually invested" representing the value in mines and mining claims, but in making this report of net annual income we desire to clearly indicate that we believe we are making a fair and just estimate when we assume that 12 years will approximate the life of the mines, and therefore the annual rate of depreciation of mines and mining claims will be one-twelfth of their total value, as shown above, being, say, $3,846,201.71. The annual depreciation, therefore, will be on mines $320,516.81 and is based upon the fair and just valuation of said mines as determined December 31, 1908, as per above memo. No depreciation is included in the ordinary and necessary expenses but is shown under the proper heading.

EXHIBIT E

The following is a statement attached to the return of net income of the Detroit Copper Mining Co. of Arizona for the year 1909 which was sworn to by C. H. Dodge, president, and George Notman, treasurer.

BASIS FOR ARRIVING AT DEPRECIATION AND VALUE OF MINES FOR REPORTING DEPRECIATION FOR RETURN OF NET INCOME FOR 1909—DETROIT COPPER MINING CO. OF ARIZONA

Balance sheet, December 31, 1908

Plant investment and real estate (not including mines and mining claims)	$414,243.52
Other assets	2,764,187.13
Estimated value of mines	2,821,569.35
Total	6,000,000.00

In fixing "a fair and just estimate of the actual amount of depreciation," this company considers that its plant and real estate will be obsolete and practically valueless in approximately eight and one-third years, and will, therefore, depreciate this class of its property, say, by an annual deduction of one-eighth of $414,243.52, equaling $51,780.44. Would say that this company has for a number of years past been depreciating its capital investment at the rate of 12 per cent annually.

The books of this company do not definitely show the "amount actally invested," representing the value in mines and mining claims, but in making this report of net annual income we desire to clearly indicate that we believe that we are making a fair and just estimate, when we assume that 12 years will approximate the life of the mines, and mining claims will be one-twelfth of their total value as shown above, being, say, $2,821,569.35. The annual depreciation will be, therefore, $235,130.78, and is based upon the fair and just valuation of said mines as determined December 31, 1908, as per memorandum above. No depreciation is included in the ordinary and necessary expenses, but is shown under the proper heading.

EXHIBIT F

PHELPS DODGE CORPORATION AND SUBSIDIARIES

The letters have been signed by the reviewer merely as a matter of form in order that case may go through regular channels. The case is handled absolutely erroneously even from the standpoint of allowing paid-in surplus; basis used to determine depletion for invested capital is groundless even should the figures be approximately correct. (Which is not admitted.) The depletion should be figured on each grade of copper separately based on a suitable production life. (This is possible.) There is also allowed reserves for bad debts and taxes $850,[illegible] which is in no way substantiated nor was it claimed by taxpayer on his own amended return.

My signature is therefore a matter of form only and I shall in no way be responsible for the inaccuracies in this case.

ROB'T P. SMITH.

DECEMBER 13, 1922.

EXHIBIT G

MEMORANDUM FROM REVIEW SECTION

Phelps Dodge Corporation and subsidiaries.

A number of discrepancies appear in this case.

In the first place, as to valuation, the amounts allowed provisionally by Engineer Darnell are not substantiated by any figures. The valuation shown by five different methods in metal section show that the value of mines could not be more than $72,000,000 as of 1913, and that the evidence shows that no paid-in surplus existed as of 1908. The largest possible value for invested capital is $45,000,000 or the par value of stock at January 1, 1914. To which should be added the acquisitions for cash between the dates of January 1, 1909, and January 1, 1914. It is understood that the metals valuation section is not allowed to make a revaluation in this case on the grounds that it is a closed incident.

This, of course, is not true, as an A-2 letter assessing additional tax is now under preparation. It should be noted that a memorandum, approved by head of division, prepared by coal valuation section, wherein the value of the coal property has been revalued and accepted by the audit, which reduces original value shown by Mr. Darnell by approximately $10,000,000. It is not clear why a revaluation is permitted on coal lands and not for metals. This method of valuing merely transfers the reduced value of the coal to the copper and is very inconsistent.

It is my judgment that case ought to be closed on basis of memorandum from metal valuation section, which is in the file, but which is not yet approved by head of division.

Assuming, however, that the value of $90,000,000 should be followed, there are apparent discrepancies which even then should be changed.

The original mineral deposit was grouped in the following companies, which were acquired for stock in 1908 by the Phelps Dodge Co. for $45,000,000 of stock:

Stag Common Coal Co	$4,000,000
Copper Queen Consolidated Co	27,000,000
Detroit Copper Co	6,000,000
Moctezuma Copper Co	8,000,000
Total	45,000,000

Allowing an additional paid-in surplus of $45,000,000, allocating proportionately as above, we would have the following original values, which also includes physical and liquid assets.

Stag Common Coal Co	$8,000,000
Copper Queen Consolidated Co	54,000,000
Detroit Copper Co	12,000,000
Moctezuma Copper Co	16,000,000
Total	90,000,000

The coal valuation section has valued the coal land as $1,652,100, hence the above should be reduced by the difference between $8,000,000 and $1,652,100, or $6,347,900.

The difference therefore should be disallowed from invested capital.

The value of the mineral assets should therefore be—

Value shown on books Dec. 31, 1916		$34,616,649.65
Plus	$45,000,000	
Less	6,347,900	
		38,652,100.00
Total		73,268,749.65

Total new value is based on provisional paid-in surplus allowance, and including assets which were acquired since organization for cash, and without deducting depletion.

The method of computing depletion is decidedly incorrect; in fact, the entire cost, including paid-in surplus, has been allocated to three companies—the Copper Queen, the Moctezuma, and the Detroit Co.—whereas there is approximately 237,000,000 pounds of copper in Burro Montana mine, which was acquired for cash before 1913; but after organization (date not known), also the Copper Queen porphyry deposit, which was assigned no value, which have not been considered.

The value of all grades of copper from various interests has been considered as being the same, whereas the value of the Copper Queen, which was the most valuable asset, has a much larger unit value than others. Hence, as the values are already allocated, the depletion on each grade of copper should be figured separately. Since the greater part of the value is represented in the Queen copper mines, it is believed that the depletion in any event would be greatly increased.

The allocation of stock acquisition includes in addition to the mining deposit considerable physical assets, for this reason depletion computation will entail considerable work; and a memorandum from valuation section containing these computations should be secured.

It is, therefore, recommended that if the above valuation of metals be approved (which is not considered correct), that the appreciation applicable to coal be eliminated; and that the depletion for invested capital be computed on metals, including computation of the Burro Montana mine, and in any event computed on the basis of the value of copper of each mine separately, which is clearly shown.

It might be well to state that should this case be closed in its present deplorable condition the department would not be able to retract its position, as this is a paid-in surplus allowance and not a January 1, 1914, value, which we are dealing with. Consequently if it is permitted to be closed for 1917 on this basis it would follow same would be allowable for subsequent years. This company has paid only about 10 per cent tax. The additional assessment increases this somewhat. The average rate for this class of companies, including largest copper mines, is not less than 18 to 20 per cent; and the average is about 30 per cent for 1917. There is more than $10,000,000 additional tax involved in this case for the three years, and since we are partially distributing the value requested by them, we might better take them at their word and close the case under section 210, as they have so requested on their amended 1917 return. See valuation request, dated November 22, 1922.

It should be borne in mind that neither the review section or metals valuation section approve the valuation in this case. Additional points to be investigated by auditor.

On the balance sheet submitted by the taxpayer or that contained in agent's report there does not appear any reserve for taxes or "bad debts," neither does taxpayer claim any such items on his return for "invested capital."

The reviewer does not follow adjustments made for depreciation. The taxpayer shows a consolidated reserve for depreciation of $3,904,847.87. Auditor has made adjustment for additional depreciation of $1,090,752.95, and for what he calls depreciation restored to capital as of December 31, 1916, of $1,440,000. These adjustments are questionable. The amounts shown on schedule (21–I) listed "as per books," do not agree with resources on balance sheets. The auditor should check this. Reviewer does not say they are incorrect, but time allocated for review does not permit of a detailed check of those items, so same should be carefully investigated by auditor.

It is recommended that above points be carefully considered.

ROBERT P. SMITH, *Reviewer.*

EXHIBIT H

DECEMBER 11, 1922.

Memorandum for Deputy Commissioner Batson.
(Attention Mr. Fay, head natural resources division.)

Reference is made to the memorandum prepared by Mr. Grimes to the commissioner, dated January 7, to Mr. Fay's memorandum to you, dated February 7, to your memorandum to Mr. Fay, dated February 16, and to the various memorandum regarding the tax liability of copper companies for 1917 and subsequent years.

Full consideration has been given to the question, and it is concluded that for 1919 and subsequent years the valuation of the ore bodies of copper mines should be revised. The price of approximately 15 cents a pound, recommended by the natural resources division, and the 10 per cent interest rate are approved for the purpose of discounting to the present worth. The Income Tax Unit is authorized and instructed immediately to proceed to the revaluation of the copper and silver mining companies for the purpose of determining their tax liability for 1919 and subsequent years in accordance with the recommendation heretofore made by it.

D. H. BLAIR,
Commissioner of Internal Revenue.

Approved:

A. W. MELLON,
Secretary of the Treasury.

EXHIBIT I

MEMORANDUM

MAY 28, 1923.

In re: Phelps-Dodge Corporation.

To the COMMISSIONER:

A conference was held in my office this morning with representatives of the above-named corporation to discuss the proposal of the Income Tax Unit to reopen the 1917 audit because of an erroneous computation of the invested capital in office letter dated June 10, 1920.

Mr. Matthew C. Fleming and Mr. Sterling, who represented the corporation, exhibited a copy of a valuation report dated December 1, 1919, signed by Mr. L. C. Graton, valuation engineer, and Mr. J. C. Dick, head metals valuation section, in which the total valuation of the mineral property was said to be in the neighborhood of $110,000,000 as of 1908, the date of the organization of the company. A subsequent memorandum, undated, signed by Mr. J. L. Darnell, then head of the natural resources subdivision, states that it was agreed that the company should be permitted to include a paid-in surplus of $45,000,000 in the invested capital, since it was clearly shown that the properties had a value in 1908 in excess of $90,000,000.

Acting upon the recommendation of Mr. Darnell, the consolidated returns subdivision prepared a letter dated March 3, 1920, in which it was stated that the invested capital for the year 1917 should be $110,756,190.37.

An audit was made shortly thereafter and the tax liability for the year 1917 determined. The auditor in preparing a letter setting forth this tax liability stated "your invested capital has been fixed as agreed in conference at $110,756,190.37." This letter is written in longhand preparatory to typing, but was never typed, as a request was made by the corporation at this time that the audit be extended to cover the year 1918. The final letter dated June 10, 1920, contained schedules 1 to 30, setting forth the tax liability for the years 1917 and 1918 and was made "subject to amendment by a field examination, which may later be made if deemed necessary by the bureau." It appears that the change in wording of the final assessment letter from that proposed by the auditor has some significance, and the inference is that the audit for the year 1917 was considered by all concerned to have been complete, but when in compliance with the request of the corporation the year 1918 was included in this audit it was thought best to make such audit for the year 1918 subject to a field examination, since no revenue agent's examination had been made for that year.

Therefore I wish to recommend that, although the year 1917 was mathematically incorrect and the invested capital allowed the corporation was considerably in excess of the proper allowance, it should be considered closed, but the unit should be allowed to reopen the audit for 1918 on all points other than the actual valuation of the property to determine the correct tax liability.

J. G. B.

Assistant Deputy Commissioner.

EXHIBIT J

THE UNDERSECRETARY OF THE TREASURY,
Washington, June 29, 1923.

To the COMMISSIONER OF INTERNAL REVENUE:

I am returning herewith the papers which you left with me in connection with the tax liability of the Phelps-Dodge Corporation. From such examination as I have been able to make of the papers and from the statements made the other afternoon by the various representatives of the Bureau of Internal Revenue and the Solicitor of Internal Revenue, I should say that the error in the computation of invested capital raised a sufficiently serious question as to tax liability to warrant the reopening of the case for both 1917 and 1918. I take it from the statements made by the representatives of the Income Tax Unit that for 1917 the result is likely to be about the same even if the case is reopened, but apparently there might be quite a different result for 1918, and since there is no doubt as to the legal power of the commissioner to reopen the case I think it had best be reopened for all purposes for both

years, thus avoiding any possibility of stopping the Government in respect to 1918 through acceptance of the computation for the purposes of the 1917 tax.

S. T. GILBERT, Jr.

EXHIBIT K

OSBORN, FLEMING & WHITTLESEY,
New York, January 19, 1924.

Hon. ANDREW W. MELLON,
Secretary of the Treasury, Washington, D. C.

DEAR MR. SECRETARY: On January 20 of last year you very kindly gave me a conference with regard to the taxes of Phelps-Dodge Corporation for the years 1917 and 1918, which we regard as finally settled in 1920. Later I sent additional data to you and afterwards had conferences with Mr. Bright and other people in the Bureau of Internal Revenue.

I have heard nothing from the department since last June, but the company is now in receipt of a bureau letter dated January 17 stating that for 1917 an additional assessment of $131,116 will be made, and also of a letter dated January 11 which suggests that the company is liable for an additional assessment of $4,303,195 for 1918. Most of the facts with regard to both these matters were set forth in the papers submitted to you last year, and it would not be right for me to ask you to reexamine them. I do think, however, that we are justified in calling to your personal attention the following summary:

For the year 1917 this additional tax of $131,116 is reached by reducing the invested capital, fixed at $110,756,190 by the bureau in 1920, to roughly $102,000,000. The bureau now claims that the reduction is made necessary by a "mathematical error." We claim that the supposed error is due to a difference of opinion as to the meaning of article 844 of Regulations 45. The important fact, however, and the one which I desire to submit to your personal consideration is this:

I have sworn, and it is absolutely the fact, that we made a bargain with the department in 1920 whereby in consideration of our obtaining the above $110,000,000 invested capital, irrespective of how it was made up, we accepted a very large reduction in the depletion figures which our engineers claimed and agreed to a reduction of about $40,000,000 in the March 13, 1913, value of our mines. We did this because we then felt that this increased invested capital would offset in taxes what we lost by reason of increased income. That this was not a one-sided bargain is shown by the fact that the entire assets of the company in 1917 were worth far in excess of $110,000,000; and then when the company was formed in 1908, as appears by a memorandum of the Government engineers dated December 1, 1919, on file in the bureau, the mines alone were worth about $110,000,000. This mine value with other assets would make a total 1908 value of $135,000,000 at the time the company was formed instead of the $90,000,000 which we agreed to accept if our 1917 invested capital was left at $110,000,000. On this basis our "paid-in surplus" in 1908 would have been $90,000,000 instead of the agreed $45,000,000. So that there is no question about the fact that the bargain was made and that it was not a disadvantageous one to the Government. We therefore contend that it is absolutely unfair for the Government now to recede from its side of this 1920 bargain by decreasing our invested capital thus agreed upon and at the same time to get the benefit of its part of the bargain by holding us to a lower depletion and lower valuation in 1908, at the time of the formation of the company, than we certainly could have obtained in 1920 if any such contentions as the present ones had then been made.

The same facts affect the invested capital and depletion for the year 1918. For as part of the same arrangement it was agreed that the invested capital and depletion fixed for the year 1917 were to be carried forward and made the basis for the year 1918.

One additional fact will show that we have always regarded the matter as closed, and that is that under section 304 (c) of the 1921 law we had a perfect right to go back and claim a refund for that part of our 1917 income due to the production of gold. We have always advised the company, however, that as the above settlement was final, it had no right to disaffirm it by making any application for refund under this section.

In order that there may be no question as to the form in which these statements are made I attach my affidavit.

We therefore respectfully ask that in some way these very annoying matters be closed for the two years in question and that the department live up to the bargain which its predecessors made in 1920.

Very respectfully yours,

MATTHEW C. FLEMING.

STATE OF NEW YORK,
County of New York, ss:

Matthew C. Fleming, being duly sworn, deposes and says that he is general counsel for Phelps Dodge Corporation and is familiar with the facts stated in the above letter, and that the same are true to the best of his knowledge, information, and belief.

Sworn to before me this 19th day of January, 1924.

JAMES HAING,
Notary Public No. 95, Kings County.

My commission expires March 30, 1924.

EXHIBIT L

(Copy of schedule No. 15, including letter of June 10, 1920, from rough draft in files; original letter not found)

SHEDULE 15

Analysis of depletion reserve, Phelps Dodge Corporation, year ended December 31, 1917

Cost of mining claims per books		$34,616,649.65
Paid-in surplus		45,000,000.00
Total cost		79,616,649.65
Value Mar. 1, 1913, per United States engineers	$132,285,000.00	
Bunker Hill mines	1,092,019.29	
Total value Mar. 1, 1913		133,377,019.29
Depletion sustained based on value Mar. 1, 1913		53,760,369.64
Depletion from Mar. 1, 1913, to Dec. 31, 1916		20,123,008.65
Depletion above divided proportionately—	Per cent	
As no depletion on cost	59.70	12,013,436.16
And realized appreciation	40.30	8,109,572.49
Total	100.00	20,123,008.65
Depletion reserve per books Dec. 31, 1916		13,432,404.33
Depletion sustained on cost		12,013,436.16
Allowable addition under schedule B		1,418,968.17
Realized appreciation as above		8,109,572.49
Total allowable addition under Schedule B		9,528,540.66

(See Exhibit M following in explanation of elimination of "Realized appreciation.")

EXHIBIT M

MARCH 6, 1924.

Mr. MATTHEW C. FLEMING,
New York, N. Y.

SIR: Receipt is acknowledged of your letters dated January 19 and 31, 1924, in regard to the tax liability of the Phelps-Dodge Corporation for the years 1917 and 1918, but presenting no information or argument which has not previously been considered by the department.

On June 29, 1923, the Acting Secretary of the Treasury instructed the Commissioner of Internal Revenue that in the case of the determination of tax liability of the Phelps-Dodge Corporation for 1917 and 1918 "the error in the computation of invested capital raised a sufficiently serious question as to tax liability to warrant the reopening of the case for both 1917 and 1918," and that "since there is no doubt as to the legal power of the commissioner to reopen the case I think it had best be reopened for all purposes for both years."

The above instructions did not reach the Income Tax Unit until after the waiver covering the 1917 tax liability furnished by the taxpayer had expired and a materially lower additional assessment resulted than would otherwise have been the case.

The Income Tax Unit has followed the instructions of the Acting Secretary of the Treasury dated June 29, 1923, concerning the audit of the 1918 return of this taxpayer. The procedure directed in the letter just mentioned has been adjusted to accord with previous instructions on copper-mine revaluation contained in a letter dated December 11, 1922, from the Commissioner of Internal Revenue under my approval.

Inasmuch as a decision was reached to allow the original, or provisional, valuations to govern the audit of returns for 1917 and 1918, but to make new valuations for invested capital and depletion for the audit of returns for 1919 and subsequent years, the values which you state were the result of "a bargain with the department in 1920" have not been altered for 1917 or 1918.

The value allowed in 1918 for invested capital as at January 1, 1909, has been reduced by the amount of depletion sustained to December 31, 1917, in accordance with the explicit instructions in regulations 45, article 839.

The only adjustment made in the reaudit of the 1917 return of this taxpayer was to eliminate the amount of realized appreciation which had been erroneously allowed in office letter of June 10, 1920.

Inasmuch as the books of the taxpayer prior to December 31, 1916, had not reflected depletion, except upon the basis of cost, it is obvious that there can be no realized appreciation added to invested capital in 1917 on account of depletion in excess of that on cost.

I am therefore of the opinion that the Income Tax Unit in its consideration of the 1917 and 1918 tax liability of the Phelps-Dodge Corporation has complied with the instructions cited, and trust that this review of the situation will be both satisfactory and conclusive to your client. If such is not the case, waivers may be filed for both 1917 and 1918 and complete reconsideration accorded to the audit of the returns for both years, including valuation questions, if you so desire.

Respectfully,

A. W. MELLON,
Secretary of the Treasury.

EXHIBIT N

MARCH 28, 1924.

Mr. MATTHEW C. FLEMING,
New York, N. Y.

SIR: Reference is made to your letter dated March 10, 1924, in regard to the income-tax liability of the Phelps-Dodge Corporation for the years 1917 and 1918, involving the depletion values established for these years as well as the invested capital.

Inasmuch as the figures arrived at by the bureau as to the determination of the March 1, 1913, values for the purpose of depletion and the amount of invested capital to which the taxpayer is entitled for the years 1917 and 1918

are not satisfactory to the taxpayer, and in view of the misunderstanding as to certain adjustments in these values, the entire case will be reconsidered.

Referring to your statement in regard to any bargain which may have been mad by the bureau's representative with respect to depletion values and invested capital, you are advised that these matters are questions of fact to be established by the best evidence available, and the bureau's representative in the particular audit case is not vested with authority whereby such values may be established through bargaining with the taxpayer's representative. The case will, however, be carefully reconsidered by representatives of the Income Tax Unit. The conference will be arranged at an early date, at which which you may present any additional evidence and arguments which you desire to be considered.

Respectfully,

D. H. BLAIR, *Commissioner*

EXHIBIT O

JANUARY 27, 1925.

Mr. GREENIDGE: I am returning memorandum dated January 10, 1923, addressed to the Commissioner of Internal Revenue and prepared for my signature, wherein a request is made of the commissioner that he inform this office (metals valuation section, Income Tax Unit) as to the interpretation of the intent of the memorandum dated June 29, 1923, from Undersecretary Gilbert, and the commissioner's letter dated March 28, 1924.

I do not see the necessity of requesting the commissioner to place an interpretation on either his letter of March 28, 1924, addressed to Mr. Matthew C. Fleming in connection with the audit of the Phelps-Dodge Corporation case for the years 1917 and 1918 or to the memorandum from Undersecretary Gilbert dated June 29, 1923, with reference to the same corporation, in view of the definite information contained in the letter of the Secretary to Mr. Matthew C. Fleming dated March 6, 1924. Your attention is invited to the last paragraph of the first page of that letter and to the last sentence of the last paragraph on page 2, which read as follows:

"Inasmuch as a decision was reached to allow the original, or provisional, valuations to govern the audit of returns for 1917 and 1918, but to make new valuations for invested capital and depletion for the audit of returns for 1919 and subsequent years, the values which you state were the result of a 'bargain with the department in 1920' have not been altered for 1917 or 1918.

"If such is not the case, waivers may be filed for both 1917 and 1918 and complete reconsideration accorded to the audit of the returns for both years, including valuation questions, if you so desire."

In all the conferences held with this taxpayer and its representatives they have been informed that the original, or provisional, valuations for the years 1917 and 1918 would not be altered, but that the commissioner had the right and authority to reopen the case for these years, inasmuch as there had been a mathematical error made in the computation of the invested capital for those two years. The error in question is on realized appreciation in an amount approximately $8,000,000 erroneously allowed in office letter of June 10, 1920. The taxpayer contended that the amount of invested capital shown in office letter of June 10, 1920, was an amount agreed to by the department, and should therefore stand, and it was not the valuation of the properties as of a certain date that was agreed to. The taxpayer's representatives were, therefore, informed that they would be permitted to produce evidence which might increase the valuation if such evidence was based in the light of the circumstances and conditions under which the valuations for the years 1917 and 1918 were made by those officers of the Income Tax Unit in charge of the metals valuations section.

Therefore it appears to me that this case is open to the Government only for the purpose of correcting the error in invested capital and to the taxpayer to permit it to prove a high valuation on the basis of evidence and facts in its possession.

J. G. BRIGHT, *Deputy Commissioner.*

EXHIBIT P

JANUARY 10, 1925.

Memorandum to the Commissioner of Internal Revenue.
In re: Phelps Dodge Corporation, 170 Broadway, New York, N. Y.

Reference is made to a memorandum of Undersecretary of the Treasury S. P. Gilbert, jr., dated June 29, 1923, to a letter of Secretary of the Treasury A. W. Mellon, dated March 6, 1924, and to a letter of Commissioner of Internal Revenue D. H. Blair, dated March 28, 1924. Copies of the above memorandum and letters are attached.

It has been the understanding of the metals section that the questions raised and presented for the consideration of Undersecretary S. P. Gilbert, and to which his memorandum of June 29, 1923, refers, were only those pertaining to certain adjustments to invested capital for the years 1917 and 1918, and that, while the language of the memorandum of Mr. Gilbert refers to "reopening the case for all purposes" the intent was to confine the reopening of the case to the question considered by Mr. Gilbert. This understanding was reached after interviewing Mr. W. C. Tungate, chief of section G, consolidated audit division, and Mr. Nelson T. Harton, Solicitor of Internal Revenue, who were present at the conference with Undersecretary Gilbert, and appears to be correct, as evidenced by the letter of the Secretary of the Treasury dated March 6, 1924.

The statement in the second paragraph of the letter of the commissioner dated March 28, 1924, might be open to the possible interpretation that the questions of valuation for invested capital and depletion are to be reopened by the unit for the taxable years 1917 and 1918, and upon the basis of valuation approved by the memorandum of December 11, 1922, from the commissioner authorizing and instructing the Income Tax Unit to revalue the copper-mining industry.

It is the understanding of the metals valuation section that the "provisional values" allowed for depletion and invested capital are to govern the unit in the audit of tax returns for 1917 and 1918 for all of the copper companies, which would include the Phelps Dodge Corporation, unless the taxpayer protesting such valuations is able to substantiate greater values than were allowed by the "provisional valuations," and the letter of March 28, 1924, signed by the commissioner is interpreted subject to the foregoing limitation.

The taxpayer has presented no new evidence to substantiate claimed values of the properties at acquisition and at March 1, 1913, and a reconsideration at this time by the unit would, in the opinion of the metals valuation section, result in material reduction in the amounts allowed by the "provisional valuations," both as at date of acquisition and as at March 1, 1913.

Will you please advise the metals section whether the above interpretation of the intent of the memorandum of Undersecretary Gilbert and your letter of March 28, 1924, is correct, or whether it is intended to make an exception in this case to the general rule that the "provisional values" shall be allowed to stand for 1917 and 1918 as indicated by your memorandum of December 11, 1922, in regard to revaluation of the copper-mining companies?

———,
Deputy Commissioner.

EXHIBIT Q

JANUARY 23, 1925

Memorandum for file of Phelps Dodge Corporation (1918 return).
In re: Letter of January 10, 1925, addressed to the Commissioner of Internal Revenue bearing symbols IT:EN:M:F.T.D. and copies of letters attached thereto.

About January 20, 1925, Mr. Greenidge, head of engineering division, stated verbally that the commissioner had instructed him that the case was to be audited in conformity with the statements of his letter of March 28, 1924, directed to Mr. M. C. Fleming, attorney for the above corporation.

In view of the questions of this office directed to the commissioner in the letter of January 10, 1925, this office can read the commissioner's letter in but one way and therefore recommends that the case be revalued for 1918 on the basis of the valuation methods approved by the commissioner in his memorandum of December 11, 1922, authorizing and instructing the Income Tax Unit to revalue the copper and silver mining industries.

The valuations of the properties of the taxpayer are therefore being sent to audit on this basis.

JOHN ALDEN GRIMES,
Chief, Metals Valuation Section.
F. T. DONAHOE,
Assistant Chief, Metals Valuation Section.

EXHIBIT R

JANUARY 26, 1925.

MEMORANDUM

In re: Phelps Dodge Corporation, New York, N. Y.

Mr. S. M. GREENIDGE,
Head Engineering Division.

Your attention is invited to the attached memorandum dated January 23, 1925, prepared in the metals valuation section of your division, which recommends that the case of the above-named company be reaudited for the year 1918, using as the basis a new valuation as at date of organization and March 1, 1913, which conforms with the valuation methods used for all copper companies in connection with their 1919 returns.

Under date of December 11, 1922, the commissioner, with the approval of the Secretary of the Treasury, instructed the Income Tax Unit to revalue the copper companies for the years subsequent to 1918, and made it very clear that no revaluation was to be attempted for the years 1917 and 1918. This procedure has been followed in all the copper companies to date, and to take the action recommended by the metals section in its memorandum mentioned would appear to place the Phelps Dodge Corporation in an unfavorable position when compared with the action taken on other companies similarly situated. It is true that the commissioner's letter dated March 28, 1924, may be interpreted to mean that the revaluation should be made for both years 1917 and 1918, but that interpretation would be in conflict with letter of March 6, 1924, signed by the Secretary of the Treasury, which explains to the attorney of the company in detail what action is contemplated for all years involved.

In view of the situation in which the audit division finds itself placed by the submission of a new valuation report for the year 1918 by your division, it is felt that your personal approval of this action should be secured before a reaudit is made upon the basis of the valuation submitted with the memorandum of January 23, 1925.

———, ———,
Head Consolidated Returns Division.

Senator KING. I would like to have the department give us their view of the matter that I suggested the other day, and I wish to suggest it now, because it will be involved in legislation, it seems to me, and I may want to make some recommendations in our report if the committee does not agree with me on this matter. In looking over the report for 1922 I find that there were 170,348 corporations that made returns showing no net income whatever.

Mr. GREGG. For what year is that, Senator?

Senator KING. 1922. What is the page there?

Mr. GREGG. We can find the page.

Senator KING. And yet those same corporations paid cash dividends amounting to nearly $254,000,000 and stock dividends amounting to $181,134,291, or a total of $4,349,794.

I should be very glad, if it is not too much trouble, Mr. Nash, to have somebody in your office look over those corporations—some of the outstanding corporations there—which paid the largest dividends and give us your view as to how it was possible for them to make the returns which they did of no income whatever, and yet

pay cash dividends and stock dividends amounting to $434,000,000, or nearly $435,000,000?

Mr. GREGG. I think I can answer the Senator now. I know I can answer him now as well as I could after an investigation.

The dividends paid by a corporation during a given year do not necessarily bear any relation at all—as a matter of fact, they usually do not—to the earnings in that year.

The CHAIRMAN. I am interested in that, because I find that the new computation on the chairman's stock based it on the dividends that were paid and those that were not paid.

Mr. GREGG. I thought they based it on the earnings of the corporation rather than on the dividends.

The CHAIRMAN. Well, the statement was that the dividends were likely to be less instead of more, or something to that effect.

Pardon me for interrupting you, Senator.

Senator KING. Let me say this: That my understanding is that many of these same corporations before and since have made similar reports.

Mr. GREGG. That is quite possible, Senator, but look at this point of view for just a minute.

A corporation's dividends during a given year are not determined, as a usual thing, by the earnings for that year. For example, you have for the first three months——

Senator KING. Oh, they may or they may not. It depends on their practice.

Mr. GREGG. During the first three months of the year a large corporation does not even know accurately its earnings for the preceding year. It certainly does not know its net income, and so many corporations adopt a policy of having their dividends fixed each year. One year it may be 10 per cent only of the earnings for that year. In another year it may exceed the earnings for that year, but it does not bear any direct relation to the income of the corporation for the year during which the dividends are paid. They are paid out of the surplus accumulated in prior years. They will pay one year more out as dividends than they will earn in that year. The next year they will pay materially less. The result is that over a period of years they are adding to their surplus and have a surplus on hand out of which they can pay in any year a dividend.

That is particularly true with reference to the dividends on preferred stock, which are included in the statement which the Senator just read. A corporation having preferred stock with a guaranteed dividend is going to pay them, if they have a surplus from prior years, whether they have earnings during a particular year or not.

Another point: A corporation may have tax-exempt income. This is particularly true of the banks. That does not show in their net income at all, but they can distribute that as dividends to their stockholders.

Again, a mining company or a natural-resource company will distribute its capital in the form of dividends since its ore body is being impaired. They have no net income. They may be absolutely operating at a loss, considering the cost of their ore properties, but they are getting money out of the property each year, and they might still

pay it to their stockholders. It is not a true dividend, although so labeled.

I think that is not difficult to explain, if you consider those factors. It is just on its face that it startles you.

The CHAIRMAN. I think Mr. Gregg's statement is a true statement of the real facts in the situation, and that those statistics do not really mean what they might imply.

Mr. GREGG. I do not think so. I do not think you can take general statistics of this sort and really get anything from them. If you will take individual companies, you will find hundreds of conditions which cause this result.

The CHAIRMAN. I think it might be better, then, for the bureau, if they did not publish those statistics, especially if they do not mean anything in so far as the interpretation of the activities of the bureau is concerned.

Mr. GREGG. Of course, our statistics are valuable for purposes other than tax purposes. They are used a great deal for purposes other than tax purposes.

The CHAIRMAN. But it seems to me that the bureau should only be interested in statistics which are valuable to itself.

Mr. GREGG. Of course, statistics as to the earnings of corporations and as to the dividend distributions of corporations are of general interest, particularly in connection with such proposals as Senator Jones's for the taxation of undistributed profits.

The CHAIRMAN. In that case, why do you not explain that your statistics of earnings and dividends have no real relation?

Mr. GREGG. I think we should.

The CHAIRMAN. Yes; I think that should be really emphasized in red figures, because they really do have no relation.

Mr. GREGG. They bear no relation to each other at all—the earnings and dividends for a given year.

The CHAIRMAN. I think the bureau overlooks a very valuable piece of information when you do not emphasize that.

Mr. GREGG. I think you are right. We should emphasize it.

Senator KING. Would it be possible, without any very great effort, Mr. Gregg, to find out whether any of these corporations to which I have just referred are paying those dividends in an improper way: that is to say, that they have concealed assets and earnings, and are paying these dividends right along from year to year without rendering a just account to the Government?

Mr. GREGG. In other words, to see if they are making a fraudulent income-tax return?

Senator KING. Yes.

Mr. GREGG. We check them, Senator, just as carefully and thoroughly as possible. Whether or not they return a taxable income, we check it to see if there is fraud. I think a taxpayer contemplating fraud would be very slow to pay large dividends and report an absolutely nontaxable return, because it must, on its face, call attention to facts which would make the department investigate it even more carefully. I think they would be more apt to return some taxable income, if they were attempting to evade the tax fraudulently.

Senator KING. Would it be difficult to determine what proportion of these 170,308 corporations which paid dividends and reported no net income, for how many years they have done it anterior to that

year, and whether since those years they have carried on the same practice?

Mr. GREGG. Well, it would involve examining the returns of those 170,000 corporations, not only for the year 1922 but for prior and subsequent years, which would be quite a task.

The CHAIRMAN. I would like to ask Mr. Gregg if he does not think that our investigations are going to disclose some of those things?

Mr. GREGG. I think they probably will.

The CHAIRMAN. I think if Senator King will look over the statistics that we have already compiled and are compiling he will find them classified as between corporations, as to those who earn and pay and those who do not earn, and those who distribute less than 60 per cent of their earnings, and he will develop from those statistics some of the things that he is inquiring for.

Senator KING. We will be very glad, Mr. Nash, if you could make a selection, just to show the point, of some 10 to 25 of those that I have referred to, giving some that paid the largest dividends. I wish you would have some clerks in your department go back two or three years and forward two or three years to see if they have indulged in the same practice for more than that year, just taking 10 to 25 promiscuously.

Mr. NASH. Yes; we will do that.

Senator KING. To give us a little slant on the extent to which this practice is carried on.

Mr. NASH. I just want to add here that the returns of every corporation of any kind that reports no net income are always examined by the field agents and a very careful check is made of such accounts. As Mr. Gregg pointed out, if they are paying any dividends that do not come out of surplus it constitutes a fraud, and we have found or discovered several such cases. Several of them are of considerable size. We have a very prominent millionaire of the Middle West serving time in Leavenworth to-day for that very thing.

The CHAIRMAN. My own observation is that the bureau is very strict and very careful to check all corporation returns of any magnitude, regardless of whether they turn in an income tax or not. Is not that correct?

Mr. GREGG. Yes, sir; that is very true, and they are very careful.

Mr. NASH. And the fact that they do not report any income usually puts them in the preferred list to be investigated.

The CHAIRMAN. I think that is very true.

Senator KING. You will remember, Mr. Gregg, in drafting the bill we did have the question up about these enormous amounts for deductions and depletions, which were distributed too often as dividends, and yet they were escaping taxes.

Mr. GREGG. Again, Senator, if I may make the suggestion, I think that is another subject which we can not get at from the point of view of general statistics.

The act lists specifically the deductions to which corporations are entitled, and it seems to me that the important point is whether they are entitled to those deductions, and not how much they aggregate in the totals. For example, take the first one—wages, salaries, and business expenses—and see whether they are entitled to that. The second one is interest. The third one is taxes. The fourth one is losses, then depreciation, depletion. We should check them in that

way to see if they are entitled to them. In doing that I think you will find that you will get further than by going to the totals to see how big the totals look. When you take the salaries, wages, interest, and taxes paid by all of the corporations in the United States, they are going to run up into a big total.

Senator KING. Of course, what they pay in wages, though, they would not distribute as dividends.

Mr. GREGG. No.

Senator KING. Because that money actually goes out.

Mr. GREGG. And what they pay in interest they can not distribute as dividends. If they had a loss, they could not distribute it as dividends, either. They can distribute dividends out of depletion reserves, although they can not, as a general rule, out of depreciation reserves.

The CHAIRMAN. Because that would be an extinction of the capital.

Mr. GREGG. Yes; there is plenty of law on that.

Senator KING. It depends on whether they are a public-service corporation or not.

Mr. GREGG. Most of the State laws are uniform in that respect, that the corporations having natural resources can distribute out of depletion reserve, but not out of depreciation reserve.

The CHAIRMAN. Because that might impair the capital.

Mr. GREGG. It impairs the capital; yes, sir.

The CHAIRMAN. Is that all?

Mr. GREGG. That is all we have.

Senator KING. Have you anything else this morning?

Mr. BOX. I have not.

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

(Whereupon, at 11.50 o'clock a. m., the committee adjourned until to-morrow, Tuesday, March 24, 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 the Solicitor of Internal Revenue; and Mr. W. S. Tandrow, appraisal engineer, Bureau of Internal Revenue.

The CHAIRMAN. You may take up your next case now, Mr. Manson.

Mr. MANSON. This is the matter of the General Carbonic Co.

Senator KING. Do you refer now to the company which had a good many subsidiaries?

Senator WATSON. The one which has its principal plant at Niagara Falls.

Mr. MANSON. That is the Union Carbide Co.

Senator WATSON. Is that the one that has factories on both sides of the falls at Niagara?

Senator KING. That is the Union Carbide Co.

Mr. MANSON. I think that is the Union Carbide Co.

The CHAIRMAN. Where is the General Carbonic Co. located?

Mr. MANSON. It has its main plant at Saratoga Springs, N. Y., and its main office in New York City.

The revenue act of 1921 levied a tax of 4 cents per pound on all carbonic-acid gas sold by the manufacturer. The manufacturer collected this tax from the purchaser. In this case the amount of tax collected monthly by the manufacturer exceeded $30,000.

The CHAIRMAN. When was that money to be remitted to the Treasury Department under the law and the regulations?

Mr. MANSON. Under the law and regulations it was to be transmitted to the Treasury Department once a month.

The CHAIRMAN. Is that the law, or is that the regulation?

Mr. MANSON. The law provides that they shall make the return in accordance with the regulations, and the regulations provide for remission once a month.

In this case there were no returns made for a period of 14 months, during which time the collections amounted to $406,351.98.

The president of the company absconded, with a shortage of $260,000. The company paid, I think it was, $110,000 in monthly installments to make good the shortage; that is, to make good the company's obligation to the Government for the tax which the company had collected on behalf of the Government. There was a balance of $296,351.98. This was compromised upon the ground that to enforce the collection of the money would have forced the company into bankruptcy, for $100,000 in cash and the release of a claim for a refund amounting to $32,000.

The CHAIRMAN. This in spite of the fact that this money had already been collected from the purchasers?

Mr. MANSON. It had been collected from the purchasers.

The CHAIRMAN. Was there no bond required by the bureau?

Mr. MANSON. That is the point that I wish to discuss.

I am not here for the purpose of criticizing the settlement that was finally made so much as I am the system.

Senator WATSON. What was the settlement?

Mr. MANSON. The ultimate settlement was $132,000.

The CHAIRMAN. On a claim of $296,000, approximately.

Mr. MANSON. On a claim of $296,000.

I am not prepared to say that that was not the best settlement that the Government could get. What I am criticizing is a system which would permit a company that had been making returns of this kind of taxes, exceeding $30,000 a month to, for a period of 14 months, go along without any return when the collector must have known that they were still in business and still collecting these taxes.

Senator WATSON. Over how long a period had the collection of the tax been made?

Mr. MANSON. I suppose ever since the tax was levied. I assume that this company was in existence. That was not brought out, but it was an old concern.

Mr. GREGG. I understand that the tax on carbonic-acid gas was levied first in the 1921 act?

Mr. MANSON. The tax on carbonic-acid gas was levied first in the 1921 act.

Mr. GREGG. Had this company ever made any return or paid any tax so as to put the Government on notice?

Mr. MANSON. Oh, yes. They had been making returns, as I say, at a rate exceeding $30,000 a month.

The CHAIRMAN. And then they were allowed to go 14 months without making any returns?

Mr. MANSON. They were allowed then to go 14 months without making any returns.

The CHAIRMAN. And as a result of that the Government lost about $190,000?

Mr. MANSON. About $190,000.

My criticism is directed to the system which permits the taxpayer under such conditions to go for any such period of time without making any return or without being checked up, because had a check been made at any time or had the regulations been enforced against this taxpayer during that period, of course the loss would have been reduced.

Senator KING. Would the fault, if there is a fault—and I express no opinion—be in Washington or in the local collector's office where the taxpayer is located?

Mr. MANSON. The duty was upon the collector of internal revenue in the district. I take it, however, that the system would be that the internal revenue collector's office is one that is prescribed by the Bureau of Internal Revenue. I am not familiar with that system.

Senator WATSON. Do you know of any other like case, Mr. Manson?

Mr. MANSON. No; I do not. We have not access to the information; that is, it would be necessary to make an investigation of the collectors' offices to determine what their system is. I merely call the committee's attention to the case for the purpose of suggesting that in all cases where taxes are collected by a manufacturer to be remitted to the Government the law should require an adequate bond and that proper machinery should be established to insure the periodic checking up of such collections.

The CHAIRMAN. What is the procedure in the case of automobile companies who collect automobile taxes and theaters which collect the theater tax, do you know?

Mr. MANSON. That is left to the internal revenue collector to check up.

The CHAIRMAN. Is that only remitted once a month or do they wait until the entire year is up?

Mr. MANSON. I think that is remitted once a month.

Mr. GREGG. Yes; monthly.

Mr. NASH. Monthly. In reference to this case, Mr. Box, the auditor for the committee, called at my office yesterday and asked as to our system of checking these monthly returns. We have a very definite system for checking them, and I gave Mr. Box that information and discussed it with him very thoroughly. Our procedure is just as tight as it can be made, and provides for a monthly check of these delinquents, and in this particular case the collector of internal revenue at Albany, N. Y., is probably at fault for permitting this delinquent to get away from him for 14 months.

The CHAIRMAN. Did not the bureau have that check on that company while they were getting away with it for 14 months?

Mr. NASH. The bureau does have inspectors that check these offices periodically. Now, I do not know whether the collector's office at Albany was checked during those 14 months or not, but the procedure for checking the office would require the inspector to call the attention of the bureau to this particular instance.

The CHAIRMAN. I assume that in the bureau's reply you will make answer as to whether they did in this case?

Mr. NASH. I would be very glad to put our procedure into the record. I think it is just as tight as we can make it.

The CHAIRMAN. Do you mean to say that there is no way for the bureau to protect itself against a case of this kind?

Mr. NASH. This case would indicate incompetence on the part of some particular clerk handling the records in the collector's office.

The CHAIRMAN. My point is, then, that it can not be very tight if a case of this kind is not caught, because a clerk is incompetent.

Mr. NASH. It comes down to a personnel problem, and it is not a matter of procedure or system.

The CHAIRMAN. I do not agree with that. I do not agree that the officials should stand for a procedure which is so loose that an incompetent clerk could make it possible to get away with a situation like that.

Mr. GREGG. Let me say in answer to the chairman, that we can not lay down a fool-proof system. If some of the individuals who are operating under the procedure are incompetent, it is not the system that is to blame. It seems to me it is unfair to the bureau to pick out an isolated case, such as this is, where the only criticism is that it happened to slip through the hands of a particular clerk.

The CHAIRMAN. I do not agree with you at all. I remember very well when I had some 40 or 50 branch houses of the Ford Motor Co. that we had our traveling auditors, and no branch department could get away for 14 months without a check. I do not think it is unfair. I think it is perfectly proper to present that case, to have the Congress assured that the Government is protected when they grant permission to manufacturers and to theater owners and to others to collect governmental taxes that the Government will receive those taxes.

Mr. GREGG. It seems to me that that——

The CHAIRMAN. That is important, because apparently no bond was required in this case. It appears to me that if the taxpayer could get away without making any returns in this case, any theater owner could do that or any manufacturer could do that in other cases, and therefore to bring this particular case to the attention of the committee is not unfair at all.

Mr. GREGG. It assumes in the other cases that there is going to be incompetence in the offices of our collectors. I do not see that this case is comparable to the case which the chairman gave at all. Our local officers from the Bureau of Internal Revenue are supposed to check these things. We have a check, as Mr. Nash has pointed out, through our inspectors. Of course, whether the inspector missed this, as well as the clerk, we do not know, but it is perfectly obvious that the clerk missed it. We have adequate procedure for checking that situation, but it slipped through in this particular instance.

Senator KING. As I understand Senator Couzens's point, it is that there should be some amendment to the law by which bonds would be required of these companies and theaters and the others collecting the taxes to insure their payment to the Government of the taxes collected.

Mr. NASH. I agree with that perfectly, Senator. In fact, I know of cases where theaters have embezzled this money and we have tried to prosecute them in the courts. We have found it very difficult to prosecute and get a conviction of a theater owner who withholds a part of this tax. We have lost more cases than we have won on that very point.

Senator KING. It may be well, then, in the new act, and this committee, perhaps, might very well consider the question as to whether to recommend to the full committee some new machinery by which those who do collect the taxes should give a bond for their payment, so that in the case of embezzlement, of bankruptcy, through defalcations or whatnot, the Government could be protected and could get

the taxes. For myself, I should be very glad to have the views of the bureau submitted in writing upon that question so that we may, if we see fit, make some recommendation in our report respecting that matter.

The CHAIRMAN. I again submit to Mr. Gregg the idea that the theatrical business is a highly speculative business and if a theater owner can go along collecting his theater taxes for the period of a year and then go into bankruptcy the Government is the loser.

Mr. GREGG. I do not think I could say that he could go along for a year without being caught for failure to file a return. As I said, this case is an isolated case.

Can you tell, Mr. Nash, just what the procedure is in the collector's office for checking these matters?

Mr. NASH. When these tax returns are made each month to the collector they are entered upon an assessment list by means of an Elliott-Fisher bookkeeping machine, and a return form is at the same operation addressed to the taxpayer for use for the next month. That is mailed out as a notice. The return comes in in two sections. One is a duplicate. That stays in the collector's office. The original accompanies the assessment list to Washington. The duplicate that stays in the collector's office is filed in a folder, which is kept for each taxpayer, and the instructions are that when this duplicate is filed in the folder the clerk must take the folder and see if the previous month has been paid and any gap is caught up. If there is a gap a report is made to the chief field deputy calling his attention to the fact that the taxpayer has not filed for some given month. He in turn refers that to one of his field men, who is supposed to make a call upon the taxpayer and find out why the return is not made. We frequently find that there is a gap because no business has been done that month; he has been closed down for repairs or something of that sort; but if there is an explanation for the gap, the explanation is put in the file. The procedure is very definite.

The CHAIRMAN. I would like to ask Mr. Manson if there is anything in the files in this case to show that anybody checked this taxpayer within any of these 14 months?

Mr. MANSON. I would say that the files, to make it positive rather than negative, show that there was no check during the period of 14 months.

Senator KING. That would be due to negligence on the part of the collector at Albany and his assistants and somebody down in your office here, probably.

Mr. NASH. I would say that as far as the inspection of the collector's office at Albany is concerned, I do not know whether it was inspected during those 14 months. In 1921, the collector's offices throughout the country were in bad shape. Most of them were out of balance, and all the few inspectors that we had were used in the larger offices in trying to reconcile the accounts and getting them balanced. There were a number of the smaller offices that went for over a year without inspection, and it is very possible that the Albany office was not inspected during those entire 14 months, because, at one time, we had all the inspectors that we had in the United States working in New York City, trying to straighten out that office. At another time we had them all in San Francisco, and

in Philadelphia, Pittsburgh, Cleveland, etc. Right now the offices are all in splendid shape, and every office, except the very largest, is being examined at least once every six months.

Mr. MANSON. What was in my mind with regard to this case was that it suggested the necessity for a system of bonding, and fundamentally my purpose in bringing it to the attention of the committee was that a glaring instance of this sort might move Congress to require bonding, where mere general statements might not do so.

Senator WATSON. How many people collect taxes for the bureau?

Mr. NASH. There are various manufacturers, under this excise tax, that collect taxes. There were more of them under the 1921 act than under the 1924 act. Of course, all of our admission taxes are collected by the owners of the theaters.

Senator WATSON. Of course, if the next Congress should abolish the theater tax, that would do away with that, so far as that goes?

Mr. NASH. Yes, sir.

The CHAIRMAN. I am interested further in this matter because of the compromise settlements to avoid bankruptcy. I would like to have some statement from the Bureau, or from our investigators, indicating how extensively this compromising of taxes has been engaged in to avoid bankruptcy. In other words, that leaves a very great discretionary power with the Commissioner, and it may or not have been exercised well, or it may have been exercised in some cases, and not in others. I think it is important as a matter of equity between taxpayers that some uniformity of procedure or conduct be had to insure equity as between taxpayers. I believe we should have uniformity of procedure as against all taxpayers.

Mr. MANSON. I wish to say in connection with this compromise that there was another feature which influenced my mind a great deal in not attempting to indulge in any criticism of the compromise.

It appears that in connection with the manufacture of sugar a process has been developed for the recovery of the carbonic acid gas, which permits sugar refineries to sell carbonic acid gas at less than it costs the carbonic acid gas manufacturer to make it.

Senator KING. Because it is a by-product in the manufacture of sugar.

Mr. MANSON. Yes, sir; it is a by-product in the manufacture of sugar, and it is a product that is manufactured without cost. It involves the mere cost of recovery, which only requires a modification of equipment.

As a result of that it appeared that this company at the time of this settlement was losing about $9,000 a month. There was a combination of circumstances—the defalcation of the president of the company, together with this run of loss from month to month—which rather influenced my mind to believe that the Government was, perhaps, lucky to get anything they could. I did believe, however, that this case should be presented in considering the necessity of bonding private individuals who are permitted to collect Government taxes.

Senator KING. And to guard against inattention or neglect of local collectors and their agents.

The CHAIRMAN. You made one suggestion, and the thought had occurred to me. Do you keep any account in the Treasury Department of the losses because of the bankruptcy of taxpayers? I mean losses in taxes to the Government?

Mr. NASH. Yes, sir; we have a bankruptcy section that handles nothing but bankruptcy cases, and their records are very complete in that respect.

Senator KING. Will you kindly, at your convenience, prepare a statement showing the losses from year to year in taxes by reason of the bankruptcy of taxpayers, and if you have any recommendations or suggestions as to how the law could be strengthened or the regulations strengthened to guard against losses from bankruptcy, speaking for myself, I should be very glad to receive the same.

Mr. NASH. With reference to the compromise of this case, Mr. Chairman, I wish to state that the case was called to my attention when the compromise was being considered, and Mr. Hartson and I went into it carefully, not into the detail, but we were thoroughly satisfied that this was the best settlement that we could get out of this company, and that if we prosecuted our claim we quite likely would not get anything; that is, if it was forced into a receivership. The people who conducted the negotiations were people that were in other business in Saratoga, and I am quite sure the money that was advanced in this offer in compromise was advanced outside of the company. Two revenue agents went to Saratoga and made an examination of the details of the company and submitted a report, and the amount that we finally received from the company was in excess of the amount that was recommended by the agents as the greatest amount that they could possibly pay.

The CHAIRMAN. Is this company still in existence, and is it doing a profitable business; do you know?

Mr. NASH. I believe it is; and that is one of the things that were taken into consideration at the time of the compromise, that it was better to keep it going as a potential taxpayer, and paying from month to month, than to close in on it and put it out of business.

The CHAIRMAN. Let me ask you at this point whether the sugar companies that make carbonic-acid gas as a by-product pay the same tax as the manufacturers?

Mr. NASH. They pay the tax at the same rate as if it was used for beverage purposes.

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

Mr. MANSON. No; except to submit this statement of facts in this case:

The General Carbonic Co. is a manufacturer of carbonic acid gas. It maintains branches in several cities in the United States, has its main plant at Saratoga Springs, N. Y., and its main office in New York City.

During the period of 14 months from February, 1922, to March, 1923, inclusive, this taxpayer collected from its customers $406,351.98 in taxes on sales of carbonic acid gas.

Sections 602 and 603 of the revenue act of 1921 provide for a tax of 4 cents per pound upon all carbonic acid gas sold by a manufacturer, and provides that monthly returns of all taxes collected shall be made under oath, these taxes to be due and payable without assessment by the commissioner or notice from the collector of internal revenue at the time fixed for filing the returns. Article 26 of Regulations 47 provides that monthly returns shall be filed during the month following the month during which the sales were made.

The taxpayer did not make monthly returns of the excise tax due the Government from its sales for the period mentioned above until June, 1923, although it did collect the taxes from its customers.

On May 16, 1923, Mr. H. E. Pettee, president of the company, absconded, leaving a shortage in his accounts with the company of approximately $260,000. On the same day Mr. Henry W. Somers was elected president, and Mr. Luther A. Wait vice president and secretary of the company. On June 1, 1923, Revenue Agents Kenneth W. Moe and Arthur O. Gray called at the New York office of the taxpayer and asked to see its books. They were advised by Mr. Wait that the tax for the 14 months in question had been returned and paid at the collector's office at Albany, N. Y.; and that the books were being audited, for which reasons he requested that the examination be deferred. Communication with the collector at Albany disclosed the fact that the tax had not been paid, and on June 4, 1923, the revenue agents returned and examined the books of the company, finding a tax liability of $406,351.98, and penalties and interest accrued of $126,154.88, a total of $568,506.86.

The officers of the company claimed that none of them knew of the delinquent taxes and of the president's shortage except the president, who was formerly mayor of Saratoga Springs, and the accountant, William J. Nusbaum, a certified public accountant, of Albany, N. Y., who was a friend of the president, and who reported directly to him and not to the directors of the company. The revenue agent's report, from which the above facts are taken, is attached as Exhibit A. The company was assessed for the total amount found due on account of delinquency and after the officers of the company informed the bureau that it could not pay the amount found due in one payment arrangements were made whereby it was allowed to pay at the rate of $10,000 per month. In the meantime liens were filed by the collector of internal revenue against the various plants of the company. Payments continued at this rate until $110,000 had been paid. A claim in abatement of the penalties and interest was filed by the company, which was rejected on June 18, 1924. Under dates of July 14 and August 19, 1924, conferences were held with the taxpayer seeking relief from the payment of the total amount. The bureau held that no relief could be granted as to the penalties because the tax had not been paid nor as to the tax because the company was solvent and the tax due and ascertained. Memoranda of the above conferences appear as Exhibits B and C.

On August 23, 1924, the company did submit an offer in compromise of $50,000 and produced a balance sheet as evidence of its insolvency. The company claimed that the amount of the tax could not be realized by distraint; that the Government would be benefited by allowing the company to continue in business; that the company lost for the six months ended May 31, 1924, at the rate of $9,000 per month because of conditions brought about as a result of the Federal Sugar Refining Co. installing equipment for the reclamation of carbonic acid gas, a by-product of the sugar refining process, which it sold at 3 cents per pound, which was below the cost of manufacture of the taxpayer; and that Mr. Somers and Mr. Wait were giving their time and best services to the company without charge, and that they would quit if the tax was not compromised. (Exhibit D.) This offer was rejected.

A second offer of $75,000 and cancellation of the company's claim for refund on account of income taxes was subsequently made in compromise of the tax amounting to $296,351.98 and an offer of $10 in lieu of penalties and interest aggregating $162,154.88 was also submitted. (Exhibit E.) Recommendation was made by Deputy Commissioner Estes that this offer be accepted. It was subsequently rejected.

On September 27, 1924, an offer of $132,000, consisting of $100,000 in cash and a waiver by the company of its right to a refund of $32,000 allowed by the Income Tax Unit to the company on account of overpayment of income taxes was submitted in compromise of the balance of taxes, interest, and penalties due, which was accepted, the Solicitor of Internal Revenue stating that in his opinion it was proper and for the best interests of the United States to accept the terms mentioned. (Exhibit F.)

Subsequent to the filing of the first offer in compromise Agents William D. Elder and R. A. McCormack made an examination of the books of the taxpayer and on September 13, 1924, submitted their report of its financial condition. The balance sheet as at May 31, 1924 (Exhibit G), shows a surplus, according to the company's books, of $264,049.13. The estimated liquidating values, according to the bureau's figures, would leave a deficit of $437,051.98. The estimated liquidating values adjusted September, 1924, according to the

bureau's figures, show a surplus of $575,358.33. The balance sheet shows capital stock outstanding on May 31, 1924, as follows: Preferred, $2,485,100; common, $2,379,060.

The par value of both preferred and common stock is $100 per share. The stock of this company is not listed on any of the principal exchanges, but information was secured that in December, 1923, 400 shares of common stock was sold at auction at $4 per share, and on December 10, 1924, 200 shares of preferred were sold at $15 per share. It appears that at the present time there is no market for the preferred, and the latest quotation on the common was $1 per share offered.

It would appear that had a proper check of delinquent returns of excise taxes been made in the office of the collector, where the returns of this company were filed, it would have been impossible for a period of 14 months to elapse before the discovery of the delinquency. It would have resulted in the discovery of the embezzlement of the president of this taxpayer and the saving of a large amount of tax in this case.

The CHAIRMAN. Has the bureau anything to put in at this time, Mr. Gregg?

Mr. GREGG. No, sir.

The CHAIRMAN. Then we had better adjourn until 10 o'clock tomorrow morning.

Mr. GREGG. Before we adjourn, Mr. Chairman, let me say this:

The members of the committee perhaps noticed in the papers yesterday the statement that Mr. Hartson had resigned as solicitor for the bureau as a result of his activities in connection with Senator Couzens's personal-tax case, that it caused so much criticism of him within the department that his resignation was asked for.

For the sake of the record, I wish to say that of course there is absolutely nothing in that. Mr. Hartson sent his resignation to the commissioner on February 6, and it was only at the insistence of the department that he stayed any longer. Of course, everyone in the department was very anxious that he should continue with the department, but he did not feel that he could afford to stay any longer.

So far as Senator Couzens's personal-tax case is concerned, the first he ever knew that there was such a question or that there was such a case was on his trip to Bermuda, where he read it in the papers, so that obviously there was no connection between the two things.

The CHAIRMAN. I think I can say for the committee that we have never had any such idea. It was purely a matter of some newspaper reporter's interpretation of it.

Mr. MANSON. I think Mr. Hartson, as far back as last January, told me that he was contemplating resigning as soon as he could do so.

The CHAIRMAN. I hope you do not think that that story originated with any member of the committee.

Mr. GREGG. Oh, no, sir: we are certain that it did not come from the committee; but in justice to Mr. Hartson, I wanted to make that statement on the record. We issued a press story from the Treasury Department in denial of the previous press story last night.

The CHAIRMAN. I hope the officials of the Treasury Department do not think that that originated with the committee.

Mr. GREGG. No; no one thought it originated with the committee.

(The exhibits submitted by Mr. Manson in connection with the General Carbonic Co. case are as follows:)

EXHIBIT A

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
New York, N. Y., June 22, 1923.

Mr. E. M. MULLER,
Supervisor of Accounts and Collections,
Customhouse, New York City.

SIR: In compliance with your instructions, we visited the place of business of the General Carbonic Co., 542 Fifth Avenue, New York, N. Y., to make an investigation of its books and records and to ascertain if tax had been paid upon the sale of carbonic-acid gas manufactured by this company as required under section 602 (F) of the revenue act of 1921.

The General Carbonic Co. was incorporated in the year 1915, with principal place of business at Saratoga Springs, N. Y.

The officers of the corporation from the date of organization to May 15, 1923, were as follows: Henry E. Pettee, president; George M. Pettee, vice president and treasurer; and James C. Minor, secretary. On May 16, 1923, the following officers were elected: Henry W. Somers, president; Luther A. Wait, vice president and secretary; and George M. Pettee, treasurer.

On June 1, 1923, we called at the New York office of the above corporation and interviewed Mr. Luther A. Wait, vice president and secretary, relative to the tax upon the sale of carbonic-acid gas as manufactured by the corporation. We informed him that the records at the office of the collector, second district of New York, disclosed the fact that payment of tax upon carbonic-acid gas had been made for the month of January, 1922, and not for subsequent months. Mr. Wait informed us that returns for each month, with the exception of January, 1922, had been filed and tax paid to the collector of internal revenue at Albany, N. Y. He stated that the reason for filing returns and paying the tax to the Albany office was that the principal place of business of the corporation is at Saratoga Springs, N. Y., and that through error the January, 1922, return was filed in the second district of New York.

Mr. Wait further stated that on the morning of May 15, 1923, the officers of the corporation learned that the president, Henry E. Pettee, had absconded with approximately $250,000 of the corporation's funds, and that on May 16, 1923; an election of officers was held and it was decided upon by the new officers to retain the firm of Nau, Rusk & Swearinger, 280 Broadway, New York City, N. Y., to make a complete audit of the corporation's accounts, and he requested that we defer our examination until the audit was completed.

During this interview he informed us that returns had been filed and tax paid for all months to the collector at Albany, N. Y.

Upon reporting the facts as stated above to you, telephone connections were immediately had with the collector's office at Albany, N. Y., and it was learned that on May 31, 1923, a Mr. James P. Hussey, tax consultant, who was retained by the corporation, had filed Form 726 for the month of April, 1923, showing tax due in the amount of $34,094.68, with check in payment of same, and he had stated to the chief office deputy, fourteenth district of New York, that the following day returns would be filed for 14 delinquent months covering the period from February, 1922, to March, 1923, inclusive.

These delinquent returns were received at the office of the collector, Albany, N. Y., on June 2, 1923, disclosing tax liability in the total sum of $406,053.26 and were not accompanied by funds.

On the morning of June 4, 1923, we again visited the New York office of the General Carbonic Co. after learning that all books and records of the corporation were in New York instead of Saratoga Springs, the main office.

On this date we met Mr. James P. Hussey, as prearranged by you, and were introduced to Mr. James P. Henderson, of the firm of Nau, Rusk & Swearinger, who are compiling data which would reflect the tax liability on sales of carbonic-acid gas.

The General Carbonic Co. operates branch offices and plants at Albany, N. Y., Buffalo, N. Y., Boston, Mass., Elizabeth, N. J., Long Island, N. Y., Providence, R. I., and Wilkes-Barre, Pa., and separate accounts are kept for these branch offices at the New York office, which are known as "Main-office accounts" reflecting daily sales. A separate set of sales accounts are kept for the New York City sales and are known as "New York City accounts." The corporation also operates branch offices and plants at Detroit, Mich., Norfolk, Va., New Orleans, La., and Philadelphia, Pa., and semimonthly reports are ren-

dered by the respective branch agents to the New York office showing the total number of pounds of nontaxable and taxable carbonic-acid gas sold.

We verified the accounts known as the "Main-office accounts" and the "New York City accounts" and feel assured that we arrived at the true tax liability on these accounts. We were compelled to accept as being correct the semi-monthly reports rendered by the branch agents of the four above-mentioned branch offices.

Mr. James P. Henderson stated that at the present time his firm, Nau, Rusk & Swearinger, was making a complete audit of the books and records of the four above-mentioned branch offices, and that if any discrepancies were found in the reports as submitted by the branch agents to the New York office amended returns would be filed upon the completion of their audit.

It was the policy of the corporation, upon the sale of taxable carbonic-acid gas, to bill the amount of tax due on each sale and to request the respective customers to make payment of the amount of tax due before shipment was made.

At the completion of our examination we compared our working sheets with those of the accountants retained by the corporation and found that we had arrived at the same amount of tax due for each month as reflected on Exhibit A.

The following is a summary of the delinquent tax, penalties, and interest as disclosed by our examination:

Month	Tax	25 per cent penalty	5 per cent penalty	Interest	Total
1922					
February	$11,209.28	$2,802.32	$560.46	$2,040.09	$16,612.15
March	19,165.44	4,791.36	958.27	3,238.96	28,154.03
April	27,282.92	6,820.73	1,364.15	4,256.14	39,723.94
May	39,136.72	9,784.18	1,956.84	5,596.55	56,474.29
June	47,482.64	11,870.66	2,374.13	6,172.74	67,900.17
July	45,114.60	11,278.65	2,255.73	5,278.41	63,927.39
August	40,735.88	10,083.97	2,016.79	4,194.93	56,631.57
September	32,511.28	8,127.82	1,625.56	2,958.53	45,223.19
October	26,145.20	6,536.30	1,307.26	2,039.33	36,028.09
November	23,900.84	5,975.21	1,195.04	1,553.55	32,624.64
December	20,518.60	5,129.65	1,025.93	1,066.97	27,741.15
1923					
January	24,306.74	6,076.69	1,215.34	947.96	32,546.73
February	20,383.84	5,095.96	1,019.19	529.98	27,028.97
March	28,858.00	7,214.50	1,442.90	375.15	37,890.55
Total	406,351.98	101,588.00	20,317.59	40,249.29	568,506.86

The Forms 726 as received at the Albany office were forwarded to us for comparison and it was disclosed that the total tax liability for the 14 delinquent months, as reflected by these returns, was $406,053.26, and our examination disclosed a liability of $406,351.98 for this period, or an additional sum of $298.72.

We secured from Mr. Hussey, tax consultant for the corporation, a balance sheet which reflects the financial condition of the General Carbonic Co. as of the close of business of the fiscal year ended December 1, 1922, Exhibit B; also the balance sheet which reflects the financial condition of the corporation as of the close of business on March 31, 1923, Exhibit C.

On the balance sheet, Exhibit C, there is carried under "Other assets" the item "Accounts receivable—personal and sundry," $274,645.33. This is the account which was used by the absconding president, Mr. H. E. Pettee, in covering his defalcations, amounting to approximately $250,000. Therefore it can readily be seen that this asset is practically worthless.

The unpaid taxes in the amount of $406,351.98 are included in the "Accounts payable" account of $492,138.98 on the balance sheet, Exhibit C.

We were informed by Mr. J. P. Hussey, tax consultant, that the balance sheet, Exhibit B, attached hereto, was prepared and submitted by William J. Nusbaum, certified public accountant, to the former, president H. E. Pettee, and that this accountant was aware of the fact that the tax liability existed, but being a very intimate friend of the former president this knowledge was withheld from the other officers and directors of the General Carbonic Co.

On June 1, 1923, this corporation forwarded to the collector of internal revenue, Albany, N. Y., Form 848, Application for registry, as manufacturer of carbonic-acid gas.

Our examination disclosed that the books and records kept in the New York office for the several branch offices were such that we had no difficulty in arriving at the number of taxable and nontaxable pounds of carbonic-acid gas sold by the corporation. There were on file affidavits submitted by customers stating that carbonic-acid gas purchased by them was to be used for other than beverage purposes. All sales of carbonic gas used for other than beverage purposes, manufactured by this corporation, were supported by affidavits of this character. The largest amounts of nontaxable carbonic-acid gas were sold to the large steamship companies to be used for refrigerating purposes.

After completing our examination as to the tax liability under the revenue act of 1921, we then checked the books and records of the corporation to ascertain the true tax liability under the revenue act of 1917, same being for the period October, 1917, to February, 1919, inclusive. We found that the tax as paid to the Albany district covering this period was correct.

At all times during our examination we received very courteous treatment and cooperation from Mr. J. P. Henderson, accountant, who was preparing a statement of the tax liability for the corporation.

Upon completion of our examination we interviewed Mr. J. P. Hussey and informed him of the amount of tax, penalties, and interest we would report for assessment, and he advised us that the matter would be taken up with the bureau at Washington at a later date.

We therefore recommend the assessment of the tax, penalties, and interest in the sum of $568,506.86, as shown hereinbefore, against the General Carbonic Co.

Attached hereto are Exhibits A, B, and C.

Respectfully,

K. W. MAE,
Internal Revenue Agent.
ARTHUR O. GRAY,
Deputy Collector.

EXHIBIT B

TREASURY DEPARTMENT,
Washington, July 14, 1924.

Memorandum for file, in re conference between W. E. Bennett, attorney, Saratoga Springs, N. Y., and P. J. Richards, auditor, representing the General Carbonic Co., Saratoga Springs, N. Y., with Messrs. Drake and Stewart.

Representatives of the company explained that defalcation was experienced on the part of the president of the company; that new officers came in and discovered he had not paid the sales tax. The new management disclosed voluntarily the liability covering a period of about 14 months, and the amount of the tax is quite large. In a previous conference an agreement was reached by which the company was to pay the tax in monthly payments of $10,000, interest at the rate of 6 per cent, and a claim for abatement of the penalty and interest was filed. It seems that that claim has been disallowed, and the company received a notice and demand from the collector, demanding payment of penalty and accrued interest, and the representatives of the company wanted to know what, if any, adjustment could be made. The company is solvent, but has a number of things to clean up, of which this is one. The $10,000 monthly payments have been regularly made. It was explained that the notice and demand arises from the fact that they filed the abatement claim and, upon action being taken by the office, i. e., rejection under date of June 18, 1924, and the collector being so advised, in order to bring the matter to an issue it was necessary that he render a bill permitting them to take advantage of the privilege of filing an offer in compromise in lieu of penalty and interest. At the rate of $10,000 per month it will probably take 40 months to pay the tax. It is believed the Government is entitled to at least 6 per cent interest on the tax from the time assessed until paid, and representatives of the company were so advised. Further, it was suggested that they file a tentative offer in compromise of, say, about $10, plus whatever interest at the rate of 6 per cent is found due from date assessed until finally paid, in order to stay collection proceedings, pending final settlement of tax found due. In

other words, it is impossible at this time to accept an offer in compromise, in view of the fact that the tax has not yet been paid.

The representative of the company also stated that there is no separate selling organization, but that the company manufactures and sells direct, although there are a few localities where the company works through jobbers.

Initialed "CAD."

EXHIBIT C

TREASURY DEPARTMENT,
Washington, August 19, 1924.

Memorandum for file, in re conference held between Mr. L. A. Waite, vice president, P. J. Richards, auditor, for the General Carbonic Co., Saratoga Springs, N. Y., and Messrs. Drake and Stewart.

Mr. Waite stated in order to acquaint the office he would review the situation. About May 10, 1923, the stockholders found that their former president had absconded with some three hundred to four hundred thousand dollars, and Mr. Somers was made president and Mr. Waite vice president, and took charge of the affairs of the company. They found within a few days that there was an unpaid sales tax of several hundred thousand dollars. They did not know how it had remained unpaid, but, nevertheless, such was the case; and they immediately reported the matter to the collector, making full disclosure as to all the facts. He stated had the Government insisted at that time on payment in full the company would have been thrown into bankruptcy. A scheme was finally worked out whereby payment at the rate of $10,000 per month was to be made, and thus far such payments have been received, probably to the extent of $100,000. He stated that the officers of the company were rather optimistic until the spring of 1924, when they ran into a price-cutting war caused by a competitor. For the first seven months of 1924 the company lost about $50,000, and prospects for making money at the present time are not bright; especially with this incubus of tax over their heads, they do not see how they are going to save the company. Further, Mr. Somers and himself have been there about a year and a half, have received no compensation, although he later admitted they would not work indefinitely without some reward. They have been trying to figure some way to finance the company, but with the tax overhanging have been unable to do so. They stated it was practically impossible to interest capital under the circumstances. They displayed a balance sheet, and in going over the different items called attention to the fact that many were of questionable value. They admitted, however, that the real estate, eliminating all buildings, had cost some $359,000 during the war period, on which a mortgage of approximately $125,000 is outstanding, leaving a net of $225,000. The balance sheet showed cash of about sixty thousand and odd dollars, but they stated this was a portion of money borrowed from banks with the understanding that a certain amount would be kept on deposit. They admitted at least $20,000 could be attached by the Government. The current assets just about equal the current liabilities, and they called attention to the large investment in plant and cylinders, which, in their opinion, would have little value in the case of liquidation.

They were advised that so far as the office was aware a compromise of the tax legally due could not be made with a solvent corporation. They do not admit that the company is solvent or insolvent but intimate that it is in a serious financial condition and feel confident that they have reached the end of their rope, and seek relief by some means of eliminating the tax or compromising it with a view to then interesting capital, saying they have hopes of pulling through. They were advised that in the event they did make an offer in compromise, attaching a check and setting forth fully the situation and analyzing the various items of the balance sheet, the office would officially pass upon the question, but until such was received the office did not feel justified in intimating any possibility of such a settlement: in fact, they were advised at stated above, that so far as the law is concerned the office is unable to suggest any relief, although agreeable to having the Solicitor pass on the legal phase of the question.

In the event such offer is received they were advised the Government would in all probability require sufficient time to make investigation and verify any statements they may make, to which, of course, they offered no objection but offered to do anything within their power to assist the investigating officers.

To-day, the 20th, they called upon Mr. Estes, who had Mr. Stewart and the writer appear, and the question discussed without any new developments. Mr. Estes stated every consideration possible under the law and regulations would be given their case, but no definite promises or intimations were made other than the question would have to be ruled upon by the solicitor's office, as it is purely a question of law.

In the event an investigation is made, I believe it would be well to ascertain the status of the president and vice president in the way of compensation or agreement or contract, as there may be some personal incentive to eliminate the tax liability and continue the corporation. They admitted that the summer is the best season in this business and that the price competition is still on, and with such conditions it is not clear to the writer how they can hope to succeed by simply eliminating the tax. They were advised to submit assessed values of the real estate, prices paid, dates purchased, and sales of any surrounding or adjacent similar property. From a perusal of the balance sheet it would seem that the Government should be able to realize the amount of tax due, inasmuch as it is my understanding the Government has the first lien on the net assets, and under such circumstances it is hard to justify granting relief unless it is simply for the purpose of enabling the corporation to live.

CHAS. A. DRAKE,
Head Sales Tax Division.

EXHIBIT D

NEW YORK, *August 23, 1924.*

Hon. CYRUS DUNEY,
Collector of Internal Revenue, Albany, N. Y.

DEAR SIR: Inclosed herewith is a certified check for $50,000, which is hereby tendered in final payment of all excise taxes and penalties accrued on the sale of carbonic gas from February 1, 1922, to March 31, 1923, with the understanding that if this tender is accepted this company is thereby released from all further liability for such taxes during the aforementioned period.

The company is in acute financial difficulties, as fully set forth hereinafter, and we believe that the interests of the United States Government will be best served by the acceptance of this offer.

About the middle of May, 1923, Mr. Harry E. Pettee, former president of this company, disappeared. Immediately after his disappearance Mr. Henry W. Somers was elected president and myself vice president of the company, both actively engaged in other affairs, but consenting to serve here to try to save the situation for close friends.

An examination of the company's affairs disclosed the fact that Mr. Pettee had embezzled approximately $300,000 of the company's funds. It was also disclosed that Pettee had failed to make returns of the sales taxes accrued on carbonic gas sold by the company from February 1, 1922, to March 31, 1923, nor had he paid his tax which amounted to $406,351.98. We immediately disclosed to the Government the company's liability for these unpaid taxes, and, after negotiations with the Bureau of Internal Revenue, arranged for payment thereof in monthly installments of $10,000 each. Under this arrangement $110,000 has been paid, leaving $296,351.98 unpaid at the present time.

Had conditions in the carbonic-gas industry remained as they were a year ago the company would very likely have been able to meet its obligations under this arrangement and finally be able to pay the tax in full. But last fall the Federal Sugar Refining Co., of Yonkers, N. Y., installed equipment for the reclamation of carbonic gas, which is one of the by-products of the sugar-refining process. This by-product gas was thrown onto the market last winter at a price of 3 cents per pound, which is less than our manufacturing cost. The prevailing price prior thereto had been 10 and 11 cents per pound.

Our business is a seasonal business and we continued to hope that when we got into the summer months we might be able to disregard this competition and secure an advantageous price for our product. Our hopes have not materialized. The company is now in a very precarious condition and can not finance itself because of the tax lien against it. With some financing for working capital, which will be possible provided the tax lien can be wiped out, we hope to weather the present price war and survive until the industry returns to a normal basis.

Mr. Somers and myself have sacrificed our other business to keep this company a going concern. We have done this without receiving any compensation for our services to date. However, with the present outlook, we can not continue these sacrifices, nor is it reasonable to expect us to. With a change in management at this critical time the outcome is apt to be disastrous.

For your information we have attached hereto as Exhibit B an income and profit-and-loss statement for the six months ended May 31, 1924, which is the first half of our fiscal year. This statement shows a loss from our operations for this period of $54,212.77, or at the rate of more than $9,000 per month. We are unable to continue our monthly payments under existing conditions.

The next thing for serious consideration is the present financial status of the company. Exhibit A, attached hereto, is a balance sheet as at May 31, 1924. In parallel columns we have shown the book values of the various assets and the possible realizable values of these same assets in the event of a forced liquidation of the company. While the books ostensibly show an excess of assets over liabilities, the assets, upon liquidation, might have at the outside a possible realizable value of $151,907.52, less than the liabilities, so that, on the basis of the actual facts, the company is hopelessly insolvent. Various supporting schedules submitted herewith explain the basis on which the possible realizable values are determined. This does not take into consideration the very heavy expenses of a liquidation which would materially reduce the amounts realized upon forced sale of the company's properties.

The hopelessness of the situation, should we be unable to secure relief from the tax, is indicated by a comparison of the quick assets with the liabilities. They are $685,482.59 of current liabilities. To meet these liabilities, there are quick assets of a possible realizable value of $249,925.07, or about 36 cents on the dollar, if all of the quick assets could be realized.

Most of the cash in banks is subject to a prior lien, as the loans from the banks were secured by our agreement to carry a balance in these banks of 20 per cent of the amounts of our loans.

The life-insurance policy is pledged as collateral on a note of $20,000 held by the Adirondack Trust Co., of Saratoga Springs, N. Y.

The accounts may be subject to even greater shrinkage than is provided for here, as set forth in Schedule No. 1 herewith.

In actual liquidation it is problematical whether the inventories would realize the values here shown.

The possible values of the plants and equipment are based largely on the value of the land owned, as shown by Schedule No. 6. The buildings and equipment have little or no value for purposes other than the manufacture of carbonic gas. At the present time, and for some time in the past, there has been a surplus of vacant factories on the market. These facts, together with the following information, help to establish the values of these properties.

This spring the mortgage on the Long Island City plant was due. We attempted at that time to borrow some more money on that plant, but the maximum amount we could secure was $100,000, which was only enough to renew the maturing mortgage, although this plant is carried on our books at $750,000 and is assessed for taxes at $335,000.

Our Detroit plant is on leased land. This lease expires in 1929. Unless the purchase option in that lease is exercised, the plant will be of very little value to anyone. In the event of liquidation the option, of course, can not be availed of.

The company owns land in Norfolk which was purchased nearly three years ago as a site for a new plant. The purchase price of this land was $35,000. We have offered this land for sale at $25,000 and have been unable to find a purchaser.

The physical condition of several of the plant buildings is such that they would be an encumbrance to the land rather than tending to increase the value thereof in the event of a forced sale.

In the event of bankruptcy proceedings the expense of liquidation would be very great, because the properties are widely scattered, necessitating the appointment of ancillary receivers in seven different States, with all the additional expense caused thereby.

The most valuable plant the company owns (Long Island City) is encumbered by a mortgage of $100,000. This is the property on which we were unable to secure an additional loan in excess of $100,000. The other mortgage of $25,000 runs against property in Norfolk, Va.

Another asset in which there would be a tremendous shrinkage upon liquidation is the cylinders or tubes used as containers in our product. While these cylinders appear on the books at a value of more than $1,000,000, this is in excess of the present replacement values. These cylinders are all old, very few new ones having been added to our equipment in the last five years. Under the old management for a considerable period of time no depreciation was written off on this asset. This asset is of value only to this company as a going concern. In case of liquidation these cylinders would be of value only as scrap. All competing companies have an even greater excess of cylinders than this company.

The $50,000 which is hereby tendered has been raised upon the personal responsibility of the president of the company and the undersigned.

Attention is directed to the fact that this payment will make a total payment by the company to the Government of $160,000 on account of the tax in question.

In view of the company's insolvent financial condition, unless relief be granted as set forth in the attached statements and as further explained hereinbefore, we believe the interests of the United States Government would be best served by acceptance of this offer, thus giving this company, with its many stockholders and employees, a fighting chance to survive. We earnestly request its acceptance.

Respectfully submitted.

GENERAL CARBONIC CO.,
By LUTHER A. WAIT, *Vice President.*

EXHIBIT E

ABSTRACT AND STATEMENT

TREASURY DEPARTMENT,
OFFICE OF THE COMMISSIONER OF INTERNAL REVENUE,
Washington, September 25, 1924.

United States v. General Carbonic Co., Saratoga Springs, N. Y. Compromise case No. 31110, fourteenth district of New York. Not in suit

To the Solicitor:

Charge: This $107,000 offer was submitted in compromise of tax amounting to $296,351.98 under section 602 (f) of the revenue act of 1921 on the manufacture and sale of carbonic-acid gas. An offer of $10 in lieu of penalties and interest aggregating $162,154.88 has also been submitted.

It appears that this delinquency was not due to a willful intent to evade the tax, the liability having been discovered by revenue agents after the former president of the firm, Mr. H. E. Pettee, absconded, in May, 1923, with funds belonging to the company approximating $400,000.

About one year ago arrangements were made with the corporation under which it was permitted to pay the tax due in installments at the rate of $10,000 per month, $110,000 having been paid up to the present time on the original tax of $406,351.98.

On July 14 of this year a conference was held in this office with Mr. P. J. Richards, auditor, and Mr. W. E. Bennett, attorney, representing the corporation, who stated that the collector had made demand upon them for payment of the outstanding penalties and interest. They stated that the company was making every effort to cancel the liability for tax; that it was solvent and it was their desire to cancel all indebtedness at the earliest possible date, and to that end it was their intention, if possible, to increase the amounts of the monthly payments to the collector of internal revenue. They were advised that although the Government recognized the hardship under which the company was laboring due to the defalcation of its president, the tax would have to be paid in full, but that the interest and penalties could be compromised, and under the circumstances it was felt that an amount equivalent to 6 per cent interest on the tax from the time when it became due until it was finally disposed of would be acceptable. However, in order to stay collection proceedings on the part of the collector, it was suggested to them that they file a tentative offer in compromise in a nominal amount, which, when received in

the department, would be filed until such time as the entire tax liability was disposed of. This suggestion met with the approval of the representatives of the company and the collector was advised under date of July 16 of the result of the conference.

On August 19, 1924, Mr. L. A. Waite, vice president, and Mr. P. J. Richards, auditor, called at this office and stated that the company was on the verge of bankruptcy, due principally to a price war caused by a competitor. They represented that for the first seven months of 1924 the company had lost about $50,000, and indications pointed to further losses. Mr. Waite also stated that unless additional capital could be secured with which to continue business, which was impossible with the tax burden to settle, the company would be forced within a very short time into bankruptcy. The representatives were advised that unless the corporation was insolvent, and it did not appear to be, the Government could grant them no relief from the payment of the tax, but that if they could show that the company is actualyy insolvent the matter of compromise could be taken into consideration. It was understood when they left the office that they would probably submit an offer with a brief explaining the financial condition of the company.

On August 26, 1924, the additional offer of $50,000 was received, together with a brief, a financial statement, and various exhibits, in connection with the financial standing of the company. On September 5 the case was referred to the deputy commissioner of the Income Tax Unit with request for an immediate report regarding the ability of the corporation to pay the tax due. The agent's report, dated September 13, was received in this office on September 16, recommendation being made that instead of accepting the offers aggregating $50,010 now pending, the company be permitted to submit an additional $50,000, making a total of $100,010. This recommendation is based on the fact that the survey of the agents shows an estimated liquidating value of approximately $341,469.68 (see Exhibit A), which is less than the Government's entire claim for taxes, penalties, and interest. The agents expressed the opinion that under present conditions the company can not continue to operate at a profit and also provide a proper amount for depreciation. Therefore, in order to permit the corporation to remain in business for an indefinite period and perhaps survive by overcoming competition, the agents recommended that full payment of the excise-tax claim be not enforced by the Government.

To get a clear idea of the condition of the company a summary has been prepared (see Exhibit A) showing book figures, revenue agent's sales tax division, and company's estimated liquidating values. There has also been prepared an explanation for each of the items entered in column 3 on Exhibit A. It will be noted that the figures of this office show that the net surplus would be $575,358.33 instead of $341,269.68, if the Government exercises its right of distraint and sale. If the figures of this office are correct and the property is sold, it is believed that there would be sufficient funds with which to pay the Government's claim in full.

The representatives of the sales tax division inferred from Mr. Waite's statements that he and Mr. Somers devoted their entire time to the company and that they had received no compensation for their services. The agent's report, however, that Mr. Somers, the president of the General Carbonic Co., and Mr. Waite, the vice president, are also officials of the Iroquois Pulp & Paper Co., Saratoga Springs, N. Y., receiving annual salaries of $25,000 and $18,000 respectively. Mr. Waite conducts a law office, maintaining a staff of four attorneys and necessary assistants, and Mr. Somers also operates a wholesale coal and coke business in Albany, N. Y., all of the coal and coke used by the General Carbonic Co. being purchased through him as broker. This, together with the understanding that his firm is one of the general creditors, may account in part for Mr. Somers's interest in keeping the General Carbonic Co. a going concern. The agents report accrued salaries on the books of the company of some $17,000 for these two officials at the rate of $7,500 per annum.

Particular attention is called to the company's statement as regards liability items $39,211.28 and $316,351.98, the former being admitted by Mr. Waite as tax already paid and the latter reduced to $296,351.98; also land, buildings, and equipment of $2,100,000 reduced by the company to a liquiadting value of $215,000, which includes lands alone that cost $384,000 and lands and buildings assessed at $684,000, showing the extreme reductions claimed. Accounts receivable aggregating $183,000 were reduced by the company to $27,000, whereas accounts less than four months old amount to $143,000. There is also

a refund due the company according to the agents of some $32,000, which has been entirely omitted in the company's assets, but which Mr. Waite admitted he and Mr. Somers expected to use to reimburse themselves in part for the $50,000 submitted by them as an offer in compromise.

Although not admitted by Mr. Waite, the representatives of the sales tax division believe that the company could liquidate for an amount at least equal to the tax due.

The delinquency is evidently the result of defalcations on the part of the former president of the company, who can not now be located, and it is probably an extreme hardship upon the present officials of the company to pay the tax due. Furthermore, it is believed that the company is in serious financial difficulties, and the impossibility of accurately estimating liquidating values is recognized. In view of Mr. Waite's statement that it is impossible to interest additional capital with the tax liability unpaid and his affidavit that unless the offer in compromise is accepted he and Mr. Somers, who furnished the $75,010 in cash, offered in compromise, will withdraw such funds and retire from the management of the company and further with the understanding that it is the policy of the bureau to accept an offer in compromise in such an amount that will allow a taxpayer to survive in business, it is recommended that the $75,010 in cash and release, or assignment, of any and all refunds due the company for overpayment of income taxes (approximately $32,000) be accepted in lieu of the total sales tax liability for tax, penalties, and interest.

I recommend acceptance.

R. M. ESTES,
Deputy Commissioner.

EXHIBIT F

ABSTRACT AND STATEMENT

TREASURY DEPARTMENT.
OFFICE OF THE COMMISSIONER OF INTERNAL REVENUE,
Washington, September 27, 1924.

United States *v.* General Carbonic Co., Saratoga Springs, N. Y. Compromise case No. 31110, fourteenth district of New York. Not in suit

Charge: This $132,000 offer, which consists of $100,000 in cash and a waiver by the company of its right to a refund of $32,000 which is understood to have been allowed by the Income Tax Unit for overpayment of income taxes, was submitted in compromise of tax amounting to $296,351.98 due under section 602 (f) of the revenue act of 1921 on the manufacture and sale of carbonic-acid gas. An offer of $10 in lieu of penalties and interest assessed in the amount of $162,154.88 has also been submitted.

It appears that this delinquency was not due to willful intent to evade the tax, the liability having been discovered after the former president of the firm, Mr. H. E. Pettee, absconded in May, 1923, with a large amount of funds belonging to the corporation.

Full details in connection with this case are set out in brief submitted by this office under date of September 25, 1924, which is included in the file attached hereto.

The delinquency is evidently the result of defalcations on the part of the former president of the company, who can not now be located, and it is probably an extreme hardship upon the present officials to pay the tax due. Furthermore, it is believed that the company is in serious financial difficulties and would probably be thrown into the hands of receivers if demand were made for immediate payment of the tax due. The impossibility of accurately estimating liquidating values is also recognized.

In view of the above facts and also because of Mr. Waite's statement that with the tax liability unsettled it is impossible to interest additional capital with which to continue in business, this office recommends that the offer be accepted in lieu of the tax, penalties, and interest outstanding.

I recommend acceptance.

R. M. ESTES,
Deputy Commissioner.

First offer. Date of offer, September 27, 1924. Amount offered, $132,000.

DEPARTMENT OF JUSTICE,
OFFICE OF THE SOLICITOR OF INTERNAL REVENUE,
Washington, D. C., September 29, 1924.

The COMMISSIONER OF INTERNAL REVENUE.

SIR: I have considered the proposition of the General Carbonic Co., Saratoga Springs, N. Y., to compromise the liabilities, as charged herein.

For the reasons embodied in the accompanying abstract and statement, which are made a part hereof, I am of the opinion and advise that it will be proper and for the best interests of the United States to accept the terms proposed, namely, $100,010 and the waiver by taxpayer of its rights to refund of income tax overpaid for the years 1919 to 1922, inclusive, estimated to be about $32,000, in compromise of taxpayer's liability to unpaid balance of excse tax on the manufacture and sale of carbonic-acid gas for the period February, 1922, to March, 1923, inclusive, amounting to $296,351.98, and also in compromise of penalties and interest assessed and accrued thereon.

Respectfully,

NELSON T. HARTSON, *Solicitor.*

EXHIBIT G

Balance sheet as at May 31, 1924

		Book values	Estimated liquidating values	Estimated liquidating values adjusted to Sept., 1924	
				Bureau's figures	Company's figures
ASSETS					
1. Cash in banks and on hand		$63,249.14	$63,249.14	$60,115.99	$63,249.14
2. Accounts receivable, customers	$174,849.57				
Less reserve for rebates and losses	20,205.70				
3. Loans due from customers		154,643.87	134,643.87	143,509.88	27,000.00
		6,000.00	5,000.00	5,000.00	2,000.00
4. Loans and notes from employees and others		37,852.78	6,000.00	6,000.00	
5. Cash value, life insurance		24,786.06	[1] 24,786.06	24,786.06	23,181.37
6. Inventories, gas in cylinders		26,071.20	20,000.00	26,071.20	2,500.00
7. Inventories, materials and supplies		39,388.42	5,000.00	5,000.00	4,000.00
8. United States Government, claim for taxes		31,921.55	31,921.55	32,116.55	
9. Unpaid stock subscriptions					
10. Investments		10,820.00	3,500.00	3,500.00	1,500.00
11. Fixed assets:					
Plants and equipment	2,619,356.13				
Less reserve for depreciation	752,986.97				
		1,866,369.16	512,300.00	512,300.00	215,000.00
12. Cylinders and valves	1,121,142.16				
Less reserve for depreciation	118,714.64				
		1,002,427.52	4,000.00	4,000.00	10,000.00
13. Deferred charges		11,930.54			
14. Good will		2,115,000.00			
15. Organization expense		207,419.50			
Total		5,597,879.74	810,400.62	822,399.68	348,430.51
LIABILITIES					
16. Mortgages payable		125,000.00	125,000.00	125,000.00	125,000.00
17. Notes payable		169,000.00	169,000.00	20,000.00	169,000.00
18. Accounts payable		51,251.61	51,251.61	17,383.63	51,251.61
19. Excise taxes, current		39,221.28	39,221.61		39,221.28
20. Unpaid dividends		71,190.00	71,190.00	71,190.00	71,190.00
21. Accrued interest and taxes		13,467.72	13,467.72	13,467.72	13,467.72
					[2] 316,351.98
Capital stock, outstanding:					
Preferred	2,485,100.00				
Common	2,379,600.00				
		4,864,700.00	341,469.68	575,358.33	
Surplus		264,049.13			
Total		5,597,879.74	810,400.62	822,399.68	785,482.49
					[3] 437,051.98

[1] Pledged. [2] Taxes. [3] Deficit.

The CHAIRMAN. Then we will adjourn here until to-morrow morning at 10 o'clock.

(Whereupon, at 11.50 o'clock a. m., the committee adjourned until to-morrow, Thursday, March 26, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

THURSDAY, MARCH 26, 1925

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

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

Present: Senators Couzens (presiding) and King.

Present also: Mr. L. C. Manson, counsel for the committee; Mr. Edward T. Wright, 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 Solicitor of Internal Revenue; Mr. W. S. Tandrow, appraisal engineer, Bureau of Internal Revenue; Mr. J. G. Bright, Deputy Commissioner of Internal Revenue; and Mr. John Alden Grimes, chief of metals valuation section.

Mr. NASH. May I make just a short statement on the General Carbonic case and the procedure of handling excise-tax items? I will take just a moment.

The CHAIRMAN. Yes.

Mr. NASH. Yesterday some criticism was made of the procedure of handling excise tax returns in collectors' offices and the apparent failure to keep an adequate check of those returns so that delinquencies could be promptly discovered. The excise tax returns are rendered monthly by taxpayers to the collector within 30 days after the close of the month in which they made the collections for the Government.

In this case it appears that from February, 1922, up to about March, 1923, there was a gap in the returns filed by the General Carbonic Co. The return filed by these taxpayers is in triplicate form, one section of which is forwarded to Washington, one section stays in the collector's office, and the third section is returned to the taxpayer as a receipt. I will not read the entire procedure, but only that part of it which provides that the duplicate which stays in the collector's office must be filed behind a guide card which bears the name of the taxpayer. This is paragraph 11 of the sales tax procedure in Internal Revenue Manual, part 2, which manual is for the guidance of the offices of collectors of internal revenue:

> Guide cards should be established in alphabetical arrangement. Prior to filing the duplicate sales tax returns at the end of each month they should be arranged alphabetically. As each return is placed behind its corresponding guide card, the entire file should be examined for the purpose of ascertaining if any return is missing either for the current or previous month. Forms 837 should be prepared at the same time for the chief field deputy.

That is this little card, Form 837 [indicating], which is addressed to the chief field deputy, giving the name of the taxpayer and address and reading, "Has failed to file a return on Form No. —— for the month of ———. Please make an investigation and report to this office the reasons why the return has not been made," and is signed by the collector.

Then as a further check the offices of collectors are periodically examined by supervisors of accounts and collections working under the direction of the deputy commissioner of accounts and collections in Washington.

In the manual of instructions to officers making examinations this paragraph is found:

Sales tax delinquents: Inquiry shall be made as to whether the sales tax division is furnishing the chief field deputy with records with reference to all taxpayers who are delinquent, and that the chief field deputy forwards the records of such delinquent taxpayers to the field deputy for proper investigation.

In the series of questions which the examining officer has to answer in his report I find this question:

Are duplicate sales tax returns properly filed and indexed in accordance with instructions? Are cards, Form 837, prepared on delinquent sales taxpayers and forwarded to chief field deputy?

That is the procedure. I think it is as tight as we can make it.

Mr. MANSON. Let me see if I understand that. You have a folder behind the guide card?

Mr. NASH. Yes, sir.

Mr. MANSON. The instruction is that when the return is filed that folder shall be examined to determine whether there are any lapses?

Mr. NASH. Yes, sir.

Mr. MANSON. Under that procedure how do you ascertain whether there is a lapse until a subsequent return is filed?

Mr. NASH. The file is also checked, Mr. Manson, after all returns are filed. There is a check on the file then to indicate whether or not a return has been filed for the month, and then all files that are incomplete are thrown out——

Mr. MANSON. That is, they are thrown out for further action?

Mr. NASH. Yes, sir. In this case yesterday I also stated that due to pressure of work in the large collectors' office during this period it was quite possible that the Albany office had not been examined by the bureau. I find that the Albany office was examined on March 31, 1922. That is about the time this delinquency might first have become apparent. It was not examined again until February 29, 1924. There was just about the same gap in the examinations of the office that there was in the delinquency of this taxpayer. I think that accounts for why the error had not been discovered by the bureau in the meantime.

The CHAIRMAN. What answer has the collector to make as to that?

Mr. NASH. As I said yesterday, an incompetent clerk, a clerk who was not properly functioning.

The CHAIRMAN. What about the collector himself, who is supposed to carry out these instructions?

Mr. NASH. The collector is in charge of the administration of the office, and I suppose has taken the proper disciplinary action in the

case of this clerk. We have had no further complaints from the Albany office along this line.

The CHAIRMAN. Has the bureau taken any action in connection with the collector and clerk for failure in this case?

Mr. NASH. I did not go into it far enough to see what action has been taken. I presume proper action has been taken, because we have had no further complaint. Subsequent examinations of the Albany office have shown the proper procedure is being followed.

The CHAIRMAN. Will you let us know what has been done in this case?

Mr. NASH. If any disciplinary action has been taken; yes, sir.

The CHAIRMAN. And what the collector's excuse was for letting it run so long?

Mr. NASH. I do not presume the collector personally looked into these things. There was a clerk in charge of the index who was not properly performing his or her job, and it was not discovered for a period of 12 or 14 months.

The CHAIRMAN. What I do not understand is the collector, in a small district like that, having received $30,000 a month from the taxpayer, not missing it for 14 months in his office.

Mr. NASH. I quite agree with you in that, Senator. The only explanation that I can offer at this time is that a $30,000 item in an office like Albany is not an unusual thing.

The CHAIRMAN. Do you mean the taxpayer could omit making a payment of $30,000 a month for that length of time and the collector would not miss the collection of such a sum?

Mr. NASH. It is a very easy thing. I imagine the collections in that district perhaps aggregate $100,000,000 a year. That may be too large. I am using that figure offhand. The collections will run very large.

The CHAIRMAN. Then, of course, he has a chief clerk, who is supposed to have charge of the clerks?

Mr. NASH. Yes; and he has a head of the sales tax division. This clerk is employed in the sales tax division. The collector personally would not have any direct contact.

The CHAIRMAN. In spite of the fact that he has a deputy collector, a chief clerk, and a sales tax supervisor, and all that, it still goes on 14 months before it is caught up.

Mr. NASH. The man who is primarily responsible is the head of the sales tax division. A $30,000 tax is by no means unusual in an office the size of the Albany office. We have never been able to provide those offices with an adequate personnel. I have to admit that we probably have not caught 50 per cent of the delinquent excise tax payers in the country. We have not much more than scratched the surface on it, because we have never had enough men to do it. It was a lapse in the office. At the time this error occurred there may have been other kinds of work that was considered to be of more importance, in the opinion of those in charge of this particular kind of work at that time, and this feature was apparently neglected.

The CHAIRMAN. It seems to me nothing is more important where under the law you collect a tax from a citizen and then let the collector keep it. I think that it is more important that they do not get away with the tax they collect from citizens than it is that the taxpayers take it out of their profits and keep it.

Mr. NASH. That is very true and I am not offering any excuse for what happened in this particular case. I do think that the office was lax and I do know that the collector was very much chagrined when it was brought to his attention. He came to Washington to see the commissioner and felt very badly about it. I think he did make the proper administrative changes in his office to correct that condition. I never followed it up in detail, but I know that we have had no further complaint from that office along this line.

The CHAIRMAN. The collector's bond does not cover a case of that kind?

Mr. NASH. No, sir. It would cover a delinquency in his own office.

Senator KING. In what class of cases or business occupations or activities is the greatest loss? You stated that you had just scratched the surface and had perhaps lost 50 per cent of the excise taxes.

Mr. NASH. No, sir. I said we have caught perhaps 50 per cent of the delinquents. That means that there are a great many excise-tax payers or people who should have paid excise taxes who have never been caught and have never paid, and we have never been able to effectively ferret them out.

The CHAIRMAN. Has the statute of limitations run in those cases?

Mr. NASH. The statute of limitations has run on some of the cases that were repealed by the 1921 act. That does not mean that we have lost any great amount of money. We have been able to keep in close touch with the big taxpayers. Yet I venture to say to-day you can go out in some parts of the United States and find moving-picture shows that never heard of an admission tax at least, they will not admit it. Our investigators are now finding 10,000 or 12,000 delinquents a month on excise taxes that were due under the 1918 law and the 1921 law.

Mr. MANSON. Do you have any system of permits which would give you a list of persons engaged in occupations subject to the excise tax?

Mr. NASH. Every manufacturer of an article that is subject to excise tax must register once a year with the collector of internal revenue, and there is a penalty for failure to register.

Senator KING. It seems to me that before we conclude these hearings, Mr. Chairman, we ought to have Mr. Nash and others of the department, as well as counsel for the committee, look into these administrative features a little to see if any just criticism can lie against the bureau and whether any additional administrative measures may be provided by law to aid the department in collecting all the taxes and ferreting out, to use Mr. Nash's expression, those who are delinquent in excise-tax payments. I appreciate the magnitude of the task and I am not making the suggestion in any critical spirit.

Mr. GREGG. I would like to call this fact to the attention of the committee. The fact was brought out in connection with the hearings on the 1924 act before the Ways and Means Committee. This is just an example of the difficulty. The 1921 act levied an excise tax on the sale of riding clothes. People who manufactured them

in wholesale lots, who manufactured a kind of khaki riding pants, said they were the only ones who paid the tax; that the people who were supposed to pay it, the hundreds of tailors in each city who made expensive riding habits, never paid it, and it was utterly impossible for the department to collect. As a result Congress repealed that provision. There were a great many of that kind of taxes in the 1918 and 1921 acts.

Mr. MANSON. I would like to ask a representative of the department whether they have ever given consideration to the advisability of an amendment to the law requiring an individual or corporation who is permitted to collect a tax to be placed under bond.

Mr. NASH. I have never given that point any consideration, but I will say that I think the Government goes a long way when it has some private individuals acting as a collecting agency. We ought to devise some other means for collecting the tax. For instance, in the admission tax it has been suggested, and I think there is a great deal of merit to it, that the Government might devise some way of printing tickets or stamps or something of that sort, to be sold to the theaters and that the theaters could in turn reimburse themselves from the people who would apply for admission, but they would not be acting as our collection agency. They would pay the tax at the time they bought the tickets or bought the stamps. I think there might be devised a means for collecting such taxes that would not make individual citizens collection agencies for the Government.

As pointed out yesterday it is very difficult for us to get a conviction when we do get an actual case of what appears to be embezzlement. I do not recall in my experience of more than two or three cases of embezzlement of admission tax where we have been able to get a conviction.

Mr. MANSON. What is the trouble there—inability to establish the amount?

Mr. NASH. It is very difficult to establish the amount and very difficult to segregate the Government's money from the theater's money. We have to get a specific case where a taxpayer goes up to a box office and buys a ticket for an admission, and then show that the theater owner does not turn in the money that this man paid him for an admission tax.

I know of one instance where we planted men outside of a box office for a week with some kind of little checking machines to check the people that went in. We counted from the time the theater opened at about 11 o'clock in the forenoon until they closed at night. Then at the end of the week we compared our report with the reports that the cashier of the theater was turning into the manager and also with the serial number of tickets which had been used, and no two of the three things would agree. We had the cashier of the theater arrested for withholding taxes. We felt that the theater was withholding taxes because they were not paying one-third as much tax as other theaters in the same vicinity, and yet they were always crowded. Yet the United States commissioner would not hold that man on the evidence we had secured. The only evidence we could get was the count that our men made of the people that went up to the box office. The commissioner threw out the

case because he said we could not prove whether those people bought a ticket when they went up to the box office or not.

Senator KING. The district attorney ought to have taken that to the grand jury and gone over the head of the commissioner.

Mr. NASH. It costs us several hundred dollars to try to make such a case. In that particular instance we were trying to make a case for the moral effect it would have on the rest of the theaters in that city. We wanted to do it for advertising purposes. Instead of that, they made sort of a laughing stock out of us, because it got pretty well advertised among the theaters that we could not catch them.

The CHAIRMAN. That is a good argument for abolishing the whole business of excise taxes.

Mr. MANSON. Yes; for it permits dishonesty.

Senator KING. It is an argument either for abolition or the adoption of different regulations, so as to make money embezzlement or concealment of receipts more difficult.

Mr. NASH. In this case I wanted to point out to the committee that I think the procedure that has been prescribed by the department for handling excise-tax returns is about as effective as we can get it without tying ourselves up in a mass of red tape trying to overcome human incompetence. These cases come in by the hundreds and have to be handled speedily, and the more operations we put them through the longer it takes to have the job done. We did try several years ago to have a recheck on this work in Washington. We found that we were just about duplicating what was being done by the collector's office, at an enormous expense, and the expense did not justify the duplicate checking, so we eliminated it.

Mr. MANSON. Before taking up the next case, I want to make a correction of a statement I made some time ago. Yesterday my attention was called to the fact that when we were before the Finance Committee on the resolution to extend this investigation I made the statement that it was my opinion that it would cost $1,000,000 to make a proper engineering examination for the purpose of determining amortization in the United States Steel case. I find that I did make such a statement. In the heat of the discussion I did not state what I intended to state, which was that it was my opinion that it would cost about $1,000,000 to make a proper engineering examination of all amortization cases.

The matter to which I desire to call the attention of the committee this morning is the tax of the United Verde Extension Mining Co. for 1917. This matter involves an additional tax of $721,260.82.

The CHAIRMAN. When was that settled?

Mr. MANSON. It was settled by a 1312 agreement of January 24, 1924.

Before taking up the engineer's report I desire to call attention to the high spots in the case. The United Verde Extension Mining Co., or its predecessor corporation, was organized in 1888, but it was not until 1915 that the bonanza lode, in which they have since operated, was discovered. From 1910 to 1914 they did not have sufficient income to require them to make a return.

The company in its 1917 return took a deduction of something over $2,000,000 for depletion. This deduction was based upon what

they claimed to be the March 1, 1913, value of approximately $40,000,000. Inasmuch as the metal had not been discovered until 1915 there was no basis for a 1913 value of the ore, and the only 1913 value there could be was the cost, which amounted to approximately $525,000.

Senator KING. You mean the cost of the property?

Mr. MANSON. The cost of the property. There had been a discovery in 1915, but the provision of the law permitting a discovery valuation did not become effective until 1918. There are three bases upon which depletion may be allowed—that is, one of three bases, either upon cost, which in this instance was $525,000, or upon the 1913 value, or upon a discovery value since 1913. Eliminating the discovery value basis, because the law did not permit a discovery value for 1917, brings us back to the cost or 1913 value, and the fact that the deposit was unknown to exist in 1913 eliminates the 1913 value except upon a cost basis.

When this company filed its return it set up a net income of something over $8,000,000.

Senator KING. For 1917?

Mr. MANSON. In 1917.

The CHAIRMAN. That was after deducting the $2,000,000?

Mr. MANSON. That was after it had deducted in excess of $2,000,000 for depletion and also a deduction in the neighborhood of some $100,000 for development costs, which should have been capitalized instead of depleted.

When this return was filed the claim was made for a representative rate of taxation upon the ground that the invested capital should not be determined. This claim was passed upon by the then existing tax advisory board. Comparative companies were selected and a rate of taxation of approximately 21 per cent was determined upon. Applying this rate to the net income as reported by the company after making these deductions, the tax advisory board determined upon a tax of $2,123,809.55. As I will show to the committee, the assessment letter levying that tax specifically stated that that was a purely tentative assessment.

The CHAIRMAN. What date was that assessment levied?

Mr. MANSON. June 10, 1918, on the recommendation of the tax advisory board a tentative assessment of $2,123,809.55 was made by the commissioner. As I stated, that assessment letter stated that that was a purely tentative assessment.

For some reason or other after that assessment was made a duplicate assessment was made by the collector at Baltimore of that same amount. A claim in abatement was filed and allowed. In other words, the allowance of the abatement was for the specific purpose of canceling the duplicate assessment, and so stated.

Senator KING. The plea for abatement was for the entire tax?

Mr. MANSON. The plea for abatement was for the $2,000,000.

The CHAIRMAN. But was only for abatement of the duplicate assessment?

Mr. MANSON. Yes; it was only for abatement of the duplicate assessment.

The CHAIRMAN. And not abatement for the principal assessment?

Mr. MANSON. No. I call the attention of the committee to these two facts: In the first place, the first assessment was a tentative assessment, as I will show, and in the second place the abatement was an abatement of a duplicate assessment and in no way an abatement of any portion of the tentative assessment, for the reason that the basis upon which this case is ultimately closed is that the bureau had taken final action, and both the tentative letter and the allowance of an abatement are pointed to as indicating final action, which precluded the bureau from afterwards determining the proper basis for the allowance of depletion.

The committee is familiar with the proceedings had with reference to the revaluation of copper mines and the order of the commissioner in December, 1922, ordering a revaluation of copper mines for 1919 and subsequent years. In this case there was no provisional valuation. There was no initial valuation which was ever applied to the 1917 tax. Yet that order of the commissioner ordering a revaluation for 1919 and subsequent years is pointed to as another evidence of conclusive action upon the part of the department that the 1917 tax of this taxpayer is closed.

Senator KING. Is there anything to show why the collector in Baltimore would be making a duplicate assessment upon property in Arizona?

Mr. MANSON. No; I do not think there is.

Mr. WRIGHT. It is simply supposed that the bureau notified him of the assessment.

Senator KING. Did the officers of the company live in Baltimore or did the company have offices in Baltimore?

Mr. WRIGHT. No; their offices were in New York. The tentative assessment was made in New York and paid there, and for some reason the Baltimore office has the same jurisdiction.

Mr. MANSON. They have jurisdiction of all cases outside of the country.

Mr. NASH. It must have been a mechanical slip which occurred. There would be no legitimate reason for it being paid in Baltimore.

Senator KING. No; I think not.

Mr. MANSON. I merely mention that to call the attention of the committee to three of the facts that were relied upon by this taxpayer and urged by the taxpayer and at least to some extent acted upon by the bureau in finally closing the case.

The facts are rather involved and this preliminary statement which I have made has been for the purpose of informing the committee as to what the facts are about. I now refer to the report of Mr. Rice, the committee's engineer.

On March 30, 1918, the taxpayer filed his 1917 return with no computation of tax, claiming that the invested capital could not be ascertained and requested to be placed under section 210 of the 1917 revenue act and assessed accordingly. This was granted and a tentative tax of $2,123,809.55 was assessed and paid by the taxpayer at New York. A similar assessment was also made by the collector at Baltimore, and when an abatement of this was claimed by the United Verde Extension Mining Co. it was allowed by the unit, since it was quite evidently a duplicate assessment.

In 1919 when the natural resources section was formed the taxpayer was requested to fill out Form A for the purpose of deter-

mining his tax liability. He protested, claiming the case was closed, and cited the abatement letter. Valuations were made by the metals section as a result of which considerable depletion was disallowed for the 1917 tax. Later, on January 24, 1923, an additional assessment of $721,260.82 was made, which the taxpayer protested claiming the case to be closed. A number of conferences were held, briefs filed by the taxpayer, memoranda prepared by the metals section, and the matter was thoroughly examined. The metals section recommended the additional assessment be collected, while Mr. Greenidge, head engineering division, and Deputy Commissioner Bright, after considering the case, recommended it be closed, as a result of which an agreement under section 1312 of the 1921 revenue act was executed and signed by the taxpayer and the bureau.

This company was first organized as the United Verde Extension, Gold, Silver & Copper Mining Co., about 1888, capital $3,000,000, divided into 300,000 shares of a par value of $10. The company acquired mining claims adjoining those of the United Verde Copper Co. at Jerome, Ariz.

Senator KING. I suppose that was chiefly paper capital?

Mr. MANSON. Yes. The company acquired mining claims adjoining those of the United Verde Copper Co. at Jerome, Ariz. One hundred and ninety thousand shares were sold at public subscription in 1899 at $6 per share.

In 1904 the United Verde Extension Mining Co. of Maine was organized, which acquired five of the original claims of the above company. This company had a capital of $4,000,000, divided into 400,000 shares of a par value of $10.

In 1910 the United Verde Extension Mining Co. of Delaware was incorporated. Capital, $4,000,000; shares 400,000; par value, $10. The five original claims were deeded to this company by the Maine company for the entire capital. Development at this time is said to have amounted to $2,000,000.

In June, 1912, this company was reorganized and the capital reduced to $750,000, with 1,500,000 shares at 50 cents par value. One million and fifty thousand shares were issued and are outstanding to the total value of $525,000.

Senator KING. It was this company that took over the five claims which is the subject of this inquiry?

Mr. MANSON. Yes. I call attention to the fact that this company in June 1912, had an outstanding capital of a par value of $525,000 and that the greatest amount of capitalization of any of its predecessors had been $4,000,000.

The ore bodies of the company are located in Jerome, Yavapai County, Ariz., while the smelter is situated at Clemenceau, Ariz., about 6 miles from Jerome. No net profit was made between 1910 and 1914, and during that period the company had no income from operations.

The taxpayer filed its return for 1917 taxes on March 30, 1918, without computation of tax and requested special treatment under section 210 of the revenue act of 1916 as amended by the law of 1917 allowing a representative tax, based on March 1, 1913, value of $40,000,000.

Permit me to interject at this point the fact to which I have already called the attention of the committee that it was not until 1915

that the property was discovered which would justify any substantial valuation.

The CHAIRMAN. When they filed the 1917 return they claimed a valuation of $40,000,000?

Mr. MANSON. Yes; as of March 1, 1913, value.

On June 10, 1918, on the recommendation of the Tax Advisory Board a tentative assessment of $2,123,809.55 was made by the commissioner.

The CHAIRMAN. Does the record show or do you intend to tell the committee later how that was arrived at?

Mr. MANSON. I will explain how that was arrived at. I am trying to get before the committee now a chronological history of this case in the bureau in as brief manner as possible.

On June 15, 1918, the taxpayer paid this assessment.

During June, 1918, the collector at Baltimore made an assessment for a similar amount, $2,123,809.55, and the taxpayer filed an abatement claim.

On August 31, 1918, the revenue agent reported on 1910 to 1917, inclusive, and disallowed depletion except that based on cost, $525,000.

On September 27, 1918, abatement order No. 3633 was filed by Collector J. M. Miles at Baltimore, to stop duplicate assessment of $2,123,809.55.

On February 19, 1919, the taxpayer's claim for abatement of tax was allowed.

On November 20, 1918, Mr. Graton, valuation engineer, wrote the taxpayer for "supplemental data, Form A, as revenue agent's report indicated large additional taxes for 1916 and 1917," to which the taxpayer replied that the case was closed for 1917, by the abatement letter of February 19, 1919.

On November 25, 1919, the taxpayer made a definite claim on Form A.M.M.S. for March 1, 1913, value of $40,000,000 on 2,000,000 tons of ore not known to exist on March 1, 1913.

On June 7, 1920, the taxpayer, apparently abandoning the March 1, 1913, claim, filed Form D claiming a discovery value at December 31, 1916, of $39,546,137.60 on 2,000,000 tons of ore, and a development cost account of $453,562.40 at date of discovery; in other words, making up the $40,000,000.

Up to this point the taxpayer first claimed a 1913 value of $40,000,000. Then he abandoned the claim for the 1913 value of $40,000,000 and set up a claim for discovery value of the same amount as of December 31, 1916.

On June 12, 1920, E. T. Cummings, assistant valuation engineer, determined discovery value at December 31, 1916, of $36,518,340.88.

I might say at this point that we have not attempted to review that discovery value for the reason that we claim that for the year 1917 the only depletion they were entitled to must be based upon the $525,000 of cost, but they were not entitled to any depletion on discovery value for 1917 for the reason that the law did not permit it and no depletion upon 1913 value for the reason that the ore was not known to exist until 1915.

The CHAIRMAN. You have not told us when they discovered the ore.

Mr. MANSON. Yes: it was in 1915 that the ore was discovered.

The CHAIRMAN. Where is the evidence to that effect?

Mr. MANSON. That is admitted by everybody. There is no dispute about that.

The CHAIRMAN. That is admitted in the record?

Mr. MANSON. Yes. When the taxpayer finally filed this claim for a discovery value the discovery is set up as having taken place in 1915 and developed by December, 1916.

Senator KING. And then they claimed $400,000 for development as abatement for that, which as counsel stated—and I think he is correct—was capital?

Mr. MANSON. Certainly. But that was in addition to the depletion claim. In 1917, based upon the $10,000,000 value to be depleted, they included their development costs, all of which they sought to deduct in the year 1917.

No action was ever taken on this Cummings valuation of $36,518,340.86. It was later discovered that in arriving at that figure of $36,000,000 plus, the engineer had failed to deduct the plant, and a new valuation was made by Engineer W. H. Harrison. On February 25, 1921, W. H. Harrison, valuation engineer, determined discovery value, at December 31, 1916, of $30,652,379 for ores only, and depletion from 1915 to 1917, inclusive, according to the engineer's report, was based on the cost of $525,000 as of March 1, 1913.

On March 28, 1921, additional taxes for 1915 and 1916 were assessed on the basis of the Harrison valuation—that is, for the years 1915 and 1916 they would be assessed on the cost basis.

The CHAIRMAN. I thought you said not on the cost basis but on the Harrison valuation?

Mr. MANSON. Harrison made two valuations. He made a valuation as of 1913, which was applicable up to the time the discovery value became effective, up to the date of the discovery, and while the actual depletion sustained would be based upon the discovery valuation, the allowance for depletion for the year 1917 would necessarily, under the law, be based upon the cost for the reason that the 1917 law made no provision for discovery valuation.

March 28, 1921, additional taxes for 1915 and 1916 were assessed on the basis of the Harrison valuation—that is, the cost valuation—subsequent to which several conferences were held, 1917 taxes not being considered.

On January 22, 1922, additional taxes assessed for 1915 and 1916 were confirmed.

On March 18, 1922, claim for abatement of the 1916 tax was filed by the taxpayer, which was subsequently disallowed.

On April 5, 1922, a conference was held with the taxpayer and the conclusion was reached that the "1917 audit is to be considered final only in the event that the Commissioner of Internal Revenue agrees in writing to such arrangement."

The CHAIRMAN. Who were the conferees at that time? Does the record show?

Mr. MANSON. I do not know. I cite this fact to show that the auditor who attended that conference with the taxpayer did not consider the 1917 tax to be closed and that they were not to be considered closed unless the commissioner agreed to such an arrangement in writing. That was as late as April 5, 1922.

On January 24, 1923, an A–2 letter was mailed to the taxpayer advising that an additional assessment for 1917 was to be made in the amount of $721,260.82.

I might interject at this point that that additional tax is based entirely upon the disallowance of the item of depletion and the development cost.

Senator KING. Which amounted to $2,400,000; that is, $2,000,000 depreciation and $400,000 development costs?

Mr. MANSON. I will give the exact figures on that. The depletion allowed, which would be the difference between depletion on the cost basis and depletion on the $40,000,000 basis, amounted to $2,265,756.33. The development cost disallowed amounted to $461,407.50. Then there was a depreciation disallowed amounting to $34,204.94 and a small item of $916.20 due to disallowance on an exchange of automobile.

Senator KING. Was that depreciation on the mine when they claim its value had gone up to $40,000,000?

Mr. MANSON. I assume it was on the plant. Then they did allow one-tenth of the development costs, correcting the net income to $10,937,277.99 instead of $8,242,909.04. The additional tax arises out of a difference in net income for the reason that the same rate was used as had been previously determined by the tax advisory board upon a comparative basis and which had been accepted without objection by the taxpayer.

February 19, 1923, the taxpayer wrote protesting this assessment, claiming the 1917 taxes were closed by the abatement order of February 19, 1919.

The CHAIRMAN. When, as a matter of fact, it was only an abatement for a duplicate assessment?

Mr. MANSON. Yes.

On April 10, 1923, there was a conference, at which the taxpayer protested the 1917 assessment on the basis that section 1313, act of 1921, prohibits such review and that under the act of 1917 the three-year statute of limitations outlaws such 1917 assessment.

I will read section 1313 into the record, but I call attention to the fact at this time that that section provides that where the commissioner has finally determined the fact or assessed the tax, that his action shall not be subject to review of any other Government officer or department. The claim has no application whatever to this situation, because, in the first place, the only tax involved here and the only tax which the commissioner had determined was the tentative tax, and the tax which was clearly stated to be a tentative tax.

In April, 1923, the taxpayer submitted a brief by Paul Armitage, its tax consultant, presenting arguments.

On May 10, 1923, there was a memorandum to Deputy Commissioner Chatterton from the metals valuation section, answering the protest and arguments of the taxpayer, and submitting that the additional assessment should stand, because of gross error in the tentative assessment as a result of misrepresentation by the taxpayer, and that there is no evidence that such assessment was final.

On July 3, 1923, there is a letter from Mr. Grimes, chief of the metals valuation section, to Mr. Greenidge, head of the engineering division, presenting the facts and records in the case.

On July 31, 1923, there is a memorandum from Mr. Greenidge to Mr. Bright, deputy commissioner.

On September 4, 1923, there is a memomarndum from Mr. Enes, conferee of the consolidated returns subdivision, to Mr. Bright, reviewing the case.

On September 6, 1923, there is a memorandum from Volney Eaton, chief of special assessment section, to Mr. Bright.

On September 6, 1923, there is a memorandum from Mr. Greenidge to Mr. Bright, recommending "that the case be considered closed for the year 1917."

I am calling attention to these different memoranda in chronological order for the purpose of indicating that at the time this final settlement was made all the facts in the case were known to both Mr. Greenidge and Mr. Bright.

The CHAIRMAN. In other words, it is one of those peculiar cases to which I have heretofore referred.

Mr. MANSON. On September 11, 1923, there is a memorandum from Mr. Bright to Commissioner Blair, recommending

> * * * that the case be not reopened for the year 1917 and that the unit advise the taxpayer that the letter of January 24, 1923, should be ignored.

On November 6, 1923, there is a letter from the taxpayer to Mr. Bright, advising that the letter of January 24, 1923—that is, the letter proposing the additional tax—"should be ignored."

On January 24, 1924, a 1312 agreement was finally executed and mailed to the taxpayer, closing the case.

On February 18, 1925, there is a memorandum to the commissioner from Mr. Grimes, recommending that the case be reopened.

The CHAIRMAN. How could it be reopened when the 1312 agreement had been executed?

Mr. MANSON. I know of no way myself by which it could be reopened, except by a showing of fraud.

The CHAIRMAN. Was there any showing of fraud in this case?

Mr. MANSON. I believe that this is a clear case of fraud.

Mr. GREGG. May I ask a question right there?

On whose part?

Mr. MANSON. I think that will be apparent before we are through. I do not care to anticipate the presentation of this case.

I have, perhaps, bored the committee with this chronological statement of these proceedings, but I have done so in order that a brief history of this case might be before the committee before we get into a consideration of the details and get lost in the details.

In the settlement of 1915 and 1916 taxes claims for depletion were made by the taxpayer based on a valuation as of March 1, 1913, of $4,000,000. This was not allowed by the unit, and the cases were finally closed with depletion deductions based on a cost value of $525,000.

This case pertains only to the settlement of 1917 taxes, the cancellation of additional assessment of $721,260.82, and the closing of the case by a 1312 agreement, with resulting loss in taxes to the Government.

For 1918 and subsequent years depletion is based on a discovery value allowed by the unit, and is not in controversy, although the

allowance of such discovery involves principles which might well be made a subject for discussion.

Inasmuch as that is not involved in this case, I might digress at this point for the purpose of explaining what principle is involved here.

This company is operating upon the same lode as that upon which the United Verde is operating. In other words, their metal deposit is an extension of a known or so-called discovery, an extension of a known deposit, and under a strict construction of the regulations they are entitled to no discovery value at all.

The taxpayer filed its 1917 return on March 30, 1918, without computation of tax liability, claiming that invested capital could not be ascertained and requesting to be assessed under section 210 of the revenue act of 1916, as amended in the act of 1917.

That if the Secretary of the Treasury is unable in any case satisfactorily to determine the invested capital, the amount of the deduction shall be the sum of (1) an amount equal to the same proportion of the net income of the trade or business received during the taxable year as the proportion which the average deduction (determined in the same manner as provided in section 203, without including the $3,000 or $6,000 therein referred to), for the same calender year, of representative corporations, partnerships, and individuals engaged in a like or similar trade or business, bears to the total net income of the trade or business received by such corporations, partnerships, and individuals, plus (2) in the case of a domestic corporation $3,000, and in the case of a domestic partnership or a citizen or resident of the United States, $6,000.

The request of the taxpayer was considered by the unit and the advisory tax board appointed by Secretary McAdoo in the latter part of 1917, and afterwards incorporated into the act of 1918, section 1301, and finally granted. A tentative tax was determined on a representative tax basis in the amount of $2,123,809.55, and the taxpayer so advised in assessment letter dated June 10, 1918. This tax was paid by the taxpayer on June 15, 1918.

The CHAIRMAN. Was that tax ever refunded?

Mr. MANSON. No.

The CHAIRMAN. That tax remained in the Treasury?

Mr. MANSON. That tax, so far as the records indicate, was paid, and the taxpayer claims the incident was closed. It was finally closed by this 1312 agreement upon that basis.

Upon notice from the bureau the collector at Baltimore, Md., assessed and demanded payment for a similar amount, $2,123,809.55, in June, 1918. The taxpayer filed a claim for abatement, advising that the same amount had been assessed at New York and paid.

On September 27, 1918, Collector J. W. Miles filed an abatement claim, order 3633, to stop the duplicate assessment.

His declaration is as follows, and I am quoting now from the order in abatement:

Amount assessed, 1917, $2,123,809.55 * * * that the United Verde Extension Mining Co. paid the amount mentioned above, under date of June 15, 1918, and such amount is recorded as an advance payment on my June, 1918, list, page 159. The assessment on my June, 1918, list, section 1, page 21, line 20, should therefore be abated.

On February 13, 1919, the above abatement order was allowed, and on February 19, 1919, the taxpayer was notified as follows:

Your claim for the abatement of internal revenue tax has been allowed as shown above. No further demand for the payment of the amount allowed and abated will be made upon you.

HOMER S. PAGE,
Acting Deputy Commissioner.

Inquiry has been made of the special assessment section as to how the tentative tax assessed, $2,123,809.55, was computed, but we are advised that same was determined by the advisory tax board and that there are no records in the files disclosing same. It is evident, however, from the records that a representative tax rate of 21 per cent plus was used by the advisory tax board on a net income, with depletion deducted as claimed by the taxpayer. It was not possible in 1918, to investigate valuation matters to any great extent, as the valuation departments were not organized until 1919. The rate used appears to have been satisfactory to the taxpayer as long as the claimed depletion deduction was allowed, but when, later, the unit determined that such depletion deduction was improper the taxpayer protested vigorously on the rate when net income was increased by the disallowance of a large amount of the depletion deduction, and the tax increased thereby.

To make that clear the taxpayer has made certain deductions which we have already discussed. The taxpayer also claimed that instead of being assessed upon the basis of his small invested capital, it was entitled to be assessed upon the basis of a rate to be ascertained by comparing its tax rates with tax rates of other taxpayers engaged in the same line of business. The rate of 21 per cent plus was arrived at by such a comparison, and the taxpayer offered no objections to the application of the tax rate.

It is claimed that the taxpayer's failure to object to the tax rate was dependent upon its being allowed certain deductions, but it is manifest that the rate at which a taxpayer shall be taxed—a thing that is ordinarily fixed by Congress itself, and this exception was only made because of the difficulty of determining invested capital in some cases—is quite a different and a separate thing and a thing which should in no way be involved with the deductions which are to be permitted the taxpayer, which affect only the amount of the net income to which the rate is to be applied.

The CHAIRMAN. The taxpayer afterwards objected to the rate, as I understand it?

Mr. MANSON. The taxpayer afterwards claimed that its consent to the rate was dependent upon the allowance of these deductions.

The CHAIRMAN. Oh, yes; I understand that.

Mr. MANSON. And one of the grounds——

The CHAIRMAN. But the taxpayer only objected to that 21 per cent plus rate because of the nonallowance of those claims?

Mr. MANSON. Yes; and one of the grounds, as will be shown, upon which the officers of the bureau, particularly, Mr. Greenidge, recommended the case be finally closed, was that if you reopened the matter of this deduction the taxpayer might reopen the matter of the rates, and that he might get a larger rate and the Government would not collect any more tax—a good deal like the explanation that was offered in regard to the revaluation of silver mines, that you might get more tax out of the silver mine owners but you would get less out of the lead people.

On August 31, 1918, the revenue agent made his report on the period 1910 to 1917, inclusive, disallowing depletion except on the basis of cost, $525,000. In the fall of 1919 a valuation section was organized in the natural resources subdivision and the matter of determining a proper depletion allowance for 1917 was taken up by Mr. L. C. Graton. The taxpayer was requested to file "supplemental data * * * not later than December 8, 1919." In its return the taxpayer had deducted depletion for 1917 in the amount of $2,301,296.48. On November 25, 1919, the taxpayer filed Form A–M. M. S., claiming a March 1, 1913, value of $40,000,000 on 2,000,000 tons of ore not known to exist as at March 1, 1913. On June 7, 1920, the taxpayer abandoned its claim for March 1, 1913, value as above, and filed Form D, claiming a discovery value at December 31, 1916, of $39,546,137.60 on 2,000,000 tons of ore, and a development and cost account of $453,862.40 at date of discovery.

On June 12, 1920, Mr. E. T. Cummins, assistant valuation engineer, reported a discovery valuation for ores only, at December 31, 1916, of $36,518,340.88.

The CHAIRMAN. Why is all of that being read into the record again? We have already had all of those figures once.

Mr. MANSON. I endeavored at the opening of the consideration of this matter to state in a summary way the points that are involved. I am now trying to get this matter presented in regular order.

This valuation, however, was not used by the unit in any tax determination and was superseded by a later valuation report, dated February 25, 1921, made by W. H. Harrison, valuation engineer, and approved by O. R. Hamilton, chief of the metals valuation section, in which a discovery value at December 31, 1916, for ores only was allowed of $30,652,379, and the March 1, 1913, value was determined based on cost as $525,000. Inasmuch as a discovery depletion was not allowable previous to the 1918 act, a depletion deduction was allowable for 1917 in the amount of $35,540.15. In March, 1921, the taxpayer was assessed additional taxes for 1915 and 1916 on the basis of the Harrison valuation. It appears to have been the impression that 1917 taxes were closed, and not until 1923 was the matter reopened. On January 24, 1923, an A–2 letter was mailed to the taxpayer calling for an additional assessment of $721,260.82.

The engineer sets up the basis of this additional assessment, showing just how he arrived at it.

In the tentative assessment the net income reported was used, $8,242,909.04. In the additional assessment this amount was increased to $10,937,277.99 by the following corrections:

Net income reported		$8,242,909.04
Additions:		
Depreciation, disallowed	$34,204.94	
Exchanged automobile, value disallowed	916.20	
Development, disallowed	461,407.50	
Depletion, disallowed	2,265,756.33	
		2,762,284.97
		11,005,194.01
Amortization of development, one-tenth allowed		67,916.02
Corrected net income		10,937,277.99

Representative rate: In arriving at a representative rate, five companies were selected, as follows:

	Invested capital	Net income	Per cent net income to invested capital	Excess profits tax	Per cent tax to net income
Arizona Copper Co	$35,140,023	$8,181,847	23.28	$1,383,651	16.91
Mammoth Copper Co	948,428	420,771	44.37	141,845	33.71
Shattuck-Arizona Copper Co	3,141,310	1,617,197	51.48	592,761	36.65
Chino Copper Co	20,324,105	10,880,261	53.53	4,062,187	37.34
Calumet & Arizona Co	41,045,372	8,307,313	20.24	1,026,389	12.36
Total	100,599,238	29,407,389		7,206,833	
Average	20,119,484	5,881,478	29.23	1,441,367	21.29

From the average per cent of net income to invested capital, 29.23 per cent, applied to the corrected income, $10,937,277.99, is obtained a constructive invested capital of $38,986,896.54. This constructive invested capital then becomes the basis for the excess-profits tax computation as provided in the regulations.

The excess-profits tax thus computed amounts to	$2,326,546.48
Tax at 2 per cent	172,174.63
Tax at 4 per cent	344,349.26
	2,845,070.37
Tax previously assessed	2,123,809.55
Additional tax	721,260.82

This clearly shows that the difference is due entirely to the disallowance of this depletion and the development costs and that small item of depreciation.

It is interesting to note what this taxpayer would have been assessed had it not received special treatment under section 210. The revenue agent reported for 1917 a tax due of $5,548,823.40. We have made a computation of the tax based on the regular basis, which shows as follows:

Excess-profits tax	$5,739,100.95
Tax at 2 per cent	103,963.54
Tax at 4 per cent	207,927.08
Total tax that would have been paid, regular basis	6,050,991.57
Total tax due under representative tax	2,845,070.37
Total tax actually paid	2,123,809.55

Senator KING. They got special treatment, and that reduced it to $2,700,000 or $2,800,000, and then they got a further reduction to $2,100,000?

Mr. MANSON. The total tax due under the representative tax rate, if this depletion is properly eliminated, is $2,845,070.37, and the tax that they actually paid and on which the case has been closed is $2,123,809.55.

Senator KING. What was the reason for the special treatment which reduced it from $6,000,000 to nearly $3,000,000? Why was it entitled to special treatment?

Mr. MANSON. Why were they entitled to consideration under section 210?

Senator KING. Yes.

Mr. MANSON. That claim is based upon this fact, that they had a very low invested capital. You see, their value here is practically all a discovery value.

Senator KING. Yes.

Mr. MANSON. And their invested capital is very low.

Senator KING. Well, it is simply based on the discovery value, then?

Mr. MANSON. It is simply based on that fact.

Senator KING. I understand.

The CHAIRMAN. But there was no discovery value allowable at that time, was there?

Mr. MANSON. No; but their invested capital would have been very low there. Their property had neither been purchased at anywhere near what it was worth, nor did it have a 1913 value that amounted to anything.

The CHAIRMAN. Then you find no fault with the special treatment?

Mr. MANSON. No; I am not criticizing the special rate that was applied here at all under the law. There is some question in my mind as to the justification of that act, but that is past history. I think the rate that was finally arrived at was a fair one. On the other hand, I would call attention to this fact, that from the taxpayer's standpoint he received very fair consideration. The United Verde Co., operating upon the same lode, operating under identical conditions, paid a tax of approximately 29 per cent. This company was allowed a rate of 21 per cent, approximately.

Senator KING. On the net returns?

Mr. MANSON. On the net income.

Senator KING. On the net income.

Mr. MANSON. And one of the grounds set up as a reason why this case should be closed is that if these deductions which were taken by the taxpayer are disallowed the taxpayer will reopen the matter of its tax rate, and it will be possible to give it the same amount of tax by giving it a lower rate.

I call attention to these comperatives for the purpose of showing that it has already received a fair rate, and even a very much lower rate than another company operating upon the same ground, practically, or operating upon the same deposit.

The CHAIRMAN. Just for the information of the chairman, could you tell us briefly why the rate in one of those five cases was 37 or 39 per cent and another only 12 per cent? I want to get the theory of fixing this special-tax rate.

Mr. MANSON. They did not get a special representative rate. Their rate was based upon the relation of their invested capital to their net incomes.

Senator KING. Was there not a part of that apparent disparity that resulted from excess profits?

Mr. MANSON. Yes; entirely. I assume they would have a higher invested capital in proportion to their net income.

The CHAIRMAN. These five cases that you have just enumerated were not special-treatment cases under the act referred to?

Mr. MANSON. No, sir.

The CHAIRMAN. They were actual cases?

Mr. MANSON. They were actual cases; yes.

The CHAIRMAN. And it was on that actual experience that this particular taxpayer received a rate of 21 per cent?

Mr. MANSON. Yes. Well, I said, "Yes." I want to clarify my answer there.

My understanding is that the tax advisory board arrived at a rate of 21 per cent, plus. There is no record that disclosed exactly how they arrived at that, but in making this special assessment here the bureau selected these five companies and reached the same result that the tax advisory board reached in its previous determination. As I have already explained, its previous determination, so far as the rate was concerned, was not objected to by the taxpayer, and the result reached by the use of these companies that I have mentioned is the same as the result which the tax advisory board had reached.

The taxpayer claimed a deduction of $2,301,296.48, based on a value as of March 1, 1913, of $40,000,000.

On November 25, 1919, Form A–M. M. S. was filed, to substantiate their claim as above——

Senator KING. That has already been stated. Are you going to go over that again?

Mr. MANSON. I am giving the details now. I have stated that summarily, perhaps, unfortunately, but I want to get the details in the record.

A valuation as of November, 1916, by James R. Finley, was submitted, showing 2,000,000 tons of ore, at $20 per ton, a total value of $40,000,000. They claimed the "market value in the mine, of the product thereof which had been mined and sold during the year for which the return and computation are made." The taxpayer maintained that, although the mine had no known ore as at March 1, 1913, he was entitled to a March 1, 1913, value, based upon the quantity and quality of the ore discovered in 1915. No ore was known to have existed in the mining property of this taxpayer, and the metals valuation section concluded that the March 1, 1913, value of the United Verde extension mine was not in excess of its cost.

The cost of the mine in 1912 to the present corporate owners was not in excess of $525,000, established by the sale of 450,000 shares at 50 cents par value to the Douglas-Tenar Syndicate, and the total issue of 1,050,000 shares at par.

The CHAIRMAN. Those shares of stock were turned over to the owners of the property that this great discovery was made upon; is that correct? I just want to establish how you arrived at the value of the property at that $525,000?

Mr. WRIGHT. By this sale of 450,000 shares at 50 cents a share.

The CHAIRMAN. I know; but what did they actually pay for this property?

Mr. MANSON. The March 1, 1913, cost is arrived at by taking the value of 1,050,000 shares of the stock, and that is arrived at by the sale of 450,000 shares of the stock out of this 1,050,000 shares at 50 cents a share.

The CHAIRMAN. Yes; but at the time they did that, did they have actual possession of this property?

Mr. WRIGHT. Yes, sir; it was turned over to the 1912 company by the predecessor company.

The CHAIRMAN. And it was in their possession at the time this stock was sold?

Mr. WRIGHT. Yes, sir.

The CHAIRMAN. Is there any record of what valuation Mr. Graton put upon this property?

Mr. WRIGHT. He did not value the property. Mr. Cummings, who was one of his men——

The CHAIRMAN. I understand that; but Mr. Graton valued it at no time? Afterwards, when he came in, he put no value on it personally?

Mr. WRIGHT. No.

Mr. MANSON. It was valued after he went out.

The CHAIRMAN. And what was it valued at after he went out?

Mr. MANSON. The ore deposit was valued at approximately $30,000,000.

The CHAIRMAN. All right.

Mr. MANSON. But, as I say, that is a discovery valuation.

The CHAIRMAN. I understand that.

Mr. MANSON. In June, 1920, when the taxpayer abandoned its claim for a March 1, 1913, value of $40,000,000 in favor of a discovery value claim it still maintained that depletion deducted in 1917 of $2,301,296 was proper, based on a March 1, 1913, value of $4,000,000.

The CHAIRMAN. He wants to take 50 per cent in that case?

Mr. MANSON. Yes.

There is nothing in the files of the case to substantiate this claim, based probably on the capitalization previous to 1912, and expenditures not only by the taxpayer, but by all the predecessor owners.

The CHAIRMAN. In other words, they were trying to capitalize all of the losses made by the stockholders who were not then in the company?

Mr. MANSON. And deduct them all in one year.

The CHAIRMAN. Yes.

Mr. MANSON. In June, 1920, the taxpayer filed Form D, claiming a discovery value at December 31, 1916, of $39,546,137.60 on 2,000,000 tons of ore, and a development and cost account of $453,862.40 at date of discovery.

On July 7, 1920, Mr. Cummings, assistant valuation engineer in the metals valuation section, made a report on this claim and placed a discovery value of $36,518,360.88 on the property. Mr. Cummings appears to have assumed that the 1917 taxes were taken care of in the original assessment and the case closed, since in his schedule of annual depletion he placed sustained depletion for 1917 at $2,472,111.81 and allowed depletion of $2,301,296. This valuation, however was not used as a basis for audit.

On February 25, 1921, Mr. Harrison, valuation engineer, made a report on the case and determined the value as of March 1, 1913, at $525,000, and discovery value, $30,652,379. This valuation for discovery differs from the Cummings valuation largely in the plant and smelter value to the amount of $6,000,000.

A schedule for depletion is shown as follows:

Year	Sustained	Allowed	Value
1915		$4,560.00	$525,000 (Mar. 1, 1913).
1916		33,529.13	$525,000 (Mar. 1, 1913).
1917	$2,074,788.14	35,540.15	$525,000 (Mar. 1, 1913).
1918	3,121,721.44	3,121,721.44	$30,652,370 (discovery).
1919	1,280,016.79	1,280,016.79	$30,652,370 (discovery).

Since the discovery law in the 1918 act applied only to 1918 and subsequent years, discovery depletion could not be used for 1917, the allowed depletion based on cost as at March 1, 1913, being $35,540.15. This valuation became the basis for audit of 1915, 1916, and 1917 taxes and subsequent additional assessments.

On December 10, 1923, after conferences with the taxpayer, Mr. Harrison revised his discovery valuation to $31,600,000, with depletion rate of $0.0551335 per pound of copper, which was accepted by the taxpayer. The revised depletion schedule is as follows:

Year	Copper sold, (pounds)	Sustained depletion	Allowed depletion
1918	58,056,936	$3,200,882.08	$3,200,882.08
1919	24,158,765	1,331,957.27	1,331,957.27
1920	41,942,709	2,312,447.85	2,312,447.85
1921	12,498,005	689,058.75	689,058.75
1922	27,027,500	1,490,120.67	1,490,120.67

We now come to the consideration of the question of the finality of the action of the bureau, as to whether this case is a closed case, which foreclosed the department from considering this deduction upon its merits.

It does not seem to me that the officers of the department can possibly take the position that these deductions were proper. If there is any possible excuse for closing this case, that excuse must rest upon this claim that the 1917 tax was not open for redetermination and that the original assessment, even though it be a tentative one, was a final assessment. It is now for the purpose of discussing the speciousness of that position that I call the attention of the committee to further facts in this case.

This taxpayer has consistently claimed that the 1917 taxes were closed. The files, however, fail to disclose any such evidence.

The assessment letter of June 10, 1918, Exhibit B, states——

The CHAIRMAN. You have already read that in, I think.

Mr. MANSON. No: I read from the abatement claim; that is, from the order allowing the claim in abatement. I am quoting now from the original assessment letter:

> A final conclusion has not been reached, but from the consideration so far given it is apparent that the amount of taxes owing will probably not be less than that indicated below.

And the amount indicated below was $2,123,809.55, and the taxpayer was notified to make payment on or before June 15, 1918.

The letter concludes:

> Upon final audit of your returns you will be advised of the conclusion reached, and if the amount determined to be due is in excess of the amount above stated

a further assessment will be made; if less, you may file a claim for refund of the amount overpaid.

I believe it is manifest that that letter can not be claimed to constitute a final action by the bureau.

The CHAIRMAN. Did the taxpayer claim that that was a final action?

Mr. MANSON. That is one of the things he claims constituted it. This taxpayer, as I already stated, switched from the 1913 value to a discovery value, and he switched many times from one fact to another for the purpose of showing that there had been a final action.

The claim, first, was that this assessment was the "fixing of a definite tax against the company."

In the brief of the company appear the following statements:

Thereafter, and in July or August of the year

That is, in 1918

•

Pursuant to the said letter, a final examination and audit of the company's books, papers, documents, and records was made.

* * * After the filing of the auditor's report deponent had certain discussions with the authorities in Washington with reference to the case, and in May, 1918, the company received a final notice, copy of which is annexed.

I would now call the attention of the committee to the fact that the assessment letter was not dated June 10, 1918, so that the final notice to which the company refers was prior to the assessment letter.

The CHAIRMAN. Did you find any evidence of any letter of May, 1918?

Mr. MANSON. There is no evidence of any such letter. There is no such letter in the files. The company in its brief states that it is attaching a copy of that letter to its brief, yet there is no copy of any such letter attached to the brief. In other words, neither in the company's brief nor in the files of the Income Tax Unit is there any evidence of this letter which the company claims to have been a final letter, and it claims that that final letter was dated in May, 1918, when, as a matter of fact, the tentative assessment letter clearly stating that the assessment is only a tentative assessment was not dated until June 10, 1918.

Quoting further from the company's brief, they say:

That after the receipt of the said notice deponent took the same up with certain members of the board of tax assessors having charge of the case, and was informed that the said notice was a final notice and settled the case.

Deponent, after receiving this information, so reported to the directors and officers of the company that their taxes had been finally settled at $2,123,809.55 for the year 1917.

The claim for abatement of duplicate assessment, made by the taxpayer, was allowed on February 19, 1919, in the following language:

No further demand for the payment of the amount allowed and abated will be made upon you.

On November 20, 1919, Mr. Graton wrote the taxpayer in part:

It will be necessary to make provisional investigation of your taxes for the year 1917 in order that the additional amount of tax indicated as due may be assessed without delay.

The following day the taxpayer replied, referring to abatement order and saying the case had been closed for 1917 as the result of this letter. Mr. Armitage, tax consultant, claimed in his brief to have interviewed Mr. Graton and to have

Showed him the original notice that had been received by the company finally fixing the tax, and made the claim that the said taxes for 1917 were finally adjusted and fixed.

See also letter of November 29, 1919. (Exhibit C.)

Further quoting from the company's brief:

Thereafter deponent saw Mr. Graton, who informed him that he had made an examination of the facts * * * and that the department had arrived at the conclusion that the tax for the year 1917 was finally settled and that no further question would be taken up or made in reference thereto.

I would call attention to the fact that that valuation was never used by the department. It was found to contain an error and was never used.

A copy of the Cummings valuation of July 7, 1920, was given to the taxpayer, and great stress is laid on the fact, as stated in this valuation

That the depletion allowed to the company for the year 1917 was not the depletion allowed under the valuation or at the unit rate allowed by the valuation, but was the exact depletion which had been claimed by the company in its 1917 return, to wit, $2,301,200.48, which claim had been allowed and settled with the settlement of the 1917 taxes between the company and the representatives of the Government as heretofore set out.

In allowing to the company for the year 1917 the said depletion as claimed by the company in its return, it was done because of the distinct understanding that the company's 1917 taxes were finally settled, including both its claim for special treatment under section 210 and its claim for depletion at the rate of $2,301,200.48.

In other words, another one of the facts which was seized upon by the company for the purpose of showing this claim was settled was a statement contained in an engineer's report, to which no effect was ever given, and as to which the engineer was laboring under a misapprehension of the fact.

The CHAIRMAN. Who took up this taxpayer's claim on the brief that you referred to just now? Who, in the bureau, checked that up?

Mr. MANSON. As I will hereafter call attention to, this whole subject has been checked up by quite a number of people. It was checked up in the first instance; that is, this subject of whether or not the claim had been finally acted upon; in other words, whether or not the tax had been closed, has been examined in the metals valuation section. It has been examined by Mr. Greenidge; it has been examined by two auditors to whom it was referred by Mr. Bright, and from a letter of Mr. Bright to the commissioner, I take it it has been examined by Mr. Bright.

Senator KING. From your statement, as I understood you, the final determination of the matter was made by Mr. Bright and Mr. Greenidge.

Mr. MANSON. Yes. The final determination was made by Mr. Bright, acting upon Mr. Greenidge's recommendation, but the whole subject appears from the records to have been thoroughly examined by everybody that had their hands on it.

The CHAIRMAN. And did those people who examined it protest against this final settlement?

Mr. MANSON. I think everybody, except Mr. Greenidge and Mr. Bright, reached the conclusion that the matter was not disposed of, and I am not prepared to say that they did not reach the same conclusion. Their memorandum is not very clear on that point, but everybody else that had anything to do with it reached the conclusion that there was no basis for the company's claim that the matter had been closed.

The CHAIRMAN. In going over the records did you find that there was any criticism made of these misstatements of the taxpayer?

Mr. MANSON. Well, there is very serious criticism made by Mr. Grimes.

The CHAIRMAN. Of these misstatements on the part of the taxpayer?

Mr. MANSON. Yes; and in one of the auditor's reports—I do not recall which one just now, but in one of the reports which is attached as an exhibit here the auditor claims that the taxpayer has misrepresented the facts, and it is upon this misrepresentation of fact here as to notices that I maintain that this is a clear case of fraud.

The CHAIRMAN. Well, as long as the bureau did not accept those statements of fact as true, is it fraud?

Mr. MANSON. I think that in the final action in this case they did accept them, although the real moving factor in the final determination of this case is this alternative claim that if they reopened this subject the taxpayer could claim something else.

Now, subsequent to all of these claims that this matter was a closed issue, on April 5, 1922, the 1917 taxes were considered in conference and the conclusion was reached, quoting from the conference report:

1917 audit is to be considered final only in the event that the Commissioner of Internal Revenue agrees in writing to such arrangement.

This conference was held between the taxpayer and the representatives of audit section F.

Coming now to the final closing of this case, I call attention to a memorandum signed by Mr. Greenidge, dated September 6, 1923, to Mr. Bright, as follows:

In re: United Verde Extension Mining Co., New York, N. Y.

As a result of your request for a recommendation by me in regard to the above-mentioned taxpayer, I wish to say that I have carefully examined the entire file in this case and find that although the unit did not consider the case as closed for the year 1917 there were some actions taken by the unit which permitted taxpayer to consider its case had been finally acted upon by the unit for the year 1917.

An investigation of the amount of tax paid by taxpayer corporation and the tax paid by similarly situated corporations leads me to believe that a reconsideration of this case by the unit will result in an amount of tax being finally arrived at not materially different from the tax already paid.

It is therefore my recommendation that this case be considered closed for the year 1917.

There is attached a memorandum of this date from the special assignment section explaining the new list of comparatives prepared in this case.

S. M. GREENIDGE,
Head of Division.

Exhibit G is a memorandum dated September 11, 1923, from Mr. Bright—J. G. Bright, deputy commissioner—to Mr. Blair, which reads as follows:

I have made a thorough and complete investigation relative to reopening the case of the United Verde Extension Mining Co. for the year 1917, in compliance with your request of May 14, 1923.

In order that the unit might have before it all the facts in connection with the closing of this case, a conference was arranged with the representatives of the taxpayer, Mr. Douglas and Mr. Seifert, at which conference there were present the head of the natural resources division, an engineer from the metals valuation section, and an auditor from the consolidated returns audit section of the natural resources division. Based on the information furnished by the taxpayer's representatives at this conference, Mr. Greenidge, head of the natural resources division, prepared a memorandum to me under date of August 6, 1923, setting forth all the facts in connection with the closing of this case, without any recommendation as to the advisability of reopening. In order, therefore, that a clearer understanding might be had of certain facts set forth in the memorandum of Mr. Greenidge, I arranged a further conference with Mr. Douglas and Mr. Armitage in my office under date of September 5, at which time the following pertinent facts were disclosed:

1. That the letter from the unit dated February 19, 1919, in which the statement was made "No further demand for payment of the amount allowed and abated will be made upon you," had no bearing on the question at issue and should not be considered. This was a standard paragraph used by the old claims division on its action in the allowance of abatement claims wherein there had been duplicate assessments.

2. That during the period from February 19, 1919, to January 24, 1923, the unit dealt almost entirely with the question of valuations for the year 1918 and that during this period representatives of the natural resources division had in part led the taxpayer to believe that its case for the year 1917 was closed. The taxpayer was furnished a copy of an audit memorandum dated June 12, 1920, signed by the valuation engineer and approved by the chief of the metals valuation section, wherein the statement is made that the case for 1917 was closed under section 210.

3. That the taxpayer was entitled to and could prove a greater March 1, 1913, value for the purposes of determining the depletion deduction than was allowed in the assessment letter of June 10, 1918, the letter upon which the taxpayer bases its claim that the case for the year 1917 was closed.

4. That if the case was reopened in accordance with the facts as set forth in the letter of January 24, 1923, and the revaluation as made by Mr. Harrison was used as the basis for determining the amount of the depletion deduction the taxpayer would be able to increase this deduction considerably through the proving of a greater March 1, 1913, value, which fact is admitted by both Mr. Greenidge and Mr. Donahue, the assistant chief of the metals valuation section.

5. That the taxpayer would be entitled to a lower rate of tax under the provisions of section 210 than that used in the letter of January 24, 1923.

Previous to the conference arranged with the representatives of the taxpayer, I had a review of this case made by Mr. Enes, conferee of the consolidated returns subdivision, and he has prepared a clear and concise statement of the facts in this case. This statement is attached and made a part of this report. After the conference of September 5, I again referred the case to Mr. Greenidge for a reconsideration of the allowable depletion deduction and the old rate as used by the advisory tax board in its letter of June 10, 1918. There is attached a statement by Mr. Eaton, chief of the special assessment section in the natural resources division, fully setting forth the facts covering the allowance of a different rate than that used in the letter of January 24, 1923.

In view of the facts as set forth in the memorandum prepared by Mr. Enes and Mr. Eaton, also the recommendation by Mr. Greenidge dated September 6, 1923, "that this case be considered closed for the year 1917," and the plea of the taxpayer that this case should not be reopened, due to the provisions of section 1313, revenue act of 1921. That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the commissioner upon (or in the case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under

or authorized by the internal revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States," I recommend that this case be not reopened for the year 1917 and that the unit advise the taxpayer that the letter of January 24, 1923, should be ignored.

J. G. BRIGHT,
Deputy Commissioner.

One of the reasons assigned by Mr. Bright for the closing of this case is that if it was reopened, the taxpayer would be entitled to a greater March 1, 1913, value.

It will be borne in mind that the deduction taken by taxpayer was based upon a valuation of $30,000,000, which is a discovery valuation of a bonanza find. This taxpayer up to the time of this discovery in 1915 had been operating at a loss. They had been trying since 1888 to find the extension of this United Verde lode, which extended under their property, as was afterwards developed.

They had been reorganized from time to time. The highest capitalization that they ever had had been $4,000,000, and the deduction taken was based upon a $40,000,000 valuation claimed; and yet Mr. Bright takes the position in this letter that if you are to disallow that deduction, based upon the $40,000,000 valuation, they might get a higher 1913 valuation upon a piece of property which at that time had never paid and upon which its highest capitalization had been $4,000,000, and which in 1912 had a value of approximately $525,000, based upon the actual sale of 450,000 shares out of 1,050,000 shares of its capital stock.

The CHAIRMAN. In establishing the March 1, 1913, values no subsequent facts are allowed to be considered, are they?

Mr. MANSON. No.

The CHAIRMAN. So that all of this discovery was not known at March 1, 1913, and of course could not be considered?

Mr. MANSON. No. Shortly before that, in 1912, this company had been reorganized, and its capital stock had been actually reduced from $4,000,000 to $760,000.

The CHAIRMAN. We have that already in the record?

Mr. MANSON. Yes; so it was not considered a brilliant prospect at that time.

The CHAIRMAN. That seems to me to be rather strange reasoning when subsequent facts are not allowed to be considered.

Mr. MANSON. Take reason No. 5, as advanced here, that the taxpayer would be entitled to a lower rate of taxes under the provisions of section 210 than that used in the letter of January 24, 1923.

I am willing to admit that in the application of the provision of the law providing for a representative rate, if you want to rig up a high rate, or if you want to rig up a low rate, you can do it; but I submit that by taking the five companies doing business in Arizona, with tax rates ranging from 12 per cent to as high as 34 or 37 per cent—I am not exactly sure which—they arrived at a rate which was fairly representative, and the fact that the United Verde Co., doing business upon identically the same piece of property, upon the same lode, under exactly the same conditions, paid a tax at the rate of 29 per cent, is fairly conclusive that under no honest method of administration of that provision of the law could this company be given a rate of tax which would have come any where near making up for

the difference which was due to the disallowance of that illegal element of depletion.

As far as section 1313 is concerned, it appears to me that the very language of that section shows that it has no application to this situation whatever. That section provides that when the commissioner has made a determination of fact, no other officer shall have the right to reopen it. It does not provide that the commissioner shall not have the right to reopen it; and, furthermore, I think the record is very complete here that there never had been a determination of the depletion allowable upon that property, and if there ever had been such a determination that such determination was directly contrary to law.

For the reasons that I advanced in the opening of the presentation of this matter, there was no property there to value that would sustain any such valuation on the 1st of March, 1913, and the discovery value which arose out of the discovery in 1915 had no application to 1917 taxes.

During 1922 the question of revaluing copper mines was under consideration by the bureau. The taxpayer cites the decision of the commissioner in his memorandum of December 11, 1922, not to reopen 1917 and 1918 cases for revaluation as again settling the question as to the finality of their 1917 tax settlement.

The matter then rests until January 24, 1923, when the assessment letter was sent to the United Verde Extension Mining Co., disclosing an additional tax of $721,260.82. The taxpayer protested this on February 19, 1923, on the following grounds:

1. That the taxes referred to therein were settled by a settlement entered into by the Government and taxpayer in the year 1918, and these taxes can not now be opened.
2. That the tax assessment is improper, illegal, and in violation of the Constitution, the several revenue acts, and the regulations promulgated thereunder.

Events subsequent to additional assessment, January, 1923.

On May 10, 1923, Mr. Grimes, chief, metals valuation section, addressed a memorandum to Deputy Commissioner Chatterton, in which he stated:

The 1917 tax should be assessed upon the basis of the letter of January 24, 1923, for the following reasons:
1. There was a gross error in the previous assessment.
2. The gross error in the previous assessment was the result of misrepresentation by the taxpayer to the Income Tax Unit.
3. There is no record in the file of this case that the tentative assessment for 1917 was ever considered final by the Income Tax Unit.

On July 3, 1923, Mr. Harrison and Mr. Grimes, of the metals valuation section, prepared a memorandum for Mr. S. M. Greenidge, head of the engineering division, setting forth a chronological record of the correspondence, assessment letters, conferences, etc., applying to the 1917 tax return of the taxpayer, in which they stated that it was apparent from the summary that—

(1) The assessment letter of June 10, 1918, was tentative and the tax paid was listed as a partial payment by the collector at Baltimore.

(2) The order for abatement, which the taxpayer has always claimed finally closed the case, was allowed because the original

tentative assessment of tax was twice listed on the collector's books for collection.

(3) No further assessment had been made by the Income Tax Unit from June 10, 1918, to January 24, 1923, when an additional tax of $721,260.82 was assessed.

(4) The taxpayer has never contested the accuracy or legality of depletion based on a cost or March 1, 1913, value of $525,000, but has contended that the 1917 return was closed and that no additional assessment could be made.

(5) The original assessment was tentative and that at the time the assessment was made no revenue agent's report was available. At no time from June 10, 1918, to the present could a case of this size be closed by office audit prior to the receipt of a revenue agent's report.

(6) That representatives of the taxpayer have consistently delayed action in the collection of additional tax for 1917 by their contentions that the case had been closed by the assessment of June 10, 1918, and abatement order No. 3633. The record shows that while some representatives of the Income Tax Unit may have given credence to the taxpayer's contentions, these contentions were never officially accepted or the case closed.

(7) That there can be no question as to the facts that the additional assessment is proper and that no revaluation is involved for the year 1917.

On July 31, 1923, Mr. Greenidge addressed a memorandum to J. G. Bright, deputy commissioner, in which he reviewed the case and presented some facts in connection with comparative tax rates, as follows:

LIST (A)

	Net income after depletion has been deducted	Per cent tax to net income
United Verde Mining Co	$10,011,653.00	28.40
Chino Copper Co	8,479,603.00	23.21
Nevada Consolidated Copper Co	8,769,234.00	19.18
Ray Consolidated Copper Co	9,551,848.00	21.04
Inspiration Consolidated Copper Co	9,357,491.00	11.34
Miami Copper Co	6,779,593.00	33.41
Calumet & Arizona Mining Co	8,307,313.00	19.08
Calumet & Hecla Mining Co	10,843,779.00	30.68
Average for 8 companies		23.30

LIST (B)

	Per cent net to gross operating income	Per cent tax to net income
Iron Cap Copper Co	50.6	36.44
Miami Copper Co	48.2	33.41
Mammoth Mining Co	59.2	37.69
Shattuck Arizona Copper Co	44.3	40.45
United Verde Copper Co	55.1	28.49
Allouez Mining Co	45.5	34.58
Mohawk Mining Co	48.1	35.16
Wolverine Copper Mining Co	45.5	14.31
Champion Copper Co	53.6	50.23
Average for 9 companies		34.53

COMMENTS ON RATES

The two companies appearing on both lists and their taxes in percentage of net income are:

United Verde Mining Co	28.49
Miami Copper Co	33.41
Average of two companies	30.95

The United Verde Extension Copper Co. case involves in 1917 the following percentages:

	Depletion allowed	Per cent depletion to net income	Net income	Total tax assessment	Per cent tax to net income
Original assessment	$2,301,296.48	27.92	$8,242,209.04	$2,123,809.55	25.77
Final assessment	35,540.15	0.325	10,937,277.99	2,845,070.37	26.01

Mr. Bright referred the matter to several officials in the unit for comment and recommendation.

I. T. Enes, conferee of the consolidated returns subdivision, in a memorandum dated September 4, 1923 (Exhibit D), says, in part:

The taxpayer's contention that bureau letter dated February 19, 1919, finally fixed the tax liability for 1917 and closed the case is not reasonable and it would almost indicate a deliberate misinterpretation of the facts.

It is true the records did not show any agreement as to the closing of the case for 1917, but if no such understanding existed as claimed by the taxpayer, why was there no attempt made to assess the additional tax before January 24, 1923. It appears that the taxpayer's representative convinced the representative of the bureau at the conferences held that the 1917 tax was a settled question but that no records were made, and the question, therefore, came up anew at later conferences.

Volney Eaton, chief of the special assessment section, in a memorandum dated September 6, 1923 (Exhibit E), says, in part:

By allowing the previous rate and settlement for 1917 to stand instead of the rate and tax as determined by the new data sheet and corrected income allowing $4,000,000, March 1, 1913, value, the Government will lose approximately $154,854.82, 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.

On September 6, 1923, Mr. Greenidge addressed a memorandum to Mr. Bright, in part, as follows (Exhibit F):

* * * although the unit did not consider the case as closed for the year 1917, there were some actions taken by the unit which permitted taxpayer to consider its case had been finally acted upon by the unit for the year 1917.

An investigation of the amount of tax paid by taxpayer corporation and the tax paid by similarly situated corporations leads me to believe that a reconsideration of the case by the unit will result in an amount of tax being finally arrived at not materially different from the tax already paid.

It is therefore my recommendation that this case be considered closed for the year 1917.

On September 11, 1923, Mr. Bright addressed a memorandum to Mr. Blair, in part, as follows (Exhibit G):

In view of the facts as set forth in the memorandum prepared by Mr. Enes and Mr. Eaton, also the recommendation by Mr. Greenidge dated September 6, 1923, "that this case be considered closed for the year 1917," and the plea of the taxpayer that the case should not be reopened, due to the provisions of

section 1313, revenue act of 1921, "That in the presence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States," I recommend that this case be not reopened for the year 1917 and that the unit advise the taxpayer that the letter of January 24, 1923, should be ignored.

On November 6, 1923, Mr. Bright advised the taxpayer by letter to ignore office letter of January 24, 1923, relating to a proposed additional assessment of $721,260.82 income and excess profits tax for 1917. (Exhibit H.)

On January 24, 1924, an agreement in accordance with section 1312, of the revenue act of 1921, covering "Your income and profits tax liability for the year 1917" was executed and mailed to the taxpayer. (Exhibit I.)

On February 18, 1925, Mr. Grimes, chief metals valuation section, in a memorandum to the commissioner recommends "that an attempt be made to collect the tax which should have been paid by this taxpayer, either by agreement with the taxpayer or through legal proceedings on a charge of fraud." (Exhibit J.)

Conclusion: Your engineers after careful review of this case desire to point out particularly—

1. That evidence is lacking in the files in confirmation of the taxpayer's contention that this case was at any time prior to the 1312 agreement officially closed.

2. That the unit is to be criticized for the lack of action in determining the taxpayer's final tax liability from February, 1921, when depletion was determined for 1917, to January, 1923, when the additional assessment was made.

3. That the allowance by the unit of cost as the March 1, 1913, value for depletion was their only possible action in the absence of additional information.

4. That the taxpayer's total tax was not excessive, as indicated by the percentage of taxes to net income of the United Verde Mining Co. of 28.49 per cent as compared with 26.01 per cent finally determined for the United Verde Extension Mining Co., both operating on same lode as adjacent properties, and the tax paid, 19.42 per cent was rank inequity as between taxpayers.

5. That the additional assessment of $721,260.32 was justly due the Government and should, if possible, be collected.

6. That measured by the provisions of the regulations the allowance of a discovery value of $31,600,000 to this taxpayer was proper, since, although an extension of known ore bodies, this bonanza body had never been and could never have been included in "probable" and "prospective" ore or in any other way comprehended in a prior valuation.

The CHAIRMAN. Mr. Gregg, do you want to say anything in connection with this case at this time?

Mr. GREGG. Just one word.

Of course, the principal criticism of the case is with reference to the 1917 closing, or leaving it settled. Counsel for the committee has stated that, in his opinion, there is fraud in the case warranting the reopening of it in spite of the 1312 settlement. It seems to me that if such a charge is made, it should be more specific than that;

it should state who committed the fraudulent acts and what acts were fraudulent acts.

The CHAIRMAN. The impression the chairman got from the statement of counsel was that the fraudulent acts were particularly applicable to the taxpayer in his presentation of the case in his brief.

Mr. MANSON. Yes; the misrepresentations on the part of the taxpayer as to the facts.

Mr. GREGG. Then, the fraudulent acts were on the part of the taxpayer. What were those acts, specifically?

The CHAIRMAN. Mr. Gregg, I think all you have to do is to read the testimony. I do not think the committee wants to go over all of the testimony now, because the statement is in the record as to the fraudulent acts.

Mr. GREGG. No, sir; I do not think so.

Mr. MANSON. I have stated that with such particularity that I have been called down by the committee two or three times for it.

Mr. GREGG. Counsel has stated the claims made by the taxpayer with reference to the final closing of the case, with which he did not agree.

The CHAIRMAN. Oh, no; he went further than that; he said there was no letter of May, 1918.

Mr. GREGG. That it had not been——

The CHAIRMAN. That it was not in the records and there was no evidence of it, and that subsequent events indicated that there was no such letter in existence. That is just one item that the chairman recalls, but there are other statements, if you will read the record, that indicate fraud.

Mr. GREGG. I followed the testimony very carefully when he was making the statement. I got that one statement. I am glad to know that this is one of the items, but there were many statements in counsel's statement of the case as to claims made by the taxpayer, and I should like to know, and I think we should be told, what those statements were on which fraud can be predicated, besides the one which the chairman has just given us.

The CHAIRMAN. So far as the chairman is concerned, I wish to say that the bureau will have a chance to answer this charge by counsel after they get the record, and if they disagree with the conclusions of counsel that there is fraud in the case they may say so.

Mr. GREGG. We have already gone into the case in that respect, but I will postpone the answer to his criticism of the 1917 settlement until we have had time to go into the case more fully.

However, in presenting the case counsel digressed for a moment to speak of the discovery value, stating that this was not a new or separate ore body but was an extension of the ore body of the United Verde, and that under a strict interpretation of the regulations the taxpayer was entitled to no discovery value.

I should like to dispose of that, which is a side issue, now, and then leave only the question of the matter of the 1917 settlement.

Mr. MANSON. That you may know my position clearly on that I do not mean to say that this law is not applicable to this case. I have taken no exception to the allowance of discovery value here. I do not intend to. I do not criticize anybody for allowing it. I do

say that under a strict interpretation of the regulations—not the law, but the regulations—there is at least a great deal of question as to whether they are entitled to discovery value here, for the reason that I understand the record shows that this is an extension of the United Verde Lode and comes under that provision of the regulations which does not allow discovery depletion where the ore body is an extension of a known ore body.

Mr. GREGG. That is the point that I wanted to make clear in the record.

I asked Mr. Grimes, who is familiar with this property, in reference to that, and he said that this is not an extension of the United Verde ore body, but that it is an entirely separate and distinct ore body.

That also, of course, applies to the statement of counsel later with reference to the rate of tax of 29 per cent paid by the United Verde, operating the same property. They were separate ore bodies, and separate and distinct properties, according to Mr. Grimes's statement to me.

Mr. MANSON. As to the latter part of Mr. Gregg's statement, my statement was that an allowance of a rate here of 21 per cent, plus, compares favorably with the rate upon which the United Verde paid a tax of 29 per cent. It does not depend upon this being an extension of the same ore body. They are operating in the same character of ore. They are operating practically adjacent to each other. They are operating under the same conditions. I understand that all of the conditions in regard to the two companies are practically identical.

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

Mr. MANSON. Yes; and I say that under those conditions, the fact that this rate is almost 50 per cent less than the rate applied to the United Verde does not add any weight to the position taken by Mr. Bright and by Mr. Greenidge, in closing this case, that if it was reopened, they would probably get a more favorable rate.

The CHAIRMAN. I would like to have an explanation, if I can, at this time, as to this feature: What is counsel's theory of what the tax would have been had the taxpayer figured his own tax in making the returns, instead of leaving it to the bureau to fix under section 210?

Mr. MANSON. If this particular rate had been applied here, if they had received no consideration under section 210, and this depletion allowance claimed had been disallowed, they would have paid a tax of something like $6,000,000.

The CHAIRMAN. Yes; I recall that now. That is in the record, and I had overlooked it for a minute; but just why did not the taxpayer fix his own tax at that time, the same as these other companies did? Was it because of the low capital stock?

Mr. MANSON. The low capital investment.

The CHAIRMAN. And that was perfectly permissible under the law?

Mr. MANSON. It was permissible under the law.

The CHAIRMAN. On what theory? Was it on the theory that they had made a great bargain or that the property had later enhanced in value, which had not been capitalized on the books?

Mr. MANSON. Yes; that is it exactly.

Mr. GREGG. I just want to narrow the case down to one point on the 1917 settlement, and get out of the way the other question of discovery value.

The CHAIRMAN. When you take up the case, you will probably analyze the testimony carefully as presented this morning. Obviously, I can not recall all of the testimony related by counsel, but I have the impression that there were a number of items and claims made by the taxpayer which were apparently accepted by the bureau, which seemed ridiculous to say the least.

Mr. GREGG. Well, of course, we shall go into the testimony very carefully.

The CHAIRMAN. We will adjourn until 10 o'clock to-morrow morning, unless you hear from us.

(Exhibits submitted by Mr. Manson in the United Verde Extension Mining Co. case are as follows:)

EXHIBIT A

MARCH 24, 1925.

OFFICE REPORT NO. 28

Mr. L. C. MANSON,
Counsel, Senate Committee Investigating Bureau of Internal Revenue.

Taxpayer: United Verde Extension Mining Co.
Business: Copper mining, milling, and smelting.
Subject: Closing of 1917 tax case by 1312 agreement and cancellation of additional assessment of $721,260.82.

Amounts involved

Original assessment, 1917, by tax advisory board	$2,123,809.55
Additional assessment, 1917, by Income Tax Unit	721,260.82
Value for depletion as of Mar. 1, 1913:	
Claimed	4,000,000.00
Allowed	525,000.00
Discovery value allowed	31,600,000.00

STATUS OF CASE

Cases 1915 and 1916 closed; 1917 case, involved in this report, closed by 1312 agreement; 1918 and 1919 taxes closed on basis of discovery value allowed.

SYNOPSIS OF CASE

On March 30, 1918, the taxpayer filed his 1917 return with no computation of tax, claiming that the invested capital could not be ascertained, and requested to be placed under section 210 of the 1917 revenue act and assessed accordingly. This was granted and a tentative tax of $2,123,809.55 assessed and paid by the taxpayer at New York. A similar assessment was also made by the collector at Baltimore, and when an abatement of this was claimed by the United Verde Extension Mining Co. it was allowed by the unit, since it was quite evidently a duplicate assessment.

In 1919 when the natural resources section was formed the taxpayer was requested to fill out Form A for the purpose of determining his tax liability. He protested, claiming the case was closed, and cited the abatement letter. Valuations were made by the metals section, as a result of which considerable depletion was disallowed for the 1917 tax. Later, on January 24, 1923, an additional assessment of $721,260.82 was made, which the taxpayer protested, claiming the case to be closed. A number of conferences were held, briefs filed by the taxpayer, memoranda prepared by the metals section, and the matter was thoroughly examined. The metals section recommended the additional

assessment be collected, while Mr. Greenidge, head engineering division, and Deputy Commissioner Bright, after considering the case, recommended it be closed, as a result of which an agreement under section 1312 of the 1921 revenue act was executed and signed by the taxpayer and the bureau.

HISTORY OF THE COMPANY

This company was first organized as the United Verde Extension Gold, Silver & Copper Mining Co., about 1888. Capital, $3,000,000, divided into 300,000 shares of a par value of $10. The company acquired mining claims adjoining those of the United Verde Copper Co. at Jerome, Ariz. One hundred and ninety thousand shares were sold at public subscription in 1899 at $6 per share.

In 1904 the United Verde Extension Mining Co. of Maine was organized, which acquired five of the original claims of the above company. This company had a capital of $4,000,000, divided into 400,000 shares of a par value of $10.

In 1910 the United Verde Extension Mining Co. of Delaware was incorporated. Capital, $4,000,000; shares 400,000; par value $10. The five original claims were deeded to this company by the Maine company for the entire capital. Development at this time is said to have amounted to $2,000,000.

In June, 1912, this company was reorganized and the capital reduced to $750,000, with 1,500,000 shares at 50 cents par value; 1,050,000 shares were issued and are outstanding, to the total value of $525,000.

The ore bodies of the company are located in Jerome, Yavapai County, Ariz., while the smelter is situated at Clemenceau, Ariz., about 6 miles from Jerome. No net profit was made between 1910 and 1914, and during that period the company had no income from operations.

HISTORY OF THE CASE

The taxpayer filed its return for 1917 taxes on March 30, 1918, without computation of tax, and requested special treatment under section 210 of the revenue act of 1916 as amended by the law of 1917 allowing a representative tax, based on March 1, 1913, value of $40,000,000.

On June 10, 1918, on the recommendation of the tax advisory board, a tentative assessment of $2,123,809.55 was made by the commissioner. (Exhibit B.)

On June 15, 1918, the taxpayer paid this assessment.

During June, 1918, the collector at Baltimore made an assessment for a similar amount, $2,123,809.55, and the taxpayer filed an abatement claim.

On August 31, 1918, the revenue agent reported on 1910 1917, inclusive, and disallowed depletion except that based on cost, $525,000.

September 27, 1918, abatement order No. 3633 was filed by Collector J. M. Miles at Baltimore to stop duplicate assessment of $2,123,809.55.

February 19, 1919, the taxpayer's claim for abatement of tax was allowed.

November 20, 1918, Mr. Graton, valuation engineer, wrote the taxpayer for "supplemental data (Form A), as revenue agent's report indicated large additional taxes for 1916 and 1917"; to which the taxpayer replied that the case was closed for 1917 by the abatement letter of February 19, 1919.

November 25, 1919, the taxpayer made a definite claim on Form A. M. M. S. for March 1, 1913, value of $40,000,000 on 2,000,000 tons of ore not known to exist on March 1, 1913.

June 7, 1920, the taxpayer apparently abandoning the March 1, 1913, claim, filed Form D, claiming a discovery value at December 31, 1916, of $39,546,137.60 on 2,000,000 tons of ore, and a development cost account of $453,662.40 at date of discovery.

June 12, 1920, E. T. Cummings, assistant valuation engineer, determined discovery value at December 31, 1916, of $36,518,340.86; this valuation made for 1918 depletion and subsequent years, presuming 1916 and 1917 closed. (Not used in audit.)

February 25, 1921, W. H. Harrison, valuation engineer, determined discovery value at December 31, 1916, of $30,652,379 for ores only. Depletion from 1915 to 1917, inclusive, based on cost of $525,000 as of March 1, 1913.

March 28, 1921, additional taxes for 1915 and 1916 were assessed on basis of the Harrison valuation, subsequent to which several conferences were held, 1917 taxes not being considered.

January 22, 1922, additional taxes assessed for 1915 and 1916 confirmed.

March 18, 1922, claim for abatement of 1916 tax filed by taxpayer, which was subsequently disallowed.

April 5, 1922, conference held with taxpayer; conclusions reached: "1917 audit is to be considered final only in the event that the Commissioner of Internal Revenue agree in writing to such arrangement."

January 24, 1923, A-2 letter mailed to taxpayer advising that additional assessment for 1917 is to be made in the amount of $721,260.82.

February 19, 1923, taxpayer writes protesting this assessment, claiming 1917 taxes closed by abatement order of February 19, 1919.

April 10, 1923, conference, at which taxpayer protests the 1917 assessment on the basis that section 1313, act of 1921, prohibits such review and that under act of 1917 the three-year statute of limitations outlaws such 1917 assessment.

April, 1923, taxpayer submits brief by Paul Armitage, its tax consultant, presenting arguments.

May 10, 1923, memorandum to Deputy Commissioner Chatterton from metals valuation section, answering the protest and arguments of the taxpayer and submitting that the additional assessment should stand because of gross error in the tentative assessment as a result of misrepresentation by the taxpayer, and that there is no evidence that such assessment was final.

July 3, 1923, letter from Mr. Grimes, chief of the metals valuation section, to Mr. Greenidge, head of the engineering division, presenting the facts and records in the case.

July 31, 1923, memorandum, Mr. Greenidge to Mr. Bright, deputy commissioner.

September 4, 1923, memorandum from Mr. Enes, conferee of the consolidated returns subdivision, to Mr. Bright, reviewing case.

September 6, 1923, memorandum from Volney Eaton, chief of special assessment section, to Mr. Bright.

September 6, 1923, memorandum from Mr. Greenidge to Mr. Bright recommending "that the case be considered closed for the year 1917."

September 11, 1923, memorandum from Mr. Bright to Commissioner Blair, recommending "that the case be not reopened for the year 1917 and that the unit advise the taxpayer that the letter of January 24, 1923, should be ignored."

November 6, 1923, letter to taxpayer from Mr. Bright, advising that letter of January 24, 1923, "should be ignored."

January 24, 1924, 1312 agreement finally executed and mailed to taxpayer, closing case.

February 18, 1925, memorandum to commissioner from Mr. Grimes, recommending that the case be again reopened if possible.

DISCUSSION

INTRODUCTION

In the settlement of 1915 and 1916 taxes claims for depletion were made by the taxpayer based on a valuation as of March 1, 1913, of $4,000,000. This was not allowed by the unit and the cases were finally closed with depletion deductions based on a cost value of $525,000.

This case pertains only to the settlement of 1917 taxes, the cancellation of additional assessment of $721,260.82, and the closing of the case by a 1312 agreement, with resulting loss in taxes to the Government.

For 1918 and subsequent years depletion is based on a discovery value allowed by the unit and is not in controversy, although the allowance of such discovery involves principles which might well be made a subject for discussion.

TENTATIVE ASSESSMENT, $2,123,809.55 (EXHIBIT B)

The taxpayer filed its 1917 return on March 30, 1918, without computation of tax liability, claiming that invested capital could not be ascertained and requesting to be assessed under section 210 of the revenue act of 1916, as amended in the act of 1917:

"That if the Secretary of the Treasury is unable in any case satisfactorily to determine the invested capital, the amount of the deduction shall be the sum of (1) an amount equal to the same proportion of the net income of the trade

or business received during the taxable year as the proportion which the average deduction (determined in the same manner as provided in section two hundred and three, without including the $3,000 or $6,000 therein referred to) for the same calendar year of representative corporations, partnerships, and individuals engaged in a like or similar trade or business bears to the total net income of the trade or business received by such corporations, partnerships, and individuals, plus (2) in the case of a domestic corporation $3,000, and the case of a domestic partnership or a citizen or resident of the United States $6,000."

The request of the taxpayer was considered by the unit and the advisory tax board appointed by Secretary McAdoo in the latter part of 1917, and afterwards incorporated into the act of 1918 (sec. 1301) and finally granted. A tentative tax was determined on a representative tax basis in the amount of $2,123,809.55 and the taxpayer so advised in assessment letter dated June 19, 1918. This tax was paid by the taxpayer on June 15, 1918.

DUPLICATE ASSESSMENT

Upon notice from the bureau the collector at Baltimore, Md., assessed and demanded payment for a similar amount ($2,123,809.55) in June, 1918. The taxpayer filed a claim for abatement, advising that the same amount had been assessed at New York and paid. On September 27, 1918, Collector J. W. Miles filed an abatement claim, Order 3633, to stop the duplicate assessment. His declaration is as follows:

"Amount assessed, 1917, $2,123,809.55 * * *; that the United Verde Extension Mining Co. paid the amount mentioned above, under date of June 15, 1918, and such amount is recorded as an advance payment on my June, 1918, list, page 159. The assessment on my June, 1918, list, section 1, page 21, line 20, should therefore be abated."

On February 13, 1919, the above-mentioned order was allowed, and on February 19, 1919, the taxpayer was notified as follows:

"Your claim for the abatement of internal revenue tax has been allowed as shown above. No further demand for the payment of the amount allowed and abated will be made upon you.

"HOMER S. PAGE,
"Acting Deputy Commissioner."

BASIS OF TENTATIVE TAX

Inquiry has been made of the special assessment section as to how the tentative tax assessed, $2,123,809.55, was computed, but we are advised that same was determined by the advisory tax board and that there are no records in the files disclosing same. It is evident, however, from the records that a representative tax rate of 21 per cent plus was used by the advisory tax board on a net income, with depletion deducted as claimed by the taxpayer. It was not possible in 1918 to investigate valuation matters to any great extent, as the valuation departments were not organized until 1919. The rate used appears to have been satisfactory to the taxpayer as long as the claimed depletion deduction was allowed, but when later the unit determined that such depletion deduction was improper the taxpayer protested vigorously on the rate when net income was increased by the disallowance of a large amount of the depletion deduction and tax increased thereby.

ADDITIONAL ASSESSMENT, $721,260.82

On August 31, 1918, the revenue agent made his report on the period 1910 to 1917, inclusive, disallowing depletion, except on the basis of cost $525,000. In the fall of 1919 a valuation section was organized in the natural resources subdivision and the matter of determining a proper depletion allowance for 1917 was taken up by Mr. L. C. Graton. The taxpayer was requested to file "supplemental data * * * not later than December 8, 1919." In its return the taxpayer had deducted depletion for 1917 in the amount of $2,301,296.48. On November 25, 1919, the taxpayer filed Form A. M. M. S., claiming a March 1, 1913, value of $40,000,000 on 2,000,000 tons of ore, not known to exist as at March 1, 1913. On June 7, 1920, the taxpayer abandoned its claim for March 1, 1913, value as above and filed Form D, claiming a discovery value at December

31, 1916, of $39,546,137.60 on 2,000,000 tons of ore; and a development and cost account of $453,862.40 at date of discovery.

On June 12, 1920, Mr. E. T. Cummins, assistant valuation engineer, reported a discovery valuation for ores only, at December 31, 1916, of $36,518,340.88. This valuation, however, was not used by the unit in any tax determination, and was superceded by a later valuation report, dated February 25, 1921, made by K. H. Harrison, valuation engineer, and approved by O. R. Hamilton, chief of the metals valuation section, in which a discovery value at December 31, 1916, for ores only was allowed of $30,652,379, and the March 1, 1913, value was determined, based on cost, as $525,000. Inasmuch as discovery depletion was not allowable previous to the 1918 act, a depletion deduction was allowable for 1917 in the amount of $35,540.15. In March, 1921, the taxpayer was assessed additional taxes for 1915 and 1916 on the basis of the Harrison valuation. It appears to have been the impression that 1917 taxes were closed and not until 1922 was the matter reopened. On January 24, 1923, an A-2 letter was mailed to the taxpayer, calling for an additional assessment of $721,260.82.

BASIS OF ADDITIONAL ASSESSMENT, $721,260.82

NET INCOME

In the tentative assessment the net income reported was used, $8,242,909. In the additional assessment this amount was increased to $10,937,277.99 by the following corrections:

Net income reported		$8,242,909.04
Additions:		
Depreciation, disallowed	$34,204.94	
Exchanged automobile, value disallowed	916.20	
Development, disallowed	461,407.50	
Depletion, disallowed	2,265,756.33	
		2,762,284.97
		11,005,194.01
Amortization of development, one-tenth allowed		67,916.02
Corrected net income		10,937,277.99

REPRESENTATIVE RATE

In arriving at a representative rate, five companies were selected as follows:

Company	Invested capital	Net income	Per cent of net income to invested capital	Excess-profits tax	Per cent of tax to net income
Arizona Copper Co.	$35,140,023	$8,181,847	23.28	$1,383,051	16.91
Mammoth Copper Co.	948,428	420,771	44.37	141,845	35.71
Shattuck-Arizona Copper Co.	3,141,310	1,617,197	51.45	592,761	36.65
Chino Copper Co.	20,324,105	10,880,261	53.53	4,062,187	37.34
Calumet & Arizona Co.	41,045,372	8,307,313	20.24	1,026,389	12.36
Total	100,599,238	29,407,389		7,206,833	
Average	20,119,648	5,881,478	29.23	1,441,367	21.29

From the average per cent of net income to invested capital, 29.23 per cent, applied to the corrected net income, $10,937,277.99, is obtained a constructive invested capital of $38,986,896.54. This constructive invested capital then becomes the basis for the excess-profits tax computation as provided in the regulations.

The excess-profits tax, thus computed, amounts to	$2,328,546.48
Tax at 2 per cent	172,174.63
Tax at 4 per cent	344,349.26
	2,845,070.37
Tax previously assessed	2,123,809.55
Additional tax	721,260.82

COMPARATIVE TAX UNDER REGULAR BASIS

It is interesting to note what this taxpayer would have been assessed had it not received special treatment under section 210. The revenue agent reported for 1917 a tax due of $5,548,823.40. We have made a computation of the tax, based on the regular basis, which shows as follows:

Excess-profits tax	$5,739,100.95
Tax at 2 per cent	103,963.54
Tax at 4 per cent	207,927.08
Total tax that would have been paid, regular basis	6,050,991.57
Total tax due under representative tax	2,845,070.37
Total tax actually paid	2,123,809.55

MARCH 1, 1913, VALUE FOR DEPLETION

The taxpayer claimed a deduction of $2,301,296.48, based on a value as of March 1, 1913, of $40,000,000. On November 25, 1919, Form A. M. M. 8, was filed to substantiate their claim as above, and a valuation as of November, 1916, by James R. Finley was submitted showing 2,000,000 tons of ore at $20 per ton, total value of $40,000,000. They claimed the "market value in the mine of the product thereof which had been mined and sold during the year for which the return and computation are made." The taxpayer maintained that although the mine had no known ore as at March 1, 1913, he was entitled to a March 1, 1913, value based upon the quantity and quality of the ore discovered in 1915. No ore was known to exist in the mining property of this taxpayer and the metals valuation section concluded that the March 1, 1913, value of the United Verde Extension mine was not in excess of its cost.

The cost of the mine in 1912 to the present corporate owners was not in excess of $525,000, established by the sale of 450,000 shares at 50 cents par value to the Douglas-Tenar syndicate, and total issue of 1,050,000 shares at par. In June, 1920, when the taxpayer abandoned its claim for a March 1, 1913, value of $40,000,000 in favor of its discovery value claim, it still maintained that depletion deducted in 1917 of $2,301,296 was proper, based on a March 1, 1913, value of $4,000,000. There is nothing in the files of the case to substantiate this claim, based probably on the capitalization previous to 1912 and expenditures not only by the taxpayer but by all predecessor owners.

DISCOVERY VALUE

In June, 1920, the taxpayer filed Form D, claiming a discovery value at December 31, 1916, of $39,546,137.69 on 2,000,000 tons of ore, and a development and cost account of $453,862.40 at date of discovery.

On July 7, 1920, Mr. Cummings, assistant valuation engineer in the metals valuation section, made a report on this claim and placed a discovery value of $36,518,360.88 on the property. Mr. Cummings appears to have assumed that the 1917 taxes were taken care of in the original assessment and case closed, since in his schedule of annual depletion he places sustained depletion for 1917 at $2,472,111.81 and allowed depletion $2,301,296. This valuation, however, was not used as a basis for audit.

On February 25, 1921, Mr. Harrison, valuation engineer, made a report on the case and determined the value as of March 1, 1913, at $525,000 and discovery value $30,652,379. This valuation for discovery differs from the Cummings valuation largely in the plant and smelter value to the amount of $6,000,000.

A schedule for depletion is shown as follows:

Year	Sustained	Allowed	Value
1915		$4,509.00	
1916		33,529.13	$525,000 (3/1-13(
1917	$2,074,788.14	35,540.15	
1918	3,121,721.44	3,121,721.44	[1] 30,652,379
1919	1,299,016.79	1,299,016.79	

[1] Discovery value.

Since the discovery law in the 1918 act applied only to 1918 and subsequent years, discovery depletion could not be used for 1917, the allowed depletion based on cost as at March 1, 1913, being $35,540.15. This valuation became the basis for audit of 1915, 1916, and 1917 taxes and subsequent additional assessments.

On December 10, 1923, after conferences with the taxpayer, Mr. Harrison revised his discovery valuation to $31,600,000, with depletion rate of $0.0551335 per pound of copper, which was accepted by the taxpayer. The revised depletion schedule is as follows:

Year	Copper sold (pounds)	Sustained depletion	Allowed depletion
1918	$58,056,936	$3,200,882.08	$3,200,882.08
1919	24,158,765	1,331,957.27	1,331,957.27
1920	41,012,700	2,312,447.85	2,312,447.85
1921	12,498,005	689,058.75	689,058.75
1922	27,027,500	1,490,120.67	1,490,120.67

THE QUESTION OF FINALITY

This taxpayer has consistently claimed that the 1917 taxes were closed; the files, however, fail to disclose any such evidence.

The assessment letter of June 10, 1918, stated: (Copy not found in file.)

"A final conclusion has not been reached, but from the consideration so far given it is apparent that the amount of taxes owing will probably not be less than that indicated below." (The amount indicated was $2,123,809.55, and the taxpayer was notified to make payment on or before June 15, 1918. The letter concluded.) "Upon final audit of your returns you will be advised of the conclusion reached, and if the amount determined to be due is in excess of the amount above stated a further assessment will be made; if less, you may file a claim for refund of the amount overpaid."

Certainly there is nothing in the above assessment letter suggestive of anything but a "tentative" assessment.

The claim, first, was that this assessment was the "fixing of a definite tax against the company." Quoting from brief:

"Thereafter, and in July and August of the year, pursuant to the said letter, a final examination and audit of the company's books, papers, documents, and records was made. * * * After the filing of the auditor's report deponent had certain discussions with the authorities in Washington in reference to the case, and in May, 1918, the company received a final notice, copy of which is annexed."

(NOTE.—No such notice attached to brief, and this was previous to tentative assessment.)

"That after the receipt of the said notice deponent took the same up with certain members of the board of tax assessors having charge of the case and was informed that the said notice was a final notice and settled the case.

"Deponent, after receiving this information, so reported to the directors and officers of the company that their taxes had been finally settled at $2,123,809.55 for the year 1917." * * *

The claim for abatement of duplicate assessment, made by the taxpayer, was allowed on February 19, 1919, in the following language: "No further demand for the payment of the amount allowed and abated will be made upon you."

On November 20, 1919, Mr. Graton wrote the taxpayer, in part: "It will be necessary to make provisional investigation of your taxes for the year 1917 in order that the additional amount of tax indicated as due may be assessed without delay."

The following day the taxpayer replied, referring to abatement order and saying the case had been closed for 1917 as a result of this letter. Mr. Armitage, tax consultant, claims in his brief to have interviewed Mr. Graton and to have "shown him the original notice that had been received by the company finally fixing the tax, and made the claim that the said taxes for 1917 were finally adjusted and fixed." See also letter of November 29, 1919. (Exhibit C.)

"Thereafter deponent saw Mr. Graton, who informed him that he had made an examination of the facts * * * and that the department had arrived at the conclusion that the tax for the year 1917 was finally settled and that no further question would be taken up or made in reference thereto." * * *

A copy of the Cumining's valuation of July 7, 1920, was given to the taxpayer, and great stress is laid on the fact "that the depletion allowed to the company for the year 1917 was not the depletion allowed under the valuation or at the unit rate allowed by the valuation but was the exact depletion which had been claimed by the company in its 1917 return, to wit, $2,301,296.48, which claim had been allowed and settled with the settlement of the 1917 taxes between the company and the representatives of the Government as heretofore set out."

"In allowing to the company for the year 1917 the said depletion as claimed by the company in its return, it was done because of the distinct understanding that the company's 1917 taxes were finally settled, including both its claim for special treatment under section 210 and its claim for depletion at the rate of $2,301,296.48."

In March, 1921, the taxpayer was assessed an additional tax for 1915 and 1916 on the basis of Harrison's valuation, and subsequent to that time conferences were held in which all mention of 1917 taxes was omitted.

In a conference memorandum dated April 5, 1922, the 1917 tax was considered, and the conclusion reached that the "1917 audit is to be considered final only in the event that the Commissioner of Internal Revenue agrees in writing to such arrangement." This was held between the taxpayer and representatives of audit F section.

During 1922 the question of revaluing copper mines was under consideration by the bureau. The taxpayer cites the decision of the commissioner in his memorandum of December 11, 1922, not to reopen 1917 and 1918 cases for revaluation, as again settling the question as to the finality of their 1917 tax settlement.

The matter then rests until January 24, 1923, when the assessment letter was sent to the United Verde Extension Mining Co., disclosing an additional tax of $721,260.82. The taxpayer protested this on February 19, 1923, on the following grounds:

"1. That the taxes referred to therein were settled by a settlement entered into by the Government and taxpayer in the year 1918, and these taxes can not now be opened.

"2. That the tax assessment is improper, illegal, and in violation of the Constitution, the several revenue acts, and the regulations promulgated thereunder."

EVENTS SUBSEQUENT TO ADDITIONAL ASSESSMENT, JANUARY, 1923

On May 10, 1923, Mr. Grimes, chief metals valuation section, addressed a memorandum to Deputy Commissioner Chatterton, in which he stated:

"The 1917 tax should be assessed upon the basis of the letter of January 24, 1923, for the following reasons:

"1. There was a gross error in the previous assessment.

"2. The gross error in the previous assessment was the result of misrepresentation by the taxpayer to the Income Tax Unit.

"3. There is no record in the file of this case that the tentative assessment for 1917 was ever considered final by the Income Tax Unit."

On July 3, 1923, Mr. Harrison and Mr. Grimes, of the metals valuation section, prepared a memorandum for Mr. S. M. Greenidge, head of the engineering division, setting forth a chronological record of the correspondence, assessment letters, conferences, etc., applying to the 1917 tax return of the taxpayer, in which they stated that it was apparent from the summary that—

(1) The assessment letter of June 10, 1918, was tentative and the tax paid was listed as a partial payment by the collector at Baltimore.

(2) The order for abatement, which the taxpayer has always claimed finally closed the case, was allowed because the original tentative assessment of tax was twice listed on the collector's books for collection.

(3) No further assessment had been made by the Income Tax Unit from June 10, 1918, to January 24, 1923, when an additional tax of $721,260.82 was assessed.

(4) The taxpayer has never contested the accuracy or legality of depletion based on a cost of March 1, 1913, value of $525,000, but has contended that the 1917 return was closed and that no additional assessment could be made.

(5) The original assessment was tentative and that at the time the assessment was made no revenue agent's report was available. At no time from June 10, 1918, to the present could a case of this size be closed by office audit prior to the receipt of a revenue agent's report.

(6) That representatives of the taxpayer have consistently delayed action in the collection of additional tax for 1917 by their contentions that the case had been closed by the assessment of June 10, 1918, and abatement order No. 3633. The record shows that while some representatives of the Income Tax Unit may have given credence to the taxpayer's contentions those contentions were never officially accepted or the case closed.

(7) That there can be no question as to the facts that the additional assessment is proper and that no revaluation is involved for the year 1917.

On July 31, 1923, Mr. Greenidge addressed a memorandum to J. G. Bright, deputy commissioner, in which he reviewed the case and presented some facts in connection with comparative tax rates as follows:

List (a)	Net income after depletion has been deducted	Per cent tax to net income
United Verde Mining Co	$10,011,653	28.49
Chino Copper Co	8,479,603	23.21
Nevada Consolidated Copper Co	8,769,234	19.18
Ray Consolidated Copper Co	8,551,848	21.04
Inspiration Consolidated Copper Co	9,357,491	11.34
Miami Copper Co	6,779,588	33.41
Calumet and Arizona Mining Co	8,307,313	19.08
Calumet and Hecla Mining Co	10,843,779	30.68
Average for 8 companies		23.30

List (b)	Per cent net to gross operating income	Per cent tax to net income
Iron Cap Copper Co	50.6	36.44
Miami Copper Co	48.2	33.41
Mammoth Mining Co	59.2	37.69
Shattuck-Arizona Copper Co	44.3	40.45
United Verde Copper Co	55.1	28.49
Allouez Mining Co	45.5	34.58
Mohawk Mining Co	48.1	35.16
Wolverine Copper Mining Co	45.5	11.31
Champion Copper Co	53.6	50.23
Average for 9 companies		34.53

COMMENTS ON RATES

The two companies appearing on both lists and their taxes in percentage of net income are:

	Per cent tax to net income
United Verde Mining Co	28.49
Miami Copper Co	33.41
Average of two companies	30.95

The United Verde Extension Copper Co. case involves in 1917 the following percentages:

	Depletion allowed	Per cent depletion to net income	Net income	Total tax assessed	Per cent tax to net income
Original assessment	$2,301,296.48	27.92	$8,242,209.04	$2,123,809.55	25.77
Final assessment	35,540.15	.325	10,937,277.99	2,845,070.37	26.01

Mr. Bright referred the matter to several officials in the unit for comment and recommendation.

I. T. Enes, conferee of the consolidated returns subdivision, in a memorandum dated September 4, 1923 (Exhibit D), says in part:

"The taxpayer's contention that bureau letter dated February 19, 1919, finally fixed the tax liability for 1917 and closed the case is not reasonable, and it would almost indicate a deliberate misinterpretation of the facts.

"It is true the records did not show any agreement as to the closing of the case for 1917, but if no such understanding existed, as claimed by the taxpayer, why was there no attempt made to assess the additional tax before January 24, 1923? It appears that the taxpayer's representative convinced the representative of the bureau at the conferences held that the 1917 tax was a settled question but that no records were made and the question, therefore, came up anew at later conferences."

Volney Eaton, chief of the special assessment section, in a memorandum dated September 6, 1923 (Exhibit E), says in part:

"By allowing the previous rate and settlement for 1917 to stand instead of the rate and tax as determined by the new data sheet and corrected income allowing $4,000,000, March 1, 1913, value, the Government will lose approximately $154,854.82, 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."

On September 6, 1923, Mr. Greenidge addressed a memorandum to Mr. Bright, in part as follows (Exhibit F):

* * * "Although the unit did not consider the case as closed for the year 1917, there were some actions taken by the unit which permitted taxpayer to consider its case had been finally acted upon by the unit for the year 1917.

"An investigation of the amount of tax paid by taxpayer corporation and the tax paid by similarly situated corporations leads me to believe that a reconsideration of the case by the unit will result in an amount of tax being finally arrived at not materially different from the tax already paid.

"It is therefore my recommendation that this case be considered closed for the year 1917."

On September 11, 1923, Mr. Bright addressed a memorandum to Mr. Blair, in part as follows (Exhibit G):

"In view of the facts as set forth in the memorandum prepared by Mr. Enes and Mr. Eaton, also the recommendation by Mr. Greenidge dated September 6, 1923, 'that this case be considered closed for the year 1917,' and the plea of the taxpayer that the case should not be reopened, due to the provisions of section 1313, revenue act of 1921, 'that in the presence of fraud or mistake in mathematical calculation, the findings of facts in, and the decision of the commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States,' I recommend that this case be not reopened for the year 1917 and that the unit advise the taxpayer that the letter of January 24, 1923, should be ignored."

On November 6, 1923, Mr. Bright advised the taxpayer by letter to ignore office letter of January 24, 1923, relating to a proposed additional assessment of $721,260.82 income and excess-profits tax for 1917. (Exhibit H.)

On January 24, 1924, an agreement in accordance with section 1312 of the revenue act of 1921, covering "Your income and profits tax liability for the year 1917" was executed and mailed to the taxpayer. (Exhibit I.)

On February 18, 1925, Mr. Grimes, chief, metals valuation section, in a memorandum to the commissioner recommends "that an attempt be made to collect the tax which should have been paid by this taxpayer, either by agreement with the taxpayer or through legal proceedings on a charge of fraud." (Exhibit J.)

CONCLUSION

Your engineers, after careful review of this case, desire to point out particularly:

1. That evidence is lacking in the files in confirmation of the taxpayer's contentions that this case was at any time prior to the 1,312 agreement officially closed.

2. That the unit is to be criticized for the lack of action in determining the taxpayer's final tax liability, from February, 1921, when depletion was determined for 1917, to January, 1921, when the additional assessment was made.

3. That the allowance by the unit of cost as the March 1, 1913, value for depletion was their only possible action in the absence of additional information.

4. That the taxpayer's total tax was not excessive as indicated by the percentage of taxes to net income of the United Verde Mining Co. of 28.49 per cent as compared with 26.01 finally determined for the United Verde Extension Mining Co., both operating on same lode as adjacent properties, and the tax paid, 19.42 per cent, was rank inequity as between taxpayers.

5. That the additional assessment of $721,260.82 was justly due the Government and should, if possible, be collected.

6. That measured by the provisions of the regulations, the allowance of a discovery value of $31,600,000 to this taxpayer was proper, since, although an extension of known ore bodies, this bonanza body had never been and could never have been included in "probable" or "prospective" ore or in any other way comprehended in a prior valuation.

EXHIBIT B

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, June 10, 1918.

UNITED VERDE EXTENSION MINING CO.,
New York, N. Y.

SIRS: Reference is made to your income and excess profits tax returns for the year 1917, which have been under consideration by this office with a view to determining the amount of tax to which you are liable.

A final conclusion has not been reached, but from the consideration so far given, it is apparent that the amount of taxes owing will probably not be less than that indicated below. This amount is in excess of that heretofore assessed and is subject to further revision upon final audit of your returns.

This amount should be paid to the collector of internal revenue of your district on or before June 15, 1918.

Total tax..... $2,123,809.55

Upon final audit of your returns, you will be advised of the conclusion reached, and if the amount determined to be due is in excess of the amount above stated, a further assessment will be made; if less, you may file a claim for refund of the amount overpaid.

Respectfully,

DANIEL C. ROPER, *Commissioner.*

EXHIBIT C

UNITED VERDE EXTENSION MINING CO.

NOVEMBER 29, 1919.

MR. L. C. GRATON,
Mining Section, Treasury Annex, Washington, D. C.

DEAR SIR: Referring again to your letter of November 29, 1919, and our reply of November 21, 1919, there are certain additional matters in connection with the assessing and fixing the income and excess profits tax for the year 1917 for this corporation that I would like to have before the department.

The original regulations relating to excess-profits tax known as regulation 41 were, as I recall, issued some time in the early part of February, 1918. After the issuance of these regulations, the writer went to Washington and saw Dr. T. S. Adams in reference to the tax of the above company. I talked with Doctor Adams about the facts of the United Verde Extension Mining Co., explained its history, and discussed the form of a report required. I explained that it was quite impossible by reason of the condition of the company books and its history to fill in the report in that form. A report was thereafter prepared and at this suggestion an extra copy sent on to the Commissioner of Internal Revenue at Washington. This was on or about March 29 or 30, 1918.

Thereafter I had many discussions with Doctor Adams, with Mr. Ramstedt, and other members of the department's staff, who formed part of the Board of Tax Assessors. The United Verde Extension case was assigned to Mr. Ramstedt.

Subsequently in June, 1918, I brought up the case before Doctor Adams and he stated that in his opinion the case was a difficult one; that the company was clearly entitled to an assessment to come within the provision of section 210 of the law as construed by the regulations, but that the Government was not in a position at that time to fix a representative tax as it had not collected sufficient data. He stated a tentative tax would be assessed.

Thereafter the company received from the department a letter, copy of which I inclose, fixing this tentative tax and subsequently in June, 1918, paid the amount thereof. In July and August in that year an examination was made of our books, papers, documents, and records by the auditor or field agent of the department, Mr. Abott, who I was subsequently informed made a report to the department in August, 1918.

I had many discussions with Mr. Abott in relation to his claims that the company was taxable in a further amount than the sum tentatively fixed, and submitted to him one or two briefs on the subject, presenting the arguments in the company's favor. We had some further discussions and arguments in the matter, but I was subsequently told by Mr. Abott that he was of the opinion that the tax as originally adjusted some time in May, 1918, would be assessed, and the company received a final notice, copy of which I forwarded in my former letter to you.

It would seem, therefore, that this action of the Government in finally fixing the tax as disclosed in their letter of February 19, 1919, was based upon a full examination and a complete report by the Government's field agent, and after a full discussion of the matter had been had and briefs filed by the company stating its contention. In fact, it is as I understand, on this same report and the same facts that the Government is now seeking to reopen the case.

I respectfully submit that a tax which has been fixed after such a full discussion, examination, and careful determination by the department should not be reopened and reassessed without any cause.

Very truly yours,

PAUL ARMITAGE.

EXHIBIT D

Quoted from memorandum dated September 4, 1923, from I. T. Enes.
To: Mr. J. G. Bright, deputy commissioner.
Re: 1917 tax return of United Verde Extension Mining Co., New York, N. Y.

* * * * * * *

COMMENTS WITH REFERENCE TO THE FOREGOING FACTS AND CONTENTION

(*a*) The taxpayer's contention that bureau letter dated February 19, 1919, finally fixed the tax liability for 1917 and closed the case is not reasonable, and it would almost indicate a deliberate misinterpretation of the facts. However, conferences have been held on this point at later dates, and from what appears in the file of the case it would seem that at one time—that is, about November, 1919—the case was considered closed for the year 1917. This understanding was, according to the taxpayer's version, had with Mr. Graton, valuation engineer, natural resources division. However, a memorandum prepared by Mr. Graton and dated December 8, 1919, does not support this contention. The taxpayer's representative also claims that he was again told in a conference with Messrs. King & McArthur in the early part of 1921 that the 1917 case was closed. However, the question of additional tax for 1917 was brought up at a conference April 5, 1922. The taxpayer's representative was apparently then told that the 1917 case was not closed unless such agreement was entered into in writing.

In a memorandum prepared by Mr. W. A. Harrison, dated July 3, 1923, it was stated that "the taxpayer's representatives have constantly delayed action in the collection of additional tax for 1917 by their contention that the case had been closed by the assessment of June 10, 1918, and abatement order No.

3623." This appears to be a very lame excuse. It will be noted from the fact above that the first valuation was made June 12, 1920, and that a copy of this valuation as approved was furnished the taxpayer and that a revaluation was made February 26, 1921, yet no assessment was attempted before January 24, 1923. However, additional taxes were assessed for the years 1915 and 1916, March 28, 1921, and these taxes were apparently based upon the second valuation.

It is true the records did not show any agreement as to the closing of the case for 1917, but if no such understanding existed as claimed by the taxpayer why was there no attempt made to assess the additional tax before January 24, 1923? It appears that the taxpayer's representative convinced the representatives of the bureau at the conferences held that the 1917 tax was a settled question, but that no records were made, and the question therefore came up anew at later conferences.

With reference to the taxpayer's claim that a case could not be reopened under provisions of section 1313 of the 1921 revenue act and his reliance upon the letter issued by the Secretary of the Treasury re revaluation, 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.

(*b*) With reference to the taxpayer's method of computing depletion it appears that same is not correct; neither does the taxpayer's representative claim that it is, but states that when consideration was given under section 210 the question of depletion was a part of the same consideration, and that when he agreed to the rates as used it was understood that same were to be applied after the deduction for depletion, and that after depletion was disallowed he does not agree to the rates. (See conference memorandum dated April 10, 1923.)

Claim is made, however, that even with the total depletion disallowed the tax as already paid is more than that paid by other copper companies. This contention seems to be carried out by the figures for the corporations claimed by the taxpayer to be representative corporations.

(*c*) With reference to the comparatives used in this case the following is noted:

(1) That the average depletion and deduction deducted by the representative corporations is $1,239,815.80, whereas the appellant corporation has a deduction only of $79,234.93.

(2) That the average income of representative corporations is slightly more than one-half of the appellant corporation.

It is understood to be an office practice that when a case was originally assessed by the advisory tax board under section 210 any later computation is made under the same percentage of tax to the net income, and this case was apparently handled in that manner.

It is believed that other corporations than those used can be found which will be better suited as representative corporations.

I. T. ENES.

EXHIBIT E

SEPTEMBER 6, 1923.

Memorandum for Mr. J. G. BRIGHT,
Deputy Commissioner.
(Through Mr. S. M. Greenidge, head natural resources division.)

In re: United Verde Extension Mining Co. of Delaware and Arizona, taxable year 1917.

In accordance with your request as a result of the conference of September 5, 1923, with the representatives of the above taxpayer, I have prepared a new data sheet and am embodying herein my recommendation and findings resulting therefrom.

The rate of 21.29 per cent as shown by previous data sheets was arrived at by the auditor in the case in an effort to sustain the rate of 21 per cent plus determined by the old advisory tax board. It was felt that this rate should be sustained for more than one reason, but principally for the reason that it reflected a constructive capital under section 210 of $38,986,896.54, which was more than $2,000,000 in excess of the discovery value allowed for 1918 by Mr. Cummins, of metals valuation section, for both plant and equipment

and ore reserves, and over $8,000,000 in excess of the value later determined by Mr. Harrison, of metals valuation section.

This new data sheet is composed of the Calumet & Arizona Mining Co., the Bay Consolidated Copper Co., both operating in Arizona, and the Chino Copper Co. operating in New Mexico, and in every respect they are similar to each other, and after overcoming the abnormalities are similar to the taxpayer's. While their gross business is greater than taxpayer's, their net income is less, for the reason that operations are conducted at a much lower percentage of production cost, indicating most favorable conditions as to plant operations, location, etc., and a well-mapped-out plan of previous development, all of which as claimed by taxpayer is not properly reflected in invested capital. In addition, overhead charges, depreciation, depletion, and repairs are far below these charges by the concerns selected as comparatives or by the majority of concerns conducting similar operations.

These conditions help to create a large taxable income and a very high percentage of net to gross as compared with similar concerns.

The rate of 15.81 per cent as determined by this new data sheet reflects a constructive capital of $49,483,805.30. In the proposed additional assessment of $721,260.82, based on the rate of 21.29 per cent, taxpayer was not allowed depletion on a $4,000,000 March 1, 1913, value. By the application of this lower rate to the corrected net income as determined by allowing the $4,000,000 March 1, 1913, value, a total tax results of $2,233,091.59, and the previously recommended additional assessment of $721,260.82 is reduced $551,406, which, together with a small element of gold production reflecting a tax on gold of approximately $15,000, leaves a difference in the tax thus computed and the previously proposed assessment of $566,406, or a tax in excess of that already paid of $154,854.82.

A low rate such as this new data sheet indicates with its corresponding large constructive capital under section 210 is a bad precedent to establish at this time after determining a rate of 21.29 per cent, which was acceptable to the taxpayer provided net income remained unchanged, for the reason that in determining the tax for 1918 taxpayer will expect a rate and constructive capital under section 328 consistent with the rate and constructive capital allowed under section 210 for 1917, and the previous rate of 21.29 per cent will justify a proportionately higher rate for 1918 consistent with the 1918 increased rates, while a rate of 15.81 per cent would call for a reduced 1918 rate in proportion.

By allowing the previous rate and settlement for 1917 to stand instead of the rate and tax as determined by the new data sheet and corrected income allowing $4,000,000 March 1, 1913, value the Government will lose approximately $154,854.82, but at the same time the United 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.

VOLNEY EATON, *Chief of Section.*

EXHIBIT F

SEPTEMBER 6, 1923.

Memorandum for Mr. Bright.
In re: United Verde Extension Mining Co., New York, N. Y.

As a result of your request for a recommendation by me in regard to the above-mentioned taxpayer, I wish to say that I have carefully examined the entire file in this case and find that although the unit did not consider the case as closed for the year 1917 there were some actions taken by the unit which permitted taxpayer to consider its case had been finally acted upon by the unit for the year 1917.

An investigation of the amount of tax paid by taxpayer corporation and the tax paid by similarly situated corporations leads me to believe that a reconsideration of this case by the unit will result in an amount of tax being finally arrived at not materially different from the tax already paid.

It is therefore my recommendation that this case be considered closed for the year 1917.

There is attached a memorandum of this date from the special assessment section explaining the new list of comparatives prepared in this case.

S. M. GREENIDGE,
Head of Division.

EXHIBIT G

MEMORANDUM

SEPTEMBER 11, 1923.

Mr. BLAIR: I have made a thorough and complete investigation relative to reopening the case of the United Verde Extension Mining Co. for the year 1917 in compliance with your request of May 14, 1923.

In order that the unit might have before it all the facts in connection with the closing of this case, a conference was arranged with the representatives of the taxpayer, Mr. Douglas and Mr. Seifert, at which conference there were present the head of the natural resources division, an engineer from the metals valuation section, and an auditor from the consolidated returns audit section of the natural resources division. Based on the information furnished by the taxpayer's representatives at this conference, Mr. Greenidge, head of the natural resources division, prepared a memorandum to me under date of August 6, 1923, setting forth all the facts in connection with the closing of this case, without any recommendation as to the advisability of reopening. In order, therefore, that a clearer understanding might be had of certain facts set forth in the memorandum of Mr. Greenidge, I arranged a further conference with Mr. Douglas and Mr. Armitage in my office under date of September 5, at which time the following pertinent facts were disclosed:

1. That the letter from the unit dated February 19, 1919, in which the statement was made "No further demand for payment of the amount allowed and debated will be made upon you," had no bearing on the question at issue and should not be considered. This was a standard paragraph used by the old claims division on its action in the allowance of abatement claims wherein there had been duplicate assessments.

2. That during the period from February 19, 1919, to January 24, 1923, the unit dealt almost entirely with the question of valuations for the year 1918, and that during this period representatives of the natural resources division had in part led the taxpayer to believe that its case for the year 1917 was closed. The taxpayer was furnished a copy of an audit memorandum dated June 12, 1920, signed by the valuation engineer and approved by the chief of the metals valuation section wherein the statement is made that the case for 1917 was closed under section 210.

3. That the taxpayer was entitled to and could prove a greater March 1, 1913, value for the purposes of determining the depletion deduction than was allowed in the assessment letter of June 10, 1918, the letter upon which the taxpayer bases its claim that the case for the year 1917 was closed.

4. That if the case was reopened in accordance with the facts as set forth in the letter of January 24, 1923, and the revaluation as made by Mr. Harrison was used as the basis for determining the amount of the depletion deduction, the taxpayer would be able to increase this deduction considerably through the proving of a greater March 1, 1913, value, which fact is admitted by both Mr. Greenidge and Mr. Donahue, the assistant chief of the metals valuation section.

5. That the taxpayer would be entitled to a lower rate of tax under the provisions of section 210 than that used in the letter of January 24, 1923.

Previous to the conference arranged with the representatives of the taxpayer, I had a review of this case made by Mr. Enes, conferee of the consolidated returns subdivision, and he has prepared a clear and concise statement of the facts in this case. This statement is attached and made a part of this report. After the conference of September 5, I again referred the case to Mr. Greenidge for a reconsideration of the allowable depletion deduction and the old rate as used by the Advisory Tax Board in its letter of June 10, 1918. There is attached a statement by Mr. Eaton, chief of the special assessment section in the natural resources division, fully setting forth the facts covering the allowance of a different rate than that used in the letter of January 24, 1923.

In view of the facts as set forth in the memoranda prepared by Mr. Enes and Mr. Eaton, also the recommendation by Mr. Greenidge dated September 6, 1923, "that this case be considered closed for the year 1917," and the plea of the taxpayer that this case should not be reopened, due to the provisions of section 1313, revenue act of 1921, "That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the commis-

sioner upon (or in the case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States," I recommend that this case be not reopened for the year 1917 and that the unit advise the taxpayer that the letter of January 24, 1923, should be ignored.

J. G. BRIGHT,
Deputy Commissioner.

EXHIBIT H

UNITED VERDE EXTENSION MINING CO.,
New York, N. Y.

SIRS: Reference is made to your income and excess profits tax return for the year ended December 31, 1917.

You are advised that office letter dated January 24, 1923, relating to a proposed additional assessment of $721,260.82 income and excess profits tax for 1917 should be ignored.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.

EXHIBIT I

JANUARY 24, 1924.

UNITED VERDE EXTENSION MINING CO.,
New York, N. Y.

SIRS: There is inclosed an agreement, properly executed, in accordance with section 1312 of the revenue act of 1921, covering your income and profits tax liability for the year 1917. This copy is for your files as evidence of the execution of the agreement.

Respectfully,

J. G. BRIGHT, *Deputy Commissioner.*

EXHIBIT J

FEBRUARY 18, 1925.

MEMORANDUM TO THE COMMISSIONER.

In re United Verde Extension Mining Co., audit of 1917 tax return.

The following memorandum is prepared in accordance with your request of February 16, 1925.

There are attached the following exhibits:

1. Revenue agent's report of August 31, 1918.
2. Conference memoranda of April 5, 1922, and April 10, 1923.
3. Letter of Douglass Armitage and McCann to the Secretary of the Treasury under date of April 30, 1923.
4. Letter of William A. Siefert, of the firm of Reed, Smith, Shaw & Beal, forwarding above letter to the Secretary.
5. Memoranda from McKinzie Moss, D. H. Blair, and E. W. Chatterton forwarding such letters to the Income Tax Unit and returning memorandum of May 10, 1923, prepared by J. A. Grimes.
6. Memorandum of May 10, 1923, from J. A. Grimes.
7. Memorandum of July 3, 1923, by J. A. Grimes. (These two memoranda give the status of the case and a chronological history of actions by the Income Tax Unit.)
8. Memorandum of July 31, 1923, by S. M. Greenidge. (This recites excerpts from documentary evidence in the case, and two lists of comparatives on pages 8 and 9, of which the Miami Copper Co. and the United Verde Copper Co. appear on both lists. The Calumet & Hecla percentage of net to gross income, exclusive of dividends, was 41.7 per cent, but it does not appear on the second list.)
9. Memorandum of S. M. Greenidge of August 6, 1923, submitting his memorandum of July 31, 1923, to Mr. Bright.

10. Memorandum of September 6, 1923, from Volney Eaton, chief of special assessment section, natural resources division, showing a minimum additional tax under any possible basis of $154,854.82.

11. Memorandum of September 6, 1923, from S. M. Greenidge to J. G. Bright recommending that the case be considered closed for 1917.

12. Memorandum of September 6, 1923, from S. M. Greenidge to J. G. Bright recommending that the case be considered closed for 1917.

13. Memorandum of J. G. Bright to Mr. Blair, dated September 11, 1923, and recommending that the case be not reopened.

14. A memorandum from Mr. Bright directing the case be closed on the basis of the initial tax paid has not been found in the file, but copy of audit letter of November 6, 1923, canceling the assessment letter of January 24, 1923, is attached.

These memoranda are largely self-explanatory.

I took my memorandum of May 10, 1923, and July 3, 1923, to Mr. Bright in person and was advised that the case was clearly open, but that it would not be the policy of the bureau to collect any additional tax.

In Mr. Bright's memorandum of September 11, 1923, reference is made to Mr. Donahoe, and it is stated that he admitted that the depletion deduction of the taxpayer could be increased through the allowance of a considerably greater March 1, 1913, value. Mr. Donahoe told me immediately after the conference with Mr. Bright that he had never admitted such a possibility, which is directly in conflict with any evidence in the case. Mr. Greenidge suggested and attempted to get Mr. Donahoe to agree to a $4,000,000 March 1, 1913, value before the conference with Mr. Bright.

Mr. Greenidge's memorandum of September 6, 1923, recommending the case be closed without additional tax was made with full knowledge of the case, as was the memorandum of Mr. Bright under date of September 11, 1923. Mr. Greenidge recommended a tax rate lower than a 15.81 per cent tax, which would have yielded $154,854.82 additional tax, with full knowledge of the fact that the average rate of taxes paid by comparative companies on the two bases given in his memorandum of July 31, 1923, would be:

	Per cent
First basis	23.30
Second basis	34.53

The three companies appearing on both lists and their taxes in percentage of net income are:

	Per cent
Calumet & Hecla Mining Co	30.68
United Verde Copper Co	28.49
Miami Copper Co	33.41
Average	30.86

I believe the portion of the documentary record comprising the attached exhibits fully substantiates 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 this case by 1312 agreement. Such an agreement has been signed by the Secretary of the Treasury.

It is my recommendation that an attempt be made to collect the tax which should have been paid by this taxpayer either by agreement with the taxpayer or through legal proceedings on a charge of fraud. If neither of these alternatives prevails, I recommend that no discovery value be allowed in later years, as the only basis advanced by the taxpayer is a claim that the March 1, 1913, value was $4,000. There is only one ore body in the mine, the mine had no value except as a container of ore, and no discovery can be allowed for continuations of known ore bodies under any of the discovery regulations.

JOHN ALDEN GRIMES,
Chief Metals Valuation Section.

(Whereupon, at 12.15 o'clock p. m., the committee adjourned until to-morrow, Friday, March 27, 1925, at 10 o'clock a. m.)

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.

Mr. MANSON. I desire to call the attention of the committee to the invested capital determination of the Pressed Steel Car Co. for the year 1917.

I will say at the outset that my criticism of this settlement is directed more to the regulation than it is to this particular case. In other words, I do not maintain that this settlement violates the regulations of the bureau. I do maintain that the regulation itself is unsound, and I propose to show this case as an illustration of the effect of the bureau's policy with respect to permitting expired patents to stand as an element of invested capital.

The history of the case in the bureau is set forth in the memorandum prepared by Mr. Box, which I offer to be incorporated in the record at this point but which I will not take the time to read.

(The statement submitted by Mr. Manson in connection with this case is as follows:)

In re: Pressed Steel Car Co., Pittsburgh, Pa.

This taxpayer was incorporated under the laws of the State of New Jersey January 12, 1899, with an authorized capital stock of $25,000,000. All of this stock excepting $3,000, which was issued to the incorporators, was issued in exchange for the assets of the Schoen Pressed Steel Co. and the Fox Pressed Steel equipment Co.

The assets are described as follows:

	Appraisal Mar. 17, 1899	Original entry Jan. 13, 1899, schedule No. 3	Affidavit and brief Sept. 15, 1920	Revenue agent Sept. 23, 1919
Cash		$1,500,000	$1,500,000	$1,500,000
Patents			10,000,000	10,000,000
Good will			5,000,000	5,000,000
Unfilled orders and contracts				2,650,000
Material and supplies		850,000		850,000
Real estate	$5,000,000			5,000,000
All other assets	20,000,000	22,650,000	8,500,000	
	25,000,000	25,000,000	25,000,000	25,000,000

On March 17, 1919, an appraisal of the assets was made by F. N. Hoffstot and Robert A. Bole, the former of whom was elected president in 1901 and has been occupying that position from that time through the year 1917.

On September 23, 1919, Field Agent D. J. Chapin reported the result of his investigations of the taxpayer for the years from 1909 to 1917, inclusive, stating:

"I made an effort to obtain the records kept by the Schoen Pressed Steel Car Co. and the Fox Steel Equipment Co., both at the Pittsburgh and New York offices of the Pressed Steel Car Co., and was informed that they no longer existed; further, the New York Audit Co. made an audit of the Pressed Steel Car Co.'s books during 1902, but this, too, has been mislaid and can not be located. My reason for wanting these records was to obtain the actual value of the tangible assets turned in for stock, so not being able to locate the records of the merged companies I visited the tax office of Allegheny County to see what the assessed value of the property located in Allegheny County was at the date of the merger, and obtained the following data:

Schoen Pressed Steel Car Co.'s plant assessed value:	
Land (supposed to be about 80 per cent of actual value)	$61,165
Buildings (supposed to be about 80 per cent of actual value)	90,950
Machinery (supposed to be about 50 per cent of actual value)	8,000
Total	160,115
Fox Steel Equipment Co.'s plant assessed value:	
Land (supposed to be about 80 per cent of actual value)	$28,080
Buildings (supposed to be about 80 per cent of actual value)	36,000
Machinery (supposed to be about 50 per cent of actual value)	76,800
Total	140,880

The following data was obtained from tax statement prepared by R. J. Morrison, assessor subdivision, section 3, Joliet, Ill., which I found attached to vouchers paying the 1899 taxes assessed against the property acquired by the new company in the files of the company, and which was supposed to represent actual values at this time; at least the statement states so:

S. part W. 679½ ft. of E. 28 46/100 ft., 10 lots, 7 60/100 acres	$3,500
W. 679½ ft. of N. 685 ft. of E. 28 36/100 ft., 10 lots, 10 7/10 acres	175,000
4 block Bruce Hopkins and Bacon subdivisions, sec. 3	8,000
E. 148 ft. of N. 11 ft., lot 1, lot 5 blocks	100
Ex. No. 48 ft. of N. 11 ft., lot 2, lots 5 blocks	1,500
	188,100
Machinery	60,000
Inventory, materials and supplies	15,000

Buildings evidently are not assessed in Illinois, as no record of buildings can be located on the statement, so I have arbitrarily placed a value of $50,000 on the buildings, which, if anything, is high, as subsequent sale shows. A letter from R. H. Hackney, superintendent, dated March 2, 1901, found attached to one of the vouchers, states that $175,000 is too high for the 10⅞ acres.

The agent stated that the records of the taxpayer were very inadequate and that he received very little assistance from the taxpayer, who claimed it was a physical impossibility to separate some of their accounts into proper components. The agent further states that during the year 1917 machinery and equipment were charged to expenses instead of to capital accounts to the extent of $10,000 per month at Allegheny and $15,000 per month at McKees Rocks. As a result of his examination he recommended an additional tax of $63,885.70 for the year 1917.

On May 6, 1920, an A-2 letter appraising an additional tax of $332,422.70 was mailed to the taxpayer. The latter protested to the proposed assessment, submitting briefs and contended that the respective valuations for the tangible and intangible assets shown by the agent and used by the bureau were erroneous and unfounded. (A copy of this letter can not be found with the case.)

The taxpayer was requested to assign and prove specific values of the various assets, but its representative stated that it was desired to include the entire $25,000,000 in invested capital under the classification shown under the heading, "Affidavit and brief, September 15, 1920," in table on page 1 of this report.

The issues raised by the taxpayer were: 1. The amount allowable as invested capital for the $10,000,000 capital stock issued by the taxpayer in exchange for patents on the reorganization January 12, 1899. 2. Was the Income Tax Unit in error in eliminating from invested capital the sum of $2,650,000, representing unfilled orders and contracts exchanged for stock in the par value of that amount at the time of organization January 12, 1899?

The taxpayer carried upon its books the assets acquired in exchange for the $25,000,000 par value capital stock issued upon organization items as follows:

Cash	$1,500,000
Material and supplies	850,000
All other assets	22,650,000
Total	25,000,000

It continued to so carry them until March 8, 1919, when the segregation was made after the law had limited for the purpose of invested capital the amount which it could claim as good will to 20 per cent of the outstanding capital stock as at December 31, 1916. Thereafter the assets were classified as follows:

Cash	$1,500,000
Patents	10,000,000
Good will	5,000,000
All other assets	8,500,000
Total	25,000,000

The unit originally disallowed the $10,000,000 representing the value of the patents from invested capital on the grounds that the patents had expired. The taxpayer contended that new patents had been acquired from time to time and that even though the life of a patent had expired there still existed the patent value, and if it had not been written off as depreciation that value could be claimed as invested capital. This contention was made at a conference held March 2, 1921. (Exhibit A.) The conferees agreed to the taxpayer's contention, but pointed out that it was not a question of whether the value of the patents was extinguished at the expiration of the patent, but did the patent value claimed exist at the date of acquisition, 1899, stating further that from the evidence submitted the value of patents as claimed has not been saisfactorily established.

Under date of December 11, 1922, conferees of the bureau—J. G. Bright, C. J. Mattson, and J. H. Ryan—decided that the evidence theretofore submitted was insufficient to establish the value claimed for patents, and requested the taxpayer to submit evidence showing how the estimate referred to under paragraph 6 of the conference report was arrived at. (See Exhibit B.)

A memorandum made by J. H. Ryan, auditor in the case, to reviewer, dated January 7, 1923 (Exhibit C), refers to a conference under date of January 6, 1923. A report of this conference can not be found in the case.

Under date of February 1, 1923, an A-2 letter was prepared proposing an additional tax of $121,482.18. The taxpayer protested against the assessment

of this additional tax, and as a result, under date of April 30, 1924, an overassessment of $123,186.93 was found for the year 1917. The unit allocated $2,650,000 of stock to the unfilled orders and contracts and disallowed this amount as an intangible acquired for stock in excess of 20 per cent of the capital stock outstanding March 3, 1917. The company protested this action and claimed that with the exception of the patents and good will, the sums of $10,000,000 and $5,000,000, respectively, all the assets acquired should be considered as tangible property. It was necessary in order to have the value of the unfilled orders and contracts included in invested capital to classify that item as a tangible asset because of the fact that the good-will value of $5,000,000 was the limitation on account of which intangible assets could be valued under the 1917 act.

The working papers of the auditor for the year 1917 showing how the amount determined as invested capital was arrived at are not included in the record, but from the fact that the invested capital for 1917 appears to have been in excess of $37,000,000 it appears that the item of $2,650,000 for unfilled orders and contracts was allowed as invested capital, as well as $10,000,000 representing the value of patents."

EXHIBIT A

Schedule No. 5.

MARCH 2, 1921.

CONSOLIDATED RETURNS SUBDIVISION—TAXPAYER'S CONFERENCE

Taxpayer: Pressed Steel Car Co.
Address: Pittsburgh, Pa.
Represented by: F. M. Hoffstott, president Pressed Steel Car Co.; W. A. C. Chamberlain, auditor, Pressed Steel Car Co.; W. A. Seifert, attorney, Pittsburgh, Pa.; Barry Mohun, attorney, Washington, D. C.

MATTER DISCUSSED

BOOK LOSS ON PLANTS SOLD

Supplementing remarks made at conference January 21, 1921, Mr. Hoffstott and Mr. Mohun advised of their inability to submit actual figures as to the various properties acquired, but claimed that the method pursued by the bureau was a gross injustice, due to the fact that the assessed values were used to allocate by proportion that per cent of the lump-sum purchase of land and buildings as the assessed value of each property bears to the total assessed value. Mr. Hoffstott advised that he would submit an affidavit as to the relative value of each property.

Decision reserved pending receipt of the additional information.

VALUATION OF PATENTS

Mr. Mohun stated that he was of the opinion that the committee on appeals and review had ruled that though the life of a patent had expired, there still existed a patent value which could be claimed as invested capital.

Taxpayer also claimed that the sworn affidavit under date of March 8, 1919, as submitted by the president of the corporation and substantiated by Mr. W. H. Schoen, who was vice president of the corporation from its inception to 1902, should be accepted as the real value of patents acquired in 1899, as through error in accounting methods pursued they had not been segregated but included under the caption 'Good will," and that therefore the company should not be penalized for such an error.

CONCLUSION

Mr. Mohun's contention regarding opinion of committee on appeals and review as to the value of expired patent rights was held to be as contended; that is, that value of patents which were never depreciated could be claimed to exist even after expiration of limitation of patent rights.

However, it is not the point as to the question whether value of patents is extinguished at expiration of patent-right limitation, but did the patent value claimed exist at the date of acquisition.

From the evidence submitted, the value of patents as claimed has not been satisfactorily established. Patents and good will were acquired in 1889 and entered upon the books of the corporation under the caption "Good will," for which $15,000,000 of stock was issued. No segregation was made until March 8, 1919, and then only after department had limited for purposes of invested capital, said good will to 20 per cent of the outstanding capital stock as at December 31, 1916, in pursuance of article 57, regulations 41.

The basis on which taxpayer segregated patents and good will was merely on an appraisal of companies as at the date of acquisition of 1899, which stated: "All the specially constructed machinery * * * dies; 158 letter patents * * *; orders aggregating about $15,000,000; stock of material; cash." The company paid for such mixed assets $20,000,000, of which $5,000,000 was considered as paid for tangible assets.

Considering that practically no change in actual ownership took place, the new corporation being controlled more than 99 per cent by the members of the partnership purchased and in the same proportion, and also considering the fact that the patents at the time of purchase were of problematic value and that cognizance must be taken of orders on hand, it is deemed that an arbitrary value as claimed by the taxpayer, after more than 20 years from the date of purchase, is contrary to the spirit of the law, and, if accepted, would give rise to unending claims through appraisals.

In view of the many peculiar circumstances and conditions in this case, it is recommended that it be considered by section 210.

Interviewed by—

C. T. HAINES,
Consulting Staff.

MR. APPEL,
Review Division.

J. L. CAIN,
Audit Section A.

MARCH 2, 1921.

WM. P. BIRD,
Chief, Consolidated Returns Subdivision.

EXHIBIT B

DECEMBER 11, 1922.

CONSOLIDATED RETURNS SUBDIVISION—TAXPAYER'S CONFERENCE

Taxpayer: Pressed Steel Car Co.
Address: Pittsburgh, Pa.
Represented by: F. N. Hoffstot, president; W. H. Chamberlain, comptroller; W. H. Seifert, attorney; O. G. Richter, accountant; N. C. Dornhoff, accountant.
Credentials.
Year involved: 1917.
Matter presented: Brief. Taxpayer's brief, sworn to December 8, 1922, formed the basis for discussion and decision. Bureau letter dated October 27, 1922.

1. Inventory correction: Accountants employed by the taxpayer have examined the records for the taxable year 1917 and submit a statement showing that the inventories of December 31, 1916, and December 31, 1917, were incorrect for the reason that the indirect or manufacturing expense applicable to the work in process had not been considered. Accountants have determined the amount of this expense applicable to each of the inventories and have allocated these amounts upon the basis of direct labor included in the work in process of inventory. These statements indicate that the inventory of December 31, 1916, was understated $142,873.86 and that of December 31, 1917, was understated $504,367.76. It was stated in conference that amended returns for 1916 and 1917 showing these corrections in the inventories have been filed.

Decision: Contention is allowed. Amended returns should be located.

2. Converting billets into plates: The evidence submitted shows that this is an intercompany item which was omitted from consolidated income.

Decision: Correction accepted.

3. Depreciation: Taxpayer contends that the unit's reduction of invested capital in the sum of $3,129,040.23, representing alleged insufficient depreciation

for prior years, is in error and submits evidence showing that in addition to depreciation charged off in the amount of $2,043,532.63 repairs amounting to more than $6,000,000 have been charged to expense. It is contended that the depreciation actually credited to the asset accounts, which approximates 20 per cent, is sufficient to care for the depreciation actually accrued.

Decision: Taxpayer was requested to submit evidence showing the nature of the various classes of repairs charged to expense so that the unit would be able to determine whether such items represented incidental repairs, replacements, and renewals or additions and improvements. Unless this information indicates some extraordinary condition with reference to these repairs, taxpayer's contention should be allowed.

4. Leaseholds: The unit has disallowed as invested capital an item of $500,000, representing "leases, agreements, contracts, assignments, etc.," which was acquired by the Western Steel Car & Foundry Co. in 1902. The evidence submitted shows that this asset was acquired by the subsidiary company for $500,000 par value of its stock. The lease acquired was a 10-year lease which contained a clause granting the lessee the option of purchase. At about the time that the lease expired lessee exercised this option and acquired the assets under lease. Taxpayer's claim is that the cost of the lease should not be prorated over the life of said lease for the reason that this option clause was the most valuable feature of the entire transaction.

Decision: Granting that the value of the leasehold, including the agreements, contracts, assignments, and option, were fully worth the $500,000 paid therefor at the time the leasehold was acquired, it would be inconsistent to assume that after the lease had expired, agreements fulfilled, contracts executed, and assignments made that the option remaining would represent 100 per cent of the cost value. The fact that various agreements, contracts, etc., did have a value is not disputed, which would indicate the necessity of establishing some value less than 100 per cent to represent the value remaining due to the option clause. Any reasonable value which can be established by the taxpayer should be accepted.

5. Excessive interest for 1917: The evidence submitted shows that the unit's computation of the amount of average indebtedness to be restored to invested capital on account of unallowable interest paid is in error.

Decision: Correction accepted.

6. Patents and good will: The unit valued the assets paid in for stock upon the basis of the average market quotations at about the time of the reorganization. As the result of this computation, the unit allowed as intangible values $10,493,750, which in turn was divided into $10,000,000 for patents and $493,750 for good will. Taxpayer contends that market quotations at about this time did not indicate the actual values of the assets. In support of this contention taxpayer computes the value of intangibles upon the basis of earnings for the five years subsequent to reorganization.

In this computation the taxpayer includes with the average net tangible assets the item of patents and computes the value of good will upon the basis of 8 and 15 per cent. Taxpayer's computation would indicate a value of $7,609,351.11. The inclusion of the patents with the net tangible assets is clearly an error, but even with the correction of this and other minor errors it would appear that the value shown by subsequent earnings was in excess of that indicated by the stock quotations. Taxpayer also submits that at the time of organization competent judges estimated that future earnings would approximate $2,650,000 annually and that the results of subsequent operations justified this estimate.

Decision: Taxpayer was requested to submit evidence showing how the estimate referred to was arrived at and any other pertinent details in regard to same. Also, some of the minor adjustments made in computation of average earnings and net tangible assets require further substantiation.

7. Proration of 1916 income tax: Taxpayer contends that the 1916 income tax should be prorated from the date due and payable, and not from the beginning of the taxable year.

Decision: Contention denied, but taxpayer was advised that the accrual of the 1916 tax for 1916 income-tax purposes would be made. Taxpayer agrees to this adjustment.

8. Reserve for dividends: Evidence submitted shows that the unit failed to include in invested capital the reserve for dividends as at January 1, 1917.

Decision: Contention allowed.

9. Capital charges disallowed from income: Evidence submitted shows that these items have not been restored to invested capital.

Decision: Contention allowed.

10. Special commissions: Taxpayer's brief requests the restoration to invested capital of an item of $1,243,262.46, representing what is termed special commissions paid. It is stated that these payments were made from 1899 to 1906, inclusive, and were "for the purpose of having the railroad companies adopt the pressed steel cars manufactured by this company to replace the wooden cars then being used." No further description of the nature of these items is contained in the brief, but it was stated in conference that these amounts represented special payments made to various officers and employees of railroad companies for the purpose of eliminating any active opposition of such officials or employee to the adopting of this taxpayer's product.

Decision: While these expenses are of an extraordinary nature, they clearly would not be proper capital charges, but would be in the nature of charges against current operations. Contention denied.

11. Bonus on contract: Taxpayer's brief states that during the first 10 days of this corporation's existence $950,000 was paid "in connection with the establishment of this company's business." No further explanation as to the nature of this item is contained in the brief, but it was stated in conference that an amount of $100,000 a year was required to be paid on a contract which covered a purchase of materials. It was also stated that these amounts were paid with the understanding that the individual receiving such payments would refrain from entering into a competitive business.

Decision: Inasmuch as the payments on this contract were on the annual basis and dependent upon the actions of the recipient, they were clearly charges against current operations and did not even have the nature of a deferred charge. Contention denied.

12. Organization expenses: Accountant's investigation showed that organization expenses of $19,556.50 had been charged to expense and not capitalized.

Decision: Amount should be added to invested capital.

Summary of decisions: Inasmuch as evidence submitted under points 3, 4, and 6 is incomplete, taxpayer was granted 15 days in which to submit further data.

Fifth conference.

Additional information required.

Interviewed by—

J. G. BRIGHT,
Assistant Chief.

C. J. MATTSON,
Conferee Technical Staff.

J. H. RYAN,
Auditor Audit Section.

December 11, 1922.

WM. P. BIRD.
Chief Consolidated Returns Subdivision.

EXHIBIT C

AUDITOR'S STATEMENT

JANUARY 9, 1923.

REVIEWER: The taxpayer having taken exception to A 2 letter referred to in auditor's memorandum of October 5, 1922, filed another brief and held a conference December 11 and 12, 1922, and also January 5, 1923.

Mr. Bright, Mr. Mattson, and the auditor attended this conference.

The case has been closed in accordance with allowance made at the conference.

All differences of opinion should be referred to Mr. Bright and Mr. Mattson and not the auditor.

J. H. RYAN.

The pertinent facts, so far as they relate to the matter that I wish to discuss, are as follows:

The taxpayer was organized in 1899 as the result of a consolidation of two car companies. One was the Schoen Pressed Steel Co. and the other was the Fox Pressed Steel Equipment Co.

The CHAIRMAN. Where were they located?

Mr. MANSON. I do not think the Fox Co., which was an English company, had a plant in this country. The Schoen Co. had a plant at McKees Rocks and a plant in Illinois. There was some litigation over patents between these two companies. The steel car had just been introduced and had become popular. It was manifest that if this litigation between the two companies over patents could be overcome the business would be a very profitable one.

The two companies were merged, and this company was organized under the laws of New Jersey, with a capital of $25,000,000. It was all exchanged for properties of the old companies and $1,500,000 of stock was sold for working capital. There is included in the property transfer of patents, which are accepted by both the taxpayer and the bureau at a valuation of $10,000,000, and good will, accepted by both the taxpayer and the bureau, at a valuation of $5,000,000. In other words, out of the $25,000,000 capital $10,000,000 is represented by patents and $5,000,000 is represented by good will. This makes 60 per cent of the original capital represented by patents and good will.

All of the patents which were in force in 1899 had expired by 1917. A patent only has a life of 17 years.

The CHAIRMAN. Had there been any renewals or attempted renewals?

Mr. MANSON. There had been many new patents taken out since the company was organized in 1899, but the old patents—that is, the patents which were included in the original capitalization of $10,000,000—had expired prior to 1917.

There is allowed as part of invested capital a surplus of approximately $12,000,000—something in excess of $12,000,000—the capital of the company being $25,000,000 and the total invested capital being something in excess of $37,000,000.

My position is that a patent, like a lease, is subject to depreciation, that that depreciation accrues from year to year, and when the patent expires as an element of property value the patent is gone and the property value incident to the patent itself has disappeared.

I take the position that for the purpose of determining whether there is a surplus which may be added to the original capital, for the purpose of determining invested capital, it is necessary to charge off all depreciation which has accrued before you can determine whether or not there is a surplus.

This case does not raise the question of whether the charging off of these patents would deplete the capital. The amount of surplus allowed here is in excess of the valuation at which these expired patents were included in the invested capital. For that reason the case merely presents the question as to whether, for the purpose of determining whether there is a surplus, it is necessary to charge off depreciation which has accrued upon patents which have expired.

The CHAIRMAN. Have you any data there as to the amount of taxes involved, or is that in the statement which you have introduced in the record?

Mr. MANSON. That is in a statement which I have introduced in the record?

The contention of the company, the taxpayer in this case, was that inasmuch as this company had in subsequent years taken out new patents upon improvements made upon the basic patents its patent account was as strong in 1917 as it was when these patents were taken out by the company in 1899. For that reason it contended that inasmuch as it had as much patent value, or as much value represented by patents in 1917 as it had in 1899, therefore the original patents, which had expired and as against which capital amounting to $10,000,000 had been issued, need not be depleted.

The CHAIRMAN. At this point, can counsel say how he would fix the value of these subsequent patents?

Mr. MANSON. I am coming to that.

The view taken by the committee on appeals and review and reflected in the regulations is this: That while the patent itself expires, yet, during the time that the patent is in force, a manufacturer is building up a demand for parts, he is taking out new patents, and making new and improved machines, and that in that way the original patent values becomes merged, or may become merged, in good will.

The view taken by the regulations is that the patent during the period that it is running gradually becomes converted into good will, and that, for that reason, it is not necessary to depreciate an expired patent for the purpose of determining invested capital.

The CHAIRMAN. Whose contention is that, did you say?

Mr. MANSON. That is a summary statement of the regulations on the subject. I will read those regulations——

Senator KING. You mean the regulations of the bureau?

Mr. MANSON. Yes; the regulations of the bureau.

Senator KING. And that would be the view of the taxpayer, I assume.

Mr. MANSON. Well, the taxpayer took a little different angle in this case. The taxpayer took the position that because it had been taking out succeeding patents, its patent values in 1917 were as great as its patent values in 1899, and that for that reason there was no justification for depreciating the patent account.

The CHAIRMAN. In other words, they did not attempt, then, to place any value on the subsequent patents; I mean by individual patents?

Mr. MANSON. No.

The CHAIRMAN. They just lumped them?

Mr. MANSON. They just lumped them, and they say, "We have as much value here." The language of the brief is that "the patent account was as strong in 1917 as it was in 1899."

Senator KING. If you were to get a patent for an engine, and before your patent expired, there are some little improvements upon the stop cock or some other device in connection with it, you would attribute to those little devices which you have patented in subsequent years the same value that you did to the original patent which was the basis of the corporation?

Mr. MANSON. That is the view taken by the taxpayer.

The theory of the regulation is that the patent becomes converted by the time it expires into good will.

The CHAIRMAN. And they capitalize this good will?

Mr. MANSON. And they capitalize it; yes.

The CHAIRMAN. The rulings of the bureau authorize the capitalization of good will.

Mr. MANSON. The rulings of the bureau do not require the depreciation of the patent during the process of its expiration, with the result, of course, that when the patent has expired, if it was capitalized in the first instance, it is still capitalized.

The CHAIRMAN. Right there I would like to ask Mr. Gregg if he knows whether or not the bureau does permit the capitalization of good will?

Mr. GREGG. The law specifically permits it.

Mr. MANSON. I am coming to that. The law specifically provides for that.

The CHAIRMAN. Under any and all circumstances?

Mr. MANSON. No. Here is the provision of the 1917 act. I think I can state it more briefly than by reading it, but it is section 207, and I ask to have section 207 incorporated in the record at this point:

SEC. 207. That as used in this title, the term "invested capital" for any year means the average invested capital for the year, as defined and limited in this title, averaged monthly.

As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title nor money or other property borrowed, and means, subject to the above limitations:

(a) In the case of a corporation or partnership: (1) Actual cash paid in; (2) the actual cash value of tangible property paid in, other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, actual cash value of such property as of January first, nineteen hundred and fourteen, but in no case to exceed the par value of the original stock or shares specifically issued therefor); and (3) paid-in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year: *Provided*, That (a) the actual cash value of patents and copyrights paid in for stock or shares in such corporation or partnership, at the time of such payments, shall be included as invested capital, but not to exceed the par value of such stock or shares at the time of such payment; and (b) the good will, trade-marks, trade brands, the franchise of a corporation or partnership, or other intangible property, shall be included as invested capital if the corporation or partnership made payment bona fide therefor, specifically as such in cash or tangible property, the value of such good will, trade-mark, trade brand, franchise or intangible property, not to exceed the actual cash or actual cash value of the tangible property paid therefor, at the time of such payment; but good will, trade-marks, trade brands, franchise of a corporation or partnership, or other intangible property, bona fide purchased, prior to March third, nineteen hundred and seventeen, for and with interests or shares in a partnership or for and with shares in the capital stock of a corporation (issued prior to March third, nineteen hundred and seventeen) in an amount not to exceed, on March third, nineteen hundred and seventeen, twenty per centum of the total interests or shares in the partnership or of the total shares of the capital stock of the corporation, shall be included in invested capital at a value not to exceed the actual cash value at the time of such purchase, and in case of issue of stock therefor, not to exceed the par value of such stock.

(b) In the case of an individual, (1) actual cash paid into the trade or business, and (2) the actual cash value of tangible property paid into the trade or business, other than cash, at the time of such payment (but in case such tangible property was paid in prior to January first, nineteen hundred and fourteen, the actual cash value of such property as of January first, ninteen hundred and fourteen), and (3) the actual cash value of patents, copyrights, good will, trade-marks, trade brands, franchises, or other intangible property

paid into the trade or business at the time of such payment, if payment was made therefor specifically as such in cash or tangible property, not to exceed the actual cash or actual cash value of the tangible property bona fide paid therefor at the time of such payment.

In the case of a foreign corporation or partnership or a nonresident alien individual the term "invested capital" means that proportion of the entire invested capital, as defined and limited in this title, which the net income from sources within the United States bears to the entire net income.

Under the 1917 law patents could be capitalized for the actual cost of the patent. If stock was issued for the patent, the value of the patent could be capitalized.

The CHAIRMAN. Let me ask you this question at this point: Supposing a going concern takes out one of these subsequent patents, as it did in this particular case, and the patent costs them $200, for example. Is that all that is permitted to be capitalized under the law?

Mr. MANSON. Under the law that is all.

The CHAIRMAN. That is rather a ridiculous amount, is it not?

Mr. MANSON. Under the law a patent taken out by the company, which might have a value of a million dollars, can only be capitalized for the fees paid to the department, for the attorneys' fees incident to the preparation of it, and, I assume, the cost, if there was a laboratory maintained for the purpose of developing patents, the cost of developing and experimenting could be capitalized as a part of the cost of that patent, but that is all that could be capitalized. In other words, they can not capitalize the value of a new patent under the law.

Under the 1917 act a patent was considered as a tangible by the act itself. The law limited the capitalization of intangibles to 20 per cent of the amount of the outstanding capital in 1917. In other words, not over 20 per cent of the outstanding capital in 1917 could be represented by intangibles, and included under the head of intangibles in the law is good will. That is the 1917 act.

In 1918, however, the percentage of intangibles which may be capitalized was increased from 20 per cent, as it was in 1917, to 25 per cent in 1918; but patents under the 1918 act are classed as intangibles instead of tangibles.

Now, applying that situation to this case——

The CHAIRMAN. What particular year are you dealing with now?

Mr. MANSON. I am dealing with 1917.

This company purchased $5,000,000 which is classified as good will. It is carrying that $5,000,000 in good will, which is the maximum amount of good will or intangibles that this company is permitted to carry into its 1917 invested capital.

The CHAIRMAN. Because that is 20 per cent of the $25,000,000?

Mr. MANSON. Of the $25,000,000 outstanding capital.

Senator KING. What were the tangible assets of the corporation?

Mr. MANSON. The tangible assets of the corporation under the 1917 act were $10,000,000 patents and $10,000,000 of other assets. I have not attempted to ascertain what those other assets were, because the only question that I am raising here is the propriety of including the $10,000,000 of patents in the 1917 valuation, which have expired; that is, including the expired patents under the value of $10,000,000 in 1917 invested capital of this company.

If we take the taxpayer's position that its patent account is "as strong," to use the language of the brief, "in 1917 as it was in 1899," and for that reason it is entitled to carry this capitalization of $10,000,000 as patents; that is, permitting the taxpayer to take invested capital upon a basis of value rather than upon the basis of cost. In other words, there is no contention in this case, and there is not a word of evidence in the record that the patents taken out subsequent to 1899 cost anywhere near $10,000,000. I do not think that anybody would seriously contend that they did.

The CHAIRMAN. Is there anything in the record to show what they did cost?

Mr. MANSON. No; there is nothing in the record to show what they did cost?

The CHAIRMAN. The taxpayer never made any claim upon that basis?

Mr. MANSON. The taxpayer makes no claim upon the cost of the patents taken out subsequent to 1899.

I merely wish to call attention to the fact that if the taxpayer's contention is sustained, that if it is entitled to carry into invested capital $10,000,000 as patents upon the theory that that is due to the new patents it has taken out, it must be based upon the value of the patents and not upon the cost of the patents. The bureau has in its regulations specifically provided for the depreciation of patents by permitting a one-seventeenth of the cost of a patent purchased, or the cost of a patent taken out, to be depreciated each year during the time that that patent runs. Now, while it permits a patent to be depreciated—and, in my opinion, that is done in recognition of sound accounting principles—while it permits a patent to be depreciated, it does not require a patent to be depreciated. It leaves it optional with the taxpayer as to whether or not he will depreciate the patent, and for the purpose of determining invested capital, if the taxpayer has not depreciated the patent, the regulation permits the carrying of the full cost of the patent into invested capital.

Assuming that $10,000,000 was a proper value——

Senator KING. For those patents?

Mr. MANSON. For those patents, and was actually paid, and the capital of the company as a result thereof is $25,000,000. I do not maintain that if the company did not earn enough to take its depreciation upon those patents its actual capital should be reduced for the purpose of determining invested capital, but I do maintain that where the company did earn enough—as they did in this case, because the record in this case shows that during this period of time they had distributed dividends amounting to approximately $26,000,000 and they are allowed a surplus of $12,000,000—before you can ascertain a surplus for purposes of invested capital you must charge off all of the depreciation which you could properly take, if you elected to take it, otherwise you would have this situation: Let us apply this now to any form of tangible property. Let us assume that you have a manufacturing plant which cost you $200,000. You conduct a profitable manufacturing business. You do not charge on your books any depreciation. The result is that your surplus, which is accruing from year to year, is in excess of your actual surplus by the amount of depreciation which has actually accrued, but which you have not charged off. When you reach the time when the

plant crumbles to the dust, a new plant has taken its place which has been built out of surplus.

You can readily see that under those conditions, while you have not increased your invested capital at all, you have an apparent invested capital. If you are to permit a surplus, which when it was reduced by depreciation was allowed to stand, you have an invested capital of twice your actual invested capital, and I take the position that when this law permitted surplus and undivided profits to be included in invested capital the law necessarily contemplated a proper surplus and a proper invested capital arrived at by the application of proper accounting principles. I maintain that that is necessarily implied in the law, and that before you can arrive at a proper surplus and a proper amount of undivided profits you must first take your depreciation upon your tangible property, upon any leases you may have if they have been capitalized, and upon any ores that you may have if they have been depleted, and upon any patents that you have if they have expired.

Let us now take the view of the bureau as expressed in its regulations that this patent value becomes gradually converted into good will.

What does that mean? Let us assume that that is what happened in this case, that the $10,000,000 of patent value which existed in 1899 gradually became converted to $10,000,000 of good will. You have $5,000,000 worth of good will purchased. You have $10,000,000 worth of good will which had arisen out of the conversion of patents into good will. You have $15,000,000 worth of good will which you are attempting to capitalize upon the basis of $25,000,000 outstanding capital stock. In other words, you have 60 per cent instead of 20 per cent, which the law recognizes as being valid.

The CHAIRMAN. In other words, in this case, then, they have not followed the law.

Mr. MANSON. I maintain that the failure to depreciate those patents results in a failure to follow the law.

The CHAIRMAN. But they do follow the regulations?

Mr. MANSON. They do follow the regulations.

The CHAIRMAN. And your contention is that the regulations are not in accordance with the law?

Mr. MANSON. My contention is that the regulation in that particular is not in accordance with the law.

I maintain that the law itself, as well as the regulations, draws a very clear distinction between good will and patents.

The 1917 act specifically declares good will to be an intangible asset, the amount of which is limited to 20 per cent. That same act permits patents to be included at cost, regardless of their value in relation to the capital. However sound or unsound that distinction may be, it is written into the law, and that distinction must be recognized at all times, and to permit the theory of converting a patent value into a good-will value is ignoring the very distinction that the law sets up here, and it is permitting the capitalization of good will in an amount three times the amount that the law permits.

Furthermore it does this: Here they purchased good will at a value of $5,000,000. To recognize good will at a value of $15,000,000 in 1917 is recognizing an appreciation in the value of the good will.

The Supreme Court of the United States in the case of the La Belle Iron Works *v.* United States (256 U. S. 377) specifically declared that for invested capital purposes cost only can be considered and that appreciation can not be considered.

The bureau in its own determinations has several times determined that any appreciation in the value of good will can not be added to the value of invested capital. That has been held in A. R. R. 337, Cumulative Bulletin 3, page 349, and A. R. R. 413, Cumulative Bulletin 4, page 381.

It is established that no appreciation in the value of capital assets can be included in the 1917 value for invested capital purposes, and that applies to good will as well as to anything else; but to permit this theory to stand, that the value of a patent when it expires is converted into good will, is to recognize an appreciation in the value of good will which is forbidden by this decision of the Supreme Court of the United States, as well as by the rulings of the bureau itself upon that specific question.

I maintain that good will and patent value are distinct not only under this law, but they are distinct in theory and in principle as well.

For instance, good will is something which arises out of the successful prosecution of a business, regardless of whether that business is the manufacture of a patented or an unpatented article.

If I have a reputation for turning out a reliable article, for making prompt deliveries, for amicably settling such disputes as may arise; if I have a good selling organization and ample capital; in other words, if I satisfy my customers, and I bring my wares to the doors of many people in such a way as to establish a tendency on their part to come back to me and to send their friends to me to buy the article that I manufacture, I am creating good will. That good will is not dependent upon a patent. The article I manufacture may be patentable. It may be covered by a patent. I might so manufacture that article that nobody will buy it. I may be unreliable; I may turn out an article that is defective; I may argue with my customers and refuse to make good on defective goods that I have sold; and when my patent expires, my basic patent, somebody else can take up that article and manufacture it, and do so much better than I do with it that they immediately establish a very valuable good will in connection with it, while my business management has been such that I have no good will at all.

The CHAIRMAN. And your patent has therefore turned out to be valueless.

Mr. MANSON. And the patent has therefore turned out to be valueless.

I take the position that good will is something which grows out of proper management; it grows out of adequate capital; it grows out of good business judgment; it grows out of advertising; it grows out of reputation for reliability; and the good will which arises out of the manufacture of a patented article is no different whatever from the good will which grows out of, we will say, the manufacture of soap or cloth or many other things which are not patentable at all. In both instances, the good will has the same source, namely, in good business judgment and in a reputation for honesty. In neither instance is the good will due to the process. In neither instance is it

due to the patent, and it constitutes no part of the patent, and there is no such thing as the conversion of a patent into good will.

The best test of that is this: You may, during the life of a basic patent, make improvements which you patent, and I may make improvements upon your basic patent which are better than yours.

Take a well-known automobile. I see advertised frequently in the papers different attachments to put onto a Ford car that are not made by the Ford Co. at all.

I recollect about 15 years ago trying a case in Milwaukee, where I was representing the Ford Co. I brought an action to restrain a dealer from selling certain parts which he advertised under a sign, "Ford parts for sale." The whole theory of that action was not that he was infringing upon the patents, because he was infringing upon no patent, but he was infringing upon the good will of the Ford Co., under the principle that the law knows as unfair competition. He was holding himself out in such a way as to lead the public to believe that he was supplying something that was made by the Ford Co., and we succeeded in restraining him from continuing to do business in such a way as to lead the people to believe that he was supplying something that the Ford Co. was manufacturing.

I would say that that was not a case of an infringement upon a patent, but it was something that was entirely different—an infringement upon the Ford good will, which under the unfair competition law any manufacturer has a right to protect: and so I say that good will is something that grows out of successful business management. It can exist with a patent or it can exist independent of a patent, and where a thing is patented and good will arises, that good will is no more attributable to the patent than it would be in a case where there was no patent at all.

The best test of whether there is any value in this patent is this: Take, for instance, a manufacturer before a patent expires, and suppose the manufacturer assigns that patent to some one else, or assigns some one a right to manufacture under that patent. What would the fellow take? If he had a license to manufacture under a patent which did not prevent the original manufacturer from continuing his business, could it be maintained that the purchaser of that license would take any of the good will which had been built up by establishing a chain of satisfied customers? Could it be maintained, for instance, that when that man bought a license to manufacture under that patent, that would deprive the original owner of that patent of a great chain of agencies that he had built up throughout the United Sates?

The good will of a company consists in its success in establishing good agencies. There may be in a community a dozen men who would like to deal in a certain particular thing, but there is one of them who is a better man than the others, whose reputation for honesty is good, who is a good salesman, and getting hold of such men, getting them to handle your goods, is one of the most important elements of good will.

Has that anything to do with the patent? Absolutely nothing at all.

The CHAIRMAN. I would like to ask counsel how he discriminates between the two cases such as these?

An inventor gets a patent, a basic patent, on a completed article, and he thereby gets a monopoly——

Mr. MANSON. Yes.

The CHAIRMAN (continuing). This article is an article which the community sorely needs or desires. During the 17 years he may go along in desultory manner, mistreating his customers and failing to make good on defective parts, and yet in spite of all of those things he has a successful business because of the monopoly——

Mr. MANSON. Yes.

The CHAIRMAN (continuing). At the end of the 17 years he has established agencies throughout the country. He has built up a big selling agency. He has sufficient capital. Then at the end of the 17 years he certainly has a much greater good will than somebody who starts the day after the 17-year period has expired?

Mr. MANSON. Oh, yes; that is certain.

The CHAIRMAN. How would you capitalize the good will at the end of the 17-year period?

Mr. MANSON. Under this law you can not capitalize it.

The CHAIRMAN. That is the law?

Mr. MANSON. That is the law. You must only capitalize in the shape of good will what you purchased in the shape of good will. You can not capitalize to exceed 20 per cent of your outstanding capital stock.

In this case they started with a full amount of good will purchased—$5,000,000—and that was the full amount of good will which they could carry into invested capital.

The CHAIRMAN. I understand that, but I was just wondering, though, if during the continuance of the life of the hypothetical case that I have just stated there was issued stock in excess of the actual value of the tangibles, and assuming, for instance, that they had issued $10,000,000 of stock on a capitalization originally of $10,000,000, then, under the law, if that $10,000,000 was in excess of the tangible assets, only $20,000,000 could be capitalized?

Mr. MANSON. You can capitalize good will to the extent of 20 per cent of the stock.

The CHAIRMAN. Yes; that is what I mean.

Mr. MANSON. Yes.

The CHAIRMAN. I am assuming in this hypothetical case that they issue $10,000,000 of stock in excess of the tangible assets, then when the bureau comes to value that $10,000,000 which is not represented by any tangible assets they, under the law, are permitted to capitalize 20 per cent of it?

Mr. MANSON. No; not 20 per cent of the $10,000,000. If the tangible assets amounted to $40,000,000——

The CHAIRMAN. Well, I am not talking about that. I am talking about a $10,000,000 corporation with $10,000,000 assets and $10,000,000 stock for tangibles. They have $20,000,000, $10,000,000 of which is issued either for patents or for good will, or whatever you call it, and then the bureau comes along and permits the recognition of that $10,000,000 which they have issued in stock in excess of the tangible assets.

Mr. MANSON. Yes.

The CHAIRMAN. Do you understand the law to imply that only 20 per cent of that might be capitalized in fixing capital investment?

Mr. MANSON. Yes: only 20 per cent.

The CHAIRMAN. That is what I want to know.

Mr. GREGG. On that point Mr. Manson has stated 20 per cent only of the stock, not the value of the good will but the par value of the stock.

The CHAIRMAN. Yes; I understand that.

Mr. MANSON. If it is $20,000,000, for instance, then $4,000,000 could be capitalized to cover good will.

Mr. GREGG. Yes.

The CHAIRMAN. I would like to ask Mr. Gregg if he thinks, in view of this situation—and I think, perhaps, he is ready to answer it now—the regulations ought to be revised.

Mr. GREGG. I am just as ready to answer now as I ever will be, Mr. Chairman.

Counsel for the committee has raised one of the most interesting and one of the most difficult points in the computation of invested capital, and without saying that I agree with him, there is a good deal in the position that he takes.

The situation is this: Mr. Manson explained it very thoroughly, but I would like to go over it briefly again.

Stating it generally the statute includes in invested capital property paid in for stock, and there is no need at this time of getting into the question of limitation on intangibles—property paid in on stock and earned surplus. The statute just says "earned surplus" and undivided profits, or something of that sort. The statute gives no definition of the term. It was up to the department to find out what constitutes "earned surplus."

We have taken the position consistently that depreciation must be recognized in computing this earned surplus, that deduction for depreciation must come out before you have an earned surplus.

I think that is sound, although it is very questionable as a matter of law, but it is more questionable on depletion than it is on depreciation, and I imagine we will have a court decision on it before long.

The only case that has ever been referred to the courts was the La Belle Iron Works case, where the court in the last sentence said that that case was not before them and they expressed no opinion on it.

On the tangible properties we have consistently held that the proper depreciation deduction, in our opinion, irrespective of what was done by the taxpayer, had to come out of earned surplus in computing invested capital. We made the sole exception with reference to patents.

In this connection I would like to say that the question, of course, first arose under the 1917 act. When the department came to lay down a definition of "earned surplus" we called in the best accountants in the country to assist us in doing that. I suppose the man who had more to do with it that anyone else was Mr. Sterritt, the senior member of Price, Waterhouse, one of the leading accountants of the country, and they wrote the definition of "earned surplus."

The subsequent acts, however, did not change in this respect the definition of "invested capital," and we have kept practically our

same definition of "earned surplus"—what the accountants wrote as the proper meaning of the term "earned surplus."

Let me read you from article 843 of regulations 62, which was in the regulations under the 1917 act and for every year since 1906:

ART. 843. *Surplus and undivided profits; patents.*—From the standpoint of assets a patent, or, more particularly, a group of patents, is closely analogous to good will. Their value is contingent upon and measured by their earning power. While patents have a definite life, there is a common tendency to extend that life by improvements upon the original, and in a successful business the patent value merges more or less completely into a trade name or other form of good will. Therefore, while deductions in respect to the depreciation of patents based upon a normal life period of 17 years are allowable in computing net income for the purpose of the income tax, such deductions are not obligatory, but are optional with each taxpayer. Where since January 1, 1909, a corporation has exercised that option to its own benefit in computing its taxable net income, the amount so deducted can not now be restored in computing invested capital. Where, however, the cost of patents has been charged against surplus, or otherwise disposed of in such a manner as not to benefit the corporation in computing its taxable net income since January 1, 1909, any amount so written off may be restored in computing invested capital if it be shown to the satisfaction of the commissioner that the amount so written off represented a mere book entry ascribable to a conservative policy of management or accounting and did not represent a realized shrinkage in the value of such assets.

In other words, with reference to patents the position is taken that having an option to charge off each year, a deduction of one-seventeeth of the cost of the patent, both for income and invested capital purposes, if that one-seventeenth is not charged off it may remain in invested capital.

As I say, the question is a very close one and a very difficult one. Sometimes it works to the benefit of the Government, and sometimes it works—and usually, as in this instance—to the benefit of the taxpayer.

However, when we held that that option, once exercised, was binding upon the taxpayer many of them were deducting depreciation in the current years, but had failed to do so in the past, and, of course, it reacted to the disadvantage of the taxpayer in such cases. That question was referred to the Board of Tax Appeals, and it has been decided in favor of the taxpayer.

Senator KING. So that the Government loses both ways, then?

Mr. GREGG. Both ways.

The CHAIRMAN. Let me ask you this, Mr. Gregg: Does the 20 per cent limitation apply at any point there?

Mr. GREGG. The 20 per cent limitation comes into it, but I do not think it is really material to this question. I think that——

Mr. MANSON. I take the position that, following the reasoning of that regulation, the patent value is converted into good will. Now, applying that to this case, they started out here with good will purchased for $5,000,000. Assuming this patent value of $10,000,000, which has disappeared as patent value, to have been converted into good will, then you have $15,000,000 out of $25,000,000 of capital represented by good will, while the law only permits $5,000,000 to be represented by good will.

There is another point in this case that I neglected to mention, but which I would like to call to the attention of the bureau at this time.

The working papers were not in the files, and for that reason we were unable to determine what was done with this invested capital in

1918. In 1918 we have this situation: Under the law the patents and good will are both intangibles, so declared by the statute. The statute limits the amount of intangibles in 1918 to 25 per cent, which would be 25 per cent of $25,000,000, or $6,250,000; so that in 1918, however you view this question, the most that can be allowed for patents and good will is $6,250,000.

We do not know whether a change has been made in 1918, for the reason that, as I say, we were unable to locate the working papers, as they were not in the files. I do not mean to imply that they were extracted, but they were not in the files, and I desired to get this case before the committee and wind up these hearings to-day, so I did not wait until a further search could be made for them.

The CHAIRMAN. In view of the fact that you want to ask Mr. Bright some questions to-morrow, I think the bureau might bring down to us what they find in connection with 1918.

Mr. MANSON. As far as those questions are concerned, I have already asked Mr. Bright all that I care to ask him.

Mr. GREGG. We will bring that down to-morrow, Mr. Chairman.

Mr. MANSON. If those papers have been located they could be submitted to Mr. Box this afternoon and let him examine them.

Mr. GREGG. I think we can submit them.

Mr. MANSON. I think you have asked for them, Mr. Box, have you not?

Mr. BOX. Yes.

Mr. GREGG. If the reduction was not made, it was an inexcusable error, because the statute of 1918 is very specific. There is no possibility of a misconstruction.

The point I wanted to make on this, Mr. Chairman, in answer to your question as to whether the regulations should be changed, is this: The question is a very difficult one and it is a close one. That is the best I can say for it, that it is a close question. This interpretation has been adopted since the 1917 law.

The CHAIRMAN. One of the reasons why Congress does not see fit to change these things is because Congress does not know anything about them.

Senator KING. We do not know how they are being interpreted or the effect of the interpretation as to whether it is disadvantageous to the taxpayer or injurious to the Government.

Mr. GREGG. I can not comment on that.

Senator KING. Unless some specific cases are brought to the attention of Congress, Congress would not know.

Mr. GREGG. But you have this situation with reference to this, that there have been thousands and thousands of cases settled on the basis of this regulation. It is applied uniformly in all cases. Even if it is not sound it represents what I think is apparently a fair and equitable rule. The value is there, and there is no real objection, as a matter of principle here, why it should not be included in invested capital.

The CHAIRMAN. I do not know about that. I do not admit Mr. Gregg's conclusion that the value is there. I do not admit that when a patent is capitalized at $10,000,000 the value is still there when the patent has expired.

Mr. MANSON. It is really a broader question than that, even, in my opinion. The question here is whether in determining invested capital it should be obligatory to take depreciation. In other words, if it is not obligatory, it is clearly an injustice to the taxpayer who does take up the depreciation, because, as I have indicated, you can have a prosperous business and you just do not specifically charge any depreciation. That enlarges your profit-and-loss balance and increases your surplus. A part of your surplus is represented by the actual depreciation, but which has not been charged off.

It strikes me that to permit a regulation to stand which makes it optional with a taxpayer as to whether he will take depreciation for invested-capital purposes is unfair to the taxpayer who takes it. The depreciation goes on. He takes it, in effect, whether he takes it on his books or not.

If I pay $10,000 for a lease, when that lease expires that $10,000 of value is gone. If I pay for a patent, when the patent expires what I paid for that patent is gone. The depreciation on buildings and machinery is going on. Whether you take it or not does not alter the fact that it has actually accrued. It is just a question of permitting surplus to be set up. It does not recognize that a certain physical fact has actually occurred.

The CHAIRMAN. Whether the bureau thinks it wise to change this regulation or not, it seems to me they might take it under consideration, and they might also consider at the same time whether this question of taking this depreciation should not be mandatory instead of optional.

Mr. GREGG. Well, it is, Mr. Chairman, with respect to everything except that.

The CHAIRMAN. I mean that I think that might be taken into consideration.

Mr. GREGG. Yes.

The CHAIRMAN. Because if a patent expires in 17 years, it should be mandatory to take it into consideration, and then the question of good will could be considered afterwards.

Mr. GREGG. It is mandatory with respect to everything but patents. As I say, this regulation has been in effect since the 1917 act. On March 15 last year the statute runs on the last excess-profits tax year. It has been applied in thousands and thousands of cases. I personally would be very reluctant for that reason to change it and upset so much work.

The CHAIRMAN. In view of that statement, would it not have some effect in figuring the profits of corporations in their taxes? Do you not have to have the capital values there?

Mr. GREGG. No, sir; this regulation applies only to the excess-profits tax.

The CHAIRMAN. Yes; but assuming that this same corporation was permitted to fix capital on the basis that this taxpayer has fixed it, would not the percentage of earnings that it paid to the Government under the present laws be affected?

Mr. GREGG. No; this does not affect that. He gets his valuation of his patent for depreciation purposes, and he can take as a deduction one-seventeenth each year. But this does not affect that. There is no difficulty there. This applies solely to the excess-profits tax.

Senator KING. How does it affect, if it affects at all, corporate profits for the purpose of the tax?

Mr. GREGG. It does not affect that. The regulation does not.

Senator KING. How do you deal with patents in determining corporate taxes?

Mr. GREGG. The taxpayer is entitled to take the cost of the patent and take one-seventeenth of that cost as a deduction each year for depreciation.

Mr. MANSON. From income?

Mr. GREGG. From income. But this regulation, the merging of good will regulation, has no application to that. It applies only in the computation of the invested capital for excess profits tax purposes.

The CHAIRMAN. In fixing the present tax at 12½ per cent, corporate, do you not have to have invested capital at all?

Mr. GREGG. No, sir; the question of determining invested capital was removed when the excess profits tax law was repealed at the end of 1921.

The CHAIRMAN. Is that all you have this morning, Mr. Manson?

Mr. MANSON. Yes; that is all I have at this time.

The CHAIRMAN. Have you anything that you desire to put into the record at this time, Mr. Gregg?

Mr. GREGG. No, sir; we have nothing to-day. We will be all prepared when the committee meets next.

The CHAIRMAN. We will adjourn now until 2 o'clock to-morrow afternoon.

(Whereupon, at 11.55 o'clock a. m., the committee adjourned until to-morrow, Tuesday, March 31, 1925, at 2 o'clock p. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, MAY 4, 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 call of the chairman.

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

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

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

Mr. GREGG. Senator, may I inquire as to the plans of the committee?

The CHAIRMAN. Mr. Manson is ill this morning, but after talking with Mr. Manson and with other members of the committee, I would say that we thought we would go along every morning at this hour as long as Mr. Manson could keep up the pace. I do not know just what the details are. He telephoned this morning that he is unable to come down, but he has asked Mr. Box, the auditor for the committee, to proceed with several cases that he is prepared to go ahead with at this time.

Mr. GREGG. What I was wondering about, Senator, is how long the committee plans to continue in session?

The CHAIRMAN. It depends upon the amount of work. We thought it would take at least a couple of weeks.

You may proceed now, Mr. Box.

STATEMENT OF MR. GEORGE G. BOX, CHIEF AUDITOR FOR THE COMMITTEE

Mr. Box. The first case that I will present this morning is the case of the Slim Jim Oil & Gas Co., of Wichita, Kans.

The Slim Jim Oil & Gas Co. was incorporated August 18, 1914, with a capital stock of $12,000, representing the cost of leases and development of a partnership formed in May, 1914, by J. C. Titus and others who had acquired leaseholds on land in the vicinity of Wichita, Kans.

Drilling was commenced and on August 3, 1914, the first well was completed and a good flow of gas discovered. Other gas wells were brought in afterwards, the gas being sold to the Wichita Natural Gas Co.

In June, 1916, after several oil wells in near-by territory had been brought in, this taxpayer sold an undivided half interest in its leasehold to the McMahon Oil Co., Tulsa, Okla., for $300,000. On March 8, 1917, taxpayer sold its other undivided half interest to the Utilities Oil & Gas Co. for $1,865,000, but reserved all the oil which it had produced and stored in tanks, in all about 618,000 barrels, from the sale. It disposed of this oil during the year 1917.

The taxpayer made a return for the year 1917, reporting as income its combined sale of oil and capital assets. This return was executed September 6, 1918. It showed net income of $2,223,859.37 and a tax liability of $1,319,582.11. This tax, for some unexplainable reason, was never assessed nor paid. The income tax return itself shows no evidence whatever of the tax being collected, nor does the record in the case.

After a further period of 15 months an amended return was filed by the taxpayer in December, 1919, showing a net income of $1,067,121.61 and a tax liability of $451,245.76. The latter amount was accepted as the tax due, it was assessed and paid, and the case sent to the closed files.

Under date of March 16, 1918, Deputy Commissioner L. F. Speer advised Mr. J. C. Titus, of the Slim Jim Oil & Gas Co., that the taxpayer and its stockholders were granted an extension of time until 20 days after notice of the final decision of the bureau of the tax matters then pending in which to file their return of annual net income for 1917. This letter is Exhibit A in this case.

On July 6, 1918, the collector of internal revenue at Wichita advised the Commissioner of Internal Revenue that in his judgment all returns made in connection with the Slim Jim Oil & Gas Co. were made for the sole purpose of defrauding the Government, and requested that all of the returns connected with said company be referred to the very best men connected with the service in his district for a thorough investigation. This letter is Exhibit B.

Early in December, 1921, Mr. Gus V. Winston, an accountant and tax consultant, of Wichita, Kans., informed Commissioner Blair that he had knowledge of the tax violations of the Slim Jim Oil & Gas Co., and on a reaudit based upon the information given by him an additional tax of $789,875.14 was assessed on July 21, 1922.

As stated above, the original 1917 return reported the profit from the sale of the company's capital assets as income for 1917. However, the amended return excluded this income, claiming the sale of its leasehold interests, which was consummated March 8, 1917, actually took place in 1916.

A claim in abatement was filed on December 26, 1922, by T. J. McDonald, trustee for the Slim Jim Oil & Gas Co., for $789,875.14, the latter having been dissolved in 1920. This claim refers to an extensive series of hearings and an investigation of the corporation's books and valuation of its leasehold by a Government engineer.

A copy of the claim referred to is Exhibit C.

Under date of December 19, 1919, J. C. Titus addressed a letter to Mr. J. L. Darnell, of the Income Tax Unit, indicating that he had been extended courtesies by the latter on a prior visit to Washington.

This letter is Exhibit D.

Under date of June 11, 1921, Mr. G. C. Hold, internal revenue agent in charge, wrote the Income Tax Unit. In this letter he invited attention to the fact that upon a visit by Internal Revenue Inspector B. C. Middleton to C. H. Taylor, of Oklahoma City, one of the principal stockholders of the Slim Jim Oil & Gas Co., Mr. Taylor offered a severe protest against the opening of his case, stating that during the year 1918, after the Slim Jim properties were sold at a profit of approximately $2,500,000, he and other stockholders of the company visited the bureau on numerous occasions during the year 1918 with a view to bringing about a settlement of the tax liability of the company and its stockholders; that he obtained a hearing with Mr. Powell and Mr. Darnell, of the natural resources division; and that in conference with Commissioner Roper finally agreed upon the tax liability of the company and the stockholders of approximately $600,000, and that therefore amended returns were prepared and filed on that basis.

This letter is filed as Exhibit E.

Senator ERNST. What year was that?

Mr. BOX. The income for the year 1917 is being discussed.

Senator ERNST. I was wondering when he came to Washington.

Mr. BOX. Under date of June 11, 1921, was the letter from the internal revenue agent in charge.

It appears from the record that in January, 1917, J. C. Titus and C. H. Taylor, the principal stockholders of the taxpayer, each gave to their respective wives 19 shares of the capital stock of the corporation, representing one-half of their respective interests. The revenue agent who examined this taxpayer reported that in his opinion these gifts were not genuine and refused to recognize them. The question was submitted to the solicitor, who decided under date of February 9, 1923, that the evidence submitted by the revenue agent was insufficient as a matter of law to warrant a conclusion as drawn by him and that in computing individual taxes of J. C. Titus and C. H. Taylor for the year 1917 the gifts in question should be allowed and the amount of additional tax for which they might be liable should be redetermined and adjusted.

This decision of the solicitor is made Exhibit F.

Under date of February 15, 1923, an offer in compromise was submitted by the representatives of the taxpayer agreeing to pay $118,368.57, without interest, in settlement and full satisfaction of all claims for income and excess-profits taxes against the Slim Jim Oil & Gas Co., and a further sum of $121,631.43 in full satisfaction of all claims for individual income and excess-profits taxes alleged to be due on the part of former stockholders in their individual capacity for the years 1916 and 1917, without interest, the offer in compromise of the additional taxes of the individuals being in full.

The offer in compromise is made Exhibit G.

By considering the sale of the capital assets of this taxpayer as being consummated in March, 1917, the tax liability of $789,875.14 arose in favor of the Government for the year 1917, against which there was an overassessment of $23,615.01 for 1916, making a net balance due the Government of $776,260.13.

Under date of February 13, 1923, the Solicitor of Internal Revenue recommended that the offer in compromise above referred to be ac-

cepted, as in his opinion it was proper and for the best interests of the United States to accept, and "particularly in view of the fact that the taxes from the corporation were adjusted and the case closed by a former commissioner."

The recommendation of the solicitor is Exhibit H.

This recommendation of the solicitor was accepted and the compromise made on that basis. This resulted in the Government accepting $118,368.57 from the Slim Jim Oil & Gas Co. in payment of a tax liability of $776,260.13, or a less of $647,891.56 in taxes due.

This is a very unusual case, which the records fail to satisfactorily explain. In the first place, the original return was not filed until September 6, 1918, which may be accounted for satisfactorily by extensions granted by the commissioner. The tax liability as shown by this return was $1,319,582.11. It appears that this tax was never paid, nor even assessed. An amended return indicating a tax liability of $451,245.76 was filed in December, 1919, about 15 months subsequent to the filing of the original return.

There are references in the record of numerous hearings had by the taxpayer with officials of the bureau prior to the filing of this return. Although nothing appears in the record of the case, the committee is in receipt of information to the effect that at the time the offer in compromise was being considered by the commissioner, Mr. J. L. Darnell, who was formerly chief of the oil and gas section of the natural resources division of the bureau, was called in and asked by the commissioner why he agreed with the taxpayer to accept an amended return on the basis on which it was submitted. This included the understanding that the sale of the taxpayer's properties in 1917 should be considered as a 1916 transaction. Mr. Darnell's reply was that he thought $450,000 was a large enough amount for the taxpayer to pay.

Attention is invited to the fact that the taxes from this corporation were adjusted and the case closed by a former commissioner, which seems to have been one of the reasons why the solicitor refrained from opening the case of this taxpayer and recommended that the offer in compromise be accepted.

Treasury Department Decision 3240 (Cumulative Bulletin 5, p. 313), approved by the Secretary of the Treasury October 31, 1921, provides that when a case has been finally closed after the taxpayer has had a hearing and been afforded an opportunity to present arguments in support of his contentions the case will not be reopened excepting under certain conditions. In the case of Penrose *v.* Skinner (298 Fed. 335), decided in the United States District Court of Colorado, August 14, 1923, the court said, "The subsequent action of Commissioner Roper in reopening the matter and compelling the plaintiff to pay the taxes has little to do with the controversy here, as I think no one will contend that a succeeding commissioner could overrule or ignore the decision of his predecessor unless such decision were in law erroneous or tainted with fraud." For Treasury Decision 3240 and dicta in Penrose *v.* Skinner, above referred to, see Exhibit I.

In this case the record raises a strong suspicion of fraud, and there is no inhibition to the opening of cases closed by a former commissioner when fraud is an element in the case, although from the opinions referred to in the above-mentioned decisions it is very

questionable whether it is proper to reopen a case closed by a former commissioner unless decisions were in law erroneous or tainted with fraud.

Messrs. Darnell and Powell, who it appears were active in the conferences with the officers of this taxpayer——

The CHAIRMAN. Just at this point I would like to know whether you have discovered any evidence sustaining the bureau for going on the 1916 transaction instead of the 1917 transaction?

Mr. BOX. I have not; no, sir.

The CHAIRMAN. Are you willing to say that there is no evidence in the files of the bureau to show why that was done?

Mr. BOX. From my examination of the case I think there is no doubt that it was a 1917 transaction, and it appears in the records in the case, taken as a whole, that from the time the original return was filed until the amended return was filed, there were several conference in the bureau in which Mr. Darnell took part, and it was there that the agreement was reached to file an amended return on the basis on which it was filed.

The CHAIRMAN. And that was the basis for placing the transaction back in 1916?

Mr. BOX. 1916; yes, sir.

The CHAIRMAN. But in those hearings there is no evidence as to why that was done, as I understand it.

Mr. BOX. There is not; no, sir.

Senator JONES of New Mexico. What evidence is there in the record that would throw any doubt around the time as to when the transaction was consummated?

Mr. BOX. I have not seen any evidence in the record.

Senator JONES. What sort of a sale was it?

Mr. BOX. It was an out-and-out sale of the undivided one-half interest of this corporation's leasehold interests in the State of Kansas.

Senator JONES of New Mexico. There must have been a definite date when that was consummated, must there not?

Mr. BOX. The date was March 8, 1917.

Senator JONES of New Mexico. Then upon what ground could any controversy have arisen regarding the question of time?

Mr. BOX. There is nothing that I know of that shows that in the record. There is nothing to show even why 1916 was considered.

The CHAIRMAN. I suppose the reason given was because the tax in 1916 was lower than it was in 1917.

Mr. BOX. Much lower as a result of throwing it back in 1916. It made an additional tax in 1917 of $23,000. The tax in 1917, based upon the 1917 rates, was about $760,000.

Senator JONES of New Mexico. Was the case finally closed on the basis of the transaction having occurred in 1916?

Mr. BOX. The case was finally closed; the corporation was dissolved in 1920. After this additional tax was assessed the trustee of the corporation made an offer in compromise, and that was accepted, reducing the tax from $760,000 to about $118,000. There was a loss of about $650,000 by accepting this offer in compromise.

Senator JONES of New Mexico. Is there anything to indicate the basis of the reduction in amount? Was the year 1916 considered in connection with the compromise proposal?

Mr. BOX. The company had, as I say, dissolved, and there were rumors—it does not appear, of course——

Senator WATSON. Was this a bankrupt concern in 1920?

Mr. BOX. No; it was not. There was a question about the additional tax that the principal stockholders of this corporation owed. They were trying also to get away from the payment of that tax, and in this offer in compromise a part of the total amount was offered in payment of the additional tax in full.

The CHAIRMAN. To get back to Senator Jones's question, in computing the compromise offer was the sale fixed as of 1916?

Mr. GREGG. I think I can answer the question. If it was considered as a 1916 sale there would have been no additional tax and there would have been no necessity for an offer in compromise. It was considered as a 1917 sale when we reopened, and they compromised the liability which resulted from considering it as a 1917 sale.

The CHAIRMAN. Then, do you know why the tax was reduced by $650,000 in that compromise offer?

Mr. GREGG. I do not remember accurately. I was just going through the record here, the statement prepared in the solicitor's office, giving the reason for the compromise. It was there, but it is not in this record. As I remember it—and I am very hazy on it—the corporation had dissolved and the tax was against the corporation. We would have had to go into court to sue the stockholders of the dissolved corporation. We could no longer assess the tax. There was just one stockholder, as I remember, who was solvent, just one of the stockholders who had received liquidating dividends, and he was the one I think who paid all of the offer in compromise. It was very doubtful how much we could have gotten if we had gone into court and sued the stockholders.

The CHAIRMAN. Would the bureau like to reply to this at a later time?

Mr. GREGG. Yes; we will later, when we get that brief, but I just wanted to answer the Senator's question.

The CHAIRMAN. Yes.

Mr. BOX. Messrs. Darnell and Powers, who it appears were active in the conferences with the officers of this taxpayer, as a result of which the 1917 sale of taxpayer's capital assets was considered as a 1916 transaction, thereby ultimately resulting in the failure to collect approximately $650,000 in taxes, subsequently resigned from the service and have held powers of attorney to represent taxpayers before the bureau in over 40 and 60 cases, respectively.

A list showing the powers of attorney of Messrs. Darnell and Powell is submitted as Exhibit J in this case.

The CHAIRMAN. Does that complete the presentation of this case, Mr. Box?

Mr. BOX. Yes, sir.

(Exhibits submitted by Mr. Box in the Slim Jim Oil & Gas Co. case are as follows:)

EXHIBIT A

MARCH 16, 1918.

Mr. J. C. TITUS,
Slim Jim Oil & Gas Co., Wichita, Kans.

GENTLEMEN: Receipt is acknowledged of your letter of the 16th instant, in which you request that the Slim Jim Oil & Gas Co. of Wichita, Kans., and its stockholders, viz, J. C. Titus, J. C. Titus, trustee for Titus Williamson, Rentata Titus, T. J. McDonald, S. A. McDonald, A. H. Hill, G. F. Bissantz, J. H. Higley, T. B. Richardson, E. C. Colvin, and A. C. Himmelwright, of Wichita, Kans., and C. H. Taylor and A. M. Taylor, of Oklahoma City, Okla., be granted until 20 days after notice of the final decision of the department on the tax matters of said company now pending within which to make their respective Federal income and excess-profits tax returns for the year 1917.

This extension of time is requested for the rason that the returns are so interwoven that accurate returns can not be made until a decision is reached by this office.

In reply, you are informed that under the authority vested in the Commissioner of Internal Revenue by the act of September 8, 1916, as amended, the Slim Jim Oil & Gas Co. and its stockholders named hereinbefore are granted an extension of time until 20 days after notice of the final decision of this office on the tax matters now pending in which to file their returns of annual net income for the year 1917 with the collector of internal revenue for their district.

A copy of this letter, or reference thereto, should be attached to each return when it is filed.

By direction of the commissioner.

Respectfully,

L. F. SPEER,
Deputy Commissioner.

EXHIBIT B

WICHITA, KANS., *July 6, 1918.*

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

MY DEAR SIR: This return 1040, as well as all other returns made in connection with the Slim Jim Oil & Gas Co. of Wichita, Kans., in my judgment is made for the sole purpose of defrauding the Government.

I am satisfied I am correct in this matter, and would respectfully ask that all these returns connected with said company be referred to the very best men connected with the revenue agent service in this district for a thorough investigation.

Yours most respectfully,

W. H. L. PEPPERELL, *Collector.*

EXHIBIT C

SLIM JIM OIL & GAS CO., A CORPORATION, WICHITA, KANS.

Character of assessment or tax—Additional income and excess-profits tax from January 1, 1917, to December 31, 1917

Amount of assessment or stamps purchased	$789,875.14
Reduction of tax liability requested (income and profits tax)	789,875.14
Amount to be abated	766,260.13
Amount to be refunded (or such greater amount as is legally refundable)	23,615.01

The undersigned, a former stockholder of the Slim Jim Oil & Gas Co., having received notice of assessment and demand for tax in the sum of $789,875.14 against said corporation on account of additional income and excess-profits taxes alleged to be due by it for the year 1917, respectfully submits in

his individual capacity only, that the same should be abated and canceled for the following reasons:

1. Because the Commissioner of Internal Revenue in December, 1919, after an extensive series of hearings, including an investigation of the corporation's books and the valuation of its leasehold by a Government engineer, and wherein all the facts were placed before the Government, directed the filing of amended returns on behalf of the Slim Jim Oil & Gas Co., involving the payment of income and excess-profits tax in the sum of $451,245.76; that said returns were accepted and the tax shown to be due thereon paid, and the case finally closed.

2. That the said Slim Jim Oil & Gas Co. is no longer in existence, having after the satisfaction of its Federal tax liability proceeded to liquidate its assets and distribute the same among its stockholders; that it has now entirely ceased business operations, and that since December 22, 1920, it has ceased to exist as a corporate entity, as it is shown by letter of that date from the Secretary of State of the State of Kansas, canceling its charter; said letter being filed in the records of this case in the Bureau of Internal Revenue.

3. That there are no corporate assets remaining with which to pay any tax or other liability.

4. That the assessment made and tax now demanded is erroneous and illegal for the reasons set up in the two briefs filed in behalf of the undersigned and the other former stockholders of the Slim Jim Oil & Gas Co. with the Commissioner of Internal Revenue on August 7 and November 10, 1922, respectively, and the undersigned hereby adopts the contentions therein made in behalf of said Slim Jim Oil & Gas Co., the defunct corporation now assessed additional taxes. The undersigned further respectfully refers to claims for abatement heretofore filed by him and other former stockholders of said corporation, which claims have been accepted by the honorable Collector of Internal Revenue, wherein the same tax here involved was assessed against the former stockholders of said corporation, and he adopts the contentions there made as being applicable to the tax liability now claimed to exist on the part of said Slim Jim Oil & Gas Co., a defunct corporation.

The premises being considered, the undersigned respectfully submits that the aforesaid tax assessment be abated and canceled.

T. J. McDONALD.

EXHIBIT D

THE SLIM JIM OIL & GAS CO.,
Wichita, Kans., December 19, 1919.

Mr. J. L. DARNELL,
Natural Resources Subdivision, Income Tax Unit, Washington, D. C.

DEAR SIR: Please find inclosed amended individual income-tax returns for the year 1917 for the following stockholders of the Slim Jim Oil & Gas Co.:

	Tax		Tax
J. C. Titus	$20,477.07	T. B. Richardson	3,566.69
Renata Titus	19,358.53	E. C. Colvin	2,537.31
C. H. Taylor	21,134.98	A. M. Himmelwright	2,432.54
A. M. Taylor	19,358.53	J. H. Higley	517.80
T. J. McDonald	7,065.21		
A. H. Hill	12,044.70	Total	111,173.40
S. A. McDonald	2,680.04		

This list includes all of the stockholders except G. F. Bissantz, who is now in California, and a stockholder holding one share of stock which shows no tax. Mr. Bissantz's return shows a total tax of $817.31 and will be forwarded to you immediately upon receipt of his power of attorney for which the writer has wired.

Thanking you for the courtesies extended to me during my recent visit to Washington, and wishing you a very Merry Christmas, I am,

Sincerely yours,

J. C. TITUS.

EXHIBIT E

OKLAHOMA, OKLA., *June 11, 1921.*

INCOME TAX UNIT,
Head Field Audit Division, Washington, D. C.:

During the present week Internal Revenue Inspector B. C. Middleton was detailed to make an investigation of the income-tax liability of C. H. Taylor, Oklahoma City. The retained copies of his return in the possession of Mr. Taylor for the year 1917 disclosed that he had received approximately $600,000 dividends from the Slim Jim Oil Co. of Wichita, Kans. These dividends were largely liquidating dividends, but were not treated as such in his returns. A large portion of them were allocated to 1915 and 1916 earnings.

Mr. Taylor offers a severe protest against the opening of his case. He visited this office and states in substance as follows: That during the year 1918 after the Slim Jim properties were sold at a profit of approximately $2,500,000, he, with his representatives and other officers and stockholders of this company, visited the bureau on numerous occasions during the year 1918, and with a view to bringing about a final settlement of the tax liability of this company and the majority stockholders therein; that he obtained a hearing with Mr. Powell and Mr. Darnell, of the natural resources subdivision, and that in conference with the honorable commissioner, Daniel C. Roper, finally agreed that this company and its stockholders should pay a tax liability of approximately $600,000; that amended returns were then prepared and filed upon that basis, and that the amount of tax with a few thousand dollars additional was paid.

It is the opinion of this office that the dividends were largely liquidating and subject to the normal tax, and also that the act of the taxpayer in transferring about one-half of his stock in the Slim Jim Oil Co. to his wife during February, 1917, is a colorable transaction. It will be understood that one-half of his stock was transferred without consideration and that his wife filed a separate return in which was included one-half, or about one-half, of the approximate $600,000 dividends received.

With these facts before you I respectfully request to be advised as soon as possible if this case was actually closed, or if this office should proceed in the usual manner with its investigation of the tax liability of Mr. Taylor.

Respectfully,

G. C. HOLT,
Internal Revenue Agent in Charge.

EXHIBIT F

FEBRUARY 9, 1923.

In re: Slim Jim Oil & Gas Co.

DEPUTY COMMISSIONER CHATTERTON: Inquiry has been made as to whether or not certain transfers of stock of the Slim Jim Oil & Gas Co. by J. C. Titus and C. H. Taylor to their respective wives were bona fide gifts. It appears that in January, 1917, J. C. Titus and C. H. Taylor each gave to their respective wives 19 shares of the capital stock of the said company.

The revenue agent in his report takes the position that these gifts were not genuine for the reason that the shares of stock were not issued when the corporation was organized, or before large profits were contemplated. The evidence submitted by him, however, is insufficient, as a matter of law, to warrant such a conclusion. Therefore, in computing individual tax of J. C. Titus and C. H. Taylor for the year 1917 these gifts should be allowed and the amount of additional tax for which they may be liable should be redetermined and adjusted. The collector of internal revenue at Wichita, Kans., should be advised and certificates of overassessment issued.

Inasmuch as the taxes involved are for the year 1917 it is requested that this office be advised immediately of the correct additional taxes due from J. C. Titus and C. H. Taylor and the action taken by your office.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT G

EDWARD F. COLLADAY,
COUNSELLOR AT LAW,
Washington, D. C., February 15, 1923.

HON. DAVID H. BLAIR,
Commissioner of Internal Revenue,
Treasury Department, Washington, D. C.

DEAR SIR: In the matter of the claims of the United States for additional taxes against the Slim Jim Oil & Gas Co., a corporation of the State of Kansas, and against the stockholders thereof, we submit the following offer in compromise settlement of income and excess-profits taxes alleged to be due on the part of the corporation, and the following further sum in payment of income and excess-profits taxes alleged to be due on the part of the stockholders of said corporation in their individual capacities. This offer in compromise and in payment is in lieu of and pursuant to various conferences which have been had by us and certain of our clients with yourself and various other officials of the Bureau of Internal Revenue, and is submitted in substitution for that contained in letter addressed to the Commissioner of Internal Revenue under date of February 6, 1923.

Our clients will pay a total sum of $118,368.57 without interest in compromise settlement and full satisfaction of all claims for income and excess-profits taxes against the Slim Jim Oil & Gas Co. Our clients will further pay a total sum of $121,631.43 in full satisfaction of all claims for individual income and excess-profits taxes alleged to be due on the part of said former stockholders in their individual capacity for the years 1916 and 1917 without interest. The sums thus agreed to be paid involve an aggregate payment of $240,000, of which said clients are willing to pay $100,000 to the collector of internal revenue at Wichita on or before February 21, 1923, and the balance on or before June 30, 1923, or, in the alternative, and at their option, will pay the entire sum of $240,000 to said collector on or before February 28, 1923. In the event of deferring the payment of $140,000 as aforesaid our clients will secure the same to the satisfaction of the collector through a bank in Wichita.

In making this offer it is understood that you, the collector, Mr. Motter, and we all have in mind that the corporation has forfeited its charter under the laws of the State of Kansas and is, as we have stated to you, dissolved; and this offer is made for the purpose of settling and satisfying any and all tax claims of the United States for the calendar years 1916 and 1917 which ever have been, now, can, or might hereafter be assessed against said corporation, its directors, and stockholders, and the persons who were former directors and former stockholders of the corporation. Acceptance of this offer by the Treasury Department must, of course, be coextensive with these terms of offer.

In the event of the acceptance of this offer we shall expect to receive in behalf of our clients a letter or other formal statement setting forth the acceptance of the offer, and showing that it is full, complete, and final as to all matters set forth or referred to herein.

Very respectfully,

EDWARD E. GANN.
E. F. COLLADAY.

EXHIBIT H

DEPARTMENT OF JUSTICE,
OFFICE OF THE SOLICITOR OF INTERNAL REVENUE.
Washington, D. C., February 13, 1923.

To the COMMISSIONER OF INTERNAL REVENUE.

SIR: I have considered the proposition of an offer made on behalf of the Slim Jim Oil & Gas Co. and J. C. Titus,, C. H. Taylor, T. J. McDonald, S. A. McDonald, A. H. Hill, T. B. Richardson, E. C. Colvin, A. Himmelweight, C. F. Bissantz, J. H. Higley, and J. C. Titus, trustee for Titus Williamson, in settlement of their liabilities, as charged herein.

In view of the statement and recommendation contained in this brief, which are made a part hereof, and the papers on file herein, I am of the opinion and advise that it will be proper and for the best interests of the United States to accept the terms proposed, $240,000, in full settlement of all tax liabilities aris-

ing by virtue of income received for 1916 and 1917 by the above-named corporation and individuals. Inasmuch as the total taxes due from the said individuals amounts only to the sum of $121,631.43, it is recommended that the said sum of $240,000 be first applied to the full satisfaction of the tax liability of the individuals, and that the balance, to wit, the sum of $118,368.57, be accepted in compromise of the corporation's tax, which it is thought proper and for the best interests of the United States to accept, and particularly in view of the fact that the taxes from the corporation were adjusted and the case closed by a former commissioner.

Respectfully,

_____,
Solicitor.

EXHIBIT I

REOPENING OF CASES

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

To collectors of internal revenue and others concerned:

Where any case in the Bureau of Internal Revenue has been finally closed after the taxpayer, or other party thereto, has had a hearing or has been afforded by written notice an opportunity to present oral or written arguments or statements of fact in support of his contentions, the case will not be reopened except (1) where a showing is made of new and material facts, accompanied by an explanation, satisfactory to the Commissioner of Internal Revenue, of the failure to produce such facts prior to the closing of the case, or (2) where the case is materially affected by the change of regulations or by the final decision of another case either by the Commissioner of Internal Revenue or by a court of competent jurisdiction. The application for reopening a case should be addressed to the Commissioner of Internal Revenue, should state succinctly the facts and circumstances upon which the application is based, and must be supported by the affidavit of a person having knowledge of the facts.

This decision is not to be construed as modifying the regulations relating to the filing of claims in abatement or claims for refund, nor as denying the right of a taxpayer to a hearing or to an appeal at any state of his case until the case has been finally closed. After the taxpayer has exhausted his remedies within the bureau, however, and the case has been finally closed, it will be reopened only under the conditions stated in the decision.

D. H. BLAIR,
Commissioner of Internal Revenue.

Approved October 31, 1921.

A. W. MELLON,
Secretary of the Treasury.

AUGUST 14, 1923.

UNITED STATES DISTRICT COURT, COLORADO, PENROSE *v.* SKINNER, 298 FED. 335

"The subsequent action of Commissioner Roper in reopening the matter and compelling the plaintiff to pay the tax has little to do with the controversy here, as I think no one will contend that a succeeding commissioner could overrule or ignore the decision of his predecessor, unless such decision were in law erroneous or tainted with fraud."

EXHIBIT J

The following are the cases for which James L. Darnell holds power of attorney:

Taxpayer	Date of execution
Adair Oil Co	June 5, 1923.
Avery Oil & Gas Co	Mar. 24, 1924.
Brown, C. B., Anson, Tex	July 25, 1921.
Cumberland Petroleum Co., Cleveland, Ohio	May 31, 1922.
Denman Bros., Sedan, Kans	May 18, 1923.
Green, William, 120 Broadway, New York City, and Tampico, Mexico	Nov. 1, 1923.
Harvey Oil Co., Texas	June 17, 1922.
Sterling Oil & Gas Co., Cleveland, Ohio	July 7, 1922.
Uhrich Mill Work (Ltd.), Independence, Kans	Mar. 24, 1924.
Victor Gasoline Co., Tulsa, Okla	Jan. 14, 1922.
Walsh, Edward F., Bartlesville, Okla	Feb. 25, 1924.
Walsh Oil Co., Tulsa, Okla	Aug. 22, 1923.
Webster, C. I., Cleveland, Okla	Sept. 13, 1922.
Zabriskie, Sage, Gray & Todd	Feb. 21, 1924.
Harvey, R. O., lease account, Texas	June 17, 1922.
Indiana Creek Coal & Mining Co., Indianapolis, Ind	Sept. 9, 1922.
Itex Oil Co., Texas	June 17, 1922.
Kewanee Oil & Gas Co., 722 Bullitt Building, Philadelphia, Pa	May 31, 1922.
Knox Consolidated Coal Co	Sept. 9, 1922.
Knox County Fourth Vein Co	Do.
Lawrence Gas Co	May 11, 1923.
Little (S. W.) Coal Co	Sept. 9, 1922.
Lynde & Darby, Tulsa, Okla	June 17, 1922.
Markham, John H., jr., Exchange National Bank Building, Tulsa, Okla	Feb. 10, 1925.
Monarch Oil & Refining Co., Houston, Tex	June 17, 1922.
Pacific Coal & Oil Co	
Paggi Bros. Oil Co	May 27, 1922.
Perkins-Snider lease, Texas	June 17, 1922.
Presidio Mining Co., 815 Mills Building, San Francisco, Calif	Oct. 23, 1924.
Rescue Oil Co., Texas	May 25, 1923.
Ruyle Farm & Oil Co., Texas	June 17, 1922.
Selby Oil & Gas Co. and Selby-Cisler Co., Tulsa, Okla	Do.
Shaffer, C. B., 3314 Sheridan Road, Chicago, Ill	Feb. 26, 1924.
Shaffer, C. B. (partnership No. 2)	Do.
Shaffer Oil & Refining Co., 208 South LaSalle Street, Chicago, Ill	Jan. 15, 1924.
Snowden & McLelland	June 16, 1922.
Snowden & McSweeney, 598 Madison Avenue, New York City	May 11, 1923.
Standard Oil Co., 26 Broadway, New York City	Mar. 7, 1923.
Stoker, K., Breckenridge, Tex	June 17, 1922.
Superior Oil Co., Lexington, Ky	Oct. 10, 1922.
Tarver Oil Co., Dallas, Tex	June 17, 1922
Texas Co., Houston, Tex	June 9, 1922.
Texhoma Oil & Refining Co., Wichita Falls, Tex	Mar. 11, 1924.
Tullos, W. H	May 4, 1923.
Walker & Perkins, Texas	June 17, 1922.
White Plains Oil & Gas Co., Kentucky	May 11, 1923.
Wilson-Branch Co., Texas	Dec. 11, 1924.

The following are the cases for which C. F. Powell holds powers of attorney:

Taxpayer	Date of execution
Artesian Oil Co	Mar. 3, 1924.
Benson, Andrew and C. W. (Benson Oil & Gas Co.), Independence Kans	May 18, 1923.
Big Four Oil & Gas Co., Pittsburgh, Pa	Oct. 21, 1922.
Calumet Oil Co., Los Angeles, Calif	Mar. 23, 1923.
Carnahan Drilling Co	Jan. 23, 1923.
Celestine Oil Co., Tulsa, Okla	Mar. 11, 1924.
Central National Oil Co., Okmulgee, Okla	Feb. 17, 1922.

Taxpayer	Date of execution
Champlin, H. H., Enid, Okla	Aug. 19, 1924.
Champlin Refining Co., Enid, Okla	Oct. 5, 1923.
Champlin & Winkler (Inc.), Eastland, Tex	Sept. 19, 1924.
The Consolidated Gas, Oil & Manufacturing Co., Independence, Kans	May 18, 1923.
Continental Oil & Refining Co., Independence, Kans	Aug. 22, 1923.
Crosbie & Gillespie Gasoline Plant, Tulsa, Okla	Dec. 11, 1923.
Cudahy Oil Co., Cleveland, Ohio	June 7, 1922.
Deaner, J. J	Mar. 28, 1923.
Deaner, Mabelle L	Do.
Denman Bros., Denman, Arthur G., and Denman, John, jr	May 18, 1923.
Eggen, P. F., Sedan, Kans	Mar. 21, 1923.
Erb, Ray L., New York, N. Y	Nov. 30, 1923.
Ewing, P. W., Findlay, Ohio	Jan. 8, 1923.
Fitzgerald, Chestnut & Withington, Tulsa, Okla	Nov. 15, 1922.
Floyd, C. W., Sedan, Kans	Mar. 26, 1924.
Gillespie, F. A., Tulsa, Okla	Nov. 22, 1923.
Griffing, J. S., Tulsa, Okla	Nov. 12, 1923.
Griffin Producing Co., Tulsa, Okla	Oct. 17, 1923.
Hurley Gasoline Co., Tulsa, Okla	July 1, 1924.
Independent Oil & Gas Co	June 28, 1923.
Invincible Oil Corporation, Virginia	Jan. 2, 1924.
King, A. F., Findlay, Ohio	Jan. 8, 1924.
Liberty National Bank, Tulsa, Okla	Dec. 12, 1923.
Lucado Oil & Gas Co., Coffeyville, Kans	Feb. 13, 1924.
Lucado Oil & Gas Co., Independence, Kans	Feb. 12, 1924.
McMahon, C. L., Okmulgee, Okla	Feb. 6, 1922.
Mary Ann Oil Co., Independence, Kans	Aug. 21, 1923.
Morton, C. L. & Wm. P., Okmulgee, Okla	Feb. 4, 1922.
Morton, William P	Apr. 3, 1923.
Morton, W. W. & W. P., Okmulgee, Okla	Oct. 14, 1921.
National Refining Co., Cleveland, Ohio	July 7, 1922.
Northern Oil Co., Cleveland, Ohio	Do.
Pine, William B	Nov. 26, 1923.
Raycomo Oil & Gas Co., Orrick, Mo	Jan. 6, 1922.
Reamey, Brewster	June 2, 1924.
Replagle, D	Nov. 25, 1922.
Roby Coal Co., Cleveland, Ohio	Jan. 4, 1923.
Roby-Somers Coal Co., Cleveland, Ohio	Dec. 22, 1922.
Somers Coal Co., Cleveland, Ohio	Do.
South Western Oil & Gas Co., Pittsburgh, Pa	Dec. 31, 1923.
Spring Oil Co., Independence, Kans	Dec. 11, 1923.
Spurlock Petroleum Co., Cleveland, Ohio	July 7, 1922.
State Line Oil & Gas Co., Independence, Kans	May 18, 1923.

STATEMENT OF MR. GEORGE G. BOX, CHIEF AUDITOR FOR THE COMMITTEE

Mr. Box. This is the case of E. R. Bradley, Lexington, Ky.

Under date of July 17, 1924, Revenue Agent E. R. Burch, of the Louisville, Ky., district, submitted a report of his investigation of the income of this taxpayer for the years 1919 and 1920. Submitted with this report was a confidential letter of Revenue Agent in Charge J. H. McMurtry, in which he stated that the taxpayer and his brother were operating the Beach Club, a noted gambling house at Palm Beach, Fla.; that no examination of the income from this club had been made by the agent of the Louisville district and that he believed if the affairs of the partnership were investigated in Palm Beach that a considerable amount of income would be disclosed. A copy of the letter is submitted as Exhibit A.

Under date of November 14, 1924, the bureau requested the supervising internal revenue agent at Atlanta, Ga., to investigate the

income of the partnership in order to ascertain the income to be reported from this source by Mr. E. R. Bradley.

(This letter is made Exhibit B.)

As a result of the examination made at Louisville, on account of which the agent recommended the assessment of additional taxes of the following amounts—1919, $66,799.84; 1920, $87,768.64—the taxpayer filed a brief in which he protested against the findings, the question involved being whether or not the losses incurred by taxpayer on account of betting on horse racing in Kentucky, Louisiana, and other States are a proper deduction from the amount won by him in transaction of the same character, the contention of taxpayer being that in the States that legalize betting the losses were a proper deduction and in the States that do not allow betting, the winnings being illegal, were not income subject to income tax. A settlement of this case was referred to Messrs. S. Alexander and C. T. Hoffman. Under date of January 12, 1925, they submitted their report, in which they referred to the letter from the internal revenue agent in charge at the Louisville district recommending that the income of the partnership in Florida be examined, and called attention to the fact that no books were kept by the partnership, and stated, in conclusion, that in view of the circumstances an investigation in Florida would be of no advantage to the unit in closing the case, that the case should be closed on the basis of the information contained in the report from the Louisville division, and that the request for an investigation in Florida should be recalled. This letter is Exhibit C.

In accordance with the request of Messrs. Alexander and Hoffman, the bureau instructed the internal revenue agent in charge at Atlanta, Ga., to suspend the investigation of the partnership of the Bradley brothers, under date of February 9, 1925.

(This letter is made Exhibit D.)

In the meantime, however, an examination of the partnership had been made by Revenue Agent C. R. Spillane, which was forwarded to the bureau by the supervising revenue agent at Atlanta under date of February 12, 1925, recommending additional taxes on account of the receipts of the Beach Club in the following amounts:

1919	$52,290.58
1920	92,095.25
1921	70,818.19
Total	215,180.02

In this report the agent stated that the Beach Club is a most exclusive restaurant and café patronized by prominent and very well-to-do northerners, not for the purpose of dining, but to gamble, for this is their main feature and drawing card. He stated that no books nor records pertaining to the gambling operations were kept, as the taxpayer destroyed all memoranda early every morning when the gaming was over, and that he advised the taxpayer that unless he could produce some records the total deposits by him at the Farmers' Bank & Trust Co. at West Palm Beach would be considered his income, against which would be allowed any legitimate losses, and the tax computed on the difference.

A conference has been requested on the findings, which has not yet been granted on account of the absence of the taxpayer.

It is contended that the fact that the partnership had no records of its transactions at Palm Beach was not a satisfactory reason for the conclusion of Messrs. Alexander and Hoffman that no advantage would be derived from making an investigation of the partnership, and had their suggestion been followed a considerable amount of tax in this case would undoubtedly have been lost to the Government.

The CHAIRMAN. It is my understanding, then, that the recommendations were not followed, and the case has not yet been closed. Is that right?

Mr. BOX. The case is not closed. The recommendations suggested by Messrs. Alexander and Hoffman were not to be followed, but in the meantime they had been followed, and as a result of that this $215,000 was found by the revenue agent who made the examination in Florida. If the recommendation of Messrs. Alexander and Hoffman had been followed before the examination had been made down there this tax, whatever it is, which is found to be due after audit made in the bureau would not have been assessed.

Senator JONES of New Mexico. Has the case been closed now?

Mr. BOX. It has not been closed now. A conference has been requested. The contention of the taxpayer is as to the legality of this gambling income and whether the losses should be reported, and he has stated that he will carry it to the Supreme Court for a decision.

Mr. GREGG. From the point of view of the bureau, I do not see how any good can come from our looking into it. The only criticism I can gather is as to what might have happened if the recommendation of Messrs. Alexander and Hoffman had been followed, and since it was not, it makes no difference. I do not see that we are called upon to answer.

Mr. BOX. The bureau did request a withdrawal of that letter, which had formerly instructed the agent in Georgia to make an examination, but it was too late, as the agent had complied with the first request.

Mr. GREGG. As I understand it, the recommendation of Messrs. Alexander and Hoffman was that no field investigation be made, since the taxpayer kept no books. They thought there would be no use in making it, but it turned out that they were wrong. The investigation did disclose some information, but there is nothing in the record to show how they got it. There is no danger in this case of the Government losing any tax that is due, and I do not see——

The CHAIRMAN. Only this, and I would like to point this out to our young solicitor: One of the criticisms of the committee's investigators up to date has been as to the power that lies within the bureau and with its subordinate officials to determine great points of issue. In this particular case the recommendation of these two officials was adhered to, and the letter to conduct the investigation was withdrawn, but through expeditious work on the part of the agent they really got the information before the letter was withdrawn. I think that is the point.

Mr. GREGG. The committee is commending our Atlanta office and is criticizing the action of the bureau here.

Mr. BOX. I would like to make the observation, Mr. Chairman, that, in my experience with the bureau, the fact that a taxpayer

has no books or keeps no records is no reason whatever for not making an examination of his income.

The CHAIRMAN. I think it would be absurd to do otherwise.

Mr. BOX. And the fact that in this case no records were kept I think would be a reason, and more than a good reason, for making an examination.

Mr. GREGG. I will say that the bureau looks at it that way, too. There are plenty of cases in which they say no books of record are kept, and we take the gross bank deposits as net income and they sometimes find records that they had forgotten about.

Senator JONES of New Mexico. In what official position were these people who directed that no investigation should be made?

Mr. GREGG. Mr. Alexander was the head of the division in the unit at the time.

Senator JONES of New Mexico. What unit?

Mr. GREGG. In the Income Tax Unit.

Senator JONES of New Mexico. And who was Mr. Hoffman?

Mr. GREGG. I do not understand his connection with the case.

Mr. NASH. I think I might correct that, Mr. Gregg.

Mr. Alexander and Mr. Hoffman and Mr. Marrs were appointed as a committee last fall to go down into the personal audit division and clean up some old cases that had been pending there, and which nobody down there seemed to be able to get rid of. These were what they call "nut" cases. Hoffman and Marrs were attorneys from the solicitor's office and Alexander was a representative of the Income Tax Unit. I think this is one of the cases that committee handled.

Senator JONES of New Mexico. It would seem that their policy is not to crack nuts but to throw them into the furnace.

(Exhibits submitted by Mr. Box in case of E. R. Bradley are as follows:)

EXHIBIT A

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
Louisville, Ky., July 17, 1924.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.
(Attention Assistant Deputy Commissioner.)

Internal Revenue Agent E. R. Burch submits the following confidential report in the case of E. R. Bradley, Lexington, district of Kentucky:

"I have the honor to advise that I have made an examination and report covering the tax liability of the above-named individual for the years 1919 and 1920, which report is inclosed herewith.

"Reference to this report will indicate that no gain or loss in either year was returned by the taxpayer from the operation of the Beach Club, a noted gambling house at Palm Beach. This is operated by J. R. Bradley and E. R. Bradley, under the name of Bradley Bros., and is a partnership, so I was advised by Mr. Bradley.

"Mr. Bradley states in this connection that it is a felony to operate a game of chance in Florida and that the season for play covers a period of less than three months each year, during January, February, and March, and that it is only occasionally that the house makes a profit. He stated further that owing to the unfriendly attitude of State officials they were open for play for short periods only during the 1919 and 1920 seasons, and as practically all play is on credit or 'I O U,' the loss from 'welchers' was very heavy during those two seasons and the house actually wound up with heavy losses in those years.

"It is believed, however, that if the affairs of the partnership are investigated in Palm Beach that a considerable amount of taxable income will be disclosed. No books are kept by the partnership, Mr. Bradley very frankly stated, for the reason that, being under almost constant surveillance by the State officials, it was not considered wise to keep any records that might incriminate him or his brother.

"The sale of a cottage in 1920, as well as the sale of other real estate owned jointly by Bradley Bros., should be investigated at that end also.

"It should be stated here, however, in justice to this taxpayer, that during the course of the examination, he has been extremely frank and unreserved in all his statements, courteous in manner, and apparently anxious to do all in his power to aid in the proper verification of his returns. His records prior to 1921 are not in good shape, as he has never employed a regular bookkeeper, but in 1921 and subsequent years his office and farm manager, Mr. Barry Shannon, seems to have kept a good record of all transactions of Mr. Bradley covering business done outside of the corporation, known as the Idle Hour Stock Farm Co., and which keeps a good double-entry set of books."

Report covering the tax liability of this individual is being transmitted under even date herewith, covering the years 1919 and 1920.

J. H. McMURTRY,
Internal Revenue Agent in Charge.

EXHIBIT B

NOVEMBER 14, 1924.

SUPERVISING INTERNAL REVENUE AGENT,
Atlanta, Ga.:

This office has for audit a report from the internal revenue agent in charge at Louisville, Ky., covering an examination of the tax liability of E. R. Bradley, Lexington, Ky., for the years 1919 and 1920.

The revenue agent states in a confidential report that this taxpayer operated a gambling house at Palm Beach, Fla., and no income was reported from this source.

The following information is quoted from the confidential report:

"Reference to this report will indicate that no gain or loss in either year was returned by the taxpayer from the operation of the Beach Club, a noted gambling house at Palm Beach. This is operated by J. R. Bradley and E. R. Bradley, under the name of Bradley Bros., and is a partnership, so I was advised by Mr. Bradley."

The revenue agent further states that it is believed if the affairs of the partnership are investigated in Palm Beach that a considerable amount of taxable income will be disclosed.

It is requested that you have an investigation made of the above-named firm in order to ascertain the income to be reported from this source by E. R. Bradley, Lexington, Ky.

Due to the fact that the year 1919 is involved, it is respectfully requested that the examination be expedited.

J. G. BRIGHT,
Deputy Commissioner.

EXHIBIT C

JANUARY 12, 1925.

In re: E. R. Bradley, Lexington, Ky.

Deputy Commissioner BRIGHT,
Income Tax Unit.
(Attention Mr. Lewis, head personal audit division, for section 3.)

An investigation in this case has been requested in the Atlanta division on the basis of a statement made in a confidential letter from the internal revenue agent in charge at Louisville, Ky., which reads as follows:

"It is believed, however, that if the affairs of the partnership are investigated in Palm Beach that a considerable amount of taxable income will be disclosed. No books are kept by the partnership, Mr. Bradley very frankly stated, for the reason that, being under almost constant surveillance by the

State officials, it was not considered wise to keep any records that might incriminate him or his brother.

"The sale of a cottage in 1920, as well as the sale of other real estate owned jointly by Bradley Bros., should be investigated at that end, too.

"It should be stated here, however, in justice to this taxpayer, that during the course of the examination he has been extremely frank and unreserved in all his statements, courteous in manner, and apparently anxious to do all in his power to aid in the proper verification of his returns. His records prior to 1921 are not in good shape, as he has never employed a regular bookkeeper, but in 1921 and subsequent years his office and farm manager, Mr. Barry Shannon, seems to have kept a good record of all transactions of Mr. Bradley covering business done outside of the corporation, known as the Idle Hour Stock Farm Co., and which keeps a good double-entry set of books."

With reference to the above statement, attention is called to the fact that no books were kept by the partnership.

In view of the circumstances, it is concluded that an investigation in Florida would be of no advantage to the unit in closing the case.

The case should be closed on the basis of the information contained in the report from the Louisville division.

The request for an investigation in Florida should be recalled.

By direction of the commissioner.

S. ALEXANDER.
C. T. HOFFMAN.

EXHIBIT D

TREASURY DEPARTMENT,
INTERNAL REVENUE SERVICE,
February 9, 1925.

SUPERVISING INTERNAL REVENUE AGENT,
Atlanta, Ga.:

Reference is made to bureau letter of November 14, 1924, in which you were requested to have an investigation made of the firm of Bradley Bros., Palm Beach, Fla., in order to ascertain the income to be reported from this source by E. R. Bradley, Lexington, Ky., for 1919 and 1920.

A reexamination of the case has been made by this office. In view of the attending circumstances, it is concluded that the case of E. R. Bradley should be closed on the basis of the information contained in the report from the Louisville division.

You are therefore requested to suspend the examination of the partnership of Bradley Bros., Palm Beach, Fla.

J. G. BRIGHT, *Deputy Commissioner.*

The CHAIRMAN. You may proceed with your next case, Mr. Box.

Mr. BOX. This is the case of the American Blower Co., of Detroit, Mich.

This taxpayer was organized under the laws of the State of New York in January, 1909, for the purpose of taking over the American Blower Co. of Michigan and the Sirocco Engineering Co., continuing the business of said corporations, which consisted of the manufacture and installation of blowers, ventilating, and heating systems.

On September 26, 1921, Revenue Agent Leslie H. Rushbrook made a report of his examination of the books and the records of this taxpayer, followed on September 23, 1921, by a supplemental report recommending additional taxes, as follows:

1917	$53,605.67
1918	267,332.09
1919 (overassessment)	8,901.22
1920	39,719.16

The one item which the agent objected to and on which a penalty for fraud was subsequently assessed in this matter was the manner of treating inventory by the taxpayer. He states that he asked Mr.

Williamson, the auditor, and Mr. Brown, head of the cost department, how the inventories were taken and priced, and both advised him that the inventories were not taken at either "cost" or "cost or market, whichever is lower," as required by the regulations, except that part of the inventory which consisted of sheet steel, which was very small. He states further:

A word of explanation was necessary as the inventory is not taken according to law; said inventory is taken on cards, the exact manner I was unable to determine, as both of the above-named men said the quantities never differed from those shown on the books. These cards are then sent to Mr. Brown, head of the cost department, who prices them in the case of raw sheet steel, as above stated, but only the one price is shown, that is the lowest; cards covering all other material are then priced, but not on either cost or market; but Mr. Brown said a conference was held and if it was decided to depreciate the inventory 20 per cent, that amount was accordingly deducted from the last invoice price, and the material priced accordingly. It is readily apparent that if the last invoice was a recent one, the inventory would be far below both cost and market, and would not represent the correct status of the business; also said method is clearly in violation of the income tax law and consequently said inventories are invalid in determining the taxable income for any period. * * *

The total of the raw material per books before adjustment was $508,160.04, which was reduced by $102,080.61, or approximately 20 per cent. As the inventory is not in existence—

That is, the inventory sheets—

and as there was not such a drop in price in December, 1918, it would be allowable to take the book figures as I believe it is the rule that the book figures are taken to represent the facts until proven otherwise, but after due consideration and conference with Agents Ball and Thurston, office auditors, it was decided that a 10 per cent deduction would give the taxpayer the benefit of any doubt. * * *

As will be recalled, I previously stated the above figures were per books, but the company went this one better and took an additional $78,301.84 from their inventory, reducing the surplus a like amount, claiming this was an additional 10 per cent on raw material, but it actually figured 19 per cent on their raw material. This deduction is not on their books and was taken only to understate the income on their 1918 tax return. However, Ernst & Ernst in preparation of their amortization claim and amended returns for 1918 passed this through their surplus account in and out as of November 30, 1920, telling the company that it would have to be on their books in order to get it by the department, but said firm of accountants made no effort to correctly state the 1918 income, though they knew said inventory was contrary to the law. * * *

I advised Mr. Williamson that approximated price which he said they used in all years was not in accordance with the law, and he explained that the original deduction of 20 per cent on raw material shown on the books in 1918 was to reduce to approximate the January, 1919, market, and the additional $78,301.84 taken but not on the books was to approximate the decline in market after January 31, up to the time they filed their return. When advised this was not in accordance with the law, he said they would take another physical inventory as of December 31, 1918, and price same according to the law. I asked him how they could take a physical inventory three years late after the material was used up and no longer in existence, and he replied from the books, for the quantities on our physical inventories never vary from the book quantities, said inventories being in reality adjustment in costing only.

As a result of this report of the revenue agent, an A–2 letter was mailed, to which a protest was filed by the taxpayer, and as a result, on March 25, 1922, after the case had been appealed to the solicitor, he handed down a decision in which he stated that "the reports indicate a taxable net income for the year 1918 of apparently double that which was reported by the taxpayer. This increase in net income is due to a considerable amount of allowances and adjustments, particularly set forth in the supplemental and confidential reports of

the agent, which will be herein detailed in so far as the more flagrant items are concerned. The taxpayer in closing its books took an arbitrary reduction of 20 per cent of the amount of the raw material in its inventory, aggregating approximately $102,080.61, and for the purpose of computing its taxable income this inventory was further reduced by the amount of $78,301.84. The agent calls attention to the fact that this entry does not appear on the books for the year in question."

In conclusion the solicitor states that "the details above noted and fully set forth in the revenue agent's reports clearly make out a prima facie case of fraud, and in the absence of evidence submitted by the taxpayer there is no alternative for this office other than to recommend the assessment of the fraud penalties for the taxable years 1918, 1919, and 1920."

The case was again submitted to the solicitor who on November 17, 1922, rendered a decision to Deputy Commissioner Batson concluding with the following statement:

> This office does not recede from or modify its former opinion of March 25, 1922. The file is returned to you with copies of the three briefs herein referred to. Criminal prosecution is not deemed practical and the case is considered closed in this office.

On February 23, 1923, the taxpayer filed an appeal in which exceptions were taken to the proposed assessment of additional tax by the bureau.

On October 17, 1923, the solicitor, after a hearing given to the representatives of the taxpayer, rendered another decision in which he stated that "As to the 1918 inventory, taxpayer excepts to the item 'understatement of closing inventory $249,115.15.'"

The opinion of the solicitor is Exhibit A.

It appears from the record that the book inventory of December 31, 1918, of raw materials, stock in process, finished parts and produce, and supplies was $1,356,717.88. This closing inventory was reduced by the corporation by what is now claimed was a physical inventory, to $1,035,248.88. Thereafter the president of the corporation arbitrarily further reduced this closing inventory by $78,301.84. The taxpayer now admits that the $78,301.84 reduction on the 1918 inventory was improper, but it is contended that the book inventory of $1,356,717.88 was not a true inventory and that a physical inventory was taken which amounted to $1,035,248.88, which amount it is not contended by the corporation should be accepted by the Government in determining the net income of the corporation for the year 1918.

> The alleged physical inventory for 1918 has never been produced by taxpayer. It is contended that when the company moved its offices the 1918 inventory slips had become so confused and damaged that they were ordered destroyed, and only the totals of the prices which it is claimed appeared on the original inventory slips are now submitted, with nothing to show the material upon which these prices were based. * * *
>
> It is further the opinion of this office, under all the evidence, that the inventory for 1918, as represented by the book values, more truly reflects the situation and should be used in computing income for 1918. * * *
>
> It appears that the acts of the officers of the corporation in 1920 indicating fraud were attempts to cover up and justify the fraud committed in 1918 and did not relate directly to the 1920 return. The evidence showing the fraudulent nature of the 1918 return consists of a series of acts by the officers of the corporation clearly showing an attempt to defeat taxes. * * *

Although the reduced closing inventory for 1918 was used in the return for that year, the same reduced inventory was not used as an opening inventory for 1919, the $78,301.84 reduction not being taken into consideration in the 1919 opening inventory.

It appears that in 1920 when taxpayer was confronted with this situation, in order to cover up an attempt to justify the acts of the officers relating to the year 1918, a meaningless entry was made on the books debiting and crediting surplus with the amount of $78,301.84.

In conclusion the solicitor states that "assessment should therefore be made of the ad valorem fraud penalty for 1918, using the true book inventory instead of the alleged physical inventory for 1918, and using the physical inventory for 1920 and eliminating the fraud penalty for the year 1920."

On November 24, 1923, Assistant Secretary of Commerce J. Walter Drake addressed a letter to the Commissioner of Internal Revenue in which he states that his friend, James Inglis, president of the American Blower Co., of Detroit, has a tax matter up in the department in which he is greatly interested; that Mr. Inglis has given him some of the details, and that he has a good understanding of the case as covered in a letter from the Internal Revenue Bureau dated November 20, 1923. He states that "to my mind it is impossible that any tax return filed by Mr. Inglis or his company could be fraudulent in so far as he is concerned. I have known Mr. Inglis for many years and at one time was associated with him in business. He is one of the outstanding figures in the business community in Detroit, and without qualification I can say that I do not know of any business man whose reputation for absolute integrity is higher or more widespread, certainly not among the business men of Michigan. If the penalty imposed upon his company is the result of any charge or implication that he has a fraudulent intent or any knowledge of a dishonest return, I feel that by all means there should be a thorough investigation of his claim by some prominent official of your department who would take into consideration the statements I have just made, and which can be materially substantiated without the least difficulty by inquiry as to the standing of Mr. Inglis and the reputation of his company." The following lead-pencil notation appears on this letter, "Secretary Denby phoned November 27."

This letter is Exhibit B.

Senator WATSON. Who wrote that letter?

Mr. BOX. Assistant Secretary of Commerce Mr. J. Walter Drake.

Senator WATSON. And he wrote it to the Commissioner of Internal Revenue?

Mr. BOX. He wrote it to the Commissioner of Internal Revenue.

Senator WATSON. What was the date of that letter?

Mr. BOX. November 24, 1923.

Under date of December 17, 1923, Mr. B. H. Littleton, who considered the case in the solicitor's office, wrote a memorandum for the file covering the action taken by the bureau in this matter. He states that on December 4 the commissioner granted the representatives of the taxpayer a hearing, as he desired to hear what they had to say concerning fraud, and directed the unit to withhold the assessment until after the hearing.

The memorandum referred to is made a part of this case as Exhibit C.

The argument made at hearing was substantially the same as made before the solicitor's office, excepting that the taxpayer, with greater stress, laid the blame for the fraudulent features of the 1918 return upon Mr. Williamson, former bookkeeper, and upon the fact that Mr. Williamson had embezzled the sum of $68,000 from the corporation. Mr. Inglis took personal responsibility for the cut of over $78,000 in the closing inventory for 1918——

Senator WATSON. Mr. who?

Mr. BOX. Mr. Inglis, the president of this taxpayer, the American Blower Co.

Senator WATSON. Yes.

Mr. BOX. Although he tries to lay the blame for this fraudulent return on his bookkeeper, who, he states, had embezzled some money, he takes the blame for making this cut in the inventory which caused the decreased income and which was the fraudulent act. He states:

* * * the failure to make proper entries on the books and the failure of the 1919 return to show an opening inventory or a balance sheet, and also the failure of the taxpayer to make an amended return after it was discovered, and after advice had been given the taxpayer by its accountants that the seventy-eight thousand cut in the inventory was not justified, and that correct entries had not been made on the books.

The memorandum states that the commissioner said that "the case was a very ugly one and it was not entirely clear that taxpayer had not attempted to defeat taxes in 1918 by the methods used, and that while perhaps the book inventory did not represent the true value of the materials on hand at the close of 1918, yet the physical inventory, according to the information in possession of the Government, was apparently much less than the value that should have been returned; that the fact that the principal evidence upon which the Government would rely as to fraud was contained in statements made by Mr. Williamson, the bookkeeper, the Government would be in a rather embarrassing situation if called into court to sustain the fraud by his testimony, in view of his admitted embezzlement."

The CHAIRMAN. Who admitted the embezzlement?

Senator ERNST. "Of his admitted embezzlement."

Mr. BOX. "Of his admitted embezzlement."

The CHAIRMAN. Whom do they mean when they say it was admitted?

Mr. BOX. Williamson, the bookkeeper.

The CHAIRMAN. He admitted the embezzlement, did he?

Mr. BOX. The records do not show that he admitted. The records show that he embezzled, and he offered to testify before the solicitor. Then later when he was called on his wife telegraphed that he was ill and could not come; so there was really nothing in the record to show that he admitted that he was an embezzler.

Mr. Littleton further stated that "prior to the conference of the 15th Mr. Miller stated to me"—Mr. Miller was the representative of this taxpayer before the department—"that if the commissioner should conclude that the fraud penalty should not be assessed for 1918 the taxpayer would be willing to increase his inventory as used in the return for 1918 by some sixty thousand dollars in addition to the seventy-eight thousand, involuntarily paying taxes thereon."

This information was conveyed to the commissioner, who instructed Mr. Littleton to state to the taxpayer's representatives "that before he reached a final decision relative to the inventory and the fraud penalty, if the taxpayer desired to submit a proposition to determine the net income for 1918 by decreasing the book inventory and increasing the physical inventory by a like amount, computing the additional tax thereon and agreeing to voluntarily pay the taxes with 6 per cent from 1919, when the tax became due, at the time the report was made he would give such proposition consideration, and that if they did not desire to dispose of the case in this way that he would render his decision."

On January 11, 1924, Mr. Littleton prepared another memorandum in which he states that another conference was given the taxpayer by the commissioner on January 10, at which "Mr. Inglis stated to the commissioner that they had computed the tax for the years 1917 to 1920, inclusive, on the basis of increasing the alleged physical inventory and decreasing the book inventory half and half, or until the two inventories met." The additional tax for 1918 computed on that basis amounts to $232,509.13 and the net additional tax for the years 1917 to 1920, inclusive, less the overpayment for 1919, amounts to $240,824.45, without interest or penalties. Mr. Inglis stated to the commissioner that he had a certified check for $240,824.45 and wanted to submit that in full satisfaction of all liability and in full settlement of the case.

(The memorandum of Mr. Littleton is Exhibit D.)

Mr. Inglis was advised by the commissioner that as a result of the hearing granted this taxpayer heretofore and by reason of the statement that the taxpayer desired to make an adjustment of the latter matter, it had been stated to them that he would consider, without binding himself as to what his final decision might be, a proposition from them to pay the additional taxes on the basis above mentioned, which was found to be $240,824.45, and in lieu of penalties for the year 1918 to pay interest on $232,509.13 at 6 per cent from March 15, 1919, the date the tax became due, up to and including December 31, 1923. He was advised that the offer to pay the tax would not be considered as in full settlement of the case. The interest at 6 per cent, computed as above mentioned, would have been $66,846.44. The memorandum states further that after Mr. Inglis left the room the commissioner stated that "he thought perhaps he would be justified in considering the proposition from the taxpayer to pay the tax of $240,824.45 and 5 per cent interest from March 15, 1919, to December 31, 1923."

Mr. Inglis was advised of the commissioner's opinion, and on February 4, 1924, the taxpayer tendered to the collector of internal revenue at Detroit, Mich., Form 656 (offer in compromise), with check for $296,562.05 in settlement of all additional taxes, penalties, and interest for the years from 1917 to 1920, inclusive. This check covered taxes and interest as follows:

	Additional taxes
1917	$9,544.35
1918	232,569.13
1920	17,835.20
Total	259,888.68
1919 (overassessment)	19,064.23
Net additional taxes	240,824.45
Interest on the 1918 additional tax, $232,569.13, from Mar. 15, 1919, to Dec. 1, 1923, at 5 per cent	55,737.60
Total	296,562.05

Under date of March 12, 1924, the Solicitor of Internal Revenue recommended that the check for $296,562.05 be accepted in payment of the additional taxes for 1917, 1918, and 1920, less an overpayment for 1919, and compromise of the ad valorem fraud penalties for 1918.

Had the net income for 1918 been computed by using the book value of the inventory the additional tax would have been $267,332.09. Instead of using the book value the inventory was estimated at the average of the book value and the value placed upon it by the taxpayer, which latter figures could not be substantiated.

The bureau could have demanded for additional taxes for 1918, penalty and interest thereon, the following amount:

Additional taxes	$267,332.09
Fraud penalty, 50 per cent	133,666.04
Interest on additional taxes at 6 per cent from Mar. 15, 1919, to Dec. 31, 1923	74,807.28
Total	475,805.41
Additional taxes and interest at 5 per cent paid for year 1918	288,246.73
Amount waived	187,558.68

The amount which the Government waived by allowing interest at 5 per cent instead of 6 per cent, regardless of the fact that no fraud penalty was assessed, was $11,147.52.

In Mr. Littleton's memorandum, dated December 17, 1923 (Exhibit C), reference is made to a hearing in the commissioner's office on December 4, at which he stated that the taxpayer "with greater stress laid the blame for the fraudulent features of the 1918 return upon Mr. Williamson, former bookkeeper, and upon the fact that Mr. Williamson had embezzled some $68,000 from the corporation." It is plainly evident that this statement was a mere camouflage and the taxpayer was endeavoring to mitigate the fraud of its president, who admitted at the hearing his personal responsibility for arbitrarily reducing the inventory $78,000 after his instructions to have it priced at values lower than either the cost or market, as required by the regulations, and failing to make amended returns to correct error after his accountants had advised him that his former procedure in handling the inventory was incorrect and not justified.

His intent in this matter is clearly shown by his attempt to reduce his 1919 income by using an inventory as of January 1, 1919, over $78,000 greater than the closing inventory for the year 1918, used in his return for that year.

That concludes the presentation of that case.

Mr. GREGG. May I bring out just a couple of points there, Mr. Chairman.

In your computation of the amount of the tax which could have been collected, you used, of course, the book inventory?

Mr. BOX. The book inventory is used; yes.

Mr. GREGG. The taxpayer contended for what he claims to be a physical inventory, which he was unable to substantiate in detail?

Mr. BOX. Yes.

Mr. GREGG. And the commissioner, in his settlement, split the difference, not knowing which was right?

Mr. BOX. Yes.

Mr. GREGG. Then, on the basis of the tax shown by splitting the difference with reference to the inventory, he collected interest at 5 per cent, and the settlement was made on that basis?

Mr. BOX. The additional tax was assessed on the average between the book inventory and the physical inventory, and the tax at 5 per cent was computed and collected.

Mr. GREGG. And you criticize the use of the 5 per cent interest rate; in your computation of the amount of the tax which might have been collected, you compute interest on the entire amount at 6 per cent, when, as a matter of fact, in 1918 we had no authority for assessing any interest.

Mr. BOX. That is very true, but the interest on the additional tax was substituted for the fraud. They assessed and collected the 5 per cent fraud penalty and that tax.

Mr. GREGG. Yes; but in your computation you put in both the fraud penalty and 6 per cent. You have here 6 per cent interest, $74,000. We had no authority to assess that. There was no interest running for the year 1918; the statute made no provision for it; so the commissioner, when he used the interest rate of 5 per cent, really got $55,000 more than we were entitled to, which, if you apply that more or less as a penalty for the fraud, seems to me to give a very fair settlement.

Mr. BOX. He did consider 6 per cent first, and afterwards reduced it to 5 per cent.

Mr. GREGG. That is true, but we could not demand either as interest.

Mr. BOX. Could you not have demanded the fraud penalty?

Mr. GREGG. Of course, that was the question.

The CHAIRMAN. As I understand, Mr. Gregg, then you collected an illegal interest charge?

Mr. GREGG. No; that is what I was going to say. He determined the tax to be so much, and then split the difference on this debatable item. Then he took as a compromise of the fraud penalty 5 per cent interest. That was in compromise of the fraud penalty. I want to bring out the fact that we were not entitled to charge any interest. The statute provides for that, and the report made to the committee in using the interest is wrong to that extent.

Senator WATSON. Is your criticism of this case the fact that the man was not prosecuted criminally.

Mr. BOX. No; my criticism is that the book inventory was not used, and that the fraud penalty was placed at such a small amount.

The CHAIRMAN. I think also you intended to imply some criticism to the effect that there was influence used through communications from other departments of the Government.

Mr. BOX. Yes.

Mr. GREGG. However, the final settlement of the case was that we collected the tax which we determined or thought was correct in our judgment, and we got $55,000 because of the alleged fraud.

The CHAIRMAN. I do not dispute that you collected what you perhaps thought was the correct amount of the tax, but I think it can well be pointed out that you assumed an inventory which was not in evidence and reduced the book value to a point which was not justified by the books either in 1918 or at the beginning of the tax in 1919, where the old book inventory was carried over.

Mr. GREGG. It was not carried on the books. Of course, we do not use book inventory figures, necessarily.

The CHAIRMAN. But you had no other basis for any figures in this case.

Mr. GREGG. The statement was that the physical inventory would have shown less than the book inventory, and we split the difference between the physical inventory and the book inventory.

The CHAIRMAN. Then, when any taxpayer says that his physical inventory is less than the book value, you assume that that is correct?

Mr. GREGG. I do not think a general statement of that sort could be made.

The CHAIRMAN. But it was done in this case.

Mr. GREGG. This is one of the peculiar cases that we get so often, where the evidence is not entirely satisfactory, and we make the best settlement we can.

(Exhibits submitted by Mr. Box in the American Blower Co. case are as follows:)

EXHIBIT A

OCTOBER 17, 1923.

In re: American Blower Co.

Deputy Commissioner BRIGHT
(For Special Adjustment Section).

Reference is made to your memorandum of March 7, 1923, IT:SA:AJ:OJT-1928, transmitting the entire file in the case of the above-named taxpayer for the years 1917 to 1920, inclusive, together with appeal from the proposed assessment of additional taxes for the years 1917 to 1920, inclusive, and the ad valorem fraud penalties for the years 1918 and 1920 as outlined in registered letter of January 24, 1923. Upon the receipt of the A-2 letter dispatched August 23, 1922, this taxpayer protested the proposed assessment and an oral hearing was granted the taxpayer, which was held in this office on October 20, 1922, at which the president, vice president, and comptroller of the corporation and its attorneys and two accountants were present, and at which hearing your unit was represented. At this hearing taxpayer's representatives submitted and argued numerous exceptions in all of the years, including exceptions to the item "Understatement of closing inventory, $249,115.15," in 1918. On November 17, 1922, this office forwarded the entire file to your unit, with memorandum recommending some adjustments in taxable items, and standing by the original recommendation of fraud penalties in memorandum of March 25, 1922, which adjustments were reflected in the registered letter of January 24, 1923. On February 23, 1923, taxpayer filed its appeal, in which appeal the following exceptions were taken to the proposed assessment:

1. Inventories: The bureau has unjustifiably altered the inventory values as determined and reported by the taxpayer, and has adopted inventory values which are not on the basis of "cost or market whichever is lower," to which basis the taxpayer is entitled.

2. Wear and tear: The bureau has allowed the same rates of wear and tear depreciation in the taxable years involved as for years involving normal

conditions, and has allowed no additional depreciation because of overtime and because of conditions existing during these years involving unusual wear and tear, whereas the actual wear and tear was much greater than normal.

3. Depreciation of patents: The bureau has failed to allow to the taxpayer adequate deductions for the taxable years as to patents owned.

4. Expense items: The bureau appears to have erroneously capitalized certain expense items.

5. Penalties: The bureau has imposed certain penalties, which penalties should not have been imposed, and are not in accordance with law.

On October 2, 1923, taxpayer, pursuant to request made, was granted an oral hearing on the appeal in this office, at which hearing James Inglis, president; W. G. F. Miller, vice president and treasurer; W. E. Motler, former purchasing agent; C. E. Orton, former manager of the cost department; E. M. Brown, former assistant manager of the cost department; Robert N. Miller, O. H. Chemillon, J. D. Watkins, attorneys; E. S. Wellmer, agent; and O. E. Bonder and George D. Bailey, accountants, appeared, and at which hearing Mr. Regis of your unit was present.

At the opening of the hearing Mr. R. N. Miller, attorney for the taxpayer, stated that only two exceptions to the registered letter would be discussed, namely, 1918 and 1920 inventory adjustments and assessment of fraud penalties. It was specifically stated that taxpayer conceded all items contained in the registered letter except those above-mentioned and that other exceptions set out in the appeal would not be urged. This, therefore, leaves exceptions 1 and 5 relating to the 1918 and 1920 inventory adjustments and assessment of grand penalties for the years 1918 and 1920 for decision.

The arguments made, and oral testimony, the briefs and supporting data filed by the taxpayer and its attorneys, and the reports and other evidence submitted by the field agents have been given careful consideration and the following conclusions are reached:

As to the 1918 inventory, taxpayer excepts to the item "Understatement of closing inventory $249,115.15." It appears from the record that the books inventory at December 31, 1918, of raw materials, stock in process, finished parts and apparatus, and supplies was $1,356,717.88. This closing inventory was reduced by the corporation by what is now claimed was a physical inventory to $1,035,248.88. Thereafter the president of the corporation arbitrarily further reduced this closing inventory by $78,301.84. The taxpayer now admits that the $78,301.84 reduction of the 1918 inventory was improper, but it is contended that the book inventory of $1,356,717.88 was not a true inventory and that a physical inventory was taken which amounted to $1,035,248.88, which amount it is now contended by the corporation should be accepted by the Government in determining the net income of the corporation for the year 1918. The alleged physical inventory for 1918 has never been produced by taxpayer.

It is contended that when the company moved its offices the 1918 inventory slips had become so confused and damaged that they were ordered destroyed and only the total of the prices which it is claimed appeared on the original inventory slips are now submitted with nothing to show the material upon which these prices were based. It is claimed that the stock in process was inventoried at an average cost over the year 1918 and the raw materials at market. The matter of the inventories was one of the exceptions taken at the first hearing, and prior to the hearing held on October 2, 1923, this office made an independent investigation relative to the 1918 inventory, securing affidavits from the former auditor, manager of the purchasing department, manager and assistant manager of the cost department, who were employed by this taxpayer up to 1919, these men being Thomas H. Williamson, former auditor; W. H. Metler, former manager of the purchasing department, who inventoried and priced the raw materials; E. M. Brown, former assistant manager of the cost department, who inventoried and priced the stock in process; and C. E. Orton, former manager of the cost department, who supervised the taking of the 1919 inventory. The former auditor, Thomas H. Williamson, made affidavit that the book inventory was used in closing the books for 1918; that thereafter about the middle of January, 1919, the president and vice president of the corporation at a conference with the men above mentioned, designated two of the number to check over and reprice the inventory and use all possible means to reduce the same; that as a result of the check and repricing the inventory was reduced from $1,356,717.88 to $1,035,248.88; that later, after the books had been audited and certified to, the president, James Inglis, instructed him to further reduce the inventory by $78,301.84.

The former auditor further testified that the reductions of the inventory were for the purpose of defeating taxes.

In affidavit secured from C. E. Orton on June 5, 1923, he states that he and the auditor and the purchasing agent were called together by the president and vice president and the matter of inventory discussed; that at the meeting the matter of decline in prices was discussed and that letters from vendors were read indicating that prices were to be less than they had been in the past; that it was decided that the prices would be less than the prices prevailing during the latter part of 1918; that the reduction in inventory was made partly to average up the cost of the material over the year 1918, since much of the material was purchased during the early part of the years at prices less than prevailed during the latter part of the year, and partly to allow for the contemplated decline in the market; that it was considered that this would bring the prices to a basis of what they considered would be a fair cost at that time.

W. E. Metler, former purchasing agent, states in his affidavit that to the best of his memory he arrived at the inventory prices on raw materials based on what he thought this material would be worth on the open market, taking into consideration the fact that it would not be worth the market value at that time on account of special sizes and designs.

This evidence, taken into consideration in connection with the revenue agent's confidential report and the absence of the physical inventory, and in connection with the further apparent fact that, due to Government control, prices of materials declined in the latter part of 1917, and in 1918, due to the armistice, material and labor were relatively cheap, which last-mentioned fact would have a tendency on an average cost basis to make the physical inventory greater than the book inventory, leads this office to believe that the alleged total of the physical inventory is not a fair valuation for 1918. It is further the opinion of this office under all the evidence that the inventory for 1918, as represented by the book values, more truly reflects the situation and should be used in computing income for 1918. Your attention is invited to the affidavits of the former purchasing agent and cost manager to the effect that the American Blower Co. was on a 100 per cent war basis. At the time of the investigation the agent was informed that the corporation was on a 30 per cent war basis.

As to the contention of taxpayer that the physical inventory for 1920 should be used, it appears from examination of the actual physical inventory and comparison of prices used that the amount shown by the physical inventory is representative of the values of the materials and stock in process, and it is the opinion of this office that the physical inventory for 1920 should be used in computing the tax for that year.

As to the assessment of ad valorem fraud penalties, this office is of the opinion that the return for the year 1918 was willfully false, with intent to defeat taxes, and that the fraud penalty for that year should be assessed, but as to the year 1920 the evidence of willful intent is not sufficiently strong to warrant the assessment of penalty for filing false and fraudulent return.

It appears that the acts of the officers of the corporation in 1920 indicating fraud were attempts to cover up and justify the fraud committed in 1918 and did not relate directly to the 1920 return. The evidence showing the fraudulent nature of the 1918 return consists of a series of acts by the officers of the corporation, clearly showing an attempt to defeat taxes. Comment has already been made concerning the manner in which the inventory for 1918 was taken and reduced approximately $102,084.61, in accordance with instructions of the president for the purpose of reducing the taxes, and thereafter arbitrarily cut $78,301.84 after the books had been closed and certified to. Although the reduced closing inventory for 1918 was used in the return for that year, the same reduced inventory was not used as an opening inventory for 1919, the $78,304.84 reduction not being taken into consideration in the 1919 opening inventory. It appears that in 1920, when taxpayer was confronted with this situation, in order to cover and attempt to justify the acts of the officers relating to the year 1918, a meaningless entry was made on the books debiting and crediting surplus with the amount of $78,301.84. In addition of this, as stated in former memorandum, depreciation of $25,979.98 in excess of the amount charged on the books was taken on the 1918 return, and an additional allowance for bad debts in 1918 for $25,000 was also taken in the return, but this was not shown on the books.

Assessment should therefore be made of the ad valorem fraud penalty for 1918, using the true book inventory instead of the alleged physical inventory for 1918 and using the physical inventory for 1920, and eliminating fraud penalty for the year 1920. The administrative file is herewith returned.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

EXHIBIT B

DEPARTMENT OF COMMERCE,
OFFICE OF ASSISTANT SECRETARY,
Washington, November 24, 1923.

Hon. D. H. BLAIR,
Commissioner of Internal Revenue,
Treasury Department, Washington, D. C.

MY DEAR MR. BLAIR: My friend James Inglis, president of the American Blower Co. of Detroit, has a tax matter up in your department in which I am greatly interested.

Mr. Inglis has given me some of the details, and I have a good understanding of his case as covered in a letter from your office over the signature of Mr. Bright, dated November 20 last.

While I can not express opinion as to the correctness of the amount of tax assessed without penalty, I am assured by Mr. Inglis that the amount is grossly excessive. I am, however, qualified to give you an opinion upon the question of fraudulent return which has caused the imposition of an extremely large penalty. To my mind it is impossible that any tax return filed by Mr. Inglis or his company could be fraudulent in so far as he is concerned. I have known Mr. Inglis for many years and at one time was associated with him in business. He is one of the outstanding figures in the business community in Detroit, and without qualification I can say that I do not know of any business man whose reputation for absolute integrity is higher or more widespread—certainly not among the business men of Michigan.

If the penalty imposed upon his company is the result of any charge or implication that he has a fraudulent intent or any knowledge of a dishonest return, I feel that by all means there should be a thorough investigation of his claim by some prominent official of your department who would take into consideration the statements I have just made and which can be amply substantiated without the least difficulty by inquiry as to the standing of Mr. Inglis and the reputation of his company.

I am quite aware that many of these cases come before you, and I would not write in connection with this one except for the belief that it may be necessary that you should direct some one who has perhaps not had any routine connection with the case to review it for you in view of the great injustice that may be done to the American Blower Co. and the greater wrong that may be done to Mr. Inglis himself by fastening the charge of fraud upon him.

Both of these points I should like an opportunity of discussing with you. I expect to be absent from the city until Wednesday morning and would appreciate your giving me a little time to discuss this matter with you on my return.

Very truly yours,

J. WALTER DRAKE.

EXHIBIT C

DECEMBER 17, 1923.

Memorandum in re American Blower Co.

In the above case after final memorandum of this office dated October 17, 1923, Mr. James Inglis, president of the American Blower Co., and his attorneys, Messrs. Miller and Chevalier, and his accountant, Mr. Bailey, of Ernst & Ernst, made request of the Commissioner of Internal Revenue that he grant the taxpayer, a corporation, a hearing in order that they might present to him their reasons that the fraud penalty should not be assessed and that the physical inventory for 1918 should be used. The Income Tax Unit had for-

warded to the corporation the statement of the amount of tax that would be assessed, from which statement there was no further appeal. The corporation received this statement and obtained an interview with the commissioner before the assessment went out. It appeared from the statement which had been dispatched that the unit had used the book inventory for 1917, 1918, and 1919 when the memorandum of this office was to the effect that the book inventory for 1918 should be used and that the other years should stand as outlined in the registered letter, using the physical inventory for 1920, no exception being taken by the taxpayer for any of the years except 1918. The use of the book inventory for 1917 and 1918, which was incorrect, resulted in a larger tax than that shown by the registered letter. For this reason and for the reason that the commissioner desired to hear what they had to say concerning fraud, he directed the unit to withhold the assessment and granted the taxpayer and his attorneys a hearing which was held in his office on Tuesday, December 4.

Present at the hearing representing the taxpayer were Mr. Robert N. Miller, attorney; Mr. Bailey, accountant of Ernst & Ernst; Mr. James Inglis, president of the American Blower Co.; and Mr. Gibbs, of Detroit. Sitting with the commissioner were O. J. Tall, auditor of the special adjustment section, and B. H. Littleton, of the solicitor's office.

The argument made at the hearing was substantially the same as made before the solicitor's office, except that they with greater stress laid the blame for the fraudulent features of the 1918 return upon Mr. Williamson, former bookkeeper, and upon the fact that Mr. Williamson had embezzled some $68,000 from the corporation. The representatives of the taxpayer and Mr. Inglis were closely questioned concerning the 10 per cent cut, or $78,000, in the closing inventory of 1918, for which cut Mr. Inglis took personal responsibility, saying that he felt he was justified from a business standpoint; the failure to make proper entries on the books and the failure of the 1919 return to show an opening inventory or a balance sheet, and also the failure of the taxpayer to make an amended return, after it was discovered and after advice had been given the taxpayer by its accountants that the $78,000 cut in the inventory was not justified and that correct entries had not been made on the books.

The matter of the destruction of the 1920 inventory was also discussed and it was insisted most vigorously by Mr. Inglis that they did not appreciate the importance of retaining the inventory and that it was destroyed because of the confused state in which it had gotten, and that its destruction was not in any way connected with the desire of the corporation to prevent the Government from having access to it. The Commissioner of Internal Revenue advised the representatives of the taxpayer that he would consider the case and reach a conclusion relative thereto.

On Saturday, December 15, the commissioner called me and requested that I come to his office at 2 o'clock and have the auditor, Mr. Tall, also present for the purpose of discussing the case. During a part of the discussion of the case between us Mr. Hartson was present. The commissioner stated that the case was a very ugly one and that it was not entirely clear that taxpayer had not attempted to defeat taxes in 1918 by the method used and that while perhaps the book inventory did not represent the true value of the materials on hand at the close of 1918, yet the physical inventory, according to the information in possession of the Government, was apparently much less than the value which should have been returned; that the fact that the principal evidence upon which the Government would rely as to the fraud, was contained in statements made by Mr. Williamson, the bookkeeper, the Government would be in rather an embarrassing situation if called into court to sustain the fraud by his testimony in view of his admitted embezzlement.

Prior to the conference on the 15th Mr. Miller stated to me that if the commissioner should conclude that the fraud penalty should not be assessed for 1918 the taxpayer would be willing to increase his inventory, as used in the return for 1918, by some $60,000 in addition to the $78,000, and voluntarily pay the tax thereon. I informed the commissioner of this statement on behalf of the taxpayer and at the conclusion of the discussion of the case the commissioner instructed me to state to the taxpayer's representative that he regarded the case as a very ugly one and that before he reached a final decision relative to the inventory and the fraud penalty if the taxpayer desired to submit a proposition to determine the net income for 1918 by decreasing the book inventory and increasing the physical inventory by a like amount and compute

the additional tax thereon, and agree to voluntarily pay that tax with 6 per cent from 1918 when the tax became due at the time the report was made, he would give such proposition consideration and that if they did not desire to dispose of the case in this way that he would render his decision.

On Monday, December 17, I called Mr. Miller, and he and Mr. Inglis came to this office; in the presence of Mr. Cannon I informed him of what the commissioner had said and they stated that they would think the matter over and let me know in a day or two.

B. H. L.

EXHIBIT D

JANUARY 11, 1924.

In re: American Blower Co.
Memorandum for file.

On January 9, Mr. James Inglis called at this office and stated that he desired to have another talk with the commissioner concerning the case of the American Blower Co. and asked if I thought the commissioner would object to seeing him. I told him that I did not know whether the commissioner would see him or not, but that he should discuss it with the commissioner's secretary. The commissioner's office telephoned me that appointment had been made for 11.45 January 10; the commissioner asked me to be present at the conference.

Mr. Inglis stated to the commissioner that they had computed the tax for the years 1917 to 1920, inclusive, on the basis of increasing the alleged physical inventory and decreasing the book inventory half and half, or until the two inventories met. The additional tax for 1918, computed on that basis, amounts to $232,509.13, and the net additional tax for the years 1917 to 1920, inclusive, less the overpayment for 1919, amounts to $240,824.45 without interest or penalties. Mr. Inglis stated to the commissioner that he had a certified check for $240,824.45 and wanted to submit that in full satisfaction of all liability and in full settlement of the case. Mr. Inglis was advised by the commissioner that as a result of the oral hearing granted this taxpayer heretofore, and by reason of the statement that the taxpayer desired to make an adjustment of the whole matter, it had been stated to them that he would consider, without binding himself, as to what his final decision might be, a proposition from them to pay the additional tax on the basis above-mentioned which was found to amount to $240,824.45, and in lieu of penalties for the year 1918 to pay interest on $232,509.13 at 6 per cent from March 15, 1919, the date tax became due, up to and including December 31, 1923.

Mr. Inglis was advised that the offer to pay the tax would not be considered as in full settlement of the case. Mr. Inglis stated to the commissioner that he did not know what the taxpayer could do if it had to pay 6 per cent interest, amounting to $66,846.44, in addition to the amount he offered, thereupon the commissioner asked Mr. Inglis to wait in the outer office until we could discuss the case.

After Mr. Inglis left the room the commissioner stated that he thought perhaps he would be justified in considering the proposition from the taxpayer to pay the tax of $240,824.45 and 5 per cent interest from March 15, 1919, to December 31, 1923. Thereupon I went out and notified Mr. Inglis that the commissioner had stated that he would not consider the offer to pay the tax alone but that if he would submit an offer through the collector of internal revenue to pay the correct adiitional tax thus computed and, in addition thereto, pay interest on the 1918 additional tax at the rate of 5 per cent up to and including December 31, 1923, he would give the same careful consideration. Mr. Inglis left stating that he would think the matter over and let me know.

B. H. L.

The CHAIRMAN. Have you another case to present this morning, Mr. Box?

Mr. BOX. Yes, sir.

STATEMENT OF MR. GEORGE G. BOX, CHIEF AUDITOR FOR THE COMMITTEE

Mr. Box. This is the case of the Draper Corporation, Hopedale, Mass.

This taxpayer was incorporated on July 3, 1916, under the laws of the State of Maine.

It is a manufacturer of textile machinery. The business originated in 1816 and was conducted as a partnership until 1897, when it was incorporated as the Draper Co. under the laws of the State of Maine.

The Draper Corporation was capitalized at $17,500,000 and acquired all of the stock of the Draper Co. The taxpayer issued 2½ shares of its common stock in exchange for one share of the common stock of the Draper Co., and 1¼ shares of its common stock for one share of the preferred stock of the Draper Co.

In the alleged reorganization of the company the assets of the old corporation were carried on the books at the same values, with the exception of patents, the value of which was increased from $100,000 to $5,000,000. The records indicate that there were over 1,200 patents at that time, which had an average life of slightly less than seven years.

The questions which have caused the bureau considerable trouble in deciding are whether or not the increase in patent value written upon the books in 1916 should be allowed for invested capital purposes, and if the increase is allowed, whether depreciation on patents should be allowed as a deduction from income for each year from 1916 to the date of termination of the patents.

The taxes for the years 1917 and 1918 are involved and are still unsettled.

The records are not altogether clear as reflecting the treatment of this case in the department. It would appear that the case was originally handled by the board of tax reviewers and assessment of an additional tax of $219,200.09 was made in letter of July 19, 1918, under section 210, articles 18, 24, and 52, act of 1917.

The taxpayer filed claim in abatement for this additional tax, in the meantime appearing, through counsel, before the advisory tax board. As a result of this hearing the advisory tax board issued ruling on depreciation, disallowed by the unit on patents, which ruling was set forth in memorandum No. 22. This memorandum is Exhibit A.

The case was then referred to the manufacturing section to make assessment based upon this ruling and disallowance of depreciation on patent value. This additional assessment was made based upon taxes as returned and independent of the assessment under section 210. Claim in abatement was filed by the taxpayer for this additional assessment. The case was then assigned to munition agent, J. T. Shock, a special representative, but it appears that considerable objection was made by the taxpayer relative to a field audit of its records, and from June 5 to November 19, 1919, the investigation was held in abeyance. The field audit was completed January 30, 1920.

The field audit report, in due course, was assigned for review. Assessment letter based upon facts developed through field audit

was mailed on June 30, 1920, covering additional tax of $332,262.51. Numerous conferences were held, and after due consideration being given objections raised by the taxpayer, revised assessment letter was constructed and mailed July 5, 1921, showing an additional tax liability of $287,341.27 for 1917.

Claim in abatement was filed by the taxpayer. The question was submitted to the committee on appeals and review for consideration, and under date of January 13, 1923, it decided (recommendation 2290) that the action of the Income Tax Unit in the assessment of additional taxes for the years 1917 and 1918, due to disallowing depreciation on patents in accordance with advisory tax board memorandum No. 22, referred to above, be sustained.

The above recommendation is Exhibit B.

Taxpayer appealed from the latter decision, and the case was again referred to the committee on appeals and review. Under date of March 27, 1924, the committee decided (recommendation 7356) "that the market value of the patents as at date of acquisition, November 20, 1916, was $5,000,000, which value should be accepted by the unit for both invested capital and depreciation purposes."

(The above recommendation is Exhibit C.)

The case was returned to the bureau and referred to the auditor who had previously worked on it for the purpose of taking final action. He, however, prepared a brief, under date of September 17, 1924, and forwarded it to the deputy commissioner for signature, with a view to having the Solicitor of Internal Revenue consider the question, the committee on appeals and review having been abolished by the revenue act of 1924.

As the auditor took exception to the last decision which was made by the committee, it was returned to the Solicitor for consideration, because the old committee that made the decision had been abolished.

It appears that the principal question in this case is that of whether or not a reorganization actually took place, as upon it depends whether the increased value of patents is allowable as invested capital, and whether a deduction on account of depreciation of patents is proper.

The records show that under date of July 5, 1916, a circular letter was addressed to the stockholders of the Draper Co., a part of which is quoted as follows:

> For various reasons it is advisable that the capital stock representing the assets of the Draper Co. should more nearly represent the actual value of the property. Furthermore, the value of the shares of the present Draper Co. is so high as to interfere seriously with the market of the stock. We are advised that the proposed exchange of stock is the simplest and most practical way of securing the desired results. We therefore believe it to be advantageous to the company and its stockholders.
>
> The preferred stock of the present Draper Co. was issued at the original organization of the company, when its assets were much smaller than at present, and when all the stock, both common and preferred, was closely held. The amount outstanding is comparatively small. We have, therefore, provided that the new company should only have one class of stock.

That is the time that the alleged reorganization took place, or along about that time. When asked for a balance sheet, as at July 1, 1916, the date the alleged reorganization took place, the corporation submitted a balance sheet which it claimed was "a very accurate estimate of the books on the day of transfer."

Under date of March 23, 1922, Mr. C. F. Butterworth, assistant treasurer, declined to furnish a list of the stockholders of the two companies. When in conference representatives of the corporation stated that all holders of stock in the old corporation exchanged their stock as provided for in the circular.

The books of the Draper Corporation were simply a continuation of those of the Draper Co., so far as current transactions were concerned. There was no closing of the books at the time of the alleged reorganization, but merely an increase in the asset represented by patents, as above mentioned.

From the evidence in the case indicating that the same stockholders owned the stock in the new corporation in the same proportions as they held in the old corporation; that the books were not closed; that the only effect of the alleged reorganization was an increase in the asset, patents; and that according to the circular letter of the company of July 5, 1916, above referred to, it appears that the action of taking out a new charter was for the purpose of adjusting the amount of capital stock so that it would represent more clearly the actual value of the assets; it is very questionable whether a reorganization took place that should be recognized by the Internal Revenue Bureau to the extent of allowing the appreciated value placed on the patents in computing invested capital.

The case was before the solicitor for decision when called for by the committee and has not as yet been closed, but attention is invited to the fact that the first decision in this case by the advisory board was May 21, 1919, six years ago, and it would appear that the case should be finally disposed of without further delay.

Those are all the cases that we have to present this morning, Mr. Chairman.

Mr. GREGG. In connection with this last case, the objections on the part of Mr. Box, as I got them, was, first, the delay which, of course, we plead guilty to. I think the delay in our closing of some of these cases has been fully explained to the committee, and there is no need of our taking further time on that now.

The other objection was to our considering this reorganization in 1916 and allowing the new corporation to set the assets up on its books at their then value. In looking through the files I find that there is an old advisory tax board memorandum, dated May 21, 1919, signed by Dr. T. S. Adams, which holds that that was reorganization, justifying them in setting up the new values on their books. There is a subsequent one, signed by Mr. Kingman Brewster, reaching the same conclusion, and a third one, signed by Mr. Hamel, who is at the present time the chairman of the board of tax appeals, reaching that conclusion. It was gone into three times very thoroughly in the department, and on each occasion the same conclusion was reached. It would seem to me from the record that they give sufficient detailed reasons for the department's treating this as a reorganization.

That leaves only the matter of delay.

Senator ERNST. What Mr. Adams was that that made that report?

Mr. GREGG. Dr. T. S. Adams.

The CHAIRMAN. Of Yale?

Mr. GREGG. Yes.

Mr. BOX. Is Doctor Adams a lawyer?

Mr. GREGG. No. The first was made, as I say, by the advisory tax board, the lawyer of which was Mr. Fred Field, of Boston, and he is a very able lawyer. The other two were also signed by very able lawyers.

Senator JONES of New Mexico. How can you value patent rights?

Mr. GREGG. It is very difficult, Senator, but we have to do it. The law specifically says that patents go into invested capital at their value at the time paid in for stock. We have to put a value on them, and it is naturally a very difficult thing to do.

Senator JONES of New Mexico. Apparently in this case they had been carrying those patents on their books at $100,000 and when it comes to the question of taxation, invested capital, depreciation, and so on, they changed that value to $5,000,000.

Mr. GREGG. I might say that they changed it before the tax situation arose. They changed it on their books on January 1, 1916.

The CHAIRMAN. Yes; but not until the tax laws had been passed.

Mr. GREGG. No excess profits tax law had been passed.

Mr. BOX. Was there not a great deal of discussion in the press, or in certain quarters, at any rate, about the excess-profits tax, about 1916?

Mr. GREGG. I do not know. The first excess tax profits law was not passed until October 3, 1917. There may have been some talk about it.

Senator JONES of New Mexico. There was depreciation allowed under the law, was there not?

Mr. GREGG. Yes, sir.

The CHAIRMAN. And, of course, the depreciation on $5,000,000 would be much greater than it would be on $100,000.

Mr. GREGG. Of course, in 1916 the tax situation was not particularly acute. The tax rate was not high enough to justify a reorganization for taxation purposes. The rate was just 2 per cent.

The CHAIRMAN. I think Mr. Manson will be able to be present to-morrow morning, and if there is nothing further now we will adjourn until 10 o'clock to-morrow morning. Mr. Manson is ill this morning and has not been able to come here.

(Exhibits in Draper Corporation case submitted by Mr. Box are as follows:)

EXHIBIT A

SECTION 326.—INVESTED CAPITAL

Section 326, Article 843: Surplus and undivided profits patents.
Section 211(a)8, Article 167.

Claim of the X Corporation for valuation of $5,000,000 for patents conveyed to it at the date of its organization, July 1, 1916, should be allowed. Such patent valuation, however, is maintained by expenditures for new patents and to some extent merges into good will; therefore no allowance should be made for annual depreciation of patents.

MAY 21, 1919.

Mr. COMMISSIONER
(For Mr. Callan):

The X Corporation filed an excess-profits tax return for the year 1917, showing a net income subject to excess-profits tax of $1,501,180.42 and an invested capital for the year of $16,497,518.81, with a 9 per cent deduction and an excess-profits tax of $2,680.74.

The questions at issue are two: (1) The value of certain patents paid in for capital stock of a par value of $5,000,000, and (2) the allowability of a deduction of $515,745 from income in 1917 on account of depreciation of patents. These questions were considered by the tax reviewers who held a hearing thereon at which the taxpayer was represented by two of its officers and by counsel. The tax reviewers did not reach a conclusion and the matter was informally referred by them to the advisory tax board.

The concern is an old one, having been established in 1816. For a long time the business was conducted as a partnership, but in 1897 it was organized (or reorganized for present purposes it is immaterial which) into the Y Co., which operated the business until on or about July 1, 1916, when the X Corporation was organized. The Y Co. at July 1, 1916, had outstanding the following capital stock:

Cumulative preferred 8 per cent	$2,000,000
Common	6,000,000

The capitalization of the C Corporation is $17,500,000, and this stock under the plan of organization was issued as follows:

(*a*) For each share of common stock of the Y Co., par value $100, there was issued in exchange two and one-half shares of the common stock of the X Corporation, par value $250, or a total of $15,000,000.

(*b*) For each share of preferred stock of the Y Co., par value $100, there was issued in exchange one and one-fourth shares of the common stock of the X Corporation, par value $125, or a total of $2,500,000. In form this was an exchange of stock for stock, but in substance the X Corporation acquired the assets and assumed the liabilities of the Y Co., and it has so treated the transactions upon its own books and desires to so treat it for purposes of income and excess-profits taxation. In view of the value of the property acquired it is immaterial, for present purposes, whether the X Corporation acquired the capital stock of the Y Co. or acquired its assets. In either case the value claimed for the capital stock issued by the Y Co. is supported by adequate evidence, and prior to January 1, 1917, the assets of the Y Co. had actually been transferred to the X Corporation.

The X Corporation took over the assets of the Y Co. at their book value, with the exception of the item of patents. For many years the X and Y concern has been a leader in the development of machinery for the manufacture of textile goods. When the business was acquired by the Y Co. in 1897 a valuation of $4,000,000 was placed upon the patents, and so far as the record discloses this valuation does not seem to be unreasonable. Between 1897 and 1916 the Y Co. had written off against its surplus account various amounts which reduced the patent account eventually to $100,000, which was considered a nominal amount and in no sense an indication of the real value of the patents. None of these write offs were taken as deductions in computing net income for Federal taxation purposes. Between 1897 and 1916 the company developed a large number of new patents and many of the old patents expired.

During these years, however, the business of the company has not been dependent upon any single patent, but rather upon a large group of patents, which in the aggregate have afforded the company ample protection. The total number of patents is in the neighborhood of 1,200, and it has been the company's policy through constant experimentation to improve its machines and devices, but as the pioneer stage of the industry has long since been passed, the advancement that can be made is not by revolutionary discoveries, but through improvements, many of which are of minor character and would mean little standing by themselves. Taken as a whole, however, these improvements form a wall of defense that seems impregnable. The company has also purchased patents that have been developed by others, and it has defended its claims with apparent success through litigation. All expenditures for the development of patents, experimentation, purchase of patents, and patent litigation were writen off as current expenses, and while the amount of these expenditures is not definitely stated in the record, it is admitted that it is large.

In the reorganization of the Y Co. in 1916 a valuation of $5,000,000 was placed upon patents, and the X Corporation seeks to maintain this as a fair value of the property acquired at the date of reorganization. It is evident that the patents have a large value. Whether this is $5,000,000 or some other amount may be open to question, but upon the basis of earnings and also upon

the basis of the selling price of the stock of the corporation, the valuation claimed by the company appears to be justified. It is therefore recommended that the claim of the X Corporation to value of patents acquired by it at July 1, 1916, in the sum of $5,000,000 be allowed.

The Y Co. has presented evidence classifying its patents as of July 1, 1916, into 2 main groups, with 19 subordinate groups under the first division and 6 subordinate groups under the second, showing the average life of the patents in each group. In the aggregate there are 1,234 patents, with a total average remaining life after July 1, 1916, of 6.97 years. Upon the basis of a valuation of $5,000,000, but not using the average life factor of 6.97 years, which was not ascertained until the return was under audit, the company has taken in its 1917 return a deduction of $515,745 for depreciation of patents. This claim should be denied. As stated above, the Y Co. throughout the years of its existence maintained the value of its patents through expenditures for experimentation, litigation, and the purchase of patents, and all of these expenditures were taken as deductions from current income. The X Corporation has proceeded upon the same business plan, and has continued the experimental and other work looking to the development of new devices and the acquisition of new patents. While the expenses thus incurred during the taxable year (except for one item of legal patent expenses) have been merged with the other expenses of the business, it is evident that they are large. Thus the whole policy of the company continues to be that of maintaining its patent position through the development and acquisition of patents upon various improvements, so that as a basic or important patent expires there will be a sufficient group of improvements upon the device to render the unimproved device as an unmarketable commodity. Furthermore, it is well recognized that in many cases the value of a patent upon its expiration is found to have merged into the good-will value of the business. The present case is an excellent illustration of this fact. A very large portion of the textile mills of the country are equipped with X machinery, and for this equipment they must buy X repair parts (and this is always a highly profitable part of a machinery manufacturer's business), and in the case of mill making plant additions, if X equipment is already in use the chances are highly favorable for the purchase of X equipment for the additional plant. To put in other equipment means, among other disadvantages, that the mill must carry two stocks of supply and repair parts, and can not readily interchange its employees from one kind of equipment to another. Thus, if all the X patents were to expire concurrently on a given date, the business could doubtless be maintained at a high level for years, because of the good will which has been built up under the patent protection. The history of the predecessor corporation shows conclusively that the patent value has been maintained: in fact, more than maintained, because the company in 1897 claimed only a patent value of $1,000,000, while in 1916 it has demonstrated a value of $5,000,000.

The X Corporation has submitted satisfactory proof showing that for 20 years, although the basic patents which were in existence at the beginning of the period have expired, the value of the patents has been more than maintained by means of improvements upon the original devices. Having proved this, it has failed to produce any evidence that the value of the patents will be exhausted before July 1, 1923, or even that the total value will be impaired in the near future. Its expenditures during the year 1917 for the maintenance of patents have been deducted in computing net income, as is usually done in such a business, and the experience of the past demonstrates that the integrity of the company's assets is amply maintained thereby. It is therefore recommended that the deduction of the X Corporation in its 1917 income-tax return of the sum of $515,745 for depreciation on its patents be disallowed.

T. S. ADAMS,
Chairman Advisory Tax Board.

Accepted for the guidance of the Income Tax Unit.

DANIEL C. ROPER,
Commissioner.

EXHIBIT B

RECOMMENDATION NO. 2290

COMMITTEE ON APPEALS AND REVIEWS,
January 13, 1923.

In re: Appeal of the Draper Corporation, Hopedale, Mass.

Mr. COMMISSIONER
(For Deputy Commissioner, Head Income Tax Unit):

The committee has had under consideration the appeal of the Draper Corporation from the action of the Income Tax Unit in assessing additional taxes for the years 1917 and 1918 due to:

1. Disallowing depreciation on patents in accordance with Tax Board Memorandum 22.
2. Disallowing claimed value of assets acquired by appellant as a basis for paid-in or earned surplus.
3. Accrual of mutual insurance.
4. The use of book rather than actual cash values in the computation of profit or loss on sale of securities.
5. Disallowing sufficient depreciation on plant items.

Oral hearings have been afforded the representatives of the appellant.

The Draper Corporation was organized under the laws of the State of Maine July 3, 1916, succeeding to the business of manufacturing machinery for use by manufacturers of textile goods formerly conducted by the Draper Co., which had been organized in 1896. The appellant company had as authorized capital stock of a par value of $17,500,000, all of which was given in exchange for the stock of the Draper Co.

Draper Corporation: $15,000,000 common and $2,500,000 preferred, total $17,500,000, exchanged for $6,000,000 common and $2,000,000 preferred in the Draper Co. Total par value, $8,000,000.

Under date of July 5, 1916, notice was sent the stockholders of the proposed arrangement by which the stock in the Draper Co. should be surrendered in exchange for stock in the Draper Corporation. Within a few days after the notice nearly all of the stock in the Draper Co. had been surrendered. On November 20, 1916, when less than 500 shares of common stock of the Draper Co. remained outstanding, all of the assets of the Draper Co. were transferred to the Draper Corporation, subject to all of its liabilities, and subsequently the remaining common stock of the old company was surrendered on the same basis as the rest of the stock.

The appellant took over the assets of the Draper Co. at their book value, with the exception of the item of patents, which was written up from $100,000 to $5,000,000. No other change was made in the books and the books were not closed until the end of the year.

The appellant's claimed value of $5,000,000 for patents was considered in Advisory Tax Board Memorandum No. 22, and the conclusion reached in that ruling was that the $5,000,000 should be allowed for invested capital purposes at date of reorganization, subject to the statutory limitations, but that as the value of the patents had so merged into good will no depreciation on that value could be taken as a deduction from income.

After a careful consideration of all the facts presented and a review of Tax Board Memorandum 22, the committee is of the opinion that the evidence fails to prove that the value of the patents and good will will be impaired, much less exhausted, in the near future, and affirms the conclusions in the above-mentioned memorandum.

It is the contention of the appellant that it is entitled to include as invested capital the cash value of the assets acquired from the Draper Co., rather than to have its invested capital determined by the value at which these assets were carried on the books of the predecessor company.

After a careful consideration of the evidence presented it is the opinion of the committee that the assets of the Draper Co. were in effect acquired by the appellant as of July 1, 1916, and the appellant is permitted under the statute to include in invested capital the cash value of the assets as of the date acquired, but that under the regulations and the established precedents of the bureau governing cases where shares are issued for a mixed aggregate of tangible and intangible property no paid-in surplus may be allowed in the instant case.

It appears that the appellant has charged to expense in the year paid the total of mutual insurance premiums, without regard to the length of the life of the policy, and reported as income the refund premium in the year received. Objection is made to the action of the unit in disallowing as expense in any year amounts of prepaid insurance.

After a careful consideration of the evidence presented it is the opinion of the committee that the insurance premiums paid in any year should be apportioned over the life of the policy and accrued on that basis, and that as there is no method of accurately predicting the amount of the refund premium it should be reported as income in the year received.

The Income Tax Unit has conceded that upon proper substantiation the fair market value as at acquisition by the appellant of the securities and plant items should be the basis for the computation of profit or loss on the sale of securities and the basis for depreciation allowance on the plant items.

It is therefore recommended in the appeal of the Draper Corporation that the action of the Income Tax Unit in the assessment of additional taxes for the years 1917 and 1918, due to disallowing depreciation on patents in accordance with the T. B. M. 22, and disallowing, because of conditions and limitations prescribed in the regulations, the claim for paid-in surplus, be sustained. It is further recommended that the mutual insurance premiums paid in any year be apportioned over the life of the policy and accrued on that basis, and that the amount of the refund premiums be reported as income in the year received; and that upon proper substantiation the fair market value as at acquisition by the appellant of the securities and depreciable assets be used as the basis for the computation of profit and loss on the sale of securities and the basis for depreciation allowances.

KINGMAN BREWSTER,
Chairman Committee on Appeals and Review.

EXHIBIT C

RECOMMENDATION NO. 7356 (NOT TO BE PUBLISHED)

COMMITTEE ON APPEALS AND REVIEW,
March 27, 1924.

In re: Appeal of the Draper Corporation, Hopedale, Mass., years 1917 and 1918.

Mr. COMMISSIONER
(For Deputy Commissioner, Head Income Tax Unit):

The committee and the solicitor have had under consideration former recommendations in the appeal of the Draper Corporation from the action of the Income Tax Unit in assessing additional taxes for the years 1917 and 1918, due to—

1. Disallowing depreciation on patents in accordance with advisory tax board ruling.
2. Disallowing claimed value of assets acquired by the appellant as a basis for paid-in surplus.
3. Denying as cost to the appellant the cash surrender value of mutual insurance premiums acquired with the other assets.

After thorough consideration of the evidence of record the following conclusions have been reached:

(1) That the assets of the Draper Corporation were acquired by the appellant on November 20, 1916.

(2) That the market value of the patents as at date of acquisition, November 20, 1916, was $5,000,000, which value should be accepted by the unit for both invested capital and depreciation purposes.

(3) That on acount of the large number of patents and the difficulty of attributing values to particular patents, depreciation should be based upon the aggregate value of the patents spread over the average life thereof.

(4) That no part of the patent valuation, $5,000,000, should be excluded from invested capital on the ground that a paid-in surplus can not be based upon intangibles acquired with stock for the reason that in this case the assets of the Draper Co. were not acquired with stock of the appellant corporation, but were acquired with tangible property—stock of the Draper Co.

(5) And that the cash-surrender value of the mutual-insurance policies as given by the insurance companies should be taken as the value of these policies as at the date of acquisition, and the amount to be charged off as insurance expense for the year should be determined by the difference between the cash-surrender value at the beginning and the end of that year.

That part of the committee's recommendation dated January 13, 1923, and that part of the advisory tax board's memorandum dated May 21, 1919, covering this case inconsistent with this recommendation are hereby revoked.

It is recommended that the Income Tax Unit revise its audit in accordance with the findings as above outlined.

CHARLES D. HAMEL,
Chairman Committee on Appeals and Review.

Approved:

D. H. BLAIR,
Commissioner of Internal Revenue.

(Whereupon, at 11.30 o'clock a. m., the committee adjourned until to-morrow, Tuesday, May 5, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, MAY 5, 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 adjournment of yesterday.

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

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

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

The CHAIRMAN. You are prepared to submit some matters to the committee this morning, Mr. Box?

Mr. Box. Yes, sir.

The CHAIRMAN. You may proceed.

STATEMENT OF MR. GEORGE G. BOX, CHIEF AUDITOR FOR THE COMMITTEE

Mr. Box. This is the case of the estate of George A. Joslyn, of Omaha, Nebr.

Mr. Joslyn died in 1916 testate, leaving a few specific bequests and the residue of his estate, approximately $7,000,000, to his widow.

When the estate tax investigation was made of the return, the total estate of the decedent was taxed, but the widow claimed that under the law of the State of Nebraska she had an inchoate right to one-half of this estate, and on account of there being no children, in lieu of dower, that her half interest was not taxable under the 1916 act.

The 1916 act provided, among other things, that only the interest of the decedent was taxable.

The attorneys for the widow, who was also the executrix, filed a claim for the refund of the tax on the one-half interest, which the widow claimed was hers, and not taxable under the will.

This claim was denied. I think it was in the year 1918 that the claim was denied.

In the year 1920, in the case of United States *v.* Field, the Supreme Court held that the interest of a widow in the estate of her husband, in the State of Illinois, was not taxable by the Federal Government for estate tax, and it is very evident that the same kind of a law is in effect in Illinois as in Nebraska. Also in Randolph *v.*

Craig (267 Fed. 993), a case decided in the State of Tennessee, the same decision was made.

As the result of these decisions, the estate tax regulations were amended by Treasury Decision 3165 on May 18, 1921.

Two years afterwards, or in May, 1923, two men by the name of Kay, who were formerly employees of the estate tax division, visited Omaha, called on the firm of attorneys who represented this widow, and stated to them that on account of their knowledge of the estate tax law and the decisions which were in effect in the bureau at that time, they thought they could secure a refund of part of the tax. They were employed, and received a power of attorney from the widow. The power of attorney which they secured gave them the power of substitution. They not being authorized to practice before the bureau, substituted an attorney by the name of Hamby, in Washington, to prosecute the case.

The bureau considered for some time whether they would acknowledge this power of substitution from Kay and Kay, because of their previous activities in getting this kind of case under the same circumstances. So the Kays got a power of attorney direct to Hamby. Then Hamby was allowed to prosecute the case.

After a lapse of about 10 months the bureau found that there was a refund due this widow of $322,174.27. A certificate of overassessment was issued in June, 1924, for that amount, and interest from the date of payment to that time of $131,961.55 was paid—in all about $453,000.

The record of the case shows that suit was brought by the Kays against the widow for their fee. She refused to pay the fee on the ground that they had made misrepresentations to her in securing the job, but that does not enter into the case.

The bureau, in corresponding with the attorneys, stated that they had made a thorough investigation and tried to find out if there was any leak in the estate-tax division whereby they were getting this information, or whether they got the information before they left; but, regardless of that fact, it seems to me that if the bureau had, after amending their regulations in 1921, brought this claim up there would have been no opportunity for Kay or any other employee of the bureau to come in and take such an unethical action as was taken in this case.

In other words, the Government had $322,000 worth of taxes of this woman, which she had made a claim for. Regardless of subsequent decisions, after the case had been closed, no action was taken to refund that money which was rightfully hers.

Mr. GREGG. As I gather from your remarks, Mr. Box, the criticism of the bureau is that this closed case, a case which was properly closed, and in which a refund was denied under our rulings at the time it was closed, was affected by a subsequent decision of the Supreme Court, that we should then, on our own motion, have somebody in the department who remembered this claim, to go and look it up, open it, and make a refund on it, or else that we should have gone through the files to see if there were any of those cases that were affected by the decision, and made the refund ourselves, so that it would not have been necessary for the widow to have taken any action?

Mr. Box. I think the bureau should have a system whereby claims especially of large amounts which have been turned down erroneously, should be refunded when there is authority for it. According to this Supreme Court decision, there is no question but that the Government had over $300,000 worth of taxes which had been erroneously collected and to which the Government had no right.

Mr. GREGG. And the first time that was called to our attention after that decision we refunded it.

Mr. Box. Yes; but after somebody who was in the bureau had gone to the taxpayer and had made representations to the taxpayer.

Mr. GREGG. We would have done it just the same, even if she herself had written in a letter calling our attention to it. The last time I looked into this matter we had 68,000 claims pending in the Income Tax Unit alone, and after having had a decision adverse to us we can not examine all of those claims to see if somebody is not entitled to a refund. It seems to me the taxpayers should look it up and protect their own rights in the matter.

Mr. Box. How was the widow to know of this refund after you had changed the regulations, and after she had done all she could in filing the claim in the first place?

Mr. NASH. Mr. Chairman, this Treasury decision was public information at the time it was issued. Our Treasury decisions are published every week, and the attorneys in this case ought to have been familiar with that decision. Practically every attorney's office in the country gets our weekly Treasury decisions.

Mr. GREGG. And they certainly ought to be familiar with a Supreme Court decision, which is in itself a matter of public record.

Mr. NASH. Mr. Chairman, I am quite familiar with this case. Kay and Kay, two brothers, were formerly employees of the estate tax unit. After they resigned they attempted to be admitted to practice before the Treasury Department. They never have been admitted to practice, and the Treasury Department has never looked with any favor upon them at all; but they did in some way secure information as to certain cases that were pending in Nebraska and Iowa in which this community property issue was involved.

Senator WATSON. Who are Kay & Kay?

Mr. NASH. They are two attorneys here in Washington formerly employees of the estate tax unit.

Mr. Box. Would it not be practicable in cases of this kind, Mr. Nash, to have a file whereby an amended regulation would automatically call it up, so that the taxpayer would have the claim opened up without giving temptation to employees in the bureau to take up a case?

Senator ERNST. Mr. Box, the trouble is that nearly every lawyer, and especially in a case of any magnitude, is watching that all the time to keep tab on 68,000, to see if some decision of the Supreme Court might not affect some one of those; you can see where that would lead to.

Mr. Box. I admit that the lawyers in this case were asleep.

Mr. NASH. Mr. Chairman, we might do it on the estate-tax cases, because they are not so numerous, but on the income-tax cases it would be a physical impossibility. There are 68,000 cases pending, besides hundreds of thousands that have already been closed. We

now have a decision on the income-tax cases, known as the Alworth-Stevens decision, which has just been handed down by the Supreme Court and which is probably going to affect thousands of cases that have already been closed. Those cases have been closed in the regular order of business during the past five years, and we could not begin to make a search of our files to see how many cases this Alworth-Stevens decision is going to affect, and unless the taxpayers raise the issue themselves, they probably will not get any refund.

Mr. GREGG. That is properly a function of the attorneys of the taxpayers, it seems to me.

The CHAIRMAN. But this case was disposed of. This widow's attorneys had undoubtedly been paid and were discharged. They may have had a row and had no further interest in her case. Do I understand that in an event of that kind there is no responsibility on the part of the Government to the taxpayer, and that some attorney that she has had three or four years previously must be held responsible for guarding her interests after he had been paid and discharged? I am not saying that I have any practical solution for it, but I do say that there is a responsibility somewhere; and the responsibility should be fixed as between the Government and the taxpayer, so that the taxpayer may get justice. We have been complaining right along in these cases because we thought the Government was too lenient with the money of these taxpayers, and our able young solicitor has told us that there are a number of cases where it was too severe with the taxpayer. I said, "Well, we will probably find some of those before we get through." Now, here is a case in regard to which I believe the bureau has not been as liberal and fair with the taxpayer as it should have been. I believe some system ought to be devised or some statute passed whereby the taxpayer will get justice, and especially widows and orphans, where their attorneys may have been through with the case and could not morally or legally be held responsible for making a claim.

Mr. GREGG. We would be very glad if some method could be devised which would give justice in all cases. However, I do not feel that there is any possible criticism of the bureau in this case. We closed the case properly. It was in accordance with our existing rulings, and the Supreme Court subsequently reversed us. Now, it seems to me that in an estate of this size someone representing the taxpayer should be interested enough in it to watch it closely and to have taken advantage of the Supreme Court's decision. I do not think it is up to the bureau, when it has properly disposed of it, to then keep tab on it to see if some subsequent event may affect it. It would be highly desirable to do as you say, but having passed on it properly once, I think then, as a practical matter, we have done all we can. We can not keep a suspense file forever to see if those cases may be affected by some subsequent decision.

The CHAIRMAN. As a matter of fact, somebody did keep tab on it; and that is one of the public criticisms, that employees of the bureau do keep tab on these cases, and then when they are removed or resign they go out and tip off the taxpayers as to how they may get their money back, and they get a rake-off for doing it. That is a wrong kind of method to encourage.

Mr. GREGG. It is wrong, and I am perfectly certain that we are not encouraging it. We have had intelligence men following this for years, trying to catch them.

The CHAIRMAN. No; the system is encouraging it; I do not say that you are.

Senator WATSON. Senator, do you say that after this decision which has been recently rendered, a good many of those cases down there should be opened up, those cases that might be affected by this decision? If you were to do that you would have to have a special force in the bureau.

The CHAIRMAN. I said in the beginning of my remarks that I do not have any solution at this time but I do believe that some solution should be had of these problems, so that these insiders can not go around and prey upon the taxpayers. Here were the employees of the estate tax unit, who, from their entrance into the bureau, kept a memorandum of all of these cases, and immediately the Supreme Court decided the question, they have gone around and solicited all these cases and got a rake-off from the taxpayers for doing something which they were not justified in doing and for which the taxpayer should not have had to pay.

Senator WATSON. Was that done?

The CHAIRMAN. That was done, and that is the reason why those cases come up here. Two employees by the name of Kay went out and solicited this account.

Senator ERNST. Of course, you have to have employees, and you can not always be assured that those employees will do their full duty while in the employ of the Government or after they have left it. If you could adopt some practical rule of making every man honest, both while he is in the employ of the Government and after he has left it, you would get some practical solution of this question. But there is no practical solution to it; there is no way of doing it.

The CHAIRMAN. Well, I can not admit that.

Senator ERNST. No; but I say there is no way of keeping a man who is dishonestly inclined from acting dishonestly. They have done it since the world began, and they will continue to do it. I think it is an absolutely absurd contention. You are trying to say that because of a Supreme Court decision, although there were hundreds of thousands of cases already determined and 68,000 pending, that somebody ought to have rushed off to these people and said, "Here, we have made a mistake; take your money back." As a practical question, I do not think there is anything in it for that reason. You have mentioned one case, and without knowing anything about it, I think the chances are a thousand to one that in any case of any size the attorney for the taxpayer who had been following that case noticed that decision, and called it up subsequently and had a refunder. Now, the number of cases in which that is not done—I imagine there is no way of counting them up—would be infinitesimal as compared with the total number of cases pending.

The CHAIRMAN. I am not sure that I understood you. Did you say that the attorneys looked this case up?

Senator ERNST. No; I am not talking about this case. I speak generally. For instance, I am an attorney. Suppose my firm had a case before the department and the department decided it adversely.

Subsequently a decision of the Supreme Court was rendered which entitled my client to a refunder. I would not have to have anybody, in or out of the department, come to me and tell me about it. Our firm gets those decisions; we note them regularly, and we ourselves would notify the client that that client was entitled to a refunder.

As I say, as a practical question this does not present any difficulty. It is solved, and solved by every law firm in the United States that knows how to look after the rights of a taxpayer.

Mr. Box. In this case, when the claim was made originally, it was contended the payment of the tax on the widow's interest was erroneous, and everything was done which could be done by her to protect her own interests.

Senator Ernst. She had a claim at that time?

Mr. Box. A claim was made on the very point that the Supreme Court decided, and that was that she was paying a tax on an interest which the decedent did not have. It was her interest.

Senator Ernst. I understand that fully, and I also understand that the department rendered this decision, whether rightly or wrongly, and then when the decision which the department had rendered was shown to be wrong by the decision of the Supreme Court, I say, where were her original attorneys in the matter that they did not know what the decision of the Supreme Court was and how it affected any finding of the department? I say that in nine hundred and ninety-nine cases out of a thousand you will find that the attorneys who represented the taxpayer originally are keenly on the lookout for any decision affecting any matter that they had before the department.

Mr. Gregg. They certainly should have done so in this case, because they raised the very point when they filed their return which was subsequently decided by the Supreme Court. It seems to me that they would watch that question closely enough to have known that it was pending in the courts and that they should have taken advantage of the decision of the Supreme Court when it was handed down.

Mr. Nash. This is not an isolated case in that community. There are hundreds of such cases in Iowa and Nebraska that were affected by this decision, and I presume all of them received refunds.

Senator Ernst. That is the point exactly. It is a practical question. That is the point I am making, and that does not amount to anything.

Mr. Nash. Kay & Kay did reach a number of taxpayers in that vicinity. They did in many cases just what they did in this case—they went out and solicited the business and got a contract to divide the refund between themselves and the taxpayer.

The Chairman. This has developed an evil which has not been apparent in the record as yet, and notwithstanding the statement of Senator Ernst, I still say that the Government has some responsibility to its citizens, and the Government should not be expected to rely upon attorneys to protect its citizens.

Mr. Nash. Well, the purpose of our publishing Treasury decisions and rulings and the purpose of publishing the decisions of the board of tax appeals is to keep the public informed of the Government's position on disputed points.

Senator Ernst. The courts of this land, with all of the experience which they have had from the beginning of our Government up to the present time, find very great difficulty in protecting the rights

of those that appear before the courts, unless the attorneys for the parties do their duty, and that is where it will have to rest.

The CHAIRMAN. You may present your next case, Mr. Box.

STATEMENT OF MR. GEORGE G. BOX, CHIEF AUDITOR FOR THE COMMITTEE

Mr. Box. The next case is that of the Roessler & Hasslacher Chemical Co. of New York.

This corporation was incorporated under the laws of the State of New York in May, 1889, for the purpose of dealing in the manufacture of chemicals. It was capitalized at $650,000. On January 24, 1911, the capital was increased by the issuance of 6,500 shares, at $100 each, making a total capitalization of $1,300,000.

For the years 1917, 1918, and 1919 the taxpayer owned 100 per cent of the stock of the Mexican Roessler & Hasslacher Co. of New York City; 59 per cent of the Niagara Electro Chemical Co., Niagara Falls, N. Y.; and 51 per cent of the stock of the Perth Amboy Chemical Works, Perth Amboy, N. J.

The Income Tax Unit decided on June 3, 1920, that the last two above-named companies were not affiliated with the taxpayer. It was subsequently decided by the unit that these companies were affiliated with the taxpayer.

A complaint has been received (that portion of which relating to this case appears as Exhibit A) from D. F. Hickey, formerly a reviewer in the affiliation section of the Income Tax Unit, and now employed in the estate tax division, against the action taken by the unit in holding that the taxpayer was affiliated with the Niagara Electro Chemical Co. and the Perth Amboy Chemical Works for the years 1917, 1918, and 1919.

The complainant states that subsequent to June 3, 1920, at which time the original ruling was made that these companies were not affiliated, when the taxpayer was notified by the bureau that the two corporations in question were not associated nor affiliated with the taxpayer, the case was appealed to the committee on appeals and review, and while before the committee additional data in the form of elaborate briefs were filed, whereupon the case was sent back to the unit for reconsideration in the light of the additional information.

He states that it was given to Mr. H. L. Robinson, who was his chief, for examination. The complainant wrote an extended opinion on the case. (Exhibit B.)

Thereafter Mr. Robinson, his chief, told him he concurred in his views, but that "we nevertheless were going to have to give it to them," after which he sent the case to Mr. Rusch, assistant head of the consolidated returns subdivision of the special audit division.

He states that subsequently the case came to his desk for review and he noticed that affiliation had been allowed, regardless of the propriety or legality of so doing. The complainant claims that the precedent set by this case is very bad and that when the question of ruling for the years 1920 and 1921 came up the taxpayer set up the incorrect ruling for prior years as an argument for getting the same favors for 1920 and 1921. The complaint is made that this

taxpayer was permitted to escape paying just tax for 1917, 1918, and 1919, owing to the incorrect reversal of the proper ruling previously made for those years.

The records show that on March 21, 1922, Mr. H. L. Robinson forwarded the memorandum of Mr. Hickey to Mr. Rusch, asking for instructions as to how the case should be closed.

(This memorandum is made Exhibit C.)

The next action taken by the bureau, as it appears from the records, was on April 8, 1922, when the taxpayer was advised by letter, signed by William P. Bird, chief of the subdivision (Exhibit D), that the taxpayer was affiliated with the Niagara Electro Chemical Co. and the Perth Amboy Chemical Co. for the years 1917, 1918, and 1919.

As certain minority interests in the two last above-named companies were owned by Germans, the stock of these individuals was taken over by the Alien Property Custodian. On November 1, 1921, I. M. Meekins, general counsel for that official, requested the Commissioner of Internal Revenue to grant him a hearing, together with counsel for the taxpayer, on the matter of affiliation, as he stated that he sought to "subserve their best interests"—that is, the stockholders whose stock they had taken over.

Subsequently a memorandum was filed by counsel for the Alien Property Custodian, which was undated and unsigned, wherein the suggestion was made that the matter of affiliation of the corporations in question be referred to some officer of the bureau having broader discretion than the officers of the Income Tax Unit. As a result of this communication the matter was referred to the committee on appeals and review and treated as an appeal.

Oral hearings were held before the committee on November 8, 1921, and February 27, 1922, which were attended by Mr. L. E. Rusch, for the Income Tax Unit, and Mr. I. M. Meekins, counsel for the Alien Property Custodian, and accountants and attorneys for the corporations in question.

Senator ERNST. What is the date of that in 1921?

Mr. BOX. The oral hearings?

Senator ERNST. The hearings that you have just referred to.

Mr. BOX. November 8, 1921, and February 27, 1922. I think there were two oral hearings held. The chairman of the committee on appeals and review referred the question of consolidation to Mr. L. E. Rusch and transmitted additional evidence (briefs, etc.) on February 27, 1922. Apparently the case was then turned over by Mr. Rusch to Mr. Robinson and by the latter to the complainant, whereupon his memorandum (Exhibit B) was written.

It appears that the general counsel for the Alien Property Custodian was very active in the settling of this case. As stated above, before the matter of affiliation was decided upon he filed a memorandum requesting some officer of the bureau having a broader discretion than the officers of the Income Tax Unit to consider the case. After the decision was rendered that the companies were affiliated it appears that Mr. Meekins called on the commissioner; that he was sent by the latter to Mr. Bird, chief of the consolidated returns subdivision, with the request that the latter give Mr. Meekins special consideration and discuss the status of the case of the taxpayer.

It appears from a letter dated May 11, 1922, from Mr. Bird to Mr. Bright (Exhibit E) that Mr. Meekins advised Mr. Bird that the case was in Mr. Bright's section; that Mr. Putnam had been working on it, and he asked particularly that the case be completed by Mr. Putnam as soon as he returned from the training class.

On October 17, 1923, a letter was written to the taxpayer superseding the letter of April 8, 1922, which declared the companies in question not affiliated for the years from 1917 to 1921, inclusive. (Exhibit F.)

Under date of January 3, 1924, Mr. Lawrence A. Baker, attorney for the taxpayer, wrote a letter to the deputy commissioner (Exhibit G) transmitting certain affidavits expressing the hope that—

you will direct the withdrawal of the recent letter from the consolidated returns section indicating that the question of affiliation of the Niagara Electro Chemical Co. and Perth Amboy Chemical Works with the Roessler & Hasslacher Chemical Co. might be reopened.

Under date of January 5, 1924, Deputy Commissioner Bright addressed a communication to Mr. Lohmann, chief of the consolidated returns division (Exhibit H) transmitting affidavits referred to above (Exhibits I and J), stating that in his opinion "the action of the unit in affiliating these companies should not be disturbed and that the letter to the company, dated October 17, 1923, reversing the previous ruling should be withdrawn in so far as the years 1917, 1918, and 1919 are concerned, and the case considered closed." This left the case with the three companies affiliated.

On January 10, 1924, the letter of October 17, 1923, was rescinded and the taxpayer was advised to attend a conference to consider the question of affiliation of these companies for the years 1920 and 1921. This conference was held on February 1, 1924. It is admitted that the same facts existed in regard to the stockholders for these years as existed during the years 1917, 1918, and 1919. As a result of this conference, report of which is made Exhibit K, the Niagara Electro Chemical Co. was held by Conferee S. A. Linzel to be affiliated with the Roessler & Hasslacher Chemical Co., and the Perth Amboy Chemical Works to be not affiliated for the years 1920 and 1921.

Mr. J. K. Polk, auditor, in signing the conference report, dissented from the conferee's opinion that the first above-named company should be affiliated with the taxpayer.

Although this case was referred to the committee on appeals and review for a decision late in 1921, it was returned, after hearings were held, to the unit without a decision being given, and the question of affiliation has not been decided by the committee on appeals and review or the solicitor, in spite of the fact that such difference of opinion existed in the bureau in this matter.

It is apparent that the taxpayer, the Niagara Electro Chemical Co. and the Perth Amboy Chemical Works, should have submitted separate returns for the years 1917, 1918, and 1919, which would have resulted in the collection by the Government of taxes in the sum of approximately $671,409.13 in excess of those paid by the taxpayer on the consolidated returns which they were authorized to submit by the bureau.

In connection with the examination of this case the committee was advised by Mr. L. C. Haugh, former chief of the inventory section of the Income Tax Unit of the Internal Revenue Bureau, that he visited the taxpayer for the purpose of making an investigation of its inventories for the years 1917, 1918, and 1919.

He stated that when he appeared at the offices of the taxpayer and advised them of his purpose he was informed that the inventory records themselves were not available at the time, as they were stored in a warehouse down on the water front of New York City, and they endeavored to obtain his consent to take the company's book figures for the inventory instead of making a detailed audit of the inventory sheets themselves.

Upon being advised that he would not consent to such a procedure he was told to return that afternoon. He called again that day and twice the following day, upon the last visit of which he was informed by the treasurer of the company that the records would not be shown to him until after their attorney had been consulted.

Mr. Haugh then visited the collector of internal revenue in New York and related his experience to him, whereupon he suggested calling on the United States attorney, which was done. The latter expressed a desire to immediately issue a subpœna for the necessary records. It was finally decided to communicate with the bureau before such procedure was followed if the records were not forthcoming the following morning. However, when he appeared and again requested the inventory sheets they were produced for him.

He states that many errors were found in the inventory, some of which he felt were not mere mistakes, and that in visiting jobbers in chemical supplies and manufacturing chemists for the purpose of checking up on the market prices of different articles which taxpayer had included in its inventory he found that many items on the taxpayer's inventory were considerably underpriced. He stated that some items were omitted in the 1918 inventory completely, whereas they appeared on the 1917 and 1919 inventories, and he obtained evidence that the articles were on hand during the whole of the year 1918. Another item was placed as at "no value," whereas he found upon questioning one of the taxpayer's dealers that the market value at the inventory time was $100 per ton, and that the taxpayer was the only concern in the United States from which the article could be purchased by the informant.

He states that in his conferences with different Government officials in New York he gained the impression that there was a general feeling among them that they were waiting for the opportunity to obtain some evidence against this taxpayer from which they could commence a prosecution, as it seemed to have a very unsavory reputation.

Of course, the last part, in regard to this inventory, has nothing to do with the complaint filed by Mr. Hickey. I added that because it came to my notice.

Senator WATSON. Has that case been closed?

Mr. BOX. It has not been closed.

Senator WATSON. Has the question of affiliation been definitely settled?

Mr. BOX. The last action on the question of affiliation was after that conference report, where the conferees decided that one cor-

poration was affiliated with the taxpayer and the other was not, and the auditor dissented from the opinion that the first corporation was affiliated with the taxpayer.

Senator WATSON. So it stands yet an undetermined proposition?

Mr. BOX. That is unsettled as yet.

The CHAIRMAN. Do you recall what percentage of the holdings were in these affiliated companies?

Mr. BOX. Fifty-one and fifty-nine per cent.

The CHAIRMAN. Is it your understanding that in a case of that kind that constitutes control under the law?

Mr. BOX. For the year 1917, as I understand it, the question of control did not enter into it. In 1918, 1919, and 1920 the control was inserted in the law, but for the first year it was not a matter of control.

The CHAIRMAN. As I understand from your reading of the report, the case has been correctly decided so far as it has gone; is that correct?

Mr. BOX. Yes; in my own opinion.

The CHAIRMAN. Yes.

Mr. BOX. Neither company should be affiliated. The complaint, of course, in the case is that instead of having the decision made by the solicitor or the committee on appeals and review, it was not done. Although the case was referred to the committee on appeals and review a decision was not rendered by it, but it was returned to Mr. Rusch, who gave orders to have certain action taken.

Mr. GREGG. But it has not yet been finally closed?

Mr. BOX. It has not yet been finally closed.

Mr. GREGG. I happen to know, because we were discussing it——

Mr. BOX. That is my understanding of the case. I do not see any action in the case showing that the additional tax has been paid.

Mr. GREGG. Well, the criticism is that the department considered at one time holding them affiliated. Is that the only criticism of the case?

Mr. BOX. The criticism is of the action taken in the bureau, and that is the criticism by the complainant.

Senator ERNST. For doing what?

Mr. BOX. For giving instructions to rule them affiliated, when they were not affiliated, according to complainant's opinion, and if they were not affiliated, or regardless of what the condition was, it should have been decided by the legal officer in the department or by the committee on appeals and review.

Mr. GREGG. I will answer the first criticism first, that it should have been decided by the legal officer.

The solicitor's office is now and has been growing tremendously for the last couple of years, and is unable to handle all of the work that it has. At the present time there are about 3,000 of these affiliation questions pending in the unit, questions as to whether corporations are affiliated, and I think it is quite apparent that those 3,000 cases could not all be dumped over onto the solicitor's office.

On the next point, as to whether the department was right in considering any of them affiliated, I would like to give the committee just a little history on that.

The statute says—and it is the same for 1917 as for subsequent years, and I want to give you the exact language, section 240 of the revenue act of 1921:

> * * * if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all of the stock of the other or others.

Now, nobody has ever known just what that meant. We have always been in great doubt about it. You will remember that when the 1924 act was up for consideration, I brought out the fact for the Treasury that we had so much difficulty and that we had so much uncertainty that the committee adopted an arbitrary rule setting 85 per cent as the dividing line.

Senator WATSON. Yes; I remember that.

Mr. GREGG. To remove all of this doubt which existed?

Senator WATSON. Yes.

Mr. GREGG. That was done in the 1924 act?

Senator WATSON. Yes.

Mr. GREGG. Back under the old act we do not know yet what the rule is. We have had about 50 cases up to the board of tax appeals to try to find out what it means. We have gotten decisions in about five of those cases, most of them reversing the position of the department, saying that we have been too strict in our interpretation of the law, and we still, even after those five cases have been decided, do not know what to do with it.

Senator WATSON. Those were cases originating before 1924?

Mr. GREGG. Yes, sir; they were cases under the old act.

Senator WATSON. Since 1924 you have had a yard stick to go by?

Mr. GREGG. Since 1924 it is just a mathematical computation.

Senator WATSON. Yes.

Mr. GREGG. It is perfectly simple.

Senator WATSON. Well, has there been an effort to determine the question arising before 1924 by the 85 per cent rule?

Mr. GREGG. No, sir; because the statute is entirely different, and we did not feel justified in applying the 1924 statute back to the old cases. We do not know what the right rule is under the old act. I think from a reading of the act it will be self-evident that nobody can say what is right and what is wrong on it.

The CHAIRMAN. Just what rule has the bureau applied, then?

Mr. GREGG. We have applied two rules, at one time or another We have reversed our position once, and it looks as if the board of tax appeals may make us reverse it again.

This is a very long story, if the committee wants to go into it.

The question arose about two years ago. It became acute when some case got to the solicitor's office, and we differed with the action that the unit had taken on it, so it was decided to issue an opinion laying down general rules with reference to affiliation. The so-called Solicitor's Opinion 154 was issued, and it was rather liberal in the definition of affiliation. It was very carefully considered, and it took a liberal view.

Senator WATSON. Which way?

Mr. GREGG. Toward allowing affiliations.

Senator WATSON. Yes.

Mr. GREGG. Mr. Hickey at that time objected very strenuously, and I, with four others, listened to him for about two days, giving his views on it.

Senator WATSON. Who is Mr. Hickey?

Mr. GREGG. He was an employee of the Income Tax Unit at that time. He is now an employee of the estate tax unit.

The CHAIRMAN. I think he could, too.

Mr. GREGG. When 154 came out, a committee was appointed composed of Mr. Winston, Undersecretary; Mr. Moss, Assistant Secretary; Mr. Page, who was chairman of the Tariff Commission; Mr. Beeman, of the Legislative Drafting Commission; and myself, Mr. Nash presiding, to listen to Mr. Hickey to decide whether 154 was right. We handed down a decision, the five of us, to the effect that we agreed with the opinion in substance. The commissioner subsequently decided, however, that he thought the best thing was to rule strictly on the matter of affiliation, and let the matter go to the board of tax appeals, where we could get an opinion.

On this matter of affiliation, I might say that Mr. Hickey, so far as I know, has been alone. Two solicitors have been of an opinion directly contray to his views. The five of us who heard him for two days could find no basis whatsoever for his arguments. The board of tax appeals, when it got to them, took the same position. So I do not regard his criticism as being entitled to any great consideration.

Senator WATSON. Is that the present board of tax appeals?

Mr. GREGG. Yes; it is an independent board created by the 1924 act.

Senator WATSON. Yes.

The CHAIRMAN. Was that opinion withdrawn?

Mr. GREGG. That opinion was withdrawn.

The CHAIRMAN. Was that because the commisisoner agreed with Mr. Hickey's contention?

Mr. GREGG. No, sir. It was because the commissioner thought it was a big question, and that we should probably let it go to the board of tax appeals for decision.

The CHAIRMAN. When did that happen?

Mr. GREGG. That happened, I should say, about a year ago, as I remember it. Since then we have gotten about five decisions from the board, which are directly contrary to Mr. Hickey's position, and it is rather interesting to note that he still continues to send memoranda to the commissioner, telling the commissioner that the tax board is likewise wrong and that we should pay no attention to the board's opinion.

Mr. BOX. Mr. Solicitor, has the commissioner acquiesced in those decisions of the tax board?

Mr. GREGG. Not yet.

Mr. BOX. Are not some of those decisions of the tax board contrary to each other?

Senator ERNST. That is, contrary to the commissioner?

Mr. BOX. No; some of the board's own decisions. Are they not in conflict to some extent?

Mr. GREGG. I do not think so. The board does not think so. The board is composed of a very, very able group of lawyers, quite

familiar with tax matters, and they do not think there is any conflict in them, and I do not. I think the board's position was clearly right.

Mr. Box. I have not read the board's decision, but I have heard talk in the bureau by affiliators that they were in conflict, and that it was up in the air at the present time on affiliation.

Senator Ernst. If the decisions of the board were in conflict, one with the other, it would not be the only tribunal that has ruled several ways on the same subject.

Mr. Box. But the department has not yet acquiesced in their decisions, as Mr. Gregg states.

Mr. Gregg. We have not said that we did not disagree. We have not acted as yet.

The Chairman. But you will be required to act before it is finally closed?

Mr. Gregg. Yes; we are going to act very shortly on it, as a matter of fact.

The Chairman. In answer to the question that I raised a while ago you said, in applying this affiliation section of the statute, you had used two methods. Am I right in that?

Mr. Gregg. And I then continued to explain about 154, as to how it had been issued by the solicitor, and it was subsequently overruled and withdrawn by the commissioner. That is what I meant by that.

The Chairman. Yes. In applying this affiliated section of the statute, has the application been uniform in all cases?

Mr. Gregg. I can not say, Senator. There have not been a great many of that class of cases finally settled. That is the section we are having the most difficulty with.

The Chairman. Prior to the creation of the board of tax appeals, what was the rule in force in the unit on such cases?

Mr. Gregg. I do not know, sir.

The Chairman. In other words, the bureau never issued any regulation in the matter?

Mr. Gregg. Yes, sir.

The Chairman. I am very much interested in this whole question of affiliation, and I would like to know just what rule was applied, because that is one of the sections of the Unit where a great discretion was evidently allowed to the subordinates.

Mr. Gregg. Here is the regulation which was in effect for all years. The question arose as to the interpretation of this regulation.

The Chairman. That was before 1924.

Mr. Gregg. Yes, sir. This is under the old act. This is all settled now.

The Chairman. That is all settled, but the cases are not all settled.

Mr. Gregg. No, sir. So far as the law is concerned it is all settled. This is regulation 45, article 633:

> Corporations will be deemed to be affiliated (*a*) when one domestic corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (*b*) when substantially all the stock of two or more domestic corporations is owned or controlled by the same interests. The words "substantially all the stock" can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or con-

trolling of 95 per cent or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required even though the stock ownership is less than 95 per cent. When the stock ownership or control is less than 95 per cent, but in excess of 50 per cent, a full disclosure of affiliations should be made, showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding.

The CHAIRMAN. What is your interpretation of the word "control" as used in that regulation and in the statute?

Mr. GREGG. That, of course, is one of the most difficult questions that we have, and that is the one that Mr. Hickey feels so strongly on. I think "control" means "control," whether legally enforceable or otherwise.

Take a typical case where that question comes up most often.

Assume a parent corporation which organizes a subsidiary. Suppose it is a subsidiary to take care of one of its smaller activities and there is a profit-sharing arrangement giving the president of that subsidiary, or the manager of it, 25 per cent of the capital stock, to enable him to share in the profits, and giving him an interest in it, with a provision that if he terminates his employment with the company he must offer his stock for sale to the company, and that he can not sell the stock to an outsider without offering it first to the company. That is quite a common provision, and that is a case where the question of control arises most frequently.

It seems to me quite plain that in such a case as that the parent company controls the stock owned by the president of this subsidiary company. He can not take any action contrary to the interests of the parent corporation. He is completely under their control; he is a creature of theirs; his employment depends upon their action, or the continuation of his employment does, and he is never free to act with reference to that stock as a practical matter.

Senator WATSON. There are a good many cases of that kind, though, where it is not so apparent, are there not?

Mr. GREGG. Yes; from that case they shade off until they get much more difficult.

The CHAIRMAN. In that case, I do not think anyone would have a very violent disagreement with your decision, but they are not all so simple as that.

Mr. GREGG. No; but it shows clearly the question.

The CHAIRMAN. In this particular case which has just been referred to by Mr. Box, where there is an ownership of 59 and 51 per cent, is that, in your opinion, an affiliated company?

Mr. GREGG. I am very doubtful of it. Frankly, I do not think that much of stock ownership is sufficient to constitute an affiliation, although I would like to bring out this fact that Mr. Box did not bring out: The intercompany transactions between those two companies were numerous; they were run as one business organization; they would transfer properties between the companies and lend money between them without interest, and such things as that. They were run as one corporation, and there was no attempt to accurately allocate the income of the group between the different corporations.

That is what influenced the people in the consolidated returns division in recommending the affiliation.

The CHAIRMAN. In a case of that kind, is there not great damage likely to be done to the minority stockholders if they can be switched around by the bureau?

Mr. GREGG. No, sir; it does not affect the minority stockholders. You see the tax is much less if the corporations are affiliated.

The CHAIRMAN. The tax is less?

Mr. GREGG. Usually.

The CHAIRMAN. Yes.

Mr. GREGG. Sometimes it works the other way, but usually the tax is less if they are affiliated than if they are not affiliated; but after the tax is determined it is apportioned between the different corporations in proportion to the income attributable to each; so it does not affect adversely the interests of the minority stockholders.

Senator ERNST. Take a case such as you have mentioned, where the business relations between the two companies are so very close and intimate, as in this case, for instance. How would you say that would affect their determination?

Mr. GREGG. That affected it to this extent: If those conditions are present, intercompany transactions, buying and selling between the companies at prices other than the actual market prices; if those conditions are present, you can not get an accurate determination, either of income or invested capital, without consolidating the corporations. I think that is perfectly apparent. Unless they are run as separate enterprises, financially independent of each other, you can not, except on the basis of the consolidated return, get the accurate income of the group or the correct invested capital.

The CHAIRMAN. I can visualize, however, by a conclusion of that kind great opportunity for manipulation.

Mr. GREGG. Well, that is the point I am coming to. The manipulation has no effect if you consolidate it.

The CHAIRMAN. Well, but there is opportunity for manipulation. By the plan of making a consolidated return they can manipulate their business so that the fact of the affiliation does reduce the tax.

Mr. GREGG. Not by manipulation between the companies, because in making the consolidated return we absolutely ignore the intercompany transactions. They are wash transactions, just like taking money out of one pocket and putting it in another.

The CHAIRMAN. Yes; but you can take a company such as was referred to in this case and have it operated so that it shows a great loss, and that loss by affiliation was deducted from the profits of the successful corporation.

Mr. GREGG. Yes, sir; but would anyone want to conduct a corporation at a loss just to get——

The CHAIRMAN. No; but after the corporation had shown a loss the taxpayer then might claim a right to file a consolidated return to absorb the loss and to reduce the tax on the profitable corporation.

Mr. GREGG. Yes, sir; that is true; but, of course, that comes back to the point: Are they affiliated? If they are affiliated, they should be allowed to do that. If they are not affiliated, they should not be allowed to do it.

The CHAIRMAN. For instance, I have been going over the case of the Union Trust Co., the Mellon National Bank, and I think the Union Savings Bank. In that case, if I remember correctly—and I do not have it before me—they were not affiliated, and the bureau decided that they were not affiliated, and yet, if I remember correctly, there is almost exact ownership, but they had different charters, and under one charter they could not do something that they could do under another charter. By deciding that they were not affiliated there was some eighty to ninety thousand dollars in taxes saved. I point that out as an instance. We have not presented that case, because in talking it over with counsel it has seemed to us to be a pretty close case, and counsel has not decided that the bureau is in error in it. It is a case, however, which parallels this case somewhat, in that the decision as to affiliation or nonaffiliation can save the taxpayer a great deal of money, either one way or the other. If it is decided to be not affiliated in this case, it saves the taxpayer money; but in most cases, indeciding that they are affiliated, it saves the taxpayer money.

Mr. GREGG. That is what I say, Senator. Sometimes the corporation pays more tax by affiliation than if it was not affiliated, but usually they pay a less tax.

The CHAIRMAN. Yes.

Mr. GREGG. Of course, it materially affects the tax of the company in the majority of cases. Otherwise, there would not be the argument and difficulty about it that there is.

Mr. BOX. In regard to the matter of control, it seems to me that it leaves too much to the discretion of the taxpayer as to what kind of a return he shall file. For instance, as Mr. Gregg has said, if an officer of the company owned a certain percentage of the stock and controlled other stock, and if he thought that he could save the tax by filing a separate return, he would not disclose to the Treasury Department the fact that he controlled the other stock, and would therefore file a separate return: whereas, if he could save the tax by filing separate returns, he would merely set up in his argument that he controlled this stock and was entitled to file a consolidated return.

Mr. GREGG. That assumes that we will not get all of the facts. Of course, sometimes we do not get all of the facts.

The CHAIRMAN. I think that is true; but I can see where a man could, in one case, have his wife own 49 per cent of the stock and in his return claim affiliation because he controlled his wife's stock, and in another case claimed that he did not control his wife's stock, reversing the actual results.

Mr. GREGG. If I may point out, Senator, that was the action of Congress in putting the test of control in the statute, and we finally got them, in the 1924 act, to take that out as a test.

The CHAIRMAN. I think you did a good job in that case, and the thought that the investigators have had in mind was to see that the cases that have not yet been closed will be uniformly decided as nearly as possible.

Mr. GREGG. If the representatives of the committee agree with Mr. Hickey on the question of control, they will be just about the first that I have seen that do.

The CHAIRMAN. Well, unfortunately, Mr. Manson is ill, and I do not know what his conclusions on the matter are.

Mr. GREGG. The board of tax appeals has taken the other position, after a most careful consideration of it.

Mr. BOX. Mr. Solicitor, you stated that Mr. Hickey stands absolutely alone in his contentions. Is it not a fact that several of the other employees who have made a specialty of affiliations agreed with Mr. Hickey and have stood with him?

Mr. GREGG. Two others have stood with him; that is, of his associates down in the consolidated returns division. I referred to everyone who had considered the question who is in a position of authority, starting with the chief, the assistant chief of the consolidated returns division, the head of the Income Tax Unit, two solicitors, the five of us who sat in at the conference, and now the board of tax appeals, have all disagreed with him.

Mr. BOX. Did not Mr. Crewe agree with him in submitting his brief to the board of tax appeals?

Mr. GREGG. Two people argued our case before the board of tax appeals after the commissioner had taken this position. After the commissioner had taken this position——

The CHAIRMAN. You, of course, had to support him?

Mr. GREGG. Our office had to support him. I do not know whether Mr. Crewe did or not. I do know that Mr. Milliken, of the solicitor's office, went over there and made a very excellent argument—the best, I think, that could have been made in support of the position that the commissioner had taken, when he did not agree with it in any particular.

The CHAIRMAN. Have you any other case now, Mr. Box?

Mr. BOX. Yes, sir. I would like to ask Mr. Gregg if he will give us a reference to some of these decisions wherein the solicitor reversed Mr. Hickey's ruling, the case where Mr. Hickey ruled——

Mr. GREGG. I did not say that the solicitor ever reversed Mr. Hickey. I said the question became acute when cases from the unit were coming up to the office, many of them holding affiliation where we did not think that they should be affiliated, and as a result of the question arising in that way—I do not know who handled it in the unit, whether it was Mr. Hickey or anyone else—as a result of it arising in that way, it brought the whole question up, and solicitor's opinion 154 was written. I doubt, as a matter of fact, that Mr. Hickey made any of the rulings which the solicitor's office reversed, because he was always against affiliation, and the ones that we were reversing, which gave rise to opinion 154, were cases where the unit had ruled that they were affiliated, and we disagreed.

Mr. NASH. I think they were cases that went up on refund claims, and were brought to the attention of the solicitor in that manner.

Mr. GREGG. Yes; they were brought to the attention of the solicitor after the unit had ruled on them.

Mr. NASH. I might add, Mr. Chairman, that we changed our organization to get a closer control of the decisions on questions of affiliation, about a year and a half ago. Under the old plan of organization, there was a small group in each audit section who would first pass on the question of affiliation, and then the cases would go on to the auditors for audit. In that way, each little group of men that were passing on affiliations gave their own views, and there was not the uniformity of decisions that there should have been in determining these questions; so about a year and a half ago we

created an affiliation section and put it directly under the control of the deputy commissioner. All questions of affiliation are now referred to that section, and must come out through the one head; so we do get a more uniform application of the regulations.

The CHAIRMAN. Have you any idea how many affiliated cases have been closed?

Mr. NASH. About 30,000.

The CHAIRMAN. And you think that as a result of their passing all through this one channel, you have secured uniformity in deciding them?

Mr. NASH. We are getting more uniformity in our decisions than we did before. Of course, many of these cases depend upon the individual judgment of the man that has the case before him, but his work is now subject to review, and if it is a close question it is subject to the scrutiny of the head of that section. We had a meeting in the commissioner's office just the other day on this question, and we are now waiting until we get one or two more decisions from the board of tax appeals covering other points at issue. When these decisions are received we will then try to work out a uniform policy that will quite likely be better than the one we now have. It is a question that has never been decided in the courts. We have waited and waited for somebody to take one of these cases to the courts, so that we could get a court decision, but we have never had one.

The CHAIRMAN. I suppose it will actually get to the courts before you get through, because some of these taxpayers will disagree.

Mr. GREGG. We had one case in court, and we were quite hopeful that we would get an opinion on it. The court decided the case and wrote no opinion on it. That was about three months ago.

Senator ERNST. In what court?

Mr. GREGG. One of the district courts; I do not remember exactly which one.

The CHAIRMAN. All right, Mr. Box.

Mr. BOX. I would like to state for the record that Treasury Decision 2662, in defining part of this law, stated as follows:

> The words "all or substantially all of the stock" as used in the above definition will, until further notice, be interpreted as meaning an ownership of 95 per cent or more of such stock by the same taxpayer during the taxable year.

The CHAIRMAN. When was that ruling issued?

Mr. BOX. I have not the date of it.

Mr. GREGG. I assume that that is the ruling which the commissioner issued when he decided not to follow solicitor's opinion 154.

The CHAIRMAN. You did not read that just now when you read that interpretation?

Mr. GREGG. No; I was reading the old interpretation, back under the old law. I was reading regulations 45.

Mr. BOX. I have not the date of it. It was subsequent, of course, to the regulation, because it was in explanation of it.

Mr. NASH. Regulations 62, on the 1921 act, says:

> The owning or controlling of 95 per cent or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute.

Then it goes on and makes an exception down to 70 per cent.

(Exhibits submitted by Mr. Box in Roessler & Hasslacher Chemical Co. case are as follows:)

EXHIBIT A

ROESSLER & HASSLACHER CHEMICAL CO., NEW YORK CITY

Although I had been in the unit from April 19, 1919, it was not until early in 1922 that I encountered a case where plainly the law was transgressed. It was then in the affiliation section of the then existent consolidated returns subdivision of the special audit division. Mr. H. L. Robinson was my chief. Mr. L. E. Rusch was assistant head of the division, and Mr. William P. Bird was head of the division. I was reviewing cases and attending taxpayers' conferences. (Chief and assistant chief of the subdivision is meant.)

Unter date of June 3, 1920, Rossler and Hasslacher had been notified by the bureau that two other corporations with which this company was associated were not affiliated with it. The case was subsequently appealed to the committee on appeals and review and while before the committee additional data in the form of elaborate briefs were filed, whereupon the case was sent back to the unit for reconsideration in the light of the additional information. It was given to me by Mr. Robinson for examination. The years 1917 to 1919, inclusive, were involved.

It was found that 41 per cent of the capital stock of one of the associated corporations was owned by Germans, English, and Americans who owned no stock whatever in either of the other two companies, while in the case of the other associated company 49 per cent of the capital stock was owned by Germans exclusively. With such large minority interests outstanding it was clear that no affiliation could be allowed if any attention was to be paid to the statutes controlling, regardless of the claim of the extent to which intercompany transactions had been carried on and corporate entity disregarded. It will be remembered that German and British aliens largely composed the minority interests mentioned. These peoples had been fighting each other during 1917 and 1918. Moreover, the German minorities had been taken over by the Alien Property Custodian, an added reason for denying affiliation in this case.

I wrote an extended opinion on this case covering the various phases of it, and indicating the obstacles in the allowance of affiliation. Mr. Robinson told me he concurred in my views, but that we nevertheless were "going to have to give it to them." Subsequently, he sent the case to Mr. Rusch, with the request that he be advised of the ruling to be made, calling Mr. Rusch's attention to my opinion. Later on the case came to my desk for review, and I noticed that affiliation had been allowed, regardless of the propriety or legality of so doing. I ascertained that my dissenting opinion was still in the case, signed the work record, and sent the case along in the regular way. I was at that time a new man in the consolidated returns subdivision, comparatively, and there seemed to be nothing more that I could do in the matter.

This case set a very bad precedent and was heard of outside the unit as well as inside. Besides, when the question of ruling for the years 1920 and 1921 came up, Roessler & Hasslacher set up the incorrect ruling for prior years as an argument for getting the same favors for 1920 and 1921. The case was taken up with Deputy Commissioner Bright some months ago, instead of with the committee on appeals and review, and lay inactive for a long time. When Solicitor's Opinion No. 154 was issued, orders were given to rule all three companies affiliated for 1920 and 1921, but these orders were subsequently countermanded when it was found that a conference on the case had been set for February 1.

After the conference of February 1, 1924, Mr. Linzel, of the technical staff of the consolidated returns audit division, who was ranking conferee at the conference, made a ruling allowing affiliation of Roessler & Hasslacher with the other corporation having the 41 per cent minority, but excluded the company with the 49 per cent minority. As Solicitor Hartson himself said when apprised of this remarkable display of absurdity, such a ruling is not supported by anything, there being no affiliation at all in this case. Mr. Linzel, as I informed you in my letter of February 15, 1924, based his ruling upon Solicitor's Opinion No. 154. The solicitor says he is wrong in his under-

standing of "154." I also say Mr. Linzel is absolutely flouting the plain letter and import of the law when he rules even one of the associated companies affiliated—as does the other conferee in signing the conference memorandum as a dissenter—but I would not venture to say any man was wrong in his understanding of the revolutionary "154." It is wholly objectionable itself. The silly rulings already made under it prove that conclusively.

These Roessler & Hasslacher people were permitted to escape paying their just taxes for 1917, 1918, and 1919 owing to the incorrect reversal of the proper ruling previously made for those years. It is time they were made to obey the laws and pay their taxes for 1920 and 1921. It is cases like this that encourage wrongdoing in the unit. Please note that the original ruling was made June 3, 1920, at a time when, according to Mr. L. T. Lohmann, the "liberal" class of rulings were in force—were being made. Strange, is it not, that these companies were denied affiliation if they were entitled to it and if we were "liberal" in those days? They were not entitled to it under any real rule.

EXHIBIT B

MEMORANDUM

In re: The Roessler & Hasslacher Chemical Co., Niagara Electro Chemical Co., Perth Amboy Chemical Works.

Mr. H. L. ROBINSON,
Chief Affiliations Section.

In compliance with your instructions the matter of the affiliations of the above-named corporations during the taxable years 1917, 1918, and 1919 has been reconsidered.

This section has ruled these companies not affiliated during the years indicated, basing such ruling upon data contained in the questionnaire submitted by the Roessler & Hasslacher Co. for all years involved.

In the reconsideration of this case the questionnaires, memorandum submitted by I. M. Meekins, general counsel for the Alien Property Custodian, with his letter dated November 21, 1921, and the printed brief, composed of various schedules of data and of affidavits by four of the officers and employees and one of the attorneys of and for these corporations, have been examined and studied.

It appears that the Roessler & Hasslacher Chemical Co., which will hereinafter be referred to as "R. & H.," has been the financial, purchasing, operating, selling, and administrative agent since 1895 for the Niagara Electro Chemical Co., hereinafter referred to as "Niagara," and since 1903 for the Perth Amboy Chemical Works, hereinafter referred to as "P. A. C. W.," and that the latter two companies are virtually unknown to the general public, and even to the postal authorities and financial institutions at Perth Amboy, N. J., where nearly all of the plants of the group are located, practically all of the business of these corporations being done in the name of "R. & H."

The questionnaires show that during the years in question R. & H. owned 59 per cent of the common stock of Niagara and 51 per cent of the common stock of P. A. C. W., no preferred stock in any of these companies being outstanding. Only one of the stockholders of R. & H. owned any stock in either of the other two corporations, such stockholder being a German concern which owned 30 per cent of the stock of R. & H. and 11 per cent of the stock of Niagara, this being the only instance in which the outstanding minority interests, 41 per cent in the case of Niagara and 49 per cent in the case of P. A. C. W., were affected. The minority interest in Niagara was thereby reduced to 30 per cent, the holdings of the German concern, however, in R. & H. and Niagara being obviously materially disproportionate.

The taking over in 1918 by the Alien Property Custodian of stock in these corporations held by German interests has no bearing upon the question of affiliation; it, therefore, follows that the only issue involved is the effectiveness of the minorities mentioned.

It being evident that these minority interests are not subject to any agreements, but on the contrary are held unconditionally, the nature and extent of the relations existing between these corporations must furnish the only grounds

for affiliation, if any such be found; and such relations must destroy the effectiveness of the minorities referred to in order to do that.

In support of the premise stated, reference is made to articles 631 and 635 of regulations 45, which stipulate that the provision of the statute requiring affiliated corporations to file consolidated returns is based upon the principle of levying the tax according to the true net income and invested capital of a single business enterprise, even though the business is operated through more than one corporation, and that a single business enterprise, and therefore affiliation exists when the stock of one or more corporations is owned or controlled, in substantial entirety, by another corporation, or when substantially all the stock of two or more corporations is owned or controlled by the same interests in substantially the same proportions.

The test of affiliation, therefore, is ownership or control of substantially all of the stock of the corporation or corporations with which affiliation is claimed.

In this case all or substantially all of the stock is not owned by R. & H., and with the questionnaires alone as the basis for consideration of the question, the bureau could not require consolidation. In fact, the questionnaires amply support the "not affiliated" ruling heretofore made.

A study of the memorandum of the general counsel for the Alien Property Custodian, and of the affidavits of the officers, employees, and attorney for R. & H. does not disclose control of the outstanding minorities in Niagara and P. A. C. W. in the sense contemplated by the regulations and the procedure of this section, although control of these companies in the popular sense flows to R. & H. as a matter of course, because of its ownership of the majority of the capital stock.

All of these corporations have been engaged in highly technical businesses of the same general nature for many years and certainly have passed beyond the experimental or doubtful stage as to their success. It does not appear that during the years in question Niagara or P. A. C. W. needed or received financial support under circumstances which would prompt the minority interests to surrender, even temporarily, their right to vote their stock as they pleased, regardless of the wishes of R. & H., and there is no claim made that such was the case. On the contrary, both Niagara and P. A. C. W. appear to have been very successful all along on their own account.

It is shown also in the affidavits and the schedules mentioned, as well as in the questionnaires, that agreements between R. & H. and the other two companies are in existence, governing charges for the various services performed by R. & H., and the other two corporations have been assessed accordingly. It is true that there is apparently some conflict between the questionnaires and the schedules as to the amounts charged to Niagara and P. A. C. W. and paid by these companies; and it is also noted that it is claimed that in some instances R. & H. is not compensated for capital investments inuring to the benefit of Niagara and P. A. C. W. The indications are, however, that such situations are covered by agreements, not disclosed, which afford advantages to R. & H.

As to exchange of the use of equipment between Niagara and P. A. C. W. it would seem that such reciprocal accommodations might be expected in any case where plants are in the same line of business and in close proximity to each other and operating under business agreements eliminating competition.

In this case the minority interests in Niagara and P. A. C. W., having distinguishing characteristics and being quite large, have apparently been alert to prevent any shifting of profits to R. & H., and as these two companies have been quite successful, there was no need of surrendering control of the minorities in order to get aid from R. & H.

It appears therefore that R. & H. not only did not own substantially all of the stock of these other two corporations but did not control it either.

The fact that Niagara and P. A. C. W. made a much higher percentage of profit on their invested capital than did R. & H. during 1917, 1918, and 1919 may be attributable to some degree to favorable contracts and working agreements with the latter company, but it does not appear that such financial success was due to shifting of profits, as contemplated by the bureau, from R. & H. to the other corporations.

The companies mentioned did not constitute a single business enterprise, within the purview of the regulations, during the years in question. Therefore the ruling of this section, to the effect that they were not affiliated, should be sustained.

DANIEL F. HICKEY, *Reviewer.*

EXHIBIT C

BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT,
SPECIAL AUDIT DIVISION.

Mr. RUSCH: Attached find memo. by Mr. Hickey, one of the reviewers in affiliation section re Roessler & Hasslacher Chemical Co.

Please instruct me how you wish this case closed.

H. L. ROBINSON.

EXHIBIT D

APRIL 8, 1922.

The ROESSLER & HASSLACHER CHEMICAL CO.,
New York, N. Y.

SIRS: Reference is made to the printed brief, consisting of affidavits and schedules supplementary to executed affiliated corporations' questionnaires covering the taxable years 1917, 1918, and 1919 filed by you.

From the additional facts disclosed you are advised that your corporation, the Niagara Electro Chemical Co., the Perth Amboy Chemical Works, and the Mexican Roessler & Hasslacher Chemical Corporation were affiliated during the taxable years 1917 and 1918, within the purview of articles 77 and 78 of regulations 41, Treasury Decision 2662, and section 240 of the revenue act of 1918. A consolidated excess profits tax return should therefore have been filed for the taxable year 1917. In the event that such a return should be needed in auditing the case you will be notified by this office. The filing of a consolidated income and profits tax return for the taxable year 1918 was the proper procedure.

Your corporation, the Niagara Electro Chemical Co., the Perth Amboy Chemical Works, the Mexican Roessler & Hasslacher Chemical Corporation, and the Pacific Roessler & Hasslacher Chemical Corporation from the date of its incorporation in June until the end of the year were affiliated during the taxable year 1919, within the purview of section 240 of the revenue act of 1918. You therefore followed the proper procedure in filing a consolidated income and profits tax return for that year.

This ruling supersedes that contained in office letter dated June 3, 1920.

In the event of further correspondence refer to IT:SA:CR:Af–JBK.

Respectfully,

E. H. BATSON,
Deputy Commissioner.
By WM. P. BIRD,
Chief of Subdivision.

EXHIBIT E

BUREAU OF INTERNAL REVENUE,
INCOME TAX UNIT, SPECIAL AUDIT DIVISION.
May 11, 1922.

Mr. BRIGHT: A few days ago Mr. I. M. Meekins was sent down to me by the commissioner with the idea that I give him special consideration and discuss the status of the case of the Roessler & Hasslacher Chemical Co., New York, N. Y.

I gathered from Mr. Meekins that the case was in your section and that Mr. Putnam had been working on it.

Mr. Meekins asked particularly that the case be completed by Mr. Putnam, and I am writing you this memorandum to suggest that as soon as Mr. Putnam comes back from the training class he be asked to expedite the closing of the case.

Mr. Blair tells me that he is particularly anxious that we give every consideration to Mr. Meekin and close the case without delay.

WM. P. BIRD, *Chief.*

This ruling supersedes that contained in office letter April 8, 1922.

If not in agreement with this ruling you are requested to submit an answer 30 days from the date of this letter, referring to IT-CR-A-HES-Af.

Respectfully,

J. G. BRIGHT,
Deputy Commissioner.
By L. T. LOHMANN,
Head of Division.

EXHIBIT F

OCTOBER 17, 1923.

ROESSLER & HASSLACHER CHEMICAL CO.,
New York, N. Y.

SIRS: Reference is made to information on file in this office relative to the affiliations of your company for the taxable years 1917, 1918, 1919, 1920, and 1921.

From a careful review of all the information presented you are advised that during the taxable years 1917, 1918, 1919, 1920, and 1921 the companies listed below were affiliated within the purview of section 240 of the revenue acts of 1918 and 1921:

Roessler & Hasslacher Chemical Co.
Mexican Roessler & Hasslacher Chemical Co.
Pacific Roessler & Hasslacher Chemical Corporation.
Nypania Transportation Co. (Inc.).

You are advised that during the taxable years 1917, 1918, 1919, 1920, and 1921 the companies listed below were not affiliated with your company or with any other company within the purview of the authorities cited above, and each company should therefore file separate income and profit-tax returns for each of the years named, provided that such action has not been taken.

Niagara Electro Chemical Co.
Perth Amboy Chemical Works.

Pursuant to this ruling a copy of this letter should be attached to each return when filed.

EXHIBIT G

WOODWARD BUILDING,
Washington, January 3, 1924.

Re: Roessler & Hasslacher Chemical Co. affiliation.

Hon. J. G. BRIGHT,
Deputy Commissioner of Internal Revenue
Washington, D. C.

DEAR MR. BRIGHT: I am pleased to hand you herewith my personal affidavit describing the procedure in the above matter, as explained to you and your associates in oral conference several weeks ago.

I am also inclosing the joint affidavit of Mr. L. H. Conant and Mr. H. Ligtermoet, who were personally present during the proceedings and have certified to the accuracy of my statement.

With these statements before you, I hope that you will direct the withdrawal of the recent letter from the consolidated returns' section indicating that the question of affiliation of the Niagara Electro Chemical Co. and Perth Amboy Chemical Works with the Roessler & Hasslacher Chemical Co. might be reopened.

Respectfully,

LAWRENCE A. BAKER
(For Baker & Baker).

EXHIBIT H

BUREAU OF INTERNAL REVENUE,
OFFICE OF DEPUTY COMMISSIONER, INCOME TAX UNIT,
January 5, 1924.

Mr. LOHMANN
(Attention of Mr. Leary, Chief Section A):

There are attached two affidavits relative to the Roessler & Hasslacher Chemical Co., the case upon which a conference was held in my office with respect to the affiliation of the above-named company, the Niagara Electro Chemical Co., and Perth Amboy Chemical Works during the years 1917, 1918, and 1919.

In view of the statements contained in the attached briefs and the information supplied by Mr. Baker in the conference at which were present yourself, Mr. Polk, and Mr. Partridge, I am of the opinion that the action of the unit in affiliating these companies should not be disturbed and that the letter to the company dated October 17, 1923, reversing the previous ruling should be withdrawn in so far as the years 1917, 1918, and 1919 are concerned, and the case considered closed.

J. G. BRIGHT,
Deputy Commissioner.

EXHIBIT I

DISTRICT OF COLUMBIA, *ss:*

Lawrence A. Baker, being duly sworn, deposes and states as follows:

In the early part of 1920 I became associated as counsel with Clifford, Hobbs & Beard, of New York, in advising the Roessler & Hasslacher Chemical Co. and its affiliated companies with regard to the pending review of the tax liability of the parent and subsidiary companies for the years 1917, 1918, 1919. At that time my employment was chiefly in consultation with Mr. Anson H. Beard of that firm who was especially concerned about the action of the Income Tax Unit in connection with a proposal to deny the Roessler & Hasslacher Co. the right to file a consolidated return which would include the Niagara Electric Chemical Co. and the Perth Amboy Chemical Works as affiliated companies. In the month of June, 1920, Mr. Beard visited Washington to attend a conference which I had previously arranged with the consolidated returns section for June 3, 1920. The conference was attended by Mr. Rusch on behalf of the Government and the only subject discussed was the question of affiliation as to the Perth Amboy Chemical Works and Niagara Electro Chemical Co.

Thereafter a field examination was concluded and letters were sent to the taxpayer restating the tax liability of the Roessler & Hasslacher Co. and several subsidiaries and separate letters were addressed to the Niagara Electro Co. and the Perth Amboy Chemical Works proposing additional assessments against each of those companies based on separate returns for those companies.

In the meantime under date of May 7, 1920, Mr. Beard had given a letter to Mr. Lee J. Wolfe introducing Mr. Wolfe to me in order that I might cooperate with Mr. Wolfe in an attempt to arrive at the possible tax liabilities of the several companies for the information of the Alien Property Custodian in whose interest I was advised Mr. Wolfe had been employed for the purpose of assisting the custodian in arriving at the fair value of the stock of the several companies affected by the proposed additional taxes. I was also informed by Mr. Wolfe or through some other representative of the custodian that an attempt would be made to have the commissioner bring the investigation of tax liability down to date in order that the custodian might more intelligently estimate the value of certain shares of stock held by him in the several companies.

Subsequently Isaac M. Meekins, then general counsel for the Alien Property Custodian, became interested in the situation, and at his request I visited the office of Judge Meekins and reviewed the general situation with him at length.

My explanation to Judge Meekins of the method of conducting the business of the Roessler & Hasslacher Chemical Co. and its various subsidiaries and an analysis of the various stock interests in the several companies led Judge

Meekins to take up with Commissioner of Internal Revenue Blair the question of affiliation which had previously been denied by the consolidated returns section of the Income Tax Unit—as I understand—on the recommendation of Mr. Rusch. Judge Meekins reported to me that the commissioner had arranged a special hearing before the committee on appeals and review and I accompanied Judge Meekins to the committee on appeals and review where we had an interview with the then chairman of that committee—N. T. Johnson—who had with him at the conference two members of the committee—Mr. Davis and Mr. Gillis. At that conference it was agreed that I would cooperate with the officers and accountants of the company in the immediate preparation of analyses of facts and figures which would enable the Committee on Appeals and Review to intelligently advise the commissioner of its recommendation.

In January, 1922, I filed with the committee on appeals and review a printed statement with exhibits entitled "Taxpayer's statements in support of a consolidated income and profits tax return for the taxable years 1917, 1918, 1919." In support of this printed statement I appeared with Judge Meekins and the accountants of the company, Mr. L. H. Conant, of L. H. Conant & Co., 709 Sixth Avenue, New York City, and his assistant, Mr. H. Ligtermoet, of the same company and address. At that conference I presented many exhibits and arguments, and I was able, with the assistance of the accountants, to answer many questions propounded by Mr. Johnson and the other members of the committee. Mr. Rusch, who had heard the matter in the Income Tax Unit, was present at the conference and was apparently greatly impressed by the large amount of additional and convincing evidence then presented. At the conclusion of the conference representatives for the taxpayer retired and a consultation was held between members of the committee and Mr. Rusch. Thereafter I was informed by Mr. Davis, of the committee, that it had been agreed in conference to refer the entire file back to the Income Tax Unit for further consideration there. I gathered the impression from conversations with Mr. Davis and Mr. Rusch that the members of the committee and Mr. Rusch were in accord in their opinion that the taxpayer's position had been sustained and that Mr. Rusch was agreeable to reconsideration of his recommendation, not only because of the attitude of the committee but because of a change in opinion on his part brought about by the argument and additional data filed before the committee.

Under date of April 8, 1922, the Roessler & Hasslacher Chemical Co. received a letter from the consolidated returns section advising that upon reconsideration the consolidation of Niagara Electro Chemical Co. and Perth Amboy Chemical Works with the Roessler & Hasslacher Chemical Co. would be granted.

The statement is made for the purpose of completing the record of the Income Tax Unit concerning my participation in presenting the argument for affiliation before the committee on appeals and review.

LAWRENCE A. BAKER.

Subscribed and sworn to before me this 31st day of December, 1923.

C. LARIMORE KELSEY,
Notary Public, District of Columbia.

EXHIBIT J

STATE AND COUNTY OF NEW YORK, *ss:*

L. H. Conant and H. Ligtermoet, being duly sworn, depose and state as follows:

That they have each read the attached copy of an affidavit by Lawrence A. Baker, of Washington, D. C., and the statements made therein, as known to them personally, are true, and as to other statements they believe them to be true.

L. H. CONANT.
H. LIGTERMOET.

Subscribed and sworn to before me this 31st day of December, 1923.

AUGUST A. HEUSER,
Notary Public.

EXHIBIT K

CONSOLIDATED RETURNS AUDIT DIVISION—TAXPAYER'S CONFERENCE

Taxpayer: Roessler & Hasslacher Chemical Co.
Address: New York City.
Represented by: L. A. Baker, attorney.
Credentials: Power of attorney on file and enrollment in order.
Years involved: 1920 and 1921.

Matter presented: The conference was arranged to consider the affiliation of the above company with the Niagara Electro Chemical Co. and the Perth Amboy Chemical Works for the years involved. The companies were ruled affiliated for the years 1917, 1918, and 1919, and practically the same facts exist for the years under consideration.

The Roessler & Hasslacher Chemical Co. owns 59 per cent of the outstanding effective stock of the Niagara Electro Chemical Co. The Alien Property Custodian holds 11 per cent, which has been held to be an ineffective minority, leaving an effective minority interest of 30 per cent.

In the case of the Perth Amboy Chemical stocks, 51 per cent only is owned by the Roessler & Hasslacher Co., 49 per cent is held by the Alien Property Custodian, and there is, in fact, a question as to whether the Alien Property Custodian does not hold 51 per cent.

It is shown that the Roessler & Hasslacher Co. exercised control of the two companies through common officers and employees, centralization of management, common use of assets, assignment of the use of patents to the companies without compensation, intercompany financing, and various other relations found in one economic unit, as set forth in Solicitor's Opinion 154.

Decision: It is held that Niagara Electro Chemical Co. should be affiliated with the Roessler & Hasslacher Chemical Co. for the years 1920 and 1921 on the basis of ownership and control, forming one economic unit. In the case of the Perth Amboy Chemical Works no affiliation is held to exist on the grounds, first, that there is a question of 51 per cent ownership by the taxpayer; secondly, that in an admitted outstanding minority interest of 49 per cent, effectual control is questionable, and a business so owned can hardly be an economic unit.

Revised ruling letter to be mailed.

Interviewed by—

F. A. LINZEL,
Conferee Technical Staff.

Dissenting.

J. K. POLK,
Auditor Audit Section A.

L. T. LOHMANN,
Head of Division.

FEBRUARY 1, 1924.

The CHAIRMAN. You may proceed with your next case, Mr. Box.

STATEMENT OF MR. GEORGE G. BOX, CHIEF AUDITOR FOR THE COMMITTEE

Mr. Box. The next case is the case of the Little Estate Corporation, New York City.

The CHAIRMAN. Is that an inheritance-tax case?

Mr. Box. No, sir; it is an affiliation case. It was complained of by Mr. Hickey.

This corporation was organized on December 28, 1916, under the laws of the State of New York with an authorized and issued capital of 2,400 shares of no par value stock. The corporation acquired all of the real and personal property of the estate of Joseph J. Little, issuing in consideration thereof 2,400 shares of its capital stock.

Its business is that of dealing in real estate and securities.

The J. J. Little & Ives Co. was organized under the laws of the State of New York with an authorized capital of 50,000 shares, par value $100 each. During the year 1916 the company was authorized to issue $1,000,000 of preferred stock, representing 10,000 shares, of a par value of $100 each.

The company is engaged in the business of printing and binding.

The St. Nicholas Seventh Avenue Theater Co. was organized on April 22, 1912, under the laws of the State of New York, with an authorized capital stock of $600,000, of which $525,000 was common and $75,000 preferred stock. The latter was issued for cash and the common stock for good will.

Formal complaint has been filed with the committee by Daniel J. Hickey, formerly employed in the affiliation section of the income-tax unit of the Internal Revenue Bureau, in regard to the action of the bureau in its procedure in regard to the affiliation questions involved in connection with the above three named companies.

The complainant states that the bureau ruled that these corporations were not affiliated early in 1922; that several conferences were regularly held, and that at one of these conferences Mr. Beekman, taxpayer's representative, stated that his principal, Mr. Litt had been informed by fellow club members in New York that what he wanted could be gotten from the Income Tax Unit if the right man was secured, and therefore he had to keep coming down on conferences; that after discussing the case with an employee of the affiliations section, and being advised that the ruling as made was right and should stand, L. E. Rusch, then assistant chief of the consolidated returns subdivision, requested Mr. Robinson, chief of section B, to look the case over; that Mr. Robinson found the previous ruling proper and advised Rusch to that effect, whereupon the latter told Robinson that Robinson "would have to give it to them" and for Robinson to do as he was told; that Robinson then ordered the lawful ruling reversed, so that affiliation might be allowed, law or no law.

The complainant further states——

Senator ERNST. Whom are you quoting from?

Mr. Box. This is the complainant. Mr. Hickey has filed a complaint with the committee, and this is from his complaint.

The complainant further states that the reversal of the lawful ruling in this case created quite a lot of talk among the men on the affiliation work; that on April 13, 1923, Mr. L. J. Potter, of the affiliations unit of section B, came upon this case in the regular course of his work, and as the taxpayer was raising some other questions in the case, Mr. Potter, who knew all about the corrupt reversal made, simply reopened the whole matter again and reinstated the lawful and correct ruling——

Senator ERNST. Are you still quoting the complaint that was filed?

Mr. Box. Yes.

Senator ERNST. And where was the complaint filed?

Mr. Box. With the committee, by Mr. Hickey.

That on April 24, 1923, L. E. Rusch, above-mentioned, appeared in Mr. Robinson's private office (which was contrary to rules promulgated by Mr. Bird), and shortly thereafter Mr. Robinson came into the room in which Mr. Potter regularly did his work and had him reinstate the unlawful ruling, telling Mr. Potter that it would be

unnecessary to write the taxpayer as to the reinstatement of the corrupt ruling, since he would tell the taxpayer's representative. Mr. Potter had written the taxpayer that he reinstated the legal ruling. A copy of a complaint made by Mr. Hickey to the Commissioner of Internal Revenue under date of February 18, 1924, in regard to this case appears as Exhibit A.

An investigation of the records in this case shows the following:

On March 1, 1922, the three above-named corporations were ruled by the unit as being not affiliated, and therefore separate returns for each corporation would be required.

On March 18, 1922, a brief was filed in protest of this ruling by the treasurer of the taxpayer. As a result of this brief, a conference was held on March 24, 1922, at which the taxpayer's representative requested the permission to file further information tending to show that all of the stock of the three companies involved was controlled by the same interests in the same proportion. He was informed that final ruling would be held in abeyance, provided this information was submitted within 30 days. (See Exhibit B.)

On April 3, 1922, taxpayer filed another brief, as a result of which a conference was held on April 7, 1922. (Exhibit C.) At this conference Mr. Beekman, the taxpayer's attorney, was informed that on the basis of the facts presented the above-named companies were not affiliated during the years named. However, in view of certain statements made by Mr. Beekman, final ruling was held in abeyance pending the receipt of an affidavit covering the oral information furnished by him, which was to be filed within 30 days.

On April 8, 1922, affidavit in relation to the stock ownership of the three corporations involved was executed and submitted to the bureau. As a result thereof another conference was held on April 19, 1922 (Exhibit D), at which the conferees recommended that the bureau's previous rulings be sustained. As a result of this recommendation, the bureau, on May 4, 1922, again ruled the three corporations not affiliated for the years 1917, 1918, and 1919.

Another brief was furnished by the taxpayer on June 6, 1922, containing additional information, as a result of which another conference was held on June 26, 1922. (Exhibit E.) At this conference Mr. Beekman, who appeared for the taxpayer, was advised that the additional information submitted was insufficient to warrant a change in the ruling of the bureau.

On August 10, 1922, the taxpayer was advised that the bureau reaffirmed its rulings as set forth in bureau letters of March 1, 1922, and May 19, 1922.

Under date of August 31, 1922, taxpayer executed a power of attorney authorizing George B. Newton, former Deputy Commissioner of Internal Revenue, to represent it before the Treasury Department in this case, and as a result of this authority Mr. Newton, under date of September 5, 1922, addressed a letter to the Commissioner of Internal Revenue (Exhibit F) in which he appealed from the decision of the Income Tax Unit rendered in its letter of August 10, 1922, and requested that the entire file be sent to the committee on appeals and review in order that the decision of the unit might be reviewed. The committee fails to find any evidence

in the records that Mr. Newton's request was complied with at this time.

Under date of November 23, 1922, the following record appears in the case—and I might explain to the committee that the record of the affiliations appears on a folder about that size [indicating], with notations made as to the action taken on the affiliation, and a signature is down on the bottom, the date of action taken is stamped up here, and also opposite to the auditor's name.

Senator ERNST. What conclusion do you draw from that?

Mr. BOX. No conclusion at all, except when I state in this report that a certain person wrote a memorandum, I do not say he signed it, because his signature is not underneath the memorandum directly.

The CHAIRMAN. But it is in his folder.

Mr. BOX. But it is on his folder, and the same date is stamped opposite the name as is opposite the action taken, so that each auditor, when he makes a memorandum, does not sign the memorandum immediately under the memorandum.

Under date of November 23, 1922, the following record appears in the case:

Ruling reversed account stock control being vested in R. D. Little, president, for all corporations. Class B ruling forms prepared and revised ruling letter written to the taxpayer, care of George B. Newton.

This memorandum was written by L. J. Potter.

Under date of April 3, 1923, the following appears on the record:

Revised ruling made November 23, 1922, was incorrect in all years, but especially in 1917, when control of stock in class B affiliations is not provided for. Large divergencies and minorities also exist in other years. If case is protested again, case should go to C. on A. & R. (committee on appeals and review). New ruling made of not affiliated for 1917 to 1921, inclusive, all companies. New ruling letter written. New forms made.

This memorandum was also written by Mr. Potter, above referred to.

On April 24, 1923, the following appears:

Ruling of 4-13-23 changed back to agree with ruling of 11-23-22 for years 1918, 1919, 1920, and 1921 by direction of the chief of section B, although in my opinion this procedure is not in accordance with the facts in this case or in accordance with law and regulations.

This memorandum was also written by Mr. Potter.

On November 26, 1923, this case was sent to the committee on appeals and review by the commissioner. The committee decided the stockholdings reported by the taxpayer disclosed no basis for affiliation during any of the years from 1917 to 1921, inclusive. Copy of this decision is made Exhibit G.

On May 31, 1924, Internal Revenue Auditor John T. Slater completed a reexamination of the three companies involved for the years from 1917 to 1920, inclusive, which report has been audited in the bureau and A-2 letters and certificates of overassessment have been prepared as a result thereof, which apparently await the final examination prior to signature by the deputy commissioner.

That was the status of the case when it was called for by the committee. Final action had not been taken, and it is evident that those letters are waiting to be sent out.

These letters disclose the following:

Name of company	Year	Additional tax	Over-assessment
Little Estate Corporation	1917	None.	$168.57
Do	1918	None.	None.
Do	1919	None.	12,263.36
Do	1920	None.	25,691.22
St. Nicholas Seventh Avenue Theater Co	1917	None.	None.
Do	1918	None.	None.
Do	1919	None.	None.
Do	1920	None.	None.
J. J. Little & Ives Co	1917	None.	5,665.62
Do	1918	None.	None.
Do	1919	$41,678.93	None.
Do	1920	59,381.84	None.
		100,460.77	43,788.57

The net results of these proposed assessments and refunds results in a proposed net additional tax of $56,672.20.

The CHAIRMAN. Have you computed what you think it ought to be?

Mr. GREGG. I think that is what he thinks it should be.

Mr. BOX. That is the result of the letters, and I think that is correct.

The CHAIRMAN. I would like to ask Mr. Gregg how he accounts for so many changes in the rulings?

Mr. GREGG. I think a few less considerations might have been given to it. However, I think the real important thing is that we finally reached the right result.

The CHAIRMAN. I was wondering how many hearings a taxpayer can get, and how many reversals he can get.

Mr. BOX. The taxpayer was granted four hearings in this case before Mr. Newton appeared.

Mr. GREGG. I do not get the criticism as to this case.

Senator ERNST. That is what I am looking for.

Mr. GREGG. It was finally settled on the basis that the committee's staff seems to think is correct.

Mr. BOX. Well, complaint was made as to the procedure in the bureau by Mr. Hickey, and the records seem to substantiate his statements, that there were four conferences, with the same thing held in each conference, and thereafter a decision was reached which was just the opposite, although the affiliators went on record as stating that they did not think the case was decided in the right way, and after it got up to the appeals board it was decided that the original ruling was correct.

Senator ERNST. But the taxpayer was certainly given every opportunity to be heard, was he not?

Mr. BOX. Indeed, he was.

The CHAIRMAN. There is no question about that.

Senator ERNST. I am glad he was given a fair deal in this case.

Mr. NASH. This is one of the cases, Mr. Chairman, that led us to make the reorganization in the consolidated section that I spoke of a few moments ago. Mr. Blair asked Mr. Hartson and I to review the files in this case. We went over them very carefully, and discovered just as Mr. Box has found out, the many reversals, and the many changes of opinion on the question of affiliation. We also went

over two or three other cases, and found a similar condition, and that is one of the reasons the recommendation was made to create a separate affiliation section to consider these questions. I do not believe the same condition would exist in a case to-day. This case is illustrative of what could happen under the old plan of organization.

(The exhibits submitted by Mr. Box in The Little Estate Corporation case are as follows:)

EXHIBIT A

This case stands out with striking vividness as a demonstration of arrogant rapacity and assurance of immunity to punishment of any kind for the crime committed. Coupled with it is an example of cowardly cooperation meriting supreme contempt.

Affiliation had been denied in this case early in 1922 after consideration of data secured from the taxpayer only after repeated efforts culminating in recourse to the cooperation of the internal revenue agent in charge—or, rather, the supervising internal revenue agent. Several conferences were regularly held, at which the taxpayer was represented by an attorney named Edgar Beekman, who with George V. Newton, former deputy commissioner, held the power of attorney. The original ruling was fully reaffirmed at each conference. At one of these conferences Mr. Beekman stated that while he understood why the Government's representatives could not grant affiliation since the law was what it was, his principal, Mr. Little had been informed by fellow club members in New York that what he wanted could be gotten from the Income Tax Unit if the "right man" was secured, and that, therefore, he had to keep coming down on conferences. It seems that four or more conferences had been held.

After discussing this case with an employee of the affiliations section and being advised that the ruling as made was right and should stand, L. E. Rusch, then assistant chief of the consolidated returns subdivision, requested Mr. Robinson to look the case over. Mr. Robinson found the previous ruling proper and told Rusch so; whereupon Rusch told Robinson that Robinson would "have to give it to them" and for Robinson to do as he was told. Robinson then ordered the lawful ruling reversed so that affiliation might be allowed, law or no law. This was in the closing days of October, 1922, just before Rusch removed his ennobling personality from the premises of Fourteenth and Ohio Avenue. Mr. William P. Bird was chief of the subdivision at the time.

The years 1917 to 1921 were involved in the ruling on this case and the taxpayer desired to file a consolidated return for three corporations. The reversal of the lawful ruling in this case created quite a lot of talk among the men on the affiliations work at the time and never was forgotten. On April 18, 1923, Mr. L. J. Potter, of the affiliations unit of audit section B, came upon this case in the regular course of his work, and as the taxpayer was raising some other questions in the case, Mr. Potter, who knew all about the corrupt reversal mentioned, simply reopened the whole matter again and reinstated the lawful and correct ruling. On April 24, 1923, L. E. Rusch appeared in Mr. Robinson's private office (which was contrary to rules promulgated by Mr. Bird) and shortly thereafter Mr. Robinson came into the room in which Mr. Potter regularly did his work and had him reinstate the unlawful ruling, telling Mr. Potter that it would be unnecessary to write the taxpayer as to the reinstatement of the corrupt ruling since he would tell the taxpayer's representative. Mr. Potter had written the taxpayer when he reinstated the legal ruling. Mr. Bird was chief of the subdivision when this happened and Mr. Lohmann assistant chief. Mr. Bird apparently knew little about what was done in the way of handling cases, Rusch lookin, after that part of the work when he was there and Lohmann doing the same when he succeeded Bright, who had succeeded Rusch. On one occasion Mr. Bird told me not to get mixed up in any dirty messes, and he also stated on the same occasion that if anybody was getting anything around there he didn't know it. I can assure you that things were being gotten, Mr. Commissioner, but I am also of the opinion that Mr. Bird probably did not know much about the benefactions.

After the incident on April 24, 1923, none of the men who handled affiliations, with perhaps an exception or two with their own ends to serve, took much stock in Mr. Robinson. He was quite generally discredited, as was to have been expected. However, some excuses were made for him, but they involved reflections on officials higher up, as you may surmise. It was understood among all the men in affiliations who had been in the unit from July, 1921, at least, that Rusch, Bright, and Lohmann were close friends and that Robinson was anxious to curry favor with that trio to get a better job, if possible. Also, it was thought that he was afraid of losing the job he did have. He told me himself that it was alright for me to ask him to reopen the Little case, but that it might cost him his job. I'd like to know who he thought would bring about that result. Rusch couldn't ask for his resignation, as he no longer was in authority in the unit--that is, not officially in authority. Still Robinson was afraid to obey the law and correct the evil he had wrought in this case at the command of Rusch, even after Potter had remedied matters by reinstating the original lawful ruling. Who is the man Robinson was afraid of? That he was afraid was patent to all.

Mr. Lohmann claims we were making rulings under the "liberal" policy in 1922. The ruling in this case was made in March, 1922—the original, lawful ruling. Still affiliation was not allowed. It would seem therefore that these people were not entitled to affiliation under any of the policies said to have been in force at various times. Mr. Lohmann is having a hard time trying to cover up the tracks of his friends and make them lily white in spite of their transgressions. If he is honest, why is he so interested? Surely Bright, Rusch, Seifert, et al. would seem to be able to take care of themselves. Would he have us understand that out of his love for fair play all the labor he is directing is for the especial vindication, protection, and benefit of the pusillanimous chief of audit section B? Mr. Robinson seems to feel that he is not being treated exactly right, regardless.

The Little case went along to audit after the unlawful ruling had been reinstated, but fresh cases of favoritism came on to attract attention and hold interest. Two of these cases will be taken up next under their respective names. These two cases, together with the Little case, may be said to have precipitated the opening up of this whole state of affairs. Coming upon the heels of the reinstatement of the unlawful ruling in the Little case—in the manner in which it was done, the brazen effrontery of Rusch's tactics--these cases offered conclusive proof to my mind that the wolves were going to take what they wanted in bold defiance of persons or consequences. That they had control of the only agency they need fear was too plain to be doubted. In short, the deputy commissioner was lined up right, so why worry? Lohmann was one of them and Robinson would have to do what he was told, as he had already done. (The assistant deputy commissioner is meant where deputy commissioner is mentioned in this paragraph.)

EXHIBIT B

CONSOLIDATED RETURNS SUBDIVISION--TAXPAYER'S CONFERENCE

Taxpayer: Little Estate Corporation.
Address: New York, N. Y.
Represented by: Edgar Beckman, attorney.

Matter presented: Taxpayer's representative protested against the ruling of the bureau denying affiliation of the above-named company with the J. J. Little & Ives Co. and St. Nicholas-Seventh Avenue Theater Co. during the taxable years 1917, 1918, and 1919.

Mr. Beckman was informed that the additional information furnished in a brief dated March 18, 1922, submitted prior to the conference was insufficient to warrant a change in the previous ruling of the bureau.

No additional information was submitted at the conference, but the taxpayer's representative requested permission to file further information tending to show that all the stock of the three companies involved was controlled by the same interests in the same proportion. He was informed that final

ruling would be held in abeyance, provided this information was submitted within 30 days.

Interviewed by—

W. F. MEHRLICH,
Technical Staff.
R. L. PETZOLD,
Affiliations Section.
WM. P. BIRD,
Chief Consolidated Returns Subdivision.

MARCH 24, 1922.

EXHIBIT C

CONSOLIDATED RETURNS SUBDIVISION—TAXPAYER'S CONFERENCE

Taxpayer: Little Estate Corporation.
Address: New York, N. Y.
Represented by: Edgar Beekman, attorney.
Matter presented: Affiliations.

Taxpayer's representative called to ascertain whether the information furnished in brief dated April 3, 1922, together with that submitted in a previous conference would be insufficient to enable the bureau to reconsider its ruling denying affiliation with J. J. Little & Ives Co. and St. Nicholas-Seventh Avenue Theater Co. during the taxable years 1917, 1918, and 1919 and make a ruling covering the years 1920 and 1921.

After a brief discussion Mr. Beekman was informed that on the basis of the facts presented the above-named companies were not affiliated during the years named. However, in view of Mr. Beekman's oral statements that some of the stock in the Little & Ives Co. was acquired by gift, that the stock held by the minority interests was ineffective, and that the stock of Margaret W. Little was controlled by her husband, final ruling was held in abeyance pending the receipt of an affidavit covering these points, to be filed within 30 days.

Interviewed by—

W. F. MEHRLICH,
Technical Staff.
R. L. PETZOLD,
Affiliations Section.
WM. P. BIRD,
Chief Consolidated Returns Subdivision.

APRIL 7, 1922.

EXHIBIT D

CONSOLIDATED RETURNS SUBDIVISION—TAXPAYER'S CONFERENCE

Taxpayer: Little Estate Corporation.
Address: New York, N. Y.
Represented by: Edgar Beekman, attorney.
Matter presented: Affiliations.

A brief was submitted by Mr. Beekman containing further information relative to the J. J. Little & Ives Co. for consideration in connection with the previous ruling of the bureau denying affiliation for the taxable years 1917, 1918, and 1919 and the action of the conferees in recommending the sustaining of this ruling and also denying affiliation for 1920 and 1921 at the conference held on April 7, 1922.

As the additional information submitted is considered insufficient to warrant a reversal of the previous rulings made for the years under consideration, it is recommended that the bureau's previous rulings be sustained. Taxpayer should be advised accordingly.

Interviewed by—

W. F. MEHRLICH,
Technical Staff.
R. L. PETZOLD,
Affiliations.
WM. P. BIRD,
Chief Consolidated Returns Subdivision.

APRIL 19, 1922.

EXHIBIT E

CONSOLIDATED RETURNS SUBDIVISION—TAXPAYER'S CONFERENCE

Taxpayer: Little Estate Corporation.
Address: New York, N. Y.
Represented by: Edgar Beekman, attorney.

Matter presented: Propriety of including the J. J. Little & Ives Co. and St. Nicholas-Seventh Avenue Theatre Co. in a consolidated return with the above-named company during each of the taxable years 1917, 1918, 1919, 1920, and 1921.

The bureau had previously ruled that these companies were not affiliated during the years under consideration.

A brief was filed prior to this conference submitting additional information, which was given careful study and consideration.

After a brief discussion taxpayer's representative was advised that the additional information submitted was insufficient to warrant a change in the ruling of the bureau. He requested that taxpayer be advised of the bureau's decision.

Interviewed by—

W. F. MEHRLICH,
Technical Staff.
R. L. PETZOLD,
Affiliations Section.

JUNE 26, 1922.

EXHIBIT F

NEW YORK, *September 5, 1922.*

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

SIR: The undersigned, duly authorized attorney in fact, appeals from the decision of the Income Tax Unit rendered in its letter dated August 10, 1922, in which it was held that the J. J. Little & Ives Co., Little Estate Corporation, and St. Nicholas-Seventh Avenue Theatre Co. were not affiliated within the meaning of the income tax law for the years 1917 to 1920, inclusive.

It is respectfully requested that the entire file be sent to the committee on appeals and review in order that the decision of the Income Tax Unit may be reviewed.

Respectfully submitted.

GEO. V. NEWTON.

EXHIBIT G

COMMITTEE ON APPEALS AND REVIEW,
December 6, 1923.

In re: Little Estate Corporation, J. J. Little & Ives Co., St. Nicholas-Seventh Avenue Theater Co.

MR. COMMISSIONER: Replying to your memorandum of November 26, 1923, in reference to the above taxpayers and the propriety of the affiliation proposed by the unit, I desire to report that the file has been examined by a member of the committee and that the examination discloses that the affiliation claimed is a so-called class B affiliation, the contention being that substantially all the stock is owned or controlled, directly or indirectly, by certain members of the Little family. The Little Estate Corporation, hereinafter called Company No. 1, is a corporation organized for the purpose of holding the property acquired by the several heirs of J. J. Little in accordance with the provisions of his will, that property consisting in the main of certain shares of stock in the second and third companies named above and a parcel of real estate occupied under a lease by the second company named above. J. J. Little & Ives Co., hereinafter called Company No. 2, carries on the business of printing and bookbinding in a building leased by it from the Little Estate Corporation. St. Nicholas-Seventh Avenue Theatre Co., hereinafter referred to as Company No. 3, owns and leases a building in which are located a theater and several stores.

The following tabulations will show the percentages of stockholdings during the several years involved, all stock of Companies Nos. 2 and 3 held by Company No. 1 being allocated as owned by the several individuals concerned on the basis of their stockholdings in Company No. 1, in accordance with familiar principles, and certain shares in Company No. 2 pledged during the years 1917, 1918, and 1919 to the acceptance corporation as collateral security for a loan being treated as owned and controlled by the pledgors. Stockholder No. 1 is the widow of J. J. Little, stockholders Nos. 2, 3, 4, and 5 are sons and daughters of J. J. Little, and stockholder No. 6 is the wife of stockholder No. 2.

January 1, 1917, to February 17, 1920

	Company No. 1	Company No. 2	Company No. 3
1. J. R. Little	35	4.5	23.3
2. A. W. Little	25	22	16.7
3. E. L. Williams	15	18.9	10
4. R. D. Little	15	17.8	10
5. L. S. Thompson	10	9	6.7
6. M. W. Little			20.8
7. Outside interests		27.8	12.5
	100	100	100

As of December 31, 1920 [1]

	Company No. 1	Company No. 2	Company No. 3
1. J. R. Little	35	14.1	23.3
2. A. W. Little	25	28.9	16.7
3. E. L. Williams	15	23	10
4. R. D. Little	15	22	10
5. L. S. Thompson	10	11.7	6.7
6. M. W. Little			20.8
7. Outside interests		.3	12.5
	100	100	100

[1] Substantially all the 27.8 per cent interest in Company No. 2 held by outside interests from January 1, 1917, to February 17, 1920, was acquired by Company No. 1, prior to December 31, 1920, as follows: 720 shares, or 15.2 per cent, on February 17, 1920; 80 shares, or 1.7 per cent, on October 13, 1920; 253 shares, or 5.3 per cent, on September 23, 1920; 252 shares, or 5.3 per cent, on October 13, 1920.

As of December 31, 1921 [1]

	Company No. 1	Company No. 2	Company No. 3
1. J. R. Little	35	14.1	23.3
2. A. W. Little	25	28.9	20.9
3. E. L. Williams	15	23	10
4. R. D. Little	15	22	10
5. L. W. Thompson	10	11.7	6.7
6. M. W. Little			16.6
7. Outside interests		.3	12.5
	100	100	100

[1] The only change as compared with December 31, 1920, is in the holdings of stockholders Nos. 2 and 6 (husband and wife) in Company No. 3.

In the opinion of the committee the forgoing stockholdings disclose no basis for affiliation during any of the years involved. Where affiliation depends upon common ownership by the same interests rather than upon ownership of a subsidiary by a parent company, section 1331 of the 1921 act, governing 1917, requires that substantially all the stock of the several corporations shall be owned by the same interests and the 1918 statute, section 240, requires that substantially all the stock of the several corporations shall be owned or

controlled by the same interests. Furthermore, article 633 of Regulations 45 provides:

"* * * The words 'the same interests' shall be deemed to mean the same individual or partnership or the same individuals or partnerships, but when the stock of two or more corporations is owned or controlled by two or more individuals or by two or more partnerships a consolidated return is not required unless the percentage of stock held by each individual or each partnership is substantially the same in each of the affiliated corporations."

Finally, the same article, article 633 of Regulations 45, seems to construe the phrase "substantially all the stock" as meaning substantially all the voting stock. Regulations 62 repeat these provisions of Regulations 45.

In the foregoing tabulations there has been included only voting stock, consistently with the provision of Article 633 last referred to. Inasmuch, however, as there may be some question whether this limitation is justified, it should be noted that the only stock excluded is the preferred stock of Company No. 2, and that if the holdings of such stock were included along with the common stock of that company the committee's conclusion would not be affected.

So far as concerns the years 1917, 1918, and 1919, denial of affiliation is justified by the existence of a minority interest in Companies Nos. 2 and 3 of 27.8 per cent and 12.5 per cent, respectively. So far as concerns 1920 and 1921, denial of affiliation is justified by the marked discrepancy in the proportionate stockholdings of the several individuals. Thus, stockholder No. 1 has a 35 per cent interest in Company No. 1 as against an interest of only 14.1 per cent in Company No. 2, whereas, on the other hand, stockholders 2, 3, and 4 have a combined interest in Company No. 2 of 74 per cent as against a combined interest in Company No. 1 of 55 per cent. As to Company No. 3 for 1920 and 1921, the outside interests of 12.5 per cent continue, as does also a substantial holding by stockholder No. 6, an individual not interested at all in Companies Nos. 1 and 2.

The unit has doubtless been largely influenced in its decision to permit affiliation by the family relationships of the individual stockholders concerned. However, the control referred to by the statutory provisions has been construed by the department to mean legal control, not moral control, and in the committee's opinion this construction is correct. There has, however, long been an inclination to give weight to considerations tending toward the establishment of a mere moral control, such as family relationships, relationships of donor and donee, relationships of employer and employee, the existence of an option to purchase, etc. The committee believes that the statute affords no justification for this procedure and decisions to that effect have not been promulgated. (See S. I. M. 2776; A. R. R. 942 (I-1 C. B. 298); A. R. R. 1231; A. R. R. 1398; A. R. R. 2164.)

It must, however, be conceded that the department's rulings as to the circumstances under which corporations are affiliated have been far from uniform. There has, for example, been a very marked disposition to construe the phrase "substantially all the stock" as affected not only by the considerations referred to above but particularly as affected by intercompany relationships. The result has been that there has been considerable divergence in the stock percentages which have been treated by the department as constituting "substantially all." The committee as at present constituted is inclined to agree with those rulings which give a minimum weight to those collateral considerations. (T. B. M. 43, A. R. R. 700, A. R. R. 1056, A. R. R. 2534, A. R. R. 3050, A. R. R. 3113, A. R. R. 2958, S. I. M. 3836.) The decision in A. R. R. 855 (I-1 C. B. 413), upon which the taxpayer relies, is considered by the committee as at present constituted to be erroneous. The committee is also inclined to dissent from certain implications of the language used in A. R. R. 378 and A. R. R. 448. However, the decisions in the two recommendations last named were correctly against affiliation, and while the decision in A. R. R. 855 was in favor of affiliation the facts in that case were so unlike those in the instant case that the decision would not be controlling, even assuming it to be correct.

CHARLES D. HAMEL,
Chairman Committee on Appeals and Review.

The CHAIRMAN. Have you any further cases ready for presentation this morning, Mr. Box?

Mr. Box. That is all, Mr. Chairman.

The CHAIRMAN. Mr. Manson is sick. He has a high temperature to-day, and he will not probably be here to-morrow, or perhaps this week. I am just wondering whether or not we had better adjourn now until the call of the chair, until we see what his condition is.

Senator ERNST. Have you any other work that we can continue with? If you have, I think it would be advisable for us to finish that up; but, of course, that is at the pleasure of the chairman.

The CHAIRMAN. Mr. Box, of course, has simply dug out information, and he has not prepared himself the same as Mr. Manson has for the presentation of the cases. I have gone over these cases myself, and some of these points have not been brought out by Mr. Box, because of his unfamiliarity with the presentation of these cases, and not having informed himself for that purpose he is not prepared himself to present these cases, but I have just asked him to fill in while Mr. Manson is ill. I doubt if we can keep this up indefinitely.

Do you want to make any comments, Mr. Gregg?

Mr. GREGG. No, sir. We will very shortly have some matter that we would like to put in.

The CHAIRMAN. Yes.

Mr. GREGG. We can get in touch with you at that time, if you will give us the opportunity.

The CHAIRMAN. Then, we had better adjourn now subject to the call of the chair.

(Whereupon, at 11.45 o'clock a. m., the committee adjourned subject to the call of the Chair.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

MONDAY, MAY 11, 1925

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

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

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

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

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

The CHAIRMAN. I understood, Mr. Nash, that you wanted to take up something with the committee this morning about some request that Mr. Parker has made?

Mr. NASH. Senator, Mr. Parker and Mr. Thomas have requested duplicate copies of engineer reports and duplicate copies of taxpayers' briefs, together with other papers, of such nature as are in the files of certain cases that Mr. Thomas is now working on.

I discussed the matter with Mr. Gregg, and there was some question in our minds as to whether the furnishing of those papers after June 1 will be in keeping with the resolution which was passed continuing this committee. The papers are a part of the files of the cases, although engineer's reports are usually submitted in duplicate and triplicate. Sometimes there is more than one copy in the file of the case.

Mr. Parker stated that they were asking for these duplicates, rather than asking for photostats, because it was quite a physical job to photostat these files, and they thought they might as well work from carbon copies as from photostats.

The reason I wanted to bring it to the attention of the committee was to determine whether or not that was in accordance with the desires of the committee, and to give the committee an opportunity to pass upon whether or not it would be in keeping with the spirit of the resolution.

The CHAIRMAN. From a practical standpoint, what would be the difference whether we had those copies or whether we took the originals between now and June 1 and made copies? There is nothing to prevent our doing that as I understand the resolution. Is there?

Mr. NASH. I believe that from now until June 1 the committee has a right to take any papers they want, and may take copies of them if they so desire.

The CHAIRMAN. I thought that that was the practical side of it, and I thought that Mr. Parker had approached it in a practical way, but, of course, if you want to be overexact, perhaps you are correct in that we could not have those copies.

Mr. NASH. I do not desire to be over exact. I just want to bring the situation to the attention of the committee before we act, Senator.

The CHAIRMAN. Mr. Parker, will you tell the committee, if you will, just what you want us to have? I do not know just what it is that Mr. Parker now is asking for.

Mr. PARKER. We are making a rather complete study of the question of amortization. I think it is fair on the part of the bureau to let us have as much information on that as they can. We want to know how much amortization was allowed in these cases, and on what basis it was allowed, etc. That is all contained in the engineers' reports.

Some six weeks ago Mr. Thomas, in examining the files, noticed that there were oftentimes as many as four copies, but sometimes only two. He took the matter up with Mr. Keenan, the head of the amortization section, and also with Mr. Rashleigh, the head of the production division, who furnishes us the papers, and they both agreed that it would be all right. However, recently—within the last week—they began to feel that they did not have authority to do that, and they probably are right, so they referred it to Mr. Greenidge. Mr. Greenidge told us that our request was a practical thing, but he wanted to refer to Mr. Nash, and I wrote Mr. Nash a letter explaining what we wanted. However, we have been working under the idea that we could have those, and of course those papers would be ultimately returned to the bureau. We have no use for them after we have drawn off the necessary information. There were a great many of these reports; I think around 350 of them.

Mr. GREGG. There is this thought that occurs to me, Mr. Chairman: We have authority to disclose data in reference to returns only in certain cases, in specified cases, and one of those cases is under the proper authority of the committee investigating the bureau. I think it is clear that the resolution technically does not permit the withdrawal of those papers. They are original papers, and, technically, it does not permit their withdrawal and retention by the committee. The reason we raised the point at all was because we doubted our authority to comply with the request.

The CHAIRMAN. You mean to do it after June 1?

Mr. GREGG. Yes; to submit those papers or to allow them to be kept for more than two weeks after June 1, because as a practical matter there is no difference in the world, as you can see, between your having originals and copying them or in having the photostats, but technically there is a little difference. However, if the committee thinks that that difference should be waived I understand that Mr. Nash is agreeable to it.

Mr. NASH. I am agreeable to it, but I did not want to take the action alone.

Mr. PARKER. There is a question as to what are called original papers. There are often two with the case, or at least one with the audit part of it, and then there may be two or three in the engineer's

files, which are separate files. Oftentimes the engineer has an unsigned copy in his desk. Are all of those official papers of the department?

Mr. GREGG. I think so. I think they are. It seems to me that everything in the file of a case is a part of the original record.

The CHAIRMAN. Just what has delayed the securing of those papers from six weeks ago until some few days ago?

Mr. PARKER. We have the papers, Senator. It is simply a matter of taking them out of the bureau; that is all.

The CHAIRMAN. Oh, they have furnished them?

Mr. PARKER. We have the majority of the papers. We have 90 per cent of them, I should say.

The CHAIRMAN. So far as the chairman is concerned, he does not want to ask the bureau to violate the law or the spirit of the resolution, or the terms of it, and if the bureau wants to insist that they be returned, we will have to proceed and take copies of them; that is all.

Mr. GREGG. I do not think we are taking that position, Mr. Chairman. We might ask Mr. Manson what he thinks of the question. The question is whether we are justified in allowing the committee to take copies of engineers' reports and similar documents, where there are duplicates in the files, to take them and keep them, not subject to the two weeks' rule as contained in the resolution.

Mr. MANSON. The law provides that we can make copies. If a copy has already been made and the paper is not an original paper, it can not be, of course, even copied. It is just a duplication of expense to make copies.

Mr. GREGG. As a practical matter that is perfectly true. I am rather inclined to think that every paper in our file is an original paper. I think the term "original papers" as used in the resolution is to distinguish our papers from papers compiled by the committee staff from our records.

Senator ERNST. It is used in the sense of papers which belong to the department?

Mr. GREGG. Yes; that is the way I would construe it, but as a practical matter it is perfectly true that the same results can be reached with less expense by the committee taking the duplicates.

The CHAIRMAN. So far as I am concerned, I will leave it with the bureau to decide. It is a question of whether they want to go to the expense of making the copies or of keeping the copies in the bureau.

Mr. NASH. Senator, the way we looked at it was that the Senate resolution is law as far as we are concerned, and we are obliged to follow it and we want to follow it, but we want to follow it with as little inconvenience to ourselves and to the committee as possible. We do not want to violate it one way or the other, and I told Mr. Parker and Mr. Thomas on Saturday that so far as Mr. Gregg and myself are concerned, at least, we were perfectly agreeable to permitting the members of the staff to take these papers after June 1, but I did not think we ought to assume full responsibility for those papers leaving the department without at least putting the facts before the committee and getting an expression from the committee on it.

The CHAIRMAN. I do not know what Senator Ernst thinks about it, but I think we ought to proceed in a practical way and save the Government as much expense as possible. If the bureau wants to insist upon it, why, we will proceed along the line of taking our own copies, but I understand that if the bureau and the committee agree you will let us have the copies. Is that the idea?

Mr. NASH. I would suggest this, Senator, on that: We ought to schedule the copies and obtain a receipt from Mr. Parker or Mr. Thomas, or whoever receives them, and we will hold that individual responsible for the return of them to the files when the committee is through with them.

Senator ERNST. Of course, you will always have either the original or the duplicate?

Mr. NASH. We will retain the original in the file, but we would not want these papers to be scattered around so that they might get into the channels where they should not go.

Mr. MANSON. I will receipt for them and will be responsible for them.

The CHAIRMAN. I have a matter that I brought down with me, because I thought Mr. Manson was going to be a little later than he has been.

In considering the cases of the United States Graphite Co. and the New Jersey Calcite Co., I think that their reply was that these cases were closed and that they were not going to reopen them. The question presented to me was, what will be the bureau's position with regard to future depletion rates, now that they have been called to their attention? In other words, if the bureau takes the position that the cases that we examined are closed, and they do not want to reopen them, the question here continues in succeeding years as to the depletion rate. I think the committee would like to know whether or not the bureau is going to continue to use this depletion rate, which we all seemed to agree was not complete at the time, and the bureau took the position that they do not want to reopen it. There should be some definite information as to whether you are going to continue these depletion rates in succeeding years.

Mr. GREGG. Mr. Nash and I have discussed that question between ourselves, Mr. Chairman, and the conclusion we reached was this, not only with respect to those two cases but with respect to other cases in which we now question the judgment of the men who settled them: It is our opinion that for the years that are not closed the matter should be considered as a fresh matter; it should be considered de novo and decided on its merits, irrespective of what was done for prior years.

The CHAIRMAN. Then, as I understand it, you tell the committee that you will reexamine the question of depletion and apply your new decision, if a new decision is reached, for years succeeding those that are closed?

Mr. GREGG. Yes.

Senator ERNST. What do you mean by a "new decision"?

The CHAIRMAN. On the question of depletion. The question of a depletion rate was raised in those two cases that I have just referred to.

Senator ERNST. Yes.

The CHAIRMAN. And there seemed to be an agreement between the bureau and the committee staff that the former depletion rates were subject to criticism, at least. The bureau now states that they are going to reexamine this depletion rate and apply it to years not yet closed.

Senator WATSON. Does that mean the adoption of a different formula?

Mr. GREGG. Not necessarily at all. It means that we will consider the unclosed years de novo on the question of depletion. Of course, it is possible that we may reach the same conclusion.

Senator WATSON. Does that mean with reference to particular cases or the whole subject matter?

Mr. GREGG. We were talking about cases that were called to our attention by the committee.

The CHAIRMAN. Because their answer to that was that the cases were closed, and they did not want to reopen them.

Senator WATSON. Yes.

The CHAIRMAN. And I raise the question whether, if they were closed improperly, they were going to continue to be dealt with in succeeding years improperly. The bureau answers that they are going to reopen that point which is under discussion.

Now, Mr. Manson, you may proceed.

Senator WATSON. Is there a consensus of the competent on the subject of depletion with reference to mines and oil wells, or is there such a diversity and variety of opinion among the skilled that you can not say that any definite conclusion has ever been reached?

Mr. GREGG. I think it will be agreed that if you put 10 expert witnesses on the stand on the question of valuation of a mine you will probably get 10 different answers, if they did not consult before, and the range of their answers would be very broad. However, there are some conclusions that you can tell were wrong, or, rather, in which the judgment used was not sound.

Mr. MANSON. But some landmarks of principle might be tied to.

Mr. GREGG. Yes.

(At 11.20 o'clock a. m. the committee adjourned.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, MAY 12, 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.

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: 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. Manson, if you are ready.

Mr. MANSON. I want to call the attention of the committee to some phases of the question of the tax on capital gains and the deduction of capital losses. This is a matter which, in my judgment, demands the serious consideration of Congress.

Up to the present time the tax on capital gains has resulted in a very large net loss to the Government, particularly in the case of incomes in the high-tax brackets.

I present a table based on a tabulation of the income and deductions of 3,066 individuals whose net taxable incomes exceeded $100,000 in 1916.

This table represents the net income, the amount of profits on the sales of real estate, stocks, and bonds taxed, and losses deducted from income for the years 1916 to 1923, inclusive, of the same individuals.

The total amount of losses deducted during that period is $609,978,087, and the total amount of profits taxed is $250,266,475.

Mr. GREGG. May I ask a question right there? Has there been any segregation of your statistics as of the year 1921?

Mr. MANSON. Yes.

Mr. GREGG. There has been?

Mr. MANSON. Yes.

Senator ERNST. This is 1916 to 1923?

Mr. MANSON. This is 1916 to 1923, as to the totals.

Senator ERNST. I see.

Mr. MANSON. In 1916 the total net incomes on this group of individuals were $970,241,764. The profits taxed were $49,283,462, or 5.08 per cent of the net incomes. The losses deducted were $1,353,199, or fourteen one-hundredths of 1 per cent.

In 1920 the total net income of this same group of individuals was $355,095,087. The profits taxed were $8,006,318, or 2.25 per cent of the net incomes. The deductions for losses on sales was $162,241,493, or 31.36 per cent of the combined net income and loss.

In 1921 the total net incomes of this group were $283,500,117. The profits taxed were $7,628,359, or 2.69 per cent of the net income. The losses deducted were $125,963,179, or 30.76 per cent.

In 1922, when the capital gains provisions of the law went into effect, the profits exceeded the losses by a narrow margin. The net income was $424,022,905. The profits taxed were $76,245,583, or 17.98 per cent of the net income. The losses deducted were $73,689,946, or 14.81 per cent of the total of the net income and losses.

However, in 1923 the situation reversed itself again.

The total net income of this group was $392,098,022. The amount of profits taxed was $57,872,509, or 14.76 per cent of the net income, while the losses were $79,246,097, or 16.81 per cent of the total of the net income and losses.

This Table No. 1 represents a group of 3,066 individuals whose net income exceeded $100,000 in 1916, and I herewith submit this table for the record:

TABLE NO. 1.—*Profits and losses on sales of real estate, stocks, and bonds, including capital net gains, net income, profits reported, and losses deducted from income each year, 1916 to 1922, inclusive, by 3,066 individuals who reported taxable net incomes of $100,000 or over in 1916*

Year	Net income	Profits on sales		Losses on sales	
		Amount taxed	Per cent net income	Amount deducted	Per cent of net income plus losses
1916	$970,241,764	$49,283,462	5.08	$1,353,199	0.14
1917	721,895,836	21,766,909	3.02	14,393,019	1.95
1918	533,539,666	5,367,393	1.01	53,722,744	9.15
1919	499,088,384	24,095,942	4.83	99,368,410	16.60
1920	355,095,087	8,006,318	2.25	162,241,493	31.36
1921	283,500,117	7,628,359	2.69	125,963,179	30.76
1922	424,022,905	76,245,583	17.98	73,689,946	14.81
1923	392,098,022	57,872,509	14.76	79,246,097	16.81
Total	4,179,481,781	250,266,475	5.99	609,978,087	12.74

Mr. MANSON. Table No. 2 is a group of 101 individuals whose net incomes exceeded a million dollars in 1916.

In this group, in 1916, the total net income of those 101 individuals was $264,613,644. The profits taxed were $16,819,674. The losses deducted were $108,010.

When you get down to 1920 the net incomes were $53,059,990. The profits taxed were $770,121, and the losses deducted were $38,407,516, or 41.99 per cent of the total income and the losses.

In 1921, the net incomes were $44,523,925. The profits taxed were $913,275, or 2.05 per cent of the net incomes. The losses deducted were $30,395,220, or 40.57 per cent of the total net income on losses.

In 1922, even after the capital net gains provisions of the law went into effect, the net incomes were $56,951,504. The profits taxed were $7,760,143, or 13.63 per cent of the net income, while the deduction for losses were $27,463,192, or 32.53 per cent of the total of net income and losses.

In 1923 the net income was almost the same, $56,532,572. The profits taxed were $6,670,911 or 11.80 per cent of the net income. The losses deducted were $23,660,000, or 29.50 per cent of the net income.

The total for the period from 1916 to 1923, for this group of 101 individuals, the net income, was $822,119,847. The amount of profits taxed was $38,656,767, or 4.70 per cent, while the losses deducted were $173,684,361, or 17.44 per cent.

I will submit this table No. 2 for the record:

TABLE No. 2.—*101 individuals who reported net incomes of $1,000,000 or more in 1916. Net incomes and profits and losses on sale of real estate, stocks and bonds, including capital net gains*

Year	Net income	Profits on sales		Losses on sales	
		Amount taxed	Per cent of net income	Amount deducted	Per cent of net income plus losses
1916	$264,613,644	$16,819,674	6.36	$108,010	0.04
1917	160,518,754	2,986,045	1.86	$8,195,659	4.86
1918	103,624,642	375,231	.36	17,165,369	14.21
1919	82,294,816	2,361,367	2.87	28,289,395	25.58
1920	53,059,990	770,121	1.45	38,407,516	41.99
1921	44,523,925	913,275	2.05	30,395,220	40.57
1922	56,951,504	7,760,143	13.63	27,463,192	32.53
1923	56,532,572	6,670,911	11.80	23,660,000	29.50
Total	822,119,847	38,656,767	4.70	173,684,361	17.44

Mr. MANSON. I made some investigation of the character of the property from which the above profits and losses were derived. I took the first 400 transcripts that were delivered to me by the Treasury Department, and went back to the original returns for the purpose of ascertaining the character of the property sold.

The stock transactions amount to 89.17 per cent of the profits. The bond transactions amount to 4.92 per cent of the profits. Real estate sales amount to to 5.91 per cent of the profits.

In the cases of the losses, the stock transactions amount to 70.66 per cent; the bond transactions amount to 20.62 per cent, and real estate sales amount to 3.59 per cent, while the charging off of worthless stocks and bonds amount to 5.15 per cent.

I have called the committee's attention to those figures for the purpose of showing the importance of anything that affects the taxes on capital gains or the deductions of losses of this character.

I wish now to call the committee's attention to certain features of the revenue act of 1924.

Senator WATSON. Wait a minute, Mr. Manson. What does all of that show that you have been telling us about? What do you aim to demonstrate by that?

Mr. MANSON. In my opinion, it shows, for one thing, that the tax on capital gains under the law as it has stood up to the present time has resulted in a very serious net loss to the Government. There is no question but that the capital of the country is increasing; there is no question but that the value of the capital of the country is increasing. Theoretically there should be more capital gains than there are deductible losses, and theoretically the tax on the gains, that is the taxable gains, should exceed the deductible losses.

Senator WATSON. Is that the fault of the law or of the administration of it?

Mr. MANSON. I believe, in the first place, it is the fault of the law. In the second place, I do not feel it is possible to frame a law which will provide for an equitable taxation of profits and deductions of losses, and there appears to be a corresponding relationship there. I do not believe it is possible to frame a law that will not result in a net loss to the Government, for this reason:

For instance, under the present act and under the act as it stood in 1921, if a taxpayer disposes of stock and buys the same stock within 30 days of the time he disposes of the old stock, the profit or loss in the transaction is not recognized as either taxable or deductible. That law is predicated upon the theory that the market with respect to each individual stock and bond goes up by itself. That is not true. The stock market will go up or down, and as a rule will go up or down in groups.

I might illustrate that: Supposing I owned Santa Fe stock. The Chicago, Milwaukee & St. Paul Railroad went into the hands of a receiver the other day. The financial troubles of the St. Paul Railroad were not due to general railroad conditions at all. That trouble dates back a good many years to the construction of the Puget Sound extension. It is a condition purely local to the Chicago, Milwaukee & St. Paul Railroad. Nevertheless, when the Chicago, Milwaukee & St. Paul went into the hands of a receiver it affected all rail stocks.

Now, as I say, I own some Atchison, Topeka & Santa Fe stock, which is in no way at all affected by the financial difficulties of the Chicago, Milwaukee & St. Paul Railroad, but this receivership causes a drop in the market. I sell my Santa Fe stock and buy Chicago & North Western, another perfectly sound railroad, that is, a financially sound railroad.

The CHAIRMAN. And in the same general neighborhood.

Mr. MANSON. Yes. Whatever condition will influence a rise in the market with respect to the good railroad stocks will generally produce a rise with respect to the Chicago & North Western stock. Therefore, after I have sold my Santa Fe stock and have taken my losses, which I can deduct from my income, I still have a similar investment which is subject to the market influences. I get the benefit of any rise in the market on the North Western, the same as I do on the St. Paul.

The larger a man's investments the more diverse they are, the more opportunity there is for him to take advantage of conditions of that sort. Theoretically, of course, we will strike the time some time when all of these transactions will result in values being fixed for tax purposes at a very low point, but we have not reached that time yet; and when you consider that the figures I have presented with relation to the same group of individuals; they do not relate to all of the taxpayers generally, but here you have men, year after year and year after year, particularly this group of 101 men, whose income exceeded a million dollars, to keep on charging off these losses.

This is the biggest single factor that there is affecting incomes in the high tax brackets.

I call attention to the situation for the purpose of showing that no matter how tight you make the law, I doubt very much whether

you can make it tight enough so that there will not be more losses to the Government than there are profits taxed, notwithstanding the economic fact that you are constantly having an increase in capital value in the country. I believe that situation makes it all the more important that no unnecessary holes be left in the law with respect to the taxation of capital gains and the deduction of capital losses, and it is for the purpose of calling the committee's attention to what I deem to be unnecessary holes that were put into the law in 1924 that I am now proceeding.

The revenue act of 1924 (sections 202 and 204) changes the basis for determining taxable gains and deductible losses upon property acquired prior to March 1, 1913. This change has the effect, in some instances, of reducing the gains which are taxable and of permitting the taking of many deductions as losses which could not have been taken under the prior revenue acts. As the deduction of losses from income has been the most important factor in reducing net taxable income in the high tax brackets in effect under the 1924 law, it is worthy of serious consideration.

All of our income tax laws enacted since the adoption of the sixteenth amendment have treated "profits" or "gains" derived from the sale of taxable assets as taxable income.

The revenue act of 1916 provides:

SEC. 2 (c). For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: *Provided*, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained.

The 1918 act consolidated the two above-quoted provisions of the 1916 act into the following provision:

SEC. 202 (a). That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and * * *.

The foregoing provisions of the 1916 and 1918 revenue acts have been construed by the Supreme Court of the United States in the cases of Goodrich *v.* Edwards (255 U. S. 597); Walsh *v.* Brewster (255 U. S. 536); U. S. *v.* Flannery (527, decided April 13, 1915); and McCaughn *v.* Ludington (733, decided April 13, 1925).

In United States *v.* Flannery, supra, the court says:

It is clear in the first place, that the provisions of the act in reference to the gains derived and the losses sustained from the sale of property acquired before March 1, 1913, were correlative, and that whatever effect was intended to be given to the market value of property on that date in determining taxable gains, a corresponding effect was intended to be given to such market value in determining deductible losses. This conclusion is unavoidable under

the specific language of section 202 (a) establishing one and the same basis for ascertaining both gains and losses.

The substance of these four decisions is that to ascertain whether there is a taxable gain or a deductible loss arising out of the sale of property acquired before March 1, 1913, it must first be determined whether there has been an actual gain or loss. This is to be determined by comparing the amount received for the property with the amount paid for it. If the amount received subsequent to March 1, 1913, exceeds the amount paid prior to that date, there is an actual gain. If the amount received is less than the amount paid, there is an actual loss. In the case of either a gain or a loss the taxable gain or the deductible loss is limited to the actual gain or loss, as the case may be.

These cases hold that when an actual gain or loss has been thus established, the value as of March 1, 1913, is to be then compared with the cost and selling price for the purpose of ascertaining the extent to which such gain accrued, or such loss was sustained, after March 1, 1913. So much of an actual gain as accrued after March 1, 1913, is taxable income, and so much of an actual loss as was sustained after March 1, 1913, was a deductible loss.

The revenue act of 1921 made no change in the effect of the 1916 and 1918 acts. The 1921 amendment stated in express terms the 1916 and 1918 acts, as construed by the Supreme Court of the United States. The revenue act of 1921 provides as follows:

SEC. 202 (a). That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value.

(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

(3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less than such basis but not less than such fair market value or price, no gain shall be included in and no loss deducted from the gross income.

The revenue act of 1924, section 204, provides as follows:

(b) The basis for determining the gain or loss from the sale or other disposition of property acquired before March 1, 1913, shall be (A) the cost of such property, * * * or (B) the fair market value of such property as of March 1, 1913, whichever is greater.

The comprehensive effects of the 1921 and 1924 acts on several hypothetical cases are based upon the facts involved in the decisions of the Supreme Court of the United States cited in the notes to the following table; in other words, these illustrations that I use are based upon the facts involved in the cases passed upon by the Supreme Court of the United States:

	Cost prior to Mar. 1, 1913	Mar. 1, 1913, values	Selling price	Taxable gain		Deductible loss	
				1921 act section 202	1924 act	1921 act	1924 act
A	$5,000	$15,000	$10,000	None.	None.	None.	[1] $5,000
B	15,000	5,000	10,000	None.	None.	None.	[2] 5,000
C	10,000	5,000	10,000	None.	None.	None.	[3] None.
D	10,000	5,000	15,000	$5,000	$5,000	None.	[3] None.
E	10,000	15,000	5,000	None.	None.	$5,000	[4] 10,000
F	5,000	10,000	15,000	5,000	5,000	None.	[2] None.
G	15,000	10,000	5,000	None.	None.	5,000	10,000
	70,000	65,000	70,000	10,000	10,000	10,000	30,000

[1] U. S. *v.* Flannery (U. S. Sup. Ct. Dec.-Apr. 13, 1925).
[2] Goddrich *v.* Edwards (255 U. S. 527).
[3] Walsh *v.* Brewster (255 U. S. 536).
[4] McCaughn, Col., *v.* Ludwigton (U. S. Sup. Ct. Dec.-Apr. 13, 1925).

(*a*) Under 1921 act no gain, because sold for more than cost; no deduction, because gain took place before March 1, 1913. Under 1924 act no actual loss, but deductible loss of $5,000, because of decrease in value after March 1, 1913.
(*b*) Under 1921 act no gain, because sold for less than cost; no deduction, because there was no loss between 1913 and date of sale. Under 1924 act actual loss, which occurred prior to March 1, 1913, deductible.
(*c*) No gain to tax, because taxpayer made no gain over original investment.
(*d*) Gain only $5,000, because that is only excess over original investment.

Take case (A). Assume the cost prior to March 1, 1913, to have been $5,000, the March 1, 1913, value would be $15,000 and the selling price $5,000. Under the 1921 act there was no deductible loss. Under the 1924 act there is a deductible loss of $5,000. Here is a case where a man has made an actual profit of $5,000 on the transaction. For that reason under the 1921 act he would not be entitled to a deduction, even though he sold for less than the March 1, 1913, value. Under the 1924 act he is entitled to a deduction of $5,000.

In cases even then the cost of the property is assumed to be $15,000 prior to March 1, 1913; the March 1, 1913, value was $5,000, and the property was sold for $10,000. There we have the reverse of the former case. A man sustains an actual loss of $5,000, although of that loss was sustained prior to March 1, 1913. The fact that between March 1, 1913, and the date of sale there has been a gain of $5,000 would entitle him under the 1921 act to no deduction, but under the 1924 act he is entitled to a deduction of $5,000.

In case (E) cited here the cost prior to March 1, 1913, is $10,000, the March 1, 1913, value $15,000, and the selling price $5,000. Under the 1921 act he would be entitled to a deduction of $5,000. Under the 1924 act he would be entitled to a deduction of $10,000.

In case (G) cited here the cost prior to March 31, 1913, is $15,000, the March 1, 1913, value $10,000, and the selling price $5,000. Under the 1921 act the taxpayer would be entitled to a deduction of $5,000. Under the 1924 act he would be entitled to a deduction of $10,000.

Then it will be noted that both the 1921 act and the 1924 act limit taxable gains to actual gains, because if the cost exceeds the March 1, 1913, value the cost under both acts is the basis for measuring the gain. Under the 1924 act losses are not limited to actual losses. Thus in case (A) there is an actual gain of $10,000 prior to March 1, 1913, which is reduced to a $5,000 gain after March 1, 1913. Although there is an actual gain in the transaction, the 1924 act permits

the deduction of a $5,000 loss represented by the decline in value after March 1, 1913.

In case (B) there is an increase in value after March 1, 1913, yet the 1924 act permits the deduction of a loss, because there has been an actual loss in the transaction.

In case (E) there is an actual loss of $5,000 on the transaction, but the 1924 act permits a $10,000 deduction representing the decline since March 1, 1913. In case (G) the decline since March 1, 1913, is $5,000, yet the 1924 act permits a $10,000 deduction because there is an actual loss of $10,000.

The 1921 act limits taxable gains to actual gains and deductible losses to actual losses. It further limits the taxable gain to such portion of the actual gain as has accrued since March 1, 1913, and such taxable losses to such portion of the actual loss as has been sustained since March 1, 1913. The 1924 act has made no change as to taxable gains, but provides a shifting basis for determining deductible losses which permits the deduction of the full amount of an actual loss, whether it occurred before or after March 1, 1913, and at the same time permitting losses to be based on March 1, 1913, values, if according to the latter standard, the loss would be greater than the actual loss.

Senator WATSON. As between the two acts, then, you favor the 1921 act?

Mr. MANSON. The 1921 act is just as between the Government and the taxpayer. As the Supreme Court has said, it is correlative; it measures both profits and losses according to the same standard.

One of the results of the double standard for measuring profit and loss is clearly shown by assuming all of the cases included in the above table as the transaction of one taxpayer closed by sales in 1924. Prior to 1913 he bought in one transaction seven blocks of stock, at the market, each of which is represented by one of the cases shown in the table. The cost of this stock aggregated $70,000. The March 1, 1913, value was $65,000 and the stock was sold in 1924 for $70,000.

In other words, there he sold for identically the same price that he paid for it.

Considering these transactions in the aggregate there has been no actual loss and no actual profit. Between the time of purchase and March 1, 1913, the stock decreased in value $5,000, which loss of value was regained in 1924.

Considered either as individual transactions or in the aggregate we get the same result under the 1921 act. Considered as individual transactions, under the 1921 act there is $10,000 of taxable gain offset by $10,000 of deductible loss. Considered in the aggregate, under the 1921 act, the property having sold for the exact amount paid for it, there was neither actual gain nor loss and therefore no taxable gain nor deductible loss.

Under the 1924 act, if these transactions are considered in the aggregate, there is neither taxable gain nor deductible loss. The cost exceeds the March 1, 1913, value, and is, therefore, the basis for measuring profit or loss, under the 1924 act. As the cost equals the selling price, there is neither gain nor loss. If, however, these same transactions are set up as separate transactions there will be

deductible losses of $30,000, offset by taxable gains of $10,000, or a net deductible loss of $20,000, to be offset against other income.

Senator WATSON. That is under the law of 1924?

Mr. MANSON. Under the law of 1924.

Senator WATSON. Yes.

The CHAIRMAN. Have you, from your inquiries, Mr. Manson, found out the reason for changing the 1921 act to the 1924 act?

Mr. MANSON. No, I have not. I will say this, that the changes that I am calling to the attention of the committee were not suggested by the Treasury Department. I have gone far enough into the subject to find out that there was no change; that is, none of these changes that I am discussing here were included in the bill that was sent up to Congress by the Treasury Department.

The CHAIRMAN. Do you know whether there was any debate in either the House or the Senate on the subject?

Mr. MANSON. The only thing I could find is in the committee report, which clearly says that the provision liberalizes the section.

Mr. GREGG. I can give you the history of that when Mr. Manson gets through, as showing you the reasons why it was done.

Senator WATSON. I have no recollection of any discussion in the Senate about it.

Senator JONES of New Mexico. I have not, either.

Mr. GREGG. It was done in the House, Senator.

Senator WATSON. Oh, it was?

Mr. MANSON. Well, aside from what I am reading here, that last suggestion that I made with reference to treating these as one transaction or as seven transactions certainly manifests a peculiar situation.

A man goes into the market and buys seven blocks of stock. Some of them go up and some of them go down. This particular aggregation of illustrations that I have used here shows this: If the whole thing is treated as one transaction—say he goes to his broker and buys all of this stock in one lump and gives his check for $70,000 prior to March 1, 1913. On March 1, 1913, the market value of that stock is $65,000. In 1924 he sells it as one transaction for $70,000. Under this law, by setting those different blocks of stock up separately, he can take a deductible loss of $20,000.

Table 2 consists of cases (F) and (G) of Table 1.

	Cost prior to Mar. 1, 1913	Mar. 1, 1913, values	Selling price	Taxable gain		Deductible loss	
				1921 act, section 202	1924 act	1921 act	1924 act
F	$5,000	$10,000	$15,000	$5,000	$5,000		
G	15,000	10,000	5,000	None.	None.	$5,000	$10,000
	20,000	20,000	20,000	5,000	5,000	5,000	10,000

A taxpayer in 1905 bought two blocks of stock, at the market, in one transaction. For block F he paid $5,000 and for block G he paid $15,000, or $20,000 for all of the stock. On March 1, 1913, stock F has increased in value to $10,000 and stock G has decreased to $10,000. In 1924 he sells stock F for $15,000 and stock G for $5,000. One

stock has steadily increased in value from the time he bought it and the other has steadily decreased, but the loss on one block has always been equal to the gain on the other block. He paid $20,000 for the stock, its March 1, 1913, value was $20,000, and it was sold in 1924 for $20,000. It seems clear that under any equitable method of measurement there would be neither a taxable gain nor a deductible loss in this case. Under the 1921 law there is a taxable gain on stock F of $5,000, which is offset by a deductible loss of $5,000 on stock G. Under the 1924 act the taxable gain on stock F is $5,000, but the deductible loss on stock G is $10,000, leaving a net deductible loss of $5,000 on the entire transaction. This is due to the fact that, while an increase in 1913 value over cost operates to limit taxable gain under both the 1921 and 1924 acts, a decrease in 1913 value under cost does not limit deductible loss under the 1924 act.

The following is a restatement of cases D and F of Table 1:

TABLE 3

	Cost prior to Mar. 1, 1913	Mar. 1, 1913, value	Selling price, 1924	Taxable gain		Deductible loss	
				1921 act	1924 act	1921 act	1924 act
D	$10,000	$5,000	$15,000	$5,000	$5,000	None.	None.
F	5,000	10,000	15,000	5,000	5,000	None.	None.
Total	15,000	15,000	30,000	10,000	10,000		

Assuming a taxpayer purchased stock D and F as one transaction at the market prior to 1913, D is purchased for $10,000 and F for $5,000. Stock D decreases in value to 1913 to $5,000, which loss is offset by an increase in the value of stock F, so that both blocks are worth in 1913 exactly what was paid for them. In 1924 each block is sold for $15,000, or a total of $30,000.

Thus this stock is sold for $15,000 more than it cost and for $15,000 more than its March 1, 1913, value; yet under either the 1921 or the 1924 act the taxable gain is only $10,000. This result is due to the fact that while the increase in the 1913 value over cost of stock F limits the taxable gain, the decrease in the March 1, 1913, value of stock D below cost has no effect on the taxable gain.

These illustrations show that no double standard can work out equitably to both the taxpayer and the Government. The taxation of gains which accrued prior to March 1, 1913, is probably barred for constitutional reasons. The Supreme Court has held that, under the language of the 1918 and prior acts gains over 1913 values were limited to actual gains over cost. These decisions are based entirely upon a construction of the statute itself. The Supreme Court has not held that Congress can not tax all increases in capital values over the March 1, 1913, value which have been realized and segregated by subsequent sales as income of the year of sale.

So long as the dual method of measuring taxable gains and deductible losses is used the law should provide that gains and losses on the sale of property acquired before March 1, 1913, should be measured by comparing the aggregate amount received during the taxable year with the aggregate amount paid for such property, to

determine whether there has been an actual gain or loss, and that the taxable gain or deductible loss should then be determined by the aggregate value as of March 1, 1913.

The 1924 act provides a method of computing losses on the sale of tangible property, which was depleted or had depreciated prior to March 1, 1913. It provides:

SEC. 202 (b). In computing the amount of gain or loss under subdivision (a) proper adjustment shall be made for (1) any expenditures properly chargeable to capital account, and (2) any item of loss, exhaustion, wear and tear, obsolescence, amortization, or depletion, previously allowed with respect to such property.

I call the committee's special attention to the language "previously allowed," with respect to the depletion or depreciation which is to be deducted.

The limitation of the losses, depletion, and depreciation, which are to be deducted from the cost on March 1, 1913, value, for the purpose of determining the profit or loss, which has resulted upon its sale, to losses, depletion, and depreciation "previously allowed," is a radical change from the former acts as construed by the regulations.

As no loss, depletion, or depreciation which occurred prior to March 1, 1913, could have been "allowed," the losses, depletion, and depreciation, which may be considered in adjusting cost, are confined by the act of 1924 to those which have been allowed since March 1, 1913.

There was no specific provision in the 1921 and previous acts covering adjustments for capital charges and loss, depletion, and depreciation. The former acts were construed by the bureau to imply that such adjustment should be made. Regulations 62, article 1561, covering the basis for determining gain or loss from sale provides:

In any case proper adjustment must be made in computing gain or loss from the exchange or sale of property for any depreciation or depletion sustained or allowable as a deduction in computing net income.

Furthermore, deductible losses on sales were limited to the difference between the March 1, 1913, value and the amount received on the sale. This limitation excluded from deductible losses all losses, depletion, and depreciation prior to March 1, 1913. As has already been shown, the 1924 act makes the cost prior to March 1, 1913, the basis of measuring a deductible loss, and this provision provides in effect that only such loss, depletion, or depreciation as has been allowed since March 1, 1913, shall be deducted from such cost for the purpose of determining profit or loss on a sale.

Assume that a taxpayer purchased two tracts of timber in 1905 for $100,000 each. The timber on tract A is cut and sold prior to March 1, 1913, for $150,000. The timber on tract B stands and increases in value. It is worth $200,000 on March 1, 1913. All of the land is of practically no value except for the timber. In 1924 both tracts are sold. For the tract A, from which the timber was removed, $5,000 is received, but because of a continued increase in timber value the other tract is sold for $295,000.

On tract B the taxpayer makes an actual profit of $195,000. Of this amount, $95,000, being the gain since March 1, 1913, is taxable. Tract A, having sold for less than cost, and no depletion prior to

1913 being deductible, affords a deductible loss of $95,000, which offsets the taxable profit on tract B and no tax is paid.

This taxpayer made an initial investment of $200,000. Prior to 1913 he received $150,000 for timber, and has land and timber left on March 1, 1913, of the then value of $205,000. He has received $450,000 on a $200,000 investment, or a profit of $250,000, of which $95,000 is due to increasement of value since March 1, 1913, yet he pays no tax.

Senator WATSON. Are these actual cases or hypothetical cases that you are referring to?

Mr. MANSON. Oh, this is a hypothetical case.

Senator WATSON. Are there any actual cases that illustrate this proposition that you are advancing?

Mr. MANSON. The country is full of cut-over timberlands.

Senator WATSON. I know; but I am talking about specific cases.

Mr. MANSON. And there are plenty of depleted mines. Under the 1924 act cut-over timberland can be sold and a loss taken for the difference between the practically nil value of the land as cut-over land and what it actually cost, and if the timber was taken off prior to 1913 no allowance was made for the timber that was taken off.

Section 214 makes deductible losses incurred in trade and business, losses on transactions entered into for profit, and losses due to fire, storms, etc. This section provides that the basis for determining the amount of such losses shall be the same as that provided by section 202 for determining gain or loss on the sale or other disposition of property. It will be noted that the 12½ per cent limit does not apply to deductions under section 214.

Mr. GREGG. Do you mean the deductions for depletion or depreciation or deductions for losses?

Mr. MANSON. A deduction for losses. In other words, if you sell property and take a loss the 12½ per cent limit applies; but if the loss is due to fire or to storms, or it is a total loss of stock——

Mr. GREGG. That is, due to anything but a sale or exchange?

Mr. MANSON. Due to anything but a sale or exchange, the 12½ per cent does not apply, and this illustrates for the purpose of showing how that works out.

Assume a taxpayer purchased two blocks of 1,000 shares each of stock, prior to March 1, 1913, at $100 per share, which we will designate as A and B. On March 1, 1913, stock A is only worth $2 per share, but stock B is worth $198 per share, so that they aggregate the same as what he paid for them. On March 1, 1913, the taxpayer has gained as much as he has lost and has, in value, just what he invested.

In 1924 stock A has no value, but stock B is sold for $300 a share. Since March 1, 1913, this taxpayer has gained $102 per share on stock B and has lost $2 per share on stock A. On the entire transaction he has gained $100,000, all of which gain has accrued since March 1, 1913. Aside from this transaction he has a net income of $100,000 in 1924, above exemption, upon which his total tax would be $22,780.

The cost of stock A exceeds its value on March 1, 1913, and is therefore the basis for determining the loss. This loss is $100,000. As this stock has no value in 1924 it is not sold or otherwise disposed

of, but a total loss is established. This is an ordinary, not a capital, deduction, and is used as a deduction from ordinary income, entirely wiping it out. He then has a capital net gain of $102,000 upon which he is taxed at 12½ per cent and pays a tax of $12,750. Thus, by this change in the law in 1924, this taxpayer not only pays no additional tax on a profit of $102,000, which accrued after March 1, 1913, and was realized in 1924, but is actually enabled to reduce his taxes on ordinary income from $22,780 to $12,750.

It will be noted that on the basis provided by the 1924 act——

Mr. GREGG. Mr. Manson, may I interrupt? I did not get that last point clearly, and I would like to.

Mr. MANSON. The point is this: He buys two blocks of stock; his profit on the one is equal to his loss on the other, but the loss is a total loss; it is not a partial loss. Therefore, it being a total loss it is offset not against his taxable gain but it is offset against his ordinary income.

Mr. GREGG. The point I was getting at is this: You said under the 1924 act. That was just as true under the 1921 act.

Mr. MANSON. Oh, yes; that is right.

Mr. GREGG. It was just as true under the 1921 act as under the 1924 act.

Mr. MANSON. Yes; that is right.

Mr. GREGG. It was true under both acts.

Mr. MANSON. It was true under both acts; but instead of his loss offsetting his taxable gain, leaving his ordinary income taxable at regular rates, his loss is offset, his ordinary income wiping that out.

Mr. GREGG. That is perfectly true.

Mr. MANSON. And leaving as taxable a capital gain the tax upon which is limited to 12½ per cent.

It will be noted that on the basis provided by the 1924 act for the measurement of gain or loss the maximum gain subject to tax is such gain as accrues subsequent to March 1, 1913. If any loss of value occurred as accrues between the date of purchase and March 1, 1913, such shrinkage is deducted from any gain accruing subsequent to March 1, 1913. In the measurement of losses the full loss since March 1, 1913, is the minimum deduction. If there was a further loss prior to 1913, it is added to the loss subsequent to 1913; and if there was a gain prior to 1913, followed by a loss after that date, the prior gain is not considered in determining deductible loss.

The 1924 act goes back to March 1, 1913, only for the purpose of decreasing taxable gains or increasing deductible losses, but stops at 1913 when prior conditions would either increase taxable gains or decrease deductible losses.

You had something to say, Mr. Gregg, about the history of that, had you?

Mr. GREGG. Yes. There is so much involved in the history of it that it is rather hard to know where to start. The matter is so complicated and technical that it is rather hard to state it. If I had known what Mr. Manson was going to take up this morning, it would not have been necessary for us to have sat on different sides of the table, because I agree with practically all of it. The most of it is explained by the history of the acts.

There are really three criticisms which he makes of the 1924 act.

The first one is the use in determining gain or loss on cost or March 1 value, whichever is higher.

In the original act the basis for determining gains and losses was not given; so the Supreme Court in several opinions, the only one which I remember offhand being that of Lynch *v.* Turrish, held that what a taxpayer had on March 1, 1913, was capital; that its then value was his capital for tax purposes. That was the date of the first income tax law. That was the starting point. We should not look back of that at all.

When the 1916 act was before Congress they wanted to put that in the act, and they did in very clear language say the basis of determining gains and losses was the March 1, 1913, value.

From both the history of the act and the language of the act, I think it is unquestionably true that Congress meant exactly what it said, that that was the basis and that you should not go back of it.

For example, take a specific case; assume stock that cost $50 in 1909; its March 1, 1913, value was a hundred dollars, and the taxpayer sold it for $50. I think Congress meant very clearly——

Senator WATSON. It was sold when?

Mr. GREGG. It was sold, say, in 1916.

Senator WATSON. It was sold at March 1, 1913?

Mr. GREGG. It was sold after March 1, 1913, for $50.

Congress meant that this taxpayer had $100 capital in this property when the tax law went into effect. Therefore, when he sold it for less than a hundred dollars, that represented a loss to him which should be deductible. He had lost something since the enactment of the tax law.

It meant also the reverse.

Suppose it cost $50, that the March 1, 1913, value was $25, and he sold it for $50. I think Congress meant equally there, and they said it, that the taxpayer had a gain since the enactment of the income tax law, and that is as far back as we should look for tax purposes; and therefore we should tax him on the $25 gain.

That is the construction that the department adopted, and it was exactly in accordance with congressional intent, because they put the same language in the 1918 act.

The cases of Brewster *v.* Walsh and Goodrich *v.* Edwards went to the Supreme Court of the United States on substantially the latter question.

Where the cost was $50, the March 1, 1913, value was $25, and the sale price in 1916 was $50, we had taxed the taxpayer on the $25, since he had an increase of $25 since the enactment of the tax law.

Mr. Frierson was Solicitor General at the time, and there was a great deal of argument about the cases when they were prepared for argument before the Supreme Court. Mr. Frierson said that if he contended that that was what the statute meant, which was what it said, the Supreme Court would say it was unconstitutional to tax the man on the $25 gain when, as a matter of fact, he had no actual gain.

The Treasury Department objected to his taking that point of view. As a matter of fact, Doctor Adams came down, and some one from the solicitor's office, together with Doctor Adams, prepared a brief in support of the position which the Treasury Department had always taken on this transaction.

But Mr. Frierson insisted on his position, and in the Supreme Court he conceded—and it has been referred to ever since as "the Frierson concession"— that the only taxable gain was the actual gain. In other words, he said that the act meant——

Senator WATSON. Gain between 1909, when he bought, and 1916, when he sold, regardless of the March 1, 1913, value?

Mr. GREGG. That there had to be an actual gain before this section as to the March 1, 1913, value applied. Then you apply the March 1, 1913, value.

After Mr. Frierson conceded it, of course, the Supreme Court followed his concession.

Senator KING. I think he was wrong.

Mr. MANSON. He certainly messed things up: I will say that.

Senator KING. The Treasury Department was right.

Senator ERNST. The Treasury Department was right; there is no question about that.

Mr. GREGG. He certainly went contrary to what Congress had intended.

Mr. MANSON. Am I to think Mr. Gregg will agree with me that there is nothing in any of the decisions of the Supreme Court of the United States even indicating that Congress could not accept March 1, 1913, values as the basis for determining capital?

Mr. GREGG. I do not think there was anything in the world——

Mr. MANSON. I have not been able to find anything that even intimates that.

Mr. GREGG. After this concession, which was prior to the passage of the 1921 act, we simply said, "If you are going to concede that as to gains we will apply the reverse as to losses, so that the Government will not be hurt both ways."

The taxpayers immediately took that to court.

Taxpayers contended that the case of Goodrich *v.* Edwards was decided on the constitutional question and that the granting of losses was a concession to the taxpayer by Congress, and they could put it on whatever basis they wanted. So they took to court the case of the cost of $50, March 1, 1913, value of $100, and sale price of $50, saying that they were entitled to deduct the loss of $50, in accordance with what Congress had intended.

Just recently the Supreme Court, in the Flannery and Ludington cases, upheld the other side of the Treasury Department's position, which we had taken after Mr. Frierson's concession, so that the language, which in the meantime had been written into the 1921 act, was held to be the proper construction of the prior acts. This rule involves comparing the sales price with the cost to see if there was an actual gain or an actual loss. Then you looked at the March 1, 1913, value to see what part of that gain or what part of that loss accrued after March 1, 1913. It is that which is deductible or taxable, and that is what we put into the 1921 law.

The 1924 bill as sent down to the Ways and Means Committee as the recommendation of the Treasury Department contained, as Mr. Manson has stated, that same language as is in the 1921 act.

If I may explain it, the reasons which caused the change were these:

Congress had always been very strongly of the opinion—and you have heard it so much that you are all familiar with it—that what

the taxpayer had on March 1, 1913, was his capital, and for tax purposes he is entitled to get that back.

The Supreme Court had said that on the gain side, or the inference was that on the gain side, that could not be strictly applied unless there was an actual gain, and there was no such limitation on the loss side, which was purely a concession by Congress; and Congress could give a taxpayer a loss on the March 1, 1913, value if it so desired, regardless of whether there was an actual loss.

So as the result in the 1924 act there was written by the Ways and Means Committee this provision which Mr. Manson has read, the effect of which is this: It adopts with reference to loss the same provision that Congress intended in the 1916 and 1918 acts with reference to loss; but with reference to gains it takes the view that the Supreme Court took in the Goodrich *v.* Edwards case, and says there must be an actual gain before there is a taxable gain. Of course, it was to the advantage of the taxpayer both ways. He gets a bigger loss and a smaller gain.

Mr. MANSON. As to losses it does not confine the losses to the losses sustained subsequent to 1913.

Mr. GREGG. It gives him the bigger loss.

Mr. MANSON. It gives him the bigger loss, whatever it may be.

Mr. GREGG. It gives him whatever loss is the larger.

Mr. MANSON. I understood you to say it was unquestionably the intention of Congress in the earlier acts to measure both the gain and the loss by the March 1, 1913, value.

Mr. GREGG. That is perfectly true. This went further than the older acts did.

Mr. MANSON. Oh, yes!

Mr. GREGG. I think it was the intention all along to give the taxpayer a loss on his March 1, 1913, value, on the theory that that was his capital, and any subsequent sale for a lesser amount produced a tax loss to him.

That is the history of that provision of the 1924 act. I think myself it should be changed and put back in the form of the 1921 act. I do not think the Treasury Department objected when the change was made in the Ways and Means Committee on the theory on which Congress has always felt so strongly that a taxpayer's capital as of March 1, 1913, can not be subsequently touched for tax purposes. But I think it should be changed back.

The second point——

Senator JONES of New Mexico. To change back, however, would be taking a different position from that which Mr. Frierson took.

Mr. MANSON. No; not necessarily.

Mr. GREGG. They could go back and take the same position on both gains and losses.

Mr. MANSON. In the 1921 act there is stated in express language the effect of the Supreme Court's decisions in all of these four cases. Is not that right, Mr. Gregg?

Mr. GREGG. Yes.

Senator JONES of New Mexico. I understood you to say that Mr. Frierson contended, in the second illustration you gave there, that where the stock was worth less in 1913 than when he bought it you could not tax the gain upon the 1913 value.

Mr. GREGG. That is true; yes, sir.

Senator JONES of New Mexico. Would you concede that under the new law?

Mr. GREGG. That is what the 1921 law did; yes, sir.

Mr. MANSON. But it applied the same rule to the losses.

Senator JONES of New Mexico. I understand that; but on that proposition you would still provide that unless there was an actual gain above the original cost there would be no taxable gain.

Mr. GREGG. That, of course, is purely a matter of policy. You could go back to the 1916 act and put it in such language that it could not be misconstrued, and say, "We will start with March 1, 1913, irrespective of the cost prior to that date."

Senator JONES of New Mexico. But in order to do that you would have to take a position against the Frierson concession, would you not?

Mr. GREGG. To do that you would; yes, sir.

Mr. MANSON. Mr. Frierson never conceded—or at least there is nothing in the opinion holding that construction upon constitutional grounds. That may have been the thing that was back in Mr. Frierson's mind.

Mr. GREGG. It was.

Mr. MANSON. But the court has never intimated that had Congress desired to make the March 1, 1913, value the determination of what constitutes capital it could not have done so. The court simply takes the position in all of these cases, or Mr. Frierson stated that that was the intent of Congress; in other words, that that was the construction that should be given to that statute; and then, in its subsequent decisions, the Supreme Court applied the measure to losses that Mr. Frierson has conceded should be applied to gains. But I do not know of any decision of the Supreme Court—I do know that the Supreme Court has said that you can not tax as income capital which existed on the 1st of March, 1913, but I do not know of any decision which even intimates that you can not tax a gain over March 1, 1913, value, even though that gain exceeds the actual gain.

Mr. GREGG. I think I can answer your question in this way, if I understood it, Senator Jones: There are two ways that you can be absolutely consistent both as to gains and losses. You can put it on the March 1, 1913, value, irrespective of cost, or you can go back to the 1921 law.

The latter rule looks first to the actual loss and the actual gain, and then to the portion of that which accrued after March 1, 1913, which represents Mr. Frierson's view of the construction of the old acts. Either one of those is consistent as to gains or losses. The 1924 act is not.

Mr. MANSON. I think Mr. Gregg and I agree upon this proposition, that the Supreme Court has never intimated that you can not accept the March 1, 1913, value as the sole basis for determining profits and losses, and that the furthest that they have gone is to say that Congress did not do that.

Senator JONES of New Mexico. To take the 1916 act as the basis, would there not arise some hardships from that?

Mr. GREGG. Yes, sir.

Senator JONES of New Mexico. Take the case of the timberlands. We will say they cost $100,000. In 1913 there is a depression in the timber business, and as of that date those lands are only worth $50,000. In 1924 they are selling for $100,000. You would have a taxable gain there of $50,000, and the man only got for his property what he paid for it and he has been out of the use of his interest during all that period of time.

Mr. MANSON. There is that argument in favor of the 1921 provision.

Senator JONES of New Mexico. And was it not that argument which caused the change in the law to be brought about?

Mr. GREGG. I think the change in the law was brought about to embody the construction which the court had placed upon the other. I remember that Doctor Adams explained before the Finance Committee that it was just writing into the law the Supreme Court's construction of the old act. But I have no doubt that that type of case was largely responsible for the acceptance of the Supreme Court construction.

I will say in connection with the matter of the making of that concession that when this case went to the Supreme Court the taxpayer was attacking first the power of Congress to tax taxable gains, and a very serious doubt existed as to whether Congress had the power to tax capital gains as income at all.

When the sixteenth amendment was adopted there were decisions of the English courts and our State courts which held that income did not include capital gains, and it was contended that income as used in the sixteenth amendment meant the same thing and did not include capital gains, so that when Mr. Frierson made his concession before the Supreme Court in the Goodrich *v.* Edwards case the big fight was on the main point of the power to tax capital gains at all. I think that is largely the explanation of the concession.

The CHAIRMAN. You would recommend, then, going back to the 1921 act rather than to the 1916 act?

Mr. GREGG. I really think the 1921 act is more sound, because of those cases where you have an actual gain or an actual loss decidedly different from your March 1 gain or your March 1 loss.

The CHAIRMAN. Do you agree with that, Senator Jones?

Senator JONES. Well, I am not prepared offhand to express a settled opinion on the subject, but I think it is perfectly clear we ought to give this whole subject of capital gains and losses a thorough study. In view of what Mr. Manson has shown us here this morning, I am not prepared to say we should continue the act at all.

Mr. GREGG. I wanted to get to that.

Senator KING. I was opposed to it.

Senator JONES of New Mexico. I was thinking, when we were discussing these matters in the absence of Senator King, that he has always been opposed to taxing either gains or losses.

Senator KING. Yes; I have always opposed it.

Mr. MANSON. I think that Senator King would be interested in the figures.

Senator JONES of New Mexico. I would like, however, to have this question further considered, and that is whether or not the questions

of gains or losses should not be restricted to physical property and not to trades or dealings in stocks and bonds and all that sort of thing. It should be restricted to physical property. I think much could be said in favor of a tax on the actual gains or the sale of physical property, which could not be said with respect to other classes of property, especially that limitation of 12½ per cent.

I oppose rather strongly the provision there that losses should be limited to 12½ per cent simply because the tax on capital gains is 12½ per cent. I do not think there is any relation between the two from the point of justice to the taxpayer, and yet I can understand why it was that the tax on the gains was limited to 12½ per cent. It was strongly urged that the surtaxes interfered with sales and transactions and dealings in properties.

Senator WATSON. That is so.

Senator JONES of New Mexico. That was the reason given, and there was very great force in it, but I think it should only be applicable to sales of physical property, and should not deter any transactions in stocks or bonds which interfered with the public welfare. It may have interfered with the exchange in those securities, but the public is not interested in the question of who owned the thing, but it is the dealing in the physical property which was looked at from a public standpoint.

I think we ought to consider this whole question anew, first, as to whether we should have any tax on capital gains at all or not, and, second, whether we should have this 12½ per cent limitation restricted to the transfer of physical property or not, or whether we should have any losses restricted to 12½ per cent. I think the whole matter ought to be studied as a fundamental question, regardless of the views which have been entertained in the past.

Senator KING. I was going to suggest, Mr. Chairman, that when we concluded our hearings on these matters, in regard to which there may be with propriety different views, I should like to have Mr. Gregg and representatives of the Treasury Department before us and get their advice upon these matters, because I have an open mind on many of these questions, and I am sure that the committee, if they are going to make any recommendation at all on these matters, want to make recommendations that will be of value of Congress.

Mr. GREGG. The other two points that Mr. Manson has taken up are more or less technical points, with which I agree entirely, in that the 1924 act should be amended, and we have as a matter of fact discussed it before the meeting.

That brings it down to the big point of what should be done in connection with capital gains and capital losses.

Senator JONES of New Mexico. I certainly feel that the tax on capital gains should not be levied beyond the transfers of the physical properties in which the public might have some interest in feeling that the revenue laws were not unfair, transfers of properties, a factory or an oil well or a gold mine or a piece of timber land; that we ought not to discourage too much transfers of those physical properties, because the owner might not be in a position to develop them as should be done, and we ought to permit a transfer without the revenue laws being too great a hindrance or brake upon the trans-

action, and to use that as an excuse for restricting deductible losses is beyond my comprehension, because the same man does not do both things. It is like applying the law of averages to various things. It does not work out as to the individual.

The CHAIRMAN. The kind of law of averages that Mr. Greenidge tried to apply to the taxpayers?

Senator JONES of New Mexico. Yes.

Senator KING. I think that the tax laws, so far as humanly possible, should be calculated not to impede commercial transactions or to retard them. I favor as many transactions as possible and to tax gains regardless of the capital. Therefore, I have always been opposed to trying to ascertain the value of the capital as of March 1, 1913, and tax the capital gains and capital losses. That leads to confusion and to complications, and I think in the long run it is injurious to business. I would tax the profits, and that has been my view from the beginning, when the first war bill was up in 1917.

Mr. MANSON. Senator Jones mentioned the confining of this limitation to physical property. I took 400 individuals whose returns showed net incomes of $100,000 and over, and analyzed gains and losses for the years 1917 to 1922.

Of the gains 89.17 per cent arose out of stock transactions, 4.92 per cent out of bond transactions, and 5.91 per cent out of real estate transactions.

The CHAIRMAN. If that means anything, then, that 89 per cent would be taxed under the theory that Senator Jones advanced.

Mr. MANSON. Now, take the losses——

Senator JONES of New Mexico. And without limitations.

The CHAIRMAN. Yes.

Mr. MANSON. As to the losses, 70.66 per cent arose out of stock transactions, 20.62 per cent out of bond transactions, 3.57 per cent out of real estate transactions, and 5.15 per cent represented worthless stocks and bonds charged off as losses.

I only carried that out in 400 cases, for the purpose of getting the kinds of properties entering into these transactions.

Senator JONES of New Mexico. Those statistics, I think, would be very valuable to us when we come to consider this question.

Mr. MANSON. I have made a further analysis of those same transactions with reference to the period of time that the property was held. I have not those figures before me, but I have analyzed them from the standpoint of how much of this property was acquired within the year of sale, how much acquired within the previous year, and how much was acquired within the period of two and less than five years, and then how much of it was acquired more than five years before the sale.

The CHAIRMAN. May we reach the conclusion from those figures that the revenues deter more business in physical property than is evidenced by those figures?

Mr. MANSON. Well, I would not say that. Of course, you would have to make an investigation covering 1923 and 1924 after the capital gains provisions went into effect. At the time I was doing this work it was difficult to get hold of the 1923 schedules; so I have made no special investigation of that point.

Senator KING. May I say, Mr. Manson, that I know of many cases—not of one, but of many—where individuals had acquired some property, real estate, and mines, particularly gold, silver, lead, and copper mines, prior to 1913, and the advance had been so great that a sale would have taken, in many instances, a larger amount than he originally paid for the property, and therefore they just held the property, and in many instances did not develop it.

Mr. MANSON. Oh, I know of cases of that sort, too.

The CHAIRMAN. I think we might safely reach the conclusion that those small percentages of gains on physical property were due to the tax on capital gains.

Mr. MANSON. I think that is justified.

Mr. GREGG. It seems to me that the figures show one thing very clearly. The matter of the realization of both gains and losses is absolutely in the hands of the taxpayer, since there is no taxable gain and no deductible loss until he sells. When he has a capital gain subject to the high rates of tax, he is not going to sell, but is going to hold on to the property. When he comes to make out his return, on the other hand, he is going to look and see where he can find some capital losses and take them to reduce his taxes.

The CHAIRMAN. In other words, he takes all of his gold mine, silver mine, and copper stocks that are valueless and deducts them from his income?

Mr. GREGG. He is deducting his losses and not reporting his gains. I think that has been true ever since we have had an income tax law.

Mr. MANSON. I want to lay before the committee a request for some information——

Senator JONES of New Mexico. In this connection, do I understand that stocks which were purchased before 1913 were valueless in 1913, and that that can now be offset against capital gains?

Mr. GREGG. Under the 1924 act; yes, sir.

Mr. MANSON. Yes, sir.

Senator JONES of New Mexico. That is my understanding under the 1924 act.

Mr. MANSON. Yes.

Senator KING. It is an outrage, too, in my opinion.

The CHAIRMAN. I do not think a thing of that kind should get by.

Senator KING. I agree with the Senator. I think it is robbing the Government and is very unfair.

The CHAIRMAN. Mr. Manson has submitted this to the committee, and I will ask him to give us his reason for it, as to why he wants this resolution considered:

Resolved by the special committee of the Senate investigating the Bureau of Internal Revenue, That the Secretary of the Treasury is hereby called upon to furnish to the committee the amount of net taxable income of 1923 of the individuals whose names and addresses appear on the accompanying list.

Mr. MANSON. There is a list there of about 5,300 individuals. The purpose of that is that the persons whose names appear on that list——

Senator KING. You are willing that they should give numbers instead of names, are you?

Mr. MANSON. What I want to get is this: I want to get the net taxable incomes in order to ascertain the distributive shares of

undivided profits. It is a cross-section list of corporations distributed among all classes of corporations for the purpose of arriving at the tax brackets that undivided profits would fall in were they distributed. It is imposing quite a job on the Treasury Department, and I do not care to make the request unless it meets with the committee's approval.

Senator JONES of New Mexico. How is that cross section made up, Mr. Manson?

Mr. MANSON. I have classified the corporate returns that we have handled into some 128 different classifications. I have explained that classification to the committee several times. For the purpose of taking a fair sample I determined in the first place to take 10 per cent out of each class. I found that that was going to be too many, and reduced it to about seven. Then we called upon the Treasury Department for the dividend reports of those corporations. We received all that they could furnish us. Owing to confusion of addresses and things of that sort there were some that they could not furnish us. That left the list unbalanced with respect to taxes. We then took those classes in which they furnished us all of the returns, and we reduced them in number so that the list was a balanced list, which now checks up to about 5 per cent of the corporations that we have been considering. I then took the names of the stockholders who received dividends of that list of corporatons. By the way, I will say that the corporations themselves, after we determined the number to be taken for each class, were selected by a girl clerk, who did not know anything about the significance of it. The idea was to try to get a fair cross section for the public of arriving at a measure that would determine the tax brackets in which undivided profits would fall.

The CHAIRMAN. As I understand it, Mr. Manson, this would demonstrate how the high surtax brackets curtailed the distribution on profits; is not that correct?

Mr. MANSON. I have not stopped to consider what lessons can be drawn from this. In any consideration that is to be given to the matter of capital gains or to the matter of undivided profits of corporations it is important to know what bracket they fall in.

Senator KING. Would it not throw some light upon the contention that Senator Jones has been making for several years, and which the Senate is seriously considering, and indeed the House, of taxing undistributed and undivided profits?

Senator JONES of New Mexico. And which was adopted by the Senate.

Senator KING. Yes.

Senator JONES of New Mexico. By a substantial majority when we passed the 1924 act.

Mr. MANSON. It is essential to the consideration of that question.

Senator KING. Mr. Chairman, I am in favor of that, and in addition I would say this, that if the officials of the Treasury Department would like to supplement that by other corporations—if they feel that this cross section which he has indicated would not give a fair cross section—to have them do so or to supply any other list that they care to submit.

Senator JONES of New Mexico. It is one of the most important things that I know of. I have been reading a great deal in the newspapers about wanting tax reform.

Not a single reference has been made to this method of taxing corporate income, and that it is unfair and unjust, I think, must be admitted by every intelligent man who has given any thought to the subject at all. This question of a flat tax upon all corporations is one of the most unfair things, it seems to me, that exists in the law, in view of the fact that we have accepted the graduated tax upon individual incomes, and not a suggestion has been made in all of these interviews which I have given attention to or which have been called to my attention with respect to tax reform—not a single reference has been made to any possible change in the present law for taxing corporations. I think it is an outrage, and it seems to me that this information goes directly to the point of telling us how unjust the present law is and furnishes some basis for a correction of the evil.

Senator KING. I am sure the committee wants to investigate it, and I certainly do, because you can remember how important it was, Mr. Gregg, and the serious consideration that was given it. Can you conceive of any fairer way to get this information than this?

Mr. GREGG. No.

Senator ERNST. You mean than the way which is asked for here?

Senator KING. It is perfectly fair, is it not? I move its adoption.

Senator ERNST. Is there any reason why the Treasury Department would not desire to furnish that information?

Mr. GREGG. Not that I know of.

Senator ERNST. Should it be furnished according to names and addresses or by numbers?

Senator JONES of New Mexico. Under the 1924 law those names and the amounts are published in the various districts now, and it is just a mere matter of getting them together in this form; that is all.

Mr. MANSON. I am perfectly willing to say this: After they tabulate that—and it will not be tabulated by names—I am perfectly willing to return the matter to the Treasury Department.

Mr. GREGG. That is all that occurred to me; that it might not be desirable from that standpoint.

Mr. MANSON. I have no way of checking up the information I have without working that up, except through names.

Senator KING. But we will not publish that.

Mr. MANSON. No.

Senator KING. It will be only a résumé.

Mr. MANSON. What I expect to get at is this, in the last analysis: This one will fall in the 2 per cent bracket, this one in the 5 per cent bracket, and so on.

Senator JONES of New Mexico. I think this, Mr. Manson: We ought to preserve in some form the detailed information. I do not care whether you call it John Brown or No. 1, so we have the individual cases. I do not want to go after John Brown or No. 1; but if they pay a certain tax at a certain rate, and by keeping the earnings in a corporation they save so much money, I do want that detailed information.

Mr. MANSON. We are keeping a very careful record of all information we get from the Treasury Department. Some day I am

going to ask somebody to give me a receipt for it, to check it over and to see that it is all there. It is immaterial to me what becomes of it, except that some day I want to be relieved of any responsibility connected with it.

The CHAIRMAN. In that connection I would like to ask Mr. Manson if he has ever submitted to the committee that schedule showing the distribution of earnings by some thousand corporations, I think, in connection with which 90 per cent of the stock was owned by the officers and the other percentages are owned by others, and where a certain percentage of the net revenue was distributed, and certain other percentages were shown, showing how the various amounts were distributed and how they were held back?

Mr. MANSON. I have offered that all for the record.

The CHAIRMAN. That is in the record now?

Mr. MANSON. It is in the record. It has not been printed yet, but it has been offered. It was incomplete. I believed at the time that some members of the committee might want to study that information during the summer, and for that reason I offered a sort of progress report on it.

The CHAIRMAN. Yes; I was looking it over last night, and I did not recall whether you had put it in the record or not.

Mr. MANSON. Yes; it was put in the record.

Senator JONES of New Mexico. We want all of these tabulations to be put into the record at one time or another.

Mr. MANSON. Yes. Of course, the work is incomplete.

I have also made a recapitulation of about 3,100—3,066 individuals. It is a very bulky document, because it is divided into many classes, and I have made it for the study of anyone who wants to study it. I intend to offer that for the record before the committee disbands at this time in order that it may be printed for the benefit of the committee. That is also incomplete, but by taking some progress studies that I have made I find that the percentages in the completed report are not going to vary materially from the percentages that will be taken off at the present time.

The CHAIRMAN. Senator King moved the adoption of the resolution. All those in favor of the resolution will say "aye."

(All of the committee present voted for the adoption of the resolution.)

The CHAIRMAN. There is no opposition; it is unanimously carried.

Mr. MANSON. Gentlemen, I have some other matters here.

Senator JONES of New Mexico. When I suggested a normal rate of tax for corporations and graduated percentages, that was struck at almost wholly in the dark. Mr. McCoy and I went over those for the purpose of putting the rates at a point which would bring into the Treasury the amount of revenue it was estimated would be brought in under a flat rate of 14 per cent. At that time the Senate had abolished the capital-stock tax, and had decided to increase the flat tax on corporations so as to raise approximately $1,000,000,000 from corporations, and it was by reason of Mr. McCoy's statement that it would be necessary to have a flat tax of 9 per cent on corporations that I embodied that rate in the bill. I have been talking over these various matters with Mr. Manson from time to time, and I am convinced now that we can reduce that normal

tax on corporations to 6 per cent, the same rate as is imposed upon individuals. That is equitably where it should be, in my opinion.

Senator KING. Senator, would you not make any distinction between, say, public service corporations and corporations whose profits are very large?

Senator JONES of New Mexico. Well, you can not do that unless you go into the question of invested capital, and I think we all want to get away from the question of dealing with invested capital. The fair thing to do would be just that, Senator King, in my judgment, but the many pitfalls and obstacles in the way of its administration deter it, at least to my mind.

Senator KING. Yes; there is no question about that.

Senator JONES of New Mexico. They are so great.

The CHAIRMAN. The mechanics of the situation are terrific.

Senator JONES of New Mexico. Yes; we do not want to deal with it, and must find some other basis, and that is why I eventually decided upon using the undistributed net income as a basis for taxation. That was really the cause for using the new basis for taxation; but I think it is an outrage that a little corporation earning a few thousand dollars should pay at the same rate that some of these closely held private corporations, earning enormous sums of money. As I say, I think it is an outrage. I think it is also an outrage that these public utility corporations, to which you have referred, should be paying at the same rate of taxation as the closely held private corporations, with large earnings, where the earnings are simply kept in the business and allowed to accumulate, and they bear a tax of only 12½ per cent.

Mr. MANSON. And every dollar of that flat tax of 12½ per cent is passed back to the public.

Senator JONES of New Mexico. Yes.

Senator KING. Mr. Gregg, so far as I am concerned, and speaking for myself, I sincerely hope that the Treasury Department on these points will give us their views before we adjourn.

Mr. GREGG. I will be very glad to do it at any time.

Senator KING. And any recommendations that they may have as to administrative or substantive questions.

Mr. GREGG. Of course, Senator Jones, the undistributed profits of corporations raise the hardest point that the income tax law has to deal with.

Senator JONES of New Mexico. There is no question about that. I agree with that.

Mr. GREGG. The evil is there, and there is no argument on it. The question is in the solution.

Senator JONES of New Mexico. That is the question.

The CHAIRMAN. Do you state, Mr. Gregg, that the mechanics of the selections of a graduated tax on corporations would be very difficult?

Mr. GREGG. It would depend upon the basis. Any graduated tax on corporations, based on invested capital, in my opinion, would be impossible. Senator Jones's amendment, which was adopted in the Senate, based the graduation on the relation of undistributed profits to the total profits, as I remember it, or the distributed profits to the total profits.

The CHAIRMAN. Is there any objection from that standpoint?

Mr. GREGG. No practical administrative objection.

Mr. MANSON. It is very difficult to figure out a just law, however, that would not take into consideration invested capital.

Mr. GREGG. That is perfectly true.

Mr. MANSON. The administrative difficulty makes that practically prohibitive.

Senator KING. Mr. Gregg, have you in the department a concise statement of the principal features of the British taxation system, the Canadian taxation system, and any European system which the Treasury Department regards as a fair standard of justice?

Mr. GREGG. I think the only system which would be of a particle of help to use is the British, and I do not think it is much.

Senator KING. I studied it carefully some years ago, and found it of some help.

Senator JONES of New Mexico. By the way, I had published as a public document a brief statement of the principal points of these foreign laws. I have not personally examined it, and I do not know whether it is of very much value or not.

Mr. GREGG. I have not examined it either.

Senator JONES of New Mexico. I was going to ask you if you had examined it.

Senator KING. Mr. Carson, I wish you would get that for us to-morrow.

Mr. CARSON. I think Senator Jones has it in his office.

Mr. MANSON. Mr. Gregg, would you mind stating on the record what you told me one day about the British method of crediting corporations with the individual tax paid on dividends?

Mr. GREGG. It is extremely hard to compare their system with ours. Their tax is raised by the normal tax. Their normal tax rate now is 22½ per cent. The exemption for a married man is approximately $1,100, so you can see the revenue that you are getting from the normal tax. Their graduated tax starts at $10,000 and runs up to 25 per cent; so when they get their normal tax of 22½ per cent, most of their troubles are over, and they are not very much worried about the graduated tax. The result is that under their system of taxtation, the normal rate of 22½ per cent is levied on corporate income when received by the corporations, and when the earnings are distributed to the stockholders they include that in their income, and include, in addition, the amount of tax paid on that by the corporation in their income. They then take as a credit against that tax the tax paid by the corporation.

Mr. MANSON. You mean paid by the stockholders?

Mr. GREGG. No; by the corporation.

Mr. MANSON. Oh, yes.

Mr. GREGG. The stockholder takes as a credit against his tax the tax paid by the corporation.

Mr. MANSON. Oh, yes.

Mr. GREGG. But the reason that that works out at all there is that the normal rate is so high that when they get the normal rate they do not have to worry much about their subsequent distribution and collection of the surtax.

Senator JONES of New Mexico. If they get the 22½ per cent, they get——

Mr. GREGG. They have gotten enough.

Senator JONES of New Mexico (continuing). A chargeable tax.

Senator KING. The taxes paid by the people of the United States, Federal, State, county, municipal—and these do not include assessments like the irrigation assessments, which are very heavy—amount to more than 17½ per cent of the gross incomes of all the people of the United States; so, when you speak about taxation, the American people are taxed very, very heavily.

Senator JONES of New Mexico. Well, in many instances taxes are paid out of capital.

Senator KING. Yes.

Mr. GREGG. Particularly property tax.

Senator JONES of New Mexico. Yes; the property tax, and, to my mind, this question since the incidence of taxation is one of the most vital questions that we have before us, and should be restudied in the framing of a Federal revenue law.

Mr. GREGG. The committee has discussed this morning the matter of capital gains. The taxation of capital gains is very closely allied with the taxation of undistributed earnings on corporations, and one of the biggest objections, to my mind, to ignoring the tax on capital gains is the difficulty of preventing an avoidance of the tax by the use of corporations. You start off with a fundamental inconsistency in your taxation system to-day. The gain from the sale of stocks is a different type of income from the dividends distributed by the corporation, although the increase in the value of the stock may be attributable solely to the accumulation of earnings by the corporation which it might distribute as dividends.

Assume a corporation earns $50,000 during a year. If it distributes that, it is taxable to the stockholders as dividends. If the stockholder sold his stock, however, and realized that through the sale, it would not be taxable.

Senator JONES of New Mexico. Unless you tax that accumulation at graduated rates when accumulated by the corporation?

Mr. GREGG. Yes.

Senator JONES of New Mexico. The two questions are closely allied.

Mr. MANSON. And the solution of one depends upon the other. You can not consider the matter of capital gains without considering the matter of accumulated earnings, of course.

Senator KING. Mr. Chairman, I have been somewhat interested in the question of these personal service corporations. There has been a great deal of talk about many kinds of enterprises and individual business enterprises being transmuted into corporations for the purpose of escaping taxation and paying only the corporation tax. I was wondering if, in your investigation, Mr. Manson, you intended to bring to the attention of the committee that question.

Mr. MANSON. I have a very great deal of material on that subject.

Senator KING. And we will be glad to have any recommendation that you may have, or any the Treasury Department may have, as to how to deal with that question.

The CHAIRMAN. I see Mr. Gregg smiling. I think he understands it largely a farce.

Mr. GREGG. As I say, the existence of that evil is not doubted. It is again a question of the remedy. We have worked our 220——

Senator JONES of Washington. You mean section 220 of the revenue act?

Mr. GREGG. Yes.

The CHAIRMAN. You have never collected anything under section 220, have you?

Mr. GREGG. I do not know whether we have or not. I think the last 220 scared a lot of corporations out of existence, with the 50 per cent penalty. It is not effective in its entirety.

The CHAIRMAN. Will you furnish the committee with the amount of money that you have collected under section 220?

Senator JONES of Washington. Yes; I am in favor of calling on the Treasury Department for that information. I am in earnest about that.

The CHAIRMAN. So am I.

Senator JONES of New Mexico. And I suggest that we have a formal request for that information.

The CHAIRMAN. The secretary will please see that the formal request is prepared for that information.

Senator JONES of New Mexico. I heard it testified in some investigation by New York representatives that that was generally being done.

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

Mr. MANSON. I wish to submit this table, No. 3, for the record.

(Table No. 3 is as follows:)

Profits and losses 1917 to 1922, inclusive, of 400 individuals who reported net incomes of $100,000 and over in 1916

	Profit	Loss	Profit	Per cent of total	Loss	Per cent of total
Stock transactions:						
Railroad and public utility	$1,208,850	$17,366,023				
All other stock	29,305,605	47,831,821				
Total stock			$30,514,455	89.17	$65,197,844	70.66
Bond transactions:						
Railroad and public utility	275,388	6,368,368				
All other bonds	1,406,813	12,655,462				
Total bonds			1,682,201	4.92	19,023,830	20.62
Real estate sales			2,022,793	5.91	3,294,245	3.57
Worthless stocks and bonds, loss on					4,749,960	5.15
Total			34,219,449		92,265,879	

The CHAIRMAN. Have you anything further now?

Mr. MANSON. I do not think I want to start on anything new at this moment.

There is one other angle to this capital gains provision or losses provision that I would like to call the committee's attention to. It is illustrated by a case that arose in New York.

Senator JONES of New Mexico. I make that request, and I make it regardless of the number of the section, whether section 220 or any other section of the revenue laws from 1913 down.

Mr. MANSON. James B. Duke, back in 1907, I think it was, bought some residence property on Fifth Avenue, New York, from his brother. At that time his brother, Benjamin Duke, was in financial difficulties. It was apparent that the price James B. Duke paid for this property was not based upon the value of the property so much as upon his brother's financial necessities. He paid him what the brother had paid for the property, plus the interest and carrying charges up to that time.

Subsequent to 1913 Mr. Duke sold this property to his niece for about half what he paid for it and claimed a loss.

It is apparent that at the time of sale he sold the property for very much less than it was worth.

I am not criticizing the action of the bureau in handling this case. I am calling attention to it because of the hole that it shows that there is in the law.

For instance, if I desire, or if a man of wealth desires, to give a dependent or a person who is the natural object of his bounty a present he can do so by buying something from him for very much more than what it is worth. In that way the gift tax is escaped at that point. The department has no means of questioning the consideration. Later that same property can be sold to another object of bounty of this taxpayer for very much less than it is worth. On the second transaction the taxpayer can not only escape the gift tax because it was a sale, but in addition to that he can set up as a loss the difference between what he paid for the property and the amount that he should receive for it.

The CHAIRMAN. In other words, he can make the Government contribute to his bounty?

Mr. MANSON. Absolutely.

The CHAIRMAN. It is a perfectly absurd situation.

Senator ERNST. Yes.

Mr. MANSON. Supposing a man of wealth wants to make a present to his son of a million dollars. He can sell him a million dollars' worth of stock for $50,000. I have searched the law in vain to find any means whereby the department can question——

Mr. GREGG. For what purpose—the gift tax?

Mr. MANSON. No; for the purpose of a loss.

Mr. GREGG. If I may interrupt there, for the gift tax, of course we have it taken care of; but, as you point out, it was very difficult for us to find out the facts.

Mr. MANSON. Yes.

Mr. GREGG. We have held in all cases that were brought to our attention that where sales are made at less than market, due to the relation between the selling parties, we can go behind the sale price; but it is very difficult for us to get the facts on which we base that. However, when we have them we do so hold.

Mr. MANSON. Yes; but I doubt very much, in the case of a transaction of that sort, if it were taken into court, whether you have any authority to question an actual sale.

Mr. GREGG. We just won before the board of tax appeals such a case, where the corporation sold property pro rata to its stockholders at less than the market.

Mr. MANSON. You have this situation that you can overcome, and you have overcome it, I know: For instance, supposing a taxpayer makes a sale with an understanding or with an agreement to buy back. You have overcome that situation. There is no sale that takes place there; but where there is an actual sale at very much less than the actual market value of the property, I can find nothing in the law that permits you to question that sale, or that permits you to refuse to allow the deduction represented by the difference between the cost of that property and the amount received for it, no matter how inadquate the consideration may be.

Senator JONES of New Mexico. The statute uses the word "sale," does it not?

Mr. MANSON. It uses the word "sale."

The CHAIRMAN. In that connection, did Mr. Duke get the benefit in his taxes for the loss incurred in the sale of that property?

Mr. MANSON. Yes.

The CHAIRMAN. And there was no way for the bureau to prevent that?

Mr. MANSON. No: I do not know of any way.

That Duke case also brings out another fact.

Duke, after purchasing this property, occupied it as his New York residence for several years, and he took the position that when he bought it he bought it as a transaction for profit. Therefore he was entitled to deduct the loss that he sustained. Under the law as it stands to-day the bureau has ruled, and I think properly, that where a residence is purchased for profit, even though occupied as a residence, it is a transaction entered into for profit, and that either the gain or the loss shall be taxable or deductible, as the case may be; but it is manifest that the only way that that question can be settled is either by leaving it to the taxpayer to furnish the answer, or to examine his mind, which can not be done. The result is that when the transaction results in a loss the taxpayer takes the position that he bought that property for sale, even though he lived in it, and when the transaction results in a profit, he takes the position that he did not buy it for a sale, but that he bought it to live in.

Mr. GREGG. On the first point, you are quite right. On the second point, it does not matter whether he bought it for profit or not, if he sells it the profit is taxed, whether that enters into the proposition or not.

Senator JONES of New Mexico. I think that would be a taxable gain that would be proper.

Mr. MANSON. Oh, yes; that is right. I am mistaken about that.

Mr. GREGG. Under all proper conditions.

Mr. MANSON. Yes: I am mistaken about that. About the only case in which this question is raised is in the case of residence property, and I think the law should fix a standard which can be determined by the act of the party, rather than by a state of mind, that the law should provide that the actual occupancy of the property for residence purposes should be conclusive.

Senator JONES of New Mexico. While you are discussing this question of residence property, I think there is another phase of it that

might well be considered also. For instance, if I am paying rent for a residence, I get no deduction from my taxes by reason of that expense. If I go and invest a hundred thousand dollars in a piece of property, and live in it, I am not chargeable with any income from the amount invested in the property, and it seems to me that something ought to be done to equalize that situation.

Mr. MANSON. You have even a worse situation than that in this case: Supposing that you are employed in Washington to represent some concern here; you are located here by orders of your employer. You enter into a lease for an apartment or a house for a three-year term or a five-year term. Then, a year after you make that lease, you are ordered to go to Boston, and you sublet at a loss. You can not deduct that loss.

The CHAIRMAN. But you have to pay the income tax on the amount that you receive from the sublease, do you not?

Senator JONES of New Merico. The income tax on the compensation you get from the employer.

Mr. MANSON. Yes.

Mr. GREGG. I can cite you a funny case of that kind. During the war a man came down here, a dollar a year man, and he took an apartment. I think it was at an annual rental of about $12,000 a year. When he was ready to leave, he had a two or three year lease on his hands, and he sublet at about half that amount. Technically, he should have included the amount for which he sublet, about $5,000 a year, in his income, and he was not to be allowed any part of the amount that he was paying.

The CHAIRMAN. That was according to the law, was it not?

Mr. GREGG. We did not hold to it. We just refused to let him deduct the excess.

Mr. MANSON. You did not let him deduct his losses?

Mr. GREGG. We did not let him deduct his losses, but we did not make him return the income for the sublease.

The CHAIRMAN. Did you have any warrant in law for waiving it?

Mr. GREGG. We construed the law to reach that result. We looked at the whole transaction as one, and regarded only the net result of the transaction.

The CHAIRMAN. I think it was perfectly justifiable, but I do not see where there was any warrant in law for permitting it.

Mr. GREGG. It was just as we do on a gambling transaction. We look at the whole transaction, and see whether on that whole transaction there was a loss, and we did not attempt to subdivide it.

The CHAIRMAN. Is there anything further this morning, Mr. Manson?

Mr. MANSON. No.

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

(Whereupon, at 12.15 o'clock p. m., the committee adjourned until to-morrow, Wednesday, May 13, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

SATURDAY, MAY 16, 1925

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

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

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

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

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. Mr. Manson, you may proceed.

Mr. MANSON. This case is that of the Anaconda Copper Mining Co.

This case does not involve a matter of valuation. It involves primarily several questions of law, which have been settled by the Supreme Court of the United States and by the bureau.

Before going into the details of the facts, in order that the committee may not be confused by a lot of detail, I will state what these questions of law are and discuss the questions of law, and then will present the details of the facts.

The law with reference to invested capital for the year 1917 provides an arbitrary definition of it. Invested capital is not to be determined primarily by economic considerations, but by the provisions of the act. The act provides that invested capital shall consist of cash paid in for stock of the corporation or property paid in for stock of the corporation and the surplus and undivided profits, excluding the undivided profits of the current year.

The Anaconda Copper Co.'s original property had been acquired for $30,000,000 of stock. As of January 1, 1917, an earned surplus was claimed. It is set up that the depletion which had accrued up to that time amounted to approximately $35,000,000. The company claimed that this depletion should not be deducted from the invested capital; in other words, it should not be deducted from its surplus, for the reason that its property had appreciated in value since the date of acquisition, so that the appreciation practically offset the depletion, leaving its invested capital unaffected by depletion.

Therefore the first question is whether, for the purpose of determining invested capital for the year 1917, a company can take ap-

preciation in value which has not been realized by the sale of the property. That is the first question. That question is settled by the case of the LaBelle Iron Works *v.* United States, decided by the Supreme Court of the United States in 256 U. S., 377, in which they hold that such appreciation can not be taken.

Senator ERNST. Do they say when it can be taken?

Mr. MANSON. They simply take the position that such appreciation on property which has not been sold can not be considered in determining invested capital for 1917 under this law.

The next question is whether under those conditions the depletion must be deducted from the value of the property for the purpose of ascertaining whether or not there is a surplus.

There is no question but that where there is no earned surplus claimed, of course, neither depletion nor depreciation is deducted, because the company under the act is entitled to its initial capital. Where it claims invested capital in excess of its paid-in capital in the shape of an earned surplus, the next question is whether or not, for the purpose of ascertaining whether there is a surplus, depletion must be deducted.

That has been determined by a ruling of the department made prior to the determination of this case, in which they hold that it must be deducted.

I might say that in this case it was held that for the purpose of determining the paid-in surplus, appreciation in the value of the property would be deducted from the depletion, leaving only a net of about $5,000,000 depreciation to be deducted. I maintain that the consideration of that unrealized appreciation is in direct conflict with the decision of the Supreme Court of the United States.

There is another question——

Senator KING. May I interrupt you there?

Mr. MANSON. Yes.

Senator KING. If there is depreciation allowed—and I am not speaking with reference to the case that you are now discussing—on a building, for instance, there is great appreciation upon the land upon which it stands, the building and the land being real estate, being one legal entity, if I may use that expression, why should not appreciation be taken into account for the purpose of diminishing depreciation?

Mr. MANSON. Because of the fact that the Supreme Court of the United States has held that this law did not contemplate it. In other words, this law contemplated that the excess-profits tax should be based upon the capital invested in the business, as distinguished from the value of the property involved in the business, and the court specifically says that economic definitions of what constitutes invested capital must be waived, that Congress here has defined what the invested capital is.

The CHAIRMAN. You could not very well take appreciation until it was realized anyway, could you?

Mr. MANSON. There would be, of course, an administrative difficulty there. It would virtually mean this, that if you were to take appreciation it would mean you would have to value, for purpose of invested capital, all the property as of the 1st of January, 1917.

Senator JONES of New Mexico. That was one of the main points discussed in the so-called Underwood proposal, when we were fram-

ing the revenue law of 1917. His plan was to have an inventory at the beginning of each year and to consider that as the invested capital.

Mr. MANSON. I am not discussing the merits of the different plans that may have been before Congress at that time. Congress enacted a law, which has been construed by the Supreme Court of the United States. I will attempt to show that the application of that law to this case is in direct conflict with the construction placed upon the law by the Supreme Court, as well as in direct conflict with the rulings of the department, made long before this case was finally disposed of, and which, I believe, have been uniformly applied, with the exception of one or two instances, to all other mining companies similarly situated. In other words, I do not know of any case except this case and the Phelps-Dodge case, where there was any departure from the rules laid down by the department and recognized by the Supreme Court of the United States in its decision.

The CHAIRMAN. In other words, those two exceptions are the only ones that you have found?

Mr. MANSON. Those are the only ones I know anything about.

There is another question involved here, and I will state it at this time, for the reason that the ruling of the department covers both questions.

This company carried into its inventory its products on hand, or, in determining its inventory, treated finished products on hand at the beginning of the year as though sold, the result of that being to throw into the income for 1916 a large amount of money which would have been thrown into the income for the year 1917 if those products had been carried at cost in the inventory of the company.

That also is a direct violation of the uniform construction that has been given to the act.

The CHAIRMAN. Was that information before the bureau when they passed upon that question, that the goods were not actually sold in 1916?

Mr. MANSON. Oh yes. Well, this case was originally passed on—and I will come to that later—it was originally passed on and the tax determined. Then, before the statute of limitations had run, the attention of the deputy commissioner was called to the fact that errors in the audit had been made, making a difference in tax of approximately $2,500,000.

Senator KING. In one year?

Mr. MANSON. In one year, and it was determined not to reopen the case.

The CHAIRMAN. Although it had not been really closed?

Mr. MANSON. Well, the statute of limitations had not run.

The CHAIRMAN. And they let it——

Mr. MANSON. The statute has now run on it.

The CHAIRMAN. And the bureau never got that $2,500,000?

Mr. MANSON. No.

The CHAIRMAN. And never attempted to.

Senator JONES of New Mexico. But the statute has now run?

Mr. MANSON. The statute has now run.

The CHAIRMAN. You said that considering the inventory as having been sold in 1916 was against the rules and regulations. Why, it was absolutely dishonest, was it not, if it was not really sold?

Mr. MANSON. Well, it was carried at the selling price. The stuff was carried in the inventory. There was no misrepresentation in the sense that it was represented that that stuff had been disposed of. It was carried as though it had been sold, namely, it was carried at selling price instead of at cost.

The CHAIRMAN. I see.

Mr. MANSON. The result being to throw the profit on those finished products into the previous year.

Senator KING. But the books of course would show that the products were still on hand, undisposed of?

Mr. MANSON. Oh, yes; there is no question about that.

The CHAIRMAN. How could they throw the profits back into 1916 if the products had really not been sold?

Mr. MANSON. For instance, if there was a profit of $1 a ton and there were a hundred thousand tons of metal that had been produced in 1916; if that were carried in the closing inventory of 1916 at $1 a ton more than it cost, it would show a profit in 1916 of $100,000 which had not been realized.

On the other hand, when you come to 1917, inasmuch as the inventory at the close of 1916 is a hundred thousand dollars in excess of what it should be, in determining the net income for 1917 you are $100,000 short.

On this question of whether or not appreciation—unrealized appreciation—in value of a mining property may be considered in determining invested capital for the year 1917, I call attention to the decision of the Supreme Court of the United States in the case of La Belle Iron Works *v.* United States, 256, 377, and read from the opinion as follows——

The CHAIRMAN. When was that decision handed down?

Mr. MANSON. This was decided on May 16, 1921. [Reading:]

There were three contentions: (1) That the increased value should have been included as "paid-in or earned surplus and undivided profits"; (2) that it should be included as "the actual cash value of tangible property paid in other than cash for stock or shares in such corporation," that is, as part payment for the new stock issued upon surrender of the original shares; and (3) "that the construction put upon the act by the Treasury Department based, as it is said, not upon value but upon the single feature of cost, disregarding the time of acquisition, would render the act unconstitutional as a deprivation of property without due process under the fifth amendment, because so arbitrary as to amount in effect to confiscation, and hence that this construction must be avoided."

1. The dominant purpose of the "war excess-profits tax" was to place the peculiar burden of this tax (designed to raise a portion of the necessary heavy increases in taxation from the unusual profits of many manufacturers and trades of every description resulting from the war) upon the income of trades and businesses exceeding what was deemed a normally reasonable return upon the capital actually embarked. But if appreciated market values, based upon estimates of interested parties, were permitted, "exaggerations would be at a premium, corrections difficult, and the tax easily evaded." The term "invested capital" was designedly adopted, and a definition of it that would measurably guard against inflated valuations. The word "invested" in itself imports a restrictive qualification. In order to adhere to this restricted meaning and to avoid exaggerated valuations, the test was resorted to of "including nothing but moneys or money's worth actually contributed or converted in exchange for shares of the capital stock, or actually acquired through the business

activities of the corporation or partnership (involving again a conversion) and coming in as extra, by way of increase over the original capital stock." This was consistently carried out, and the statute distinctly negatived any allowance for appreciation in value, with the single exception that tangible property paid in prior to January 1, 1914, might be taken at its cash value on that date, but in no case exceeding the par value of the original stock or shares specifically issued for it, a restriction in itself to a pre-war valuation not exceeding the original stock valuation. And in view of the context, surplus "earned" as well as that "paid in" excludes the idea of capitalizing (for the purpose of this tax) a mere appreciation of values over cost.

Clauses (1), (2), and (3) of section 207 can not be construed as permitting "any marking up of the valuation of assets upon the books to correspond with increase in market value, or any paper transaction by which new shares are issued in exchange for old ones in the same corporation, but which is not in substance and effect a new acquisition of capital property by the company." Hence the appreciation could not be included as paid in or earned surplus or undivided profits. The arguments that appreciated value is as real as cost value, and that in the terminology of corporation and partnership accounting "capital and surplus" mean merely the excess of all assets at actual values over outstanding liabilities, and "surplus" means the intrinsic value of all assets over and above outstanding liabilities plus par of the stock is beside the mark. Nor has the distinction between capital and income, discussed in Doyle *v.* Mitchell Bros. Co. (247 U. S. 179, 187), Hays *v.* Gauley Mountain Coal Co. (247 U. S. 189, 193), and Southern Pacific Co. *v.* Lowe (247 U. S. 330, 334–335), any proper bearing upon the questions here presented.

2. The surrender of the old shares, regarded as tangible property under an administrative ruling, of distribution of the stock dividend, can not be regarded as a payment in of tangible property for stock or shares, entitling the corporation to include the appreciation, represented in the value of the old shares, in invested capital. The distribution in substance and effect was an internal transaction in which the company received nothing from the stockholders any more than they received anything from it. (Eisner *v.* Macomber, 252 U. S. 189, 210, 211.)

I take the position that that decision of the Supreme Court settles the question of whether or not appreciation, unrealized appreciation in value, can be considered in determining invested capital.

I now refer to a ruling of the committee on appeals and review. The date of this ruling is not given, but it is A. R. R. 517, reported in Cumulative Bulletin No. 4, January to June, 1921.

The syllabus is as follows:

Recommended, in the appeal of the M Co., that a mining corporation, in computing its invested capital for the purpose of the war excess-profits tax, be required to reduce its earned surplus by the amount of its sustained depletion to the beginning of the year for which the tax is computed; and under normal conditions to inventory its metals on hand and not sold at the close of its annual accounting period at cost or cost or market, whichever is lower.

The committee has had under consideration the appeal of the M Co. from the action of the Income Tax Unit in holding that the surplus earnings of the taxpayer at the beginning of the taxable year 1917, amounting to 16½x dollars, which the company claimed as a part of its invested capital for the taxable year and which represented the undistributed accumulations of mining and incidental profits during several years, are overstated to the extent of 9½x dollars; and from the expressed purpose of the unit to revise the valuation of the taxpayer's inventory of metals on hand at the beginning of the year 1917.

I might say at this point that this ruling is on all fours with the case that I am now presenting to the committee.

Senator JONES of New Mexico. You say it is on all fours. The decision was not the same, was it?

Mr. MANSON. No, no; the decision was not the same, but the facts involved are on all fours with the case I am now presenting to the committee.

Senator KING. In other words, in the case before the committee they did not know of the ruling of the department?

Mr. MANSON. No.

Senator KING. Nor the decision of the Supreme Court of the United States?

Mr. MANSON. No.

The questions involved being wholly ones of law, the case was referred to the Solicitor of Internal Revenue for his consideration, and his conclusions are quoted below:

"You present for consideration the questions whether the M Co. is required, in computing its invested capital for the purpose of the war excess-profits tax imposed by the revenue act of 1917, to reduce the amount of its earned surplus by the amount of any sustained depletion to the beginning of the year for which the tax is computed, and whether it is permitted to inventory metals on hand at the date of the inventory and not sold, at the selling price.

"Section 207 of the revenue act of 1917 provides in part that—

"'As used in this title "invested capital" does not include stocks, bonds (other than obligations of the United States), or other assets, the income from which is not subject to the tax imposed by this title nor money or other property borrowed, and means, subject to the above limitation:

"'(a) In the case of a corporation or partnership: (1) Actual cash paid in; (2) the actual cash value of tangible property paid in other than cash for stock or shares in such corporation or partnership at the time of such payment (but in case such tangible property was paid in prior to January 1, 1914, the actual cash value of such property as of January 1, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor); and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year. * * *'

"Section 10 of the revenue act of 1916, as amended by section 1206 of the revenue act of 1917, provides:

"'(a) That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation * * * organized in the United States, no matter how created or organized, * * * a tax of 2 per cent upon such income; and a like tax shall be levied, assessed, collected, and paid annually upon the total net income * * *.'

"Section 13 (b) of the revenue act of 1916, which was not modified by the revenue act of 1917, provides that:

"'A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.'

"The X mine was discovered prior to 1883. The N Co. was organized with a capitalization of $3x$ dollars to develop and operate the mine. In 1886 additional capital was put into the development of the mine and from that time it has proved immensely profitable, in 1889 the profits, without allowing for depletion, amounting to approximately $4x$ dollars. In 1900 the M Co. acquired, through purchase, the mines and works of the N Co.; also the entire issue of the stocks and bonds of the O Co.; also all of the real and personal property of the N Co., comprising lands, mining claims, buildings, machinery, tools, ore on dumps and in the works, and supplies and stores of all kinds; also the right to receive what was paid in the distribution of the remaining assets of the N Corporation in dissolution.

"The consideration paid by the M Co. for the above property was (a) the issue and delivery of its capital stock, consisting of y shares, par value of $10 per share, (b) $3x$ dollars of its income bonds in exchange for the transfer of x dollars of the cash assets of the N Corporation, and (c) the assumption of all contracts, debts, and obligations of the N Corporation, amounting, as shown by the accounts, to $\frac{1}{7}x$ dollars.

"Upon the evidence filed the Income Tax Unit allowed the M Co. a paid-in surplus as of the date of its organization in 1900 of $23\frac{1}{2}x$ dollars, giving it an invested capital of $26\frac{1}{2}x$ dollars. At the beginning of the taxable year 1917 the company had on hand surplus earnings to the amount of $16\frac{1}{2}x$ dollars. In its return for the year 1917 the company deducted from its invested capital the sum of $1\frac{1}{2}x$ dollars, being the amount of the deductions for depletion allowed it under the act of October 3, 1913, and the act of September 8, 1916. The bureau claims that the amount of the deductions should be increased by $9\frac{1}{2}x$ dollars, making a total deduction of $11x$ dollars, the amount of the sustained depletion from the date of the acquisition of the property to 1917, based upon the original capital investment value of $26\frac{1}{2}x$ dollars.

"At the close of the year 1917 the M Co. had on hand some $20z$ pounds of metals produced during that year, which it valued on a basis of cost of production. At the close of the year 1916 the company had on hand some $14z$ pounds of metals ready for sale, some of which had already been sold for future delivery, and following the method, which it alleges it had consistently followed since 1902, it valued all such metals in its closing inventory for the year 1916 at the prices actually obtained for the metals sold (about 40 per cent of the whole), and the prices which, it was estimated, could be counted upon for the remainder of such metals, less the cost of marketing.

"In making its return for 1917 the company protested against being required to value at cost its inventory of bullion and contended that it should be allowed to continue its long-established accounting method and value its inventory of metals on hand at the end of the year 1917 on the basis of the value to a going concern, to wit, at prevailing selling prices.

"The questions presented will be considered in the order in which they were stated.

"Article 42 of Regulations 41, relative to war excess-profits tax imposed by the revenue act of 1917, provides:

"'The term "invested capital" as used in the excess-profits tax law means the invested capital of the present owner. The basis or starting point in the computation of invested capital is found in the amount of cash and other property paid in, the original values of such other property being determined in accordance with the rule laid down in these regulations. But the computation does not stop with such original entries or amount. It must take properly into account the surplus and undivided profits. In the computation of surplus and undivided profits, however, full recognition must first be given to expenses incurred and losses sustained from the original organization of the business concern down to the taxable year, including among such expenses and losses a reasonable allowance for depletion, depreciation, or obsolescence of property originally acquired for cash or for stock or shares or in any other manner.'

"Article 64 of Regulations 41 provides that:

"'Where through failure to provide for depletion, depreciation, obsolescence, or other expenses or losses, or where for any other cause or reason the books of account of the taxpayer do not show the true paid in or earned surplus and undivided profit, in the computation of invested capital such adjustments shall be made as are necessary to arrive at a statement of the correct amount.'

* * * * * * *

"(5) The taxpayer shall also show that adequate provision has been made for the depletion, depreciation, or obsolescence of such of the assets so required as are, under the rulings of the department, subject to recognized depreciation.

"Regulations 45 (1920 edition) construing the very similar provision of the revenue act of 1918 provide (article 838):

"'Only true earned surplus and undivided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. In the computation of earned surplus and undivided profits full recognition must first be given to all expenses incurred and losses sustained from the original organization of the corporation down to the taxable year, including among such expenses and losses reasonable allowances for depreciation, obsolescence, or depletion of property (irrespective of the manner in which such property was originally acquired) and for the amortization of any discount on its bonds. There can, of course, be no earned surplus or undivided profits until any deficit or im-

pairment of paid-in capital due to depletion, depreciation expenses, losses, or any other cause has been made good. * * *'

"Article 839 of Regulations 45 (1920 edition) further provides that:

"'Depletion, like depreciation, must be recognized in all cases in which it occurs. Depletion attaches to each unit of mineral or other property removed, and the denial of a deduction in computing net income under the act of August 5, 1909, or the limitation upon the amount of the deduction allowed under the act of October 3, 1913, does not relieve the corporation of its obligation to make proper provision for depletion of its property in computing its surplus and undivided profits. * * *'

"This article is equally applicable under the act of 1917.

"It is contended by the taxpayer that, owing to the peculiar character of mining properties, there is no depletion so long as discovery and development outrun depletion, and that any actual prior depletion is taken care of by the provision for the valuation of tangible property paid in as of January 1, 1914.

"The peculiar character of mining property was well stated in Stratton's Independence *v.* Howbert (231 U. S. 399, 413) as follows:

"'The peculiar character of mining property is sufficiently obvious. Prior to development it may present to the naked eye a mere tract of land with barren surface, and of no practical value except for what may be found beneath. Then follow excavation, discovery, development, extraction of ores, resulting eventually, if the process be thorough, in the complete exhaustion of the mining contents so far as they are worth removing. Theoretically, and according to the argument, the entire value of the mine, as ultimately developed, existed from the beginning. Practically, however, and from the commercial standpoint, the value—that is, the exchangeable or market value—depends upon different considerations. Beginning with little, when the existence, character, and extent of the ore deposits are problematical, it may increase steadily or rapidly so long as discovery and development outrun depletion, and the wiping out of the value by the practical exhaustion of the mine may be deferred for a long term of years.'

"This statement contains the answer to the contention of the taxpayer. The reason that in the case of mines the Supreme Court has consistently held that no deduction for depletion or depreciation in computing net income can be allowed in the absence of statutory authority is that by reason of the fact that discovery and development may outrun depletion there is not necessarily any actual decrease in the value of the taxpayer's property, and therefore the entire net receipts may well be considered income. The rule is not new, but has come down to us from the common law of England. This, however, does not negative the fact that the removal of each ton of ore depletes pro tanto the ore originally known to exist in the mine and which was originally valued. The maintenance or increase of the original value is solely due to the fact that the loss of value through depletion is equalled or exceeded by the appreciation in value through discovery or development. To treat the entire net income as earnings and as constituting earned surplus in the succeeding year when not distributed by the company would therefore, to the extent of the depletion actually sustained during the year, be to permit the inclusion of appreciation in the value of the mine, by reason of development and discovery, in invested capital, a thing which is not contemplated by the statute nor permitted by the regulations. This was clearly pointed out in Tax Reviewer's Memorandum of January 29, 1919, approved and followed in Law Opinion 753 (not published in the bulletin service).

"While the provision in section 207(a) for the inclusion in invested capital of actual cash value as of January 1, 1914, of tangible property paid in prior to that date permits the inclusion of appreciation up to the par value of the capital stock for which such property was paid in (see article 55, Regulations 41), it clearly contemplates that in valuing the property as of that date any depletion or depreciation shall have been made out of earnings, and therefore such a valuation does not involve a second deduction for depletion."

I might say in this case that the matter of the value on January 1, 1914, is not involved, for the reason that the property when originally taken over was taken over for the full par value of the stock issued.

Regulations 33, revised, construing the revenue act of 1916 as amended by the revenue act of 1917, contains no provision relating to inventories of

mining companies, but article 91 governing inventories by manufacturing corporations, to which mining companies are closely analogous, provides that:

"Gross income for the purpose of returns of manufacturing companies shall consist of the total sales plus the inventory at the end of the year less the sum of the cost of goods or materials purchased during the year and the inventory at the beginning of the year. Instructions as to how inventories shall be taken will be included in special regulations to be furnished upon application to the collector of internal revenue. * * *."

The special regulations referred to are contained in Treasury Decision 2609, which provides in part as follows:

"(1) For the purpose of income and excess profits tax returns, inventories of merchandise, etc., and of securities will be subject to the following rules:

"A. Inventories of supplies, raw materials, work in process of production, and unsold merchandise must be taken either (a) at cost or (b) at cost or market price, whichever is lower, provided that the method adopted must be adhered to in subsequent years unless another be authorized by the Commissioner of Internal Revenue."

The regulations relating to inventories under the revenue act of 1918 (Regulations 45, 1920 edition) are much more extensive, but are general and equally applicable under the acts here considered. Article 1581 of these regulations provides in part that:

"Title to the merchandise included in the inventory should be vested in the taxpayer, and goods merely ordered for future delivery and for which no transfer of title has been effected should be excluded. The inventory should include merchandise sold but not shipped to the customer at the date of the inventory, together with any merchandise out upon consignment; but if such goods have been included in the sales of the taxable year they should not be taken in the inventory. * * *"

Article 1582 provides that—

"Inventories must be valued at (a) cost or (b) cost or market, as defined in article 1584 as amended, whichever is lower. * * *"

Article 1584 provides that—

"Under ordinary circumstances 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which ordinarily purchased by the taxpayer, and is applicable in the cases (a) of goods purchased and on hand, and (b) of basic elements of cost (materials, labor, and burden), in goods in process of manufacture, and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost. * * *"

This article also provides for valuing goods in process of manufacture and finished goods on hand at sale price where, "owing to abnormal conditions, the taxpayer has regularly sold such merchandise at prices lower than the current bid price as above defined." But this provision can have no application to the instant case, since the evidence shows that the M company at the close of the year 1917 was selling its copper at prices which included abnormally large profits.

Under these regulations a mining company is required to inventory all metals on hand at the date of the inventory, including goods sold but not shipped to customers, at cost, or cost or market, whichever is lower, except in the case of metals on hand for delivery "upon firm sales contracts entered into before the date of the inventory," which it is required to inventory at cost. Article 1581, however, recognizes the right of a mining company, which keeps its accounts upon an accrual basis, to include its metals sold, but not shipped, in its accounts receivable rather than in its inventory, if it elects so to do. This provision, however, can have no application to goods on hand at the date of the inventory which have not been sold.

It is recognized that, as contended by the taxpayer, to require an inventory at the close of 1917 to be made upon the basis of cost, or cost or market, whichever is lower, while leaving the inventory at the beginning of the year as it was originally made—that is, upon the basis of the selling price of all metals on hand, sold or unsold—would lead to a distorted statement of income. The inventory at the beginning of the year, which was the same as the closing inventory of the year 1916, must, therefore, be reconstructed and amended returns made for the year 1916. If the adjustment due to the amended returns occasions inequality in the tax prior to the year 1916, such inequality may be

remedied in the return for 1916 by the deduction from or addition to the tax accruing in that year of an amount equal to the net income overpaid or underpaid in prior years, such amount to be determined by filing with the return for 1916 a composite return for all prior years, accompanied by a statement showing the total adjustment for each of the years and the net income for the entire period.

It is accordingly held that a mining corporation, in computing its invested capital for the purpose of the war excess-profits tax, is required to reduce its earned surplus by the amount of its sustained depletion to the beginning of the year for which the tax is computed, and under normal conditions to inventory its metals on hand at the close of its annual accounting period and not sold at cost, or cost or market, whichever is lower.

"So far as I have been able to ascertain, the ruling laid down in that committee's decision, which I have just read, has been pretty uniformly adhered to. In view of the matter of requiring depletion sustained up to the beginning of 1917 to be deducted from the value as of January 1, 1917, and denying the right to offset that by appreciation, I know of no case, except this case and the Phelps-Dodge case, in which the rule has been departed from.

The CHAIRMAN. Have you any views as to how a rule could be violated in that manner and get through the bureau?

Mr. MANSON. Well, I will simply call attention to the history of this case. The history of this case will answer the chairman's question.

What was done here was this:

The revenue agent set up sustained depletion up to December 31, 1916, as amounting to $35,676,623.55.

Subsequently, on further examination by the metals section, that figure has been raised to about $45,000,000; but I do not care to go into the valuation feature of this matter. It is merely the principle that I care to consider.

When they came to audit this case, which was some time previous to March, 1920, an agreement was reached by the unit on matters under discussion with the taxpayer.

The question of appreciation in the valuing of the original Anaconda properties appears to have been disposed of by deducting $30,000,000 from the depletion sustained of $35,676,623.55, as disclosed by an undated memorandum signed by J. L. Darnell, head natural resources subdivision, and approved by J. H. Callan, assistant to the commissioner, as follows:

Memorandum re Anaconda Copper Mining Co.

Inasmuch as it has been clearly shown that at the date of the consolidation of the various properties in 1910, which now make up the bulk of mine values of the Anaconda Copper Mining Co., the original Anaconda Copper Co. itself was possessed of mineral values in excess of double its capital stock of $30,000,000, which values have been disregarded in the computation of the invested capital of the consolidated companies; and inasmuch as it has been clearly shown that as a matter of fact mine values have not been appreciably diminished through operations since the date of the consolidation, it is held that—

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

It is directed that the audit be conducted in accordance with the above.

That is signed by J. L. Darnell, head natural resources subdivision. Then the tax was settled upon that basis.

The CHAIRMAN. When you say the tax was settled on that basis, do you mean it was paid on that basis?

Mr. MANSON. It was paid on that basis. There was an additional tax levied of some $800,000.

Senator JONES of New Mexico. What date was that?

Mr. MANSON. That was in March, 1920. The A-2 letter——

Senator KING. For what year?

Mr. MANSON. For 1917. The A-2 letter is dated March 1, 1920.

The CHAIRMAN. I understood you to say that that decision of the Supreme Court was not rendered until 1921.

Mr. MANSON. Oh, but I understand that there was a great deal done with this case after that.

On March 1, 1923, Mr. W. C. Tungate, head of the audit division, which had charge of this matter, sent a memorandum for Mr. E. W. Chatterton, deputy commissioner, which reads as follows:

In re: Anaconda Copper Mining Co., New York, N. Y.

Attached hereto is a memorandum prepared by an auditor in the division relative to apparent errors in the former audit of this corporation for 1917, which if corrected would result in an approximate additional tax of $2,500,000.

This case was closed by assessment letter prepared in the natural resources subdivision dated March 1, 1920, and appears to have been made in accordance with instructions issued by Mr. Darnell, then chief of the subdivision, who made personal recommendations on some of the major adjustments.

The excess profits tax as computed in this letter is slightly more than 4 per cent of the consolidated net income which, of course, is an exceedingly low rate.

It is understood that this audit was made under protest by the audit section, which at that time recognized the errors which were being incorporated therein and orally registered such protest to the chief of the subdivision. However, no written memorandum by the audit section in regard to its holdings is now in the case. Upon hearing the audit section's objection to this audit, Mr. Darnell prepared a memorandum (undated) which was approved by Mr. J. H. Callan, assistant to the commissioner, in which the item of sustained depletion is definitely stated at $5,676,623.55, which figure was to be used in the computation of invested capital. The actual depletion sustained on cost, however, was $35,676,623.55. This, of course, results in the inclusion in invested capital of $30,000,000 appreciation. The memorandum referred to closes with this statement: "It is directed that the audit be conducted in accordance with the above."

You will recall the conference had with the commissioner some time ago relative to reopening the case of the Phelps-Dodge Corporation in which a similar error appeared. It was his opinion in that case that a reaudit should be made and the error corrected. This case is similar except that the memorandum directing the audit to be conducted along certain lines was approved by Mr. Callan, assistant to the commissioner.

Will you kindly advise me whether you wish us to reaudit the returns of the Anaconda Copper Mining Co. for the year 1917 in order to correct the errors which exist in the original audit? As no waivers have been filed by this company it will be necessary, should the case be reopened, to place the assessment prior to April 30, 1923.

That was dated March 1, 1923.

The CHAIRMAN. To whom was it addressed?

Mr. MANSON. That was addressed to Mr. Chatterton.

The CHAIRMAN. Yes.

Mr. MANSON. The deputy commissioner.

Senator KING. By whom?

Mr. MANSON. By Mr. Tungate. It is not signed here, but that was sent by Mr. Tungate, the head of one of the audit sections; I do not know which one it is.

Attached to Mr. Tungate's communication to the commissioner is a memorandum prepared by one of the auditors, in which——

Senator KING. Was that sent to Commissioner Blair?

Mr. MANSON. This was sent to Commissioner Blair. I do not know whether it ever went beyond him or not, except that it was subsequently acted upon by Mr. Bright.

In this memorandum, which was attached to Mr. Tungate's memorandum, the different errors of audit are set up.

This memorandum reads:

I respectfully submit the following report based on a superficial examination of the results of an audit in the case of the above-named company for 1917:

(*a*) Copper depletion reserve: On the basis of the value of the property acquired in 1910 (including paid-in surplus) and cost of property acquired prior to that date, the accumulated depletion reserve to December 31, 1916, was computed as follows:

Book value of ores Mar. 1, 1913	$65,399,920.12
Paid-in surplus under provisions of article 63, Regulations 41	67,792,187.50
Cash paid for claims Mar. 1, 1913, to Dec. 31, 1916	2,712,204.40
Value of ores Mar. 1, 1913	135,904,312.02
Total tonnage of ore reserves	67,772,000
Value per ton	$2.0053
Tons mined Mar. 1, 1913, to Dec. 31, 1916	17,791,165.19
Depletion sustained	$35,676,623.55
Depletion reserve used for invested capital in the determination of the tax as assessed	5,676,623.55
Difference	30,000,000.00

This decrease in the reserve for depletion was made primarily because it was considered that the assets acquired for $30,000,000 par value capital stock in 1895 had doubled in value to the year 1910, and therefore no depletion of that amount was considered to have been sustained.

Comment: There appear to be various other discrepancies in the method used by the auditors to arrive at $35,676,623.55. These discrepancies include available tonnage as at March 1, 1913, the book value as at March 1, 1913, and the manner of treating tons extracted prior to March 1, 1913. However, these are of minor importance compared to this discrepancy of $30,000,000. It should be borne in mind that no reorganization occurred in 1910, but merely an increase of stock voted to pay for the acquisition of new assets. After revision the account for invested capital purposes was allowed, as follows:

Assets	$138,005,853.08
Reserve for depletion	5,676,623.55

This was unquestionably entirely out of proportion to the percentage of the total tonnage depleted to December 31, 1916.

(*b*) Copper inventories: In determining the net income for 1917 it was decided to treat all finished products as sales and unfinished products at cost. This procedure has consistently been held to be contrary to the method set forth in article 1581, Regulations 62, which has been followed in the audit of the cases of several other large copper companies. A rough estimate of the discrepancy in income resulting from this method of treatment as compared with the method now used is as follows:

	Pounds	Difference in rate between cost and selling price	Amount
Dec. 31, 1916		*Cents*	
Finished copper	39,758,839	10.7	$4,254,195.77
Finished zinc	2,916,878	9.7	282,937.16
Total			4,537,132.93
Dec. 31, 1917			
Finished copper	9,271,819	4.7	435,776.90
Finished zinc	8,481,853	2.5	212,046.33
Total			637,823.23

Amount taxed at 1916 (2 per cent) rates which should have been taxed at 1917 rates		$4,537,132.93
Amount taxed at 1917 rates which may have been taxed at 1918 rates		647,823.23
Possible addition to 1917 income		3,889,309.70

(*c*) Elimination of intercompany holdings: The following apparent discrepancy appears in the treatment of intercompany holdings:

Asset set upon balance sheet of Anaconda Copper Mining Co., as representing investment of affiliated companies		$31,798,773.15
Total capital stock of subsidiaries	$23,894,210.68	
Surplus of subsidiaries (Dec. 31, 1916)	6,878,767.03	
Total	30,772,977.71	
Less surplus earned since date of acquisition	2,445,721.82	
Amount eliminated from invested capital		28,327,255.89
Additional amount to be eliminated		3,471,517.26

The above discrepancy is apparent and not as evident as adjustments (*a*) and (*b*). Possibly upon a thorough audit a larger discrepancy would be discovered either in favor or against the department.

(*d*) There are numerous other discrepancies that are apparent to the auditor but have not been commented upon because of lack of definite substantiation which would result from a thorough study of the case.

CONCLUSION

As a result of the above discrepancies the following is a revised computation of the excess profits that might have been assessed:

Consolidated net income as shown in A 2 letter		$30,272,469.31
Add adjustment (*b*)		3,889,309.70
Revised		34,161,779.01
Consolidated invested capital as shown		255,803,535.96
Deduct:		
Adjustment (*a*)	$30,000,000.00	
Adjustment (*c*)	3,417,517.26	
		33,417,517.26
Revised		202,386,018.70
Percentage of credit (accepted)		7
Revised excess profits tax only		3,589,145.35
Excess profits tax as assessed		1,088,223.86
Discrepancy in excess profits tax only		2,500,921.49

That is signed "Auditor."

I wish to call attention to the fact that there are three errors in here—major errors.

One of them is the matter of considering appreciation as an offset to depletion. The other is a matter of the valuation of the inventory, and the third is the matter of the duplication of assets between the subsidiaries and the parent corporation.

The CHAIRMAN. Would you call those errors? They were done with intent.

Mr. MANSON. Well, the first is clearly predicated upon an erroneous theory of the law. The others apparently are errors made in the audit.

There is a matter here of $3,471,517.26 due to failure to eliminate intercompany entries which swell the invested capital by that amount.

I take the position that all of these items, which result in a difference of tax of about $2,500,000, are gross errors of audit. They are not matters involving judgment of appraisal. They are clean-cut questions of law, and, for that reason, any excuse for not reopening this, which might apply in the case of an appraisal where the judgment of men might differ, has no application to a case of this sort.

On March 30, 1923, we find this memorandum in the record. It is addressed to Mr. Fay, in re Anaconda Copper Mining Co. and Phelps-Dodge Corporation. Mr. Fay then, I believe, was the head of the natural resources subdivision:

> I have carefully noted your comments with respect to reopening the case of the Anaconda Copper Mining Co. in order that an adjustment to invested capital of $30,000,000 could be made, and also your comment with respect to a similar situation in the case of the Phelps-Dodge Corporation. After thorough consideration of all of the facts, including a statement made at a conference held with Mr. Donohue and Mr. Tungate of your division, and the question of allowance of this amount of invested capital having been carefully considered before final adjustment was made by Mr. Callan, at that time assistant to the commissioner, it is my opinion that this case should not be reopened nor should any adjustment be made in the Phelps-Dodge case involving a similar adjustment. However, Mr. Tungate has informed me that there has been an error in computation in the Phelps-Dodge case that should be adjusted and that the representatives of the company agreed in conference to the adjustment; therefore, the Phelps-Dodge case should be reopened only for the purpose of making this adjustment and no further action should be taken in the case of the Anaconda Copper Mining Co.

Mr. MOSS. From whom is that memorandum, Mr. Manson?

Mr. MANSON. This is from Mr. Bright.

It is apparent from this memorandum that Mr. Fay had sent some communication to Mr. Bright in connection with this matter.

The CHAIRMAN. Was that not in the record?

Mr. MANSON. We did not find it, but that is referred to in this memorandum, and is apparently along the same lines as Mr. Tungate's memorandum to Deputy Commissioner Chatterton.

Senator ERNST. You say that that memorandum was signed by Mr. Fay?

Mr. MANSON. This is signed by Mr. J. G. Bright, assistant deputy commissioner.

Senator KING. Is that the only reason he gives?

Mr. MANSON. That is all. That is all that appears of record.

I would call attention to the fact that that reason does not apply to anything except the matter of this $30,000,000 appreciation. While there is a direct order not to reopen this case, the other errors in the audit are ignored in that memorandum.

The CHAIRMAN. That finally settles the case, then, does it?

Mr. MANSON. The statute of limitations settles the case.

The CHAIRMAN. I mean, when that memorandum was written, nothing further was done by anybody in the bureau?

Mr. MANSON. No.

Senator KING. I think Mr. Bright ought to be subpœnaed to testify in connection with this matter.

Mr. MANSON. I was not present when the Phelps-Dodge matter was presented to the committee. I was sick at that time, and Mr. Box, our chief auditor, presented the Phelps-Dodge matter. Therefore, I do not know how it was presented, and I do not know what issues were presented to the committee; but the Phelps-Dodge matter involved the very same question involved here with respect to the use of appreciation as an offset against depletion.

Senator KING. I remember that in the Phelps-Dodge case one of the questions involved was that the property had been acquired for, I think, in the aggregate, $46,000,000, and it was appraised at more than $100,000,000 for the purpose of basing depletion upon the same—a very gross wrong.

The CHAIRMAN. As I understand it, there is a statute making it mandatory upon an employe who observes things of this sort to draw them to the attention of the head of the department.

Mr. MANSON. In this case some auditor, whose name does not appear in the record, called Mr. Tungate's attention to this. Mr. Tungate, who I asume was a subordinate of Mr. Fay, prepared a memorandum, which Mr. Fay sent on to Mr. Chatterton, deputy commissioner. It appears that the answer to that memorandum, was this memorandum signed by Mr. Bright to Mr. Fay. It seems to me that those auditors, Mr. Tungate and Mr. Fay, did all that they could to see that those errors were corrected.

The CHAIRMAN. Mr. Nash, will you bring Mr. Bright down here, or shall we subpoena him?

Mr. NASH. I will bring Mr. Bright down at any time. Do you want him here today?

The CHAIRMAN. No; I do not think so. It will do to have him here at the next meeting, perhaps.

Mr. MANSON. While the law of this matter was not settled by these rulings and by this decision of the Supreme Court of the United States at the time of the original A–2 letter in 1920, yet it was settled long before these memoranda of 1923.

The CHAIRMAN. Even though the Supreme Court of the United States had not decided it, I understand from your statement, practically all of the cases that you know about, with the exception of these two, were settled on the same basis as the Supreme Court decided this one.

Mr. MANSON. Oh, yes; the Supreme Court of the United States merely upheld the department's own construction or application of the law; is not that right?

Mr. GREGG. Yes.

Mr. MANSON. And I cite the Supreme Court of the United States decision inasmuch as it is final authority.

The CHAIRMAN. This just illustrates what we have contended throughout the presentation of these cases, that various subordinate officials in the bureau may decide great questions, involving hundreds of millions of dollars in the aggregate, without any proper check or passing upon.

Mr. MANSON. There is one thing here that I have not dwelt upon at all, because the principle is not involved.

Mr. Grimes, when he came to recompute the sustained depletion for the year 1918 or 1919, increased the sustained depletion up to 1917 by about $10,000,000. That would reduce the invested capital about $10,000,000 more than the figure involved in this memorandum that I have read; but in view of the fact that that is a matter which might turn on a question of judgment as to what was the proper figure to use I have not attempted to pass on that, nor have I put any weight on that question.

Senator KING. However, if the case had been reopened in view of that letter to Mr. Chatterton, those figures of Mr. Grimes would have been considered?

Mr. MANSON. Oh, yes; I assume so.

Senator KING. And if his view had been correct, that would have increased the tax?

Mr. MANSON. Yes.

Senator KING. About $2,500,000?

Mr. MANSON. Yes.

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

Mr. MANSON. As to that other question, involving about $3,000,000 of invested capital by the duplication of assets, I have not even cited any authority upon it. I do not think there can be any possible dispute but what that item should have been eliminated in the case of the consolidated return. It is a straight question of accounting. In fact, there is no question there at all. It is just a matter of fact as to whether it is true or not.

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

Mr. MANSON. No; I have not this morning. I have a lot of matters on my desk that I want to present to the committee, but in some instances there are five or six that can be simmered down to one, and it is going to take me a couple of days——

The CHAIRMAN. I would like to ask Mr. Gregg if he wants to present anything?

Mr. MANSON (continuing). In addition to Sunday to get those things in shape.

The CHAIRMAN. Mr. Gregg, will you want to put anything in on Monday? You have prepared several cases. I do not want to crowd you, but we will not all be able to occupy the last few days.

Mr. GREGG. No; we have not anything that is ready. There are several cases that have been gone into. There are not very many cases that we will have an answer on, except the very recent ones.

The CHAIRMAN. Have you a record of the cases that we have taken up, in which you said you would make a reply?

Mr. GREGG. Yes, sir; we have kept a very careful record of them.

The CHAIRMAN. I recall one relating to George Brothers, in connection with which we have received no reply.

Mr. GREGG. I made my reply in the George Brothers case at the time.

The CHAIRMAN. And you do not want to make any further statement in that connection.

Mr. GREGG. I do not want to make any further statement on that case.

The CHAIRMAN. We can not always tell whether you are just making an informal reply or really an official reply.

Mr. GREGG. We have gone over everything, and we have kept a record of every case that has been taken up. There are a few cases such, for instance, as the Los Angeles Shipbuilding case that has not been completed, and as soon as we get something more on that case we will want to put it in. We have referred it to the field for some additional data. Then there are some recent cases that the committee has taken up, which we have not as yet had an opportunity to answer.

The CHAIRMAN. When you are silent on a case, are we to construe that as consenting to our contention? Is that right?

Mr. GREGG. No, sir.

Mr. MANSON. Silence does not mean consent, by any means?

Mr. GREGG. No.

Senator JONES of New Mexico. I would like to ask whether the bureau has ever consented to any of these criticisms.

Mr. GREGG. Senator, let me clear our position on that.

Senator JONES of New Mexico. I do not recall a case.

Mr. GREGG. Let me clear up our position on that.

I have told the chairman informally several times that there have been cases that we have reopened after action by the committee. There have been plenty of them, but in view of the way that the bureau is on trial we thought, and I think now, it is our duty to put in the justification and reasons for the settlement of the case on the basis on which it was settled, even if we did not agree with it and now intend to change it.

For example, Mr. Nash prepared an order yesterday, going back to the unit, on one of the coal cases that the committee had up, directing that the valuation be reopened for years which had not been closed; but the reason we put in our answer in every case is that we thought it was due the bureau that the justification should be stated to the committee for the action which was taken on each case, even if Mr. Nash and I may not now agree with that action, and even if we intend to reopen the case for the unclosed years.

Senator JONES of New Mexico. Well, do you not think it is fair, as far as the investigation is concerned, for you to make a frank statement as to whether you agree with these things or not, so that we may not draw the inference which was suggested by my first remark?

Mr. GREGG. I made the statement the other day, Senator Jones, that there were a great many cases to which the committee called our attention where we differed, Mr. Nash and I, with the settlement which had previously been made in the case and which we intended to recommend be reopened for the unclosed years; but, at the same time, we have put into the record the justification for the action of

the bureau. I have stated time and again that all of these case certainly would not have been closed the same way if I had passed on them or if Mr. Nash had. We may differ with the previous disposition of the case, but it seems to me, in justice to the bureau, we are forced to put in the record the justification of the action previously taken, even if we differ with it now.

Senator KING. Speaking for myself, I would feel that those who made the settlement are entitled, or their successors—and, I think perhaps the duty devolves upon them—to present to the committee the grounds which they conceived sufficient to justify their action, and we can determine whether it was right or wrong; and I hope the department, if it feels that those gentlemen were wrong, will reopen them and will not have any pride of opinion, which would prevent the changing of some of these ruling which are manifestly wrong.

Mr. GREGG. I can assure the committee that we are doing that.

Mr. NASH. That is exactly what we are trying to do.

Senator KING. Because even the Supreme Court of the United States takes back its decisions sometimes.

Mr. GREGG. That is exactly what we are doing; but I wanted to answer Senator Jones's question, because it may appear that it was a just criticism; but when you analyze it, I do not think it is.

Mr. MANSON. I would like to say this in that connection. It may be an unfortunate personality that makes it appear as though I am trying, as you might say, to indict the bureau. I have never entertained that idea within myself. I have endeavored to lay before the committee matters which I thought were wrong, with the idea that if the bureau itself did not adopt some change of policy the committee might, perhaps, desire to recommend some changes in the act. There is not anyone who appreciates any more the difficulty surrounding the handling of these matters, particularly the early matters and the difficulties of organization, than I do. I have pointed those out as I have gone along from time to time, but I never felt that I was trying the bureau or trying any individual in the bureau.

Mr. GREGG. Well, if you were sitting on the other side of the table, Mr. Manson, I think you would feel that the bureau was being tried.

Mr. MANSON. Well, I want to say this, that I have occupied your position in other investigations, and I know exactly how you feel.

The CHAIRMAN. I think Mr. Gregg stated just a few moments ago that he feels required to put in a defense of the bureau, no matter how fallacious the defense might be.

Senator ERNST. No; he did not say that.

Mr. GREGG. I did not say that.

The CHAIRMAN. I mean, that he was required to put in a defense and you have stated on the record that you have told me personally that you felt required to put in a defense, because the bureau was on trial, even though you did not agree with the defense. I submit that that is a fallacious defense, then.

Mr. GREGG. I do not think it is, and I will give you a specific example of my attitude.

The committee brought up here a case where, in the early days, we had placed a valuation on some coal properties, which I think was clearly excessive. At the time, I pointed out the difficulties under which the bureau was laboring at that time, and how it was

possible for such a thing to happen. I think I should have done that. At the same time, Mr. Nash ordered yesterday that the case be reopened for the years not closed, and the property revalued. We have done that time and again, and we intend to do it in all cases; but I think, in justice to the people who closed the previous cases, we should point out to the committee how such things could happen, the explanation of them, the justification, and the reasons which prompted the men who closed them, even though Mr. Nash and I may not agree with those reasons.

Senator KING. For the purpose of negativing the idea of corruption on their part, or a willful purpose to avoid the law, but not for the purpose of justifying their mistake or their erroneous interpretation of the statute?

Mr. GREGG. One of the strongest defenses, at least the one that I felt as strongly over as any that has been brought up here, was the case of the valuation of an iron property, where the valuation in the bureau had ranged from nothing to $10,000,000. I got quite heated——

Mr. MANSON. The Witherbee-Sherman case.

Mr. GREGG. I got quite heated in discussing the case. I did not agree with the final valuation placed upon it, but I think the action of the people who decided that case was justified. I do not think we can say that they did anything absurd, that they did anything irregular, and I wanted that fact brought out to the committee. I might differ with them, and Mr. Nash might differ with them, and that case will unquestionably be gone into for the subsequent years; but I do think we should put our position in the record, and I hope that explains to Senator Jones my action in defending the settlement of these cases.

The CHAIRMAN. I think you said something a while ago that perhaps has not appeared in the record before. You said this morning that you conceded some of these errors, and I doubt whether that has appeared in the record before, and which Mr. Nash has sent out instructions to revise. That has been brought out by Senator Jones's query. In other words, you did not come and tell the committee that you did this until Senator Jones wormed it out of you this morning.

Mr. MANSON. I think it might, in the long run, be a little unfair to the bureau, if that situation were not cleaned up, for this reason:

I know that I would not want to go away laboring under the apprehension that the bureau to-day was standing upon a justification of its action in some of these cases. It does not seem to me that the bureau is fair to itself in permitting anybody to carry away that idea.

Senator JONES. I will state very frankly that the impression which I have gotten has been along this line, that the bureau has been very free to put into the record anything which would tend toward a confirmation or an excuse for practically everything that has been brought out, and that the attitude of the bureau has not been one of helpfulness to the investigation by the committee.

Senator KING. I agree with the latter part of your statement, Senator. I do not think the bureau, and that is the impression I have gotten, has been helpful in some ways.

Senator JONES. And it has created further in my mind the thought that Congress, which is legislating upon these various matters, seeking through amendments to legislate a rectification of the evils which have been made to appear, can not rely for its information solely upon the bureau itself, but that an independent investigation, such as this committee has been attempting to make, is fully justified, and in my humble judgment there ought to be a permanent organization of some sort to keep in touch, not only with the Bureau of Internal Revenue, but to keep in touch with the various expenditures of the Government, that the Congress——

Senator KING. Is at the mercy of the Executive Departments, if you will excuse me.

Senator JONES of New Mexico (continuing:) That the Congress must legislate and provide the law under which the various activities of the Government are to be carried on, and for it to be dependent solely upon the executive branch of the Government for information which is the foundation for legislation, is wholly unjustified.

Senator KING. I agree with you.

Mr. GREGG. May I say this: These statements that have been made recently by Senator Jones are criticisms primarily of me, and I think I should answer them.

Senator JONES of New Mexico. I never intended them as personal criticisms, because I feel that Mr. Gregg himself has been very helpful to the Finance Committee in the past, and so far as the situation would arise he undoubtedly intends to continue to be helpful; but the organization of the department, the administrative branch of the Government, is such that it makes it impossible for anyone in the bureau to see the mistakes of the bureau which an investigation such as we have been conducting has brought out.

The CHAIRMAN. Does Mr. Gregg admit that?

Mr. GREGG. No, sir.

The CHAIRMAN. You do not admit that we have found anything that the bureau officials did not know about?

Mr. GREGG. Oh, no, sir; I do not say that. Of course, you have found out specific cases that I did not know about, but we knew that such cases existed.

Let me give you my point of view, and I am speaking solely for myself now.

We have never contended that the bureau was perfect. Goodness knows, Mr. Nash and I would be the last two persons in the world to make any such contention. We know that as a matter of organization it is not perfect; that it can be improved upon; and we are doing everything we can all the time to improve upon it. We know that cases have been decided incorrectly. We know that there have been cases of irregularity, some isolated cases of fraud. We have admitted all of that; we know it and we are doing everything we can to correct it. But put yourselves for just a minute in our position. The bureau has done a big job, and it has done a wonderful piece of work. Now, to have a few isolated cases picked out, the existence of which we knew, that were incorrectly settled, and have them advertised as typical of the action of the bureau, puts us in a

position where we naturally want to defend ourselves and the action taken.

I will give you something to illustrate that. Representatives of the committee have come to me in my office to inquire about given cases, with this statement:

> What do you intend to do with the case? If we agree with the settlement that you are going to make, if we think you are going to settle it correctly, we do not want to go into it.

In other words, they are only hunting for the black spots, and that is not fair to us. We do not like to have the bureau held up to the public in a light where its action is to be typified by the mistakes in a few individual cases. Naturally, if that is done. I feel that I must defend just as strongly as possible, or justify just as strongly as I can, what has happened in those particular cases which the committee has pulled out.

Has the committee ever taken out the thousands and thousands of cases that they think were settled correctly?

Mr. MANSON. I have been very free to say here, with respect to every branch of the work that we have gone into, that where it appears that the work was on a sound foundation I have commended it.

The CHAIRMAN. You told us yesterday that you commended the timber section.

Mr. MANSON. And if I have not done it, I know that before this thing is over with I am going to do it. In other words, you can not bring up here all of the work of the bureau. In so far as it is all right it does not need remedial legislation. I have assumed that the purpose of the investigation was to find out where remedial legislation might be necessary.

Senator ERNST. Have you concluded your statement, Mr. Gregg?

Mr. GREGG. No; and I should like to finish it, because I feel quite strongly on what Senator Jones has said.

Mr. Manson's statement yesterday about the timber section was that he commended it. Now, take the timber section, a big section, which handles very many important matters. It was thoroughly examined, and Mr. Manson says briefly that its work is good, and he commends it; but he found one little flaw in it, an organization flaw, an argument as to who should decide appreciation, to which attention was called and which Mr. Nash immediately took steps to correct.

Is not that rather typical?

The committee took up the nonmetals section, where Mr. Briggs called attention to the few cases that he does not think have been settled correctly. They spent weeks on that, holding up those errors in the bureau, which we all knew existed, and at the same time, on the timber section, a brief statement is made that it is all right.

I think this—and this expresses my own feeling—that if we are on trial, as we have been, and our little errors are to be held up as more or less typifying the work of the bureau we should, just as strongly as we possibly can, show that those errors are justified.

The CHAIRMAN. Oh, you do justify errors, then?

Mr. GREGG. Oh, absolutely. I have sat here and I have explained an error which was made in the coal case, although we corrected it. Possibly my use of the word "justify" is wrong.

The CHAIRMAN. That is what I was referring to.

Mr. GREGG. I explained the error in the coal case, although we corrected it to the extent that it could be corrected, and we have done that in every case, and intend to continue to do it, and also to show how it is possible for those errors to be honestly made; to show how it is inevitable that sme of them will be made, and to show the factors that the man who decided the case took into consideration in arriving at the conclusion that he did arrive at, although we may not agree with it and intend to subsequently correct it to the extent that it can be corrected.

It seems to me that my attitude, which Senator Jones has criticized, has been necessary in view of the manner of conducting the investigation.

Now, Senator Jones said that we had not been helpful to the committee. I do not feel that is quite fair to us. I have done nothing to impede the work of the committee in any sense. I have been at all times at the disposal of the committee if the committee desired to use me.

Senator JONES of New Mexico. Have you or anyone in authority in the organization suggested to the investigators of the committee any of these things that you now speak of as errors, which have been presented by our investigators to the committee?

Mr. GREGG. Do you mean did we go down in the bureau and hunt for specific cases?

Senator JONES. Yes.

Mr. GREGG. Which had been incorrectly closed?

Senator JONES. Yes.

Mr. GREGG. No, sir; for the reason that if we found specific cases that had been incorrectly closed——if we found this coal case, where an excessive valuation—back in 1920, before we had adequate records, was allowed—it would not have been necessary to call it to the attention of the committee. We should have corrected it ourselves.

The CHAIRMAN. But you say these errors were known.

Mr. GREGG. No; I do not say that the specific errors were known. I say it was known that some cases have been incorrectly closed. I will admit that I have probably closed plenty of them incorrectly myself, but I did it to the best of my ability, and that is what we wanted to show, that in these cases they were handled to the best of the ability of the men handling them.

The CHAIRMAN. Take the case of the Anaconda Copper Co. which was presented this morning. Do you think that that was handled to the best of the ability of anybody?

Mr. GREGG. I do not know a thing about the Anaconda Co. I expect Mr. Bright will come up here and explain his own action on that; but I will explain, on the copper cases, which the committee spent a great deal of time on, our attitude in defense there.

These valuations had been allowed by the department back in 1920. Competent men had passed on them. Before the committee ever heard of the copper cases, we ourselves had reopened them. We differed with the judgment of the men who had previously con-

sidered them and ordered them reopened for the years that were as yet unclosed, and had revaluaticns made. Nevertheless, we brought Mr. Graton, who made the original valuation, before the comittee to show that the original valuations were made by an intelligent, competent, and honest man. We disagreed with him. Our disagreement is shown by the fact that before the committee ever heard of the cases we had modified his action for the years remaining unclosed; but I repeat again that I think we are justified in explaining these errors which have occurred by showing how they could honestly be made by intelligent men.

Now, on the other matter——

Senator JONES of New Mexico. In presenting all of those matters in justification or excuse, have they not been presented in a way that would carry the thought that what had been done was approved now?

Mr. GREGG. If that is so, that is my error, and I will try to correct it in the future.

Senator JONES of New Mexico. Of course, I have not been present at all of the sessions of the committee, but, so far as I have been present, and the bureau has presented matters in justification or excuse, they have practically all been presented as matters of justification and not excuse. That is the impression I have gotten, and I am glad to get this present explanation from the Solicitor of the Bureau of Internal Revenue, that they did not intend, in presenting these matters, to be understood as justifying what has been done, but that they have been presented in many instances, if not in the great majority of instances, as matters of excuse——

Senator KING. Explaining the conduct of those who decided them.

Senator JONES of New Mexico (continuing). And explanation.

Mr. GREGG. I said to the committee the other day that we intended to reopen for the years that were not closed yet these matters of valuation, where we disagreed with the valuations previously placed on the properties. Mr. Nash and I have been checking, and are going to check, every case that has been taken up with the committee to see if we disagree with what has been done, and if so, we will have them reopened for the years remaining unclosed.

Senator KING. Not only those cases, but all cases that would come within the same type or category.

Mr. GREGG. Any case that we think has been incorrectly handled. In other words, we are going to try in the future to close the cases correctly.

Senator JONES of New Mexico. A great many of the matters that have been brought out here have doubtless been considered by our investigators as merely typical cases, and the criticism of our investigators has gone not to the action in any case, but to what you might call blanket action in numerous cases.

Mr. GREGG. That is true, Senator, of some cases. However, I want to say that I think a majority of the cases brought before the committee have been unique cases.

Senator JONES of New Mexico. Of course, when you get one typical case, you would not bring forward here all the facts in numerous cases falling under the same category?

Mr. MANSON. In many cases, after bringing out a case here, I have confined our future work to gathering statistics to see to what extent the evil that is complained of in that particular case exists.

Senator ERNST. But, Mr. Manson, there were not many cases which were said to be typical cases. You have brought out some cases to demonstrate the principle.

Mr. MANSON. Yes.

Senator ERNST. But most of them have been isolated cases, and you demonstrated what you thought to be an error.

Mr. MANSON. In a lot of valuation cases, Senator, that is true.

Senator ERNST. Yes.

Mr. MANSON. I have presented those for the reason that I believe that, entirely aside from the correction of that particular case, which has not been a matter of primary importance in my mind, I believe that it showed the necessity for some change in the system which would prevent the recurrence of that sort of thing, and perhaps have some restrictive legislation upon the matter of appraisals.

Senator JONES of New Mexico. And to show, as I understood, that in respect to many of these questions, there was no uniform system?

Mr. MANSON. Yes.

Senator JONES of New Mexico. For deciding a given question?

Mr. MANSON. Yes.

Mr. GREGG. As I stated at the start, we all recognize the weaknesses of the bureau, and that the organization can be improved. We recognize that cases have been incorrectly decided; I do feel that a great majority of the cases which have been considered by the committee are unique or freak cases. The twelve cases, I think it was, that were called to the attention of the committee by Mr. Grimes were cases from his division that were settled contrary to what he thought was correct.

I might say that one of those was a legal question, passed upon by the solicitor. Mr. Manson has not taken it up, but Mr. Grimes sent me a copy of the memorandum which he sent to Mr. Manson. Mr. Grimes took every case that he disagreed with in the bureau, and called it to the attention of the committee, even, I think, rather overlooking the fact that he might, as an engineer, not be competent to pass upon the legal opinion of the solicitor.

Those cases were unique in my opinion.

The cases which Mr. Briggs called to the attention of the committee, where valuations were made contrary to his own valuations, were, in my opinion, unique.

It seems to me that a great majority of the cases have been unique and not typical.

As to whether we have helped the committee, Senator Jones, I would like to get back to that. I do not think our help has been called for. I think it would have been rather presumptuous for us to have offered it any more than we have. We have been ready at any time to help. I have called to the attention of the committee at various times some things in the law which I thought were wrong, and which I thought should be corrected, and we are ready at any time to help the committee; but I still believe——

Senator KING. Is that quite accurate, Mr. Gregg, that you have not been asked? I know there has been scarcely a session——

Mr. GREGG. Oh that is true——

Senator KING (continuing). In which I have not said that we would be glad to get any suggestions that could be offered by any head of any section in the bureau, or the Secretary, and only the other day I said that before we concluded, speaking for myself, I should be very glad to have you and any other persons that the Secretary might designate to come before us and give us your views on any of these questions that have been presented, or to make any recommendations for legislation, and have you point out what you think should be done by this committee in a helpful way to correct errors or to correct the law.

Mr. GREGG. And I am sure, Senator King, you have found no reluctance on our part to submit any material, data, or information, or anything the committee has desired.

Senator KING. No; and when I made that suggestion you said you would be glad to comply with it.

Mr. MANSON. I want to say this, in justice to the bureau in that connection, that at about the time that I first had any connection with the investigation the Secretary of the Treasury issued instructions that the committee was to get everything it asked for, and that Mr. Nash, who was designated as the representative of the Secretary and through whom we were to do business, has done everything within his power to carry out those instructions, and they have been carried out in the spirit in which I am sure the Secretary meant them to be carried out.

There has been one isolated case of one chief of a section who has endeavored to impede our work, but as soon as I called it to the attention of Mr. Nash it was remedied. I want to say that we have had the most whole-hearted cooperation in giving us everything we have asked for.

The CHAIRMAN. Let me remind you at this point that you took up with me the other day a list of things that you were going to ask the bureau for yesterday, but I do not recall that you asked them for it. What did you do with those cases about the refunds?

Mr. MANSON. I was going to ask the bureau whether it is practicable—I did not want to ask for the information until I found out whether it was practicable to get it—to get a recapitulation in total of the amount of money that has been spent from the various appropriations that have been made for refunds, for the refunding of taxes under court order, for the refunding of taxes pursuant to the act of Congress reducing the taxes 25 per cent, and for refunds made by action of the bureau itself. I was wondering whether it is practicable to get those totals. I do not know whether it is or not.

Mr. NASH. Mr. Chairman, I want to thank Mr. Manson for what he said about the efforts of the bureau to cooperate with the committee. I am sure that I have endeavored in every way that I could to cooperate with this committee and to profit by the experience I have had up here.

I also want to say that my office has been open, ever since this committee started in its work, to any member of the committee or any of its staff. I have spent hours discussing the problems of the bureau with the various engineers on the staff of the committee. Mr. Manson has been to my office a few times. Mr.

Davis, who used to be with the committee, visited my office several times. I do not know of any effort on the part of anyone in the bureau not to cooperate with the committee, except the instance which Mr. Manson has cited, and which I believe was corrected as soon as it was brought to my attention.

A great many requests for information have come in in the last few days, and in one or two instances we thought they might conflict with the resolution continuing this committee. We have brought these situations to the attention of the committee, and we are exerting every effort to get out all the information that the committee has asked for.

The information that Mr. Manson is now asking for is available to some extent. I have prepared for the Appropriations Committee once or twice a statement showing the amount of refunds which have been made as the result of various court proceedings. We also have segregated in a separate account the amount refunded last year as a result of the 25 per cent tax reduction.

Mr. MANSON. In that connection, let me ask you whether you have any way of ascertaining approximately what it cost the bureau to make that 25 per cent refund?

Mr. NASH. We can make an estimate, of course. The work was done principally in the offices of the 65 collectors of internal revenue. We spread that out into the field so as to make a quicker job of it, and in the bureau we have one section working on those schedules. I think we can come within——

Senator KING. Ten per cent?

Mr. NASH (continuing). A fair degree of giving you an accurate estimate as to just what it cost us.

Mr. MANSON. My purpose in asking for that information is this: For instance, the last Congress made an appropriation of a hundred million dollars, I believe, if my recollection is right, for refund of taxes. It created considerable discussion in Congress and out. I appreciate the fact that a very large part of that money was necessary for the 25 per cent refund that was ordered by Congress itself, and with which the bureau had nothing to do, except as a purely administrative job of making the refund.

Mr. NASH. Nearly $20,000,000 of it was used for the 25 per cent refund.

Mr. MANSON. Another large portion of that money was doubtless necessitated by court decisions.

Mr. NASH. That is very true.

Mr. MANSON. And then the question occurred to my mind whether it might not be valuable to know what it cost to make one of these blanket refunds. In other words, I am not questioning the policy of Congress in ordering a 25 per cent or a 10 per cent or a 50 per cent refund of taxes.

The CHAIRMAN. I question the policy very much under that kind of a system.

Mr. MANSON. Well, I was not, but I thought it would be interesting to Congress to know what the cost of doing a thing of that sort was.

The CHAIRMAN. Is that all the questions you have?

Senator JONES of New Mexico. Another question that I have been somewhat interested in, in rather a speculative way, is the real

amount of interest that is being paid on these so-called Treasury certificates. For instance, I read this morning in the papers that the Secretary was now calling for 16⅔ per cent, I believe, of the proceeds of the bond issue or Treasury certificates which were sold in the middle of March.

Senator KING. Senator, is that a part of this committee's work?

Senator JONES of New Mexico. I think so, to find out what the Bureau of Internal Revenue is doing and how it is managing the financial end of it.

Mr. GREGG. That is under the Treasury, of course, Senator, and not under the bureau.

Senator JONES of New Mexico. I guess you are right about that.

Senator KING. It seems to me that that is not a part of our duties.

Senator JONES of New Mexico. Of course, that is true.

Mr. MANSON. You have nothing to do with the bond issues?

Mr. GREGG. No.

The CHAIRMAN. You do not want to meet on Monday, then, Mr. Manson?

Mr. MANSON. I will have to have a couple of days in addition to Sunday to get my material in shape.

Senator KING. I think the committee ought to meet and discuss this question of prohibition. I am not at all satisfied with what we have done and what we have not done. I don't know just what we ought to do. I would like the committee to meet and see if there is anything further that we should do.

The CHAIRMAN. I think that is a good suggestion, because I have probably 85 or 90 cases which I would like to lay before the committee, and talk them over, and see what the committee thinks ought to be done about them.

Senator KING. If I were to make a report to-day as to what we should do about prohibition, I would not know what to say. I am not at all satisfied with our investigation of that feature of it. After some discussion in the Senate we were charged with that duty, and speaking for myself, I feel that we have not discharged it. Now, what we can do, I do not know, and I would be glad to get the suggestions of my colleagues here.

The CHAIRMAN. If it is agreeable, we will adjourn until 10 o'clock Monday morning, at which time I will bring those cases down here, and we will discuss that among ourselves.

Mr. GREGG. That will be a prohibition matter, and we will not need to be here?

Senator KING. Nor on Tuesday.

The CHAIRMAN. We will let you know on Monday if we will want you on Tuesday.

Senator ERNST. Mr. Manson, how many more days, if you have made any calculations on it, will it take to finish up your part of the work?

Mr. MANSON. I want to get before the committee all of the material which has been accumulated up to the present time. I will try to boil it down, for the sake of the record as well as for the sake of the committee. I do not believe we are going to be able to keep the committee busy more than about three or four days, as far as our material is concerned.

Mr. NASH. Mr. Chairman, do you want anybody from the Prohibition Unit down here on Monday morning?

The CHAIRMAN. You might tell Judge Britt and Mr. Simonton to come down, if you will, please.

The committee will adjourn now until 10 o'clock on Monday morning.

(Whereupon, at 11.55 o'clock a. m., the committee adjourned until Monday, May 18, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, MAY 20, 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 Monday, May 18, 1925.

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

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

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. A. W. Gregg, solicitor, Bureau of Internal Revenue; Mr. J. G. Bright, Deputy Commissioner of Internal Revenue; and Mr. H. C. Armstrong, chief rules and regulations section.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. I telephoned to Mr. Nash yesterday and told him that I wanted to examine somebody to-day who could tell us about the rulings, the weight that is given to these different kinds of rulings that are published, who passes on them as to what is to be published, etc.

Is there anybody here for that purpose?

Mr. NASH. We have Mr. Gregg here, Mr. Bright, and Mr. Armstrong, the head of the rules and regulations section, here. I think Mr. Gregg is familiar with the general scheme, Mr. Armstrong is familiar with the origin of Treasury decisions, income-tax rulings and amendments to the regulations.

Mr. MANSON. I wish somebody would describe——

Mr. GREGG. Did you have in mind a particular thing, Mr. Manson, or do you just want it generally?

Mr. MANSON. I want a general discussion of the whole subject.

Mr. GREGG. Of course, the starting point on our precedents is the regulations. They are issued usually after a revision of the act. Regulations 62 were issued right after the passage of the 1921 act and Regulations 65 after the passage of the 1924 act. They contain in general the construction by the department of the acts.

Mr. MANSON. And those regulations are issued pursuant to provisions of the act?

Mr. GREGG. Yes.

Mr. MANSON. And in so far as they do not actually conflict, or may not actually conflict, with the law, they have been construed by the courts to be a part of the law itself, having the same force and effect as the law?

Mr. GREGG. I do not think that is quite accurate. The regulations fall in two classes—regulations which represent the department's interpretation of the law and regulations which are administrative in the sense of providing for the filing of returns and the procedure which a taxpayer must follow, and such things as that. Those latter regulations have the force and effect of law.

Mr. MANSON. That is, the administrative regulations?

Mr. GREGG. Yes; they have the force and effect of the law.

The regulations which represent the department's construction of the act are valid if they represent the proper construction, and they are invalid if they do not represent the proper construction. Sometimes, the courts place some weight on the regulations, and sometimes the courts do not. They are not in any sense bound by the department construction, as adopted by the regulations, although there are a good many cases to the effect that if the department regulations have been consistent for years, and Congress has reenacted the statute in the same language as contained in the regulations that constitutes an approval of them.

Mr. MANSON. The effect of the reenactment is to virtually legislatively approve the regulation?

Mr. GREGG. Yes, sir.

Mr. MANSON. And make it a part of the law?

Mr. GREGG. I might say that the courts do not always follow that, by any means. They do upset our regulations. For example, in the Alworth-Stevens case, on the depletion allowed the lessee on mineral properties, they upset a regulation which has been in effect since the date of the act. Sometimes they adopt that theory, and sometimes they do not. I do not think you can make the general statement that the reenactment by Congress of the same language writes into the law the departmental construction. It does not go quite that far.

Mr. MANSON. The regulations are approved by the Secretary, are they not?

Mr. GREGG. They are signed by the commissioner, and approved by the Secretary. They are absolutely binding on the department. The next are the Treasury decisions which are, in effect, regulations. The regulations, for example, are promulgated by a Treasury decision, and if we have to amend those regulations, it is done by a Treasury decision.

Mr. MANSON. So that the Treasury decisions are a part of the regulations, even though not incorporated in the book, and from time to time, as I understand it, when you get out a new book of regulations, the Treasury decisions promulgated since the last book was published are incorporated in the new book. Is that correct?

Mr. GREGG. That is correct.

The CHAIRMAN. Just what do you mean by "Treasury decisions"? Is it a decision of the Commissioner of Internal Revenue or of the Secretary of the Treasury?

Mr. MANSON. That is just what I was going to ask Mr. Gregg.

Mr. GREGG. It is a decision by the commissioner, approved by the Secretary.

The CHAIRMAN. A decision on a specific case?

Mr. GREGG. No: the regulations are always general. They are not specific.

Mr. MANSON. Will you describe the actual origin of those?

Mr. GREGG. Let me take a specific case. Assume that a specific case comes to the solicitor's office with reference to an article in the regulations and we become convinced that the regulation is unsound. A Treasury decision is prepared in the office amending the regulations.

Mr. MANSON. You mean in the solicitor's office?

Mr. GREGG. In the solicitor's office. They are usually prepared there.

Mr. MANSON. Yes.

Mr. GREGG. That is prepared, amending the regulations. That goes to thrrugh the solicitor's office; it is approved there and is sent to the deputy commissioner whose unit is affected by the Treasury decision. If it is an income-tax decision, it is sent to Mr. Bright, and he sends it for consideration to such men in the unit whose opinion he wants with reference to it. Then it goes to the commissioner for his signature, and from him to the Secretary for approval.

Mr. MANSON. And when approved it stands as with the force and effect of a regulation?

Mr. GREGG. It stands on the same basis as a regulation. Some Treasury decisions originate in the Income Tax Unit. The majority of them which originate there originate in the rules and regulations section, or I suppose all of them.

Mr. ARMSTRONG. Practically all of them.

Mr. GREGG. They originate there. They are prepared there and sent to the solicitor's office for consideration, and when they are approved there they go to the commissioner for his signature, and then to the Secretary for approval.

Mr. MANSON. Will you tell us at this point what the functions and jurisdiction of the rules and regulations section are?

Mr. GREGG. Mr. Bright, I suppose Mr. Armstrong had better answer that.

STATEMENT OF MR. H. C. ARMSTRONG, CHIEF RULES AND REGULATIONS SECTION, BUREAU OF INTERNAL REVENUE

The CHAIRMAN. Mr. Armstrong, will you tell the committee just what your position is?

Mr. GREGG. Mr. Armstrong is the chief of the rules and regulations section.

Mr. ARMSTRONG. The main work we do there is the making of decisions on specific cases presented by taxpayers or their attorneys. Then we have a lot of cases which we pass on for the audit divisions of the Income Tax Unit. The latter decisions are in the minority, and they are generally based on precedent or some previous decisions, and are cases which we think unnecessary to send to the solicitor for an opinion.

Mr. MANSON. Then, as I understand it, your section performs about the same functions as the solicitor, except in matters that go to the solicitor from your section?

Mr. ARMSTRONG. Yes. We have a great many letters from the outside to answer. There are quite a volume of them. Then, there are

those cases which are doubtful, or which are leading cases, or which raise some new point not covered by the regulations or by some previous court decision. We prepare them for the signature of the commissioner, and we route those cases by the solicitor.

Mr. MANSON. What kind of questions do you pass on; that is, are they questions of law, questions of appraisal, or engineering and audit questions?

Mr. ARMSTRONG. We do not pass on questions of appraisal or engineering questions.

Mr. MANSON. Do you pass on any questions of fact?

Mr. ARMSTRONG. On questions of fact.

Most of our cases are presented to us with the facts for a decision on the facts, with respect to the legal questions involved.

Mr. MANSON. With respect to the legal question?

Mr. ARMSTRONG. Yes.

Mr. MANSON. What is the personnel of your division made up of? Is it made up of lawyers?

Mr. ARMSTRONG. The majority of them are lawyers, but we have some accountants there, and some men who are neither lawyers nor accountants, but who have been with the Government for several years in this particular line of work.

Mr. MANSON. Well, do I understand that your function is confined to construing the regulations or construing the former decisions, for the purpose of determining their application to some particular case that is brought to your attention?

Mr. ARMSTRONG. That is practically it; yes.

Mr. MANSON. How does a case reach your section?

Mr. ARMSTRONG. Most of the cases are presented from taxpayers on the outside or their attorneys, where they, with respect to the current year, have a statement of facts, and they want to get a decision now, so as to enable them to prepare their return or to advise the shareholders of a corporation whether this is a taxable dividend or not.

Mr. MANSON. In other words, the bulk of the work in your section is the passing on questions submitted before the question reaches an auditor or an engineer or some other employee of the bureau, whose duty it is to pass on it after it gets into the bureau; is that your idea?

Mr. ARMSTRONG. Yes.

Mr. GREGG. Maybe I can clear up that point.

Mr. MANSON. Yes.

Mr. GREGG. As I understand it, your office does not pass on any case that is pending in the audit divisions?

Mr. ARMSTRONG. Yes; that is correct.

Mr. MANSON. That is, you do not pass on any case after it gets into the bureau?

Mr. ARMSTRONG. Only with this exception, that we get cases from the audit—that is, a few of them. I should say maybe 10 per cent or less than that of cases from the audit, cases which are under consideration and in which a hearing has been had in the audit. They send them up to us for a ruling, according to an agreement with the taxpayer. They will say, "We will submit that to the rules and regulations section for a decision," and most of those

cases will be cases in which we have a decision already, and we immediately send them back to audit.

The CHAIRMAN. How many employees are there in your section?

Mr. ARMSTRONG. I believe there are about 85; but there is a great deal of our work that can be done by men who are not lawyers. We have other work in our section besides this—miscellaneous work.

The CHAIRMAN. Let me ask you this one other question. After these decisions are made that have just been described by Mr. Gregg as passing from him to the deputy commissioner and from the commissioner to the Secretary, when are they published?

Mr. GREGG. They are published immediately. Those Treasury decisions are published——

Mr. NASH. Every week.

Mr. GREGG (continuing). Every week. It is a pamphlet of Treasury decisions that is printed weekly.

The CHAIRMAN. Is there any way in which any of those decisions do not get into the publication?

Mr. GREGG. No, sir. Every Treasury decision is published. There are some rulings of the department—and I will come to that in a few minutes—which are not published, but every Treasury decision is published. You see, that is a point that I wanted to emphasize. The Treasury Decisions are general and not specific. They deal with general questions and state general rulings, rather than the ruling in a specific case.

The CHAIRMAN. But you relate a specific case to a previous decision, do you not?

Mr. GREGG. No, sir; no reference is made. For example, a Treasury decision will say this—and it will not give reasons, either, but just simply conclusions—that depreciation of a lease based on the March 1 value of the lease is not permissible under the revenue laws.

The CHAIRMAN. In some of the hearings that we have had here there was a reference to case X or X dollars.

Mr. GREGG. That is not a Treasury decision. I will come to those in a minute.

The CHAIRMAN. What do you call those?

Mr. GREGG. There are a good many of them, with different names. There are solicitor's opinions; there are solicitor's memoranda, solicitor's recommendations, and recommendations of the old committee on appeals and review.

The CHAIRMAN. They are not published, then?

Mr. GREGG. Yes, sir; some of them are, and some of them are not.

The CHAIRMAN. What is the determining factor of whether they shall or shall not be published?

Mr. GREGG. May I give briefly what the other rulings are?

The CHAIRMAN. Yes.

Mr. GREGG. To go into that more generally.

Mr. MANSON. I want to lead up to that. It appears to me that we have gotten at the opposite end of this matter.

Do I understand that when you make a ruling on a case put to you by an outside taxpayer, that ruling becomes a precedent to the department?

Mr. ARMSTRONG. Yes, sir.

Mr. MANSON. There is no case in the department on this subject——

Mr. ARMSTRONG. And a certain percentage of those, a small percentage, are what we call leading cases, and they are afterwards used as a precedent for the department.

Mr. MANSON. Are those rulings submitted to the solicitor or to the commissioner before they are published?

Mr. ARMSTRONG. They are written up in the rules and regulations section by one of the attorneys there. Then they are reviewed and approved, and then routed by the solicitor for final review before publication.

Mr. MANSON. That is, in case you consider them as dealing with a novel question; is that the idea?

Mr. ARMSTRONG. Yes.

Mr. MANSON. When you make a ruling in any case submitted to you from the outside, is that ruling considered as binding in that particular case when it reaches the bureau?

Mr. ARMSTRONG. As a general rule it is based on the facts submitted.

Mr. MANSON. In other words, if, when that return is made—we will say a taxpayer, before he submits his return, sends in a statement of facts asking for a ruling, you make the ruling, and if, when the auditors reach that case, they find that the statement of facts is as represented to the rules and regulations section, is the ruling which you have made upon this case before it reached the bureau considered binding in that case?

Mr. ARMSTRONG. As a general thing it is.

Mr. MANSON. Under what circumstances would it not be considered binding if the facts conform to the facts set up in the request for the ruling?

Mr. ARMSTRONG. If the facts are identical, and there has not been any change in the law or regulations, or by court decision, it should be binding.

Mr. MANSON. If that ruling thus made is not based upon an established precedent, such as the solicitor's opinion, or some ruling of higher dignity than the class of rulings we are talking about, is it always routed for publication?

Mr. ARMSTRONG. If we have no precedent on a case we route it by the solicitor as a leading case. It is approved or disapproved by the solicitor, but in its final form it will be submitted for publication. It is not all of the cases which are submitted for publication that are published.

Mr. MANSON. Well, I understand that, but whatever in your judgment appears to you to be a new question or an exception, for instance, to a precedent that has been established or throws a new light upon the subject, do you route all of those for publication?

Mr. ARMSTRONG. Well, I do not know whether we do all of them or not, but practically all of them are routed for publication.

Mr. MANSON. Is that routed for publication before the case in which it was made has been passed upon by the bureau?

Mr. ARMSTRONG. No. After the case has been decided and signed, of course, the papers come back to the rules and regulations section.

Mr. GREGG. I do not think Mr. Armstrong understood your question, Mr. Manson.

Mr. MANSON. What I mean is this: A taxpayer, we will say in Milwaukee, prior to the filing of his return, submits a question to your section. You make a ruling upon that question. The taxpayer submits his return. The case comes into the audit section for audit. I want to know whether your ruling on that question is routed for publication prior to the time this case actually reaches the bureau.

Mr. ARMSTRONG. It will probably be in most cases. The recommendation that the case be published is generally done within 10 days after it is actually signed.

Mr. MANSON. That is, your recommendation to some superior; is that the idea?

Mr. ARMSTRONG. The mechanics there, which will consume several days, may run into three or four weeks, but as far as the actual process of the publication of the decision is concerned, it will start in I would say, 10 days after the decision is actually signed, which should make it, of course——

Mr. MANSON. Is signed by whom?

Mr. ARMSTRONG. By the commissioner.

Mr. MANSON. Do all of your rulings come up to the commissioner for signature, or only those that you consider novel?

Mr. ARMSTRONG. Only those that are considered novel or leading cases.

Mr. MANSON. Yes.

Mr. ARMSTRONG. That is, the smaller percentage of our cases are leading cases.

Mr. MANSON. Yes. Now, the other class of cases that you get and upon which you make rulings are cases that are referred to your section by one of the other sections for advice?

Mr. ARMSTRONG. Yes. I might say here that the bulk of our work is not leading cases and is not cases received from the audit.

Mr. MANSON. Now, I want to stick to these cases that come to you from another section for advice.

Mr. ARMSTRONG. Yes, sir.

Mr. MANSON. Is there any regulation or office rule requiring an auditor to appeal to your section for advice as to whether a question has been passed upon or whether it is a new question or how it should be decided?

Mr. ARMSTRONG. There is an office order to the effect that when a ruling is desired with respect to a particular point in a case the audit section will ask the rules and regulations section for a decision, and if we have sufficient precedent on the question we will answer it.

Mr. MANSON. Then, it is entirely optional with the audit section as to whether or not they do ask for a ruling from your section?

Mr. BRIGHT. I might answer that by saying that the auditor, when he is confronted with a question on which there are no precedents established, either by rulings which have been previously submitted or by the rules and regulations section, or by the solicitor's office, or by the committee on appeals and review, is required, under those circumstances, to send that case to the chief of section for consideration, and a decision reached as to whether or not there is a precedent for passing it, or should they require further information with respect to the subject.

Mr. MANSON. Now, I understand that under your office rules the auditor passing on the case, when he finds no precedent, is required to report that case to his chief?

Mr. BRIGHT. Yes.

Mr. MANSON. Is it then within the discretion of the chief to pass upon that question or to refer it to the rules and regulations section, or is the chief required to refer it in case there is no regulation governing the case?

Mr. BRIGHT. There are no orders requiring the chief to send a case to the rules and regulations section.

Mr. MANSON. He uses his discretion as to whether he refers that to the committee or not?

Mr. BRIGHT. Yes.

Mr. MANSON. In a case involving a novel question, there being no ruling upon it, the head of the section determines that he will pass upon the question without reference to this committee, then?

The CHAIRMAN. When you refer to "this committee," do you mean the rules and regulations section?

Mr. MANSON. I mean the rules and regulations section.

In a case of that sort the ruling of that chief never becomes a published ruling?

Mr. BRIGHT. No; it would not.

Mr. MANSON. If the head of the section, then, determined to take the law into his own hands and construe it to suit himself, you could go along for an almost indefinnite period of time before the question involved ever reached the rules and regulations section, or the solicitor, or any authority whose determinations are published; is not that true?

Mr. BRIGHT. Well, those cases are passed on by the review section of the division in which the section where the chief passed on the question is a part of that particular organization.

Mr. MANSON. Let us take the engineering division for illustration. We will assume this situation: A case comes up—a question is raised by an engineer, or a question is presented in the case. The chief of the section takes that question up with the head of the engineering division. The head of the engineering division has determined that they will not refer that case to the rules and regulations section, even though there is no precedent, but he determines that he will pass on that question himself. Is there any way whereby the practice or the construction of the law, which in that manner becomes a practice of that division, ever reaches the point of publication?

Mr. BRIGHT. It never reaches the point of publication. The ruling as passed on by the head of the division is subject to review in the review division for audit at the time the audit of the cases is completed. If there is any question as to the correctness of the decision handed down by the head of the engineering division or a decision by the head of an audit division, the reviewer handling the case is the one to take it up and report to his respective chief that it is not in conformity with the rulings or precedents previously established.

Mr. MANSON. If the construction were one which involved an engineering practice, we will say, where the question was whether or not such an engineering practice conformed to the law, an auditor

would not be apt to question the judgment of the head of the engineering division as to the validity of a construction which had been placed upon the law by the head of the engineering division, would he?

Mr. BRIGHT. It has been done——

The CHAIRMAN. Just at this point, a question occurs to me.

Assuming the kind of a case you have just referred to, Mr. Bright, as having gone to the review section after the head of the section had passed upon it, and supposing that the review section agreed with the chief of the section, then that closes the incident.

Mr. BRIGHT. That closes the incident, ordinarily.

Mr. MANSON. And that practice or that construction of the law, then, never finds its way into any publication of the department?

Mr. BRIGHT. No, sir.

Mr. MANSON. Now, to come back to Mr. Armstrong, what classes of cases do you make rulings upon other than the two that you have mentioned?

Mr. ARMSTRONG. We have classes of cases in which the taxpayer or the attorney does not understand what interpretation should be placed upon it, and they submit the facts for a ruling. Those rulings are signed by the deputy commissioner or by myself. That part of the work is the majority of the work done. They will come in from banks, from the taxpayer himself, or from his attorney, and those cases are covered by the regulations or by published decisions, the taxpayer generally not knowing just where to find the answer.

Mr. GREGG. Mr. Manson, may I amplify this a little?

Mr. MANSON. Yes.

Mr. GREGG. I may be able to bring out the point that you have in mind if I ask Mr. Armstrong how many letters are prepared in the rules and regulations section a month.

Mr. ARMSTRONG. They will average 60,000 a year.

Mr. GREGG. Sixty thousand a year?

Mr. ARMSTRONG. Yes.

Mr. GREGG. That is 5,000 a month. The point I wanted to bring out is that it is very difficult to speak in general terms of this type of cases, and I think by giving a more or less specific example we can clear it up.

Mr. MANSON. Of course, I am trying to get the general practice.

Mr. GREGG. Yes; but I would like to show the type of cases that come through there.

Mr. MANSON. Yes; go ahead, Mr. Gregg. This is an around-the-table discussion as far as I am concerned. I am not trying to monopolize it.

Mr. GREGG. Well, I may be able to anticipate some of your questions on this matter. I should say that the great majority of the cases that come to the rules and regulations section are simple. All requests for extensions of time come there.

Mr. MANSON. Yes.

Mr. GREGG. A taxpayer writes in and says, "I have had a salary of $3,000. I am a married man with two children. Shall I make an income-tax return?" There are hundreds of that type of case, and as I understand it those replies go out from Mr. Armstrong's division over his signature.

Mr. ARMSTRONG. Either over my signature or that of the deputy commissioner.

Mr. GREGG. Then there are hundreds more which fall in this class: A taxpayer writes in and says, "I have received stock in a reorganization" or "a dividend from such and such a company, paid out of capital," cases in regard to which there are many precedents published by the department, but he has not asked a lawyer to go into it for him and he is not familiar with the precedents. In those cases the replies are prepared in the rules and regulations section, and they, assuming his facts to be correct, tell him how to make his return. Those letters go out over the signature of either Mr. Armstrong or the deputy commissioner.

The third class of cases is where a taxpayer presents a question in connection with the preparation of his return, which is difficult, a reorganization question or something of that sort that is not clearly covered by a precedent. In those cases the letter is prepared in Mr. Armstrong's section for the commissioner's signature, and is sent from the solicitor's office for approval there.

That is the type of case which may eventually find its way into a published ruling, if it is such a case as could be published.

Mr. MANSON. I want to find out who passes judgment upon whether a particular ruling falls within the first two classes mentioned by Mr. Gregg or within the third class.

Mr. ARMSTRONG. The initial judgment is exercised by the particular attorney or clerk who handles the case. There may be a question involving exemption or credit for taxes. Those questions are all covered by the regulations, and he knows that he can look at the regulations and get the answer to them.

Senator JONES of New Mexico. Is that determined at the time the mail is distributed?

Mr. ARMSTRONG. Immediately after it is distributed.

Senator JONES of New Mexico. Who distributes the mail to this branch of the service and the other branch, and so on?

Mr. ARMSTRONG. This particular class of mail goes to a desk, at which there are two girls, who formerly had a chart. From years of experience, they now know, and if it is a question involving credit on a tax, it will go to this particular clerk, and a question involving an exemption under 231 would go to another clerk.

Mr. GREGG. I do not think that just answers Senator Jones's question.

Senator JONES of New Mexico. No.

Mr. GREGG. The mail is distributed this way, as I understand it: All letters coming in that do not refer to cases pending in the department, such as letters requesting advice as to how to prepare a return, are, in the mail room, sorted and sent to the rules and regulations section.

Senator JONES of New Mexico. Then, all cases in bulk go to the rules and regulations section. Now, when they get there, who is going to say whether it is of the first type, the second type, or the third type?

Mr. GREGG. That is the point he was answering, Senator Jones. It is originally decided by the clerk who has it. He decides it when he makes the reply. He prepares it for the signature of the chief of section, and if he does not think it is a new point, it gets to Mr.

Armstrong, and if he thinks it is a new point, he changes it for the commissioner's signature, and routes it through the solicitor's office.

Is that correct, Mr. Armstrong?

Mr. ARMSTRONG. That is correct.

Mr. BRIGHT. Mr. Armstrong, do you not have in your section a review unit which reviews decisions after they have been made by the particular clerk or lawyer handling that question?

Mr. ARMSTRONG. Yes; I have a review unit, consisting of three or four experienced men and lawyers, who make a review of each case before it comes to me.

Mr. MANSON. You said "experienced men and lawyers." Do you mean that these men are all lawyers in this review section?

Mr. ARMSTRONG. No. I have one man who has been with the organization for 10 or 12 years.

Mr. MANSON. Yes.

Mr. ARMSTRONG. And he is probably more valuable to me than some men there who came in recently, who are attorneys.

Mr. MANSON. Does the review section pass upon the question as to whether the question involved in this ruling is a new question?

Mr. ARMSTRONG. That must be considered at the time they consider the question as a whole; yes.

Mr. MANSON. Do you regard any question that is not on all fours with a published ruling as being a novel question?

Mr. ARMSTRONG. Well, the facts will not have to be identical.

Mr. MANSON. No.

Mr. ARMSTRONG. But there will be in some cases enough precedents on a given subject, which will not warrant making this particular case a leading case.

Mr. MANSON. Supposing an inquiry is made as to the formula or the method that is to be used for the purpose of—well, we will say, to ascertain the profit or loss, or for the purpose of ascertaining the value of an oil well, or for the purpose of ascertaining the measure of the deduction to be taken for amortization. Do those questions come to your section?

Mr. ARMSTRONG. They come to us first.

Mr. MANSON. They come to you first.

Mr. ARMSTRONG. If that is a question presented by a taxpayer from the outside, it will come to us.

Mr. MANSON. If there is no published ruling laying down the formula that is to be applied in that particular case, do you regard the ruling that you make as a novel ruling?

Mr. ARMSTRONG. Yes.

Mr. MANSON. Now, when you have determined in your section that a ruling is a new ruling, that it covers a new question, what is the next step toward the publication of that ruling?

Mr. ARMSTRONG. Well, after it is prepared, it is routed by the solicitor's office for review.

Mr. MANSON. That is, it is sent to the solicitor's office by your section?

Mr. ARMSTRONG. Yes.

Mr. GREGG. Yes.

Mr. ARMSTRONG. We may be wrong about it. The solicitor may write an opinion in which he does not agree with us, and in looking

it over we believe that the solicitor is right about it, we will draft the letter in accordance with his views.

Mr. MANSON. Suppose you do not think he is right about it? What do you do then?

Mr. ARMSTRONG. We would ask for a reconsideration.

Mr. MANSON. That is, you would ask the solicitor for a reconsideration?

Mr. ARMSTRONG. Yes.

Mr. MANSON. Suppose you do not agree, that he adheres to his position and you adhere to yours. What happens then?

Mr. ARMSTRONG. Well, I do not remember any cases in which we did not reach an agreement—not in the past few years.

Mr. BRIGHT. In no instance, though, where there was a disagreement, as far as your section is concerned, with a decision rendered by the solicitor, would your section send out a ruling contrary to the opinion handed down by the solicitor?

Mr. ARMSTRONG. No; we would not. Where the question was still undecided, and where we still maintained we were correct, I would ask the deputy commissioner to take the matter up with the commissioner.

Mr. MANSON. The matter would then be taken to the commissioner?

Mr. ARMSTRONG. Yes.

Mr. MANSON. In case you were asked for an advisory ruling by an audit section, and the question is a new question, and your ruling goes to the solicitor, and the solicitor disagrees with you——

Mr. ARMSTRONG. Right, there, our rulings to the audit are made on published decisions and precedents. If the audit asks us for a decision on a question as to which we have no precedent, we will route that case to the solicitor for an opinion.

Mr. GREGG. They do not hand down an opinion on it first?

Mr. ARMSTRONG. No.

Mr. MANSON. You do not attempt to pass on it?

Mr. ARMSTRONG. No.

Mr. MANSON. That is, if it is a case that is pending in the department, you do not attempt to pass on it, unless you consider it as being governed by an established precedent?

Mr. ARMSTRONG. Yes.

Mr. MANSON. Then, for the purpose of determining whether or not you have a precedent in such a case, do you regard your rulings as being precedents?

Mr. ARMSTRONG. Well, our own rulings would be the office decisions. Those are our particular rulings, and the next thing is that we are governed by the regulations and decisions of the solicitor.

Mr. MANSON. Well, take a case of this sort: Assuming that a question comes to you from an audit section, and there are no solicitor's opinions on the subject; there are no determinations of the committee on appeals and review. There are, however, published rulings which have emanated from your section. Do you regard the public rulings which have emanated from your section as precedents for the determination of such a case, where those rulings are the only rulings on the subject?

Mr. ARMSTRONG. Yes.

Mr. BRIGHT. Mr. Armstrong, in those cases, where they are published as rulings from your section, they are the I. T.'s income-tax rulings, are not those decisions in every instance routed through the solicitor's office for the signature of the commissioner?

Mr. ARMSTRONG. Yes.

Mr. MANSON. I was just coming to that.

Do you regard as precedents any rulings which you have made, that have not been published as precedents for your guidance in a case, where the question is presented to you by an audit section?

Mr. ARMSTRONG. We do not call the ordinary so-called rulings which are not published precedents, because they are cases which would not be published, as they are based on precedents, so that there is really no unpublished ruling by me which establishes a precedent.

The CHAIRMAN. I recall having heard in the hearings here, in reading opinions rendered, they have wound up by saying "This will not be used as a precedent for other cases." What is done with those? Are they published if they are not used as a precedent in other cases?

Mr. ARMSTRONG. I do not remember seeing many decisions of that kind in our section.

Mr. GREGG. I do not think any of them came from your section.

Mr. ARMSTRONG. No; I do not think we have ever had any, Senator.

Mr. GREGG. There have been a few from the solicitor's office and some from the committee on appeals and review, which are not to be used as a precedent.

The CHAIRMAN. Then, how do you excuse—or perhaps that is not the best word to use—but how do you explain the establishment of a precedent in an individual case which may not be used for other cases?

Mr. GREGG. There are a great many cases that turn on their own peculiar facts to such an extent that the commissioner is not willing to publish it as a precedent to be construed and applied by auditors and not lawyers. There are not many of those cases. Since I have been with the department I do not remember seeing more than five cases that had on them that they were not to be published. But that is the reason. It is very difficult to hand down an opinion which is not susceptible of misconstruction.

Take the opinions of the Board of Tax Appeals that we acquiesce in. Mr. Arundel, who is in charge of that division, sends the decision back to the unit if we acquiesce in it, with the statement as to what it holds and for what it is to be considered as a precedent, for fear that the auditors might misconstrue the opinion and apply that to a case to which it ought not properly to be applied.

Mr. MANSON. Do you mean to say, when you get a decision from the Board of Tax Appeals, that before that decision gets into the unit you construe the decision?

Mr. GREGG. Not always. I will give you a specific case.

In the case of the Regal Shoe Co. a decision was handed down. We were afraid that that decision would be misconstrued. We believed that the decision was correct, and we acquiesced in it, but we were afraid it might be misconstrued and we sent it back to the

unit with a memorandum saying that the case held so and so, but it was not authority for such and such a decision.

Mr. MANSON. When you pass judgment that a question is a new question, Mr. Armstrong, or that a ruling is upon a new question, that then goes to the solicitor. I will now take this ruling up with Mr. Gregg. Does the solicitor then pass judgment upon whether it is a new question?

Mr. GREGG. It does not make any difference to us whether it is a new question when it gets to the office.

Mr. MANSON. You just approve it or disapprove it?

Mr. GREGG. We approve it or disapprove it.

Mr. MANSON. Who finally determines whether or not that ruling is to be published?

Mr. GREGG. In a letter prepared in the rules and regulations section.

Mr. MANSON. Yes. I am taking now a ruling that comes from the rules and regulations section, which they consider to be upon a new question; they have determined that there are no precedents. They send that ruling along to the solicitor's office for approval. It is approved in the solicitor's office. Who now determines whether or not that ruling should be published?

Mr. GREGG. As I understand the practice, and Mr. Armstrong will correct me if I am wrong about it, when a case gets to the reviewing officer in the rules and regulations section he writes on the carbon copy of the letter "Subject," meaning by that that it was to be digested and submitted for publication.

Mr. MANSON. Whom was it submitted to? That is what I am trying to get at.

Mr. GREGG. It is submitted to the solicitor. The whole bulletin comes to the solicitor for approval, you see.

Mr. MANSON. Yes.

Mr. GREGG. There are a great many rulings that come over in the bulletin, submitted for approval, which we think it is unnecessary to publish.

Mr. MANSON. Then, in the last analysis, the solicitor determines whether the ruling is to be published?

Mr. GREGG. Yes. I think that is right.

Mr. MANSON. Now, Mr. Armstrong, what percentage of the rulings which you forward for publication as new rulings are finally published?

Mr. ARMSTRONG. We send by the solicitor many cases which we know will not be published, but it is difficult to ascertain whether or not it is covered by a precedent.

Mr. MANSON. This is the situation, as I understand it: Your force down there is made up of lawyers and other experienced men who are considered to be qualified to answer questions, both for taxpayers on the outside, and to advise the audit sections. A question is presented to you and you determine that it is a close question, whether or not that question has been passed upon by some published ruling, and you determine it is a close question, and you send it on to the solicitor. Do you mean to say that there are a large number of those questions thus submitted which are finally determined to be not new questions, and therefore not to be published?

Mr. ARMSTRONG. There will be, for example, many cases in connection with a liquidating dividend or a reorganization. You have some very involved contracts to read and facts to digest, and while the question in regard to the liquidating dividend is a difficult one to digest the facts and apply the law, yet, insofar as having the case published, it would not be necessary to publish several cases on the same subject of liquidating dividends when we have the law and regulations and maybe one or two other cases on it..

Mr. MANSON. If it is not clear to you, Mr. Armstrong, with all of the experience that your men have in this particular field, as to whether or not this question has been settled by a published ruling, would it not be much more difficult for the ordinary lawyer in general practice, who may be advising or representing the taxpayer, or for the ordinary taxpayer, to determine what precedent, if any, governed his particular case?

Mr. ARMSTRONG. I would say that the ordinary taxpayer would probably never have a case like that.

Mr. MANSON. I understand; but the purpose of the publishing of rulings is that some taxpayer may have a case that is going to be covered by that ruling. Is not that true?

Mr. GREGG. May I answer your question there, Mr. Manson?

Mr. MANSON. Certainly.

Mr. GREGG. Assuming that a question is submitted to the rules and regulations section for an opinion. They are doubtful on it, and they send it to the solicitor for approval. It may be a case where the ruling is just limited to that case; it is a peculiar situation, which may not arise again, and it may not be of any value as a general precedent.

Mr. MANSON. Can you imagine, Mr. Gregg, any question that can be raised under the income tax law that may not subsequently be raised in another case?

Mr. GREGG. Yes; there are plenty of them.

The CHAIRMAN. Give us an example of the kind of case, so that we may have it clearly on the record.

Mr. GREGG. I will tell you the type of case that probably illustrates it best. There are a good many exemption cases written up in the rules and regulations section, and probably all of them are sent to the solicitor's office for approval.

The CHAIRMAN. When you say "written up in the rules and regulations section," you mean written up in the rules and regulations section and not published?

Mr. GREGG. No; I was coming to that. They are written up in the rules and regulations section and sent to the solicitor's office for approval. The question comes up for consideration as to whether they should be published, and there are not a great many of them published. The Bulletin is now full of rulings on these exempt corporation cases. Any general question has already been covered, but in the matter of applying the ruling to this particular case, the published rulings may be difficult; so it is submitted to us, and the decision has no value whatsoever as a precedent.

Mr. MANSON. Is it not true, for instance, Mr. Gregg, in almost any case that comes before the Supreme Court of the United States; the common law is a thousand years old or older, and every case that

comes before the Supreme Court of the United States is a question of the application of principles of law to a particular situation; and is it not just as true of the rulings of the Income Tax Unit as it is of the decisions of the Supreme Court of the United States, that the only way that you could get a settled body of law on this subject is by the application of the statute or the regulations to particular cases?

Mr. GREGG. That is true; but you see, the volume of letters coming out of the office is so great that if you publish them all you would just confuse rather than help.

The CHAIRMAN. But I asked Mr. Gregg to give us a case so that we could visualize what kind of a case might arise that would never arise again.

Mr. GREGG. I attempted to give it in reference to exempt corporation cases. We have to rule on every corporation that claims exemption. Section 231 granting exemption is quite a long section, and I think it exempts some 12 different types of organizations. We have to pass on every one of them when they apply for exemption. Now, it certainly is not necessary to publish our ruling in each case.

The CHAIRMAN. Outside of those exempt corporations which are mostly considered, I suppose as educational, philanthropic, and charitable, are the only other cases in ordinary business where you might not have published rulings, or where you may not think it necessary to publish the rulings.

Mr. GREGG. I can not think of a specific case now.

Mr. ARMSTRONG. I can give you a type of case there. We have a reorganization case, and the question involved is whether or not there is any taxable profit to the shareholder. We are pretty sure in the rules and regulations section that the decision here is correct. It is a large case and a lot of people are affected—the shareholders. We think that case should go by the solicitor's office, although there is probably enough precedent to warrant a decision, but we would rather have the solicitor's opinion on this particular case before it goes out to the corporation to be disseminated to the shareholders.

Mr. MANSON. Yes; but, Mr. Armstrong, the question that has been the basis of all of this discussion was, in substance, this: That in a case where it is doubtful in the minds of your own reviewing unit or section as to whether or not that question is governed by precedent, or as to whether it is a new question with new angles to it, all of those rulings are submitted by you to the solicitor, and are published if approved by him?

Mr. ARMSTRONG. No: they are not all published.

Mr. MANSON. Now, then, Mr. Armstrong——

The CHAIRMAN. Well, I understand that. I think that is clear to the committee, but Mr. Gregg has stated that novel questions arise in those standard cases that we have just referred to, and which may never arise again, and for that reason they do not think it worth while to publish the ruling. I think the committee ought to have a specific case where they conclude that the same question may not arise again, because I, for one, would like to know what question would arise with one taxpayer that may never arise again with any other taxpayer. I think Mr. Armstrong or Mr. Gregg ought to be

able to give us one case where they do not publish the ruling, because they think the question will never arise again.

Mr. GREGG. I was trying to find one which has been published and which I do not think there was any reason for publishing. There are a great many of these cases. I might add, that are not published, because it is impossible to delete the facts sufficiently for it to be permissible to publish them.

Mr. MANSON. In other words, in a case of that sort, where the facts are so peculiar that you could not so state them as to conceal the identity of the individual or the corporation involved, do you withhold that from publication, even though the question is a novel question, not covered in some published ruling?

Mr. GREGG. No: if the case involves a point which can be stated hypothetically, it will be published, but if it is so tied in with the facts of that case and depends so much on the facts of that case that you can not delete the facts and keep to the opinion, then it is not published.

Mr. MANSON. Even though it be a novel question?

Mr. GREGG. Yes; there is no way in the world of publishing it.

Mr. MANSON. These rulings which emanate from the rules and regulations section and are approved by the solicitor, and are published, are known as income-tax rulings. And that is the designation that they have, is it?

Mr. ARMSTRONG. Yes.

Mr. BRIGHT. Yes, sir.

Mr. MANSON. Is there any distinction between income-tax rulings and income-tax memoranda?

Mr. ARMSTRONG. At the present we have our solicitor's recommendations, which are published; the solicitor's memoranda may be what you have reference to——

Mr. MANSON. There is only one class of rulings, then, that emanates from your section?

Mr. ARMSTRONG. Yes; that is those known as the "I. T.," the income-tax decisions. That is the only class of decisions we prepare.

Mr. MANSON. After that has been approved by the solicitor and has been published, is that considered as a binding precedent for the government of the unit in subsequent cases?

Mr. BRIGHT. I would say so, if the facts surrounding the question are the same all the way through. Some conditions might arise under the ruling which was given with reference to a certain section of the law which did not exist in this particular ruling. A ruling would then be requested on that particular question.

The CHAIRMAN. I understand your answer is that there is no difference between an income-tax ruling and an income-tax memorandum?

Mr. BRIGHT. There are no income-tax memorandums, Senator.

The CHAIRMAN. What did you mean, Mr. Manson, when you raised that question.

Mr. MANSON. I understood that there was another class of rulings. I am looking for information here. I am not informed on this subject.

Mr. ARMSTRONG. There is the solicitor's memorandum. Maybe that is what you have in mind. That is the memorandum of the solicitor on the specific case coming up from the audit.

The CHAIRMAN. And which is not considered a ruling for all cases?

Mr. ARMSTRONG. There are a great many of those cases in which the decisions are not prepared in form for publication. It may be the question of the validity of a waiver or something of that kind.

Mr. BRIGHT. Administrative.

Mr. ARMSTRONG. Administrative matters. It may be a question of interest. Most of those are not important enough to publish.

Mr. MANSON. What is the difference between a solicitor's memorandum and a solicitor's opinion?

Mr. GREGG. The solicitor's memoranda are written in cases where they are not as important and have not the general effect that the questions considered in the solicitor's opinions have.

Mr. MANSON. What is the solicitor's recommendation? Is that a third class?

Mr. GREGG. That is a third class. You know how the organization of the office functions in handling appeals from the Income Tax Unit?

Mr. MANSON. No; I want you to trace such an appeal. How does it get to the solicitor's office?

Mr. GREGG. That is an entirely different matter from what you have been discussing.

Mr. MANSON. Yes; I understand it is.

Mr. GREGG. Do you want to jump to that subject?

Mr. MANSON. I want to know about the solicitor's opinions, the solicitor's recommendations, and the solicitor's memoranda. How do the questions which finally culminate in those three classes of rulings reach your office?

Mr. GREGG. Do you just want the income-tax side of it?

Mr. MANSON. Yes.

Mr. GREGG. With reference to income-tax matters, the office is divided into interpretative division No. 1, which handles a portion of the work, into the so-called review division and penal division, and then, of course, the civil division handles the court cases, but that has no bearing on this matter.

Interpretative No. 1 gets two types of cases; first; the cases that are submitted by the Income Tax Unit for an opinion.

Mr. MANSON. Who submits them?

Mr. GREGG. The auditor handling the specific case will see this question, or the head of the division will see it, and the general question is submitted to the solicitor for an opinion. They will all come from the Income Tax Unit.

Mr. MANSON. That question arises out of some particular case that is in process or that is being considered in the engineering or some other division.

Mr. GREGG. Yes. Take this case, for example, to be more specific: In consolidated returns, in one case they raised a question of how the net loss provision of the statute should be applied to a consolidated group, when the corporations forming the consolidated group were different in the three years affected by the net-loss provision. One case raised just one point on that general subject. The head

of the division, seeing that the question would come in in many different forms in other cases, submitted a request for a general opinion, asking the solicitor's office to give a ruling on the whole subject. That comes to interpretative No. 1 for an opinion. I think the opinion covered some 10 or 15 different points on the subject, and it was sent back to the Income Tax Unit for its guidance.

Mr. MANSON. That question was first raised, I suppose, by some auditor, who went to his chief with the question: the chief of the section went to the head of the division, and the head of the division then determined the solicitor's opinion should be had upon that subject. Under the office regulations, that is one of the conditions under which the head of a division is supposed to call for a solicitor's opinion.

Mr. BRIGHT. There are no written instructions, Mr. Manson, with reference to that question. There has been a general understanding from the time of the organization of the Income Tax Unit, that questions of a novel nature should be submitted to the solicitor's office. Under the old procedure, the question was routed through the rules and regulations section first, and then to the solicitor's office, or direct to the solicitor's office for an opinion on the matter.

Mr. MANSON. Then, that is left entirely to the discretion of the head of the division as to whether he will ask for a solicitor's opinion, is it not?

Mr. BRIGHT. That is correct, subject, of course, always to our review organization. At the time we established our review organization——

Mr. MANSON. What do you mean by the "review organization"?

Mr. BRIGHT. The review section in each division, which reviews the case after the auditor has completed his work and passed it through his unit and through his section chief. He may at the same time have taken the matter up with the head of the division and have had an opinion given him as to how it should be handled. Nevertheless that case is reviewed in the review section.

Mr. MANSON. Yes; but that review section is under the head of the division, is it not?

Mr. BRIGHT. Yes.

Mr. MANSON. And if the head of that division determines that he will pass judgment on that question, instead of asking the solicitor's office for an opinion, the review section has nothing further to do with it.

Mr. BRIGHT. Oh, yes, it does. Memoranda have been prepared in cases showing that the head of the review section was not in agreement with the head of the division and the matter has been referred to my office. I have in turn referred the matters to the solicitor's office.

Mr. MANSON. Is it not discretionary—here is the head of this review section; the chief of that review section is a subordinate of the head of the division.

Mr. BRIGHT. Yes.

Mr. MANSON. If the head of the review section determines that the solicitor's opinion should be had, he prepares a memorandum on that subject, does he not, asking for an opinion?

Mr. BRIGHT. Yes.

Mr. MANSON. That memorandum goes to the head of the division, does it not?

Mr. BRIGHT. Yes.

Mr. MANSON. Assuming that in this particular case, when this case was in audit, the chief of the audit section that had the case came to the head of the division and asked for his construction of the law on this question, and the head of the division passed upon the question; the case then goes through the review section in the same division, and the head of the review section also thinks a solicitor's opinion should be had on the question; he goes to the head of the division, and the head of the division says to him, "I passed on that question." Is there any way for that question to reach the solicitor?

Mr. BRIGHT. No; not under our rules.

Mr. GREGG. At this point I think I might refer to a conversation that Mr. Nash, Mr. Bright, and I had yesterday along this line. Your point is not a new one, Mr. Manson. It is possible that in the past that type of question had been decided in the unit without its being submitted to the solicitor, which has given rise in some cases to this very embarrassing situation, that the case would be decided in the unit on this point; and the entire case would be audited on that theory, and possibly a year's work done on it, and it would then come through our office, the claims section, for review, and we would differ with the decision previously made on that point.

Mr. MANSON. That is where it involves a refund?

Mr. GREGG. Yes; that is not true in all cases, but just where it involves a refund.

Mr. MANSON. Yes.

Mr. GREGG. We would send that back then, and it may be necessary to rework the entire case because of our decision. What we were trying to work out was some way of getting those cases to the solicitor's office for an opinion, those which should come. Of course, it is only a small fractional port of the cases that it is possible to come to the unit before they are decided.

Mr. NASH. Mr. Bright and I went over that situation yesterday and decided tentatively that what should be done is this—and I think our recommendation on it will be put into effect just as soon as possible: Have men from the solicitor's office, still responsible solely to the solicitor, in the review divisions of these different sections for the purpose of seeing those cases which should go to the solicitor's office, whether they involve a refund or abatement, or just a matter of an additional tax, and send them over there at that time for consideration.

The CHAIRMAN. Up to this time, then, as I understand it, a case such as has been described by Mr. Manson may be closed in the section or division without going to the solicitor's office, no matter how much disagreement there may be between the head of the review section and his superior officer, the head of the division?

Mr. GREGG. Of course, he could take the case to the deputy commissioner and have him send it over to us.

Mr. MANSON. That is, you mean the head of the review section might?

Mr. GREGG. Yes, sir; and Mr. Bright sent me a case about three days ago, and those were the facts.

Mr. MANSON. Well, it is not the general practice, is it, for the head of the section who disagrees with the chief to go over his chief's head and take a case up to the solicitor?

Mr. BRIGHT. No; it is not a general practice, but those questions arise, Mr. Manson. They will come up occasionally, and they are called to my attention by heads of divisions, where there have been matters of dispute.

The CHAIRMAN. And there is nothing compulsory about it?

Mr. BRIGHT. There is no written order on that. There has not been up to this time.

Mr. GREGG. That is where Mr. Nash and I got into it.

Mr. MANSON. I recall a case which has been presented here where the question involved was whether the regulations permitted the filing of amended returns for the purpose of charging to expense certain items that had been capitalized in the case of an oil well.

The CHAIRMAN. That was the case of the Standard Oil Co. of California, was it not?

Mr. MANSON. I do not recall the name of the case, but I recall the facts. Yes, I believe it was.

In the first place, that case went to the rules and regulations section. They held that the regulations did not permit the filing of amended returns for that purpose. They sent the case to the solicitor's office. The solicitor sustained the rules and regulations section and held that such returns could not be filed for that purpose. The case went back to the engineering division, and I recall that the chief of the section wrote a memorandum in that case, in which he took the position, which is rather novel to a lawyer, that the matter of the construction of the rules and regulations was not a question of law: therefore, the solicitor's opinion should be ignored.

Now, I am wondering whether, in case the division—the head of the division in that case also took the position that notwithstanding the fact that the solicitor had ruled upon this question, the question was still an open question, and I am wondering whether, under conditions of that sort, where the chief of the section determines upon a construction of the law, where the chief of an engineering section construes the regulation or construes the law and the head of the division agrees with him—whether, under such conditions, if the case does not involve a refund (and in this case there was a refund involved), there is any way for that question to reach the solicitor's office?

Mr. BRIGHT. Heretofore there have been no established rules on that subject, Mr. Manson. That is why this question was raised by Mr. Nash and Mr. Gregg. I raised this subject two years ago in the Tax Simplification Board. The matter was up with the solicitor at that time, and probably it was not gone into as deeply then, because there had not been so many issues raised in connection with audit and engineering matters as recently, due to this investigation. My request was to have a lawyer in each review section of the Income Tax Unit, where they might review all types of cases.

Mr. MANSON. Does that include the engineering division?

Mr. BRIGHT. Yes, sir.

Mr. MANSON. I do not know as it is within my province to make suggestions, but I would like to ask whether Mr. Bright does not

believe that there should be a hard-and-fast rule that questions involving the construction of the law, involving the construction of the regulations, or the application of ruling, are questions of law which should be submitted to a lawyer for determination?

Mr. BRIGHT. I certainly do. I can not answer that in any other way.

The CHAIRMAN. I want to point out the viewpoint that I have gotten from hearing the testimony in the case of the Standard Oil Co. of California.

Assuming that there was no refund or rebate at issue, that the case was not settled, it was under discussion; the rules and regulations section had given an opinion, and the solicitor had given an opinion, the commissioner had ruled upon it, and the chief of the engineering section disagreed with them all. There is nothing that I have observed in the rules, nor have I discovered anything in the methods of procedure, whereby the chief of the engineering section may not still carry out his own opinion without being caught at it. In other words, he has refused so far to acknowledge this opinion to be correct. It goes back to him, and he makes a settlement of the case adverse to the opinion of all of those others. Having done so, he agrees with the taxpayer, and, of course, there is no issue. He settles the case, it is audited, and closed on that particular basis. There is no check anywhere that I have been able to see to show that he has not settled the case in accordance with all of these opinions which have been rendered.

If there is any way of catching a case like that, I wish some of the representatives of the bureau here would tell me about it.

Mr. MANSON. When that case reaches the auditor, the auditor, if he questions the judgment of the engineer, may raise the question——

The CHAIRMAN. Oh, but if he agrees with the engineer, what then?

Mr. MANSON. Here is the dangerous situation, in my opinion:

We will say this question of law arises in connection with the determination of the question of depletion. The engineers have determined depletion and have sent their report on to the auditors. Of course, an auditor may review the engineer's work in arriving at the depletion unit, but the presumption is that he is going to accept the depletion unit as determined by the engineer and not go behind those units to see whether there might have been some question of law involved back there in the engineering work.

I do not take it that it is any function of an auditor to go behind an engineer's report. He may do it, however, and in former cases that have been brought to the attention of the committee the auditors have done it; but ordinarily I do not take it that it is the function of an auditor to go behind an engineer's determination of the units of depletion and find out how he arrives at it.

Is not that correct?

Mr. BRIGHT. I should say that is correct to a certain extent, but auditors do go into these questions. They have gone into engineering questions and corrections have been made, and there have been joint conferences between auditors and engineers. I know of instances, when the auditor and engineer were located over in the Interior Building, where they would even call in an attorney from the solicitor's office.

Mr. MANSON. I know that sometimes auditors do it. In other words, an auditor will have discharged his full duty to the unit——

Mr. BRIGHT. By accepting the depletion unit?

Mr. MANSON. By accepting the depletion unit, and never attempting to go into the methods pursued by the engineers in determining depletion, amortization, or any other matter that the engineers report upon. Is not that true?

Mr. BRIGHT. That is correct.

The CHAIRMAN. I still have not had an answer to my question as to that case that I asked about before Mr. Manson interposed his remarks.

Mr. GREGG. Can you answer it, Mr. Bright?

Mr. BRIGHT. Mr. Chairman, in answer to your question, the particular point that was involved there is more of an audit question than it is an engineering question, therefore the question would certainly be raised in the audit section at the time the case went through.

The CHAIRMAN. But I still have the assumption that the auditor agreed with the engineer on the interpretation of the facts. Then there would be no way of knowing whether the solicitor's opinion had been followed or not, would there?

Mr. BRIGHT. I certainly do not think it would be passed by the reviewing auditors.

The CHAIRMAN. But supposing it was passed by the reviewing auditors, there would be no check up to find whether the opinion of the rules and regulations section and the solicitor's opinion had been followed.

Mr. BRIGHT. Of course, that is true, but that is what the review section is there for.

The CHAIRMAN. But he is still subordinate to the head of the audit section, you say?

Mr. BRIGHT. Of the division.

The CHAIRMAN. And I said that the auditor agreed with the chief of the audit section, and the chief of the engineering section contended that the solicitor was all wrong, and there would be no way of knowing whether the solicitor's opinion would be carried out or not.

Mr. BRIGHT. There is no check other than the review auditor.

Mr. NASH. Mr. Chairman, I want to say that we assume that some of these men are going to be reliable enough and honest enough to call it to the attention of their superiors if there is a general disregard for solicitor's opinions or rulings. It is understood down in the unit that solicitor's rulings and solicitor's opinions, or any other ruling coming from the solicitor, must be respected, just the same as a commissioner's order must be respected.

Mr. BRIGHT. Yes.

Mr. NASH. And if the head of a division takes it upon himself to disregard a solicitor's opinion, it does not mean that everybody around him must do the same thing.

The CHAIRMAN. I understand that; but in this case the head of the engineering section seems to have been very arbitrary in the position he has taken. The records all show that he has, and I want to know how it was that he could still maintain that position and get away with it?

Mr. GREGG. Not unless you assume that everybody else around him takes the same position, that the reviewers in the audit section and the head of the audit section have the same opinion that he has and take the same position on it.

The CHAIRMAN. That is what I mean.

Mr. GREGG. Well, if you assume the whole——

Mr. MANSON. He determines depletion in that case based upon the amended returns. The auditor in that case would discharge his full duty to the Government, would he not, if he accepted the engineer's determination of depletion?

Mr. NASH. I would say that he would not if there was a solicitor's opinion in the file on that case which called to his attention the fact that the solicitor had passed on it and recommended a certain procedure to be followed. Then, if that procedure is disregarded, it is the duty of that auditor to call it to the attention of somebody higher in authority.

Mr. GREGG. And it would be the duty of anybody that came in contact with it.

Mr. MANSON. Assume that same case that we have been discussing. Suppose the head of the oil section had entertained the same view when he called upon the rules and regulations section for an opinion that he entertained after he got the opinion, namely, that it was not a matter of a question of law but was properly a matter to be determined by the engineers, and he never called for this opinion from the rules and regulations section. The question would never have reached the solicitor in the first instance, because it reached the solicitor in this case through the rules and regulations section. In that instance that case would have been closed and have gone to audit with the depletion units determined. There would have been no memorandum in the record from the solicitor and no memorandum in the rules and regulations section to call the auditor's attention to the question. Would not the auditor, under those conditions, have discharged his full duty by accepting the engineer's determination of the depletion unit and have audited the case?

Mr. GREGG. Possibly so; but it so happens that in that particular case that question was raised by the audit section.

The CHAIRMAN. Yes, sir; but we are assuming that it was not raised. We are assuming that it was the general practice. That might happen, might it not?

Mr. GREGG. Yes; a case could be decided in the unit on legal points, without its going to the solicitor. That is what brought forth our session of yesterday.

Mr. MANSON. But the chairman made the suggestion that that case could go clear through to the audit and be closed. Is it not also true that not only that case but all similar cases, involving the same question, could go through the unit without there ever being a published rule upon the subject, provided the determination was satisfactory to the taxpayer?

Mr. GREGG. Yes; if it were never submitted to the solicitor.

Senator JONES of New Mexico. I am still traveling in a mental maze regarding the question as to who decides what rulings shall be published. I have listened to a whole lot of discussion here, questions and answers, and thus far I have not discovered any individual who is responsible for the publication of any decision.

Mr. GREGG. Let me answer, Senator. The rulings that go out from the solicitor's office, the solicitor's opinions, have attached to them, as the Attorney General's opinions have, a memorandum to the effect that any objection to the publication of this ruling by the audit divisions should be made within 30 days and, if not, we will consider that they agree——

The CHAIRMAN. You say "We." Whom do you mean by "We"?

Mr. GREGG. The solicitor's office.

The CHAIRMAN. The solicitor's office decides what rulings should be published, then?

Mr. GREGG. On some rulings: yes, sir; on the rulings which it issues itself.

Mr. MANSON. Is not that same thing true of rulings that come up to it from the rules and regulations section?

Mr. GREGG. Yes; that is decided, first, by the rules and regulations section, but we have the final say on it, then.

Mr. MANSON. Yes.

Mr. GREGG. The solicitor's office passes on the question of publication.

Senator JONES. That had not been made clear to me before.

Mr. MANSON. To get back to the question that I asked Mr. Armstrong, and which I do not think has been answered, as to the percentage of the rulings that you send to the solicitor upon the ground that they are novel rulings, or that they cover novel questions, what percentage of those rulings finally reach publication?

Mr. ARMSTRONG. I do not know that I could say the exact percentage. I have never counted them.

Mr. MANSON. Well, could you make a stab at it?

Mr. ARMSTRONG. I would say 70 per cent of the rulings which are passed on by the solicitor are submitted for publication, and that after they are submitted, possibly there is——

Senator JONES of New Mexico. Submitted to whom?

Mr. GREGG. To the solicitor.

Mr. ARMSTRONG. To the solicitor. They are submitted in the form of a bulletin, which goes to the solicitor for review.

Senator JONES of New Mexico. Who prepares that?

Mr. ARMSTRONG. It is prepared in the rules and regulations section. We have a separate unit in the section for that purpose. It might be termed an editorial or publication unit, which gathers this data together. Four carbons are prepared, and it is finally sent to the solicitor for review. After it is initialed by the solicitor it goes to the Government Printing Office.

Mr. BRIGHT. Mr. Armstrong, does not this answer Mr. Manson's question with respect to the percentage of cases that are published of those submitted from your office, through the solicitor's office, and are finally approved and become income-tax rulings? The percentage of those that are published is approximately 70 per cent?

Mr. ARMSTRONG. Yes.

Mr. BRIGHT. All rulings, as I understand it, income-tax rulings, solicitor's opinions, solicitor's recommendations, and solicitor's memoranda, are routed through the solicitor's office for his approval. Those emanating in the solicitor's office have attached to them a memorandum routing them back through the rules and regulations

section and the audit section for their comments as to whether or not they may have any objection to the ruling as made. Then they are returned to this editing section, as you might call it. If there are no objections they are then prepared for the bulletin, if they are to be published. The bulletin is then sent to the solicitor's office, where all matters are again reviewed. In a few instances the solicitor's office will take out a ruling that has been approved and submitted for publication, due to the fact that the matter contained therein has been previously published.

Does not that answer the question, Mr. Armstrong?

Mr. ARMSTRONG. Yes; that is correct.

Mr. MANSON. Now, I understand your answer to be that about 70 per cent of the rulings that you send on as being, in your judgment, noval are accepted for publication?

Mr. ARMSTRONG. Yes.

Mr. MANSON. And finally they reach publication?

Mr. ARMSTRONG. Yes.

Mr. BRIGHT. Mr. Manson, may I add right there that the other rulings which go out from Mr. Armstrong's section, under his signature and for my signature, are based on the regulations or on published rulings, and in every instance the regulation is quoted or the ruling is quoted in the letter?

Mr. MANSON. That was not my question. My question to Mr. Armstrong, which I put several times, is this: That where, in the judgment of Mr. Armstrong, or the lawyers or experienced men in his section, who, I assume, are specialists in this line, the question is a novel one and for that reason the ruling is sent to the solicitor, with their recommendation that it be published, what percentage of that class of rulings reaches publication?

Mr. BRIGHT. He says 70 per cent.

Mr. ARMSTRONG. No——

Mr. BRIGHT. You would say more than that, would you?

Mr. ARMSTRONG. I thought you meant the total number which are signed by the commissioner and which are approved by the solicitor. I should say 70 per cent.

Mr. BRIGHT. If I understood it correctly, Mr. Manson asked this question: What is the percentage of the cases arising in your section which involve a novel question or a question on which no precedent has been established, within the bureau as a whole, including the solicitor's office and the Income Tax Unit, which reach publication, and you said that 70 per cent of the I. T.'s. That is your answer, is it not?

Mr. ARMSTRONG. Yes.

Mr. BRIGHT. The I. T.'s are those which are prepared in your section for the commissioner's signature and are routed to the solicitor's office for approval, and if approved they are then signed by the commissioner, and 70 per cent of those rulings are published.

Mr. ARMSTRONG. That is what I understood it to be.

Senator JONES of New Mexico. Let me ask a question there? As I understand it, you do not send anything to the solicitor's office unless you think it is a novel question or doubtful as to whether it is or not. Of all the cases which you send to the solicitor's office how many decisions are published?

Mr. ARMSTRONG. Well, that is what I intended to answer. I should say approximately 70 per cent. I never counted them, but that is my opinion this morning from memory.

The CHAIRMAN. Have you any particular things in mind, Mr. Manson, that raised this question this morning? As I recall it, one of our staff has been checking up some of these unpublished rules and regulations.

Mr. MANSON. Yes. I have no report on that checking up as yet. What I am trying to do is to get, for the information of the committee, what the procedure is which brings questions to the point where they reach publication.

The CHAIRMAN. One of your problems in the Income Tax Unit is the enormous turnover of help, is it not?

Mr. BRIGHT. There is no question about that.

Mr. MANSON. That is one of the most serious problems, is it not?

Mr. BRIGHT. Yes.

Mr. MANSON. That problem is aggravated and is to a very large extent brought about by the fact that the bright, capable men employed in the department gain a knowledge of the methods of ascertaining the tax, which can not be gained by reading the publications of the department, is it not?

Mr. BRIGHT. Well, I would say that this could not be gained by reading the publications of the department, but it certainly is due to the education that they receive.

Mr. MANSON. In other words, there is a whole lot to know about how deductions are measured, about the formula used, about the practices, for instance, that have been established by the different audit divisions and in the engineering division, to which taxpayers have taken no exception, and therefore they have never found their way into the publications. That fund of information has made the best men in the department, at least many of the best men in the department, of particular use to taxpayers on the outside and is to a certain extent responsible for the enormous turnover in your help, is it not?

Mr. BRIGHT. I would say that the knowledge gained in the unit has been valuable to them, in that they can receive greater compensation on the outside than the Government has paid them in their positions in the unit. If adequate salaries could have been paid our men in the beginning, I believe they would have stayed.

Mr. MANSON. On the other hand, do you not believe that were it possible for the general practitioner of law and the general practitioner in accounting to ascertain from the publications of the department how the taxpayer's tax liability is measured there would be less premium upon this special knowledge, which can only be gained inside the department?

Mr. BRIGHT. Well, there is only one answer to that, and that is yes.

Mr. NASH. Mr. Manson, I think at this point it might be well to state that the publication of rulings is something that has taken place within the last two or three years. Prior to 1922 very few rulings, outside of Treasury decisions and regulations, were published. The department in the last three years has been amplifying its published rulings very much, and within the last year, as has

been explained this morning, every ruling of general application, or that can be divorced from a specific case, is published.

The men who have left the bureau are men who did have knowledge of the rulings before there was a general policy of publishing the rulings, and it is true that they did sell their knowledge. This very situation led us to publish these rulings.

Mr. MANSON. But you do not think that the extension, if I may use that term, of the policy of publication has had something to do with the lessening of the turnover?

Mr. NASH. It may have. We have had this situation, Mr. Manson, where a great many high-grade technical men came into the bureau with the thought in mind of staying only a year or two years to familiarize themselves with the procedure and then getting out. There was no way of retaining those men, because they left salaries greater than we could pay when they came in and they stepped out into even greater salaries.

Mr. MANSON. We have developed here in general terms the fact that there are still many practices, as you might call them, of the department with reference to the measurement of the tax liability that never do find their way into any form of publication. For instance, I might call attention to the different rules that have been followed for the ascertainment of deductions for amortization. I have been unable to locate more than one published ruling upon that subject, and I have not been able to locate a single case in which that ruling has been followed.

It is manifest to me that a taxpayer who has a claim for amortization would have a great deal of use for the services of some one in the department who knew the yardsticks that have been applied for the purpose of measuring that kind of a deduction.

The CHAIRMAN. That might also apply with respect to oil depletion.

Mr. MANSON. I do not know of any ruling or any publication of the department which incorporates any formula used for the purpose of measuring the value of anything, except in the case of sale of stock or bonds. I may be wrong about that; and I do not make it as a statement of fact. So far as my research has been able to carry me, I have been unable to find any publication which lays down the procedure followed for ascertaining the value of mines, the procedure followed for ascertaining the value of oil wells, or for ascertaining the value of anything, except that there are some rulings on the question of ascertaining the 1913 value, or retrospective appraisal of a manufacturing plant, or anything of that sort.

Mr. BRIGHT. There is the Oil and Gas Manual. I do not know how far that went in the determination of values and depletion.

Senator JONES of New Mexico. In that connection, Mr. Manson, do you think it would be advisable for some one in the unit to go through these decisions and try to get up some typical decisions bearing on these various questions to which you have just referred?

Mr. MANSON. I was just coming to that. I was going to make this suggestion: I was going to ask whether the formula used, for instance, by engineers for the purpose of measuring amortization has ever been reduced to writing in the form of instructions for the engineers?

Mr. BRIGHT. No; not that I know of.

Mr. GREGG. I think I can answer that. The whole question of the formula for determining value in use is under consideration in the solicitor's office now, and whatever conclusion is reached there will be published.

Mr. MANSON. Yes; I understand that, but I would call attention to the fact that while that is under consideration now, there have been about $600,000,000 of allowances made, or approximately that.

The CHAIRMAN. And it is a pretty late date to make rules and regulations covering that now.

Mr. MANSON. My suggestion, in response to Senator Jones's question, is this: That a large body of the information which it would be necessary for a taxpayer, or a lawyer, or an accountant to know in order to be able to determine tax liability without the assistance of a former employee of the department has never been reduced to writing in any form, and that, in my judgment, the first thing that should be done is to know just exactly what they are doing now with amortization; namely, determine a policy, reduce that policy to writing, and publish it in some form, and that there should be some provision of the law providing that no determination of tax not in accordance with a published ruling shall be final.

The CHAIRMAN. I think that is a very sound viewpoint.

At this point, it occurred to me, with reference to Mr. Manson's statements and Mr. Nash's and Mr. Bright's confirmation of them, that many of the employees have left the bureau to go in private practice and private service, whether or not this rule, or a statute, or both, prohibiting these men from practicing before the bureau is really effective, in view of the fact that in going over some of the files I have found a case where a man had been employed by Mr. Doheny at $15,000 a year, as I recall it, while in the service of the bureau. The question was raised whether he should receive his two week's vacation with pay and still serve Mr. Doheny, and I think the bureau properly ruled that he could not serve Mr. Doheny and the Income Tax Unit at the same time. But there was nothing under the statute or under the law to prevent his going to Mr. Doheny and working for him, so long as he does not appear before the bureau. In other words, he might transmit his information and his knowledge and his experience with cases and settlements to Mr. Doheny's lawyers, or to Mr. Doheny, and they could go to the bureau and take advantage of all of that without being affected at all by the two-year limitation.

Is it not also possible for one of these men to join a legal firm, a law firm, and not appear before the bureau, but transmit the knowledge and information gained there to some other lawyer who will appear before the bureau?

Mr. NASH. I think regulations 230 of the Treasury Department provide that no firm of lawyers or accountants can employ a former employee of the Treasury Department and present any case on which he had knowledge within the two-year period any more than he could himself.

The CHAIRMAN. He may not have knowledge of a specific case, but he does have all the information that we have been talking about, about the rules and regulations and the way to route them through the bureau, in addition to these formulas, etc.

Mr. NASH. He could not appear in any cases that were pending in this division, or that he might have been associated with in any way. The committee on enrollment and disbarment passes on such cases.

The CHAIRMAN. But I think you still miss the point. He may not have dealt with any of the cases that were pending in the division when he worked there, but he may have all of this general knowledge which you have described and he may have transmitted it.

Mr. NASH. He may have general knowledge of the procedure.

The CHAIRMAN. Yes.

Mr. MANSON. Take this illustration: A taxpayer actually has a claim for amortization, but he does not know it; he does not know that he has such a claim or that, for instance, the solicitor's opinion published in the J. I. Case case is the law on the subject, and that under that opinion he can not figure out a claim. That is the only publication there is. Therefore, he has filed no claim for amortization; there is no claim pending before the Income Tax Unit.

An engineer who knows how to figure out a claim for that man, and he knows that the solicitor's opinion is not regarded in the unit as binding upon the unit, can go to that taxpayer and show how he can frame up a claim and present that claim, and because of the fact that there was no claim pending by that taxpayer for amortization, I do not know of anything under the two-year statute which prevents that engineer from representing that taxpayer. There is not. He can do it the very day after he steps out of the bureau, and there is nothing in the statute at the present time that prevents it, and I do not think there is anything in your regulations, either; is there?

Mr. NASH. Of course, that is a Treasury regulation and not an internal-revenue regulation.

Mr. MANSON. Yes.

Mr. NASH. I think, in the case you have cited, there is not any regulation to prevent that man from appearing.

The CHAIRMAN. As a matter of fact, he does not need to appear. He can just tip off the taxpayer, and then his lawyer can make the claim.

Mr. MANSON. He does not have to do that. He can go down there, enroll, and appear, and file his power of attorney. He can do that without any violation of the statute or any present regulation of the Treasury Department.

Senator JONES of New Mexico. May I inquire if any questionnaire is submitted to prospective employees as to their purpose in coming into the bureau, whether they are coming in for a permanent position there or whether they are coming in with the view which you expressed a while ago, Mr. Nash, of gaining this information and then leaving the bureau?

Mr. NASH. Senator, the condition of which I spoke existed several years ago, during 1919 and 1920, and it was such that we required employees, or people seeking employment, to sign a guaranty that they would stay with us for at least one year after we put them through their training course. If they did not stay at least one year, we would make our records show that they were dropped with prejudice and would not accept their resignations.

Mr. MANSON. How about enrolling after that to practice before the department? Did you have a provision as to that?

Mr. NASH. There was not any enrollment committee at that time. That is something of more recent growth.

Mr. BRIGHT. In answer to that, I know of one specific case where the party went out after the period of 10 months. He applied for enrollment and was refused. We would not permit him to appear until after his two years out of the department had expired. Then he was granted permission to do so.

Mr. MANSON. To get back to the publications, how long after an income-tax ruling is approved by the solicitor is it before that ruling reaches publication?

Mr. ARMSTRONG. It is practically three weeks.

Mr. MANSON. How long is it after the solicitor's opinion is promulgated before it reaches publication?

Mr. GREGG. The same thing—three weeks. And I will anticipate your next question. About seven or eight months ago we realized that there were a lot of old rulings which had not been published, such as that in the J. I. Case Threshing Machine Co. case.

Mr. MANSON. Yes; I recall that that was something over a year old at the time it was promulgated.

Mr. GREGG. We went through the files, getting the opinions which had been handed down and which had not been published, and then they were published. That was done within the last year and a half, I should imagine, and for that reason there have been, within the last year and a half, a great many rulings published which were handed down a year, or sometimes two years, before they were published. Then at that time we went through all the rulings to check them up to see which ones had not been published and which had been, and we then published them.

The CHAIRMAN. I do not suppose this committee gets any credit for that?

Mr. NASH. No, sir.

Mr. GREGG. No, sir; that was before the committee started its investigation.

Mr. NASH. Senator, that was in line with our general policy of publishing more of these rulings which I stated we had adopted about two years ago. At that time we appointed a committee in the solicitor's office to go over all of the old rulings of the solicitor and of the old committee on appeals and review. As they have reviewed those old opinions, they have been published in current bulletins.

Mr. MANSON. Another matter that we have not touched on, the rulings of the committee on appeals and review. Were they all published?

Mr. NASH. No, sir.

Mr. ARMSTRONG. No; they were not all published. Some of them were very short, especially in connection with that special committee that you were in charge of, Mr. Gregg.

Mr. GREGG. We did not write opinions.

The CHAIRMAN. You just decided them?

Mr. GREGG. We just decided them.

Mr. MANSON. Where opinions were written were they all published?

Mr. GREGG. No; they have not been. The work of that old committee is now handled by the review division of the solicitor's office. Comparatively few of those memoranda are published, the principal reason being that, in the first place, you can not separate the ruling on a matter of law from the facts of the case. It is practically impossible in those cases to so delete the facts as to enable you to publish the ruling. Again, a great many of them turn on their own facts. In other words, it is a matter of making a ruling which is specific and which is not a matter of general precedent. A great many of them we just reject and say, "This is covered by article so-and-so of the regulations." In that event it is rejected. Many of them are repetitions of questions which have previously been considered and the ruling published.

Mr. MANSON. There is no one outside of the employees of the department who has any knowledge of how those cases were decided, is there?

Mr. GREGG. Those cases?

Mr. MANSON. This grist of cases that you are talking about, on the law and regulations being applied to specific cases. There is no one outside of the employees of the department that knows how the law has been applied to those particular facts?

Mr. GREGG. No.

Mr. MANSON. Now, I get back to the proposition of the way in which the body of our common law was built up. It was by the application of the law by the courts to specific cases. It frequently occurs that the supreme courts of the States and of the United States will summarily dispose of a case by saying that "this case is governed by the decision in such and such a case," particularly where they decide a group of cases together, and I can see no reason for the publication of a ruling that this matter is disposed of by another ruling; but it does strike me that wherever the application of either the law, the regulations, or a former precedent to a case requires the preparation of an opinion; in other words, where it is not governed on all fours, so that it can be disposed of by a mere citation of a former ruling, it strikes me that if we are ever to get a well settled body of law upon this subject, with which taxpayers, lawyers, accountants, and engineers can become familiar, it is necessary to publish any ruling that requires the preparation of an opinion.

Mr. GREGG. I am very much inclined to think that we are publishing too many rulings now. I have always had the feeling that a ruling should not be published, unless it has some real value. There are so many cases where the ruling in a particular case is of no value whatsoever in any other case. If the committee will come down and look at them, particularly on these review cases, I think that they will appreciate it.

I was just glancing through the bulletin a minute ago to see if there was any case that I thought had been published, and which should not have been published.

Let me read a couple of rulings. This is from Cumulative Bulletin III-2, on page 122:

The fact that it was known during the taxable year that a debt might be uncollectible in some other taxable year does not warrant charging off the amounts as bad debts. The debts in question can only be taken as a deduction in the year when they actually became worthless. There is no authority of law

for apportioning a deduction for a bad debt over a period prior to the time when it became worthless.

The statute provides for the deduction—I can quote it, I think—of debts ascertained to be worthless and charged off during the taxable year.

That is so utterly obvious that I do not see why it should have been published.

Mr. MANSON. Somebody evidently raised the question and brought it up for determination.

Mr. GREGG. Yes, sir; we get letters every day from men, and they say, "I have a wife and two children, and my income is so much." He wants to know whether he has to make a return. He did not know that. We had to tell him, but there was no need of publishing the ruling.

Mr. MANSON. Do you regard that statute, Mr. Gregg, as being any clearer than the provision of the regulations which provides that the taxpayer shall have his option to charge development and expense of an oil well to either capital or expense, and that when that option is exercised it shall be binding?

Mr. GREGG. That is perfectly clear, but I can see how the question can arise as to what constitutes the election which is irrevocable.

Now, let me read you another ruling, on page 125, Cumulative Bulletin III-2:

What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of facts and will vary as between classes of business and with conditions of business prosperity. Consideration should be given to any abnormal business conditions which may affect the collection of accounts and notes receivable of the taxpayer for the year.

That, too, is perfectly obvious.

Mr. MANSON. Were you not reading the syllabus there?

Mr. GREGG. I was reading the syllabus, and I read the syllabus in the other case, too.

Mr. MANSON. Have they not really generalized that syllabus to a point where it does not mean much?

Mr. GREGG. That is possibly true. In the other case, in the first case I read, the opinion is just about as short, and it contains the same point as the syllabus. I have not read the opinion, the syllabus of which I was reading in the last case.

The CHAIRMAN. I will ask Mr. Gregg, at some subsequent hearing, to see if he can not bring us a few cases here in which no ruling was published or no decision was published, and which he thinks involves such questions as will never arise again.

Mr. GREGG. I can give the committee any number of cases where the ruling was not published, and in which I think it should not have been published, and I can give the reason.

The CHAIRMAN. Yes; but what the committee wants is a case where you think the question will never arise again, because you have referred to that to-day a number of times.

Have you anything else this morning, Mr. Manson?

Senator JONES of New Mexico. I would like to go into this question further for a moment.

Mr. Nash, what is the rule now regarding the employment of new people? Do you have some agreement with them as to remaining a specific length of time?

Mr. NASH. Yes, sir. An auditor must sign an agreement that he is going to stay at least one year before we put him into our training class.

Senator JONES of New Mexico. You spoke a while ago of some people coming there from positions which paid larger salaries than they were paid by the bureau. Do you ascertain such facts as that before the employment is made?

Mr. NASH. Senator, when the income tax law was new, in 1918–19, I think every accounting firm in the country of any importance let some of their staff come down here and go to work. Law firms did the same thing. They would send lawyers down here to work in the solicitor's office or in the rules and regulations section, or wherever we needed high grade technical people at that time. We took them, and we were glad to get them; and they did good work for the bureau while they were here. But they were people that professionally could earn more money than we could pay, and after they served their time they left us and went back to the places where they could get higher salaries.

Senator JONES of New Mexico. To what extent does that prevail at the present time, if at all?

Mr. NASH. I do not think that condition prevails at the present time to any extent, Senator. Our organization to-day is more stable than it ever has been before.

Mr. GREGG. That is still true of the solicitor's office. I do not believe that 25 per cent of the present list of men in the office intended to remain permanently. I think at least 75 per cent of them intend to get out eventually.

Senator JONES of New Mexico. Is it possible to bring about some change in that respect?

Mr. GREGG. Senator, I am trying to get them to stay.

Senator JONES of New Mexico. I can see how the bureau may become a school for the education of these people; that they come in there deliberately with the view of getting all the information they can regarding pending cases and all that sort of thing, although the cases may not come under their direct jurisdiction, and then they go out and profit by that knowledge which they obtained during the year or whatever the period of time may be that they remained there; and it strikes me, especially in view of your statement that 75 per cent of them come in there with that purpose in view, that that is rather an alarming situation.

Mr. Manson awhile ago referred to the fact that while the particular case may not come under the official eye of the employee he may obtain information regarding these matters and go out and stir up business.

For the moment I am not able to suggest any remedy, but is it not an alarming situation?

Mr. MANSON. My idea of the remedy is that there are two things that can be done to stop it. One is to reduce the premium upon this special knowledge by making the facts available, or making the law available, to the great body of lawyers, accountants, and taxpayers in the country who see fit to study them. That is one step.

The other step is recognition by Congress of the fact that this bureau involves higher-class requirements than the present salaries will permit taking care of.

Senator JONES of New Mexico. It strikes me that the situation is serious.

Mr. MANSON. I believe so; yes.

Senator JONES of New Mexico. And it ought to be changed, if it is possible to do it. Now, I am not prepared to say that you can't change it, because the very fact that 75 per cent of the force down there——

Mr. GREGG. That is just in the solicitor's office, Senator.

Senator JONES of New Mexico. Well, I am taking the solicitor's office, and I assume that while it may not be so large in other branches of the service, yet it prevails to a considerable extent. It may be that we can not pay high enough salaries to keep those men indefinitely, and that we could not get enough people in there to turn out the amount of work that is required, unless we took those whom we were sure were going to leave in a relatively short time; but, nevertheless, the gravity of the situation exists, and if there is any way that can be devised for remedying it, it should be done.

Mr. MANSON. Without reflecting in any way upon the personnel of the Income Tax Unit, it is manifest to me that this present situation leaves the mediocre for the work of the Government, and that the really high class, capable men are induced to get out and I firmly believe that the written formulation of the procedure of the office is a thing which I conceive could not have been done several years ago, which perhaps could not have been done two years ago, but which I believe can now be done, because I doubt whether there are many questions, whether there are very many formulas, whether there are very many practices that are going to be required, which have not already been brought to the attention of the bureau by a question that has been presented—by more definitely laying down of the law, as it was, in written form, and by the publication, the wider publication, of the rulings and not confining them to mere generalities, the situation could be remedied. Why, to me, the reading of these rulings in a body reminds me of trying to learn the law by studying a hornbook textbook. Nobody would ever think of preparing a law student and basing his case upon what he would get out of a textbook that lays down the law in such general terms as an ordinary law school textbook does. The way you get at the law of a case is by studying the application of that law to a particular case by the courts; but I can see no way whereby you can remove this special premium upon the information that the men in this bureau have, except by a wider publication of the rulings.

Senator JONES of New Mexico. Just thinking out loud, has not this situation developed, at least to a marked degree, through the prevailing public assumption that everything carried on in the bureau is at least semiconfidential; that it is a secret, star-chamber organization, and the workings of the bureau are supposed to be of a confidential nature; and would not publicity in the workings of the bureau, in a large measure, have an influence on this situation?

An outside auditor has no privilege, as I understand it now, of going into the auditing division of the bureau and finding out by a personal search or observation what is going on in the section, and in some of the various other sections.

I might say that, personally, I have been inclined to feel that there is much merit from the individual taxpayer's viewpoint in not having his particular facts understood by the public or available to the public; but in view of this situation, I am inclined to think that we may well consider the advisability of bringing about greater publicity of proceedings in the bureau.

I think that has application in direct line with what Mr. Manson has said, but I doubt whether you ever can, through the mere publication of rulings down there, bring to the general public a knowledge of the inner workings of the bureau.

Mr. MANSON. You can not do it under the present system, for the reason that there is so much involved in the determination of tax that never gets to the point of a ruling. In other words, there is only a ruling made when there is a controversy between a taxpayer and the bureau which can not be agreed to. Whenever the practice is accessible to the taxpayer it never reaches the point of a ruling.

I know that there is a general belief among lawyers that there is something about income tax that is surrounded with a mystery that can only be dispelled by employment in the bureau. I do not claim any special qualifications; I have never had any experience with income-tax work; I have not come in contact with anything that I could not gain a fair understanding of when I should want to find out what was done there. There is not anything about this income-tax work that affects every individual and every corporation in this country, which a man of ordinary intelligence can not understand when he can get access to the facts, and there is no reason why a small group of former employees should be in a position where they can practically compel the taxpayers of this country to employ them, and why the Government should be deprived of the services of those men because of that particular situation, and why the great body of the mediocre should be left to represent the Government, while the brains get out to represent the taxpayers.

Senator JONES of New Mexico. I would like to make this observation:

I have not any doubt but what many high-class men have remained in these bureaus. There are a great many advantages from such positions which can not be obtained in private life. You are engaged in a great service, of which one can very well be proud, and I am sure that in many activities of the Government people can be found who are working for a mere pittance as compared with what they could get in services in private life. There is a value, or rather an advantage or standing or prestige in connection with public positions which does go to some extent—not measured in dollars, though—to induce the people to remain in the Government service; but the fact remains that a very large number of the bright and expert people do not remain in the Government service, and especially in this bureau. It seems that service in there becomes extremely valuable to a man in private life, because of the fact that there is so much mystery and so much secrecy. I am not reflecting at all upon the administration, but the law provides for that secrecy,

and so on. By reason of that fact it makes that service extremely valuable in private life to one who has had this experience in the department. Such a man does gain a great deal of information there, at least with regard to particular cases. The very atmosphere must be charged with information which would be reflected from the particular facts in given cases and which would enable one to go out of the service and use that and yet remain within the law as to his having participated in the particular case.

Mr. GREGG. I think, Senator, answering what you have said in answer to what Mr. Manson said, those statements exaggerate the importance that the taxpayer has placed upon the knowledge of unpublished rulings and unknown practices. I think it is the result of the feeling, whether the feeling is warranted or not, that a man who has been in the bureau and who has worked on taxes for two or three years knows more about taxes than an ordinary person. It is not that they know the unpublished rulings, but because they know the practices better. I can illustrate that. A man can build up an immense tax practice who has never been in the bureau. Some of the men with the biggest tax businesses in the country have never been in the bureau.

Senator JONES of New Mexico. That is quite true, and perhaps, as you say, the remarks that have been made here exaggerate the situation; but, nevertheless, I think that throughout the country there is a feeling that what is going on in the bureau is known only to the people who are in the bureau and work there, and when a citizen or taxpayer feels that he has an important case, if he can get someone out of the bureau to handle it, he thinks he is worth more to him, whether he is or not. He feels that way about it, and I think that is made perfectly manifest by the people who have gone out of the bureau and have at once gone into a very profitable business. It is true of lawyers, not only in the Bureau of Internal Revenue, but in every other department of the Government; of the Interior Department, for instance, where they are dealing with public lands. I think if I wished to do so I could name several who have gone out of the General Land Office or the Secretary's legal force and have at once stepped into a profitable business by reason of the fact that the public feels that there is something mysterious that you need to know in order to get effective results.

Mr. GREGG. I really do not feel it is so much that, Senator, as it is the other point.

Senator JONES of New Mexico. But I want to add that I think that exists with respect to the Bureau of Internal Revenue much more than as to any other branch of the Government service, and that is doubtless due to the fact that all of these returns are confidential.

Mr. GREGG. I think it is really due more to the fact that they think a man who has been working on these matters exclusively knows more about them.

Mr. MANSON. There is not any doubt, Mr. Gregg, but what there is a great deal that a man must know. For instance, I used the matter of amortization as an illustration. A man could judge his rights by reading the solicitor's opinion on the subject, and conclude that he had no case at all, when as a matter of fact, anybody who

had anything to do with the handling of that class of claims would know that he has a case under the practice followed by the bureau.

The CHAIRMAN. Are any of these decisions marked confidential?

Mr. GREGG. No.

Mr. ARMSTRONG. No; we do not have any decisions labeled or marked confidential. Our position there, in general, might be summed up as this: In the preparation of these decisions it is not our desire in the rules and regulations sections to hold back anything from the public. We try to publish leading cases, cases that will be of value.

Senator JONES of New Mexico. But it appears that that is but a recent practice.

Mr. GREGG. Within the last two years.

Senator JONES of New Mexico. Yes.

Mr. ARMSTRONG. It might not be amiss to state why this bulletin service was inaugurated. There was a time when the men in the section retained carbon copies of decisions, and then we got so that we mimeographed the opinions. In 1919, when we brought into the bureau a great many auditors from the outside, when a special drive was made we published for our own information all of these decisions so as to have them in concrete form.

They had grown from a few hundred to several thousand, and at the time this bulletin service was inaugurated it was not with the idea of sending them out to the public. It was really for internal purposes, and I think had been in operation for about six months before the question was ever considered of making this service available to the public. Finally, after careful consideration, it was released to the public; and practically the same idea in our leading cases exists now as always, and that is to publish the things that are really worth something to the man who reads it, although the impression seems to have been on the outside that we are holding something up our sleeves. So far as I am personally concerned, I do not know of anything that is not published that would be of any value to me in deciding a case. I am governed entirely by the law, the regulations, and the published decisions.

Senator JONES of New Mexico. Yes; but I think it is quite true, as Mr. Manson has clearly pointed out, that the numerous applications of the statute, or a regulation, to facts is what fills up a definite trend of action.

In my own legal practice I have found a number of cases where the syllabus may practically be the same, but in order to really understand it you have to go into the facts of the particular case. Otherwise there will be no reason for a lawyer citing more than one case on a given proposition. Instead of that he cites several cases, because, in the reasoning set out in the decision you get a different slant on the thing, and it is highly important to have various decisions, even though one might say that they were all simply announcing the same conclusion.

Mr. MANSON. I would call attention in that connection to the well-known Dartmouth College case, which is virtually the leading case upon the question of whether or not a legislative grant of a charter constitutes a contract. I dare say that the exceptions to the rule laid down in the Dartmouth College case constitute a greater and

far more important body of the law to-day upon that subject in its application to public utilities than the Dartmouth College case itself does.

Senator JONES of New Mexico. Yes.

Mr. MANSON. And every one of them has arisen out of the application of the principles to a particular case.

Senator JONES of New Mexico. And the cases which have been decided in the courts upon the question as to whether or not the Dartmouth College case applied are almost innumerable.

Mr. MANSON. Until to-day it is almost impossible to find a situation to which the Dartmouth College case applies, although it is the leading case on the subject.

Mr. GREGG. I do not think it is the knowledge that the men within the bureau have with reference to unpublished rulings that makes the men valuable. I looked into this same question in England. There they have no published rulings whatsoever. They have no regulations. They have just the law, which is, to my mind, the most hopelessly complicated thing I have ever read. There are no regulations construing it, and there are no published rulings. They have volumes of unpublished rulings for the guidance of the inspectors and the men in the service. At the same time they have not been bothered with this problem of personnel at all.

Senator JONES of New Mexico. Why not? Have you ever found out?

Mr. GREGG. I have never found out definitely; but the best I could get was that it was due to a different point of view. Government service there is something that a man takes up as a career when he comes out of college. He goes into it as a life work, and he has a position of dignity.

Mr. MOSS. It offers a more stable career.

Mr. GREGG. It is much more stable. They have a position of honor and dignity, and they take it up as a life work.

Mr. MANSON. That is true of the whole public service of Great Britain. It is true of the consular service, the foreign service, and the army.

Mr. GREGG. They spoke to me in a very complaining way about the fact that a few of their employees during the war resigned and went out to practice tax law. I told them about the percentage of turnover that we had, and I do not think they believed me. They just did not have that problem to contend with.

Senator JONES of New Mexico. May that not furnish a basis for thought on this subject? Should we not consider whether our civil service should be extended, and not have this uncertain tenure of office?

Mr. MANSON. I do not understand that there is any uncertainty as to the tenure of office in the Income Tax Unit.

Mr. GREGG. No; that is under civil service, and the office of the solicitor is also under civil service.

Mr. MANSON. I think there is one thing that detracts from the dignity that ought to attach to the decisions of the Income Tax Unit, and that is a fact that they have no real standing in the law. All over the United States we have Federal judges sitting on benches, robed in silk gowns, occupying a position of dignity in the com-

munity, a position that is unsurpassed by any other position in the community. The Federal judge in any community has a standing by reason of his occupancy of that position. He is not surpassed by anybody. However, he is spending most of his time trying bootleggers, while we have men down here engaged in this work on matters that involve millions and hundreds of millions of dollars, involving more money and a greater responsibility than, perhaps, is shouldered by any nisi prius Federal judge in the United States, and they are merely employees. They hold no position; you could go through the law, and you will not find an office established by Congress. They are just Government employees. You might almost put a number on them.

Senator JONES of New Mexico. When we were considering the question of having the board of tax appeals conduct these proceedings in public, the thought occurred to me that that would have some bearing upon the question of the personnel and the so-called turnover of the personnel, the thought appearing that there is little individuality in these various bureaus. A man does not get credit for what he is doing. What he does is buried; it is kept secret. Nobody has any idea of the quality of work he is doing. He has no opportunity to stamp his individuality upon the work, and it is contrary to human nature, I thought, for a man to be willing to just bury himself and become a mere cog, which no one can see working.

Mr. MANSON. Unless there is enough salary attached to the job to make it attractive from that standpoint.

Senator JONES of New Mexico. That is it.

Mr. MANSON. And when you get a combination of a lack of individual recognition with a small salary it does not make a particularly attractive job.

Senator JONES of New Mexico. A great many of these decisions, doubtless, are prepared by a person who merely put his initials on them. He might as well have put No. 1 or No. 10 on them; give him a number, the same as the convicts of the country have, because what they do is buried, and he does not get any individual credit for what he is doing, unless it is, perhaps, by his immediate superior, who is in touch with him, but that immediate superior is only one in millions, and it seems to me that it is contrary to human nature for people to be willing to hold that sort of office.

Mr. Moss. If this committee can work out any arrangement which will curtail the turnover you will accomplish a great deal. It is one of the most serious things the department has to deal with.

Mr. NASH. I want to say that I think the question of salaries is one of the reasons for our tremendous turnover. The salaries that we are forced to pay the lawyers and auditors are almost ridiculous when you consider the work that they have to do.

Senator JONES of New Mexico. Yes; and when you consider that they are merely buried there, and they are not working in such a way and to such an end as would build up a record for themselves. In view of all those things, the salaries are quite inadequate, and yet when you come to a consideration of the question as to whether the Government should pay salaries in such an amount as would keep those people there solely for the salary, I do not think it could be done.

Mr. Moss. I was going to make that further suggestion. I had not concluded.

Mr. Manson's two suggestions were an increase in salary and a more extensive publication of those rulings.

The salary, as Government salaries go, could not be increased by Congress to such an extent as to correct the evil, because these men, the very best of them, go out and make a great deal more than any Government employee receives, any Government official receives; so I doubt the efficacy of a higher salary. They should have more salary as a matter of course and as a matter of justice.

I am not prepared to discuss the other point, as to how much of this difficulty would be removed by further publicity of the rulings. I do not know much about that. I have this idea, however, to suggest, that the fact that a man has been in the Government employ and in the employ of the Income Tax Unit has a certain advertising value to a law firm or an accounting firm, and they want to get that man. He may not be a highly efficient man, but he has been in Washington and he has been in the Income Tax Unit, and he has a certain advertising value, which will draw clients.

Senator JONES of New Mexico. But, Mr. Secretary, to illustrate what I had in mind, practially every decision that goes out goes out as a decision of the bureau or the department. Take the Supreme Court. I imagine that the justices there would take very little pride in their work if their decisions were merely to be signed by the court. You will observe that in all such cases the particular justice who prepares the decision signs it, and then it is concurred in, but the public generally knows who prepared that opinion, and, for that reason, the justices take more pride in preparing those decisions and in their general work, because there is some individuality about it.

The CHAIRMAN. I think that is the reason that Mr. Gregg, our eminent young solicitor, took a reduction in pay in order to become the solicitor, so that he might be able to have pride in the fact that he is signing his own opinions.

Mr. Moss. The Senator has pointed out a very deplorable situation, and that is that a man does lose his personality in this great organization. He becomes a mere cog in the wheel.

Senator JONES of New Mexico. Yes.

Mr. Moss. And it is almost necessary. Take a Cabinet officer, for instance, or you can go to even a lower status than that. The papers which they sign are rarely prepared by themselves. I do not think a one-hundredth part of them are.

Senator JONES of New Mexico. That is true.

Mr. Moss. It has to be done in that way; so, when you take the great income-tax organization, with some 10,000 people, is it not, Mr. Nash?

Mr. NASH. About 8,000.

Mr. Moss. You will find that these things are signed by the deputy commissioner, or so-and-so by the deputy commissioner.

Senator JONES of New Mexico. Now, let me make this suggestion, that the person who prepares the decision sign it and have the deputy commissioner approve it, so as to let the individual who does the actual work get some credit for what he is doing.

The CHAIRMAN. Are you ready to go ahead to-morrow morning at 10 o'clock, Mr. Manson?

Mr. MANSON. Yes.

Mr. NASH. Mr. Chairman, you asked that Mr. Bright be brought up on the Anaconda case. Do you want to take up that now or to-morrow?

The CHAIRMAN. It is rather late to take it up now.

Mr. MANSON. It is very nearly 1 o'clock. Of course, we can sit here all afternoon, if you wish to.

The CHAIRMAN. Mr. Bright is very valuable here at other work.

Mr. BRIGHT. It will take me but a few minutes to say what I want to say on that case.

The CHAIRMAN. If it is agreeable, I would like to have him come back to-morrow morning.

Mr. BRIGHT. Yes, sir.

The CHAIRMAN. Then we will adjourn here until to-morrow morning at 10 o'clock.

(Whereupon, at 12.45 o'clock p. m., the committee adjourned until to-morrow, Thursday, May 21, 1925, at 10 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

FRIDAY, MAY 29, 1925

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

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

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

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

Present on behalf of Bureau of Internal Revenue: Hon. McKenzie Moss, Assistant Secretary of the Treasury; Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; and Mr. A. W. Gregg, Solicitor Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. We had some discussion a few days ago about the publication of rulings. At that time I drew the conclusion from what was said with reference to the publication of rulings that where rulings were not published they were not used as precedents.

I call attention to Exhibit B, attached to the General Motors case, which I presented yesterday.

Exhibit B (see p. 3923, pt. 18) is recommendation No. 6617 of the committee on appeals and review and deals with the method of determining the value of the stock of the United Motors Corporation. The primary ruling on that subject is known as A. R. M. 34. A. R. M. 34 recommends as the basis for determining the value of good will the average net earnings over a five-year period. Recommendation No. 6617 adopts as the basis a three-year period.

The CHAIRMAN. Has that been acted upon finally?

Mr. MANSON. Yes. I call attention to this at this time to show that here is an important departure from the rule laid down in the published rulings and in a ruling which is not published.

Senator KING. You say in a published ruling, and then you say in a ruling not published. Which is it?

Mr. MANSON. I say that A. R. M. 34 is a published ruling, and so far as I have been able to ascertain all of the rulings dealing with this subject which are published adopt a five-year basis. The ruling which is not published adopts a three-year basis. From an examination of this unpublished ruling there are seven other unpublished rulings cited as authority, cited as precedents.

The CHAIRMAN. Who got those seven unpublished rulings? How did you know about them?

Mr. MANSON. Of course, those unpublished rulings were available to the bureau, but I understood the bureau did not accept an unpublished ruling as a precedent. That was the understanding that I received from the discussion the other day. In this particular ruling that I refer to, and which I say is Exhibit B of the General Motors case that I put in yesterday, I find that there are seven unpublished rulings cited as precedents.

Mr. GREGG. What is the date of that ruling?

Mr. MANSON. This ruling is dated November 30, 1923.

I also find that one of these unpublished rulings is stated in this ruling to be cited by the appellants as well as by the bureau, and the query arises in my mind as to how the taxpayer might have access to an unpublished ruling.

The CHAIRMAN. Well, you do not have much doubt about how that happened, do you?

Mr. MANSON. In the case of the Draper Corporation——

Mr. GREGG. May I say, before you leave that other matter, you gave the date of that opinion as some time in 1923?

Mr. MANSON. Yes.

Mr. GREGG. The policy of not using unpublished rulings as precedents was adopted about January 1, 1924. So that is the explanation of that.

The CHAIRMAN. Well, we understand from that, that since that period there have been no unpublished rulings used as a precedent?

Mr. GREGG. I can not say that they have not been used, but our instructions are very clear that they are not to be used as a precedent.

The CHAIRMAN. There is not, then, any way really of checking up to find out whether they have been used or are continuing to be used?

Mr. GREGG. It is impossible to check every man at the bureau who is passing on a case.

The CHAIRMAN. Well, I say, as long as they are unpublished rulings, anybody may use them if he wants to.

Mr. MANSON. In the matter of the Draper Corporation, the question was the depreciation on patents. This question is passed on in T. B. M. 22. T. B. M. No. 22 denied depreciation on the patents in this case, upon the ground that the patents were kept up and supplemented by other patents; they were carried into their invested capital, and that they had merged into their good will.

I do not subscribe to that doctrine, but nevertheless T. B. M. 22 handed down this case and denied the depreciation under those circumstances.

A. R. R. No. 2290—that is a recommendation of the committee on appeals and review—sustained the position of the tax advisory board in T. B. M. No. 22. That is not published.

We do not criticise the failure to publish that ruling, because it is a reiteration of what was said in the published ruling.

There is a solicitor's memorandum questioning the ruling in T. B. M. No. 22, and advising that the matter be sent to the committee on appeals and review. This solicitor's memorandum, No. 1602, is not published.

A. R. R. No. 7356 reverses T. B. M. No. 22. It denied depreciation, which was allowed by T. B. M. No. 22, and it is not published.

In other words, for the guidance of future taxpayers or, as the public knows, T. B. M. No. 22, handed down in this case, was the law of this case. The fact is that the case was not settled upon that basis, but was reversed.

The depreciation that was denied under the published ruling was allowed under an unpublished ruling, and without going into the question of the soundness of any of those rulings, I take the position that when a subsequent ruling reverses a former ruling, if the first ruling is published, the latter must of necessity be published.

This appears in the exhibits on the Draper matter, presented May 4, 1925, page — of part — of the record. You already have a copy of the exhibit that I referred to in the other case.

Mr. GREGG. I have just looked at this last recommendation, and it seems to be perfectly obvious from a reading of it, that it would have been of no value as a precedent to publish it. Some notation should unquestionably have been made that T. B. M. No. 22 was reversed, but I do not think this ruling should have been published. If the committee wants to read it, I think you will see that it is quite apparent from the ruling itself that it should not have been published.

Mr. MANSON. Well, the mere fact that it allows what was disallowed under a published ruling seems to me makes it imperative that it be published, for the reason that other taxpayers would naturally be guided by that published ruling.

Mr. GREGG. I said that some notation should be made that T. B. M. No. 22 was overruled.

The CHAIRMAN. It has substantially the same result. I think that is rather a technical objection to Mr. Manson's statement, because the same result would have been accomplished if T. B. M' No. 22 had been repealed, but it was not.

Mr. GREGG. This is a good example of an opinion which can not be published. If the committee will read it, I think they will see it.

The CHAIRMAN. I think if we had publicity of all of these decisions in all of these rulings, it would prevent a lot of these controversies.

Senator ERNST. Is there some explanation that you want to make in connection with that, Mr. Gregg, after reading it?

Mr. GREGG. No; it is going in as an exhibit. I think the ruling is perfectly valueless as a precedent.

Mr. MANSON. I do not think that any ruling is valueless as a precedent. I do not think the public would stand for a court's failing to write opinions and publish those opinions, appellate courts, for an instant. I do not think the public would for one instant tolerate delegating discretion to the courts as to what opinions they should publish and what opinions they should not publish. I can see no distinction.

(At 10.30 o'clock p. m. the committee adjourned.)