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

JANUARY 19, 20, 21, 22, 27 AND 28, 1925

PART 9

Printed for the use of the Select Committee on Investigation of the Bureau of Internal Revenue

WASHINGTON
GOVERNMENT PRINTING OFFICE
92919
1925

SELECT COMMITTEE ON INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

JAMES COUZENS, Michigan, *Chairman*

JAMES E. WATSON, Indiana.
RICHARD P. ERNST, Kentucky.
ANDRIEUS A. JONES, New Mexico.
WILLIAM H. KING, Utah.

BORDER ISLAND COMPANY CASE

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, JANUARY 19, 1925

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

The committee met at 10.30 o'clock a. m., pursuant to adjournment of Saturday, January 17, 1925.

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

Present also: L. C. Manson, Esq., of counsel for the committee; 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; Mr. Nelson T. Hartson, solicitor Bureau of Internal Revenue; Mr. James M. Williamson, office of solicitor Bureau of Internal Revenue; Mr. S. M. Greenidge, head engineering division, Bureau of Internal Revenue; and Mr. F. T. Eddingfield, engineer, office of solicitor, Bureau of Internal Revenue.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. I feel that, in justice to the Income Tax Unit I should call the attention of the committee to the fact that the bureau has voluntarily issued an order which abolishes the special conferee system, which in my opinion, was responsible for the trouble in several of the cases presented here. They have also provided in this order that minutes of all conferences shall be made at or about the time of the conferences. That also was the subject of considerable criticism in the committee. I think, in justice to the bureau, I should read this order into the record:

ENGINEERING DIVISION, INCOME TAX UNIT,
January 9, 1925.

Memorandum to chiefs of sections: Oil and gas, timber, coal, metals, nonmetals, appraisals, production committee, Mr. Griggs.

In re: Conferences.

Paragraph 2 of memorandum dated December 19, 1923, which reads as follows:

"(2) In any conference where there appears to be no likelihood of agreement between the taxpayer and the department, before adjourning the conference this office is to be notified and a special conferee will be delegated to sit in the conference."

is hereby revoked.

Effective as at the beginning of business Wednesday, January 14, 1925, each engineer in this division is instructed to write a memorandum on each case about which he talks with a taxpayer or taxpayer's representative. This instruction means that each time a taxpayer or taxpayer's representative talks with an engineer on any case such conversation, of however

trivial a nature, will be considered a conference and the engineer is directed to write and promptly forward to this office, as well as to file with the case, a copy of such report.

A report will be kept in the head office of each case on which an engineer has been called to meet the taxpayer or the taxpayer's representative and to avoid delay in keeping this record current, engineers are requested to write conference reports as soon as possible after holding the conference.

In the case of conferences where the conferee-engineer of this division and the taxpayer or taxpayer's representative do not reach an agreement, conference memorandum will bear in its upper righthand corner the word "disagreed."

The above instructions are also to apply to the chiefs of sections and assistant chiefs of sections.

S. M. GREENIDGE,
Head Engineering Division.

Senator KING. I was not here when that matter was under consideration by the committee. May I ask, Mr. Manson, whether that order which you have just read will be beneficial and helpful to the Government as well as to the taxpayer?

Mr. MANSON. There is no doubt about that, in my opinion.

Senator KING. I do not quite see the significance of that, now, but I will read the testimony concerning it.

Mr. MANSON. I call the committee's attention this morning to the Border Island Co. depletion on March 1, 1913, value for invested capital purposes.

I wish to offer my apologies to the department at this time for not giving them earlier notice of bringing up this case. I did not notify them until this morning. That was due to the fact that I intended to take up another case, but yesterday when I came to examine the engineers' report on the other case, I found nothing in it which I personally could criticize.

This is a small case, but it is important for the reason that, in my opinion, it represents another bad practice.

In the first place, it is a case where a value had been fixed by the appraisal engineers, and the solicitor's office assumed to set aside that valuation and fix a valuation of its own.

I hate to criticize lawyers, but I do not believe that the legal end of the Income Tax Unit is the proper place to make valuations.

This case also illustrates quite clearly a matter that was discussed here some time ago, namely, the difference between the utility value of a piece of property to the owner, and the market value of it.

In this case the Border Island Co., the taxpayer, acquired an island in the Niagara River, on the line of the city of Buffalo, which island consisted of a deposit of sand and gravel. This island was acquired in June, 1912, for some $130,000, consisting of $6,000 cash, $54,000 in the stock of the Border Island Co., and a mortgage of $70,000. The mortgage was already on the island. The island was acquired subject to this mortgage of $70,000.

At the time of the acquisition of the island by the taxpayer, the previous owners had given a lease for the excavation of sand and gravel, under which they were to receive 8 cents a cubic yard for a given amount of the sand and gravel and 7½ cents thereafter. This lease was to expire in 1926.

The engineers allowed for depletion purposes the sum of $127,000, which was the purchase price of the island less the value of that

portion of the island which consisted of soil that was not sand and gravel.

The value finally allowed was $196,159.99, making a difference in the tax of $10,959.

Senator KING. They allowed a depletion that was more than the property cost?

Mr. MANSON. Yes; the depletable value was $196,159.99.

As I stated, the property was acquired in June, 1912. The value was fixed as of March 1, 1913. The taxpayer—that is, the president of the taxpayer—states in an affidavit in the record that there had been no change, that the value in 1913 was the same as the value in 1912. It is manifest that there could be no change, for the reason that the island was acquired subject to the lease. The lease was a lease under which the gravel was being taken out.

If the island had doubled in value, so far as the gravel was concerned, it would not have benefited the lessor.

The value finally arrived at was determined by capitalizing the royalties to be paid under this lease and discounting them at a 6 per cent profit rate. If the receipts of royalties provided under this contract were capitalized and discounted at a 10 per cent rate, you would get an amount which was within $1,000 of the amount paid for the island.

That raises this question in my mind: In June, 1912, the owners of this property had every advantage that the Border Island Co. acquired from them, and which the Border Island Co. had on March 1, 1913. They saw fit to sell this property at a price which, under that contract, would give them a 10 per cent return on their money. The solicitor's office took the position that the property had a value which would yield a 6 per cent return on the money.

My first proposition is that the fact that this property was sold within a few months before March 1, 1913, and that the same conditions existed with respect to the lessor on March 1, 1913, as existed at the time of the sale of the property, indicated that there could be no such thing as an increase in the value of the lessor's interest in that property, namely, the reversion. The actual sale demonstrated that men are not willing to invest money in that kind of a property under those conditions, at a price which will yield them less than about 10 per cent. It must be assumed that if the former owners of this property could get a higher price for that island they would have demanded it. If the purchasers of it had been willing to pay more, the former owners would have probably received more. The mere fact that the transaction took place is conclusive of what the market value was, and is also conclusive, if you wish to appraise this property on the analytical basis, of capitalizing earnings, as to the rate of profit that the purchaser expected to make on that kind of investment.

I wish to call the attention of the committee to this fact, that the discount rate used, 6 per cent, is approximately the rate on first-class real estate mortgages, where the value in the property is double the amount of the mortgage.

The CHAIRMAN. Do you know what the interest rate was on the $70,000 mortgage?

Mr. MANSON. I do not know. The record does not disclose it. That mortgage is not in the record, and I do not know. But a 6

per cent rate is about the rate, or approximately the rate paid upon first-class real estate mortgages, and it is inconceivable that anyone would consider investing his money in a project of this sort, where he was to receive his principal back in driblets, year by year, and at the end of that time would have nothing coming, where he was to take all chances of erosion on this island. There is constant erosion going on in the Niagara River, and all chances of erosion rested upon the owner, with the consequent liability for loss of his gravel because the lessees only paid for the amount they actually took out. He took all chances of the lessee failing to perform his contract, and I maintain that even if you had no fixed standard, as it is fixed in this case by the actual sale which took place a few months before March 1, 1913, the 6 per cent discount rate used here is manifestly ridiculous.

The CHAIRMAN. Do you want to say anything in connection with this case at this time, Mr. Hartson?

Mr. HARTSON. I think I should say this, Mr. Chairman, with particular reference to the statement of counsel that, in his judgment, it is unwise, inappropriate, and a bad policy for lawyers to sit in judgment on the engineers in the Income Tax Unit.

On that point, I desire to make this explanation: The solicitor's office is, under the present organization, divided into a number of different groups, one group being known as the review division of the solicitor's office. That division has as its backbone the former commitee on appeals and review organization and personnel. There have been changes made in it so far as personnel is concerned, but the general character and nature of the old committee on appeals and review is now incorporated in the review division of the solicitor's office. There are lawyers and accountants, and engineers in that division.

The CHAIRMAN. Was that the staff of the solicitor at the time this case was considered?

Mr. HARTSON. Yes; I so understand. This may, however, Mr. Chairman, be a case which came to the old committee on appeals and review, and was not disposed of by that committee during its organization, but was inherited, in a sense, by the solicitor's office.

Mr. MANSON. That is true, Mr. Hartson?

Mr. HARTSON. It was?

Mr. MANSON. Yes.

Mr. HARTSON. Now, if that is true, this case was no doubt assigned to an engineer. The engineer heard the taxpayer on his protest, and the report of that engineer was I have no doubt, reviewed by lawyers, and reviewed by the usual reviewing agency, which the review division in the solicitor's office provides.

I quite agree with counsel that on a pure engineering question, the solicitor's office, if it were composed entirely of lawyers, would, on engineering questions, be functioning in a manner which might be unwise and inappropriate. If the lawyers reversed the engineers on pure engineering questions. I agree with counsel on that. However, our present organization does not contemplate that that be done, and I think it is not done.

The number of engineers in the solicitor's office on that work is limited, and, as a result, the engineering cases that do come up there

are not disposed of as rapidly as they would be if we had more engineers on review work. But it is true that when the cases go out under the present organization, they go out with the solicitor's name attached and from the standpoint of one looking at it superficially, the impression would no doubt be gained that a lawyer had reversed an engineer on a pure engineering question.

The CHAIRMAN. Well, was this purely an engineering question? It seems to me it was not an engineering question, but it was a question of policy as to whether this should be determined on the analytical basis, or whether it should be determined on some other basis, and that it did not involve an engineering problem.

Mr. HARTSON. Mr. Chairman, I think the determing of a value is ordinarily left in the hands of valuation experts.

The CHAIRMAN. Was it true in this particular case? Let us deal with this case.

Mr. HARTSON. Yes: and I think this is a clear example of the general statement which I made.

If a court has to pass upon a value as of a given date, experts are called to advise the court as to what is, in the opinion of the witnesses, the proper value. If the property is real estate, they call real estate experts. If, on the other hand, it is a mine or a quarry, or some natural deposit, it is customary to have engineers familiar with those deposits and the methods of their operation and development testify as to what, in their judgment, the values are.

I think this formula which Mr. Manson has referred to is a formula which has been constantly and customarily used for years in determining values and in appraising mining properties.

The rate is one which I desire to be heard on later, because, as I have said, I know nothing about the facts in this case, and I am sure the committee will give us an opportunity to reply to the criticism as to the rate used and also the formula that was used.

The CHAIRMAN. If, as a matter of fact, this case had gone to court, and there was a dispute between the engineers and the taxpayer as to whether they should have used the purchase price or the analytical system, a lawyer would have to decide it, would he not?

Mr. HARTSON. The judge would decide it, and, of course, he is a lawyer. That is true; but, on the other hand, he has the advice of the expert witnesses who are presented to the court for the purpose of testifying on this point.

The CHAIRMAN. Well, the solicitor had that advice, too, had he not, when he passed upon it?

Mr. HARTSON. Yes; he had.

The CHAIRMAN. I would like to ask Mr. Manson if there is any reason shown in the records as to why the solicitor's office overturned the viewpoint of the engineers?

Mr. MANSON. The only thing I can find in the records is the recommendation to the commissioner, signed by the solicitor. There is no report in the records of any engineer in the review section of the solicitor's office. There is nothing to indicate whether an engineer did pass on the matter of the discount rate to be used.

I wish to say this, in connection with what Mr. Hartson has just said. This matter of the discount rate to be used may not be

purely an engineering question, but it is a matter which should be based upon information and experience. Appraisal engineers are called upon to use this formula, and the appraisal engineers are the people who have, in connection with the use of the formula, gathered information and assembled data as to what rates of profit investors in the different kinds of enterprises expect to receive. It is for that reason that I maintain that the matter of the discount rate to be used is a matter which should be passed upon by an appraisal engineer.

As to the question of whether or not, under the regulations, the actual sale price of this property a few months before March 1, 1913, should be used, or whether the analytical appraisal method should be used, I think that is a matter the legal department could properly pass on.

The CHAIRMAN. What varying rates of discount have been used by the department? We have heard a good deal about these rates of discount in the testimony. What have been the varying rates used by the department?

Mr. MANSON. The highest one that we have had brought to our attention was 10 per cent, in the case of the Graphite Co., in New Mexico.

Mr. HARTSON. I would like to ask Mr. Eddingfield to answer that question, if he knows.

Mr. Eddingfield is an engineer in the solicitor's office, and he can tell you what rates have been customarily used in the valuation under this analytical appraisal method.

Mr. EDDINGFIELD. They vary, of course, with the type of ownership. For a property which is under lease, the owner is generally allowed 6 per cent. On coal, I believe they allow a discount rate equal to 8 per cent. The highest rate I personally know about was in the case of a lessee where 35 per cent was used. In my own case, the largest I have used is 25 per cent.

The CHAIRMAN. What is the usual rate?

Mr. EDDINGFIELD. Six per cent for a case of this character.

The CHAIRMAN. What is the usual rate in cases where there is not a lease?

Mr. EDDINGFIELD. For an operating owner, it would depend largely upon the circumstances, but generally about 7 or 8 per cent.

The CHAIRMAN. Is it your opinion that 6 per cent and these low rates are equitable rates?

Mr. EDDINGFIELD. Yes, sir.

The CHAIRMAN. Notwithstanding all of the hazards of the business, you capitalize these properties at a very high value, so as to be able to get big depletion figures on a basis which the most conservatie invester can get on his money?

Mr. EDDINGFIELD. Well, I would not say the most conservative, because Government bonds are 4 per cent and even 3½ per cent.

The CHAIRMAN. Well, a first mortgage bond is pretty conservative.

Mr. EDDINGFIELD. Yes, fairly so; but they do lose money on those sometimes?

The CHAIRMAN. Not very often.

Mr. EDDINGFIELD. I have seen a great many in income tax matters, where foreclosure proceedings were had on mortgages which resulted in a loss by the mortgagor.

The CHAIRMAN. That is not due to the rate or the fact that it is a mortgage, but it is due to the original valuation, or the fact that it is an excessive loan on the valuation.

Mr. EDDINGFIELD. Yes.

The CHAIRMAN. But it is a well-known fact that conservative mortgages, 50 per cent below valuation, can secure 6 per cent, and they are perfectly safe.

Mr. EDDINGFIELD. Are there any other features of it, Mr. Hartson, that you want taken up?

Mr. HARTSON. Mr. Chairman, Mr. Eddingfield was the engineer in the solicitor's office who handled this Border Island case, that Mr. Manson has referred to this morning. Until he arrived here this morning he did not know that this case would be brought up. He came up here in the expectation that the case that Mr. Manson referred to as being the one he had though he would take up this morning, but decided not to, would be heard. So Mr. Eddingfield has had no opportunity to go over his records. It has been six months, or probably a year, since he considered this Border Island case, and I would like to have him be given the opportunity of discussing it to-morrow with the committee, unless the committee desires now to ask him some questions in connection with the case.

Senator KING. Yes; I think we had better have it all at one time.

The CHAIRMAN. I still think that Mr. Manson ought to have some information there as to the reason, which reason he should have taken from the records, as to why this change was made.

Mr. MANSON. The records do not state any reason. The records merely contain the following memorandum, signed by the solicitor:

[Recommendation No. 582. In re protest of Border Island Co., Mutual Life Building, Buffalo, N. Y. Years 1917, 1918]

OFFICE OF SOLICITOR OF INTERNAL REVENUE,
August 23, 1924.

Mr. COMMISSIONER
(For Deputy Commissioner, head Income Tax Unit).

This office has had under consideration the protest of Border Island Co. against the action of the Income Tax Unit in its determination of the value at March 1, 1913, of certain sand and gravel deposits.

Hearing was held August 15, 1924.

On March 1, 1913, the taxpayer's sand and gravel was under lease, having 13 years to run with a specified minimum of $24,000 a year and a royalty rate of $0.075 a ton in addition for all sand and gravel removed in excess of 320,000 cubic yards a year. A sale of the taxpayer's interest on March 1, 1913, would be made subject to this lease agreement and would be measured by the terms of the lease.

Valuation Mar. 1, 1913:	Cubic yards
Reserves—sand and gravel at acquisition	4,700,000
Paid for Mar. 1, 1913	266,667
Reserves—Mar. 1, 1913, unpaid for	4,433,333
Royalty rate	$0.075
Gross expected receipts	332,499.98
Less estimated expenses for 13 years (taxes, salaries, etc., at $2,000)	26,000.00
Net expected receipts	306,499.98
Present worth at 6 per cent and 4 per cent for 13 years, factor	.64
Value of taxpayer's interest Mar. 1, 1913	196,159.99
Unit of depletion per cubic yard	0.0442

It is, therefore, recommended that the action of the Income Tax Unit be modified to the extent of allowing a value at March 1, 1913, of $196,159.99 and a depletion unit of $0.0442.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

Approved:

D. H. BLAIR,
Commissioner of Internal Revenue.

There is nothing further in the record to show on what ground the solicitor reversed the action of the unit. I submit that this is a straight redetermination of value.

Senator KING. Does that now involve a refund of the tax?

Mr. HARTSON. Not necessarily, Mr. Chairman.

Mr. PARKER. It relieves him of an additional assessment of $10,000.

Mr. MANSON. $10,959.

The CHAIRMAN. As a matter of fact, without impugning anybody's motives, those things can be done arbitrarily and automatically, if they are done in any such manner as that.

Mr. HARTSON. Now, Mr. Chairman, in answer to the question, the memorandum which Mr. Manson has read is the recommendation of the solicitor, which, as has been indicated, was approved by the commissioner. That memorandum constitutes the reply to the Income Tax Unit, to their letter of transmittal, when the case is referred to the solicitor's office on this taxpayer's protest. It advises the unit of the conclusion on the protest, and is the decision, of course, of the commissioner, that is finally made in the case. Now, the files of the solicitor, no doubt, have some memoranda which were prepared by Mr. Eddingfield, and which indicates his line of reasoning.

The CHAIRMAN. Well, as I understand Mr. Manson there is no such record.

Mr. HARTSON. Mr. Manson has not had access to the solicitor's files in this case—not because they are not available, but by reason of the fact that his engineers have gone over what we call the administrative files. We maintain a separate file in our office, of cases that come over to the solicitor. The only thing that goes back into the administrative files are the conclusions of the solicitor in such cases as these, and that file contains the decision.

Senator KING. Do you not think the decision should contain the reason for the reversal of the ruling of the engineers?

Mr. HARTSON. Of course, the decision does give the basis for it. You can take that decision and find out just exactly what was done. As to the reasoning in support of what was done, it probably would take a good many pages, and cases are being handled there by the hundreds. We are getting out something in excess of 200 a week of these cases—cases like these.

The CHAIRMAN. When the commissioner comes to accept that recommendation of yours, he just accepts your blank recommendation, without any argument? Now, it appears that there were two units or two divisions of his own department which differed, and he took your conclusion without making any inquiry as to the reason for it at all, and that, of course, could be done in little cases or in big cases, or in any case; is not that correct?

Mr. HARTSON. Well, it can be done in little cases and it can be done in big cases. It is done in little cases, but it is not done in all big cases. These other cases, Mr. Chairman, are handled in the bureau a good deal like the more important business that the Senator handles. He gives them a little different attention and more careful scrutiny than he gives to matters that do not amount to so much.

When I am permitted to engage regularly in the business of my office, when these cases come, I take to the commissioner's personal attention different cases, cases that seem to me of tremendous importance, which I think he ought to go into personally, and I say to him, "I want to call your attention to the fact, Mr. Commissioner, that the Income Tax Unit and my office have opposite views on the question here. There is a sharp disagreement. This is my view, and this is why I think so." I think the commissioner might well call in the representatives of the unit and get from them what their view is. I can not tell you how many times that same thing has been done. The commissioner has heard both sides, and then he has approved one or the other. Not so long ago, a case running into several millions of dollars was one which I thought should be reversed; I thought the action of the Income Tax Unit should be reversed. The commissioner, upon my taking it to him, said, "I do not agree with you," and he sustained the Income Tax Unit.

So that, in these cases, each one is given the attention that the particular case seems to warrant; but it is true that, in the usual run of cases, these recommendations of mine go over on the commissioner's desk, and he signs them personally without going into them carefully at all, just as I have to sign things without going into them carefully myself.

In these review cases it so happens that, by reason of the large number of them, and by reason of the fact that there was an equally large number of other cases going through my office, straight out and out opinions on legal propositions, and by reason of our appearance in court, both in the Federal courts and before the Board of Tax Appeals, and by reason also of our handling penal cases and compromise cases, my name is signed to a good many cases that I never see. It so happens that my name was signed to the Border Island case, and I never heard of it until Mr. Manson mentioned it this morning. So, in the actual operation of the bureau's affairs, things have to be done by subordinates, by people whom we have chosen by reason of their qualifications and our confidence in them to make these decisions and make them properly, and yet they go out in the commissioner's name and in my name.

The CHAIRMAN. As I understand it, you desire to leave this case until you have an opportunity to make reply?

Mr. HARTSON. Yes; I would like to have an opportunity to-morrow morning of having Mr. Eddingfield tell you just what occurred here, and just what the files of our offices show, if anything, in addition to what Mr. Manson has called attention to. He can certainly give you the basis for his reasoning, and the committee can hear him at that time.

There is another request, Mr. Chairman, that I should like to make, and that is that to-morrow's session be devoted to the tying up and the closing up of some of these cases in connection with which the bureau

would like to introduce some additional evidence. In other words, if agreeable to the chairman and counsel for the committee, I would like to devote the entire session to-morrow to putting in the replies in two or three cases, and to gathering up some loose ends that I think ought to be definitely closed from the bureau's standpoint.

The CHAIRMAN. Will those matters deal with the case of the United States Steel Corporation?

Mr. HARTSON. I have this to say about the United States Steel Corporation case. I do desire to say something in addition in that case——

The CHAIRMAN. I think the committee ought to know, in addition to the reply that you made at the end of the cases, whether the bureau intends to take any cognizance of the findings in this case or the evidence that has been developed, in dealing further with that particular case.

Mr. HARTSON. I made the statement some time ago, Mr. Chairman, that the bureau would substitute actual figures for estimated figures in the postwar period of the steel company's production. I make the further statement that there will be an entire disallowance of amortization based on the cost of any transportation facilities that the steel corporation might own when such transportation facilities were used by common carriers. Those changes are already being made in the adjustment of the United States Steel Corporation case.

The CHAIRMAN. Will the bureau please report to the committee just when that is completed and what the difference in the computation of their tax amounts to.

Mr. HARTSON. We shall be glad to, Senator.

The CHAIRMAN. Have you any further reply to make in connection with the Penn Sand & Gravel Co. case?

Mr. HARTSON. I have. I have had no opportunity to reply to that case, due to the fact that that was the last case that the committee had under consideration at its last session.

The CHAIRMAN. That is the type of case that you want to deal with at the session to-morrow?

Mr. HARTSON. Yes, sir.

Senator WATSON. Now, let me ask you a question there. You have said that you were going to make certain changes in the tax of the United States Steel Corporation. Are those changes the result of the testimony that has been adduced before the committee in its investigations, or would they have been discovered and made if this committee had not been organized?

Mr. HARTSON. That is hard to say, Senator, in definite terms. I did make the statement here, and this is correct, that there was a disagreement in the engineering division of the Income Tax Unit about this amortization allowance in the steel company case before the committee introduced any evidence on it here, and it was stated that the matter would have been referred to the solicitor's office for opinion.

Now, Mr. Manson developed, on examining one of the witnesses, that the exact points of criticism that the committee made formed no part of the reasons for the intended reference of the case to the solicitor's office; but notwithstanding the case would have gone

over to the solicitor's office, and what might have developed as the result of the scrutiny of the matter over there it is difficult to say. It would have gone there; the case would not have been closed forthwith, even had the committee not heard evidence on it.

The CHAIRMAN. Has the committee's work in connection with the Steel Corporation case been helpful?

Mr. HARTSON. I believe it has. I believe it has.

The CHAIRMAN. Where did Mr. Gary get the impression, as publicly stated, that the case was closed?

Mr. HARTSON. I have tried to explain that several times, Senator. I believe his statement was made in entire good faith, for this reason, that the engineer's report had been finally agreed upon in conference with the Income Tax Unit.

The CHAIRMAN. I understand, and he thinks that settles it?

Mr. HARTSON. He thinks that is settled.

The CHAIRMAN. That is far enough. I think the committee understands it.

Mr. HARTSON. And, in the usual case, that would have settled it, but it so happened that some of the reviewers, in going over that after the conferees had finally agreed on it, thought that there were some questions that should be determined by the solicitor, and it would have gone over to my office in any event. It might have gone over on these other points that the committee has questioned about.

Senator KING. Mr. Hartson, will not the criticisms of the committee and the facts developed in that case, as well as any other cases that have been brought to our attention, require, in justice to the Government, in justice to the taxpayer, and in justice to the Income Tax Unit, a reconsideration of some other cases that may rest upon the same basis and be brought within the same category as some of the cases which have been brought to our attention?

Mr. HARTSON. I think that the cases in which the committee has found things that we all have conceded should be corrected will develop information and corrections in other cases that are not specifically mentioned by this committee.

Senator KING. And will your unit, at as early a date as it is possible—and I know the vast amount of work which devolves upon you—revert to those cases, so that none may escape or be lost in the shuffle, without due opportunity being afforded to consider them in some unit of the bureau?

Mr. HARTSON. It will be the conscientious effort of the unit to do that, Senator.

Senator KING. I would like to make one suggestion, if I may, Mr. Chairman. It is not germane to anything under discussion now, but a number of taxpayers—I shall not mention their names, and it has not been recently, either—have stated to me that they were allowed, they thought, more than they should have been by way of credits and what not because the department adopted a method of determining value on the 1st of March, 1913, which was not quite just. It took into account a great many factors and conditions which arose and developed subsequently, to the advantage of the taxpayer and to the disadvantage of the Government. In other words, they did not adhere to the value in 1913 as of the date fixed in the law;

they gave an entirely new value, which relieved the taxpayer of taxes which ought to be paid.

I just want to call attention to that, so that Mr. Manson and the department, if that is the case, may bring that to our attention, and the department may govern itself accordingly in reviewing these cases. Two taxpayers have told me that they have had quite an advantage by reason of that.

The CHAIRMAN. Do I understand, Senator, that that was done by the department on its own initiative, and was not initiated by the taxpayer?

Senator KING. Well, I did not inquire enough about it, but they got that allowance, and factors were brought onto the equation that should not have been considered, and that gave them a very great advantage.

Mr. MANSON. I will state to the committee that it is very difficult, in fact, impossible, to arrive at what has been done, except to take a particular case and analyze that case and see what has been done in that case. That is exactly the policy that we have pursued.

Senator KING. It is like hunting for a needle in a haystack to carry out the suggestion about learning something on this point, but the department, it seems to me, ought to bear that in mind in considering some of these unadjudicated and undetermined cases.

Mr. MANSON. It is my purpose to try to present cases to the committee which are illustrative of different angles and practices. That is very difficult to do, because it requires an examination of a case with the same degree of care whether we present it to the committee or not. For instance, the engineers worked up this Geauga Silica Sand Co. case, and presented it to me. I notified the department that I would bring it up, but when I came to examine it, I could not find anything in the record to criticize.

Senator KING. Do the engineers who are making the investigation for the committee think that it should be criticized?

Mr. MANSON. Well, one of the new engineers that we have recently put on thought there was something to criticize about it, but I could not see anything myself to criticize about it, so I did not waste the time of the committee to consider it. That sometimes happens.

I wish to say this, in connection with the case we have just considered, that in connection with the Climax Fire Brick Co. case and in connection with some other cases, we had illustrations of the harmful results of permitting engineers to pass on questions of law. I believe there is a very clear differentiation between a question of law and a question of fact. I do not think the engineers should pass on questions of law; nor do I think the legal end of the unit should pass on questions of fact, and particularly where they involve expert knowledge on an accumulation or fund of information, such as is involved in the case just presented.

Senator KING. But in a case like the one under consideration the unit that finally passed on it consists of a lawyer and engineer, and they collaborate. They have the findings of the engineer sitting with the attorney, who writes the opinion or passes upon it. The opinion of the engineer is the basis of the judgment formed by the lawyer, and that constitutes the basis of the judicial determination.

Mr. MANSON. The fact of the matter is that they are all subordinate to the solicitor, who is a lawyer and not an engineer. I just repeat that in my opinion, it is a bad practice.

Mr. HARTSON. Of course, the answer to that is that everything that is done by engineers in the Income Tax Unit is done in the name of the commissioner, who happens to be a lawyer. Now, you have to look through the form to see what actually is done in order to see whether the practice is justified or not. I have tried to explain that while my name is attached to that opinion and to other opinions which issue from the review division in my office, the opinion was actually written by an engineer, and the conference was conducted by an engineer, but the review work and consultation was in connection with the lawyers in the office, and possibly an accountant went over it as well. It is our effort to have these cases that are there on review considered by the technical men who are best qualified to pass on the questions raised, and to have an interchange of views and combined judgment on them, rather than the single individual judgment of one person.

The CHAIRMAN. Mr. Nash spoke to me the other day in connection with this matter of decentralization. I, as one member of the committee, am extremely interested in that, and I recall that Mr. Nash said that they had extended the decentralization of the work to a greater extent than heretofore. Will you please tell us briefly for the record how that has worked out and when you did it?

Mr. NASH. Prior to 1924 all individual income-tax returns showing a net income of $5,000 or less were held in the offices or retained in the offices of the collectors of internal revenue for audit and adjustment with the taxpayer. At the beginning of 1924 the procedure was changed, so that all individual income-tax returns showing a gross income of $15,000 or less were held in collectors' offices for audit and adjustment. The procedure worked very successfully during 1924, and out of something over 8,000,000 returns that were filed, about 7,000,000 were held and adjusted in the collectors' offices before the close of the year. At the beginning of this year we increased the amount to $25,000 gross, and that now means that a little better than 90 per cent of all personal returns that will be filed during this present filing period will be retained in the collectors' offices for audit.

The CHAIRMAN. I think that is good progress.

Senator KING. Yes.

The CHAIRMAN. I want to congratulate the department for extending that activity, so as to minimize the amount of work to be done here in Washington. The collector of internal revenue at Detroit, Mr. Woodruff, was in to see me the other day, and he spoke about some division in Detroit that had connection with your bureau, in charge of a man by the name of Crone.

Mr. NASH. That is the office of the internal-revenue agent in charge at Detroit. His office has to do with the examination of corporation returns, the large individual returns, and partnership returns. These returns are sent out by the bureau for examination.

The CHAIRMAN. That is entirely separate from the internal-revenue collector's office, is it?

Mr. NASH. Yes, sir.

Senator KING. That is, it is a separate branch of the work, but it is all in the internal-revenue office?

Mr. NASH. The internal-revenue agent in charge works under the direction of the deputy commissioner in charge of the income-tax field unit.

The CHAIRMAN. In other words, then, the internal-revenue collector at Detroit has charge of or management of this other bureau?

Mr. NASH. No, sir.

The CHAIRMAN. Just why do you have two departments in the big cities, where they are functioning under the department, without any connection with each other?

Mr. NASH. They do have a connection in that they cooperate with each other. We have in the internal-revenue organization, and always have had, two agencies. One is the internal-revenue agents, and the other is collectors' offices. There are 65 collectors' offices, and there are 35 internal-revenue agents in charge. Every State has at least one collector's office, and several States have more than one office. The agent in charge may cover one State or he may cover several States. The men that are employed by the collectors are noncivil service employees, for the most part. The men that are employed in the office of agents in charge are technical men and civil-service employees.

The investigation of income-tax returns prior to the war was entirely in the hands of the internal revenue agents. Then, when the war revenue acts were passed, and we began collecting taxes and requiring returns from people of smaller incomes, it brought in millions of returns, where before it had been less than a million. There was more work than the income-tax organization in Washington could handle, and the smaller returns were kept in the collectors' offices for audit. This function in the collectors' offices has been growing, and the tendency has been to add a little more each year.

The CHAIRMAN. These returns, where the gross returns are $25,000 or less, are dealt with in the collectors' offices and not the agents' offices?

Mr. NASH. That is true.

The CHAIRMAN. Is there any good reason why the agents' offices and the collectors' office could not be combined; I mean under one head?

Senator KING. And the employees put under the civil service?

Mr. NASH. I believe, Senator, in view of the way in which the personnel is secured at the present time, it would be inadvisable. The collectors are presidential appointees, and usually political appointees. Their time is usually taken up in two ways; one by politics and the other by running an office for the Government. A few of them may devote more time to one job than the other.

The CHAIRMAN. That is the fact, is it?

Mr. NASH. In some instances that is the case; yes, sir.

Senator KING. There is no doubt about it. The charge is made—I will not mention the State—that in the last election every man in the collector's office was giving from half to most of his time for several weeks before the election to a particular party.

The CHAIRMAN. I am not influenced by the personnel. It seems to me that the Government is higher than the personnel. You said because of the personnel of the organization, you thought it was inadvisable to combine the operations of the two sections or units. Are all of the employees of the collectors' offices political employees?

Mr. NASH. No, sir.

The CHAIRMAN. How many of them are, and how many of them are under civil service?

Mr. NASH. I believe about 25 per cent are civil service employees.

The CHAIRMAN. Then, if you had all of them civil service employees in the collectors' offices would there be any objection to combining the agent's office with them?

Mr. NASH. Providing you had employees of the technical qualifications to handle the work.

The CHAIRMAN. I mean, if they were just transferred over to the collectors' offices, would the civil service protect them?

Mr. NASH. I want to say this, Senator, that the present administrative heads of the bureau are not entirely satisfied with our field organization. It is a thing that was developed during the war to take care of an emergency, and we are right now in the process of reorganization, and are boiling it down. Personally, I am not at all satisfied with the present plan of organization, in having part of our work done in collectors' offices and part done in the offices of agents in charge, another part by general prohibition agents, and another part by prohibition directors, etc. If all of this field work could be put under on administrative head, the ideal organization would be to have one administration head in each State, in charge of all internal revenue work.

The CHAIRMAN. The collectors who issue these liquor permits are the collectors of internal revenue, and they have no connection with the general agent's division?

Mr. NASH. The collectors of internal revenue have to do with certain activities that might properly come under the jurisdiction of the prohibition directors.

Senator KING. But they are not connected with the general agent's division?

Mr. NASH. They are not connected with the internal revenue agents in charge.

The CHAIRMAN. The internal revenue agents in charge have nothing to do but to pass upon the records and check the records, and they handle no money.

Mr. NASH. That is it exactly. Theirs is investigative work.

Senator KING. To what extent do they investigate the returns in the States that are made to the collectors' offices, and particularly the small returns, or where returns are made showing no taxable income?

Mr. NASH. The internal revenue agent in charge very seldom gets in on a case that involves a small return, unless the agent who is examining a corporation at the same time takes up the examination of individual returns of the officers and some of the employees receiving the larger salaries. It is our plan to have one man go into a business and take up everything, and not to bother the heads of the business by having our men follow one another on different phases of the work.

Senator KING. In many of these States, as you know, in many districts, there are hundreds, if not thousands, of returns. Most of those returns have been prepared by incompetent men in the collectors' offices; that is, by beginners, because, when there is a change of administration, they turn those men out, and from 60 to 75 or 80 per cent of the personnel is composed of new men. Many of them are wholly unacquainted with the law or with the making of those returns, and they go out and talk with the taxpayer. Your officer is ignorant of the law, and the taxpayer is ignorant of the law, and the returns are made as best they know how. They may be correct, or they may not be correct. Is there any way to check those returns?

Mr. NASH. I do not quite get your point, Senator, because our men do not prepare the returns. The taxpayer prepares his own return.

Senator KING. You say they do, but in many cases the return is prepared by the taxpayer collaborating with the collector's agent. In many cases the taxpayers go to the collector's office. I know that is the case in my State.

Mr. NASH. We have probably 2,000 deputy collectors, who are working on a schedule, visiting every town in their districts, and advertising ahead when they are going to reach those towns, for the purpose of assisting taxpayers in the preparation of their returns and giving them information. That is a part of the educational campaign that the bureau puts on every year. Now, the men that go out on that work are trained men. We do not send an inexperienced man out. We have a half dozen men in the bureau who are experts on income tax matters, and, during the course of the year, they go to every collector's office and hold a school for two or three weeks. The men who are sent out to assist the public must attend that school, they must pass an examination, and they must attain a certain grade before they are permitted to go out.

Senator KING. But that does not answer my question. When those returns are filed, whether they are filed after cooperation between the taxpayer and these experts whom you send out, does anybody in the collector's office look over those returns?

Mr. NASH. Oh, those returns are all reaudited after they are filed.

Senator KING. That is what I am asking about.

Mr. NASH. They are audited by the audit division in the collector's office, but if the return is in excess of $15,000 gross, it comes on down to Washington for audit.

Senator KING. Is there anybody in the collector's office that is sufficiently skilled to audit those returns?

Mr. NASH. Yes, sir; some of the best income tax people that we have in the service are in the collector's offices.

Senator KING. Are those under civil service?

Mr. NASH. Some of them are and some of them are not.

Senator KING. At any rate, then, it may be said that all returns filed are audited at some time and at some place?

Mr. NASH. Yes, sir.

Senator KING. By competent persons?

Mr. NASH. That is true, absolutely true.

The CHAIRMAN. Are all of the men in the agents' offices civil service men?

Mr. NASH. Yes, sir.

The CHAIRMAN. What are the relative salaries paid to the men in the agents' offices and those in the collectors' offices?

Mr. NASH. The average salary of deputy collectors is a little less than $2,000. The average salary of the internal revenue agents on income tax and estate tax work is about $3,000.

The CHAIRMAN. So that the civil service men in the agents' offices get higher pay than the men in the collectors' offices, who are not under civil service?

Mr. NASH. Well, they are different types of men, Senator, men of different training and education.

Senator KING. But they do get a higher salary, as the Senator asked?

Mr. NASH. Yes; but they are doing a higher grade of work.

The CHAIRMAN. I think that is correct. I am not criticizing that. I just asked for information.

Mr. NASH. Yes, sir.

The CHAIRMAN. How many fewer employees would you have to have if you increased the maximum gross income that may remain in the collectors' offices?

Mr. NASH. It will mean probably a slight increase in personnel in some collectors' offices, but we are working on a program of reduction in the Washington end that will reduce our personnel about 500 between now and June 30. That is due, not to this particular change in procedure, but to a great many other things.

The CHAIRMAN. What I want to get at is whether the decentralization of so much of this work would not automatically reduce your staff here in Washington by a large number?

Mr. NASH. What we have in mind is a cleaning up in Washington, and bringing more work into Washington does not help us clean up. The more we can keep out, the better chance we have to get rid of the accumulation that is already here.

The CHAIRMAN. How much of an accumulation have you here now?

Mr. NASH. The last statement that I saw, which was several weeks ago, or since Christmas, certainly, showed about 250,000 cases for 1920 and prior years.

The CHAIRMAN. For 1920 and prior years?

Mr. NASH. Yes, sir.

The CHAIRMAN. You still have, of course, 1921, 1922, and 1923?

Mr. NASH. 1923 is about 40 per cent complete—that is, in the bureau, I mean; the field work is complete on it—1922 is about 40 per cent complete, and 1921 is about 60 per cent complete.

Senator KING. In the bureau?

Mr. NASH. Yes, sir.

Senator KING. And it is all complete in the field?

Mr. NASH. Yes, sir; the collectors' end of it is complete. The internal revenue agents, of course, are working on such 1918, 1919, 1920, and 1921 cases as are being referred to them.

The CHAIRMAN. Then, the collectors' work is current?

Mr. NASH. Practically so; yes, sir.

Senator KING. I have heard a good deal of criticism growing out of the fact that, notwithstanding the great diminution in taxes collected since the peak during the war, you are maintaining throughout the organization substantially the same number, if not more, employees than when you were collecting twice the amount that you are collecting now, and at a time when the law was more complicated and less understood and the men were green and all that sort of thing. What is the fact about that?

Mr. NASH. Senator King, in the years that we collected the most tax, nothing was done except to collect the money. That was during 1918 and 1919. The internal revenue organization at that time was a comparatively small organization. It was not until 1920 and 1921 that the internal revenue organization was built up to audit returns that were filed during the war, and it is since 1921 that practically all of the auditing and adjustment on the returns that were filed during 1917, 1918, and 1919, has been completed.

Senator KING. But the criticism goes to the extent of charging that even in the collectors' divisions and in other activities of the department not connected with the auditing the same number of employees is maintained.

Mr. NASH. Senator King, there are just as many taxpayers now as there were five years ago, or more. The function of the collector is to get the current returns, get the money in the bank, to adjust the small returns and send the big ones on to Washington. Last year we had something over 8,000,000 returns filed, that is, for the year 1923, as against something over 7,000,000 for 1922, almost a million increase in the number of income tax returns. The collectors' men are constantly searching for delinquents, the people who do not file a return until they are caught. I think our statistics show for the fiscal year ending June 30, 1924, something over 425,000 that had never heretofore filed tax returns were discovered and compelled to file returns.

Senator KING. Does that bring in much money in taxes?

Mr. NASH. Yes, sir. In the fiscal year 1924 we collected about $54,000,000 from delinquent taxpayers, and as a result of verifications.

The CHAIRMAN. Did that include penalties, too?

Mr. NASH. That includes penalties, taxes, interest, and fines, etc., and includes not only income tax, but also excise tax, and distraint warrants.

The CHAIRMAN. I think that is work well worth while.

Mr. NASH. It would be folly to reduce that organization. The expense of a deputy collector averages about $2,500 for his salary and travel expense, and our collection statistics point out that he pays for himself about ten times.

The CHAIRMAN. In addition to creating respect for law?

Mr. NASH. We have reduced our organization by over 2,000 in the last two years, and we are turning out more work. I think we are getting rid of a lot of deadwood. This reduction program that they are working on to be effective between now and June 30, ought not to seriously hurt our production. Here and there we find drones that are not producing, and when we find them, we get rid of them.

The CHAIRMAN. As a matter of fact, then, if it were not for using this organization to catch up on the back work, the decentralization of this work would greatly reduce the staff here, would it not?

Mr. NASH. Oh, there is not any argument about that. The tendency now is, as we develop auditors in Washington, to transfer them into the field. We do not make any original appointments in our field offices. The additions are made by transfer of the auditors that have been developed in Washington. It is in effect a promotion to the auditors. After a man comes in here and works in the bureau on returns for two or three years, and shows the ability to handle difficult cases, we can transfer him to the field. That is where he has to audit the actual records of the tax payer.

The CHAIRMAN. Is your office located at Pennsylvania Avenue and Madison Place?

Mr. NASH. My office is in the Treasury Building.

The CHAIRMAN. In the Treasury Building?

Mr. NASH. Yes, sir.

The CHAIRMAN. Where is Mr. Hartson's office?

Mr. HARTSON. My office is in the Interior Building. That is four or five blocks away. Mr. Bright is in the building that you refer to. Mr. Bright is the deputy commissioner in charge of the Income Tax Unit.

The CHAIRMAN. Have you anything else you wish to take up now, Senator?

Senator KING. No. Has Mr. Manson anything more this morning?

Mr. MANSON. No.

The CHAIRMAN. Then, we will adjourn here until to-morrow morning at 10.30 o'clock.

(Whereupon, at 11.50 o'clock a. m., the committee adjourned until to-morrow, January 20, 1925, at 10.30 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, JANUARY 20, 1925

United States Senate,
Select Committee to Investigate the
Bureau of Internal Revenue.
Washington, D. C.

The committee met at 10.30 o'clock a. m., pursuant to adjournment of yesterday:

Present: Senators Couzens (presiding) and King.

Present also: L. C. Manson, Esq., of counsel for the committee; 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; Mr. Nelson T. Hartson, solicitor, Bureau of Internal Revenue; Mr. James M. Williamson, office of solicitor, Bureau of Internal Revenue; Mr. S. M. Greenidge, head engineering division, Bureau of Internal Revenue; Mr. F. T. Eddingfield, engineer office of solicitor, Bureau of Internal Revenue; and Mr. John A. Grimes, chief metals valuation section, Bureau of Internal Revenue.

The Chairman. You may go ahead, Mr. Hartson.

Mr. Hartson. Mr. Chairman, I should like to ask Mr. Eddingfield to take the stand.

STATEMENT OF MR. F. T. EDDINGFIELD, ENGINEER OFFICE OF SOLICITOR, BUREAU OF INTERNAL REVENUE

Mr. Hartson. Give your full name for the record, Mr. Eddingfield.

Mr. Eddingfield. E. T. Eddingfield.

Mr. Hartson. By whom are you employed now, Mr. Eddingfield?

Mr. Eddingfield. I am in the office of the solicitor of internal revenue, review division.

Mr. Hartson. In what capacity are you serving?

Mr. Eddingfield. I am serving as an engineer; determining valuations.

Mr. Hartson. Where did you obtain your engineering education.

Mr. Eddingfield. I graduated from the Columbia School of Mines in New York.

Mr. Hartson. In what year?

Mr. Eddingfield. 1906.

Mr. Hartson. Did you secure a degree?

Mr. Eddingfield. Yes, sir.

Mr. Hartson. What was it?

Mr. EDDINGFIELD. M. E.—mining engineer.

Mr. HARTSON. Will you very briefly outline what your experience has been since graduation, Mr. Eddingfield?

Mr. EDDINGFIELD. I have operated and managed a number of properties. I was assistant superintendent of El Cobre Mines, of Cuba. I was manager of the Deer Lodge Consolidated Mines, a silver and lead mine in Montana. I operated the cyanide plant of the Dolores Mines, of Chihuahua, Mexico. I was connected with the Bureau of Mines in Manilla, and made numerous valuation reports for the bureau and for private individuals in the Philippine Islands. I examined placer gold properties, gold vein properties, copper properties, iron, and numerous nonmetal deposits of various kinds, such as road materials, sand, building stone, and limestone.

I worked on the oil strata of West Virginia at one time. I was general manager of the Blanton Copper Mines, of Santo Domingo. I was in the Bureau of Mines in this city. I was consulting engineer for the Bureau of Mines and investigated the State inspector's office in Minnesota, and wrote quite an elaborate report on the iron mines of Minnesota.

I worked in the war minerals relief of the Bureau of Mines, and compiled a book on the iron ore resources of the world.

Mr. HARTSON. That was done when you were in the Bureau of Mines?

Mr. EDDINGFIELD. When I was in the Bureau of Mines; yes.

Mr. HARTSON. When did you go into the Bureau of Internal Revenue, Mr. Eddingfield?

Mr. EDDINGFIELD. 1920.

The CHAIRMAN. In this experience that you have had, you wrote reports for private investors?

Mr. EDDINGTON. Yes, sir.

The CHAIRMAN. Did you recommend that any of them engage in mining on a 6 per cent basis?

Mr. EDDINGFIELD. No, sir.

The CHAIRMAN. I thought not.

Mr. EDDINGFIELD. That was for an operating owner.

The CHAIRMAN. But you did not recommend any operating owner going into mining on a 6 per cent basis?

Mr. EDDINGFIELD. No, sir.

Mr. HARTSON. Mr. Eddingfield, would you have recommended that a lessee operator go into the mining business on a 6 per cent basis?

Mr. EDDINGFIELD. Yes; it is done, and sales are made on that basis, sales of interests, of lessor interests in Minnesota. Numerous sales have been made on that basis.

Mr. HARTSON. You came into the bureau in 1920?

Mr. EDDINGFIELD. I came into the bureau in the fall of 1920.

The CHAIRMAN. What salary are you getting in the bureau?

Mr. EDDINGFIELD. $5,200.

Mr. HARTSON. That is what you are now receiving?

Mr. EDDINGFIELD. That is what I am now receiving; yes.

Mr. HARTSON. You came in under the civil service, did you, Mr. Eddingfield?

Mr. EDDINGFIELD. Yes.

Mr. HARTSON. After an examination?

Mr. EDDINGFIELD. Yes.

Mr. HARTSON. Where did you serve in the bureau prior to your present assignment?

Mr. EDDINGFIELD. I was in the metals valuation section—natural resource division it was called at that time.

Mr. HARTSON. Were you present at the session of the committee yesterday, when Mr. Manson called the committee's attention to the Border Island case?

Mr. EDDINGFIELD. Yes; I was.

Mr. HARTSON. Have you had any personal knowledge of that case?

Mr. EDDINGFIELD. Yes; I made a valuation, which was the basis of the solicitor's recommendation.

Mr. HARTSON. Were you in the solicitor's office when the case was there on protest, and did you handle the case for the solicitor?

Mr. EDDINGFIELD. Yes, sir.

Mr. HARTSON. I would like to have you explain to the committee the basis for the recommendation and the reasoning that you followed in arriving at the conclusion which was incorporated in the solicitor's recommendation.

Mr. EDDINGFIELD. With your permission, Mr. Chairman, I will read some rough notes that I made since yesterday, hurriedly prepared.

The question of the valuation at March 1, 1913, of the interests of the Border Island Co. has been presented by the counsel of the Senate investigating committee. The statement was made that the cost to the Border Island Co. was $130,000, of which $70,000 was represented by mortgage assumed, $6,000 cash, and $54,000 stock of the Border Island Co. It has apparently been assumed by counsel that the stock, amounting to $54,000 par value, was actually worth no more nor less than par.

The Income Tax Unit accepted this value as at acquisition, but the reasons for this acceptance do not appear in the record. It is assumed that, had $100,000 par value of stock been issued, the unit would have accepted that without question.

The par value of stock issued for property is no proof of its value, and it has not been the practice of the bureau to accept such a basis of valuation. Therefore, inasmuch as there is no evidence showing that the property acquired for stock, cash, and liabilities has been valued either by the taxpayer or the Income Tax Unit, it can not be said that determination of a value at March 1, 1913, of $196,159.99 was allowing the Border Island Co. any value in excess of cost.

It is pointed out in the brief submitted by the taxpayer that the statement in the letter of transmittal of the Income Tax Unit, showing $54,000 par value of stock issued to the Strawberry Island Co. is incorrect. It is stated in this brief that the stock was divided equally between the Strawberry Island Co. and the various parties owning the northerly end of the island, which are referred to as the Cherry interests. Consequently, the organization of the Border Island Co., which took place in September, 1911, and the acquisition of the property, which took place some time between that date and May 1, 1912, supported by a further deed, dated June 12, 1912, represented consolidation of the interests owning the northern and

southern portions of the island. The property thus acquired for stock, cash, and liabilities, would be subject to valuation on that date, for invested capital purposes.

Counsel for the investigating committee referred to the recommendation of the solicitor as the determination of invested capital. It may be noted in the recommendation that the only point passed upon was the value at March 1, 1913, for depletion and that no mention is made of invested capital.

It was further mentioned that on account of the nature of the mining of sand from this deposit and the fact that it was subject to erosion, a greater interest rate factor should be applied than 6 per cent, as used in the recommendation of the solicitor's office.

In this connection, it might be mentioned that the sand deposit was a result of the accumulation of sand on and surrounding Strawberry Island, owing to the peculiar nature of the currents at that point. The taxpayer stated in conference that this accretion was constantly going on and the deposit was increasing rather than diminishing on this account. Therefore, there is no justification for a high risk rate on account of erosion.

The question of what rate to use is one of judgment, and all of the conditions connected with the operation should be considered. It might be pointed out that there was a specific minimum royalty of $24,000 a year to be paid whether sand was removed or not which represented payment for 30,000 cubic yards per year. There appears to have been no question as to the ability of the lessee to make such payments nor as to the probability of such payments continuing until the property was exhausted. Therefore the situation is very similar to the valuation of fixed annuities, $24,000 a year being practically assured, since the conditions of the market at that point were exceedingly good and there was no reason to believe that such conditions would change. It might be admitted that a 10 per cent rate would be applicable if the value were based upon the profits of an operating owner and might be even in excess of 10 per cent if a valuation was being made of the lessee's interest, that is the interest of the Empire Limestone Co., which company was a second party in the contract calling for the payment of $24,000 a year.

It is pointed out in the taxpayer's brief that, both prior to and subsequent to the organization of the Border Island Co., certain suits were carried on in court to protect the interests of the owners of Strawberry Island and to define the limits of their rights. It is not stated whether or not all of the suits had been terminated at the time the deeds of the property were passed to the Border Island Co. However, litigation had been going on for nearly a year, and this litigation may have had some effect upon the value of the property at the time it was acquired. This point, not being one of issue, was not transmitted to the solicitor's office for a decision. It appears that the Income Tax Unit was willing to accept the value of $130,000, and that the taxpayer did not protest.

Referring again to the interest rate of 6 per cent used in the valuation included in the recommendation of the solicitor's office, I desire to present the following authorities which tend to confirm the rate used in situations of this character——

The CHAIRMAN. In your statement, you refer to the fact that there was an accretion to the gravel and sand, due to the peculiar

currents, rather than any erosion and that that fact was developed in conference. Is there any record of the fact that that did develop in conference?

Mr. EDDINGFIELD. No; just my recollection on the matter.

The CHAIRMAN. That is a fine record for a governmental agency, is it not, to trust to an individual's memory with reference to conditions such as that?

Mr. EDDINGFIELD. The geological effect is sufficient to confirm that.

The CHAIRMAN. But anybody examining the records would not have access to the same methods of reaching conclusions as the conferees had, would they?

Mr. EDDINGFIELD. The point was not brought out.

The CHAIRMAN. But it was brought up in conference, and it influenced the decision, did it not?

Mr. EDDINGFIELD. The only time that it has been questioned, is it not, that that question of erosion has been brought up, has been by the engineer and the counsel of this committee.

The CHAIRMAN. But, as I say, to overcome that criticism, you relied upon your memory, and stated that in conference the taxpayer made that statement.

Mr. EDDINGFIELD. Yes, sir; I recalled it.

The CHAIRMAN. Yes; but there is no record of that fact.

Mr. EDDINGFIELD. No, sir. We have no stenographers for that purpose, and do not take the minutes of the hearings. We always request the taxpayer to present his information in writing, to avoid the necessity of having a stenographer take down the hearings word for word.

The CHAIRMAN. But in this case he did not submit that fact as a consideration of value, did he?

Mr. EDDINGFIELD. No, sir; but in view of the circumstances in the case, it did not seem to be an essential point at the time. Had it been a vital issue at the time, I certainly would have made a notation of it.

Mr. HARTSON. And, as I understand you, it has only become vital by reason of counsel's criticism?

Mr. EDDINGFIELD. That is it.

Mr. HARTSON. It was not one of the things that were in dispute before in the solicitor's office?

Mr. EDDINGFIELD. No. Shall I proceed, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. EDDINGFIELD. Although it is admitted that an investor in mines expects a greater rate of interest than used in ordinary mercantile and industrial transactions it is submitted that the rate of interest of 6 per cent is adequate for a lessor of a mine in which the ore reserves and the profit per unit are proven.

1. The lessor shares none of the inherent risk of loss to which the operator is exposed. If the lessee operator is forced to abandon the operation and surrender the lease, the lessor does not suffer any loss except a deferment of profit until another lessee exploits the ore. Often in cases of surrender of a lease, covenants in the lease require that a surrender of title to the lessor of all the plant and equipment and other fixtures installed by the lessee during his

tenure. In such cases the lessor frequently profits by unsuccessful operation by the lessee.

Mr. MANSON. Was there any plant here?

Mr. EDDINGFIELD. I do not know, sir.

Mr. MANSON. Does not the record show that there was no plant, as a matter of fact?

Mr. EDDINGFIELD. I did not investigate that feature of it.

Mr. MANSON. Well, does not the record itself show that the owner of this property owned no plant, and that there was no plant connected with the property at all? The lessee had some dredges.

Mr. EDDINGFIELD. Yes.

Mr. MANSON. The excavation was made by suckers, was it not?

Mr. EDDINGFIELD. Suckers or buckets—I do not know which.

Mr. MANSON. It was done by dredging?

Mr. EDDINGFIELD. Yes.

Mr. HARTSON. I do not believe Mr. Eddingfield has in mind the recitation of these facts as applying particularly and definitely to this case. He is speaking of the general principles, and he is illustrating by an example, which may not be exactly comparable to the case which is under criticism.

The CHAIRMAN. I think that is correct. I understood that this was just a general statement.

Mr. EDDINGFIELD. Yes. I have here a few excerpts or quotations from published papers of various recognized mining engineers:

R. C. Allen, Mining and Engineering World, September 12, 1914:

> The Michigan States Tax Commission used discount rate of 6 per cent and 6 per cent.

R. C. Allen, Fourth Proceedings Michigan State Conference on Taxation, Detroit, January 28, 1915:

> If due conservatism is maintained in the estimation of prospective ore it will be generally unnecessary to make great allowance for hazards by application of a high-interest rate to invested capital. Therefore, the common investment rate of 6 per cent is used.

The CHAIRMAN. Let me ask you at this point, does the bureau use that rate in computing the inheritance taxes, in valuing properties in inheritance-tax cases, the same as they do in figuring invested capital for income-tax purposes, or excess-profit taxes?

Mr. EDDINGFIELD. For lessor interests, they do, sir. In fact, I have seen even lower rates applied; 5 per cent and 5 per cent, to the inheritance tax.

R. B. Brinsmade. Transactions American Institute of Mining Engineers, Volume XLV, page 322:

> The investing public is evidently satisfied with a net yield around 5 per cent from Michigan mines, for during many years the stock of the Calument & Hecla Co. has been often quoted at prices to yield only 7 per cent, and this includes the necessary sinking fund annuity.

H. M. Chance, "Valuation of coal lands," Transactions American Institute of Mining Engineers, volume 47, page 111 (1913). In a formula developed he uses as remunerative rate 6 per cent and as a redemption rate 5 per cent.

Mr. MANSON. As of what date was that?

Mr. EDDINGFIELD. 1915.

W. E. Fohl, "The valuation of coal lands." Colliery Engineering, volume 36, page 965 (September, 1915). Mr. Fohl uses 5 per cent compound interest in the valuation of a royalty equity, and 6 per cent and 4 per cent in valuing the operators' interest of developed coal land.

R. V. Norris, consulting mining engineer, Wilkes-Barre, Pa. ($1 a year man on Government job during war). Discussion of "Federal taxation of mines," by L. C. Graton. Transactions of American Institute of Mining Engineers, September, 1919, Bulletin 155, page 2957:

> In the case of a lessor who has constant tonnage royalty, regardless of the profits or losses of the lessee, the returns can and should be divided into interest on the value of the property and depletion to amortize its value in its probable life; and, as these returns are practically independent of mining profits, the legal rate of 6 per cent be used in calculating the value of this property.

He further states:

> I would respectfully suggest that the present value of coal properties be calculated on the basis of 6 per cent. Six per cent plus the necessary percentage to amortize the property value is all that is justified in calculating present values in the case of coal mines.

Report of the Commissioner of Corporations on the steel industry, part 1, July 1, 1911 (Government Printing Office), page 3. The royalty valuation made in this report is on the basis of 700,000,000 tons of free ore, at an average royalty rate of 28 cents per ton, and a 6 per cent rate of interest.

In the following cases the present value method was subjected to judicial attack and in both cases it was sustained:

Sunday Lake Iron Co. *v.* Wakefield (1915), 153 N. W. 14.

Newport Mining Co. *v.* Ironwood (1915), 152 N. W. 1088.

Sunday Lake Iron Co. *v.* Wakefield, 247 U. S. 350.

The cases involved a refund of taxes paid under protest under the Michigan statutes in 1911. The tax was based on an appraisal by J. A. Finlay made by the engineering appraisal method in which he used a discount rate of 5 per cent.

The courts said that the appraisal was made by sound business methods, and that there was no reason to disturb the findings of the board of commissioners.

Mr. HARTSON. Mr. Eddingfield, based on your experience and your knowledge of good engineering practice, do you believe that the use of a 6 per cent interest rate in the valuation of a property such as this deposit contained in the Border Island case was thoroughly warranted?

Mr. EDDINGFIELD. I think it would be the maximum rate that should be applied in this particular case, because the contract specifies a minimum annual royalty payment of $24,000.

The CHAIRMAN. What was the attitude of the other engineers who disagreed with the commissioner's office and with your viewpoint?

Mr. EDDINGFIELD. I have not noted any; I have not seen any——

Mr. HARTSON. The Senator wants to know what was the basis for the allowance by the unit of the value as of March 1, 1913.

The CHAIRMAN. Yes. Some other engineers disagreed with him, because they had protested or objected to the ruling of the solicitor's

office and used some other factors in arriving at the cost, or at least they disagreed with the engineer in the solicitor's office, that the valuation of March 1, 1913, was a proper valuation.

Mr. EDDINGFIELD. I examined the record, and was unable to find any valuation on any basis made by an engineer of the Income Tax Unit.

Mr. HARTSON. They just accepted it, and they assumed that the cost was $130,000?

Mr. EDDINGFIELD. $130,000.

The CHAIRMAN. As I understand it, it was developed in some of our former hearings that the statute somewhere said that the par value was to be used.

Mr. MANSON. That is the 1917 statute as to invested capital.

Mr. HARTSON. And this question is one, as Mr. Eddingfield has pointed out, which is limited entirely to depletion. It was necessary to determine the value as of March 1, 1913, for the purpose of depletion. Is not that the point in controversy?

The CHAIRMAN. I understand, but is there a different valuation for invested capital than there is for depletion?

Mr. HARTSON. There is, sir.

The CHAIRMAN. Why?

Mr. HARTSON. For the reason that the depletion value is based upon a March 1, 1913, value, whereas the valuation for invested capital purposes is the value of the asset at the time of the acquisition, if acquired before March 1, 1913; so that for invested capital purposes, it was necessary to value this deposit at the date of acquisition, which was in 1912. For purposes of depletion, it was necessary to value the same property as of March 1, 1913, that being the effective date of the first income tax law.

Mr. MANSON. A difference of nine months.

The CHAIRMAN. What I am trying to get at is this: It was only a few months prior to March 1, 1913, that this property was acquired, and I would like to know whether any different factors are used in arriving at valuation for depletion than valuation for invested capital purposes?

Mr. EDDINGFIELD. Actually, there should not be.

The CHAIRMAN. That is what I am trying to get at.

Mr. EDDINGFIELD. There is a tendency for including in a March 1, 1913, value an element of probability; that is, they are not quite so strict as to value as of March 1, 1913, as they are in valuing for invested capital. That is a distinction without a difference. In my experience, there has been no difference in the value that I have determined. A value is a value, and it does not matter at what time you determine it.

The CHAIRMAN. I thought that that was true, but considerable emphasis seems to have been laid on the fact that this was arrived at for depletion purposes and not for invested capital purposes.

Mr. EDDINGFIELD. That was merely because it was mentioned by counsel that we determined the invested capital. Such was not the case. We did not make a determination of invested capital.

The CHAIRMAN. Well, the result would be the same, would it not?

Mr. EDDINGFIELD. Yes, sir. Had we been called upon to do so. But there was never——

The CHAIRMAN. Why lay emphasis on the fact that it was done for the purpose of depletion and not for invested capital purposes?

Mr. EDDINGFIELD. Because, had we been asked to make a value for invested capital in 1912, it is possible that the value which we would have determined would not have been different from the March 1, 1913, value.

The CHAIRMAN. And yet it might have been different?

Mr. EDDINGFIELD. It might have been different, because——

The CHAIRMAN. On what theory?

Mr. EDDINGFIELD. I mentioned in my statement a while ago that there was litigation going on during 1911 and 1912; which might influence the market value of the property.

The CHAIRMAN. What was this litigation to determine?

Mr. EDDINGFIELD. The rights of the owners of the island to the sand surrounding the island, and until that had been fixed by the courts, the owners of the property did not know how much sand they really owned, and they were subject to trespass all the time by these sloops that came around and dredged the sand surrounding the island. So that, if that litigation had been settled at the time the corporation acquired the property, I should say that the value that should have been given for invested capital, or to which the taxpayer would have been entitled, would not have been less than the March 1, 1913, value as we determined it; but I have endeavored to point out that there has been no valuation made by the Income Tax Unit, either at acquisition or at March 1, 1913. They have merely accepted the par value of the stock, plus the cash, plus the liabilities assumed, presumably on the theory that it was sufficiently low.

The CHAIRMAN. Do you want to ask the witness any questions, Mr. Manson?

Mr. MANSON. Yes; have you made any inquiry as to the extent of these accretions?

Mr. EDDINGFIELD. No.

Mr. MANSON. You do not know whether the accretions are sufficient to overcome erosion or not?

Mr. EDDINGFIELD. I have seen no proof of the fact that there was any erosion.

Mr. MANSON. There is a strong current in the Niagara River there, is there not?

Mr. EDDINGFIELD. Not at this point. Have you any evidence of the fact that there was erosion, or that there was a strong current?

Mr. MANSON. I know that there is a strong current in the Niagara River.

Mr. EDDINGFIELD. Yes, sir; but that is in the mouth of the harbor.

Mr. MANSON. Yes; I know exactly where it is.

Mr. EDDINGFIELD. It seems to me that if the contention is made that there is erosion, it is incumbent upon the engineers to prove such a thing.

The CHAIRMAN. I do not think that is relevant. We need not go any further on that.

Mr. MANSON. What I am trying to get at is this: This value was made for depletion purposes?

Mr. EDDINGFIELD. Yes, sir.

Mr. MANSON. Depletion allowance is made to take care of the investment in the property which is consumed in operation. If there were accretions to this island by reason of the action of the current, it is very clear that the depletion would not be equal; that is, the depletion in value would not be equal to the value of the sand and gravel taken out of the island, and it strikes me that if you were determining a value here for depletion purposes, and there was any evidence whatever of accretions, you could not determine a value to be depleted until you ascertained the extent of the accretions.

The CHAIRMAN. I think that is sound; but in going back to the records of the bureau we find that they do not indicate any such theory as that, and I think we will have to dispense with any lengthy discussions of that subject, in view of the fact that the records do not show it. We must let the records stand, showing that the bureau decided these questions on the statements of taxpayers without a proper record or a proper consideration.

Mr. MANSON. You spoke of there being a fixed allowance of $24,000 a year under this lease. It is a fact, is it not, that that $24,000 is the minimum which is to be paid until the gravel or sand is exhausted?

Mr. EDDINGFIELD. Yes, sir.

Mr. MANSON. And that that stops the moment that it is exhausted?

Mr. EDDINGFIELD. Yes, sir.

Mr. MANSON. So that, instead of being a fixed annuity, it is contingent upon the amount of sand and gravel that is removed?

Mr. EDDINGFIELD. Yes, sir; that is, provided there is still sand and gravel remaining.

Mr. MANSON. Yes.

Mr. EDDINGFIELD. It is not contingent upon the sand and gravel removed.

Mr. MANSON. I say, it is not contingent upon the sand and gravel removed. It is contingent upon there being sufficient gravel on the island to make up the $24,000.

Mr. EDDINGFIELD. Yes.

Mr. MANSON. At the royalty rate specified in the lease.

Mr. EDDINGFIELD. Yes.

Mr. MANSON. You spoke of these appraisals having been made on the basis of sales, is it not a fact that an appraisal made according to the present-value method is the basis on which negotiations start, instead of being the place where they end?

Mr. EDDINGFIELD. In most——

The CHAIRMAN. I think that would apply to a specific case, but not in general.

Mr. MANSON. I think that is true as a general rule. Is it not?

Mr. EDDINGFIELD. There are usually two reports made in a case where a valuation is necessary. The prospective purchaser has an engineer make a report along the most conservative lines. The seller, the owner of the property, has an engineer make a report along exceedingly liberal lines.

The CHAIRMAN. I am glad you state that, because it shows that the engineer will make such a report as he is hired to make. That is something that I have contended for some time, as applied to not only engineers but to attorneys and experts, and I have been literally "panned" by the members of those professions for assuming that these experts have any such attitude of mind.

Mr. EDDINGFIELD. I might state in that connection that there are engineers who will not lend themselves to the latter basis.

The CHAIRMAN. Oh, I knew I would get a rise if I said that. So it all depends upon the engineer as to whether we get an honest report or not.

Mr. EDDINGFIELD. There are plenty of engineers in this country who will not lend themselves to certain statements, just as there are attorneys who will not defend an obviously erroneous case.

Mr. MANSON. Assume a situation of this sort: Say a corporation desires to get out a bond issue, and they go to a firm of underwriters with an engineer's valuation, based, we will say, on a 6 per cent discount value, and say the valuation shows the property to be worth $50,000,000, and they desire to get out a bond issue of $10,000,000. If the underwriters accept that valuation as the basis of the $10,000,000 bond issue, you would not say that that was an acceptance of a 6 per cent discount factor as the proper factor in determining the value of that property, would you?

Mr. EDDINGFIELD. Not necessarily.

The CHAIRMAN. That would probably be shown in the prospectus that they would issue when the underwriters attempted to sell the issue?

Mr. MANSON. Yes.

The CHAIRMAN. But if the underwriters hired engineers to go out and check up the prospectus, the person who applies for the underwriting, according to the witness' testimony, would get an entirely different result.

Mr. MANSON. Yes.

The CHAIRMAN. In other words, he would get a conservative result, while the engineer who presented the valuation for the underwriting would get an optimistic report.

Mr. MANSON. What I was endeavoring to point out, in connection with these appraisals based upon capitalization of prospective profits, is this: That they are a useful and intelligent basis to start figuring from. If the prospective purchaser of a mine is shown an appraisal by an engineer in whom he has confidence, he looks to see what discount factor has been used. If a 6 per cent discount factor has been used, and he expects to get 18 per cent on his money, he will pay one-third the value shown by the engineer's appraisal. If a firm of underwriters were figuring on floating a bond issue, and are shown an engineer's appraisal made by an engineer in whom they have confidence, they will look at the discount factor. If the discount factor is 10 per cent, and they do not care to loan on any less basis than 20 per cent, they may lend up to the amount of the appraisal. In other words, this method is an intelligent method of arriving at a basis of value. When you come to make an actual sale or actual loan, you figure from the discount factor used on the basis you desire to buy on or on the basis you desire to loan on. The use of these fac-

tors by engineers is by no means conclusive that the result arrived at either represents market value or represents the loan value. That is the point I wanted to make.

The CHAIRMAN. Of course, if the bureau, in inheritance tax matters as well as in the matter of appraisal for capital investment or depletion, used uniformly the same discount rate for all alike, I would not find any particular fault with their being liberal to the taxpayer in fixing these amounts, but I think it has been developed that there has been a lack of uniformity. I do not think the committee, so far as I can speak for it, is prone to criticize a liberal treatment of the taxpayer in these matters, when there is a question of doubt as to market value, but they do find fault with the apparent lack of uniform policy in all cases.

Mr. EDDINGFIELD. I might say, Mr. Chairman, that the capital stock tax people have of late years been in close touch with the valuation section of the Income Tax Unit, and they use their values for capital stock tax purposes; the valuation section is in close touch with the inheritance tax division, and whenever there is a case of inheritance they use the value assigned by the inheritance tax people.

The CHAIRMAN. I am glad to have you make that statement, and I would like counsel to check up on that, because, in conversation with counsel in the past, I have gotten the impression that no such relation existed between the various units of the bureau or between the various departments of the Government, and that there was no such understanding as he thinks.

Mr. EDDINGFIELD. When I was in the metals valuation section, representatives from the capital stock tax division used to be in our office very frequently, checking up on the various taxpayers, and I, myself, have visited the inheritance tax people on numerous occasions to get a value.

The CHAIRMAN. But it is only spasmodic and irregular; there is no system about it?

Mr. EDDINGFIELD. They have a system in the capital stock tax division. They are there all the time.

The CHAIRMAN. I think I can substantiate the belief of counsel, as transmitted to me, at least, that there is no system about it, but they rely simply upon the initiative and good judgment of the engineer and the auditor dealing with the case.

Mr. EDDINGFIELD. That may be possible.

The CHAIRMAN. Do you know whether that is true, Mr. Nash?

Mr. NASH. The valuations for invested capital and for depletion in the same case would be under the supervision and direction of the man handling that case.

The CHAIRMAN. How about the inheritance tax division?

Mr. NASH. The proper procedure is for them to check it with the proper valuation section of the engineering division on any valuation that requires engineering judgment.

Mr. HARTSON. They are acting under such instructions, too, are they not?

Mr. NASH. They are acting under under such instructions; yes, sir.

The CHAIRMAN. Is there any check-up to see whether or not that is done?

Mr. NASH. We do not have individual inspection of cases to see that it is, but we have enough confidence in our supervisory officers in charge of these divisions to feel that it is done.

Mr. GREENIDGE. We have written instructions to that effect, that we can not change.

Mr. MANSON. How long have those instructions been in effect?

Mr. NASH. Ever since I have been in the bureau, Mr. Chairman.

The CHAIRMAN. Well, we do not want to waste any more time on that now. I have asked Mr. Manson to check that up and see if that is true, and report to the committee.

Mr. MANSON. Very well.

Mr. HARTSON. Mr. Chairman, I would like to address myself to the comment that Senator Couzens made about employing experts whose judgment differs, that one expert will reach a conservative result and another a liberal result. I quite agree with the chairman in his statement that there are conservative individuals employed in all of the professions, and there are men of less conservative tendencies engaged in those professions. We all know, of common knowledge, that in trials of law suits, doctors go on the stand and one will testify, using his expert knowledge, and will reach one conclusion. Another doctor of equal experience and of equal integrity will reach another conclusion. The difficulty, Mr. Chairman, as I see it——

The CHAIRMAN. Just a minute. I do not want to encumber the record with that, Mr. Hartson. What I say is that the same doctor will testify on either side of a case, dependent upon which side he is employed to testify for. I was not developing the fact that an engineer or doctor of equal expertness will testify on a different side. I know that is true, and I am not finding any fault with it, but your witness said that you could get an engineer who would make a liberal valuation, dependent upon what his client wanted, or he would make a conservative valuation, dependent upon what his client wanted. That was the point I was making, and not the point that you are developing here, and I do not want the record to show that.

Mr. HARTSON. I merely had this in mind, that the subject with which we are dealing and the subjects which require the assistance of expert testimony allow and permit such a wide latitude of judgment and discretion that there is not any exact answer to it. Therefore, a man can be intellectually honest and morally honest and reach a more liberal result than the same man might possibly reach had he a different point of view in approaching the subject.

The CHAIRMAN. Well, as I say, it depends on who hires him as to the point of view he has, because the employer designates the point of view, and the engineer goes out to establish that point of view.

Mr. HARTSON. I think it is human nature——

The CHAIRMAN. I am not finding any fault with it, but I was glad to have such an expert engineer confirm my theory, which theory I have been condemned for having advanced.

Mr. EDDINGFIELD. Mr. Chairman, there are two values in every case, or an infinite number. There is a minimum value, which, based upon the most conservative line, would be an absolutely safe investment. There is another value, which might show the possibility of developing and operating a property. Anyone purchasing the

property would want both statements, the maximum possibilities in the property, and the minimum possibilities in the property.

The CHAIRMAN. I know, but the man who is selling the property would not want the minimum possibilities.

Mr. EDDINGFIELD. He would not publish them.

The CHAIRMAN. Certainly not. He would not want them, and probably would not want to know.

Mr. EDDINGFIELD. But the purchaser would want to know both.

The CHAIRMAN. He may not want to know the maximum either.

Mr. EDDINGFIELD. Oh, yes.

The CHAIRMAN. Because he would not want to be keyed up to paying too much for the property.

Mr. EDDINGFIELD. I think the purchaser wants to know the maximum as well as the minimum, sir.

Mr. MANSON. In connection with this matter of discount rates, I want to say that when I first started this work, I had a conference with Mr. Greenidge, and I had a conference with the chief of the appraisal section in the estate tax division, and tried to get from both of them some information as to the discount rates that they applied to different classes of industries. It appeared to me that, with the large number of people engaged in this work, there must be some set of instructions which would at least fix the minimum and maximum discount rates that could be applied to different classes of investments, appraised according to this method of appraisal. The best that I could get out of either of them, after most persistent efforts, was that it was all a matter of judgment, and I have not, as yet, any knowledge of the rates that are applied, except as brought out in specific cases. It seems to me, if there is to be any uniformity, even in the same office, to say nothing about it as between two offices, there must be some accepted standards. If there are, I have failed to discover what they are.

The CHAIRMAN. That is what the committee has asked you to look up and report back to the committee on, Mr. Manson.

Mr. MANSON. Yes.

The CHAIRMAN. To see if there are any standards.

Mr. MANSON. I just made the statement, for the purpose of informing the committee, that was one of the first things I attempted to do.

The CHAIRMAN. Have you anything more to put in now, Mr. Hartson?

Mr. HARTSON. Not so far as Mr. Eddingfield is concerned.

(The exhibits offered by Mr. Manson in the Border Island Co. case are as follows:)

EXHIBIT A

JANUARY 17, 1925.

Mr. L. C. Manson, counsel, Senate Committee for Investigation Bureau of Internal Revenue.

Office report No. 11.

Taxpayer: Border Island Co., Buffalo, N. Y.

Business: Lessor of gravel bed.

Subject: Depletion and March 1, 1913, value.

Amounts involved:

Actual price paid for island, June, 1912—		
Cash		$6,000.00
Stock		54,000.00
Mortgage		70,000.00
Total		130,000.00
Value first claimed by taxpayer		120,000.00
Value allowed by engineers	$130,000.00	
Less value silt land	3,000.00	
Net value sand and gravel		127,000.00
Second value claimed by taxpayer—		
Finally allowed value		196,159.99
Difference in tax, 1917–18		10,959.00

STATUS OF CLAIM IN AUDIT

Final set-up allowed:

Reserves, sand and gravel and acquisition ....cubic yards	4,700,000
Removed up to Mar. 1, 1913 ....do	266,667
Reserves, Mar. 1, 1913 ....do	4,433,333
Royalty rate	$0.075
Gross expected receipts	$332,499.98
Less estimated expenses, 13 years	$26,000.00
Net expected receipts	$306,499.98
Present worth at 6 per cent and 4 per cent for 13 years, factor	$0.64
Value of taxpayer's interest at Mar. 1, 1913	$196,159.99
Unit of depletion, cubic yard	0.0442

SYNOPSIS OF CASE

The taxpayer has been allowed to greatly increase the value of his property for March 1, 1913, over the cost of one year previous, on date of acquisition. There is no proper substantiation or logical reason for any such increase in value in so short a period of time.

Second, a valuation has been allowed by the solicitor's ruling on the basis of the analytical method of appraisal, using a profit factor of 6 per cent and a discount factor of 4 per cent. Profit factor of 6 per cent in the sand and gravel business is ridiculous.

HISTORY OF THE CASE

The Border Island Co. is stated as being "a corporation organized in September, 1911, under the laws of the State of New York. The seal used by the company gives date of incorporation as 1912." The first meeting was held in June, 1912. The company holds title to an island in Niagara River, partly within limits of city of Buffalo. This property acquired by company by deed in June, 1912. Its sole business is leasing of the right to dredge or pump sand and gravel in and around said island. This right is held by lessee, the Empire Limestone Co.

Prior to the date on which the Border Island Co. acquired title to the island, the then owners of the island, represented by Allan I. Holloway and Maurice C. Spratt, trustees, entered into an agreement with the Empire Limestone Co. on April 24, 1912, whereby the latter company was to pay 8 cents per cubic yard for the first 300,000 cubic yards, the next 20,000 cubic yards to be free, and the remaining material taken out to be at the rate of 7½ cents per cubic yard, the minimum payment to be $24,000 per annum, the company having the right to operate until May 1, 1926, provided island is not removed before that date.

Correspondence on this case has been protracted over four years, the taxpayers not appearing to give much helpful information. Conferences were

arranged and postponements thereof successively requested by taxpayer; when finally held little seems to have been accomplished in the way of substantiating claims.

The information contained on Form F dated May 12, 1921, not being satisfactory to the unit, taxpayer presented a statement on December 20, 1921, setting forth certain additional information, the most important part of which shows that the purchase price of the property was $130,000. (See Exhibit B attached.)

On February 27, 1922, the unit disallowed the depletion claimed by taxpayer. (See Exhibit C attached.)

On April 5, 1922, taxpayer having protested the action of the unit noted above, presented a brief, claiming a value of $3,490 per acre instead of $3,000 per acre originally claimed on his Form F. (See Exhibit D attached.)

On April 5, 1922, following the conference, Mr. S. L. Shontz, valuation engineer of the unit, wrote up the report allowing a value of $127,000 for the gravel based on the cost as furnished by taxpayer. (See Exhibit E attached.)

Again on June 11, 1922, he makes a more extended valuation report. (See Exhibit F attached.)

On November 24, 1922, taxpayer was notified of a proposed additional assessment based on the valuation report of Mr. Shontz, above noted. (See Exhibit G attached.)

On December 12, 1922, taxpayer files a formal protest to the proposed assessment. (See Exhibit H attached.)

On January 16, 1923, a field agent made an examination of the books and records of the Border Island Co. (See Exhibit I attached.) The revenue agent was in error in not having the information as to the valuation set up by the valuation section.

On April 14, 1923, the above was set forth in valuation memorandum sent to the taxpayer approving their original allowance for depletion based on cost. (See Exhibit J attached.)

Therefore, on February 5, 1923, the unit notified the taxpayer of an additional assessment of the taxpayer, $10,959 based upon the depletion allowances as originally made by the nonmetals section. (See Exhibit K attached.)

On October 4, 1923, the Border Island Co. filed a formal appeal to this additional assessment setting up a value based on total receipts from 1912 to 1923, inclusive. (See Exhibit L attached.)

On October 26, 1923, the engineering division prepared a memorandum to the committee on appeals and reviews, giving the history of the entire matter to date. (See Exhibit M attached.)

After considerable delay, the taxpayer on July 23, 1924, files a supplementary brief, further protesting against the additional assessment mentioned above. (See Exhibit N attached.)

A verbal hearing was accorded taxpayer on August 15, 1924, by the solicitor's office. The result of this hearing was handed down by the solicitor in his recommendation No. 582, dated August 23, 1924, which fixes the valuation and depletion unit on taxpayer's property at $196,150 and 0.0442 respectively. (See Exhibit O attached.)

The nonmetals section on September 16, 1924, prepared a memorandum setting up the new valuation and depletion as required by the solicitor. (See Exhibit P attached.)

This was the last paper of the case and we understand that the case is now in audit.

DISCUSSION OF THE CASE

There seems to be no good reason in this case why the value of this gravel property should have increased any appreciable amount, between date purchased in June, 1912, and March 1, 1913. In fact, the unit has been liberal in allowing the cost shown by the taxpayer; inasmuch as about half of this cost is represented by a payment of $54,000 in capital stock and there is no evidence that this stock was worth the above-stated par value.

The records show that the unit consistently denied the repeated claims made by the taxpayer from November, 1920, to August, 1924, the time the solicitor's recommendation No. 582 allowed the use of the analytical appraisal method. This memorandum not only allowed the use of this formula but it designated a rate of profit at 6 per cent. In fact, the solicitor's office took over the entire function of the engineering division, as it set up a detailed appraisal of the taxpayer's gravel, as well as fixing the unit of depletion to be allowed thereon.

We submit that a procedure of this kind makes it impossible for the engineering division to give different taxpayers equal and just treatment. It would seem proper for the solicitor's office to indicate the points of law, or even the general method which should be applied to the taxpayer's case, but we deem it decidedly unwise for the solicitor to set up definite valuations. Such action makes of the engineering division a mere rubber stamp.

The use of the profit rate of 6 per cent in a sand and gravel business of this character, subject to risks, such as defaulting the lessee, risk of erosion, risk of parties dredging around island, risk of overestimation of recovery, a rate of interest which is expected only on sure investments such as bonds and mortgages thoroughly secured by property of value far in excess of the total amount of the bond or mortgage, is absolutely without sound foundation. We contend that even if it was proper to use the analytical appraisal method, in this case, a profit factor at least of 10 per cent should be used. If this rate had been used, the value of the taxpayer's gravel on March 1, 1913, would have been approximately $130,000, an amount in practical agreement with the $127,000 allowed cost of this gravel.

To sum up, we contend that the cost of this property in June, 1912, was the best indication of its fair market value on March 1, 1913. We further contend that an allowance of 6 per cent profit for this business can not be justified.

Respectfully submitted.

H. M. PARKER, *Investigating Engineer.*

Approved:

L. H. PARKER, *Chief Engineer.*

EXHIBIT B

BUFFALO, N. Y., *December 20, 1921.*

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

DEAR SIR: Referring to your letter of October 18 re Border Island Co., we finally succeeded in getting a survey of the property which shows the depletion much greater than we had thought possible, and I am inclosing your affidavit setting forth all the facts. We have a map of the island and if you would like to have us file it with you we would be glad to do so. I think the affidavit inclosed covers all the points which you want to know.

Yours very truly,

THOMAS R. STONE, *President.*

STATE OF NEW YORK,
Erie County, ss:

Thomas R. Stone, of the city of Buffalo, N. Y., being duly sworn, on oath says he is the president of the Border Island Co., which owns an island in the Niagara River, Erie County, N. Y.: that said company was incorporated in September, 1911. That said island was purchased by said company on or about June 15, 1912, at and for the sum of $130,000.

That said company did not conduct any business in or about said island until the year 1918; that in the year 1918 it was estimated that 2 acres of land had been removed, and the same amount was estimated as removed during the years 1919 and 1920 and claimed as depletion in its returns for said years; that a survey of said island was made during the month of November, 1921, which shows that the depletion of said island from September 28, 1917, to November, 1921, is 20 acres. The head or south end of said island was composed entirely of sand and gravel, up to the line thereof reached during the year 1920, and from that line north the island is overlaid with several feet of silt or mud, which has to be removed before the sand and gravel can be pumped, and thereby a much greater acreage of the island was taken away during the year 1921, in order to procure sufficient sand and gravel; that the pumping operations are carried on fom May to November each year. Depletion of 2 acres was claimed in the income-tax return of said company for the year 1918, and 2 acres each for the years 1919 and 1920, making a total of 6 acres, and the number of acres actually removed, as shown by said survey, during the years 1918, 1919, 1920, and 1921 is about 17 acres.

That said island when purchased by said company was encumbered by mortgages amounting to $70,000, and title was taken subject to same, and stock of the company amounting to $54,000 and cash $6,000 was paid, making a total of $130,000.

That the value of said island in 1913 was about the same as 1912.

The estimate of the surface area in report for year 1921 as 35 acres, at $3,000 per acre, is shown by said survey to be not correct. That there is not at this time to exceed 20 acres estimated to be the value of $3,000 per acre, and from latest developments shown about 20 acres of the value of $1,500 per acre, and 35 acres of the value of about $50 per acre. It is estimated that at least 7 acres of surface of said island were removed during the year 1921.

The estimate of the amount of depletion of said island during the years 1918, 1919, and 1920 was not, therefore, equal to the amount actually removed.

THOMAS R. STONE.

Sworn to before me this 20th day of December, 1921.

[SEAL.] A. W. PLUMLEY, *Notary Public.*

EXHIBIT C

FEBRUARY 27, 1922.

BORDER ISLAND CO.,
Buffalo, N. Y.

SIRS: With reference to your income-tax returns for the years 1917 to 1920, inclusive, you are advised that the evidence submitted in Form F and in your letter of December 22, 1921, does not substantiate your claim for depletion, which is therefore disallowed.

Value claimed at acquisition	$30,000
Fair market value at acquisition	None.
(Lease not subject to depletion.)	
Depletion claimed, 1919	6,000
Depletion allowed, 1919	None.
Depletion claimed, 1920	6,000
Depletion allowed, 1920	None.

This action will be reflected in the audit of your returns which will begin 20 days from date of this letter, and you will be notified of the tax liability resulting therefrom.

Respectfully,

E. H. BATSON,
Deputy Commissioner.
By A. H. FAY,
Head of Division.

EXHIBIT D

STATE OF NEW YORK,
County of Erie, City of Buffalo, ss:

Thomas R. Stone, being duly sworn, deposes and says that he resides at the city of Buffalo, N. Y., and is an attorney and counselor at law, practicing his profession in said city; that he is an officer, to wit, the president of the Border Island Co., a business corporation organized in September, 1911, under the laws of the State of New York; that he has been president of said corporation since its first meeting in June, 1912; that in June, 1912, said corporation acquired Strawberry Island, located partly within the city of Buffalo in the Niagara River, by deeds of conveyance from the Strawberry Island Co. and from William H. Heimbach and wife, which deeds were recorded, respectively, in Erie County clerk's office on the 17th day of June, 1922; that title to said island was taken by the said Border Island Co. subject to mortgages aggregating the sum of $70,000, and also subject to a certain agreement licensing the removal of sand and gravel from and around said island, made with the Empire Limestone Co., engaged in the business of removing sand and gravel from the Niagara River and selling the same for commercial purposes in the city of Buffalo and vicinity, which agreement was dated April 24, 1912.

That prior to the acquisition of title by the Border Island Co. to said island a trust agreement was entered into between the Strawberry Island Co., William R. Cherry, Anna L. Cherry, Frank C. Hibbard, the then owners thereof, with Allan I. Holloway and Maurice C. Spratt as trustees, wherein the said trustees agreed to oversee the removal of sand and gravel from said river under the said Empire limestone contract of April 24, 1912, and apply the net proceeds thereof upon the principal and interest of the above mentioned mortgages outstanding on said island the surplus therefrom, if any, to be distributed as therein provided.

That pursuant to the provisions of said contract of May 1, 1912, said island owned by the Border Island Co. was duly leased on June 17, 1912 by the said Border Island Co. to the said trustees, who agreed thereafter to pay the said Border Island Co. for any and all uplands of said island removed in the operations under said contract of April 24, 1912, or any subsequent modification thereof, at the reasonable value thereof of $3,000 per acre.

That thereafter, and on August 4, 1917, the said agreement of April 24, 1912, between Empire Limestone Co. and the prior owners of said property, was amended by a supplemental agreement dated on that day, and said Empire Limestone Co. has exercised the right and operated under said agreements since April 24, 1917, and is now exercising the right to take sand and gravel from and about said island, and is now so operating under said agreements, which license right is therein given the said Empire Limestone Co. until May 1, 1926, provided said island is not removed before that date.

That said license agreements with the Empire Limestone Co. provided rules and regulations for the removal of said materials by the said Empire Limestone Co., and that the uplands of said island should not be removed in said operations until a determination was made by arbitration as to the necessity therefor, and it was determined therein that such removal was necessary to enable the said Empire Limestone Co. to obtain the minimum yearly amount of materials specified to be paid for in said agreement.

That during the latter part of the year 1916 the Empire Limestone Co., as such licensees, applied to the Border Island Co. for a determination and its permission as to the removal of materials constituting the upland of said island for the operating season of 1917 and thereafter, and, after due deliberation between the parties, it was determined and agreed that the Empire Limestone Co. and its licensees should have the right and privilege of removing the uplands of said island beginning in the spring of 1917, and thereupon the removal of said uplands was commenced and has continued since under the terms of said contracts.

That during the season of 1917 there was removed from the uplands of said island, under said contracts, 6¾ acres at the southerly end and east and west sides of said island, which is located in the city of Buffalo, and the said Allan I. Holloway and Maurice C. Spratt, trustees, duly accounted to the said Border Island Co. therefor at the agreed value thereof, to wit, $3,000 per acre.

That on January 1, 1919, the lease theretofore made by the Border Island Co. was mutually canceled and annulled, and on an accounting in writing, made at said time for the acreage of the island removed during the year 1918, said trustees paid to the Border Island Co. the sum of $9,000 in payment for the estimated acreage of said uplands so removed during said year; that said adjustment was estimated by the parties, as no survey of the island was made for said purpose at said time, the prior surveys of the island having been made in November, 1913, and September, 1917.

That since January 1, 1919, the Border Island Co. has supervised and collected the amounts paid by the Empire Limestone Co. under its agreement of April 24, 1912, and the subsequent modification thereof, and during the year 1919 two acres of the uplands of said island were estimated to have been removed in said operations, and in its income tax return for that year said Border Island Co. claimed under the item of exhaustion for two acres, so estimated to be removed, of the value of $6,000.

That in the operations during the year 1920 there was estimated as having been removed from said island by the said Empire Limestone Co. and reported by the Border Island Co., and claimed in its return for that year, depletion of 2 acres of said uplands at $3,000 per acre, which, in deponent's judgment, was much less than the market value of such acreage so removed.

That in the operations during the year 1921 there has been estimated as having been removed from said island by said Empire Limestone Co., 7 acres of the uplands of said island, which deponent verily believes was worth in

excess of $3,000 per acre; that in November, 1921, a survey was made of said island by Straley Bros., civil engineers of the city of Buffalo, and such survey shows that from the beginning of said operations in 1917 upward of 20 acres of the southerly portion of said island within the city of Buffalo had been removed by said Empire Limestone Co. under said contracts.

That the time of the Border Island Co., to file its income tax return for the year 1921, has been duly extended until the 15th day of June, 1921, and only a tentative tax return has yet been filed.

Deponent is a stockholder of the Border Island Co., and is acquainted with all of the stockholders thereof; that none of the stockholders of the Border Island Co., is now, or ever has been, a stockholder of the Empire Limestone Co., or interested in its business operations in connection with the removal of materials from said island; that said corporations are entirely distinct and unassociated except under said contracts. All of the payments made to the Border Island Co., under said license agreement were made in good faith and as per the bona fide contract agreements of the parties.

That deponent is a stockholder in said Border Island Co. and has during the last 10 years had experience concerning the market value of the land in said island containing sand and gravel, and also knows the price paid for other land of similar kind and character and in the same location, excavated for such purposes, and deponent knows that the market value of said land was in the year 1913 upward of the value of $3,000 per acre, and since that time has increased in value by reason of the fact that the market value of said materials has advanced and the supply has decreased in the Niagara River and vicinity; that said Border Island Co. purchased said island for the sum of $130,000 in June, 1921; that in the opinion of deponent on March 1, 1913, as shown by later developments, said island was worth much more than the purchase price thereof, and was reasonably of the value of $3,000 per acre; for 48 acres of the southerly portion of said island, consisting of said 48 acres, was composed almost entirely of commercial sand and gravel, and the northerly portion of said island has not been developed, or proven, as to the value thereof, or of what character of material it consists.

That it has been estimated by deponent and others who are familiar with the situation and know the amount of materials removed during the year 1921, that at least 7 acres of uplands of said island were removed during said year of 1921.

That deponent has computed the cubic contents of an acre of land to a depth of 30 feet, which was the average depth of the acreage removed from said uplands, as shown by affidavits submitted herewith, and upon said computation it is found that an acre of upland contains 48,400 cubic yards, which at the minimum price paid to the Border Island Co. by the Empire Limestone Co., under the contract of April 24, 1912, amounted to the sum of $3,490 per acre; that deponent knows of his own knowledge that said acreage so removed is, and was at the time of said removal, of the value of $3,490; that the number of cubic yards of materials actually removed and paid for by the Empire Limestone Co. and its licensees from the uplands of said island, from the spring of 1917 to the fall of 1921, greatly exceed the number of yards claimed as depletion for said years. On the basis of 48,400 cubic yards per acre for the 21¾ acres claimed as depletion since the spring of 1917 the computed yardage therefor would amount at the minimum contract price of 7½ cents per cubic yard to $78,090, and during said period the Empire Limestone Co. had paid a total of $24,000 per year as a minimum and have removed in each year in excess of 320,000 cubic yards.

That the Border Island Co. does not own any boats except a small motor boat used by the inspector and for supervision and measurement of loaded sand suckers and scows, and that it owns no other property of any description except said island so located in the Niagrara River, materials from which are removed by the Empire Limestone Co., or its licensees.

Deponent further says that when said materials are removed from said island the upland disappears and where the island existed before there is deep water, which has no known commercial use or value.

THOMAS R. STONE.

Subscribed and sworn to before me this 4th day of April, 1922.

AGNETH R. HANSON,
Commissioner of Deeds, Buffalo, N. Y.

STATE OF NEW YORK
County of Erie, City of Buffalo, ss:

Jacob J. Straley, being duly sworn, deposes and says that he is a civil engineer and has practiced his profession at the city of Buffalo, N. Y., for upward of 27 years last past; that he is a member of the firm of Straley Bros. and had personal charge of the survey and preparation of the map of Strawberry Island, of which the attached blue print is a copy; that the said survey was made by deponent in the month of November 1921, and shows the said island and the margin of the lands thereof as they existed in said month; that the southerly portion of said island has been excavated by means of so-called sand suckers and through the operations of what is known as a digger operating upon the uplands of said island, which digger is the property of the Empire Limestone Co., engaged in the sand and gravel business in and about the city of Buffalo; that during the month of November, and while said survey was being made, such operations were in progress along the southerly margin of said island; that deponent has been familiar for many years with said island, of which, prior to November 1913, 38.13 acres were within the limits of the city of Buffalo; that said portion of said island has since been removed with the exception of 1.44 acres, now remaining at the time of said deponent's survey within the limits of said city; that said portion of said island so removed was 3 or 4 feet above the mean level of the river and quite heavily wooded with large trees; that said portion of said island except the surface soil, was entirely of sand and gravel taken for commercial purposes from said uplands; that the greater part of said portion of said island heretofore lying within the city of Buffalo, has been removed since the year 1916, when the more extensive operations in said uplands commenced; that the removal by said operations of the upland of said island has extended along the easterly and westerly shores thereof, beyond and northerly of the line indicated on said map as the Buffalo city line, to an amount practically equal to the acreage yet remaining of said island within said city.

That deponent has caused to be indicated on said map, of which said blue print is a copy, the outlines of said island and the margin of the river as located September 27, 1917, in the survey thereof and map made by Frederick K. Wing, civil engineer, of the city of Buffalo, and also by the survey thereof made by said Wing in November 1913, and the said blue print correctly shows the location of the margins of said island as evidenced by the said maps and surveys of the said Frederick K. Wing.

From said surveys and deponent's personal knowledge of the situation at said island in November 1921, in deponent's opinion, upward of 26 acres of the southerly portion of said island have been removed, to a depth of upward of 30 feet, since the year 1916.

JACOB J. STRALEY.

Subscribed and sworn to before me this 1st day of April, 1922.

CHARLES A. HAHL,
Notary Public, Erie County, N. Y.

STATE OF NEW YORK,
County of Erie, City of Buffalo, ss:

Robert Vellacott, being duly sworn, deposes and says that he resides in the city of Buffalo, N. Y., and that in the month of May, 1913, he was employed as an inspector by Spratt & Holloway, trustees, to supervise the pumping of sand and gravel in the Niagara River, and to inspect and measure each boatload of material that was taken by certain sand suckers, which are boats equipped with centrifugal pumps; that deponent entered upon his duties in the month of May, 1913, and has continued from that time on until the present to act in the capacity aforesaid; that deponent has seen and been on and around the island in the Niagara River owned by the Border Island Co. each spring, summer, and fall of each year beginning with the year 1913, and ending in the year 1921; that deponent was well acquainted with and knew the shore outline of said island as it existed in May, 1913.

Deponent further says that said shore line as it existed in May, 1913, continued to be the same without material change until the spring of 1917, at which time the operators of said sand suckers were given permission by the owner of said island to encroach upon and take away the material contained

in the upland of said island; that the south end of said island as it existed during the year 1913 to and including 1916, was between three and four feet above the mean water level of the Niagara River; that said south end of said island was not covered with any mud, silt, or any other material, and was composed wholly of sand and gravel and extended north approximately 1,000 feet without change and from that point north to what is known as the Buffalo city line, the surface of said island is covered with silt averaging from two to three feet and becomes thicker as the distance continues north on said island.

Deponent further says that all of said material so removed from said island so owned by the Border Island Co. was removed by boats owned by the Empire Limestone Co. to take and remove said material and for which the Empire Limestone Co. accounted to the trustees or owner of said island.

Deponent further says that the captains of various sand suckers which removed the material from said island are as follows: Sand sucker *Trenton* was operated by Capt. John Gamble; sand sucker *Hyman* was operated by Capt. Fred Barry; sand sucker *Victoria* was operated by Capt. Murray Maines; and that the sand digger *Elco* was operated by Capt. Edward Henrietta.

Deponent further says that the Buffalo city line bisected said island about thirteen hundred feet north of the original south end of said island in the year 1913 and the spring of the year 1917, and that all the sand and gravel which composed the south end of said island up to said city line has been entirely removed by said sand suckers with the exception of two small points as shown upon the survey made by Straley Brothers in November, 1921, and to great depth, and that where said island originally existed there is very deep water at this time.

Robt. Vellacott.

Subscribed and sworn to before me this 30th day of March, 1922.

E. J. Plumley, *Notary Public.*

State of New York,
County of Erie, City of Buffalo, ss:

John B. Gamble, being duly sworn, on his oath deposes and says: That he resides in the city of Buffalo, N. Y.,; that he has been engaged as a captain on sand suckers operating in the Niagara River since the year 1892 to and including the year 1921, and that in the operation of said sand suckers sand and gravel was pumped during the years 1917, 1918, 1919, 1920, and 1921 from the mainland of the island owned by the Border Island Co. in the Niagara River to a depth of an average of about 30 feet and that the south end of said island has been entirely and completely taken away by sand suckers and an elevator dredge; that the portion of said island so taken away during the years 1917, 1918, 1919, 1920, and 1921 has been excavated and completely removed to an average depth of about 30 feet and that water is now where a portion of said island formerly was.

Deponent further says that the shore line of said island in the early spring of the year 1917 was practically the same as the shore line of said island in the spring of 1913.

Deponent further says that during the year 1917 operations were carried on by said sand suckers so that a portion of the south end and portions of the east and west sides of the uplands of said island were removed; that the material composing the south end of said island so taken consisted almost entirely of sand and gravel; that the extreme south end of said island was about from 3 to 4 feet above the mean water level of the Niagara River and consisted entirely of sand and gravel except a covering of loam from 2 to 8 inches; that the said land on said island gradually tapered down to the north until the island now as it exists averages about 1 foot above the mean water level of said river and said island as it exists at this time is covered with a silt which varies in depth from about 8 inches to about 8 feet.

John B. Gamble.

Subscribed and sworn to before me this 30th day of March, 1922.

[seal] A. W. Plumley, *Notary Public.*

EXHIBIT E

TAXPAYERS' CONFERENCE,
NATURAL RESOURCES DIVISION, NONMETALS SECTION,
April 5, 1922.

Taxpayer: Border Island Co.
Address: Buffalo, N. Y.
Represented by: G. C. Riley, attorney (stockholder).

Matter presented: Affidavits and maps to support claim for value of sand and gravel based on cost at acquisition.

Issues discussed: Mr. Riley read and explained affidavits to show that the gravel was worth more than $3,000 per acre because of its location very near the docks in Buffalo. He explained that this is the nearest available supply of sand and gravel. Other islands near by being too valuable for real estate to use for sand. He also called attention to a lease which added value to the purchase, it being a consideration of the transaction. Under the terms of this lease the Empire Limestone Co. agreed to pay the Border Island Co. for sand and gravel removed from the Niagara River or from Strawberry Island from April 24, 1912, to May 1, 1926, as follows:

First 300,000 cubic yards, at 8 cents per cubic yard; next 20,000 cubic yards nothing; all other yardage, 7½ cents per cubic yard. Minimum payments, $24,000 annually.

The Border Island Co. should have received about $250,000 for sand and gravel produced under the terms of this lease.

Mr. Riley produced the original contract and original deeds. Copies were not submitted. He offered to submit any other data that may be required.

He explained that a trust agreement had been entered into by the Strawberry Island Co. prior to acquisition by the Border Island Co. providing for the payment of certain receipts from this sale of sand and gravel to trustees to be disbursed to other former owners and to others holding mortgages. That $3,000 were paid to these trustees for each acre removed by the Empire Limestone Co.

Mr. Riley was advised that he had apparently substantiated their claim for the value of the sand and gravel, as they claimed only the amount of purchase price less value of portion of island known to be covered with silt, which he stated to be at least 8 feet deep.

The value claimed:

Purchase price stock	$54,000
Cash	6,000
Mortgages	70,000
Total	130,000
Less value of silt-covered land	3,000
Net value sand and gravel	127,000

S. L. SHONTS,
Valuation Engineer.

Approved:

——— ———,
CHIEF NONMETALS VALUATION SECTION.

EXHIBIT F

SECTION OF INORGANIC NONMETALS,
April 11, 1922.

BORDER ISLAND CO.,
Buffalo, N. Y.
MAURICE C. SPRATT and ALLEN I. HOLLOWAY,
Trustees, Buffalo, N. Y.

1. This company was incorporated in 1911. In June, 1912, it acquired an island in the Niagara River, partially within the boundary of the city of Buffalo, for payments as follows:

To Strawberry Island Co., stock	$54,000
William R. Cherry, W. H. Heinbach, and Moses Cherry, cash	6,000
Mortgages	70,000
Total	130,000

The total capital of the company is $60,000. A contract was acquired with the purchase which provided that the Empire Limestone Co. might dredge sand and gravel from the Niagara River and from Strawberry Island from the period April 24, 1912, to May 1, 1926, unless previously exhausted, for which the Border Island Co. was to have been paid as follows: First, 300,000 cubic yards, at 8 cents per cubic yard; next, 20,000 cubic yards, nothing. All other production, 7½ cents per cubic yard. Minimum payment, $24,000 per year.

In the following tabulations the number of cubic yards produced was taken from Form F.

Year	Cubic yards produced	Rate	Amount due under contract
		Cents	
1912	219,176	8	$17,534.08
1913	218,086	{ 8 7½	6,465.92 8,794.65
1914	400,839	7½	30,062.92
1915	434,552	7½	32,591.40
1916	503,471	7½	37,685.33
1917	420,915	7½	31,568.62
1918	377,362	7½	28,302.15
1919	347,333	7½	26,049.98
1920	404,310	7½	30,323.25
	3,326,044		249,378.30

The gross income for the years 1912 to 1920, inclusive, should be no less than the amounts in the above tabulation.

The total value claimed is cost at acquisition	$130,000
Less value of land covered with silt	3,000
Net value of gravel and sand	127,000

In an affidavit submitted in conference May 5, 1921, 48 acres is stated to have been the area of the position of the island containing sand-gravel, the lower end being composed of silt. The gravel is dredged to a depth of 30 feet, leaving no residual value. The volume of 1 acre 30 feet deep is 48,400 cubic yards; 48 acres would produce 2,323,200 cubic yards.

Total area sand and gravel on island	acres	48
Area dredged from island 1917 to 1921, inclusive	do	26.7
Area dredged 1920	do	7
Area dredged 1917 to 1920, inclusive	do	19.7
Area sand and gravel remaining at end of 1920	do	28.3

Sand and gravel remaining at end of 1920	cubic yards	1,369,720
Sand and gravel removed from 19.7 acres	do	953,480
Sand and gravel removed from river	do	2,371,564
Total available at acquisition	do	4,694,764

Possession of the island apparently carried the right to gravel and sand in the river adjacent, as this company was paid for it at the same price as for material taken from the island. The total quantity was depletable. The supply in the river has been practically exhausted.

Action taken:

Value claimed for Strawberry Island, cost at acquisition, June 12, 1912	$130,000.00
Less value of portion not containing sand and gravel	3,000.00
Value claimed and allowed for sand and gravel at acquisition	$127,000.00
Value allowed for sand and gravel, March 1, 1913	$121,082.25
Estimated depletable quantity of sand and gravel ... cubic yards	4,695,000
Depletion rate per cubic yard	$0.027

Year	Cubic yards produced	Depletion allowed for income tax and sustained against invested capital	Selling price under contract
1912	219,176	$5,917.75	$17,534.08
1913	218,080	5,888.32	15,260.57
Balance		24,000.00	8,739.43
1914	400,859	10,822.65	30,062.92
1915	434,552	11,732.90	32,591.40
1916	502,471	13,566.72	37,685.33
1917	420,915	11,364.71	31,568.62
1918	377,362	10,188.77	28,302.15
1919	347,333	9,378.00	26,049.98
1920	404,310	10,916.37	30,323.25
Total	3,325,044	89,776.19	258,117.73

MAURICE C. SPRATT AND ALLEN I. HOLLOWAY,
Trustees, Buffalo, N. Y.

Nineteen hundred and seventeen return for the trustees included with Border Island Co.

Prior to this acquisition by the Border Island Co. a trust agreement had been made by which the Strawberry Island Co. agreed to have the net proceeds from the sale of gravel and sand distributed through Allen I. Holloway and Maurice C. Spratt, trustees, among Thomas R. Stone, George C. Riley, Frank C. Hibbard, and Strawberry Island Co., mortgagors and mortgagees.

Depletion applies to the Border Island Co. and not to any of the parties to whom payments were made through the trustees.

S. L. SHONTS,
Valuation Engineer.

Approved:

———— ————,
Chief Nonmetals Valuation Section.

EXHIBIT G

BORDER ISLAND CO.,
306 Mutual Life Building, Buffalo, N. Y.

SIRS: An examination of your income-tax return for the year 1917 discloses an additional tax liability for that year aggregating $4,274.08, as shown in detail in the attached statement.

In accordance with the provisions of section 250 (d) of the revenue act of 1921, you are granted 30 days within which to file an appeal and show cause or reason why this tax or deficiency should not be paid. No particular form of appeal is required, but if filed it must set forth specifically the exceptions upon which it is taken, shall be under oath, and contain a statement that it is not for the purpose of delay, and the facts and evidence upon which you rely must be fully stated. The appeal, if filed, must be addressed to the Commissioner of Internal Revenue, Washington, D. C., for the specific attention of IT:NR:F-DWJ, which will be referred to the Income Tax Unit before transmittal to the agency designated for the hearing of such appeals.

You may, if desirable, 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 of such appeal has been made, no claim in abatement of the assessment shall be entertained.

Payment should not be made until a bill is received from the collector of internal revenue for your district, and remittance should then be made to him.

Respectfully,

E. H. BATSON,
Deputy Commissioner.
By A. H. FAY,
Head of Division.

In re Border Island Co., 306 Mutual Life Building, Buffalo, N. Y.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

SIR: Receipt is acknowledged of your office letter dated November 24, 1922, bearing identification symbol IT: NR: F-DWJ, and showing as a result of an examination of our tax returns—

Additional tax liability

Year 1917	$4,274.08
Total	4,274.08
Net additional tax	4,274.08

In response thereto we hereby advise that—

(1) We accept as correct the above statement of net additional tax liability and agree to its assessment in due course, or

(2) We believe the above statement of net additional tax liability is incorrect, and we desire and shall proceed within the time fixed in your letter to prepare and present evidence showing that the amounts stated above should not be assessed.

NOTE: Taxpayer should sign but one of these statements.

BORDER ISLAND CO., *Buffalo, N. Y.*

1917

Net income reported		$10,300.38
Depletion deducted	$20,250.00	
Depletion allowed	11,364.71	
		8,885.29
Net income corrected		19,185.67

The amount of capital stock outstanding, $60,000, has been accepted as your invested capital.

Computation of tax:

Net income corrected	$19,185.67	
Less: Excess-profits tax	3,293.55	$3,293.55
Balance subject to tax at 2 per cent and 4 per cent	15,892.12	
Tax at 2 per cent and 4 per cent		953.53
Total tax		4,247.08
Tax previously assessed		None.
		4,247.08

Allowable depletion is based on the cost at date of acquisition of Strawberry Island, $130,000 less $3,000, the value of the part not containing sand or gravel, or $127,000, and estimated recoverable reserves of 4,695,000 cubic yards of sand and gravel, which produces a unit rate of $0.027 per cubic yard.

In view of the data at hand and information submitted at the various conferences held in this office with your representatives, it is held that the income statement reported in the return designated "Maurice C. Spratt and Allen I. Holloway, trustees," more properly represents the income statement of your corporation. The amount reported thereon has therefore been used in the adjustment shown above.

EXHIBIT H

BUFFALO, N. Y., *December 12, 1922.*

COMMISSIONER OF INTERNAL REVENUE,
Washington, D. C.

Attention: Natural Resource Section.
In re: Border Island Co., Buffalo, N. Y.

SIR: Reference is had to communication from your office dated November 25, 1922 (IT: NR: F-DWJ), addressed to the above-named corporation, in which notice is given of examination of 1917 tax liability and tentative determination of additional tax liability in amount of $4,274.08, with accompanying schedule showing the basis of assertion of the additional liability.

There is inclosed herewith, in accordance with the instructions in the letter of your office, receipt of the communication with protest against the proposed assessment. There is also inclosed herewith original amended returns executed on behalf of the corporation and signed under oath by the president and treasurer thereof, together with comparative balance sheets for all years from December 31, 1912, to December 31, 1921, inclusive, and complete reconciliation of surplus for the entire period of existence of the corporation. In order to complete your files there is also inclosed copy of claim for refund filed on behalf of the corporation for all of the years 1917–1921, inclusive.

The amended returns and collateral evidence submitted are the result of correspondence had with your department and of several conferences held before officers of your department at which the value on March 1, 1913, of the property owned by the corporation subject to depletion was determined. At the conferences held contention was made on behalf of the corporation for a different basis of valuation, but in order to close the case as promptly as possible returns were prepared and are being submitted in which the valuation placed by your department has been used for the purpose of depletion, and in which tax liability has been determined entirely in accord with the values fixed by your department. The proposed assessment shown in letter of your department of November 25, 1922, is erroneous, not only because it ignores the valuation of assets heretofore fixed by your department but also because it does not take into account the actual investment of the corporation. The returns herewith submitted, which are forwarded direct to your department in order that no unnecessary delay may occur, have been prepared with extreme care and are thought to be entirely correct. If any question arises regarding the acceptance of the figures submitted it is requested that your department name a date on which conference can be held and evidence submitted which will satisfy the examining officer that the amended returns herewith submitted are entirely correct.

This communication is not written for the purpose of causing any delay in the completion of the case at hand, but, on the other hand, in order that it may be expedited as much as possible.

Respectfully,

AMEN, SENDAM & CO.

STATE OF NEW YORK,
County of Erie, ss:

Thomas R. Stone, being duly sworn, deposes and says that he is president of the Border Island Co., of Buffalo, N. Y., and that he has read the foregoing statement and that the facts contained therein are true and correct to the best of his knowledge and belief.

THOMAS R. STONE.

Sworn and subscribed to before me this 13th day of December, 1922.

E. J. PLUMLEY, *Notary Public.*

EXHIBIT I

(Copied for the Senate committee. All computations and calculations verified by office of internal revenue agent in charge)

JANUARY 16, 1923.

In re: Border Island Co., care Fuller Audit Co., Brisbane Building, Buffalo, N. Y. Examining officer, W. F. Bookser; examination commenced January 16, 1923; examination completed January 16, 1923; days, 1.

INTERNAL REVENUE AGENT IN CHARGE,
Buffalo, N. Y.

An examination of the books and records of the above-named corporation for the year 1917 disclosed the following in connection with its income and profits tax liability: 1917, additional tax, $509.52.

Kind of business, owners of Strawberry Island, Niagara River, selling gravel and sand therefrom to sand companies on royalty basis.

Authority for examination, transcript for year 1916; examination disclosed no basis for consolidation.

History of organization: Incorporated under the laws of the state of New York June 15, 1912 with autholzed capital stock of $60,000 all common fully paid up.

Important features: Empire Limestone Co. get their supply of sand or gravel from this island and pay to the above-named corporation a royalty based on the number of cubic yards removed.

Further information: Additional taxes found is due to the fact that original return showed no tax liability. Subsequently corporation had their books examined and rewritten as the original books were very incomplete and the Fuller Audit Co. was engaged to look after this work and the corporation's interest.

Claim pending is marked IT: NR: F—DWJ—November 25, 1922.

Mr. Fuller was very courteous and assisted your examiner in every possible way. Amended return was filed by corporation during September, 1922.

Index to report, schedules 1-2, Exhibits A-C, inclusive. Inclosures, transcript year, 1916, filed by M. C. Spratt, as trustee, with memo attached, Fuller Audit Co.

W. F. BOOKSER,
Internal Revenue Agent.

SCHEDULE 1—NET INCOME YEAR, DECEMBER 31, 1917

Net income as disclosed by books, $8,492; as corrected, $8,492; net changes, none.

SCHEDULE 1-A—EXPLANATION OF ITEMS CHANGED

Corporation claims depletion in the amount of $20,250 on the basis of the fair market value as of March 1, 1913; in accordance with the rules set out in articles 170-173, regulation 33, revised.

Facts are as follows: Originally set up on books, $130,000; appreciation of real estate, $185,000; value March 1, 1913, $315,000.

Island consists of 105 acres, which bring value March 1, 1913 at $3,000 per acre. Provision in the accounts for depletion of natural resources during the years 1917 to 1921, inclusive totals, $98,250. Year 1917, the sum of $20,250 represents 6¾ acres, at a value of $3,000 per acre. Balance, $78,000, was apportioned to the years 1918-1921, inclusive, upon the basis of cash received as a royalty from the Empire Limestone Co. as per agreement April 12, 1912.

Prior to year 1917 corporation maintains that uplands were untouched: that is, of the island itself; consequently no adjustment. Depletion adjustment is left to the natural resources division accordingly.

SCHEDULE 2—COMPUTATION OF TAX 1917

Balance sheet December 31, 1916, reflects that deduction exceeds income found. Taxable net income, Schedule 1, $8,492. Taxable at 2 per cent, $169.84; taxable at 4 per cent, $339.68; total tax liability, $509.52.

EXHIBIT A.—*Balance sheet December 13, 1917*

	Books	Reductions	Amended
ASSETS			
Cash in banks	$3,118.10		$3,118.10
Deferred charge	2,367.52		2,367.52
Equipment	209.33		209.33
Real estate, island property	130,000.00		130,000.00
Appreciation of real estate	185,000.00	$185,000.00	
	320,694.95	185,000.00	135,694.95
LIABILITIES			
Accounts payable	77.28		77.28
Mortgage payable	30,000.00		30,000.00
Reserved for appreciation real estate	185,000.00	[1] 185,000.00	
Capital stock	60,000.00		60,000.00
Surplus	45,617.67		45,617.67
	320,694.95	185,000.00	135,694.95

[1] Appreciation eliminated from balance sheet.

Exhibit B—Balance Sheet December 31, 1917

	Books	Reductions	Amended
ASSETS			
Cash in banks	$4,656.46		$4,656.46
Deferred charges	1,867.52		1,867.52
Equipment	209.33		209.33
Real estate, island property	130,000.00		130,000.00
Appreciation of real estate	164,750.00	[1] $164,750.00	
	301,483.31	164,750.00	136,733.31
LIABILITIES			
Accounts payable	77.28		77.28
Mortgage payable	20,000.00		20,000.00
Reserved for appreciation real estate	164,750.00	[1] 164,750.00	
Capital stock	60,000.00		60,000.00
Surplus	56,656.03		56,656.03
	301,483.31	164,750.00	136,733.31

[1] Appreciation eliminated from balance sheet.

Exhibit C—Analysis of book surplus

Date	Item	Debit	Credit	Balance
Dec. 31, 1912	Earnings, year 1912		$12,722.67	
Jan. 1, 1913	Distributed to stockholders	$10,000.00		$2,722.67
Dec. 31, 1913	Earnings, year 1913		18,218.75	20,941.42
Jan. 1, 1914	Distributed to stockholders	8,000.00		12,941.42
Dec. 31, 1914	Earnings, year 1914		19,202.24	32,143.66
Jan. 1, 1915	Additional income tax, 1913	22.15		
	Distributed to stockholders	13,000.00		19,121.51
Dec. 31, 1915	Earnings, year 1915		18,855.82	37,977.33
Jan. 1, 1916	Notes payable (old notes paid)	600.00		
	Additional income tax, 1915	201.27		
	Income tax paid	1.89		
	Distributed to stockholders	11,500.00		25,674.17
Dec. 31, 1916	Earnings, year 1916		19,943.50	45,617.67
Jan. 1, 1917	Income tax, 1916	203.64		
	Distributed to stockholders	17,500.00		27,914.03
Dec. 31, 1917	Depletion		20,250.00	
	Earnings for year		8,492.00	56,656.03

It is assumed that the following entries were made in the books of record in transferring the realized depletion to Surplus Account:

	Debit	Credit
Reserve for appreciation	$20,250	
Appreciation of real estate		$20,250
Profit and loss	20,250	
Surplus		20,250

EXHIBIT J

SECTION OF INORGANIC NONMETALS,
April 14, 1923.

BORDER ISLAND CO.,
Buffalo, N. Y.

Sand and gravel.
Taxable years 1917 to 1920, inclusive.
Waiver Filed March 6, 1923.

R. A. R. February 13, 1923, shows additional tax for 1917 of $509.52, apparently allowing $20,250 depletion, the amount taken by taxpayer. Assessment letter dated March 30, 1923, is based upon that report.

Valuation memorandum dated April 11, 1922, allowed $11,364.71 for depletion in 1917. No information has been received since that date to alter the depletion rate.

Action taken: Valuation of April 11, 1922, is hereby approved.

Years	Depletion taken	Depletion sustained against invested capital and allowed as a deduction from income
1917	$20,250.00	$11,364.71
1918	21,707.40	10,188.77
1919	19,133.40	9,378.00
1920	17,495.40	10,916.37

S. L. SHONTS,
Valuation Engineer.

Approved:
————— —————,
Chief, Nonmetals Section.

EXHIBIT K

(Copied for the Senate committee)

Listed for registration September 5, 1923.

BORDER ISLAND CO.,
Buffalo, N. Y.

SIRS: An examination of your amended income and profits tax returns and of your books of accounts and records for the years 1917 and 1918 discloses an additional tax liability for those years aggregating $10,959.45, as shown in detail in the attached statement.

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

In accordance with the provisions of section 250 (d) of the revenue act of 1921, you are granted 30 days within which to file an appeal and show cause or reason why this tax or deficiency should not be paid. No particular form of appeal is required, but if filed, it must set forth specifically the exceptions

upon which it is taken, shall be under oath, contain a statement that it is not for the purpose of delay, and the facts and evidence upon which you rely must be fully stated. The appeal, if filed, must be addressed to the Commissioner of Internal Revenue, Washington, D. C., for the specific attention of IT:NR:FNL:DWJ-495, 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, 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 ssessment in accordance with the final decision on such appeal has been made, no claim in abatment of the assessment will be considered.

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 HEAD OF DIVISION.

STATEMENT

1917

Net income reported amended return		$8,492.00
Depletion deducted	$20,250.00	
Depletion allowable	11,364.71	
		8,885.29
Net income corrected		17,377.29
Invested capital:		
Capital stock outstanding Jan. 1, 1917		60,000.00
Surplus, balance sheet Jan. 1, 1917	$45,617.67	
Less depletion reserve	47,928.34	
Nonoperating deficit		2,310.67
Invested capital, begining of year		57,689.33
Less dividend distribution, Jan. 1, 1917		17,500.00
Invested capital for the year		40,189.33
Computation of tax:		
Net income corrected	$17,377.29	
Less excess profits tax	4,974.22	
		4,974.22
Balance subject to tax at 2 per cent and 4 per cent	12,403.07	
Tax at 2 per cent and 4 per cent		744.18
Total tax		5,718.40
Previously assessed		509.52
Additional tax due (waiver of file)		5,208.88

1918

Net income corrected		6,144.31
Depletion deducted	$21,707.40	
Depletion allowable	10,188.77	
		11,518.63
Net income corrected		17,662.94

Invested capital:		
Capital stock outstanding Jan. 1, 1918		$60,000.00
Surplus, balance sheet as at Dec. 31, 1917	$56,656.03	
Less depletion reserve	59,293.05	
Cooperating deficit		2,647.02
Invested capital, beginning of year		57,362.98
Less dividend distribution Jan. 1, 1918		17,500.00
Invested capital for the year		39,862.98
Computation of tax:		
Net income corrected	$17,662.94	
Less profits tax (sec. 302)	4,398.88	
Exemption	2,000.00	
	6,398.88	
Balance subject to tax at 12 per cent	11,264.06	
Tax at 12 per cent		1,351.69
Total tax		5,750.57

Previously assessed, none.
Total tax due, $85,750.57.

Allowable depletion is based on cost of Strawberry Island at date of acquisition, $130,000 less $3,000, the value of the part not containing sand or gravel, or $127,000 and estimated recoverable reserves of 4,695,000 cubic yards of sand and gravel which produces a unit rate of $0.027 per cubic yard.

Allowable depletion is shown in the following tabulation:

Year	Production, cubic yards	Unit rate	Amount depletion
1912	219,176	$0.027	$5,917.75
1913	218,086	.027	5,888.32
1914	400,839	.027	10,822.65
1915	434,552	.027	11,732.90
1916	302,471	.027	13,566.72
1917	420,915	.027	11,364.71
1918	377,362	.027	10,188.77

Exhibit L

Buffalo, N. Y., *October 4, 1923.*

Commissioner of Internal Revenue,
Washington, D. C.

In re Border Island Co., Buffalo, N. Y.

Sir: This is an appeal from decision of the Income Tax Unit of the Bureau of Internal Revenue in the case of the Border Island Co., 316 Mutual Life Building, Buffalo, N. Y., a corporation organized in the State of New York, with principal office and place of business at Buffalo, N. Y. This appeal covers the question of tax liability for the years 1917 and 1918, the amount involved in the appeal being $5,208.88 for the year 1917 and $5,253.25 for the year 1918. This appeal is taken in good faith and not for the purpose of delay or the evasion or avoidance of any proper tax liability on the part of the appellant corporation.

The particular adjustments made by the Income Tax Unit to which this appeal is directed are (*a*) the disallowance of allowance for depletion claimed by the corporation in amounts of $20,250 for the year 1917 and $21,707.40 for the year 1918, based upon fair market value of the natural resources owned by this corporation and in place on March 1, 1913, and the substitution therefor of depletion allowances in amounts of $11,364.71 and $10,188.77, respectively.

for the years 1917 and 1918, based upon the "cost of Strawberry Island at date of acquisition, less $3,000, the value of the part not containing sand or gravel," and (b) the reduction of invested capital based upon the proposed disallowance by the Income Tax Unit of the fair market value of the natural resources owned by the company on March 1, 1913, and the consequent diminution of capital by depletion on cost only.

The particular point at issue in this case is the fair market value of the natural resources (sand and gravel) acquired by the appellant corporation through the acquisition in the year 1912 of the property known as Strawberry Island, an island situated in the Niagara River adjacent to and partially within the boundaries of the city of Buffalo and consisting, at the time of acquisition and on March 1, 1913, of approximately 105 acres of land, practically all of which was known at that time to be composed almost entirely of commercial building sand, gravel, and grit. The issue was originally somewhat confused through the operation of a trust agreement made on the 19th day of May, 1912, between the appellant corporation and certain trustees which was intended largely as a guaranty that certain mortgage liabilities of the appellant corporation would be met from the sale of the natural resources of Strawberry Island prior to determination of any income of the appellant. However, under date of November 25, 1922, a communication was addressed to appellant corporation advising of the opinion of officers of your department that the trustees under said agreement should be deemed to be acting on behalf of the corporation and that the income received by said trustees should be reported by the appellant corporation, and accordingly amended returns were prepared and submitted covering the years 1917–1921, inclusive, in which depletion was shown as a deduction on the basis of a valuation of $3,000 per acre for the land cut away during each of the years covered by said amended returns through the operation necessary to the removal of the sand, gravel, and grit owned by appellant.

The valuation on $3,000 per acre used in the amended returns was not a new figure established by the appellant, but was one on which considerable evidence had been submitted to your department and one which the officers of your department stated would represent the maximum allowance for value on March 1, 1913, at the time when the appellant corporation, through its representatives, was attempting to demonstrate a different basis of valuation. In connection with the figure of $3,000 per acre used in the amended return, attention is called to affidavit of Thomas R. Stone, under date of April 4, 1922, in which an estimate is made of valuation of $3,000 per acre for said island. It is also desired to call attention to the fact that the trust agreement just referred to, dated May 19, 1912, placed a valuation of $3,000 per acre on the property owned by the Border Island Co. This last-mentioned document could not possibly have been prepared with a view to its use in the support of the fair market value of said property. It was for an entirely different purpose, was executed as a trust agreement for the purpose of liquidating indebtedness, and was so near in point of time to the effective date (March 1, 1913) as to be peculiarly applicable to the question at issue. About the time copies of the above agreement and affidavit were submitted to your department the corporation was claiming a valuation for the natural resources owned by it based upon the realizable income from a sale contract entered into prior to March 1, 1913. At that time a copy of contract entered into on April 24, 1912, by and between Strawberry Island Co., William R. Cherry, A. L. Cherry, and Frank C. Hibbard (the last three named individuals acting for and on behalf of the appellant corporation), and the Empire Limestone Co. was presented to your department. This contract evidenced the fact that the sand and gravel in place as owned by the appellant corporation through its agents and appointees was purchased by the Empire Limestone Co. at a price of $0.07½ per cubic yard, and it was contended that the contract sale price furnished the best basis for valuation of the natural resources owned by the Border Island Co., on March 1, 1913. This claim was denied by officers of your department, who stated that realization values were not used by the natural resource section of the Treasury Department as a basis of valuation except where other methods of determining value could not be secured, and who also pointed out the fact that evidence on file in the Bureau of Internal Revenue established a value of Strawberry Island on March 1, 1913, of $3,000 per acre and indicated that said value would be the only basis acceptable by the Treasury Department for determination of annual depletion. It is not admitted by appellant that the realizable value based upon sale contract entered into prior

to March 1, 1913, does not constitute a proper basis for valuation of natural resources, particularly in the light of decisions which have been rendered by your department and of memorandum 2039 of the Internal Revenue Bureau issued under date of December 11, 1922, and governing the method of valuation of mineral properties. However, the valuation of $3,000 per acre, apparently acceptable to officers of your department in the fall of 1922, was used as a basis for amended returns conforming with the opinion expressed that the corporation should account for all income, and a communication was addressed to your department under date of December 12, 1922, in which acceptance was made on behalf of appellant corporation of the tentative declaration by officers of your department that $3,000 per acre should represent a proper basis for depletion reserves.

In the letter of your department dated September 7, 1923, the valuation used for purposes of depletion is based upon the "cost of the property at date of acquisition." In view of the statements made at the conference in Washington the above decision was not understood, and the records in the case were therefore carefully checked in order to ascertain, if possible, the basis for the decision of your department. Certified copies of a number of contracts, agreements, mortgages, etc., have been furnished your department. In checking over these papers it is noted that the license agreement by which the Empire Limestone Co. contracted to remove sand and gravel and grit from the cost expressed in terms of mortgage executed and stock issued by thereof is dated April 24, 1912, and the deed transferring title in Strawberry Island to the Border Island Co. is dated May 1, 1912. The fact that the deed by which the Border Island Co. secured title to the property was dated subsequent to the license contract may have created the impression in the minds of the officers of your department that the Border Island Co. acquired the property after the license contract had been consummated by the vendors and that the March 1, 1913, value should not be greatly different from the cost expressed in terms of mortgage executed and stock issued by the Border Island Co. As a matter of fact, the organization of the Border Island Co. and its ownership of Strawberry Island represented at the most but a change of 50 per cent interest, inasmuch as the Strawberry Island Co., which had previously been the owner of approximately one-half of Strawberry Island, became a 50 per cent stockholder in the Border Island Co., while the organizers of the Border Island Co. had acquired the remaining 50 per cent interest through the Cherry contract early in the year 1911, and not in the year 1912, as is indicated by the records heretofore submitted, and as your department has assumed.

Prior to the year 1911 approximately one-half of Strawberry Island had been owned by William R. Cherry and Anna L. Cherry. During the early part of the year 1911, Messrs. Thomas R. Stone, Maurice C. Spratt, George C. Riley, and Frank C. Hibbard formed a plan for acquirement of the portion of Strawberry Island owned by Anna L. Cherry and William R. Cherry because of its valuable sand and gravel deposits, and negotiations were opened with said individuals for the purpose of acquiring their interests and of thereafter combining an organization with the Strawberry Island Co., owner of the remaining half interest, for the purpose of exploiting the natural resources of said island. After considerable negotiations a contract was entered into between William R. Cherry and Anna L. Cherry with Frank C. Hibbard for the purchase of their interest in Strawberry Island. Subsequently, and in September, 1911, the Border Island Co. was organized for the purpose of taking title to Strawberry Island, one-half interest in said corporation to be held by the purchasers of the interest formally owned by Anna L. and William R. Cherry, and the remaining one-half interest to be owned by the Strawberry Island Co. Title was not transferred immediately because of the plans which had been made to issue mortgages on the property and to thereafter transfer title in the property to the Border Island Co., subject to said outstanding mortgages. An affidavit setting forth the above facts executed by Mr. Frank C. Hibbard is attached hereto and made a part hereof (Exhibit A).

It is thought that the above will clarify the questions in the minds of the officers of your department, for it will be seen that the license contract providing for the sale of the sand and gravel deposits of Strawberry Island was consummated on behalf of the Border Island Co. and of the interests which had succeeded the former owners of Strawberry Island, but that on account of the legal title remaining in the names of the former owners it was necessary that

the license contract be executed by said individuals jointly with Frank C. Hibbard, the contract pu chaser. Actually the ownership of Strawberry Island was in the Strawberry 'sland Co. and the individuals who early in 1911 acquired by contract the rights of Anna L. and William R. Cherry, and no change whatever occurred i. actual ownership thereafter subsequent to the contract of purchase, and said contract effected a 50 per cent interest only. Thus the excess of value on March 1, 1913. over the amount of mortgages against the island, plus the capital stock issued by the Border Island Co., is of far less significance than was apparently given it by the officers of your department. for it would seem that the tentative holding, that the March 1, 1913, value was the same as cost, must have been premised upon the proximity to March 1, 1913, to the time when title to Strawberry Island was transferred to the Border Island Co., and the fact that the license contract apparently antedated the time when the island was conveyed to the Border Island Co.

The record in this case is apparently somewhat confused. The officers of the appellant corporation had been of opinion that since all proceeds from the sale of sand and gravel resulted from a contract entered into prior to March 1, 1913, that said contract should be controlling of the value on the effective date of the natural resources owned. After some negotiations it was apparently determined by officers of your department that a value of $3,000 per acre should be fixed as the valuation of March 1, 1913, of the property owned by the Border Island Co. on that date. Thereafter the appellant corporation prepared and submitted amended returns, using as a basis of valuation the $3,000 per acre fixed by your department, and accepted said valuation in communication addressed to your department under date of December 12, 1922. It is thought that the valuation so accepted is extremely conservative but the appellant corporation is prepared to accept said valuation, and in support thereof submits that the only transaction in comparable property known to the officers of the appellant corporation indicates that the valuation of $3,000 per acre is extremely conservative. An affidavit of Thomas R. Stone, dated September 20, 1923, is submitted herewith and made a part hereof (Exhibit B). After attesting to the accuracy of the statements made by Mr. Hibbard in his affidavit, Mr. Stone relates the circumstances, so far as they are a matter of record, of the transfer of a similar property on February 6, 1915. The Squaw Island property referred to is very similar to Strawberry Island.

It has been determined by the assessors of the city of Buffalo to be approximately 110 acres in extent, while Strawberry Island was approximately 105 acres in extent on March 1, 1913. It is somewhat nearer the mainland, but it is not known to have as extensive a deposit of sand and gravel as Strawberry Island. The transfer was made on February 6, 1915. Probably the negotiations were made in the latter part of the year 1914 Either date is between one and two years after the effective date for valuation of Strawberry Island, and possibly the value might have been slightly greater on either date than it would have been on March 1, 1913. But the mortgage placed on the property alone of $500,000 would show a cost of approximately $5,000 per acre. It is understood from individuals who would be in position to secure accurate information on the subject that the consideration paid for Squaw Island was $600,000, or approximately $6,000 per acre. If Squaw Island was worth from $5,000 to $6,000 per acre late in 1914 or early in 1915, there can be no question but that Strawberry Island had a fair market value on March 1, 1913, of at least $3,000 per acre. The appellant corporation is of opinion that the property had a value greater than $3,000 per acre on March 1, 1913, in view of the transaction in comparable property within a reasonable period of time from that date, and of the license contract by which the sand and gravel deposits were sold prior to March 1, 1913. However, the formal claim has been entered of a value of $3,000 per acre and the appellant corporation is prepared to adhere to said claim. There is believed to be ample evidence that the property known as Strawberry Island was, on March 1, 1913, of a value of at least $3,000 per acre. No evidence has been produced which would tend to indicate a lesser value of such property.

The above is considered to constitute evidence which establishes beyond doubt the justice of the claim made by appellant corporation for a valuation on March 1, 1913, of $3,000 per acre of the property known as Strawberry Island and then owned by the Border Island Co. But the proof of valuation is conclusively demonstrated by the results of the operation of the property since March 1, 1913. There is shown herewith detail of the quantity of sand and gravel removed from the property of appellant corporation by the Empire

Limestone Co. for the years 1912–1923 inclusive (the figures for 1923 covering the period to September 30).

	Quantity	Amount		Quantity	Amount
1912	213,333	$16,000.00	1919	371,097	$27,832.28
1913	320,000	24,000.00	1920	339,403	25,455.23
1914	320,000	24,000.00	1921	381,361	28,602.07
1915	320,000	24,000.00	1922	332,414	24,931.05
1916	320,000	24,000.00	1923 (5 months May 1-Sept. 30)	306,231	26,967.32
1917	448,945	33,670.88			
1918	420,915	31,568.62			

The above receipts by the appellant corporation through sale of the sand and gravel deposits of Strawberry Island practically equal to the March 1, 1913 value which has been claimed. In connection with these figures it should be stated for the information of your department that there is still a sufficient deposit of sand, gravel, and grit on the property owned by the Border Island Co. on March 1, 1913, to continue operations at the same rate as is shown for the past few years for a period of at least five years. This fact shows conclusively that the amount which had been realized by the border Island Co. on March 1, 1913, to continue operations at the same rate as is shown for the past few years for a period of at least five years. This fact shows conclusively that the amount which had been realized by the Border Island Co. through the operation of a contract entered into prior to March 1, 1913, will be considerably in excess of the March 1, 1913 value which has been claimed.

Respectfully submitted.

AMEN SURDAM & CO.

STATE OF NEW YORK,
County of Erie, ss:

Thomas R. Stone, being duly sworn, deposes and says that he is president of the Border Island Co., and that he read the foregoing communication and that the facts stated therein are true and correct to the best of his knowledge and belief.

THOMAS R. STONE.

Sworn and subscribed to before me this 4th day of October, 1923.

ARTHUR R. JENKINS, *Notary Public.*

EXHIBIT M

OCTOBER 26, 1923.

From: Engineering Division, Income Tax Unit.
To: Committee on Appeals and Review (through Records Division).

Case of Border Island Co., Buffalo, N. Y. Incorporated June 15, 1912, State of New York. Fee owners of sand and gravel lands.

Statement: Years under audit and additional tax 1917, $5,208.88; 1918, $5,253.25.

1. Determination of March 1, 1913, value as a basis for allowance for depletion. This is the only issue raised in the appellant's brief.

In June, 1912, the taxpayer acquired Strawberry Island, located in the Niagara River, near Buffalo, N. Y., comprising 105 acres, partially containing sand and gravel. This property was acquired from the Strawberry Island Co. and various persons and cost as follows:

To Strawberry Island Co., stock	$54,000
To various persons, cash	6,000
Mortgages assumed	70,000
Total	130,000

Prior to the acquisition of the island by the taxpayer, the former owners had entered into an agreement with certain trustees, whereby the trustees were to oversee the removal of sand and gravel from the river and apply the net proceeds derived, upon the principal and interest of the mortgages outstanding. When the taxpayer acquired title to the island these mortgages were assumed

as a part of the purchase price and the trust agreement apparently continued to be effective. Title to the island carried with it the right to remove sand and gravel from the river adjacent.

An important consideration in the transaction between the taxpayer and the former owners was the acquisition of a sale contract between the Strawberry Island Co. and various persons and the Empire Limestone Co., whereby the latter company had contracted to purchase sand and gravel from the former parties; this sand and gravel to be obtained from Strawberry Island and the river adjacent and to be paid for at royalty rates as follows:

First 300,000 cubic yards at 8 cents per cubic yard; next, 20,000 cubic yards at nothing. All other production at 7½ cents per cubic yard. Minimum annual payment, $24,000. Contract to be in force until May 1, 1926.

An affidavit made April 4, 1922, by Thomas R. Stone, president, states that 48 acres only, are considered to have proven sand and gravel. The material is recovered to a depth of 30 feet, so that the total resources on the island at acquisition were 2,323,200 cubic yards. Production to the extent of 2,371,564 cubic yards was derived from the river adjacent to the island, so that the total resources at acquisition amounted to approximately 4,695,000 cubic yards.

Taxpayer's contentions: That the $130,000 paid in 1912 was not the just basis for depletion, for the following reasons:

(*a*) A trust agreement dated May 19, 1912, placed a valuation of $3,000 per acre on the island.

(*b*) The contract sale price furnished the best basis for valuation as of March 1, 1913, citing memorandum 2039 of the Internal Revenue Bureau, issued December 11, 1922.

(*c*) The valuation of $3,000 per acre was "apparently acceptable to the officers of your department in the fall of 1922."

(*d*) Comparison with the transfer of Squaw Island located nearby, stated in affidavit to be very similar to Strawberry Island, and stated to be worth $5,000 to $6,000 per acre in 1914.

Unit's contention: Valuation claimed by taxpayer on Form F submitted May 12, 1921, and substantiated in conference April 5, 1922, was as follows:

Total cash value of all consideration paid	$130,000
Less value of silt-covered land	3,000
Net value sand and gravel	127,000

Valuation report dated April 11, 1922, allowed cost at acquisition in accordance with those figures. The March 1, 1913, value allowed was based on cost less depletion sustained. Depletion was allowed on cost and March 1, 1913, value at a rate of 27 cents per cubic yard based on a total content at acquisition of 4,695,000 cubic yards. This valuation is approved for the following reasons:

(*a*) The trust agreement made between the taxpayer and certain trustees "was intended largely as a guarantee that certain mortgage liabilities of the taxpayer would be met from the sale of natural resources from the island, prior to any determination of profits by the taxpayer" (appellant's brief). As the taxpayer states that only 48 acres of the island contained recoverable gravel which could be expected to yield a return, it can not be considered that this trust valuation applied to the whole 105 acres, the remaining 57 acres of which was valued at $3,000 in conference. A valuation of $3,000 per acre would not be far from $127,000 allowed by the unit, if applied to only 48 acres, the rate per acre then being $2,645. However, this would disregard the fact that approximately one-half of the total recoverable quantity of sand and gravel was in the river adjacent to the island. As this quantity is practically exhausted and can be reasonably closely estimated, this unit holds that computation based on yardage are preferable to those based on acreage.

(*b*) Memorandum 2039 cited by the taxpayer in (*b*) above refers specifically to the copper and silver industry and is not applicable in this case. Valuation on the realizable value, based on the sale contract, can not be considered here as the sale contract was a consideration in the transaction, which was actually consummated, as far as the taxpayer is concerned only eight months before the basic date. The sale contract must have been an important factor in the negotiations between the buyer and the seller. The taxpayer has not substantiated any claim for appreciation during these eight months.

(*c*) There is no evidence in the case to substantiate the statement by the applicant that a valuation of $4,000 per acre was "apparently acceptable" to the officers of the unit. It may have been orally stated in conference that

such would be acceptable as applying to the content of 48 acres, plus the quantity obtained from the river, with the total apportioned over 48 acres. There is no record, however, of such statement having been made.

(*d*) The comparison with the transfer of Squaw Island is not applicable, as the taxpayer stated in conference April 5, 1922, that other islands in the river nearby are too valuable as real estate to be used for sand and gravel production.

The president of the Border Island Co. stated in an affidavit dated December 20, 1921, that "the value of said island in 1913 was about the same as in 1912."

It should be noted that the production figures reported on Form F, and on which the valuation report of April 11, 1922 was made and depletion allowed do not correspond with those reported on the brief submitted October 4, 1923. Income was reported based on the latter set of figures for the years 1917–1920, inclusive. The taxpayer has been asked to reconcile the differences but has not done so.

Conferences: First conference, April 5, 1922; issue No. 1 considered. Second conference, June 29, 1922; issue No. 1 considered.

No request for an oral hearing before the committee on appeals and reviews has been made.

A copy of this letter of transmittal is being forwarded to the taxpayer in accordance with Treasury Decision 3492.

J. G. Bright,
Deputy Commissioner.

Buffalo, N. Y., *July 23, 1924.*

Commissioner of Internal Revenue,
Office of Solicitor of Internal Revenue,
Washington, D. C.

In re: Border Island Co., Buffalo, N. Y.

Sir: This is a supplemental memorandum for the consideration of the Solicitor of Internal Revenue in the matter of appeal of the above-named taxpayer from the decision of the Division of Natural Resources of the Income Tax Unit in the determination of the tax liability of the appellant corporation for the years 1917 and 1918, the amounts of tax liability involved in this appeal being as follows:

1917	$5,208.88
1918	5,253.25
Total	10,462.13

Formal appeal from the decision of the Income Tax Unit has been entered and copy of memorandum of transmittal to the committee on appeals and review dated October 26, 1923, has been furnished the taxpayer. Conference has been set for August 15, 1924, before the committee on appeals and review, and, as it is understood that matters before the said committee on appeals and review have been transferred to the solicitor of internal revenue, this memorandum is addressed to said officer for consideration in connection with the hearing on the case above referred to.

ISSUE

As stated in the memorandum of the Income Tax Unit, the issue involved in the appeal of the taxpayer is the amount of depletion allowable on the basis of exploitation of natural resources owned on March 1, 1913. A collateral issue is involved of the amount of invested capital, but as this is controlled entirely by the valuation placed upon the natural resources as of March 1, 1913, and the allowable annual depletion for all periods subsequent thereto, it will not be enlarged upon in this memorandum.

FACTS

In the memorandum of the Income Tax Unit it is stated that the appellant corporation acquired Strawberry Island, comprising 105 acres, partially containing sand and gravel, in June, 1912. It is true that the appellant corpora-

tion acquired legal title to Strawberry Island in the year 1912 (see copies of deeds from the Strawberry Island Co. and William H. Heimbach dated May 1, 1912, on file in your office). It is not understood how the Income Tax Unit arrives at the date of June, 1912. However, the exact date of transfer of legal title is immaterial. The equitable title to the property in question rested in the Border Island Co. on and after September 16, 1911, the date of organization of said company, for the corporation was formed solely and specifically for the purpose of taking over title to said island and exploiting the natural resources which were inherent in the title to said island. The delay in transfer of legal title was merely for the purpose of completing certain suits which had been instituted and placing a mortgage upon the property prior to the transfer of title. The Income Tax Unit has placed considerable stress upon the date of acquisition of legal title to Strawberry Island by the appellant corporation in the determination that the nominal cost value should be used in lieu of fair market value as at March 1, 1913, and this matter will be referred to later on in this communication.

It is further noted that the Income Tax Unit states that the acreage of Strawberry Island partially contained sand and gravel. This statement of fact is incorrect. In the original negotiations with the Income Tax Unit in the year 1922 it was stated that a part of the island had not been sounded to determine to what extent it contained sand and gravel—see affidavit of Thomas R. Stone, president of the Border Island Co., dated April 4, 1922, in which it is stated that "the southerly end of said island, consisting of said 48 acres, was composed entirely of commercial sand and gravel and the northerly portion of said island has not been developed, or proven, as to the value thereof, or of what character of material it consists." However, since that date the actual operations of the licensee in obtaining sand, grit, and gravel from Strawberry Island have demonstrated that all parts of the island, under the surface covering of silt, consists of the same material as the southerly end thereof, which had been surveyed by engineers at the time of Mr. Stone's affidavit in 1922.

The Income Tax Unit has shown in its memorandum, issuance of capital stock of the Strawberry Island Co. of a par value of $54,000. This is incorrect, as the nominal capital issued by the appellant was issued in equal amounts to the Strawberry Island Co. and to the individuals who had purchased the interests of certain farmers in said island, hereinafter referred to as the Cherry family. However, the total stock issued is correct, as is also the amount of mortgage assumed, and, therefore, this question is not of any particular moment in the determination of value on March 1, 1913, of natural resources owned by the appellant corporation.

The following is quoted from the statement of facts of the Income Tax Unit in transmitting the case to the committee on appeals and review.

"An important consideration in the transaction between the taxpayer and the former owners was the acquisition of a sale contract between the Strawberry Island Co. and various persons and the Empire Limestone Co., while the latter company had contract to purchase sand and gravel from the former parties; this sand and gravel to be obtained from Strawberry Island and the river adjacent."

This statement is only partially correct. The acquisition of the sale contract was of no consideration whatever in the assumption of title to Strawberry Island by the appellant corporation. The interests of the Cherry family in Strawberry Island were acquired by the organizers of the appellant corporation on or about April 6, 1911. Thereafter and on September 16, 1911, said vendees organized the Border Island Co. for the sole purpose of taking title to Strawberry Island and exploiting the natural resources of said island. As hereinbefore stated some time was necessarily consumed in completing certain legal actions which had been instituted and in negotiating the contract with the Empire Limestone Co., promptly upon the completion of which the legal title to Strawberry Island was transferred to the Border Island Co. The mere fact that indebtedness was assumed and stock issued in a total amount representing the purchase price to the incorporators some time previous to May 1, 1912, is of no particular moment since the transfer of the title to the appellant corporation and the issuance of stock by said corporation expressed no change in interest whatever.

To review this matter from the beginning requires going back to the year 1911 when the purchase of Strawberry Island was made. The greater portion of the island was owned by some farmers who had, prior to the making of the

contract, permitted material to be taken from the Niagara River adjacent to the island so that the upland was being encroached upon. They made frequent protests, but took no action in the courts to prevent these trespasses. There were at the time several boats pumping sand, gravel, and grit in the Niagara River, and the material was taken from any part of the river where the captain of the boat desired to begin operations. These farmers, all members of the Cherry family, were clients of Thomas R. Stone. They consulted him several times about the matter, but were unwilling to incur the large expense to maintain actions to procure injunctions against the different owners of the boats doing the pumping.

They were desirous of disposing of their interest to some one who would be willing to incur the necessary expense to protect the property by legal action, and about the 6th day of April, 1911, a Mr. Sherwood, Frank C. Hibbard, George C. Riley, and Thomas R. Stone made an arrangement by which the property was to be purchased in the name of Frank C. Hibbard and actions commenced to restrain the owners of the different boats operating in the river from trespassing upon the island, and such an action was commenced in the Supreme Court, Erie County, in which William R. Cherry and one were plaintiffs and Perry Sand Co., et al, were defendants, which resulted in a judgment entered in 1911, by which the rights of the plaintiffs were established and a permanent injunction was granted against these defendants from further trespassing upon the property of the plaintiffs, which included the riparian rights and the rights to lateral support for the island, and prohibited excavation or removal by the defendants of the shoals, bars and deposits of material in the river in and about said island. This injunction did not operate against any person except the 11 defendants in this first action, and when the owners of the other boats got within the prescribed limit as defined by the court in the first action, new actions were commenced and the same routine gone through to maintain the rights of the plaintiffs.

This litigation extended over the years 1911 and 1912 when the rights of the plaintiffs were finally established. All of this expense had been borne and the legal work performed by Mr. George C. Riley, who is an attorney at law, and Mr. Thomas R. Stone, who is also an attorney at law, and later by Maurice C. Spratt, now deceased, who was also an attorney at law of considerable prominence, who devoted a great deal of his time to the work and who purchased the interest in the contract of Mr. Sherwood.

These various actions, which had been brought in the name of Cherry and one, pertained only to the northerly portion of the island, and did not affect the southerly end of the island which was owned by the Strawberry Island Co.

It became necessary also for the Strawberry Island Co. to begin and maintain actions to protect its rights against the trespassers in a manner similar to the actions brought and maintained in the name of Cherry and one, so that this litigation pertaining to the whole of the island was going on for nearly two years before the two interests consolidated by conveyances thereof to the Border Island Co., a New York corporation, organized with a nominal capital of 600 shares of the per value of $100 each, and without any relation to the actual value of the property, and without any necessity for determining the real value of the assets that were being conveyed to it, and which the parties in interest sought to protect against invasion by the several boats then operating in the river and adjacent to the island.

The Border Island Co. was organized under the laws of the State of New York on the 16th day of September, 1911, but the title to the property was not taken by the company until May 1, 1912, when William R. Cherry and the other original farmer owners of the northerly portion of the island, in pursuance with the agreement made with Frank C. Hibbard early in 1911, conveyed the northerly end of the island to William H. Heimbach, who took title on behalf of the Border Island Co. for the purpose of making the bond and mortgage required to secure the payment of the balance of the purchase price of the premises, and after that was done he immediately and on the same day conveyed the northerly part of the island to the Border Island Co.

On June 12, 1912, Frank C. Hibbard, for the purpose of divesting himself of all and any rights which he had under and by virtue of the contract made with Cherry and others to purchase the island, executed and delivered a deed of the same portion of the island as had been conveyed by the Cherrys to Heimbach to the Border Island Co.

On May 1, 1912, the Strawberry Island Co. conveyed all its interest in the southerly end of the island to the Border Island Co., subject to mortgages

to the amount of $35,000 so that the Border Island Co. became the owner of the entire island, with all the riparian and appurtenant rights, including various lands under water adjacent to the island theretofore conveyed by the State of New York to the original owners.

This recital is made for the purpose of showing that the value of the island was established by these various court actions, and had they not been successfully maintained the island would have been of little value, as it was not practical to use it for any purpose except for the material which it contained. The judgments in the various court actions enhanced the value of the property several times more than it was before the judgment in these actions had been rendered. It should be remembered that this enhanced value had been established before March 1, 1913.

Under date of April 24, 1912, a contract was entered into and executed and delivered June 19, 1912, between Strawberry Island Co. and William R. Cherry, Anna L. Cherry, and Frank C. Hibbard, of the first part and the Empire Limestone Co. a domestic corporation with offices at Buffalo, N. Y., of the second part, wherein exclusive right to remove materials from the lands and premises of the parties of the first part constituting the whole of Strawberry Island, and to invade the riparian rights, and the rights of the owners of lands under water around said island, were given to the Empire Limestone Co., and the rights of the owners were therein described as those set forth in the various judgments rendered by the Supreme Court of the State of New York in suits brought by the original owners against various infringers upon said rights and lands at the instance of the contract owners. This contract was negotiated by Messrs. Stone, Riley, Spratt, and Hibbard and the Strawberry Island Co., who had organized and were the sole owners of the stock of the Border Island Co.

The Empire Limestone Co. had been a defendant in several of the various actions brought for trespassing upon the island and the rights of the owners thereof and it had, for many years, been engaged in removing material from the Niagara River for commercial purposes.

The contract with the Empire Limestone Co. could never have been made had not these judgments in the court actions been rendered.

Subsequent to the taking of title by the Border Island Co., it commenced an action in the Supreme Court, State of New York, against Cowles Shipyard Co. and others, to restrain trespasses by said defendants upon the island and an infringement of the riparian rights of the plaintiff.

Issue joined in this suit was referred to the Hon. Albert Haight, former judge of the court of appeals, the highest court in the State of New York, as referee, to hear, try, and determine all the questions involved. After a hotly contested fight by the defendants, and after taking voluminous testimony a judgment was rendered defining the rights of the Border Island Co. as shown on the map, which has been heretofore submitted, and enjoining defendants from removing materials from the island, plaintiffs' lands under water or within the boundaries extending to the international boundary line on the west and the center line of the Niagara River on the east of said island properties. This judgment finally determined the rights of the Border Island Co. in the island and the lands adjacent thereto.

When the contract with the Empire Limestone Co. was made, it established the value of the island not only for the acreage contained in the upland of the island but also for the rights which pertained to the island and which were a part of the island, and which permitted the removal of materials which had been deposited by accretion to the upland and constituted the lateral support of such uplands.

The situation of the island, after the rights had been established by these various suits, created a value which did not exist prior to the judgments, and this value was the true result of the efforts of the individuals consisting of the stockholders of the Border Island Co. in their individual operations under the Hibbard agreement.

It should also be remembered that at the time that this contract was made and that these suits were brought, the income tax was not thought of, so that any action taken by those interested in the island, who afterwards became the sole stockholders of the Border Island Co., was only for the purpose of owning the island as soon as the conditions were right to have the property transferred.

The incorporators of the Border Island Co. were nominal incorporators and had no interest in the corporation, and as soon as the company began active business they resigned and the present officers, who had been the real parties in interest since early in 1911, with the exception of Mr. Spratt, who was an officer up to the time of his death in November, 1922, continued to be officers and owned the whole of the stock of the company.

In the statement of facts of the Income Tax Unit reference is made to a trustee agreement entered into "prior to the acquisition of the island by the taxpayer" by which certain individuals named as trustees were to receive the proceeds of the exploitation of Strawberry Island and to devote a certain specified portion of said proceeds to the payment of mortgages and other liabilities. The statement of the Income Tax Unit as to the time of said contract is incorrect (see agreement dated May 10, 1912, between the Border Island Co. and Allen I. Holloway et al). It will be noted that the agreement was entered into by the appellant corporation after acquiring legal title to Strawberry Island. This point is not of particular importance and is not at issue in the appeal from the decision of the Income Tax Unit, but is referred to because, taken with other erroneous statements of fact of the Income Tax Unit, it betokens an apparent lack of careful review of the case and consideration of the claims made by the appellant corporation.

CONTENTIONS OF THE TAXPAYER

The appellant corporation takes issue with the position of the Income Tax Unit that the valuation shown on Form 7 compiled by the taxpayer should be used to determine the valuation on March 1, 1913, of Strawberry Island and of the sand, grit, and gravel located in the Niagara River adjacent to Strawberry Island. Form F when submitted covered the cost to the Border Island Co. of the uplands of Strawberry Island. As has been carefully pointed out in this communication a large part of the value of the natural resources of Strawberry Island arose from the suits which were instituted by the incorporators of the Border Island Co. who had acquired the interests of the Cherry family and subsequently of the Strawberry Island Co., all prior to the taking over of legal title by the Border Island Co. Prior to that time various dredging companies had taken sand, grit, and gravel from the Niagara River without let or hindrance and had encroached upon the riparian rights and lateral support of Strawberry Island. After the suits had been completed and the rights of the parties had been established the appellant corporation leased to the Empire Limestone Co. the right to remove sand, grit, and gravel from the Niagara River adjacent to Strawberry Island, and from the island itself. The lessee removed material from the river adjacent to the island and paid the appellant corporation for that privilege from the year 1912 until the year 1917 before it was necessary to remove any material from the mainland of the island. But the Income Tax Unit proposes to allow only the figure of nominal cost of the uplands of the island to the incorporators of the appellant corporation and to spread such cost over the entire deposit of sand, grit, and gravel—both that located on the uplands and that in the river adjacent thereto.

The appellant corporation for some time claimed that the value of Strawberry Island was best evidenced by the contract of sale with the Empire Limestone Co., for that contract was unequivocal and provided for payment at a definite fixed price covering removal of a minimum quantity of sand, grit, and gravel for a period of not less than 14 years. Even the minimum specified in the contract and reduced to the present worth in accordance with Hoskald's formula on a basis of 5 per cent interest for an average of 7 years, would show more than double the amount proposed to be allowed by the Income Tax Unit. After considerable correspondence and two separate conferences before the Income Tax Unit it was understood that that division of the Treasury Department proposed to allow depletion on the basis of $3,000 per acre on the uplands of Strawberry Island and amended returns for the years 1917 to 1921 were compiled and submitted on that basis. In the memorandum of the Income Tax Unit, it is denied that this was the intention. The appellant corporation therefore reiterates its position that the best basis of valuation of Strawberry Island on March 1, 1913, was the contract of sale, or realization value evidenced by that contract entered into between the representatives of the appellant and the Empire Limestone Co. in the year 1912 and under which the natural resources of the Border Island Co. were actually sold.

It is understood that depletion of natural resources based upon the value of March 1, 1913, is presumed to be arrived at by the determination of the fair market value of said natural resources in place on that date. In the Cummulative Bulletin for the year 1919, Office Decision 7 stated that:

"In general, value as at March 1, 1913, of property, real, personal, or mixed, may be established by consideration of bona fide transactions in like property occuring on or about March 1, 1913, together with all other facts pertaining to such value."

This seems to be the first rule of evidence as set forth by your department. However, the actual sale of the property would seem to be of even greater weight when made on or about March 1, 1913. It has been shown, controverting the statements of the Income Tax Unit, that the property was not acquired by the Border Island Co. on or about March 1, 1913, from disinterested parties for a fair consideration. It is clearly shown that the natural resources owned by the Border Island Co. were actually sold to disintrested parties by contract of April 24, 1912, for what must be presumed to be a fair consideration under all of the circumstances of the case.

In addition to that fact there was shown in brief of October 4 and the affidavits accompanying said brief the record of a transaction in exactly comparable property within a short period after March 1, 1913, and before any decided changes in cost of building materials had occurred at an approximate price of $6,000 per acre. The Income Tax Unit states that:

"The comparison with the transfer of Squaw Island is not applicable, as the taxpayer stated in conference of April 5, 1922, that other islands in the river nearby are too valuable as real estate to be used for sand and gravel production."

There is no record in the file of the appellant as to statements which may have been made in the conference of April, 1922. The records given of the transfer of Squaw Island are records of the transfer of property clearly comparable in character and used for exactly the same purpose as Strawberry Island—the exploitation of the natural resources thereof consisting of sand, grit, and gravel of the same character and quality as is secured in and about Strawberry Island. The attempt of the Income Tax Unit to cast aside record evidence to transfer of comparable property merely on the statement of the opinion or recollection of some individual conferee on behalf of the appellant taxpayer does not seem to evidence the best of judgment on the part of the Income Tax Unit or an apparent desire to arrive at a fair and equitable conclusion on the issue involved. This is the type of evidence which has always been found to be of first importance. It is subject to exact verification and check by the Treasury Department, and yet the Income Tax Unit proposes to disregard such evidence merely on the statement that some individual was of opinion that other property located in the Niagara River was too valuable for exploitation of the natural resources contained therein, but which the owners of Squaw Island are now and for several years have been actually doing. So far as is known by the appellant corporation, the transfer of Squaw Island is the only transaction of comparable property within a period of years. However, it is possible that other transactions in comparable property within a reasonable radius might have been made which are now known to the officers or representatives of the appellant corporation. It is thought that their lack of knowledge of the facts can not be held to controvert of change such facts and the position of the Income Tax Unit in this respect is not understood.

The Income Tax Unit proposes to ignore the ruling contained in Memorandum 2039 because it "refers specifically to the copper and silver industry and is not applicable in this case." It is not understood how a principle once clearly defined can be limited to any particular case or cases. If the principle is correct in the determination of value of natural resources of one industry, it does not seem logical that it has no relation to the method of determining value of natural resources in a different industry.

CONCLUSION

The appellant corporation has attempted to place before your department every factor which can bear upon the determination of value on March 1, 1913, of the natural resources owned by it on that date. A number of contracts and agreements have already been furnished to your department with prior

communications, and in order to avoid repetition it is desired to refer to said contracts and agreements, together with the communications which they accompanied, and to incorporate said communications, contracts, and agreements as a part of this communication for the consideration of the Solicitor of Internal Revenue.

Representatves of the appellant corporation will make arrangements to be present at the conference set for August 15, 1924.

Respectfully submitted.

AMEN, SURDAM & CO.

STATE OF NEW YORK,
County of Erie, ss:

Thomas R. Stone, being duly sworn, deposes and says: That he is president of the Border Island Co., of Buffalo, N. Y.; that he has read the foregoing communication; and that the facts stated therein are true and correct to the best of his knowledge and belief.

THOMAS R. STONE.

Sworn and subscribed to before me this 4th day of August, 1924.

WM. G. DARGAN,
Notary Public, Erie County, N. Y.

EXHIBIT O.—*Recommendation No. 582*

OFFICE OF SOLICITOR OF INTERNAL REVENUE,
August 23, 1924.

In re protest of Border Island Co., 306 Mutual Life Building, Buffalo, N. Y. Years 1917, 1918.

Mr. COMMISSIONER
(For Deputy Commissioner, *Head, Income Tax Unit*):

This office has had under consideration the protest of Border Island Co. against the action of the Income Tax Unit in its determination of the value at March 1, 1913, of certain sand and gravel deposits.

Hearing was held August 15, 1924.

On March 1, 1913, the taxpayer's sand and gravel was under lease, having 13 years to run with a specified minimum of $24,000 a year and a royalty rate of $0.975 a ton in addition for all sand and gravel removed in excess of 320,000 cubic yards a year. A sale of the taxpayer's interest on March 1, 1913, would be made subject to this lease agreement and would be measured by the terms of the lease.

Valuation at March 1, 1913

	Cubic yards
Reserves, sand and gravel at acquisition	4,700,000
Paid for at Mar. 1, 1913	266,667
Reserves, Mar. 1, 1913, unpaid for	4,433,333
Royalty rate	$0.075
Gross expected receipts	$332,499.98
Less estimated expensse for 13 years (taxes, salaries, etc., at $2,000)	26,000.00
Net expected receipts	306,499.98
Present worth at 6 per cent and 4 per cent for 13 years—factor	0.64
Value of taxpayer's interest at Mar. 1, 1913	196,159.99
Unit of depletion per cubic yard	0.0442

It is therefore recommended that the action of the Income Tax Unit be modified to the extent of allowing a value at March 1, 1913, of $196,159.99 and a depletion unit of $0.0442.

NELSON T. HARTSON,
Solicitor of Internal Revenue.

Approved:

D. H. BLAIR,
Commissioner of Internal Revenue.

EXHIBIT P

ENGINEERING DIVISION,
NONMETALS SECTION,
September 16, 1924.

BORDER ISLAND CO.,
Buffalo, N. Y.

Lessors sand and gravel.
Incorporated September 16, 1911.
Valuations for years 1917, 1918, 1919, 1920.
Returns in case: Tentative, 1920. Regular: 1912, 1913, 1914, 1915, 1916, 1917, 1918, 1919, 1920. Amended: 2-1917, 2-1918, 1919, 1920.

Form F originally received May 12, 1921; a copy with more data received October 11, 1921; conferences were held April 5, 1922, and June 29, 1922; valuation reports are dated April 11, 1922, and April 14, 1923, the latter to modify a R. A. R. dated February 13, 1923, which is a part of the case; an appeal from the findings of the Income Tax Unit is dated October 4, 1923, and this appeal was considered before the review division of the solicitor's office August 15, 1924; the results of this hearing are given in solicitor's recommendation No. 582, dated August 23, 1924, a copy of which is attached for reference.

The Border Island Co. acquired Strawberry Island, in the Niagara River, May 1, 1912, for the following considerations:

Cash	$6,000
Stock	54,000
Mortgage	70,000
Total	130,000

A contract with the Empire Limestone Co. was also acquired by the Border Island Co. at the same time, the essential details of which follow.

The Empire Limestone Co. to pay $0.08 per cubic yard for the first 300,000 cubic yards; no charge for the next 20,000 cubic yards; $0.075 per cubic yard for subsequent units; $24,000 minimum annual payment; contract to terminate May 1, 1926.

The Border Island Co. claimed a higher value at the basic date, March 1, 1913, than the Income Tax Unit would allow; the unit would concede the value at acquisition only as the proper value to apply.

The case is forwarded to audit, using the factors advocated in solicitor's recommendation No. 582, as follows:

Valuation March 1, 1913

	Cubic yards
Reserves, sand and gravel at acquisition	4,700,000
Paid for at Mar. 1, 1913	266,667
Reserves, Mar. 1, 1913, unpaid for	4,433,333
Royalty rate	$0.075
Gross expected receipts	$332,499.98
Less estimated expensse for 13 years (taxes, salaries, etc., at $2,000)	26,000.00
Net expected receipts	306,499.98
Present worth at 6 per cent and 4 per cent for 13 years—factor	0.64
Value of taxpayer's interest at Mar. 1, 1913	196,159.99
Unit of depletion per cubic yard	0.0442

The tabulation that follows uses the unit depletion recommended above, together with the annual production figures from the taxpayer's protest of October 4, 1923, to arrive at the yearly depletion sums allowable, and the cost at acquisition, which is $130,000 claimed and allowed, with the same production figures to arrive at yearly depletion sums based on cost.

Year	Cubic yards produced	Depletion sustained on cost at acquisition; unit, $0.0277	Depletion allowed on Mar. 1, 1913, value; unit, $0.0442
Previous to Mar. 1, 1913	266,667	$7,386.68	
Subsequent to Mar. 1, 1913	266,667	7,386.68	$11,786.68
1914	320,000	8,864.00	14,144.00
1915	320,000	8,864.00	14,144.00
1916	320,000	8,864.00	14,144.00
1917	448,945	12,435.78	19,843.37
1918	420,915	11,659.35	18,604.44
1919	371,097	10,279.39	16,402.49
1920	339,403	9,401.46	15,001.61
1921	381,361	10,563.70	16,856.16
1922	332,414	9,207.87	14,692.70
	3,787,469	104,912.91	155,619.45

W. L. SCANLAN,
Valuation Engineer.

Approved:

E. S. BOALICH,
Acting Chief of Section.

Mr. HARTSON. Mr. Chairman, I have a very brief statement to make about the United States Graphite Co. case. There was a suggestion made by the chairman at the time that the Graphite Co. case was under consideration to the effect that this graphite deposit, which was acquired by this company some 10 or 15 years after the acquisition of the first property, was, in fact, a prospect. The low price paid for that could well be understood. I have caused an examination of the files in the Graphite Co. case to be made to determine what the evidence was as to the nature of the deposit or the property that was acquired in 1918, with reference to whether it was a prospect or not, and I have this to say about it:

The taxpayer, in his brief, on page 16, in connection with the Moradillas mine—and that is the mine which was the development of the prospect.

The CHAIRMAN. You mean that that was the later mine?

Mr. HARTSON. Yes; that was the later mine:

> On December 31, 1917, the company obtained from Aquirre Hermanos, owner of the Los Pocitos ranch, which comprises some 20,725 hectares (about 51,812 acres) and adjoins the Santa Maria property, an option to purchase the graphite rights on said Los Pocitos ranch—

I think I have made a mistake about the identification of these two properties. I think that Moradillas mine is the old mine. Am I right about that?

Mr. PARKER. The Santa Maria is the old mine.

Mr. HARTSON. The Santa Maria is the old mine, and the Los Pocitos ranch is the new property:

> * * * for the sum of $37,500, said option to be exercised after the extraction of a quantity of graphite ore, not less than 1,500 tons, from the Moradillas mine, which is situated thereon.

It does, then, work out that the Moradillas mine is the mine which was developed on the Los Pocitos property.

> The latter property was only a prospect, and the company merely took it over because they believed it had great possibilities in the future.

Mr. MANSON. Did they not take out a certain amount of ore before they exercised the option?

Mr. HARTSON. That is correct. The situation, as I understand it, though, was this: They acquired an option to purchase during a time when it was a prospect, and they agreed that if they exercised their option and they took out a certain quantity of ore, then they would pay the full amount for it. In other words, had they not found ore in paying quantities there—and at the time they acquired their option they did not know that they would find it—they would not have exercised their option and have paid the full amount.

Mr. MANSON. In other words, at the time they actually closed the deal under the option it was no longer a prospect.

Mr. HARTSON. Yes; at the time they acquired the total amount they had taken out apparently the 1,500 tons, but they had reached the final purchase price agreed upon already, not knowing that there was ore there in paying quantities.

Mr. MANSON. Did you find this also, Mr. Hartson: In the first place, they had already developed a mine, the old mine; that it was a seam in the earth, and that there were outcrops in both cases, and they knew from the development of the old one what the general nature of this new one would be, provided the quality was what they wanted?

Mr. HARTSON. No; I think that is not right.

Mr. MANSON. And that was settled by their taking out this 1,500 tons?

Mr. NASH. No; I do not understand it that way.

Mr. HARTSON. I do not understand it that way, either.

Mr. NASH. The mines are not on the same side of the mountain. The Moradillas is on one side of the mountain and the Santa Maria is on the other side of the mountain. They are several miles apart.

The CHAIRMAN. I think the testimony shows that they are farther apart than that.

Mr. NASH. Well, there are 50,000 acres in the property.

The CHAIRMAN. I think, in view of the fact that they tried to go in on that property and extract 1,500 tons, it was no longer a prospect, after they made their payment.

Mr. HARTSON. Well, the payment, Mr. Chairman, was made before they extracted their 1,500 tons. They merely had an option, which gave them the right to buy it at $37,500 if they could extract or did extract, in fact, this 1,500 tons.

The CHAIRMAN. Yes; but they did not pay the money until after they extracted it.

Mr. HARTSON. No; the payments were made as follows, so that we will have them exactly set forth in the record:

On December 31, 1917, the company obtained an option from Aquirre Hermanos, owner of the Los Pocitos ranch, to purchase the graphite rights contained therein for the sum of $37,500. (See page 16 of our report.) This option was exercised and the $37,500 due on the same paid as follows:

Jan. 15, 1918	$4,000
Feb. 14, 1918	1,000
Oct. 15, 1918	5,000
Mar. 15, 1919	27,500

The CHAIRMAN. Does the record show when they extracted this 1,500 tons?

Mr. HARTSON. It does not.

The CHAIRMAN. I assume from the way you read it they had a right to extract these 1,500 tons before making any payment or exercising any rights under the option.

Mr. MANSON. They had to pay something for the option.

The CHAIRMAN. Yes.

Mr. HARTSON. Oh, yes; that is what they did, but that bound the seller to transfer and convey title at the price that the optional agreement called for, subject, however, to their determination that it really was no longer a prospect, but had the mineral content there which they desired.

The CHAIRMAN. Yes; it did not bind the buyer, though.

Mr. HARTSON. No. If, in fact, he decided not to exercise it, predicating it on the development there, and finding that there was not the graphite that he hoped there might be, he could disregard it, and all that he would lose would be his payment for the option.

Mr. MANSON. Yes; but all he was paying for the prospect was whatever he paid on the option. When he paid the $37,500 he was buying the mine.

The CHAIRMAN. Yes; I think that is correct.

Mr. HARTSON. The price, however, that was agreed on was one which was entered into prior to his final determination that it was a mine.

Mr. MANSON. I wish to call the attention of the committee to this. In Exhibit B in this case, it says:

> It has never been necessary to survey or map mine workings because the course of vein can be traced by surface outcroppings, and ore production commences practically at "grass roots." Further, because of comparatively small tonnage consumed and extent of deposit, but little time is needed to block out a year's production.

Mr. HARTSON. Mr. Chairman, there was a question asked with regard to the Climax Fire Brick Co., of Climax, Pa., as to whether the case had been closed or not.

The record shows that waivers for 1917 and 1918 are on file and that keeps the case open until March 15, of this year.

The CHAIRMAN. You say you can keep it open until March 15?

Mr. HARTSON. In other words, the statute of limitations has not run out on it. I do not know whether it has been closed or not. The matter has been closed in the Bureau, subject, however, to the possibility of reopening it within the statutory period. The statute has not yet run against us.

Mr. MANSON. I do not understand that the statute runs, Mr. Hartson, on allowances for depletion?

Mr. HARTSON. Mr. Manson, the statute runs on the right of the commissioner to levy an additional assessment and if an allowance has been made for depletion which, for instance, is too high, and it is necessary to decrease that depletion value, and the effect of that would be to levy an additional assessment, if the limitation period has run it can not be corrected.

Mr. MANSON. I understand.

The CHAIRMAN. So it applies to the amortization of any of those accounts?

Mr. HARTSON. Yes.

The CHAIRMAN. Where an additional assessment is involved?

Mr. HARTSON. That is right.

The CHAIRMAN. Do I understand that the bureau will go into this Climax Firebrick Co. case, in view of the fact that the statute of limitations has not run?

Mr. HARTSON. The bureau is and has been looking over this case, Mr. Chairman. There was another point in this case that I asked Mr. Greenidge to furnish me data on.

Mr. GREENIDGE. That is being typed now, Mr. Hartson.

Mr. HARTSON. It was in connection with a question that the chairman asked.

In that case also, there was a lease obtained some years after the acquisition of the first property, and at a figure which counsel for the committee has taken the view reflects the value of the first property, and my understanding was—and I want to verify it by the introduction of such proof as we have——

The CHAIRMAN. You will continue to check up on this case and let the committee know, will you?

Mr. HARTSON. Yes.

Mr. Chairman, we have another matter of great importance to submit to the committee, and it is in connection with a general policy rather than in connection with any specific case. It arises by reason of the general criticism which the committee is making against the appraisal method of determining values of natural resources. You remember that Senator Jones invited the assistance of the bureau and its officials in correcting what he thought was an abuse, and what undoubtedly is considered by the members of the committee to be an incorrect practice in the bureau. We have devoted a great deal of time and thought and study to the question since it was first raised here in the committee, in its proceedings, and without regard to any specific case, necessarily, but as a general policy or a general plan we have worked out a statement which we desire to make on it. This statement is extended; it is not a short one, by any manner of means, and it goes into the subject in some detail.

I desire to have an opportunity to call one of our engineers, who will make a statement of the bureau's position with regard to its practice of determining values by means of the appraisal method. It certainly could not be concluded this morning, but we can start now if the chairman wishes.

The CHAIRMAN. Yes; you may start now.

Mr. HARTSON. And continue it over such time as it might take. I will ask Mr. Grimes to take the stand.

The CHAIRMAN. Before you begin with his statement, let me ask who has prepared the statement?

Mr. HARTSON. Mr. Grimes has prepared it personally, but I have read it over, Mr. Nash has read it over, and other engineers in the bureau with Mr. Grimes have also read it over.

The CHAIRMAN. It is a statement dealing with the past work of the bureau, or does it illustrate what the bureau intends to do in the future?

Mr. HARTSON. It is, Mr. Chairman, a statement of conditions which confront the bureau in determining these values and a justifi-

cation of their determination by appraisal methods, and a frank discussion of the whole subject.

The CHAIRMAN. Does the statement contain conclusions?

Mr. HARTSON. I imagine it can be said that it does contain certain opinion evidence. That is all opinion evidence is—somebody's judgment with reference to it. We hope to show that the highest engineering authority in the country not only justifies the use of the analytical appraisal method for determining values, but that it also is common and ordinary practice to use it, not alone in the valuation of these resources, from the standpoint of the Government, but it is commonly used in commercial practice, and we hope to show that the results reached by these methods are not very different from commercial values themselves.

The CHAIRMAN. Yes; but is it in accord with the statute, when the statute requires market values?

Mr. HARTSON. Oh, absolutely. That is what we are trying to determine, the market values, by such methods as are available, and it has never been our position here—and the committee has misunderstood it if they gained the impression—that the bureau disregards satisfactory evidence as to market value and flies to some theoretical method of determining value, when there is more satisfactory evidence, but we hope to show that in the application to mineral deposits, commercial transactions as reflecting valuations are very seldom available, and, when transactions have occurred, they are of no real assistance in determining the value of the particular property that is being appraised.

The CHAIRMAN. Is this the unanimous opinion of the gentlemen who have reviewed this, that you have enumerated at the beginning?

Mr. HARTSON. Mr. Chairman, there would not be any unanimity of view on a question such as this. Men's minds differ, and I can not say that this is the unanimous view of everybody who has read it. I do not know. I would not say that it was not.

The CHAIRMAN. Is it the view of the commissioner and of the Secretary of the Treasury, both, or either one?

Mr. HARTSON. The commissioner, the Secretary of the Treasury, neither one has read it, nor do they know, other than in a general way, what is in it.

The CHAIRMAN. In other words, you assume, though, that it would meet with their approval?

Mr. HARTSON. I rather think it would; yes.

The CHAIRMAN. Then, the witness may proceed, after stating his connection with the bureau.

STATEMENT OF MR. JOHN A. GRIMES, METALS VALUATION SECTION, BUREAU OF INTERNAL REVENUE

Mr. HARTSON. What is your full name, Mr. Grimes?

Mr. GRIMES. John Alden Grimes.

Mr. HARTSON. What position do you hold in the bureau?

Mr. GRIMES. I am chief of the metals valuation section.

Mr. HARTSON. How long have you been in that position?

Mr. GRIMES. Since March, 1923.

Mr. HARTSON. Were you in the bureau before that time?

Mr. GRIMES. Since January 15, 1920.

Mr. HARTSON. In what capacity were you serving before you became chief of the section?

Mr. GRIMES. I entered the bureau as a valuation engineer. I think I was valuation engineer for a year and a half. Subsequent to that time I became assistant chief of the metals valuation section, and held that position until March, 1923.

Mr. HARTSON. Where did you gain your engineering education, Mr. Grimes?

Mr. GRIMES. I graduated from the School of Mines at the University of Minnesota in 1908, with the degree of engineer of mines.

Mr. HARTSON. Have you been continuously engaged in mining-engineering work since your graduation?

Mr. GRIMES. I took a two-year course of graduate work in geology, metallurgy, and mining engineering in Columbia University from 1908 to 1910, and in July, 1910, I entered the employ of the Anaconda Copper Mining Co. at Butte, Mont. I was in their employ continuously until the time that I entered the Bureau of Internal Revenue, except for about eight months of military service.

Mr. HARTSON. What was the character of your work with the Anaconda Co.?

Mr. GRIMES. I was in the geological department of the Anaconda Co. At first my work consisted of taking geological notes in about one-third of the mines of the Anaconda Mining Co. in Butte and making recommendations to the mine foremen as to development work which they should do to find ore bodies.

About 1915, as I recall, the geological department was given complete charge of the development work of all of the mines of the Anaconda Co. The mine foremen were not permitted to do any exploratory work without written instructions from the geological department, and from that time on I had complete charge of the development of about 10 mines, comprising one-third of the Anaconda Co.'s properties, or about 12,000 or 15,000 feet of development work per year.

The CHAIRMAN. What salary did you get in a position of that character?

Mr. GRIMES. It varied. I started at $100 a month, and when I left the Anaconda Co. to go into the employ of the Government I was drawing $315 a month from the Anaconda Co. and making during the last two years that I worked for them better than $125 a month on the outside doing mine-examination work for independent operators outside of Butte. I was not permitted to do any work in Butte naturally. Working for one company there, we were not expected to use our experience in assisting others in that district.

The CHAIRMAN. What salary do you get with the bureau?

Mr. GRIMES. I entered the bureau at a salary of $4,500 a year. I am getting $5,200 a year at the present time.

The CHAIRMAN. You may proceed, Mr. Hartson.

Mr. HARTSON. Mr. Grimes, at Mr. Nash's request, you have prepared, have you not, a statement dealing with the methods used by the engineering division in appraising natural resource deposits?

Mr. GRIMES. Yes, sir.

Mr. HARTSON. I should like to have you, if you will, read your statement in the record, and I invite the chairman's attention to this

point, that if any questions occur to the chairman, or to counsel for the committee, during the course of the reading, it is entirely proper to have the points discussed at length here, because we would like to have the committee thoroughly informed of what we are doing, and we want to lay the whole picture before the committee, if we can.

The CHAIRMAN. I would like to have him go through the report with as little interruption as possible, so that we can get a consecutive picture of it.

Mr. MANSON. At this point I want to say that, so far as the committee is concerned, counsel for the committee has less objection, if any, to the application of the analytical appraisal by Mr. Grimes and his section than to its application anywhere else in the bureau's work. In other words, our investigation so far discloses that the use of this method by Mr. Grimes and his section has been attended with less abuse than any other place in the bureau's work.

The CHAIRMAN. Does this report reflect the application of it to Mr. Grimes's section, or does it reflect the application of it to all of the sections?

Mr. HARTSON. In that regard, Mr. Chairman, this ought to be said: Mr. Grimes, of course, has personal knowledge of everything that has occurred in his own section and other sections of the engineering division, but has not that definite or intimate knowledge of what has taken place in other sections that he has with regard to the business of his own immediate associates. He, however, is one of the conspicuous figures in the engineering division and engages constantly in discussion and interchange of ideas with men engaged in the same work in the entire division, and he has a general knowledge of things that go on there, sufficient so that I think he can enlighten the committee as to just what takes place in other portions of the engineering division.

The CHAIRMAN. Does this statement that he is going to read apply to the sections over which he has not immediate control?

Mr. HARTSON. There is a discussion there, Mr. Chairman, of the application of this analytical appraisal method by other sections in the engineering division, as well as the metals valuation section.

The CHAIRMAN. That is contained in this statement?

Mr. GRIMES. That is correct, sir.

The CHAIRMAN. Then, Mr. Grimes may commence, but before he does that let me ask whether Mr. Grimes is under Mr. Greenidge?

Mr. GRIMES. Yes, sir.

The CHAIRMAN. Mr. Greenidge is Mr. Grimes's superior officer?

Mr. GRIMES. Yes, sir.

The CHAIRMAN. He is your immediate superior officer?

Mr. GRIMES. There is an assistant head of the engineering division. Mr. Greenidge is the head of the engineering division. Both of them are my superior officers.

The CHAIRMAN. All right.

Mr. GRIMES. The appraisal method for valuing natural resources:

Economists regard as axiomatic the statement that the investment value of any property depends upon its present or potential ability to produce income. As an illustration, the following is quoted from page 239 of Henry Rogers Seager's Principles of Economics:

> As an investment, land is valued, as in any other form of income-producing property, by capitalizing its annual return at the current rate of interest.

This involves analytical appraisals of all types of income-producing property that are bought or sold, and both the buyer and seller customarily make such appraisals in one of two ways. The first method is to determine what rate of interest the income from the property will yield upon the price of the property. If it is estimated by the prospective buyer that an investment will safely yield a satisfactory rate of interest at the price asked by the seller, he resorts to the second method of appraisal, that is, the determination of the replacement cost of the property in question. If the prospective purchaser is assured that he can not acquire similar property at a lower price, and that his investment at the price asked for the property will yield a satisfactory rate of interest, a sale of the property ensues. Frequent sales after appraisals of this type establish a comparative market by which buyers and sellers, who are incompetent to make appraisals, may judge of the relative values of other properties.

The analytical appraisal method is used to value all classes of income-producing property and is the primary method of valuation from which all others must be derived. If no two properties could be compared, or if sales of a comparable nature should be very few and far between, the only basis for determining value would be by an analytical appraisal.

Such a condition exists in the valuation of public utilities for various purposes. For instance, in the State of New York a valuation on the basis of earning power is made and the difference between that valuation and the replacement cost of physical assets is the value of the franchise upon which the public utility must pay a tax.

Public utilities are customarily valued by appraisal methods for rate-making purposes, but the method of appraisal used is the cost of replacement method. If the valuation is required for the consolidation of two public utilities, the appraisal is made on the basis of income-earning capacity, and the relative values of the two properties to the consolidation are determined as accurately as possible.

The CHAIRMAN. If, on the question of consolidation, there were no earnings, as in the case of some municipalities, where the authorities do not permit a high enough rate to create earnings, what basis is then used for consolidation? Can you answer that, Mr. Grimes?

Mr. GRIMES. The potential earnings, as well as the present earnings, are taken into consideration. I do not think there would be any consolidation if there was no prospect of any earnings at any time in the future, because there would be no object in such consolidation or transfer of the property.

The CHAIRMAN. On that point, in Washington at the present time, there is now an attempt at consolidation of the two street railway companies.

Mr. GRIMES. Yes; but they are both earning money.

The CHAIRMAN. Not according to the statement made to Congress by the Washington Railway & Electric Co. They make the statement that they are not earning money, that their traffic is dropping off, and it would be interesting to know how you would arrive at a valuation of that company in order to consolidate it with the Capital Traction Co., and, as I understand it, it is the intention of some Members of Congress to compel that.

Mr. GRIMES. There does not seem to be a very strong inclination on the part of the Capital Traction Co. to favor that consolidation.

The CHAIRMAN. I am not discussing the attitude of mind of the Capital Traction Co. I am saying that Congress may pass a law compelling it. In that event what basis would be used?

Mr. GRIMES. It would be very difficult to say. If one property was producing income and the other property was not producing income, the only way that I can see that that consolidation could take place would be by some legislative enactment, because there would be no object otherwise for the company earning money to enter into such a consolidation.

The CHAIRMAN. Assume, for instance, that the heads of the two companies got together, and the head of one of the companies said, "You do not make any money, while we make $1,000,000 a year, but combined we can make $2,000,000 a year because of decreased operating expenses, the unification of routes, etc." Then on what basis would the Washington Railway & Electric Co. join hands with the Capital Traction Co.?

Mr. GRIMES. The potential earning capacity, probably checked up with a physical valuation of the properties, or the replacement cost. The Washington Railway & Electric Co. would undoubtedly hold out to get at least the replacement cost of their properties as the basis for consolidation.

The CHAIRMAN. All right; you may proceed with your statement.

Mr. GRIMES. If the property is sold it is necessary to determine actual value to a willing buyer and seller, but in case of the consolidation of two or more properties the appraisal need show only the relative values of the several properties.

The discussion of the general application and use of appraisal methods in determining values might be continued indefinitely, but a sufficient number of illustrations have been cited to demonstrate that the use of analytical appraisal methods by the Income Tax Unit is neither unique nor even a departure from the methods of appraisal customarily used in nearly every kind of business for valuing practically every kind of income-producing property.

To proceed as rapidly as possible let us consider the application of engineering appraisal methods to the valuation of natural resources, considering first the differences between valuation for commercial purposes and for taxation which can not be avoided.

The valuations required for income and excess profits tax purposes are valuations at some prior date and under conditions which can not be visualized accurately at the present time. The valuer can not avoid some consideration of the subsequent history of the property valued. It is humanly impossible to overlook the fact that a particular property has been a huge success or a rank failure since the date at which a valuation is required. It would be much easier to value natural resources at the present than at dates in the past. The valuation for commercial purposes is at the present date in nearly every case.

The commercial valuation is made after exhaustive field examination, physical examination of properties valued, and the accumulation of all possible information concerning the property. A present physical examination of properties, such as mines or oil wells, would

be little good when one is establishing a value as at March 1, 1913, and the income-tax unit has but one source of information—the taxpayer. It is to be doubted that any great amounts of unfavorable facts are voluntarily furnished, and under these conditions it is reasonable to believe that if the income-tax unit applies strictly commercial methods of valuation it will get higher than commercial values as a result.

A valuation for commercial purposes need not be similar in method or result to any other valuation ever made either by the same or other persons. The valuer can exercise his judgment to the fullest possible extent in each individual case and can profit from his experience by entirely changing his methods as often as he desires or considers necessary. With valuation for income-tax purposes there are many men of various degrees of capability and differing judgment employed in the task of determining the tax-free depletion deductions of competitor taxpayers in the same industry or of competitive industries. It becomes necessary to adopt less flexible valuation methods than would be employed by engineers doing commercial work. Changes in methods are recommended and adopted only after long study and conclusive proof that the new methods result both in more accurate values and greater equity between taxpayers. But little deviation from a standard method and from standard factors is possible if the income-tax unit would avoid constant criticism for arbitrary and discriminatory decisions.

There are similar differences in the tangible elements and factors found in nearly every type of valuation. In previous hearings there have been mentioned the inclusion of manufacturing profits—that is page 1357 of the hearings, Mr. Chairman—and the value of a going concern or the lack of that value (p. 1362). Management, marketing ability, and other factors have been mentioned. Political conditions are of superlative importance in countries such as Mexico, Siberia, China, and others. Labor conditions might also be mentioned, including adequacy of the supply, scale of wages paid in comparison with scales of wages paid for other mining districts and with other industries in the vicinity, nationality of labor, degree of satisfaction with wages and working conditions, etc. All of these factors are considered in a general way by the engineering division in valuing metal mines, but it has been impossible to give as definite consideration to these intangible elements of values as would be given in a commercial valuation.

To illustrate this particular question of tangible and intangible elements of value: Take the case of two leasor equities in iron mines, both extending over a future period of 30 years, both having lease clauses calling for the payment of $100,000 a year as minimum royalty, and both containing ore reserves which, by the terms of the respective leases, would provide the same total ultimate royalty to each lessor. In one case the lessor receives 25 cents a ton royalty and in the other a royalty of $1 a ton, but in both mines it is estimated that the operating profit will average $1.25 a ton, including royalty. When the royalty rate is approximately one-half of the expected operating profit it is a normal royalty rate. The lessor with a 25-cent royalty has almost no risk that his income will stop through surrender of the lease by the lessee, but the lessor with a

royalty rate of $1 has that risk, which involves also the risk of releasing at a lower rate of royalty and the interim expense of the property until a new lessee is secured. Any intelligent buyer would pay more for the lessor's equity in the 25 cents a ton royalty lease than for the lessor's equity in the $1 a ton royalty lease. The income-tax unit recognizes that there is this difference in value and in valuing such a mine would use a higher interest rate in discounting to present worth the expected income from the high-royalty mine.

The engineering division does make a sharp distinction between the going concern and the new mine which has yet to prove its merit. Good will or other elements of value separate from the ore body are not important in the metal-mining industry, but when a mine has never been operated successfully its value is more speculative, and therefore less, than is the case after it has been proven that the mine can produce profitably in competition with other sources of supply of the same natural resource.

The CHAIRMAN. Take the kind of a mine which you have just described, which has not been worked and which you admit is speculative. Should that be capitalized on a 6 per cent basis?

Mr. GRIMES. We use 10 per cent as a minimum.

The CHAIRMAN. Ten per cent as a minimum?

Mr. GRIMES. Yes, sir.

The CHAIRMAN. What elements would you consider in arriving at 10 per cent on that kind of a mine?

Mr. GRIMES. We have found from experience that 10 per cent is about the proper rate as a minimum to give by our appraisal methods, in comparison with such cash transactions as we have. We check the methods of appraisal, using the 10 per cent interest rate in case of mines of that class, with as many cash transactions as we can get a record of.

Mr. MANSON. When you speak of cash transactions do you mean the stock sales or sales of mines?

Mr. GRIMES. I mean a number of different things—the actual sales of mines for cash, cash sales of the majority interest of stock, underwriting agreements, in which underwriters in consolidations guarantee to purchase any stock of the companies entering the consolidation that is not turned in for the stock of the new company, and similar transactions of that kind. We have in addition frequently stock quotations of the predecessor company and the successor company, which may or may not be an indication of the value. Such stock quotations may be away above normal or away below normal at the time of the consolidation, but we keep those records up for as long a period of time as we can get stock quotations, and we check up that basis as well as by others which we have available.

Mr. MANSON. The stock quotation reflecting the net return will show the earnings of a going business, which includes capital, does it not?

The CHAIRMAN. Well, I understood he took that into consideration.

Mr. MANSON. I am trying to find out, Mr. Chairman, whether it is a going mine and whether he would have to make a comparison with the stock of a mine that was not a going mine or a successful concern.

The CHAIRMAN. You may proceed, Mr. Grimes.

Mr. GRIMES. A metal mine sometimes doubles in value for no other reason than that it has been proven that the estimates of profit previously made were substantially correct. The same condition exists in the coal-mining industry. The value of a going business is frequently double the cost of purchasing coal lands, developing and equipping them, and meeting the other expenditures required in launching a new enterprise. This important increment of value is entirely a function of the decrease in risk brought about by the operating demonstration of the accuracy with which the estimates of profits were made at the inception of the enterprise.

The CHAIRMAN. Let me get this clear in my mind. The more successful the management, the more successful the marketing, and the more competent the officers the concern has the less tax they pay, because of the higher valuation that you give them on their mine, based on a return, and the less competent the concern, the more inefficient the concern the higher the tax it pays, because you do not give them the same capital investment, because when you come to capitalize it on a 6 per cent return the higher the value is to the competent concern and the lower the value is to the incompetent concern. Is not that correct?

Mr. GRIMES. That is correct to a certain extent. In valuing operating profits, the management and all that goes with management is reflected in the operating profit; but in the particular industry in which I have had experience in valuation—that is, the metal mining industry—practically every company of any importance has a paid management, and even their financial arrangements are through paid officers, who own very little stock in the company.

The CHAIRMAN. I do not see that that makes any difference, because you are working on the assumption that the paid officers do not work as well as those who have a stock investment. I do not think that is relevant.

Mr. GRIMES. But in the expenses of the company for operation there is the cost of management, and each company has that cost, and we assume that each one has average management.

The CHAIRMAN. Yes; but getting back to my point, the least competent management would show the lowest returns; is not that true?

Mr. GRIMES. Yes.

The CHAIRMAN. And therefore they would receive a lower valuation, because they did not earn as much as the other concern, which did earn big returns, and they in turn would show a higher value.

Mr. GRIMES. A company with lower earnings would sell its property to some prospective purchaser at a lower price than a company owning the same property and having good management and good earnings would sell it for.

The CHAIRMAN. I am not denying that, but I am saying that the company with the best management pays the least taxes and the company with the poorest management pays the most taxes.

Mr. GRIMES. No; that is not correct.

The CHAIRMAN. If your methods of valuation are different.

Mr. GRIMES. The value, we will say, amounts to from a quarter to one-half of the operating profit. That means, we will say, one-third of the average of the operating profit is deducted for depletion.

Now, two-thirds of that operating profit is not subject to tax deduction. A man pays his income tax on two-thirds of it. He has a tax exemption on account of his better management, so he gets one-third of his additional income on account of better management exempt from taxation and two-thirds of his additional income, on account of better management, is taxable.

The CHAIRMAN. Two individuals or two corporations each bought a piece of property at $2,000,000, and you use the analytical method, and if in the one case he earned 12 per cent you would capitalize that on a 6 per cent basis at $4,000,000, would you not?

Mr. GRIMES. No, sir.

The CHAIRMAN. Why?

Mr. GRIMES. We do not capitalize it at 6 per cent except for lessor operations under long-life conditions.

The CHAIRMAN. What about the cases I have just given?

Mr. GRIMES. The case of an operating owner?

The CHAIRMAN. Yes.

Mr. GRIMES. Who buys his property for $2,000,000?

The CHAIRMAN. Yes.

Mr. GRIMES. After March 1, 1913, or before?

The CHAIRMAN. Well, at any time, where you use the analytical method of fixing the capital investment.

Mr. GRIMES. In the case of a cash transaction after March 1, 1913, there is only one basis of deduction, and that is the cost of the property divided by the number of recoverable units.

The CHAIRMAN. Suppose you go back, then, to March 1, 1900, and he pays $2,000,000 for it, or go back to March 1, 1910, and he pays $2,000,000, and he asks 12 per cent on $2,000,000? What would the valuation be at which you would fix it, at March 1, 1913, assuming that there are no outside allowances such as depletion and other things? What would you base that on—on the 6 per cent, or what basis would you use for capitalization?

Mr. GRIMES. There are a great many factors that will enter there that are not mentioned in the problem as you have stated it, Mr. Chairman. There is really not sufficient information there to state what method of valuation would be used.

The CHAIRMAN. Suppose the conditions were equal, so far as the actual investment in the property was concerned, and you would use the analytical method?

Mr. GRIMES. If we had a property earning 12 per cent and had the operating record for some years under normal conditions showing that it could earn 12 per cent under normal conditions on the cost of the property, that property would not sell for the $2,000,000 that was paid for the property. It would sell for a higher price than $2,000,000 at the date of valuation.

The CHAIRMAN. What would it sell for?

Mr. GRIMES. If that property had a life of, we will say, approximately eight years, and then was exhausted, and this interest that we are figuring is in addition to the return of capital, we are assuming the return of capital is assured in discussing the interest rates, if the property had eight years' life, the 12 per cent interest rate would be just about right to express the hazard of a mining business. If the property had a 10-year life, a 10 per cent rate would be ap-

proximately correct. If the property had a 15 or 20 year life, 8 per cent would express the same hazard as 10 per cent for 10 years. If the property had 30 or 40 years' average life, 7 per cent would be sufficient to express the same hazard.

The CHAIRMAN. That is, with the assumption that it would earn 12 per cent. Suppose it earned 6 per cent, what would you do?

Mr. GRIMES. The property would have depreciated in value, because, for a mine operator, 6 per cent would not be a sufficient rate of interest to make the purchase attractive.

The CHAIRMAN. So that you would fix it at a less capital investment figure, would you not?

Mr. GRIMES. Yes.

The CHAIRMAN. That does not prove that he has a less capital investment figure than the man who earns twice the amount, and yet the property may be identical. I mention that to prove that it all depends on the kind of management you get as to the figures you would arrive at for capital stock and for capital investment.

Mr. GRIMES. At the date of acquisition, we would have the same invested capital of $2,000,000 in your statement, both properties costing $2,000,000. These properties, we assume, were acquired several years before March 1, 1913. In the one case, where the mine earns 12 per cent—and we will say both properties had a life of 20 years after March 1, 1913—the value after March 1, 1913, by our method would be in excess of the original cost of the property. Where the property was earning 6 per cent after March 1, 1913, the value by our methods would be less than the original cost of the property; and we do have those identical problems in our work. We have a large number of appraisals where the cash cost of a mining property would be considerably in excess of the value at March 1, 1913.

The CHAIRMAN. Then, assume, for instance, that this mine which is operating efficiently and earning an estimated 12 per cent, should be in a position to go out and buy that next mine, which is operating less efficiently, at $2,000,000. Would not that be a basis for fixing the capital investment on the first mine?

Mr. GRIMES. No.

The CHAIRMAN. Even though it was contiguous to it, and the conditions were identical, it would not be the basis for figuring the value of the successfully operating mine?

Mr. GRIMES. There is no such thing as two identical metal mines. I have never seen any two metal mines yet that were anywhere nearly identical. Each one has its individualities.

The CHAIRMAN. That may be so, but I am assuming that this is a case where you considered the management, in relation to the value of the property, rather than what you might buy on the same prospect in another mine.

Mr. GRIMES. It would be evidence of value in cases where the properties were comparable. Coal properties are more comparable than metal mines.

The CHAIRMAN. I am only talking about properties where they are comparable, not where there are a lot of outside elements. However, I think I have developed what I wanted in that connection. You may proceed.

Mr. GRIMES. In the coal-mining industry, one of the major elements of value in the securities of a company is the market supplied. A coal-mining company makes large profits, if it can sell its capacity production throughout the year, but an identical mine might be operated at a loss if it depended upon the caprice of seasoned demands for its market.

A cement maker derives his profit from manufacturing and marketing ability to a much greater extent than is true in the majority of natural-resource industries.

The CHAIRMAN. I want to call the attention of counsel for the committee to some of the statements that are made in this brief. I do not know whether he agrees with them or not, but I do not. A statement is made that a coal mine, operating at full capacity all the time is more successful than a coal mine that may only be operating during certain seasons of the year. That statement is not at all conclusive, because the mine that operates at all times may have a poor grade of coal, selling for railroad purposes, and for which they may not be able to get the same margin of profit as the mine that is operated only six months in the year, with a high-grade domestic coal, with a larger margin of profit. I think, if you will check that up, you will find that those things are not conclusive, at least as far as I am concerned.

Mr. GRIMES. These things are all elements of value in the going business because the value of a going concern depends upon the profits it can realize, but the profits due to marketing, management, etc., have nothing to do with the value of the natural resources which furnishes the raw material for such industries. Occasionally it is possible to segregate the total value into its constituent parts, but in cases where this is impossible a higher interest rate is used for discounting to present worth. The Commissioner of Internal Revenue and the Secretary of the Treasury have approved such procedure for the use of the engineering division.

Discussions of the limitations of the "present value method" for valuing natural resources by discounting expected future profits to present worth at some rate of interest were frequent during 1920 in the natural resources subdivision which comprised both audit and engineering sections. The metals valuation section found that the present value method of engineering appraisal was the only possible method it could use in valuing most metal mines, while the nonmetals subsection (of the metals valuation section) and the coal valuation section found that they had to employ entirely different methods to get results comparable to commercial valuations. The reason for this difference is simply that the profits from metal mining are largely due to the value of the mineral deposit, while in the coal and nonmetallic mining industries profits are due in greater part to management, marketing, and other extrinsic causes. Nothing in this discussion is intended to convey the impression that there is any sharp distinction between the several mining and quarrying industries. One method of valuation fits one industry and its type of valuation work better than another, and where one type of work predominates, the appraisal method best suited to that kind of work is most frequently used.

The engineering division uses a number of different valuation methods following in general the methods which have been adopted by the several industries themselves for commercial valuation purposes.

In valuing some coal fields and some nonmetallic mineral deposits, such as the sulphur deposits of Louisiana and Texas, it would be almost impossible to use any method of valuation except the present value method of engineering appraisal.

Both the coal and nonmetals sections use that method of valuation as a supplement and alternative to the determination of values by comparative sales. For instance, if a property is leased on the open market to-day for a royalty of 10 cents per ton, that royalty comprises the entire value of the natural resource. Ten years ago similar properties were leased for royalties of 5 cents per ton. The difference, or 5 cents per ton, is the royalty differential, which represents the lessee's equity under the lease of 10 years ago. If the expected royalty at date of lease is reduced to present worth at a proper rate of interest by the present value method of engineering appraisal, and the value of the land for purposes other than mineral production is added to this amount, the result should be the value of the property which may be expressed in dollars per acre. Such valuations may be checked with cash sales of similar properties and the proper rate of interest determined.

In timber-valuation work, there are large numbers of cash sales and valuations for tax purposes may be based upon comparative sales to the greatest extent possible in any natural-resource industry. In the majority of the coal and nonmetallic mineral industries, cash sales are less frequent and the properties sold are less comparable than in the timber industry. Engineering appraisal methods must be resorted to more frequently than in the timber-valuation work, but the accuracy of the methods employed is subject to very close check. In the oil and gas industry, there are numerous sales, particularly of leases, but when such sales are accomplished before the existence of oil or gas in the property is known, or during a boom period, which is part of the history of every new oil field, the comparative sales are worthless as indications of value under normal conditions of oil production after discovery. Still, there are a sufficient number of cash sales to afford a fair check upon the methods of engineering appraisal adopted by the income tax unit. In the metal mining industry, prospects or young mines are sold, but profitable mines very rarely change ownership except by consolidation into larger and more efficient operating units, and, as no two mines are alike, comparisons become impossible. Some anthracite mines and some nonmetallic mineral properties fall in much the same category. It is still possible to obtain some comparative evidence of the value of metal mining properties through a few cash sales, offers to purchase, stock quotations over long periods from the larger stock exchanges, purchases of large blocks or control of the stock of a company, issues of bonds convertible into stock, underwriters agreements to purchase minority stock interests for cash when consolidations of properties take place, and other evidences of an even less tangible nature.

The engineering appraisal methods advocated and adopted in large part by the metals valuation section have been checked by all

other possible methods and by comparison with the appraisal methods used by mining engineers and the mining industry the world over. They have been found to give results closely approximating commercial transactions, the average value allowed for income tax depletion deductions being less than 25 per cent in excess of average for commercial valuation. The timber valuation engineers can cut this margin of about 25 per cent to around 10 per cent, and the methods used in valuing other natural-resource industries should obtain results between these limits.

There would be no difficulty in developing appraisal methods which would give 100 per cent of the average of commercial transactions for income tax valuations, but the element of barter must be considered. An appraisal method to be administrable can not give results that reflect bargain prices to any great extent. The bargain price may be 75 per cent, the average price 100 per cent, and the maximum price 125 per cent.

This discussion has touched in general upon the principles of valuation applicable to all of the natural-resource industries. The same principles and methods are applicable to all kinds of valuation, but the accuracy of the results must vary to some extent with the different types of valuation. It has been stated that the greatest variation from commercial values, and the greatest variations in commercial valuations of the same natural-resource property by various appraisers, will be found in those industries in which sales of properties are most infrequent. In the engineering divison of the income tax unit, the greatest variation should be expected in the appraisals of the metal mining and the oil and gas industries. It is not contended that the appraisal methods now in use are perfect, nor that improvements are not possible in those methods in any or all of the several valuation sections, but any improvements or changes in method can only be made after long and careful study and experience in the application of the methods evolved to a large number of concrete cases.

The preceding statements may be summarized briefly as follows:

(1) In some natural-resource industries valuation by the present-worth method of analytical appraisal is the only possible method that can be employed.

(2) The methods of appraisal in use are those adopted by the several industries for commercial valuations.

(3) There are discrepancies between values obtained by the methods in use by the Income Tax Unit and commercial values, but it should be possible to limit the margin to between 10 per cent and 25 per cent in excess of the average of commercial values.

(4) Details of the methods of valuation in use can be improved in time if funds become available to finance the necessary study, but there are no other known methods which can be substituted for those now used.

Similar conclusions have been reached by other organizations which have made investigations of the methods by which it is possible to value mines, as witness the following typical quotations:

Excerpt from report of the engineers' advisory valuation committee to the United States Coal Commission, September, 1923:

Various methods of valuation for mining properties have been suggested, but all authorities seem to agree in accepting as the fairest and most practicable

and logical a capitalization of the estimated future earnings, when such estimate can reasonably be made. Hoover and Finlay both emphasize this.

Excerpt from report of the committee on Federal taxation of the American Institute of Mining and Metallurgical Engineers appointed in 1919:

> A proper value of a mining property is the present value of the prospective net earnings, taking into account probably variations in output and value.

Senator Jones has remarked that it seems to him that it would be impossible to get at the market value of a body of ore or any other natural resource by any absolute formula. That is correct. It is equally impossible to determine the market value of a farm or a piece of city real estate. You can determine approximately what a fair price would be for any of these properties, but the market value is something else. People who had great need of money sold Liberty bonds at 85, but the majority of the bondholders did not believe 85 was a fair price for Liberty bonds and still have them.

Mr. Herbert C. Hoover, in his book Principles of Mining, published in 1909, says:

> It should be stated at the outset that it is utterly impossible to accurately value any mine owing to the many speculative factors involved. The best that can be done is to state that the value lies between certain limits, and that various stages above the minimum given represent various degrees of risk.

There seems to be entire agreement with this statement of Mr. Hoover by all mining engineers. The mining industry is essentially Anglo-Saxon, and the perusal of at least 500 books and articles on mine-valuation methods which are published in the English language would fail to reveal a dissenting opinion.

The only error in Senator Jones's statement is the assumption that an engineer valuing a natural resource, such as an ore body, attempts to use an absolute formula. The only formula used is one for interest, such as every banker uses in his everyday business. The average engineer knows there is such a formula, but he is only interested in the tables for discount which have been derived from the formula. Such tables of discount factors have been published for over 300 years and have been used ever since interest became a recognized factor in business. Thus in valuation a mathematical formula is used in determining the effects of one factor of valuation—the interest rate.

The other factors of valuation which are selected according to the judgment of the valuer are numerous and of much greater importance than the interest rate in the majority of valuations. In order to obtain engineers with sufficient mining experience and particular knowledge of some important branch of the industry the metals valuation section requires of applicants for positions as valuation engineers a degree of mining engineer, followed by 10 years progressive experience in the mining industry, at least 3 years of which must have been in positions requiring the exercise of personal judgment and personal responsibility. The average personnel of engineers is about 10, and within the last five years the section has lost 12 men who were drawing salaries of $4,500 a year or more. It takes an average of 18 months to train an experienced engineer to do the specialized work of valuation in a fairly satisfactory manner, and it should be evident that only very highly

trained engineers can handle valuation work rapidly and with a minimum of error. If it were possible to reduce the turnover of employees, the percentage of error could also be greatly reduced.

To proceed to the subject of valuation. The process of computation alone is quite simple, but wide experience and sound judgment are required in making the selection of factors entering the computation. It consists of—

(1) A determination of the expected profit that can be won from the different classes of ore (such as developed, partly developed, and prospective ores; from direct shipping ores, milling ores, etc.);

(2) A determination of the amount of profit that will be received each year;

(3) The immediate and future costs of plants, equipment, mine development, and other facilities necessary to derive the profit;

(4) A proper rate of discount to determine the present worth of operating profits; and

(5) An allocation of the value of the operating profits to the several items of capital required to derive the profit, the residual amount, after all other items are provided for, being the value determined for the mine.

One can readily see that the accuracy of result obtained by such a method depends entirely upon the accuracy of the basic information, the good judgment and experience of the valuer, and the subsequent management of the mine by the purchaser. But this method must be used, because there is no other method available which can be applied to all taxpayers or even equitably applied to the majority of taxpayers.

In previous hearings doubts have been expressed that the values determined by engineering appraisal methods are, in any way, related to actual values. Senator Couzens states: "From the taxpayer's standpoint, for instance, if you trace these properties back to their local political subdivisions you will find that they do not stand for any local assessment based on the theory you adopt for valuing the mine."

It might be well to call attention to the fact that an identical basis has been used by the State of Michigan since 1911; that the States of Minnesota, Wisconsin, California, New Mexico, and Arizona have similar systems for valuing mining properties; and that there is very little protest against mining taxes in Michigan where values are determined scientifically and fairly according to honest judgment, but that there is a loud outcry from mining companies in several States where less perfect systems are used.

The Finlay method of valuation, as adopted by the Michigan State Tax Commission, is an analytical appraisal or present worth valuation of the future expected profits. It has been subjected to the acid test of judicial attack in two test cases, and in both cases the Supreme Court of Michigan, the assessments based on appraisals by the present value method were fully sustained. (See Sunday Lake Iron Co. *v.* Township of Wakefield (1915), 153 N. W. 14, and Newport Mining Co. *v.* Ironwood (1915), 152 N. W. 1088.) The Sunday Lake case was taken to the Supreme Court of the United States on a constitutional question (247 U. S. 350), and the court sustained the assessment. Although the Supreme Court of the United States did not

pass directly on the Finlay method, the transcript of the record from the lower courts was before the Supreme Court and the Supreme Court, no doubt, considered the question.

The following are excerpts of the court decision:

The Supreme Court of the United States (247 U. S. 350):

We are unable to conclude that the evidence sufficed clearly to establish that the State Board entertained or is chargeable with any purpose of design to discriminate. Its action is not incompatible with an honest effort in new and difficult circumstances to adopt valuations not relatively unjust or unequal.

The Supreme Court of Michigan, Sanday Lake Mining Co. *v.* Wakefield (153 N. W. 14):

In the opinion of this court in the Newport Mining Co. case, supra, we have discussed and determined the propriety of the Finlay method of appraising mining property and of the use of such an appraisal by the State Board of Tax Commissioners, reviewing the assessments. Indeed, in this case no serious criticism is made of that method of appraisal and it is said that it, "When based upon correct factors and assumption might produce reasonably satisfactory results." I find no evidence in this case which would justify the court in arriving at a conclusion that the State Board of Tax Commissioners acted fraudulently toward this plaintiff or unjustly. The evidence all indicates that they used their best judgment and their honest endeavors assisted by the State in having this expert (Finlay) employed. I know of no way by which a more accurate or just method could be found for getting at the value of these mines.

Newport Mining Co. *v.* City of Ironwood (185 Mich. 668, 152 N. W. 1088):

In this case the Supreme Court of Michigan said (pp. 686, 688):

Witnesses for plaintiff and for defendant, who spoke upon the subject, maintain some such method as that of Mr. Finlay must be used to determine the value of the mineral, and therefore of the land. And if it is true that the Finlay method necessarily led to a valuation of the mining business, it does not follow, I think, that its result was not the fair value of the land. Large iron mines are, it seems, very infrequently sold. Comparisons, therefore, can not be made to determine the cash value by any standard of selling value. The availability and value of minerals unmined are not matters of common knowledge, nor to be correctly ascertained or estimated except by men possessed both of certain particular information and of expert knowledge.

The point we are concerned with is whether a method wrong in principle was adopted by the assessing officers in their endeavor to form a judgment as to the present value of the particular land. There is no reasonable ground for contending that the State may not use the method of business to ascertain such values. In such a case it is not compelled to ignore or discount the fact of demonstrated availability, quantity, and quality of mineral. If a rate or method exists by which engineers and business men ascertain the values of ore bodies for the purpose of buying or selling them, if no better rule is or can be suggested, how can it be said that the rule is wrong in principle when adopted by the State? The State must of necessity treat the peculiar subject of taxation as the subject requires, not to change or modify a cardinal rule of taxation but to apply it. Upon this record no other rule is suggested and the rule employed is conceded to be the rule of engineers in these cases.

It might not be out of place to invite attention also to the fact that as recently as 1921 and 1922 the State of New Mexico employed the same authority on mine valuations who appraised the mines of Michigan in 1911, and that this mining engineer, Mr. J. R. Finlay, wrote a report of appraisal of mines in New Mexico, using interest rates adopted by the Income Tax Unit for discounting to present worth, and I have been told that the tax commission of the State of New Mexico has not used his report extensively because the values determined were too low. This statement may be verified and this

committee may obtain a copy of Mr. Finlay's report from the tax commission of New Mexico.

The following is quoted from page 1375 of the transcript of proceedings of the committee for December 30, 1924:

> Senator JONES of New Mexico. May I inquire if you know of any mining concern that, in buying a piece of property in the ground, has ever been willing to pay for a mine on any such basis as is fixed here for valuation?
>
> Mr. GREGG. I can not give you an example of that at all.
>
> Senator JONES of New Mexico. I say you can not do it. If you go into a mining venture you expect a great deal more profit than has ever been figured on here. If you can not get a hundred per cent or a thousand per cent, or something like that, on what you put into it, you do not do it.

Mr. Gregg is a lawyer and, of course, could not be expected to cite offhand, specific instances of mine purchases.

The committee is again referred to New Mexico. In 1920 the Calumet & Arizona Mining Co. purchased the assets of the Eighty-five Mining Co., of Lordsburg, N. Mex., for cash and notes. A profit was made on the sale on the basis of the appraisal by the Income Tax Unit as at March 1, 1913.

Reference is also made to the recent consolidation of the Calumet & Hecla Mining Co. with several other Michigan mining companies with important blocks of minority stock outstanding. A number of the noted mining engineers of the country were called upon to make the appraisal of these properties and I was told by one of the appraisers that the relative values found for the several mines were very close to those determined by the Income Tax Unit. I was also informed by Mr. Vivian, the chief mining engineer for the Calumet & Hecla Mining Co., that the values approved for consolidation were in excess of those allowed by the Income Tax Unit.

I have also been told that all but one of the steel companies, which were considered for various proposed consolidations within the last three years, have been willing to accept the appraised values of iron mines determined by the metals valuation section.

Some of this evidence is hearsay and it is quoted for what it is worth, but a large number of specific instances may be cited. The United States Steel Corporation has made all purchases of mining properties for cash since 1901. Half a dozen or a dozen properties in the Lake Superior district were acquired within two or three years prior to March 1, 1913, at higher prices than the appraisals by the Income Tax Unit at March 1, 1913.

A taxpayer owning a silver property in Mexico tried to obtain a value by appraisal which the Income Tax Unit considered to be excessive on the basis of the evidence submitted. A French syndicate of unquestioned financial standing made an offer to purchase not less than 80 per cent of the stock of this company for cash within 60 days of the deposit of the stock and at a price for the property greatly in excess of that which the Income Tax Unit regarded as excessive. This offer and its rejection were within two or three months of March 1, 1913. A half interest in the Cerro de Pasco Corporation changed hands in July, 1915, for $13,500,000 cash, and $1,500,000 commission paid to the underwriters. Slightly more than a half interest in the Chile Copper Co. was soold in 1923 for in excess of $70,000,000 cash. It can be positively asserted that the appraisal methods now in use by the Income Tax Unit would give

values within 25 per cent of these amounts. The figures are quoted to indicate to the United States Senate's special committee to investigate the Bureau of Internal Revenue, that because high values are allowed for some natural resources, they are not necessarily erroneous. The margin of error in the small valuations is apt to be much greater than in valuations involving large sums of money, chiefly because of the comparative amount of reliable information available for making and checking the appraisals.

A large silver mine in Utah was discovered, and it was valued by the metals valuation section at $4,150,603. Within six months after the valuation, the company owning the mine received an offer of $1,500,000 cash and $4,500,000 in interest-bearing bonds. The offer was refused, the ore reserve valued has since been exhausted and the mine has as much and as good ore to-day as it has ever had.

Ninety-six per cent of the stock of a large gold mine in Colorado was purchased in 1916 on the basis of a mine value of $4,270,000 after an appraisal of the mine at that value by a mining engineer from Denver, Colo.

In 1910 the assets of the Original Consolidated Mining Co., at Butte, Mont., were sold to the Anaconda Copper Mining Co., by W. A. Clark for $5,000,000 cash, after both buyer and seller had their engineers appraise the properties on the basis of expected future earnings.

A rich gold mine was discovered in California. The seller had the option of retaining 40 per cent of the stock of a company to be formed to operate the property, or of accepting $600,000 cash. The buyer states that the seller reluctantly agreed to accept the cash payment which places a maximum value of $1,500,000 on the mine. The discovery value allowed by the appraisal method of the Income Tax Unit was below that amount.

Noninterest-bearing notes have been given by the United States Steel Corporation and by the Northern Pacific Railway to lessors of iron mines in payment for specified tonnages of ore. These notes mature periodically over long periods of years. The Income Tax Unit discounts such notes to present worth or cash value at a 6 per cent rate of interest. The Northern Pacific Co. redeems its notes for cash at a 4 per cent interest discount rate. One corporation receiving a large amount of the noninterest-bearing notes of the United States Steel Corporation distributed these notes to its stockholders in 1919 as a liquidating dividend on the basis of a rate of 4¾ per cent interest for discounting to present worth, some stockholders taking notes maturing in the immediate future and others taking the notes which did not mature for 20 or 30 years. In December, 1924, a block of $3,000,000 face value of these notes was sold to an insurance company at a discount on the basis of 5¼ per cent interest.

Probably no successful purchase of a large metal mine has been made in the last quarter century except upon the basis of an engineer's report as to expected operating profit, and a determination of the present worth or cash value of the expected profit by either an engineer or a financier. A chart was prepared in 1922 in support of a previous recommendation to the commissioner that the copper and silver mining industries be revalued in accordance with valua-

tion methods then recommended. This chart shows the percentages of interest recommended for use in discounting operating profits to present worth by engineers who have written in the English language on the subject of mine valuation. A copy of this chart is attached. There are also attached excerpts from the published opinions of several prominent engineers bearing on the same subject, and a copy of the recommendations for improvement of valuation methods as made by the metals valuation section and approved by the commissioner.

It is certain that a court, if called upon to determine the value of a mining property for income-tax purposes, would consider evidence of value indicated by a competent engineering appraisal.

Senator Jones is again quoted as follows:

> I would like to invite the honest and sincere effort on the part of you gentlemen engaged in that work to devise some plan for handling this thing other than that which has been adopted, because I declare this will not stand the light of day, etc

As to errors in method and errors in result, it is admitted that these exist to a greater or less extent in all of the valuation sections and vary in degree as between individual engineers in a section. It is remarkable that more and greater errors have not been made. But no matter how excellent the system of valuation adopted, the values computed in dollars and cents depend almost exclusively upon the capacity for judgment in the individual engineer in the division. Absolute equity as between taxpayers can never be attained, but a much greater equity in results is possible not only between taxpayers in an industry but between the several industries. The improvements, however, will develop gradually as the result of greater experience and more intensive study.

There is one general error in the present methods of appraisal which could be corrected after several months of statistical study. This error is also common in commercial valuations; in fact, it is generaly made. It consists of the neglect to deduct interest on working capital as an operating charge. To make the correction it would be necessary to have statistical investigations of the amounts of working capital required in the various industries, for inventories (of supplies, materials in process, finished products, etc.), and for emergency or times of financial depression. Speaking of the appraisal methods adopted for valuing metal mines, because I am thoroughly familiar with all of the detail of those methods, I can state that failure to deduct interest for working capital is the only general error of method now known and not corrected. The correction would necessitate the review of every valuation made since the initiation of valuation work over five years ago, and it is doubtful whether the results of the correction would justify the reopening of all of the prior appraisals.

The CHAIRMAN. We will adjourn now until 10.30 o'clock tomorrow morning.

Mr. HARTSON. Before we adjourn, Mr. Chairman, I would like to offer those exhibits that were referred to in Mr. Grimes's report. I should like to have them made a part of the record.

The CHAIRMAN. Yes.

(The exhibits referred to by Mr. Grimes in his statement and introduced by Mr. Hartson are as follows:)

EXHIBIT A

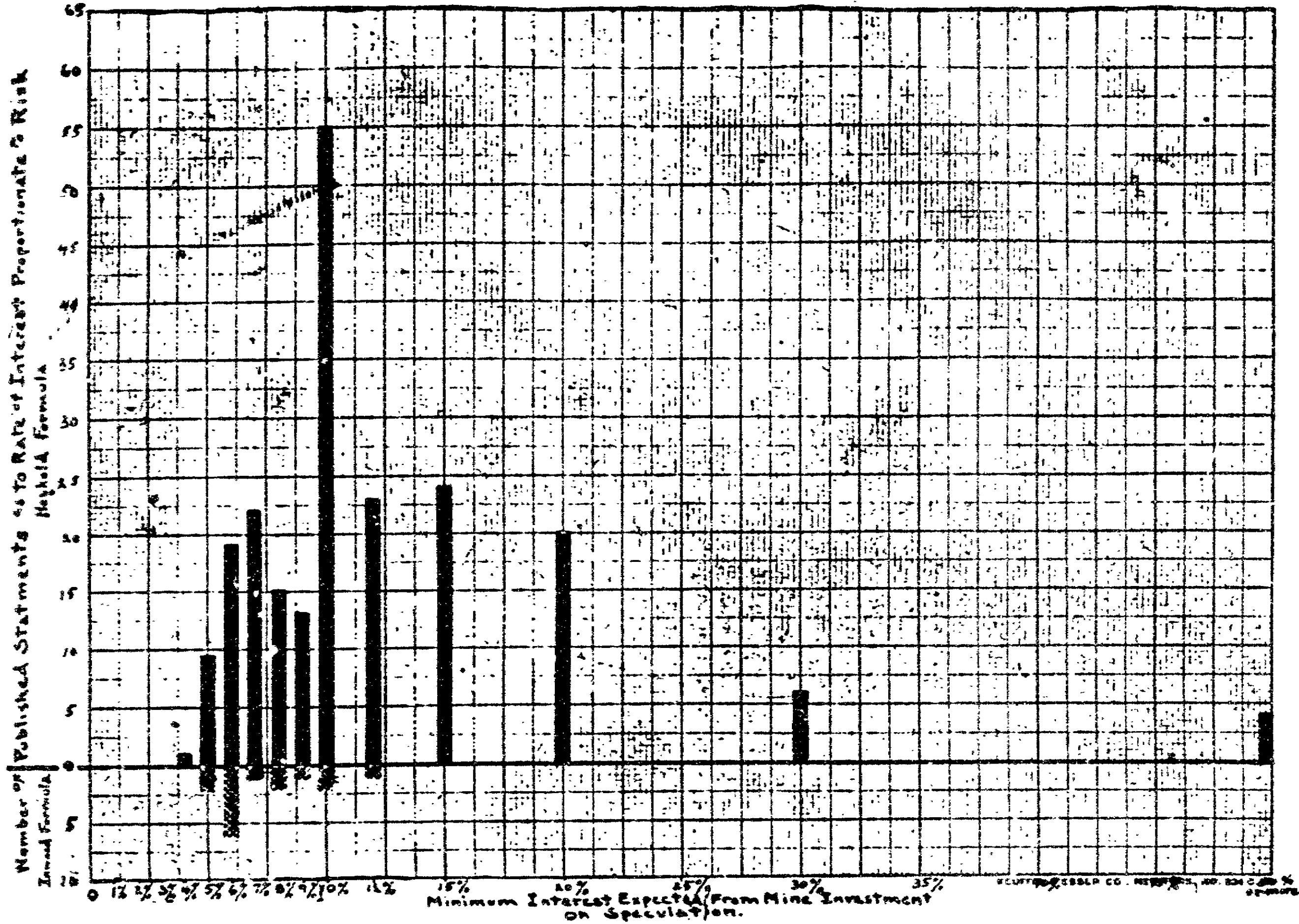

EXHIBIT B

Memorandum in re revaluation of copper and silver properties.

Under date of December 11, 1922, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, "authorized and instructed" the Income Tax Unit "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 recommendations heretofore made by it."

The recommendations of the Income Tax Unit, to which the commissioner made reference, are summarized as follows:

"(1) That a standard basis for the determination of expected future sales prices of the common metals be adopted. That the arithmetical average price for the 10 years preceding the basic date be adopted as the expected future sales price, except in the case of metals for which such an average price is not available or for which the price trend during the 10-year period is strongly and consistently up or down.

"(2) That in the case of valuations of long-life properties, based upon operating records and upon fully developed ore reserves, the present minimum risk rates of 6 per cent for lessors, 7 per cent for operating owners, and 8 per cent for lessees are reasonable, but that relatively higher risk rates, according to the peculiar conditions of each case, be used:

"(*a*) In the case of mines in which the ore reserves are not fully developed.

"(*b*) In the case of mines for which the cost of operating must be estimated.

"(*c*) In the case of mines in which the indicated life is less than 10 years.

"(*d*) In the case of discovery values of short-life mines during the war period whose value is largely dependent upon war conditions.

"(*e*) In the case of mines subject to interruption of operations for any reason.

"(*f*) In the case of mines or mineral deposits in which the profit to be realized depends to any extent upon manufacturing or marketing ability or upon any factor other than the intrinsic value of the mineral product.

"(3) That the basis of all valuations, except short-life discoveries in war times, be the expected profit as determined by pre-war costs and metal prices, rather than the expected profit as determined by costs attained and expected future prices as influenced by war conditions.

"(4) That all valuations by analytical appraisal methods, based upon estimates of any factors, such as operating costs, grade of ore, quantity of ore, or increased rates of production, be provisional until actual operations by the taxpayer have demonstrated the essential accuracy of his estimates; in other words, that information derived from operations subsequent to the required basic date will be the test of the accuracy of analytic valuations which must be based upon estimates.

"(5) That in the case of a valuation of any mining or mineral property in which the period required for the exhaustion of the ore or mineral exceeds the life of plant or equipment utilized in its exploitation, provision shall be made in the valuation for deduction from the value of operating profit at the date of valuation, of the value at that date of the entire amount which is expected to be returned in depreciation during the exhaustion period.

"(6) That a 10 per cent interest rate is the minimum rate at which the expected profit from untried mines should be discounted to present worth or cash value.

"(7) That if a 'price-trend' method is used, 'cost trends,' 'interest-rate trends,' and other trends should be considered in the valuations. Increasing prices represent depreciating money value and are accompanied by corresponding increases in costs of production and interest rates. Increasing prices should not be considered as any indication of increased profits or of increased values, unless the general price trend of commodities and wages is increasing at a far less rapid rate."

That such gross errors in provisional valuations as follow be corrected:

"(8) Increasing the recoverable mental content per ton without increased cost per ton, adding 50 to 100 per cent to estimated operating profit per ton.

"(9) Using a production cost per pound of copper attained in past operations mining a high-grade ore and using the same cost per pound as the ex-

pected future cost with much lower-grade ore, adding 25 to 90 per cent to the estimated operating profit per ton.

"(10) Assuming that the grade of the ore would remain constant when a long period of operations had shown that the assay value of the ore was constantly decreasing and might be expected to do so in the future.

"(11) Increasing the estimated present worth of the same total profit by assuming large additions to plant capacity with decreased production costs attending increased capacity, and then assuming an average rate of production and an average cost for the entire life of the mine.

"(12) Making no provision for plant replacement when the useful life of the plant is less than the life of the mine.

"(13) Accepting erroneous estimates of the taxpayer without check or correction.

"(14) Allowing depletion deductions for ore of such low value that it was profitable only in war times, and was not included in the valuation. Thus, in one instance, a ton of low-profit ore is excluded to each 2 tons of high-profit ore included in the computation of value. The ore excluded must be removed to permit mining of the commercial ore, and if the price of copper is such that it can be profitably treated, the ore is shipped to the mill instead of to the dump. Perhaps a profit of 25 cents per ton is made and depletion of 50 cents per ton allowed for this ore. Using a portion of the plant capacity for treating this ore has also a direct effect upon the value of the commercial ore, in that it reduces the plant capacity available for the commercial ore and reduces the present value of that ore."

Exhibit C

R. C. Allen (p. 15, fourth State conference on taxation, Detriot, Mich., January 28, 29, 1915):

"In approaching the problem of determining the full cash value at private sale of a mining property, the appraiser will discover that the records of sales and purchases are of no value for two reasons, viz: (1) Such transactions are rare and (2) the value of a mine is subject to fluctuations which are, in many cases, so rapid as to render a sale transaction a few months or a year old an unsafe guide to present worth. He must, therefore, turn from the investigation of what these properties do actually sell for to a determination of the amount of money they should command in the event of a sale. He assumes the attitude of a purchaser, or an adviser of one who desires to purchase, and seeks to determine what a business man or a capitalist could afford to pay for the mines, having full knowledge of their operating records, financial experience, present condition, and future prospects."

R. C. Allen (principles of mine valuation applied to the Miami district of Oklahoma-Kansas, September 15, 1919):

"A mine is worth the amount of money it will command in the event of a sale. The determination of the worth of a mine takes account of two elements of value which may be termed 'assured value' and 'prospective value.' Most mines have both elements of value, but some have only one, and where both elements are present the prospective value often exceeds the assured value.

"A calculated value can be nothing more than the fair weighting and combination of all of the factors determining value at the time of appraisal; it may closely approximate the sale value if good judgment is used in weighting each factor in the calculation."

R. C. Allen (p. 16, fourth Michigan State Conference on Taxation, Detroit, Mich., January 28, 1915):

"Mineral values may be considered as both intrinsic and speculative. That which lends intrinsic value to a mine is a measurable quantity of valuable ore. Mines which have intrinsic values usually have in addition a speculative value depending on the occurrence of an additional amount of valuable ore over and above that which is susceptible of actual measurement. For such speculative values the owner will demand and the purchaser will have to pay an equivalent in money."

R. C. Allen (pp. 17–18, fourth proceedings Michigan State Conference on Taxation, Detroit, January 28, 1915):

"The purchaser of a mine must look, first, to the safety of his capital, and, second, to an income therefrom in fair proportion to his investment; in other

words, his investment must be predicated on an eventual return of principal with interest.

"The valuation of a mine is an attempt to determine the amount of capital locked up in an ore body. We may as well state here that a precise determination is impossible, except through a post mortem calculation, i. e., after the mine is exhausted and all of the operations are terminated.

"The value of a mine may be defined as the total capital represented by the present worth of the sum of all operating profits which may be reasonably assumed on the basis of its experience, present condition, and prospects. In most cases its experience has been carefully recorded, its present condition may be determined by examination, and from these and general considerations its prospects may be inferred. The calculation of value is based on three main factors, which are: (1) The operating profit per unit of production; (2) the total ore reserves; and (3) the productive life.

"What is a fair income from a mine investment and what rate of interest should redemption fund bear are questions which may be discussed only in connection with the hazards of mining. Somewhere in the calculations of value a proper discount must be allowed for hazards of mining. Such allowance may be small or great as the case demands, but it is an element that must receive due consideration.

R. C. Allen (p. 16, Fourth Proceedings of Michigan State Tax Conference, Detroit, Mich., January 28, 1915):

"The entire value of a mine resides in the 'ore in sight' or 'developed ore' and such prospects as there may be for additional ore or 'prospective ore.' This means, of course, that the equipment, such as shafts and other openings, machinery, etc., has no value considered apart from the ore tributary to it.

"* * * there are cases where the exhaustion of ore occurs or unfavorable conditions force an abandonment before the equipment is entirely consumed or worn out. In such cases a small value attaches to what remains of the equipment. This statement does not mean that the ore body lacking equipment is of the same value as an exactly similar one equipped, for it is patent that there is a difference exactly equal to the value of the equipment. It is true that the two ore bodies will produce the same amount of wealth, but in the one case each ton of ore is credited with its proportionate share of the cost of equipment, whereas, in the other no such credit has as yet been made."

R. C. Allen (Principles of Mine Valuation Applied to the Miami District of Oklahoma-Kansas, September 15, 1919):

"With ores blocked out and plant installed the net earnings of a mine may be fairly determined for a few months or a year in advance but * * * as the period of operations becomes longer the hazard in the estimate increases The estimated earnings of a partly developed mine have still less of certainty in them and for an undeveloped ore body such estimates are correspondingly more uncertain. 'Therefore, in the estimation of earnings as a basis of purchase an investor discounts the sum of calculated probable yearly earnings by an amount proportioned to the uncertainty of realization.' This may be called discount for hazards. Each calculated yearly earning is further discounted in accordance with its period of deference on the principle that a deferred payment is worth only a sum, which invested at compound interest will equal the amount payable on the due date. The whole sum of calculated earnings reduced by the discount for hazard and interest is the amount a purchaser could pay were he satisfied to invest in running property on the basis on which bonds and mortgages are procurable, for the discounts have made provision only for the return of capital with an ordinary rate of interest. But no one would knowingly buy a mine on such a basis.

"The purchaser must pay himself for the trouble and responsibility devolving on him as a mine owner out of mine earnings.

"He therefore subtracts finally an amount which represents his opinion of what the rewards of successful operation should be. The remainder is the amount he can wisely pay for the property.

"A refined method of calculation based on factors which at best be only roughly estimated adds nothing to the meaning of the result.

"The value of mining property is determined by men's opinions of value. Where these opinions are evidenced by actual transaction of purchase and sale we have the best evidence of value, but when this guide fails it is generally necessary to resort to calculations in order to approximate the amount a property should command in the event of sale. The results of such computations do not, of course, determine value, but they may be accepted and used where

no better measurement of value is possible. * * * Men's judgments of value do not run parallel, even when they are based on precisely the same data."

J. R. Finlay, writing in the Engineering and Mining Journal, May 3, 1919, said:

"It may be worth while to repeat for the sake of emphasis that the shortest justifiable life is that which will merely return the capital with such interest as might be obtained merely by lending the money on good security. When one comes to take account of the difficulty of guarding against the chances of failure, such as is in an overestimate of ore supply, underestimate of cost, unfavorable change in price, or unavoidable accidents, it seems venturesome to consider a return as low as 10 per cent a safe margin for investment. To justify it, it is necessary to count on exterior factors, such as a probability that the business would continue to expand indefinitely instead of being limited to an exhaustible deposit. Perhaps I shall not be far astray if I assert that most mining enterprises are based upon a return of between 10 per cent and 50 per cent on the money required for development, plant, and working capital: that these returns vary according to the relative abundance of the material handled; and that the higher returns are obtainable only upon bonanza deposits, in which mere discovery is a matter of capital importance."

J. R. Finlay (p. 15, "Cost of Mining"):

"The valuation of mining properties depends on some cardinal principles that are easily understood in general terms.

"The basic factors are: First, average market price; secondly, average costs; thirdly, the life of the mine."

"In the case of a mining property, two concurrent questions must be answered in order to determine its value: What will be the sum total of dividends? and How long will it take to realize them?" (P. 25.)

J. R. Finlay (pp. 25–29, "Cost of Mining"):

"A valuation of a mine based upon a given ore reserve must generally contemplate that the value of a mine declines in direct proportion to the rate of mining. But, in general, development work continually adds to ore reserves so that mines having six months to five years' ore reserve developed 20 years ago still have the same amount developed ahead of operation. Mine valuation must consider whether the mine is old or young, strong or weak, and adopt factors for valuation accordingly. Increased discoveries usually result in increased production rather than increased life."

J. R. Finlay (p. 38, "Cost of Mining"):

"When we come to take account of the difficulty of guarding against chances of failure such as lie in the overestimate of ore supply, underestimate of cost, unfavorable changes of prices, or in absolute accidents, it seems venturesome to count upon a return as low as 10 per cent as a safe margin for investment.

"Perhaps we shall not be far astray if we assent that the bulk of mining enterprises are based upon a return between 10 and 50 per cent on the capital required for development, plant, and working capital. * * * and that the higher returns are obtainable only upon bonanza deposits in which the mere discovery is a matter of capital importance."

J. R. Finlay (p. 47, "Cost of Mining"):

COSTS

"*Labor.*—'High wages do not cause high costs under competitive labor conditions,' as 'where wages are high, the most ambitious and intelligent men are attracted, and they compete with each other for the places. From one-half to all the difference in wages is made up in increased efficiency according to different authorities. Since the labor accounts generally are about 60 per cent of the total current cost of mining, differences in wages are not likely to account for a variation of more than 18 per cent' (of the total cost). Where native labor is employed at a large plant at very low rates 'it is well known that the costs are not lower than in the United States for similar work.'

"*Supplies.*—The prices of fuel, timber, explosives, steel, and tools does not vary over 50 per cent from the maximum in the United States and as the cost of these supplies is rarely over 20 per cent of the current cost of mining, variations in the cost of supplies will produce a maximum difference of 10

per cent in current mining costs. In any country where the cost of labor is unusually low the cost of supplies is usually high.

"*Underground conditions.*—The hardness of the rock is a comparatively unimportant factor. The stability of the ground is more important, as timbering is often an important item. Increases in cost at depth are far from proportionate to the depth as transportation and temperature difficulties increase at depth. Temperatures of 80-90° F. affect the energies of the men adversely and cause serious increases of cost.

"*Climate, altitude and population.*—Excessive rainfall, heat, cold, altitude, distance from transportation or civilization often make it difficult or impossible to secure adequate labor.

"Transportation is often the most vital element in the cost of mining and marketing ability often is a vital factor in costs as it may determine plant capacities, volume of operations, etc., as well as price received (coal, iron, salt, etc.).

"Internal factors, size, attitude, uniformity, continuity, relation of ore to gangue, and metallurgical problems are the greatest factors in cost. causing variations of several hundred per cent. Four feet is the minimum for cheap mining. Low mining costs frequently mean high ultimate costs and low recoveries beyond the mine, and sometimes mean a loss of ore in the mine. The cost of mining and percentage of recovery should be related to the value of the product."

John Hays Hammond (E. and M. J., Vol. LXXXIX, p. 10, January 1, 1910):

"In many mines persistency of the ore deposits, and therefore the reliability of the mines as dividend payers, justifies the investment upon a basis in some instances as low as 8 per cent dividends, to which, of course, must be added a certain percentage to provide for the amortization of the capital. Generally speaking, however, investments in mining securities are not to be regarded as attractive unless they return from 10 per cent to 15 per cent in dividends, in addition to the profits to be set aside for amortization."

John Hays Hammond "Suggestions regarding mining investments" (E. and M. J., January 1, 1910, p. 8, vol. 89):

"Investments in partially explored or developed ore bodies are always speculative.

"The capital required to purchase and develop a prospect is, of course, much less than that required for the purchase of a developed mine and the installation of the mining and reduction plant necessary for its exploitation."

Mr. Hammond then states, in effect, that:

"1. Investments in prospects are entirely speculative.

"For that reason a greater percentage of investments in prospects is lost than in the case of investments in developed mines, although individual losses in prospects are smaller.

"2. Probably not one out of six good prospects becomes a profitable mine."

Fred Hellmenn (T. I. M. and M., Vol. VI; "Determination of the Present Value of a Mine on the Rand," London, 1897-1898):

"The determination of the present value of a mine, and, as a sequence, the intrinsic value of the shares, is naturally a matter of interest to engineers, financiers, and mining men generally.

"The accuracy with which the problem can be solved depends upon the reliability of the various factors entering into the calculation. If the life of the mine and the profit per ton milled over the total reef tonnage of the property—which involves the average grade of the ore and the average working costs over the life of the mine—could be definitely determined, the problem would be susceptible of an exact solution. As a matter of fact the life of a mine can hardly be determined within a year or two, and the profit per ton milled can only be estimated on the basis of the development to date and the costs obtaining at the time of examination. Furthermore, the formulæ deduced below presuppose the payment of an annual dividend at a fixed rate of interest on the present value. In reality a mine begins usually by paying a small dividend and gradually works up to a maximum, after which the dividends may or may not fall off as the mine approaches exhaustion. Since the variation in the yearly dividends can not be estimated in advance, the only course possible is to assume an equal distribution of profits over the life of the mine.

"It is, however, not expected that an exact value shall be placed on a given mine. All that an engineer can do is to gather such information as the mine affords and base on it the possible approximation."

Terminology:
- L=life of mine in years.
- P=total net profit.
- S=annual payment to amortization fund.
- D=annual dividend.
- a=rate of interest on amortization fund divided by 100.
- d=rate of interest for dividends divided by 100.

Formulæ:

$$LSLD=P$$

$$V=\frac{S(1a)L-1}{a}$$

$$S=\frac{aV}{(1a)L-1}=\frac{aP}{aL(1a)L-1)Ld}$$

$$D=dV$$

$$V=\frac{P}{\frac{aL}{(1+a)\ L-1}+Ld}$$

Hellmann then discusses a minor modification of the above formulas, which he does not advocate for general use, and develops tables for annual and semi-annual annuities, using 3 per cent for amortization-fund interest and 5 to 7 per cent for dividend rates.

By inference Hellmann suggests 6 per cent as a proper rate of dividend for the Rand mines when all factors of valuation have been conservatively determined.

MINE VALUATION AND MINE FINANCE

[By H. C. Hoover. Abstracted from Mining Magazine (London), Vol. VII, p. 275, October, 1912]

Valuation of mines, especially where the property is offered for sale for cash, or cash and shares, or where the promoter or the vender wishes to secure working capital necessary for its development and equipment, should be put on a practical, sound basis. To do this the valuation should be stripped of its academic and theoretical features; it should not be determined or interpreted in money by any algebraic formula, and it should not be fixed upon any sum representing an assumed percentage in excess of the profit assured.

"The valuation of a mine involves two parts of widely different risk; that is, profit assured and the prospective value. Therefore it is but logical that the mine, when financed, should be capitalized into securities directly interpreting this varied risk, namely, debenture, representing the 'profit assured,' and shares, representing the 'prospective value.' For convenience in the discussion, this debenture may be termed 'an assured profit debenture.'"

Such a valuation will, broadly speaking, have two extremes to meet: (1) No mine starts at the surface with any considerable amount of proved ore, and yet this is the period when its prospective value is the greatest; and (2) this same mine fully developed to the 3,000-foot level with all its ore intact presents a large amount of proved ore and a greatly diminished prospective value. Therefore the prospective value is simply a matter of how far the ore in individual mines will be expected to extend, and to this no mathematical factors can be applied. Rather the governing factors are a blend of psychology and geology. The prospective value of any mine will represent much of the individual's personal equation and metallurgical, economic, and geologic risk.

In the statement "proved ore" there are, of course, several speculative features, the greatest of which is a geological one. Assuming a definite distance beyond each sampled face as proved ore, this distance varying with the type of deposit, experience, etc., the greatest risk is removed and the other factors can be assumed as constants. "Proved ore" will then equal "profit assured." In presenting any statement of profit assured the following must be included: (1) The tonnage of ore, (2) distance in feet the ore extends beyond the sampled face, (3) average assay value, (4) average recoverable value, (5) cost of mining, (6) price of metals assumed, (7) cost of necessary plant for life, and (8) loss of interest during period necessary to recover the profit.

In any event there are two distinct values in a mine—proved ore or profit assured and probable and prospective ore, or prospective value. Therefore the

profit assured should be represented by debentures redeemable in principal and interest out of such profit and the prospective value represented by the share capital.

Such a representation would give the investor buying debentures a security for his money, and he should be returned at least 6 per cent, with some discount, and also have a bonus in shares. Further, the debentures should be convertible into shares. This method of capitalization has the advantage that it forms an easy basis to negotiate between capital and the vender. It would further encourage investment in mines, for the industry would then be on a sound footing. If the vender should underestimate the required capital to bring the mine to production, he would either be forced to give up his share interest through foreclosure proceedings or supply the money to go ahead on.

Hoover's "Principles of Mining," 1909:

"It should be stated at the outset that it is utterly impossible to accurately value any mine owing to the many speculative factors involved. The best that can be done is to state that the value lies between certain limits, and that various stages above the minimum given represent various degrees of risk:

"The following discussion is limited to in situ deposits of copper, gold, lead, silver, tin, and zinc: The value of a metal mine of the order under discussion depends upon: *a*. The profit that can be won from ore exposed. *b*. The prospective profit to be derived from the ore beyond exposing. *c*. The effect of a higher or lower price of metal. *d*. The efficiency of management during realization.

"The first may be termed the positive value, the second and third speculative values, and the fourth is indeterminate.

"For the purposes of this discussion the subjects involved in the valuation of mines are: 1. Average metal contents of the ore. 2. Quantity of ore. 3. Prospective value. 4. Percentage of recoverable to gross value of the ore. 5. Price of metals. 6. Cost of production. 7. Redemption of amortization of capital. 8. Valuation of mines without ore in sight.

"The average metal content is usually determined by sampling and assaying the ore exposures, but where experience has proved a sort of regularity of recurrence (as in Mississippi Valley Pb and Zn and Michigan copper mines) dependence must be placed on past records, or certain typical sections must be mined and treated in test runs.

"The accuracy of sampling as a method of determining the value of standing ore is a factor of the number of samples taken.

"With 5-inch by 2-inch trenches for samples, careful quartering, duplicate assaying, and including high samples at the average of those adjacent, sampling usually indicates higher values than those attained in mining the ore. In the case of three Australian mines, for two years the sampling assay values were 10–12 per cent too high and on the Witwatersrand there is a constant discrepancy of 10–12 per cent. At Broken Hill the yield is 12 per cent less than indicated by sampling.

"In mines where the minable ore can only be determined by assays and can not be determined by physical appearance the discrepancy is greater.

"1. A factor of safety of at least 10 per cent should be allowed on any sampling results and more in most cases, as ore is diluted in mining, more than a fair proportion of sulphides gets in the sample, etc.

"2. A factor of safety of 10–25 per cent is also allowed on tonnage because of porosity, losses in mining, varying widths, moisture, and variations in specific gravity. This factor is usually applied in the cubic feet per ton.

"3. In gold-quartz veins no ore should be called proven that is over 50 feet from an assay, and in limestone and other replacements the distance should be less but in defined lodes and lenses it may be greater, say 100 feet, and on Witwatersrand, 200 or 250 feet. Ore further away is probable ore or prospective ore.

"Mines are seldom priced at a sum so moderate as that represented by the profit to be won from the ore in sight and what value should be assigned to this unknown portion of the deposit admits of no certainty. 'Any value assesesd must be a matter of judgment and this judgment based on geological evidence.'

"The addition of various percentages to the profit in sight has been used by engineers and proposed in technical publications as varying from 25 to 50 per cent but this method has little foundation in science or logic as the quantity of ore which may be in sight is largely the result of managerial policy.

"Logically the prospective value can be simply a factor of how far the ore in the individual mine may be expected to extend * * *.

"Extension of half length of ore shoot in depth used as minimum in vein mines or shear zones but not in replacement mines.

"All mines become completely exhausted at some point in depth. The really superficial character of ore deposits even outside of the region of secondary enrichment is becoming every year better recognized.

"Conclusion: The prices asked for vein mines are in excess of the profits to be won from the standing ore. Whether or not the price should be paid depends on the engineer's estimate of the possibility of finding sufficient additional ore, based on (1) the origin and structural character of the ore deposit; (2) the position of the opening in relation to secondary alteration; (3) the size of the deposit; (4) the depth to which the mine is already exhausted; and (5) comparison with the depth and continuity in adjacent mines."

H. D. Hoskold (Engineers Valuing Assistant (2d edition, Longmans Green & Co., 1905)):

Mr. Hoskold cites 19 prominent mining engineers, actuaries, and mathematicians of Great Britain in the preface of the first edition, published in 1877, as having reviewed and approved the principles and formulas of valuation presented in his book. (See pp. IX–X of preface of 2d edition.)

"Every beneficial interest or sum of money accruing, or to accrue, and to be paid at the end of a year, or portion of a year, may be considered as an annuity, and may be either terminable with the life of an individual or perpetual. Any sum of money left unpaid for a certain number of years is called an annuity in arrear, and when not payable until after a fixed number of years it is said to be a reversionary or deferred annuity.

"On either case the annuity is transferable and may be purchased on certain agreed terms; each class of annuities must, however, receive a particular mode of treatment, adapted to, and peculiar to, the nature of the circumstances connected with each particular case.

"If money could not be employed, and a marketable rate of interest obtained for its use, the value of any sum of money or annuity would be equal to that to be paid at the end of one year, multiplied by the whole period or number of years the annuity has to run; but as compound interest is involved in all these cases, it is clear that if A desires to sell an annuity to B, and which has to last a certain number of years, a certain agreed interest or discount must be allowed to B upon the whole sum to be purchased and received by him for the fixed period.

"Tables of the value of leases on annuities have frequently been published. That of Mr. Ward was written as far back as 1710: but Mr. Smart's celebrated five tables of compound interest, which appeared in 1726, far excelled all that had been done previously to that time: indeed, his tables have been incorporated more or less into the works of many writers to the present time.

"The tables specially referred to are: 1. The amount of £1 in any number of years. 2. The present value of £1 due at the end of any number of years. 3. The amount of £1 per annum for any number of years. 4. The present value of £1 per annum for any number of years. 5. The annuity which £1 will purchase for any number of years.

"None of the tables of this class that I have seen (and I have examined a large number of works upon the subject) are computed to rates of interest higher than 10 per cent, and many of them extend only to 5 per cent.

"The rate of interest allowed to a purchaser of mineral property, such as collieries, iron mines, and others, frequently ranges between 10 and 25 per cent, but more generally between 14 and 20 per cent, depending, of course, upon the character of the property. It is evident, therefore, that tables calculated for rates of interest no higher than 8 or 10 per cent and to two or three places of decimals could not be employed for ascertaining the true value of annuities derived, or to be derived, from high rates.

"It is stated on page 2 of all the editions of Inwood's Tables of Annuities that I have seen—that is to say, those published from 1837 to 1866—that 'A lease or annuity for 14 years, to make 3 per cent and get back the principal, is worth 11.296 years' purchase of the clear annual rent,' and this rule is repeated as a footnote as far as page 9 as being true for all the rates of interest up to 10 per cent. The table goes no higher than 10 per cent, but it is identical with Mr. Smart's table—and that of all subsequent writers—of the present value of £1 per annum for any number of years. This table, and others of its kind to be found in most works on annuities, is constructed correctly according to the

mode laid down, but as that mode is based on incorrect principles its application to the valuation of annuities, where interest is allowed at higher rates per cent than can possibly be found for reproducing capital, is entirely fallacious, for the principle upon which it is based assumes that we can reproduce capital which may have been invested at the same rate of interest as that allowed and expected to be realized on the purchase money invested.

"The practice, therefore, of valuing upon tables constructed on the assumption of reproducing capital at the same high rate of interest as that which may be realized on it is opposed to the truth and calculated to mislead and injure a purchaser to a very large extent.

"Thoman's definition is that the present value of a deferred annuity is equal to the difference between two immediate annuities of the same yearly income, one for the whole term, the other to continue until the time of entering on the deferred annuity.

"This rule, however, embraces but one rate of interest in the present value of £1 per annum, but it has, I believe, been followed by all writers on annuities and by many valuers since Thoman's time.

"It will be observed that throughout the problems where the condition was introduced that a certain sum was necessary to be expended upon open or unopened mines with a view to obtain an estimated yield of minerals and constant profit extending over a definite future period the ordinary or customary mode of allowing 5 per cent upon any such sum has been followed. It was considered advisable that this mode of solution should be fully exhibited, as it is believed to be good practice by some of the profession."

Speaking of deferred annuities, Hoskold says:

"Generally, therefore, in cases of deferred annuities of this kind—that is, when two rates of interest are involved—a certain sum, P_{t+n}, has to be paid down immediately; but as no annuity is or can be payable under the circumstances during the deferred period the purchase money, P_{t+n}, accumulates at the rate allowed to the purchaser on his capital, or r' per £, to a certain sum= $P_{t+n}(1+r')^t=P_n$; but at the expiration of t years the deferred period closes, and the annuity commences or is then entered upon, and its payments have to yield interest at the rate agreed upon between the parties to the business, or r' per £ on the accumulated purchase money, $P_n=P_{t+n}(1+r')^t$, and also a sum sufficient to reinstate the sum P_n, to which the purchase money has accumulated at the end of the assigned term of t+n years, at another rate per £, or r."

Ruckard Hurd, "Iron Ore Manual, Lake Superior District" (Syndicate Printing Co., Minneapolis, Minn., 1911):

"Rule for determination of present value of royalties:"

Gross receipts equal tonnage not paid for in advance times royalty rate per ton.

Life of the mine equals gross receipts divided by minimum royalty payment per year; or the unexpired term of the existing lease, if this is a shorter period.

"Multiply the annual payment, payable quarterly, by the present value of $1 per annum, payable quarterly, at the assured rate of interest and for number of years determined as the life of the mine. The result is the present royalty value of the lease.

"*Determining interest rate and factors.*—While under the conditions named the security of the investment is unquestioned, for calculating present value the determining interest rate depends upon a number of factors, such as—

"1. Average worth of money at the given time and interest rate expected for a long-time investment.

"2. Fluctuating yearly income as the property passes back and forth from shipping and nonshipping stages, from large royalty income on shipments one year to minimum annual payments when not operating.

"3. Quality of the ore and availability for furnace demands.

"4. Amount of the tonnage and the time required under normal mining conditions to exhaust the ore.

"5. Character and standing of the lessee and his ability to meet the terms of the lease.

"6. Possibility of a surrender of the lease, depending upon whether the ore is good or lean, monetary situation, and the financial condition of the lessee.

"Under all these conditions such an investment demands and is entitled to a high rate of interest even greater than a highest-grade preferred stock or bond security would yield. Capitalists would not entertain the purchase of such a proposition at ordinary rates of 5, 6, or even 7 per cent. While 10

per cent seems to be the customary prevailing interest rate, it would appear that 8 to 10 per cent should be now used in calculating the present value of iron-ore royalties; that is, the investment required to purchase the royalty rights of a mineral lease containing known developed tonnage of merchantable iron ore.

"*Royalty only basis of value.*—It will be observed that the assessed or full value or market price of the tonnage is not and should not be considered. That concerns only the operating company and the tax officials. That value has gone beyond the control of the fee owner with the lease; his value is in the royalty alone."

Hurd uses the Inwood tables of the present value of $1 per annum, payable quarterly or annually, as the case may be, for valuation purposes.

William Young Westervelt, "Mine examinations, valuations, and reports" (sec. 25, p. 1515, Peele's Mining Engineers' Handbook; John Wiley & Sons, 1918):

"Since the value of a mine is its resources for producing future profits, that value is no more susceptible of accurate determination than any other future value, even in the ideal case of an absolutely developed mine. Fluctuation in market value of all products (except gold) may change a profit into a loss or the reverse; and it is seldom, if ever, determinable whether or not further discoveries, laterally or in depth, will resuscitate an apparently exhausted deposit, or whether improvements in treatment, transport facilities, or labor conditions will render profitable a seemingly valueless mine. The engineer must bear in mind these uncertainties, use his best judgment to determine their probable combined effect, and the uncertainties in the basis of * * * conclusions should be so expressed in the report as will indicate * * * the degree of importance they occupied in the engineer's judgment.

"Proper margins of safety are essential, but a serious underestimate of value is as great an error as an overestimate: * * * though it usually involves less conspicuous censure, as close an approach as possible to the properties' true value must be made, * * * without concealing either favorable or unfavorable aspects.

"Sampling is the process of securing a more or less representative part or sample for the purpose of gaining information as to the composition of the whole.

"The process is essentially one of approximation * * *.

"The greatest difficulty in securing an accurate sample is due to the inaccessibility of most of the interior of the mass.

"Owing in part to the more finable nature of the valuable minerals, and particularly to the inevitable inclusion, when mining, of some of the adjacent low-grade or barren material * * * the yield per ton of a carefully sampled deposit is generally lower than the calculated average, and the tonnage higher. An allowance (say, 10 per cent) should therefore be made for this in reporting values.

"In general deposits not definitely limited are likely to contain at least 25 to 100 per cent more ore than can be actually assured.

"In estimating total costs, ample allowance must be made for general overhead charges, selling, and sampling costs, freight to market, and contingencies, the last usually being put at 10 per cent (sec. 21; sec. 28; art. 36; sec. 32).

"Fluctuations in market price of all other mineral products (except gold) form one of the most uncertain elements of mine valuation. In case of the metals or coals having a standard market, it is questionable whether an engineer should recommend purchase of a property which he estimates is incapable of making a small profit, when mining its choicest reserves and selling its product at the minimum price of, say, 25 years past. The value of a property which would fail to make an attractive profit under normal operation, at the average price for a like period, is even more doubtful."

Price table (pp. 1543–1544) gives highest and lowest prices with quantities sold, and the average 25-year price and quantity sold for all common metals and nonmetals.

Scale of operation limited by minimum rate of profitable working on the one hand; and by assured and probable ultimate mineral resources, available capital, available market, etc. "The profit per unit multiplied by the proposed annual production (on the usual basis of 300 days' actual operation) gives the estimated annual profit."

"* * * there should be assured mineral reserve at least sufficient to produce profits that will more than return the capital required to put the property into successful operation."

The cost of securing capital under favorable conditions "often does not exceed 10 per cent and may not be more than 5 per cent."

"* * * the engineer must make allowance for amortization in drawing conclusions as to the value of the property. Amortization of capital is its return, with interest at or before the time of exhaustion * * * of the property."

Table of Hoskold formula rates with 4 per cent sinking fund interest is given for 5 to 10 per cent risk rates, and 6 to 30 per cent dividend rates (p. 1546).

"In the absence of assured mineral reserves, the whole question of value is one of inference, and amortization tables have little application."

(Whereupon, at 12.55 o'clock p. m., the committee adjourned until to-morrow, Wednesday, January 21, 1925, at 10.30 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, JANUARY 21, 1925

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

The committee met at 10:30 o'clock a. m., pursuant to adjournment of yesterday.

Present: Senator Couzens (presiding).

Present also: L. C. Manson, Esq., of counsel for the committee; Mr. L. H. Parker, chief engineer for the committee; Mr. Raleigh C. Thomas, investigating engineer for the committee; and Mr. James M. Robbins, assistant engineer for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, Assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, Solicitor Bureau of Internal Revenue; Mr. James M. Williamson, office of solicitor Bureau of Internal Revenue; Mr. S. M. Greenidge, head, engineering division, Bureau of Internal Revenue; and Mr. John A. Grimes, chief, metals valuation section, Bureau of Internal Revenue.

The CHAIRMAN. Mr. Hartson, you had something more to present to-day?

Mr. HARTSON. No; Mr. Manson announced yesterday that he wanted to question Mr. Grimes.

The CHAIRMAN. Oh, yes.

Mr. MANSON. Before questioning Mr. Grimes I wish to make a short statement.

Mr. Grimes's statement is a general explanation and defense of the analytic system of appraisal. It is confined almost entirely to the application of that system to the appraisal of mines. It is perhaps unnecessary, but well for me to say, that so far we have considered no cases in which this method of appraisal has been applied to mines. When we reach that point, as we will when we take up the matter of the revaluation of copper mines, I expect to discuss this method of appraisal more at length.

I do desire to say at this time, however, that the instances in which its use has been condemned by the committee counsel, as well as by Senator Jones, who was quoted to some extent in the statement of Mr. Grimes, are all cases where this system of appraisal has been applied to nonmetal resources, where the element of profit constituted a large part of the selling price, and in which cases it was possible to show the market value by either the sale of the property itself or by sales of similar properties.

It is manifest that in cases where the element of profit is but a small percentage of the price received for the product the intangible elements that are brought into the appraisal, such as capital, business organization, selling ability, etc., are reduced to a minimum.

It is unnecessary to discuss the advisability of applying this method of appraisal to nonmetal resources, where the value to be depleted can be ascertained by other means, for the reason that the regulations themselves condemn the use of this method where the value can be ascertained by the sale of the property itself or by the sale of comparable properties.

I am glad to have had the benefit of Mr. Grimes' views before discussing this method of appraisal when it is applied to mines in cases where the value can not otherwise be determined.

STATEMENT OF MR. JOHN A. GRIMES, CHIEF METALS VALUATION SECTION, BUREAU OF INTERNAL REVENUE—Resumed

Mr. MANSON. Mr. Grimes, how do you examine the value of an ore deposit, of an undeveloped ore deposit, where there is no plant and of course no operation and no profit to use as a basis for price?

Mr. GRIMES. It is impossible to use an analytical appraisal based upon an undeveloped property.

Mr. MANSON. What is your method?

Mr. GRIMES. We would have to take the best evidence that we had of other kinds.

The CHAIRMAN. Would the necessity appear for valuing such property when there is no profit and no excess-profit tax or income tax?

Mr. MANSON. It might appear in a case, for instance, where a company owned an undeveloped body of ore as of March 1, 1913, which was subsequently developed, and the question is the value of that body of ore on the 1st of March, 1913.

Mr. GRIMES. That would probably fall into the class of discovery value. If the existence of the ore body was not known at March 1, 1913, or if it was simply known that there was an indication that there might be an ore body there, and the mine was subsequently developed at considerable cost, the value for depletion would in all probability be a discovery value rather than a March 1, 1913, value.

Mr. MANSON. You have cases, have you not, where the ore body is known to exist and some considerable data as to the extent of the ore body on March 1, 1913, but which has not been developed as a mine?

Mr. GRIMES. I think the difference there would be in the use of the word "developed." That can be used with two meanings. One would be explored so that the extent of the ore body could be determined and its content of metals; and the other use of the term "developed" would be developed for mining, the mine workings as contained in the ore body for the purpose of extracting the ore. The term "developed" has both of those meanings; one that of exploring the ore body to find its extent and richness, and the other the driving of the mine workings for the purpose of extracting the ore.

Mr. MANSON What I was referring to, then, was the first case, namely, where they have developed it to a sufficient extent to determine the quality and quantity of the ore body.

Mr. GRIMES. In that case, an engineering appraisal could be made, because the extent and grade of the ore body would be known, and the cost of mining could be estimated with a fair degree of accuracy. The expected gross earnings of the ore deposit could also be estimated with a fair degree of accuracy, which would enable an engineering determination of the expected profit per unit of the ore body, and for the total developed ore body.

The unknown factors, which have to be estimated according to the best judgment of the valuer, would be: (1) The rate at which it would be possible to mine that ore body; that is, the rate of production per year, which would determine the exhaustion period or life of the ore body. (2) The cost of the development for working purposes; that is, the shafts, mine levels, and other underground workings, or, in the case of an open-pit mine, the cost of stripping and other preparatory work required before mining operations could begin; as well as the cost of plant and equipment and other facilities, possibly power plants, railroads, and similar facilities, which would have to be built before the mine could be operated.

Those factors would be dependent to some extent upon the financial resources of the person or corporation owning the property, in the case of the owner. If you are figuring on a willing buyer and a willing seller, you would have to estimate also what might be done by a willing buyer with adequate financial resources. Those elements are known for an operating property, and we customarily use a lower rate of interest in discounting expected profits to present worth in the case of an operating property than in the case of one which has had no prior operating record.

The CHAIRMAN. What consideration do you give to the marketability of a product in arriving at that?

Mr. GRIMES. In a metal mine, if the mine can produce in competition with the present producers in that industry, say, the copper or lead and zinc industry, there is no question about a market. There is a market for a certain amount of each one of those metals. The supply is not unlimited. The introduction of one new mine that can market, we will say, at 5 cents profit per pound of copper, and produce enough copper to have an effect upon the world's supply, say, two or three hundred million pounds of copper a year, may reduce the spread of profit for the whole industry sufficiently to put some other company out of business which has been operating on, say, a one or two cent margin per pound of copper; but the market for any metal always is sufficient, so that the new mine has a market for its entire product if it is able to produce that product at a sufficient profit per pound.

The CHAIRMAN. How do you arrive at the point, however, of determining whether they can produce it at a sufficient profit per pound or not?

Mr. GRIMES. The only basis you can use for that is one which takes into account the fact of whether the additional supply of the particular metal is sufficient to have any serious effect upon the world's supply and demand.

The CHAIRMAN. Suppose, for instance, the business was somewhat depressed and there was a rate war or a price war between producers. Might not that disturb your entire calculations as to the method of fixing value of these properties?

Mr. GRIMES. In any period which departs from the normal, either a slump in the industry or a boom period, we assume arbitrarily two years of production at the current rate of profit.

The CHAIRMAN. You only use two years; you do not use 10 years? I understood that in some of your formulas you used a 10-year period.

Mr. GRIMES. We use 10 years to determine the average normal selling price. We use a 10-year normal period, without either peak or slump years, or without the greatest peaks or the greatest slumps. We have some ups and downs in that 10-year period, but we take as normal a period as we can and assume that conditions will return to normal within two years whether the industry is in a slump or a boom condition at the date of valuation, and assume two years at the current rate of profit, which may be nothing.

Mr. MANSON. The life of the property and the period of time necessary to recover the ore reserves is predicated upon the capital available for plant, is it not?

Mr. GRIMES. In a good mine it is predicated upon the past rate of production.

Mr. MANSON. Assume two mines with similar ore bodies, similar accessibility, and similar quality of ore, one of which has had adequate capital to carry on all of the development work that is physically possible, and adequate capital to supply all the plant that is required to mine at the highest possible rates; and the other one which only has 50 per cent of the facilities of the first. In that instance you would have about twice as long a life for the second mine as you would for the first, would you not?

Mr. GRIMES. Yes, sir.

Mr. MANSON. The value that you would give to those two mines for purposes of depletion would differ as the present value of $1 would differ for those periods, would it not?

Mr. GRIMES. Not entirely. It would differ to some extent as the present worth of a dollar, but there are other factors which affect the computation. The mine with the shorter life would probably require a much greater investment for plant and development.

Mr. MANSON. That would be about in proportion to the output, would it not?

Mr. GRIMES. It would be very much in proportion to the output.

Mr. MANSON. So that if your investment was in proportion to your output, and the life of one property was twice as great as the life of the other, your valuation for depletion would be in direct proportion to the difference in the present value of $1 for the respective assumed lives.

Mr. GRIMES. There is a little difference in there, because——

Mr. MANSON. Well, is it really a very material difference? Would it make a great deal of difference?

Mr. GRIMES. It makes a very appreciable difference, because you take out the full cost of the plants and developments from the present worth of profit in allocating present value of the total profit to the different capital assets, and that present worth of total profit includes value for depletion, value for depreciation, and the value of development, and other facilities necessary to exploit the ore body; taking out the full amount for those capital additions or

capital requirements from the present worth of future profits makes a very appreciable difference in the value. It is not exactly the difference between the value factors in use.

Mr. MANSON. Assuming the present value of $1 on a 10-year life to be 54.5 cents and the value of $1 on a 20-year life to be 37.4 cents plus, the value you would give to the mine for a 10-year life for the purpose of depletion, and the depletion unit per ton would be a great deal higher than it would be in the case of the mine having the 20-year life, would it not?

Mr. GRIMES. Might I ask what rate of interest is used in determining those factors?

Mr. MANSON. Well, does it make any difference?

Mr. GRIMES. Yes, sir.

Mr. MANSON. Assume a 10 per cent rate.

Mr. GRIMES. If these were operating mines, we would use a 10 per cent rate for the 10-year life property and an 8 per cent rate for the 20-year life property, because that expresses about the same degree of hazard in the mining industry. That hazard is determined from a discount for interest alone, assuming that 4 per cent covers interest on investment. If the same profit figure for the 10-year life property and the 20-year life property were reduced to present worth by a discount factor of 4 per cent interest to cover interest on the investment alone, we would take off about 35 per cent or 40 per cent of that value determined by the 4 per cent discount, to cover the hazard of mining, management, and other factors of the business.

Mr. MANSON. Now, let me get this again: Do you apply a greater discount factor to the 20-year life than you do to the 10-year life?

Mr. GRIMES No, sir.

The CHAIRMAN. It is the reverse.

Mr. MANSON. Yes.

Mr. GRIMES. The reverse.

Mr. MANSON. Then, the difference would be more than the difference in the present value of the dollar, because, in the case of the short-life property, you used a greater discount factor?

Mr. GRIMES. The difference would be less if we used a greater discount factor in the short-life property.

Mr. MANSON. Oh, yes; I beg your pardon. In such instances at what point would you abandon the 10 per cent and use a different percentage?

Mr. GRIMES. We try to select our interest rates. We have been using interest rates to discount to present worth, but that was not entirely satisfactory, and we have developed this other system of taking about the same relative hazards as apply to the industry, and that same hazard means a different interest rate for each different exhaustion period or life of the property. We try to select our interest rates to give about 35 per cent to 40 per cent discount for hazard and management in a going business, and we have quite elaborate tables, and are preparing graphic charts to enable us to make our valuations in that way, because we find that by the use of that method we obtain values which are closer to actual transactions in every case.

Mr. MANSON. Is it not a fact, Mr. Grimes, that in your work in the Income Tax Unit you have taken this analytical appraisal

method and have compared the results obtained according to that method with the results obtained by other means of ascertaining the value of the property, and that you have endeavored to arrive at factors which would give you an answer that would be comparable, fairly comparable, with the value determined by other means? Is not that true?

Mr. GRIMES. Yes; we are engaged in constantly gathering information from every possible source to compare the accuracy of our method with actual transactions, or evidences of value obtained from other sources. We are making improvements all the time, and I think those improvements will be constant. Every once in a while we will find some way by which we can improve our methods.

Mr. MANSON. Is it not true that you have found, from your experience in the use of this analytical appraisal method, that unless you do gather and consider a great deal of data other than the mere life of the property and the amount of the reserves, the expected profit and the interest rate based upon current interest rates, you do not arrive at a reliable result?

Mr. GRIMES. You could not arrive at a reliable result in any valuations unless you had as complete information as it is possible to get. The more complete your information and the more you have tested out your methods by comparison with other transactions, the more reliable your methods are going to be.

The CHAIRMAN. Have you any examples which you can give us showing the results obtained by your analytical method as compared with the valuation of capital stock on the market in the case of certain corporations?

Mr. GRIMES. Yes, sir.

The CHAIRMAN. What has been your experience in comparing those two methods?

Mr. GRIMES. I think our methods will give values which are on the average almost identical with stock quotations on the larger exchanges, such as the New York Stock Exchange and the Boston Stock Exchange. Curb quotations are more erratic, and the smaller exchanges, such as San Francisco, Butte, Colorado Springs, and Salt Lake City, and around the different mining districts of the country are very unreliable.

The CHAIRMAN. If in valuing a certain mine by the application of your analytical method and then you compared it with the total value of the outstanding capital stock and you found them approximately equal, would you assume that it was a fair valuation?

Mr. GRIMES. I think, on the whole, stock quotations are too high for values of a property, because they include other elements than the actual physical values of the properties.

The CHAIRMAN. In other words, they would include the back earnings of the company, the management and other elements?

Mr. GRIMES. Yes.

The CHAIRMAN. Which you would not give credit to in the analytical method?

Mr. GRIMES. Not for the physical assets. We are obtaining results which, I think, on the average will closely approximate the stock-market quotations on the larger exchanges. I think those values on the exchanges are probably about 25 per cent too high from other indications of value. That is one of the lines of evidence

that has led me to the conclusion that our values in the metals valuation section on the average are somewhat in excess of the commercial values. I think we average between zero and 25 per cent in excess of commercial valuations.

The CHAIRMAN. That all inures to the benefit of the taxpayer, does it not?

Mr. GRIMES. Yes, sir.

Mr. MANSON. What do you mean by "commercial values," Mr. Grimes?

Mr. GRIMES. Actual cash transactions.

Mr. MANSON. Stock sales?

Mr. GRIMES. Not unless it was a control of the stock or a very large block of stock, which would be bought to afford control of the property.

The CHAIRMAN. If a taxpayer appearing before the bureau should argue for a valuation based on the total value of the stock outstanding, computed at the market rate, would you consider that his position was sound?

Mr. GRIMES. We would check up that value by other methods. We would not accept that without a check by appraisal methods and by any other evidence of value that might be available.

The CHAIRMAN. The market value, of course, might depend upon many elements, such as, for instance, an overzealous desire on the part of an ambitious person to get control of the property.

Mr. GRIMES. Yes.

The CHAIRMAN. And to use any such basis might work an injury to the Government, might it not?

Mr. GRIMES. Yes; and stocks will vary as much as 100 or 200 per cent within a year or within two or three years. Now, we might be working an injustice to the taxpayer by taking the stock quotations at the date of valuation, at a time, we will say, when Liberty bonds were selling for 85. If we took the stock quotations during the war times as an indication of value, we would be giving greatly inflated values.

The CHAIRMAN. Can you give us briefly some other method that you used in preparing your analytical results with the total outstanding value of the capital stock?

Mr. GRIMES. In practically every mining industry there are a few cash sales of property. Those are the most reliable evidences of values that we have. There are probably more offers to purchase which are rejected, and that would give us a fair line on the property, if the offer to purchase the property was made by responsible persons and was refused by the owner of the property.

There are also, in a number of the larger mining companies, bond issues, mostly issued on the basis of engineers' reports. Whenever a mining company floats a bond issue, the underwriters of the bond issue have very competent engineers to examine the property. In the case of a bond issue by a large mining company, we usually have a very reliable engineer's report.

The CHAIRMAN. In that connection, in your work do you find the valuations arrived at by the engineers of the underwriters and of the mine owners at variance with each other?

Mr. GRIMES. The mine owners do not usually have a report made.

The CHAIRMAN. They do not have any report made when they apply to the underwriters for a bond issue?

Mr. GRIMES. We do not get those evidences in our files. I think the officials of the mining company make a statement to the underwriters and the underwriters determine from that statement whether they would care to handle the matter at all. If they think they would care to handle it, they have a report made by some engineer that they have absolute confidence in before they will go any further with the matter.

The CHAIRMAN. That is true also in the case of timberlands, where they employ cruisers to figure the amount of timber on a given property; is not that so?

Mr. GRIMES. I am not familiar with the timber industry, but I should imagine they would employ very similar methods.

The CHAIRMAN. You may proceed, Mr. Manson.

Mr. MANSON. What I am trying to arrive at is whether, in your use of the analytical appraisal method you have not resorted to all the sources of information that you could find for the purpose of adjusting the factors that you apply in the use of this method, so that you get a result that is comparable with evidences of value obtained by other methods.

Mr. GRIMES. We have tried to do that.

Mr. MANSON. Yes.

Mr. GRIMES. I would not say that we have exhausted every resource for such comparative information, but we have done the best we could.

Mr. MANSON. You have tried to do it?

Mr. GRIMES. Yes.

Mr. MANSON. In your discussion of your methods and the manner in which you apply them to the result you obtain you have special reference to the way this analytical appraisal method is applied by you in your own section of the income tax unit, engineering division?

Mr. GRIMES. Yes, sir; more especially with reference to the metal section than to others.

Mr. MANSON. Yes. You do not pretend to be able to discuss the use of this method by anyone outside of your own section, do you?

Mr. GRIMES. Not the application of the use, because I do not know specifically the details of the methods that are employed.

Mr. MANSON. Yes.

Mr. GRIMES. I know the general methods, but not the detail methods.

Mr. MANSON. Well, after all, the reliability of this method and the results obtained depend very largely upon the application of it, do they not?

Mr. GRIMES. I should think altogether; yes.

Mr. MANSON. So far as your knowledge of that is concerned it is confined entirely to the work of your own section; is not that true?

Mr. GRIMES. Yes.

The CHAIRMAN. I think you may proceed with the case now, Mr. Manson, that you want to develop this morning.

Mr. MANSON. I had one other matter. Is the engineer here who was on the stand yesterday; the engineer from the solicitor's office?

Mr. HARTSON. No; Mr. Eddingfield is not here.

Mr. MANSON. I think Mr. Hartson can answer the question that I want to ask.

Is it customary on a taxpayer's hearing in the solicitor's office to have the section from which the appeal is taken represented?

Mr. HARTSON. I can not say, Mr. Manson, that it is customary. It is frequently done. Ordinarily in every important case which involves a good deal of money the unit engineers are notified of the date of the hearing and are invited to be present. I can cite dozens and dozens of cases where that has been done, but I would not say it is customarily done, because the greater run of cases are these smaller cases, and to have the unit representatives present at those hearings would take their time and would also consume additional time of others, which would seem not to be warranted.

The CHAIRMAN. In other words, there is no rule applied to it?

Mr. HARTSON. There is no definite rule; no. It is left to the discretion of the assistant solicitor in charge of the review division as to whether they shall be called in or not.

I know this, furthermore, that on cases where there is dispute about it to the point where there may be some feeling developed the unit representatives are called in and are given an opportunity to question the taxpayer and his representatives in the solicitor's office and engage in such other participation in the hearing as is warranted and the facts justify. In this case I can say that it was not done.

Mr. MANSON. You refer to the Border Island case?

Mr. HARTSON. I refer to the Border Island case.

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

THURSDAY, JANUARY 22, 1925

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

The committee met at 10.30 o'clock a. m., pursuant to adjournment of yesterday.

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

Present also: L. C. Manson, Esq., of counsel for the committee: Mr. L. H. Parker, chief engineer for the committee; Mr. Raleigh C. Thomas, investigating engineer for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, Solicitor Bureau of Internal Revenue; Mr. James M. Williamson, office of Solicitor Bureau of Internal Revenue; Mr. S. M. Greenidge, head engineering division, Bureau of Internal Revenue; and Mr. F. T. Eddingfield, engineer, office of Solicitor Bureau of Internal Revenue.

The CHAIRMAN. Were you to continue this morning, Mr. Manson?

Mr. MANSON. Yes; I have several matters that I would like to take up this morning.

The CHAIRMAN. You may proceed.

Mr. MANSON. The Chairman will recall that on December 8, while the Standifer case was under consideration, Senator Jones suggested that the bureau should at once make an investigation to ascertain what contractual amortization had been allowed by the several governmental departments and whether or not it had been deducted from amortization allowances by the Income Tax Unit.

At that time I suggested that this work be done in cooperation with Mr. Thomas, of our engineering force, and that suggestion was concurred in by the chairman.

The CHAIRMAN. As I remember it, we also took the matter up with the Navy Department, the War Deartment, and with other departments having contractual relations with taxpayers, and they found it impracticable to go through the records and ascertain what the committee wanted to know.

Mr. MANSON. In the case of the War Department and the Navy Department, they advised us that they did not have the available forces for the purpose of searching their records to get this information. In the case of the Shipping Board, we are receiving information as fast as they can turn it out.

I wish now to call on Mr. Thomas to make a report as to the progress of this work.

STATEMENT OF MR. RALEIGH C. THOMAS, INVESTIGATING ENGINEER FOR THE COMMITTEE

Mr. MANSON. I believe Mr. Thomas has already been identified as one of the engineers employed by the committee.

Mr. THOMAS. This is a memorandum that I have written to Mr. Manson, dated January 22, 1925:

Memorandum to Mr. L. C. Manson, Counsel.
Subject: Compiling data by the Income Tax Unit's engineers on contractual amortization.

Shortly prior to December 11, 1924, the Senate Committee investigating the Bureau of Internal Revenue, directed that an examination be made of the several contractural departments and agencies of the Government with the view of determining, if possible, the amount of contractual amortization allowed by each to the various contractors holding war-time contracts with the Government.

In order to determine whether or not the Income Tax Unit in its allowances for contractual amortization to the several taxpayers making claim for same had made a duplication of allowances.

The writer was advised that this work was to be done by engineers of the Income Tax Unit under his supervision and proceeded to make plans for the organization of the engineering force.

On December 11 four men were assigned by the engineering unit of the Income Tax Bureau to handle this work. Immediately thereafter, two of these men left their desks to go on annual leave and for a while another one was, as I have been told, on sick leave.

It was not until January 2 (when the men had returned from their annual leave) that the force actually began work as a unit. This force was increased to five men, including Mr. Koenig, who was delegated to direct the work. Between December 11, 1924, and January 2, 1925, 20 cases were taken from the records of the War Department at random.

On January 5 the writer handed to Mr. Koenig a supplemental list of cases which included the following: Northwest Steel Co., Kerr-Turbine Co., Aluminum Co. of America, General Electric Co., Ford Motor Co., Albino Engine & Machine Works, Standard Steel Car Co., Crucible Steel Co. of America, Colorado Fuel & Iron Co., Atlas Powder Co., National Aniline Dye & Chemical Co. This list was submitted in the order in which the cases were required.

Work proceeded without any apparent results with the exception of the case of the Aluminum Co. of America, a report on which was submitted by Mr. Koenig on Friday, January 16. Mr. Koenig has been consulted from time to time as to the progress of the work. So many conflicting statements were made in this connection that the writer delegated Mr. Robbins, assistant engineer of the Senate Committee, to look into the matter in detail.

On or about January 9, Mr. Robbins visited the engineering force at the War Department and was told by Mr. Watkins, one of the engineers, that there were 12 cases completed. On Tuesday, January 20, Mr. Koenig informed the writer that with the exception of the Aluminum Co. of America no cases were completed, and on Wednesday Mr. Koenig submitted reports on nine cases, none of which, however, appeared on the list which was given to him to act as a guide in this work. From the above it will be seen that this work as it is now being handled by the unit is a waste of both time and money.

You will realize, I am sure, that it is impracticable for the writer to personally direct all of the details involved in getting the information required, and further, that from past experience it is worse than useless to expect the cooperation of the unit in this work. It is therefore recommended that this work be taken out of the hands of the unit and be continued by our own forces. And it is my opinion that by so doing we can accomplish a great deal more work with fewer men in a shorter period of time.

In closing, I might add that about three weeks ago I requested that a detailed expense account be kept by the unit, and after being referred from one official to another, was finally told this morning, at 9.40 o'clock, that it would be necessary for Mr. Parker, chief engineer, to address a letter to Mr. Greenidge, chief of the engineering division, making a formal request for

this information. This is only one of many illustrations of the manner in which the work of your engineers in the amortization section are being hindered in their efforts to obtain results.

Respectfully submitted, RALEIGH C. THOMAS.

The CHAIRMAN. Mr. Nash, have you anything to say about this matter?

Mr. NASH. This is the first criticism that has come to my attention, Senator. I spoke to Mr. Manson about the status of this work some time ago, and at that time he said he would have something to say about it later on, but that for the time being, we should let it rest. At least, that is the way I understood him, and I assumed that it was going along satisfactorily.

The CHAIRMAN. How long ago was that, if you remember?

Mr. NASH. I do not remember. Do you, Mr. Manson?

Mr. MANSON. I do not remember the conversation at all.

Mr. NASH. It was one day when we were taking up some matters that were hanging over. I had a memorandum here to take up some matters with the committee and I had a note that this seemed to be a very difficult task, or almost an impossible task. I spoke to Mr. Manson about it before the meeting.

The CHAIRMAN. I understood from a discussion with Mr. Manson yesterday that you had a card list of corporations that had received amortization allowances, and that you were checking back with the War Department and the Navy Department to ascertain if they, too, had contracts with these taxpayers, whether they had had any amortization matters in connection with them.

Mr. MANSON. Mr. Thomas can undoubtedly state that better than I can.

Mr. THOMAS. Yes; that is the case exactly, Senator.

Mr. MANSON. Will you describe just exactly what was done and the methods that have been used?

Mr. THOMAS. The Income Tax Unit had typewritten lists, running serially, from one on up, but not alphabetically at all, and it was rather confusing. So I had card indexes made, giving certain information, arranged alphabetically. Those cards were confined to amortization allowances—not claims, but allowances by these several other Government departments, of $50,000 or more.

The CHAIRMAN. What was the total number of cases, do you remember?

Mr. THOMAS. I do not recall that, sir, but I should say there were three or four thousand of them. There were certain cases which both Mr. Parker and I had in mind, which should receive attention before others. I picked those cases out and handed them to Mr. Koenig, who was in direct charge of the engineers, with the request that they work on this original list of 20, which we picked out at random, simply to get going, and that they should take precedence. As I say, with the exception of the Aluminum Co. of America, no reports have been handed in on any of them.

The CHAIRMAN. Can you account for that, Mr. Nash?

Mr. NASH. I certainly can not, Mr. Chairman.

The CHAIRMAN. Before we go further into any scheme of checking up on those, I would like to have a report from you as to what the committee may expect in connection with this matter, because time is slipping by and this work was started more than a month ago.

Senator ERNST. When was the information requested?

Mr. MANSON. December 8.

Senator ERNST. What kind of information was requested?

Mr. MANSON. The request was for a check-up on allowances made by the contracting departments of the Government, like the War Department, the Navy Department, and the Shipping Board, which had allowed amortization to contractors, to determine whether such allowances had been taken into consideration by the Income Tax Unit in allowing applications for the same.

Senator ERNST. What corporations were asked for, or did you ask it on every corporation?

Mr. MANSON. That was the request of the committee.

Senator ERNST. You know that that is an impossible request. Why are you finding fault with that?

The CHAIRMAN. I resent that statement and wish to say that it is not an impossible task.

Senator ERNST. I say it is an impossible task. How many did you say there were?

The CHAIRMAN. Three or four thousand.

Mr. THOMAS. Several thousand, sir.

Senator ERNST. Did you request detailed inforamtion on every one of those for that length of time?

Mr. THOMAS. No, sir; I did not ask for that. For those cases upon which amortization has been allowed in the amount of $50,000 or more. I suppose there are more than half of them in which amortization allowance was nothing, or——

Senator ERNST. Did you put your request in writing?

Mr. THOMAS. No, sir; I did not.

Senator ERNST. Who did you speak to?

Mr. THOMAS. Mr. Koenig, who has charge of the engineering force.

The CHAIRMAN. It is a matter of record here with the committee.

Mr. THOMAS. And with Mr. Keenan, who, in turn, was directly in charge of Mr. Koenig's work.

Senator ERNST. Just what information did you ask for?

Mr. THOMAS. I asked for the amount of amortization allowed for certain tax payers, or claimants, as we call them, because they had claimants in the War Department and the Navy Department, from $50,000 up, giving the several amounts and the names of the contractors, and if any depreciation had been paid, to make a note of that, too. That was the sum and substance of the request that I made, sir.

Senator ERNST. That request was made concerning 3,000, corporations, roughly, you say?

Mr. THOMAS. That is a very rough estimate. There were stacks and stacks of cards. I should say there were 3,000 to 3,500 cards; Yes, sir.

Senator ERNST. And you wanted that information on all of them?

Mr. THOMAS. No, sir; only on those covering $50,000 or over, which would be greatly in the minority.

Senator ERNST. Mr. Hartson, did that information come to you?

Mr. HARTSON. Senator, I would like, if I may, to question Mr. Thomas, and then answer your question.

I think you stated in the beginning, Mr. Thomas, that the agreement was that there be assigned certain engineers to work under your direction and secure this information?

Mr. THOMAS. That is the way I understood it, yes, sir.

Mr. HARTSON. And, as I understand it, there were some five or six engineers so assigned?

Mr. THOMAS. Four at first.

Mr. HARTSON. And two were on annual leave, so that they were not all present until after the first of the year?

Mr. THOMAS. Yes, sir.

Mr. HARTSON. After which time they were all present?

Mr. THOMAS. Yes, sir.

Mr. HARTSON. They worked under the direction of Mr. Koenig?

Mr. THOMAS. Yes, sir.

Mr. HARTSON. And Mr. Koenig was answerable directly to you, was he not?

Mr. THOMAS. Yes, sir.

Mr. HARTSON. Under the arrangement that the committee had with the representatives of the bureau you were to get this information yourself and use these individuals to secure it?

Mr. THOMAS. I do not quite understand the question?

Mr. HARTSON. I mean that they were to be your agents?

Mr. THOMAS. No, sir; not at all. As I understood it, they were the agents of the unit, but they were working under my direction.

Mr. HARTSON. Well, that is another way to express exactly the same meaning that I have in my own mind, namely, that those men were responsible to you?

Mr. THOMAS. No.

Mr. HARTSON. So far as the information was concerned, at least?

Mr. THOMAS. Mr. Koenig was; yes.

Mr. HARTSON. You kept in contact with the progress of the work, did you not?

Mr. THOMAS. Yes, sir.

Mr. HARTSON. And if they were working immediately under your direction, or answerable to and reporting to you, you certainly would have known before to-day that progress was not being made.

Mr. THOMAS. Why, certainly, before to-day.

Mr. HARTSON. When did you first learn that satisfactory progress was not being made in securing this information?

Mr. THOMAS. I should say about January 9.

Mr. HARTSON. Did you go to Mr. Greenidge and complain at that time, on January 9?

Mr. THOMAS. I went to see Mr. Greenidge three times. Mr. Greenidge was not in his office, and I went to see Mr. Keenan, who told me that he was looking after that work.

Mr. HARTSON. You did not see Mr. Greenidge personally at any time?

Mr. THOMAS. No; but I saw his representative, Mr. Keenan.

Mr. HARTSON. You complained to Mr. Keenan that the information was not coming to you in a proper sort of way, did you?

Mr. THOMAS. I certainly did.

Mr. HARTSON. And as a result of your complaint to Mr. Keenan, was any appreciable progress made?

Mr. THOMAS. None whatever.

Mr. HARTSON. None whatever. Did you attempt to speak to Mr. Nash about it?

Mr. THOMAS. I did not know that Mr. Nash had anything to do with it.

Mr. HARTSON. Now, Mr. Chairman, I want to bring out this situation: Mr. Nash and I are in charge of the conduct of the bureau's appearance before this committee, and we feel personally responsible for all of the information the committee desires, and we have again and again assured the committee that we would do anything within human possibility to secure information. Mr. Nash and I, until this very moment, did not know that there was anything to be complained about in the furnishing of this specific information. That is so as far as I am concerned, and I know Mr. Nash feels the same way about it.

If this information has not been produced, one of two things must be the reason. There is either inefficiency in attempting to secure it, or it is an impossible task.

I personally would like to be shown the courtesy of having complaints directed to me before they are brought up here before the committee. I think that would be fair.

There has been no effort on our part whatever, at any time, to attempt to hold back and cover up, or to be slow in producing. That is not my thought, and it is not Mr. Nash's thought. But we have a big organization; we have to work through our representatives, and if these other people, for one reason or another, are unable to produce results, we would like to know about it.

The CHAIRMAN. I would like to ask Mr. Manson at this point why he did not take it up with Mr. Nash. That statement has been repeated here a number of times, and I know that the committee is in full accord with what Mr. Hartson says, in that they have offered whole-hearted cooperation. I wonder why you have not taken it up with them, when you, yourself, have complained to me a number of times.

Mr. MANSON. The reason I have brought it up before the committee is the conflicting statements that have been made.

The CHAIRMAN. Why did you not go direct to Mr. Nash, as Mr. Nash has requested a number of times?

Mr. MANSON. Well, I deemed it advisable to bring it to the attention of the committee. That is all I can say about it.

Senator ERNST. You did what?

Mr. MANSON. I deemed it advisable to bring it to the attention of the committee. This work was presumed to be done. These men were presumed to have reported to Mr. Thomas as to their progress, and to be compelled to travel around on each one of these steps through Mr. Nash makes a circuitous route in the securing of information that ought to be forthcoming directly.

Senator ERNST. Mr. Manson, I differ with you. The most direct route for you at any time is to speak right to him, and then, if you do not get it, you have gone to the responsible source. He has time and again said that he wants to know about these matters. Why do you not go to him if there is any complaint, and then, if he does not furnish it, appeal to the committee?

Mr. MANSON. I wish to say in that connection that what we are complaining about here is not that we have not received all of this information, but what we are complaining about is that no progress has been made toward getting it. That is really the gist of this complaint.

The CHAIRMAN. I think, now that we have brought it to the attention of Mr. Nash and Mr. Hartson, we might defer any further discussion of it, and let Mr. Nash tell us at the next meeting just exactly what he is going to do to get it. I have hesitated to make any complaint, though I have been in contact with the workers for the committee off and on. I have tried to be patient and not annoy the chiefs any more than it seemed necessary to annoy them with these complaints, hoping all the time that the thing would work out between the two staffs. I now do not see any reason why they could not have gotten out the reports on at least those 20 cases that Mr. Thomas asked for. I am not finding any fault with the managers of the bureau in this investigation at all; but now that it has been brought to our attention, I would like to know at the earliest possible date just what we may expect in connection with the getting of this information.

Mr. NASH. I will be glad to check up on that this afternoon, Mr. Chairman, and will endeavor to have a report for you to-morrow. As I stated before, this is the first time that this matter has come to my attention. I have assumed all along that the engineers that are assigned to Mr. Thomas were properly performing the duties assigned to them and that they were carrying out his orders.

The CHAIRMAN. What do you want to proceed with now, Mr. Manson?

Mr. MANSON. I would like to examine Mr. Briggs.

STATEMENT OF MR. JOHN H. BRIGGS, CHIEF NONMETALS SECTION, BUREAU OF INTERNAL REVENUE

Mr. MANSON. Mr. Briggs, you are the chief of the nonmetals section of the engineering staff of the bureau, are you not?

Mr. BRIGGS. Yes, sir.

Mr. MANSON. Your section has jurisdiction over valuations places on gravel pits and stone quarries?

Mr. BRIGGS. Yes, sir.

Mr. MANSON. And on all other nonmetal deposits?

Mr. BRIGGS. Yes, sir.

Mr. MANSON. Do you have occasion to use what is known as the analytical method of appraisal in arriving at the value of gravel pits, stone quarries, sand pits, clay deposits, and properties of that character?

Mr. BRIGGS. We have used it in arriving at the March 1 values quite frequently.

The CHAIRMAN. March 1, 1913?

Mr. BRIGGS. Yes, sir.

Mr. MANSON. In cases where you are called upon to determine the depletion which is to be allowed to lessors of such property, what discount factors do you use in making your valuations?

Mr. BRIGGS. We have generally used 8 and 4. That was used up to several months ago. Several months ago we thought it best to use 10 and 4.

Mr. MANSON. Have you made any comparison of the results that you got by applying the 10 and 4 per cent rates with actual cash transactions?

Mr. BRIGGS. Yes, sir.

The CHAIRMAN. So as to have it in the record, just explain the difference between the 10 and 4. I understand what the 10 is for, but I am not quite sure that I understand what the 4 is for.

Mr. MANSON. As I understand it, the 10 is the profit factor.

Mr. BRIGGS. The 10 is the profit factor, and the 4 is the factor used in returning capital on the investment.

The CHAIRMAN. In other words, before you started to use the 10 per cent basis you charged up 4 per cent for the interest on the investment?

Mr. BRIGGS. It is a formula which is known as Hoskold's formula, which is a combination of the profit rate and the return of capital rate.

Mr. MANSON. This is not a return on capital, but is a return of capital actually invested in the property.

Mr. BRIGGS. Yes, sir.

The CHAIRMAN. On the basis of 4 per cent per year?

Mr. BRIGGS. Yes.

Mr. MANSON. Four per cent compounded. It is the sinking-fund basis.

The CHAIRMAN. That is always counted in when a property may be completely depleted in a set period of time; is that it?

Mr. BRIGGS. Yes.

Mr. MANSON. What has been the result of these comparisons that you have made where you used the 10 and 4 per cent?

Mr. BRIGGS. My recollection is that Mr. Greenidge wrote a memorandum to me several months ago in which he asked me what factors I was using. As I recall it, we had used 8 and 4, but more recently we used 10 and 4, and even then I found the result was a higher value than what actual cash transactions would have demonstrated.

The CHAIRMAN. In spite of that fact, as I understand you, you reduced it to 6 in some cases?

Mr. BRIGGS. No, sir; we have never used anything under 8, except, as I recollect, in two cases, which were valued before I came into this work, some time over three years ago. Both of those cases were cases which presented greater risk. In one of them they used 7 and 4, and in the other they used 6 and 4.

The CHAIRMAN. In the case of the Border Island Co., which we have just had up for consideration, you used 6?

Mr. BRIGGS. That was the rate used in reversing our section. It was not used in our section at all. It was used after the case had gone from us.

The CHAIRMAN. Do you ever use 6 in your section?

Mr. BRIGGS. We never use anything under 8, not to my knowledge.

Mr. HARTSON. I thought you just said that you did in one or two cases.

Mr. BRIGGS. I said that was before I came into the work, three years ago. There were two cases that I had in mind, and both of them were very risky cases, in which 7 and 4 was used for one and 6 and 4 for the other. One of these was the Texas Sulphur Co. case, in which they used 7 and 4, and the other was the Myles Salt Co. case, in which they used 6 and 4. Both of them were considered most risky, and instead of lowering those rates they should have used 15 or even 20 or more.

The CHAIRMAN. That is the way I understood it. In other words, the more assured the return is, the lower the discount factor.

Mr. BRIGGS. Certainly.

The CHAIRMAN. And the more risky it is, the higher the discount factor?

Mr. BRIGGS. If it is a risky business, I would not want to put my money into it unless I could figure on getting a big profit—that is, if there is a risk—where something might happen that might destroy my business.

Mr. MANSON. If a discount factor of less than 8 per cent has been applied to any valuations arising out of your section since you have been in there, it has been because the case was appealed to some other authority and you were reversed?

Mr. BRIGGS. Well, that is the only case I know of where I was reversed.

Mr. MANSON. What is the case where the 6 and 4 were mentioned?

Mr. BRIGGS. That was the Border Island case.

Mr. MANSON. Is that Border Island case the only case you know of where a discount factor as low as 6 per cent has been applied to a nonmetals valuation?

Mr. BRIGGS. Yes, sir; as far as I can recall. In a similar case to that I think our work was upset. It came down about the same time, and they used 8 and 4. In the Border Island case they used the royalty rate for a term of years. In the Geauiga Silica Co., in determining the value, they used a royalty rate of 10 and 40 years and 8 and 4. Now, I can not see why there should be any difference, as long as they are determined on the basis of the royalty rates, so that they should change the factor from 6 and 4 in one case to 8 and 4 in the other.

The CHAIRMAN. Let me inquire at this point what is the name of the engineer in the solicitor's office? I do not recall his name.

Mr. HARTSON. Mr. Eddingfield.

The CHAIRMAN. Yes. I would like to ask him if he knows of any cases that were settled on a 6 per cent basis?

Mr. EDDINGFIELD. In nonmetals?

The CHAIRMAN. Yes.

Mr. EDDINGFIELD. I do not.

The CHAIRMAN. You testified before the committee as an engineer in the solicitor's office the other day; is that correct?

Mr. EDDINGFIELD. Yes, sir.

The CHAIRMAN. Can you tell us why this particular case was settled on 6 and you do not remember any other case being settled at 6?

Mr. EDDINGFIELD. I am not very familiar with the cases that have been settled or determined in the nonmetals section, not being in that section myself.

The CHAIRMAN. Yes; but——

Mr. EDDINGFIELD. I am only familiar with the cases that have come up to me in the solicitor's office. In those two particular cases, the two cases that were recited by Mr. Briggs, the Geauiga Silica Co. and this case, the circumstances were entirely different. In the Border Island case there was a specified minimum royalty and a guaranteed cash payment of $24,000 a year.

The CHAIRMAN. Whether they took out any gravel or not?

Mr. EDDINGFIELD. Whether they took out any gravel or not. The final-risk rate which we use depends largely upon the elements of risk that have been taken care of in the other factors which were used.

The CHAIRMAN. Then, as a matter of fact, in your capacity as engineer in the solicitor's office you do not remember any other case being settled on the 6 per cent basis?

Mr. EDDINGFIELD. Nonmetals case?

The CHAIRMAN. That is what we are talking about, nonmetals cases. Your answer is no?

Mr. EDDINGFIELD. Yes, sir.

The CHAIRMAN. All right, Mr. Manson.

Mr. MANSON. Mr. Briggs, were you called up in the solicitor's office, or was there any representative of your office called into the solicitor's office, in this or any other case in which an appeal was taken from your office?

Mr. BRIGGS. Oh, yes; I have been up on one case in particular, and I have been called up to be asked questions on one or two other cases. One case I was there a half a day and in another case I put in the whole day.

Mr. MANSON. Is it customary to call you in, or to call in the engineer who made the original determination?

Mr. BRIGGS. I think perhaps I can explain that. The first time I was called in there was following a case where we made a protest to the board of appeals and review. They said that the next time they had a case coming up they would call up the engineer, and shortly after that I was called up on some cases, known as the Texas cases. Since then I have been called in and asked my opinion, I should say, about three times. I was told, as a matter of fact, when I said something about I would like to go before the board of appeals and review the commissioner preferred that the engineer should not go there; that he wanted the board of appeals and review to handle those cases without being prejudiced by the engineers in the divisions.

Mr. HARTSON. Now, if I may interrupt there——

Mr. MANSON. Who told you that?

Mr. BRIGGS. Mr. Griggs told me.

Mr. MANSON. Mr. Griggs?

Mr. BRIGGS. Mr. C. C. Griggs.

Mr. MANSON. Who is Mr. Griggs?

Mr. BRIGGS. Mr. Griggs is the assistant head of the division and was formerly my chief.

Mr. MANSON. He is the assistant to Mr. Greenidge?

Mr. BRIGGS. Yes, sir. I do not recall just when it was, but it was some time ago that Mr. Griggs made that remark. He said he

preferred them not to come up, that they did not want the board prejudiced or influenced.

Mr. MANSON. That is your general rule?

Mr. BRIGGS. I have been called up since that time. I should say two or three times I have been called up to be asked my opinion.

Mr. MANSON. Your understanding is that you are not supposed to go to the appellant authority on consideration of appeals from your section unless you are specifically called in?

Mr. BRIGGS. Unless I am specifically called in; yes, sir.

Mr. HARTSON. Mr. Manson, on questions of policy which affect the work in the solicitor's office I am better qualified to testify than is Mr. Briggs.

Senator KING. I suppose that is true, but we have a right to ask Mr. Briggs in connection with these matters.

Mr. HARTSON. That may be true, but Mr. Manson has already asked me about the policy that was followed in our office in regard to calling engineers from the unit.

The CHAIRMAN. Yes; I understand, Mr. Hartson, and I was just about to bring that out, but I think it is perfectly competent testimony to find out to what extent that policy is carried out.

Mr. HARTSON. Yes. I think my statement of the policy has been borne out by what Mr. Briggs has said, that in important cases, where we want the advice of the engineers in the unit, it is sought.

The CHAIRMAN. I believe Mr. Manson's question is perfectly proper, in view of the fact that there is some question in the minds of some of the members of the committee as to the extent to which some of these policies are carried out. It is perfectly competent testimony to find out how far the policy which you enumerated yesterday has been carried out.

Mr. HARTSON. Yes.

Mr. BRIGGS. I can state, with regard to the remark Mr. Griggs made to me, that it was a case where I said I wished they would call me, that I would like to go up. He said the commissioner did not want the men to go up there; that they would be apt to prejudice and influence the members of the committee in handling the case; that they had better handle it unbiasedly; which, perhaps, was perfectly sound.

The CHAIRMAN. I would question the soundness of that, whether you think so or not; you are on the job, and being on the job you might better be able to handle it from a practical standpoint than somebody else can handle it theoretically.

Mr. MANSON. That is all.

Mr. HARTSON. I should be very glad, as head of the solicitor's office, to inform Mr. Briggs that if any case ever comes to his attention which involves facts and which involves a presentation of views and arguments that, in his judgment, as chief of the nonmetals section, should be brought to the attention of the solicitor's office, Mr. Briggs will be welcomed with such information. We will be glad to have it.

Mr. BRIGGS. I have no doubt about that, Mr. Hartson.

Mr. HARTSON. And that goes for anybody else in the unit. The only difficulty, of course, is a practical one. We are so far removed from them that there can not be that contact that would be helpful in an organization such as ours. We are a half a mile away, and

unless a man takes the afternoon off and comes up there and visits the representative of the solicitor's office, there is really not that opportunity of interchange of views or ideas in regard to these cases that there might be.

The CHAIRMAN. Yes; but as I recall it, these cases that are referred to here are usually set for hearing at a date and hour, are they not?

Mr. HARTSON. Oh, yes; they are given a definite date for hearing.

The CHAIRMAN. So that there would be no great difficulty in getting these engineers who have been on the job up there by letting them know in advance when the particular cases were coming up.

Mr. HARTSON. There would be no difficulty about it, but it would take some time from their work to go back and forth. There is this feature to be considered: The commissioner, under the regulations, has designated that the taxpayer be given a hearing in an independent tribunal from the Income Tax Unit. Under the 1921 act there was a provision that an appeal might be taken to the commissioner and the commissioner designated under that act the committee on appeals and review, which was an independent organization, responsible only to the commissioner, and acting free from what might have been done in the Income Tax Unit.

The CHAIRMAN. Yes; but they would no doubt want evidence from a competent authority.

Mr. HARTSON. Of course the evidence is included, or presumably so, in the files. That includes everything the unit had before it, the reasons and the grounds for the conclusion reached by the Income Tax Unit. That is fully set forth in the files, so that the written documents will contain a full statement of the reasons for the original determination by the unit.

The CHAIRMAN. But, according to the testimony we have heard so far, the taxpayer is represented before this unbiased tribunal, and is permited to argue his case.

Mr. MANSON. And present new evidence.

The CHAIRMAN. Yes; he is permitted to bring in new testimony orally. He can discuss it and bring in extraneous matters. There is no check on what he may put in; but on the Government's side the records only are put in.

Mr. HARTSON. Well, the representative of the commissioner is the Government's representative.

The CHAIRMAN. Yes; but he is the unbiased man. He is the judicial man and not the proponent of any particular decision.

Mr. HARTSON. Of course, he is acting in a dual capacity there. His function is quasi-judicial. That is true, and he is the only representative the Government has there. He has before him all of the facts which have been developed by the revenue agent, if there has been an investigation in the field, together with the engineering reports, if any, which have been made in the case. At these hearings there are no witnesses sworn; there is no testimony taken as such; they are not authorized to administer oaths, and they do not sit as a court. The result of it is that we have to get this information in written form, so to speak.

Senator KING. However, Mr. Hartson, the taxpayer may be there with his attorney, and he or the attorney, or a person who accom-

panies him, who may know some particular fact, or be familiar with the law, is permitted to give explanations. It would seem to me that, in a circumstance of that kind, it would be wise to have the engineer there, because he might be able to clear up a good many perplexities in connection with the case.

Mr. MANSON. I would call attention to the fact that in the Border Island case the testimony of the engineer from the solicitor's office was that the first evidence of accretions was presented at this hearing in the solicitor's office. It will be recalled that there was nothing in the record on that subject.

The CHAIRMAN. I have been very attentive at all of these meetings, and have been extremely interested in the whole subject. One of the criticisms, to my mind, is the method of settling these cases. That is one of the things the committee has been finding fault with and criticizing, that in all cases that have come to us, the taxpayer seems to have gotten every possible advantage, and has gotten the benefit of the policies of the bureau. I have no fault to find with their getting a fair opportunity in these cases to make a full showing. In the Border Island case, which Mr. Manson has referred to, the testimony was that the evidence as to the accretions of sand was introduced by the taxpayer, that that was an entirely new element, and that it influenced your own engineers, and yet the engineers on the Government's side, who had dealt with this case, had no opportunity to either contradict this evidence or to use any other outside element for the benefit of the solicitor's office, who was determining this matter. That situation seems to run through all the testimony. It was particularly developed in that case, and I am glad to see that the bureau has changed, but it still seems to stick out all over. I think the representatives of the bureau will say that we have not been unduly critical in that respect.

Mr. HARTSON. Mr. Chairman, the comment that you are now making would indicate that there would be an opportunity for the taxpayer to be, in a sense, better represented than the Government in many of these cases. It is true that the representatives of the bureau sit in a quasi-judicial capacity there. They are judge on the one hand and advocate on the other. If they are not advocates, the Government has no advocate at the decision of whatever the issue may be.

The collection of the tax, of course, is really an administrative job. It has judicial functions inseparably wrapped up in it. It would be highly desirable if the cases could be litigated. Let the Government be represented, and let the taxpayer be represented before an independent tribunal. That is the ideal and theoretical way in which these questions in dispute should be settled; but there are too many thousands of them, Mr. Chairman, to really settle them in that way, as a practical matter. Every citizen of the country is a possible litigant before any such tribunal as you may create. Our courts are totally unable to handle it because there is other important litigation before them. Congress has created the board of tax appeals, which is a specialized tribunal, and yet such a court, Mr. Chairman, is a court created for what purpose? For the relief of the taxpayer. And I must say that the irony of the situation sometimes strikes me with compelling force when I listen to the remarks of the chairman and members of this Senate committee

as to the liberal action of the bureau in favor of taxpayers, and yet Congress in the last act created a tribunal which was designed to protect the taxpayer against harsh action, seemingly believing that the representatives of the bureau, sitting in this quasi-judicial way, were arbitrarily acting against the taxpayer, and that the taxpayer did not have an impartial hearing and did not have an unprejudiced consideration of his case, and so they permitted him to have it by going to this independent tribunal.

The CHAIRMAN. But in that case, Mr. Hartson, you must recognize that the Members of Congress receive individual complaints from citizens from all sections of the country, and they are impressed by these individual complaints, and they properly attempt to enact laws to relieve what they believe is an oppression, perhaps, on the part of the bureau. The Members of Congress can not analyze the merits of these complaints; so they deal with the matter more or less superficially, and they have assumed, of course, that this board is necessary to get a judicial decision and one that is fair at all times, believing that the administrative end of this, in their anxiety to protect the Government, will not, perhaps, be judicial.

That is an entirely different thing from what we are developing here, where we are dealing with specific cases, and where we find, at least in our belief, that the Government has not been properly protected.

In other words, Congress at all times has been taking the position of protector of the citizen, without regard to whether the citizen is being unfairly dealt with or not; but in these proceedings we are dealing with specific cases, and we believe the testimony shows that the Government itself has not been protected. In the one case Congress is protecting the citizen. We are here developing the fact that the Government has not been properly protected, and that was one of the inspirations back of this whole investigation—that the Government was not getting its share; in other words, it was too easy, not only on account of the volume of the business you had but because of the insufficient salaries paid, to get competent men, the Government itself was not being properly protected, and we thought it was time that somebody took the Government's side.

Senator KING. May I say, Mr. Hartson, that the resolution which I offered over a year ago in the Senate—perhaps nearer two years ago—was prompted by boasts which big taxpayers and others have made to me of the ease with which they had secured great reductions in their taxes. They would go away from Washington, they and their attorneys, very much buoyed up in their feelings because they had saved so much. In many instances they would feel that the Government had been imposed upon. I made some inquiries and I found in many instances young men, perhaps not very skillful and perhaps not of very great experience, have been delegated the duty of passing upon these very complicated questions. Doubtless they acted with integrity and according to the best light they had. In some few instances, I am afraid, they were influenced by improper methods and considerations, and I felt that perhaps the Government was not receiving a fair deal. That was emphasized when so many attempts were made to get refunds of millions and tens of millions.

Congress was asked to appropriate that money to return it to the taxpayers, and, as I say, that is the chief reason which prompted the introduction of the resolution, because I felt that we ought to set up some different system of passing upon these matters. This is a summary matter, and yet, as you have very pertinently said, you can not delegate this to the Federal courts because many of the judges are not competent to pass on these intricate questions. When I was judge I would not have felt competent to do so. It needs some peculiar training and a peculiar knowledge to go through these reports and interpret these laws, and I believe we would find that a great many Federal judges would not be competent to do that. So you have to have a specially trained court to pass upon these very complex questions.

I am speaking for myself, but I am sure that the other Senators share that view, that we not only want to see a course adopted down there, an administrative course, which will be fair to the taxpayer; but we are also here to protect the Government, and we feel that the Government ought to be well protected.

Mr. HARTSON. I want to say to the chairman here—and I think the chairman probably knows that this is the fact—that some cases that have been and will be brought before this committee are cases in which I have disagreed with the result. I have not been satisfied with the result in each instance, and had the commissioner known about them personally he might not have settled on the basis used. I have no doubt that this committee might sit for another year and hear cases, one after another, in which the committee will disagree with the result that was reached, and I might disagree with the result that was reached; but with the thousands and thousands of cases going through the bureau, the average—and you have to deal with an average in doing a job of that size—has been reasonably correct. You will find many cases where the bureau has been just as wrong against the taxpayer as for him, and no doubt complaints have been made to the chairman and to the other members of this committee, where the bureau has adopted the policy that the taxpayer thought was arbitrary, and upon going into it you might reach the conclusion that the bureau was wrong in settling it against the taxpayer. You are going to find disagreements, and they are going to work both ways.

The CHAIRMAN. That is the point I tried to make a while ago, that these people who disagree with the conclusions of the bureau are the ones who are urging Congress to afford relief at all times.

Mr. HARTSON. Yes.

The CHAIRMAN. And that was the reason why Congress set up this impartial tribunal to settle these cases.

Now, when the taxpayer is pleased with the decision of the bureau, no one complains to Congress. In other words, the bureau could go on indefinitely with the most liberal policy of exempting taxpayers from the payment of taxes, and Congress would know nothing about it.

Mr. HARTSON. That might be true.

The CHAIRMAN. As long as you give the public money away, by remissions or refunds, in harmony with a taxpayer's view, Members of Congress will never hear about it. It all goes back to the

proposition that the Government has no representation if the bureau's policy is exceptionally liberal, or even unfair, in the interest of the taxpayer; so it must be apparent to the solicitor that somebody has to take the Government's side in a controversy that exists between the taxpayers and the bureau. That controversy is a continuing one, and it was suggested to Congress that they set up this impartial tribunal.

I want to say at this point that I find no fault with the commissioner for setting up this system of hearing these cases, when it was provided in the act that an appeal be made to the commissioner, because I know he had to delegate it. I know he had to set up machinery to do it.

The one outstanding fault that I find—and it has been apparent throughout all of this investigation—is that no one has vigorously prosecuted the Government's side when the taxpayer has appealed. When there is an appeal to the commissioner, or through the commissioner to the organization which he has set up, no one takes the side of the section or the engineer who decided unfavorably to the taxpayer. All that is considered on behalf of the Government is the written record.

On the other hand, the attorney for the taxpayer, with his big voice, his brilliancy, and his training, appears before this impartial bureau set up by the commissioner. He makes all kinds of statements and uses all kinds of oratory and personal magnetism to get this impartial bureau to decide in favor of his client; but the bureau which decided against him has no representative there. There is no one there to upset this magnetism and power of argument which is used by the taxpayer's attorney. That has resulted in a criticism and a justifiable one, because he raises questions which the bureau has to find in the record, and the committee is impressed with the arguments of the taxpayer, while, if there were sitting on the other side of the table the auditors and engineers who had decided against the taxpayer to show that their conclusion was correct, much of the argument of the taxpayer's attorney might be dissipated.

I think that is the real fault that has developed in this situation in the handling of these tax matters, and it is one which it seems to me the bureau itself, through the commissioner and his deputies, has not recognized early enough. That is one of the practices which are being most criticised to our engineers by engineers in the bureau themselves, engineers like Mr. Briggs, who is as sincere in his desire and earnest for justice to the Government as anyone is in his desire for justice to the taxpayer. He is just as anxious to have the Government win as is the attorney for the taxpayer to have his client win, and such men should have the same opportunity in protecting the Government as the attorneys for the taxpayers have in protecting their clients.

Mr. Hartson. Such a system, Mr. Chairman, would be ideal. There is an inherent objection to it, however, under the old law which required the appeal to be taken to the commissioner. It would be impossible for him to set up a court which was independent, for if he delegated, for instance, to one of his agents the judicial function, and then delegated to another of his subordinates the function of arguing the case to that independent individual, you would have a

situation in which the commissioner was divided against himself. You would have there an advocate speaking in his name, and you would have a judge deciding in his name, the taxpayer, of course, being represented by counsel.

The CHAIRMAN. I think that is a theoretical objection.

Mr. HARTSON. But, does it not strike the Senator as being a practical one; that is, with people who are all acting in the commissioner's name——

The CHAIRMAN. That shows the smartness of the attorneys. The solicitor is an able advocate, and able to present his case in a very forcible manner, and yet an examination of the language that he himself has used just now would be impressive to a person who had probably not given as much attention to this particular investigation as I have; but, as a matter of fact, when the law contemplated an appeal to the commissioner, it was assumed that the commissioner was going to be an impartial judge of the decision reached by his own staff on the one hand and the objection by the taxpayer on the other; so, when he reaches that decision, he is lifted out of the position of an administrator and is acting as a judge.

All through this testimony it has developed that the magnitude of the work is so great that the commissioner himself can not deal with all of the things and can not know about all of these matters. On your theory, then, the commissioner may sit by his delegated representatives and just hear the fault finding of the taxpayer, just hear the taxpayer's criticism, admitting all the time that he knows nothing personally about it himself, and that the man who decided against the taxpayer, or the section which decided against the taxpayer, must have no representation at all, because, theoretically, as the solicitor says, it is the commissioner divided against himself. Now, theoretically, I say the solicitor is right, but in practice the solicitor is wrong, in my judgment.

Mr. HARTSON. I think, Mr. Chairman, that the creation of a board of tax appeals is an answer to the Senator's objection. The task of sitting in this dual capacity, charged with responsibility both of protecting the Government's interests and also acting impartially on the taxpayer's case, was considered by Congress to be an impossible one, and they created this court outside, which had been a court before, in practice, but not in theory, so they created it outside of the bureau.

The CHAIRMAN. But at this point I want to put this thought in the record, that wherever the taxpayer is able to bring influence, proper or improper, upon the Government officials there is no appeal. I believe that an engineer in the Bureau of Internal Revenue, an auditor, or a section chief, ought to have the right to appeal to the same board against the decision of his superiors, so that the Government would have the right of appeal as well as the taxpayer. If all of the decisions by the engineers and auditors are in favor of the taxpayer, the Government gets no opportunity to settle a dispute between those who are its own agents. These men are representing the bureau. Six of them may agree that this is the way that it ought to be settled, and six others may agree that this is the way it ought to be settled. And then some one in another office decides between the two, and he may decide for an improper consideration in the taxpayer's interest, and yet the Government has no appeal; but if he

decides in favor of the Government, immediately the taxpayer appeals.

Does not that occur to the solicitor as an unfair system in favor of the taxpayer?

Mr. HARTSON. I know just what is in the Senator's mind, and it is a thing that has been discussed and considered in the bureau.

There have been cases, no doubt, where the appeal or the constant demand that an independent consideration be given the case has resulted finally in the taxpayer finding some representative of the commissioner who agrees with him, and in good faith, and it goes out and is settled in his favor, and there is no appeal.

The inherent difficulty is this, that the commissioner has to act through subordinates. The law designates the commissioner as being the individual who makes the decisions. They are made in his name by somebody else, and he can not be heard to appeal from his own decision. If some independent organization made a decision, the commissioner could take an appeal from it, but when somebody decides a thing, makes a decision for the commissioner, and in his name, it is, under the present law, improper to give the commissioner an appeal from that decision of his own subordinate, because, presumably, he is entirely satisfied with the decisions that his subordinates reach.

The CHAIRMAN. Let me say at this point that I find no fault with the power being placed with the commissioner, but I think the bureau chiefs, the deputy commissioners, and all ought to lend more encouragement in connection with these highly controversial and technical questions to engineers and auditors who file complaints against the decisions of their chiefs. Instead of criticising these engineers and auditors for raising these objections, they ought to be encouraged. Then, if the commissioner wants to set up an agency, or to do it himself, to hear the differences between his own staff, that would be satisfactory to me, without setting up any extra tribunal.

In other words, if I were president of a company and my own staff got into a controversy; if an assistant superintendent were quarreling with his superintendent, I would feel that the assistant superintendent was not a good man if he did not appeal to the president of the company against the decision of his own chief. I do not say that for the purpose of encouraging insubordination, but when there is a legitimate difference of opinion on highly controversial questions I think consideration should be given to these engineers and these auditors in presenting their case. They ought to be encouraged and not discouraged in appealing those matters on which they disagree with their chiefs.

Mr. HARTSON. It is not discouraged, Mr. Chairman.

Mr. MANSON. I would like to remark right here that Mr. Hartson has very truthfully and justly stated that neither he nor the commissioner knew of these cases which have been called to the attention of this committee until they were brought out before the committee, but if some system, such as the Senator suggests, were adopted they would be bound to know of all of these cases before they passed to a final settlement.

The CHAIRMAN. I recognize the difficulties of the situation, and, as a Member of Congress, I would not be satisfied, in dealing with

a controversial question between Mr. Briggs and some other members of the bureau, to simply go to Mr. Grennidge, who is not an official of the Government, and let Mr. Greenidge, of his own sweet will, decide it in any way he pleases.

During the course of this investigation I have heard many stories and have received many written complaints, as well as some affidavits, which I have not even presented to the committee, but which we, among ourselves, have given consideration to. As I say, we have not presented them to the committee, because we did not desire to encumber the record with hearsay and personal criticisms, personal jealousies, and personal likes and dislikes; and yet, in some of the cases, there appears to be a real, sincere, earnest difference of opinion, and in some cases, I am informed through reliable sources engineers and auditors have had the temerity to go over the heads of their chiefs, to the commissioner, and the commissioner has sustained them. This, in some cases, has resulted in the chief being displeased, dissatisfied, and aggrieved at his subordinate, and the chief has attempted to use his animus against the subordinate for appealing to the commissioner. My admiration is unbounded for the man who dares to appeal to the head of the bureau over his immediate chief, when he thinks his immediate chief is wrong.

In other words, this Government is so big and the amounts involved here are so large that certainly every member of the bureau ought to feel that he is working for the Government and not working for Mr. Greenidge or for Mr. Blair. At the same time, I recognize that respect is due them, and we can not encourage insubordination, and yet their loyalty must be, first, last and all the time, to the Government. As I say, I have known of cases where the employee has had the temerity to do that, and has had his own chief reversed.

I have even heard of cases where the solicitor's opinions have been withdrawn because of protest at the decision of the solicitor. I do not mean to say that that was the solicitor who is present at this hearing, but probably some of his assistants.

Mr. Hartson. The instance that the Senator no doubt has in mind is a case where this solicitor was reversed.

The Chairman. I have heard a good deal about Decision 154. Is that it?

Mr. Hartson. Yes; that is the one.

The Chairman. I think the solicitor is a big man, and I think he encourages that sort of thing.

Mr. Hartson. I am not afraid of it, Senator.

The Chairman. Certainly not. I judged you were big enough not to be afraid of it. Only the men who have come up in the Army are competent to be generals, and any man who starts out to be a general and does not understand the situation from the bottom up never makes a good general, and no man who can not accept orders is competent to give orders.

The whole criticism, as I see it, is that Mr. Greenidge has probably been too powerful or has intimidated some of his subordinates to the point where they have not felt justified in protesting against his decisions. By saying that, I do not mean to infer that Mr.

Greenidge has been wrong in all of his decisions. I think the evidence produced here shows that he has been wrong in some of his decisions, if not in many.

Have you anything more, Mr. Manson?

Mr. MANSON. I wish to call attention to the statement that Mr. Hartson made to Mr. Briggs, that he was welcome to come down at any time he desired to come, and that Mr. Briggs could not do that without being guilty of insubordination, because the orders of his own immediate superior are that he shall not do that.

The CHAIRMAN. Have you anything further?

Mr. MANSON. That is all.

The CHAIRMAN. One thing has been running through my mind, Mr. Briggs, and that is whether you know whether there is any estimate of the number of cases that were settled by Mr. Shepherd in these special conferee cases?

Mr. BRIGGS. That is, in my work?

The CHAIRMAN. Yes.

Mr. BRIGGS. I think Mr. Shepherd was in four or five cases only.

The CHAIRMAN. Was your decision reversed in those cases?

Mr. BRIGGS. Well, the two most important cases were cases that we have had up here.

The CHAIRMAN. The ones that have been discussed here?

Mr. BRIGGS. Yes. There was one other more recently, in which Mr. Shepherd was not allowed to reverse us. He expressd his opinion dissenting. A dissenting opinion was given by him in that case, but he was not allowed to take charge of the case and overrule us.

The CHAIRMAN. Have you any idea how many of these amortization cases were settled on an estimated basis of production instead of the actual basis of production?

Mr. HARTSON. Mr. Briggs has nothing to do with amortization, Mr. Chairman.

Mr. BRIGGS. No; I have nothing to do with amortization.

The CHAIRMAN. Oh, I see. You have nothing to do with that?

Mr. BRIGGS. No.

The CHAIRMAN. Does anybody here know just what relation the cases settled on an estimated basis of production bear to the whole number of amortization cases?

Mr. HARTSON. I think there is no one here who could say that offhand, Mr. Chairman.

The CHAIRMAN. I want to say that I am very much impressed with the injury that has been done the Government by the use of that basis of production. There may be some cases where injury has been done the taxpayer, but in those cases the taxpayers are quite competent to take care of themselves.

I am impressed with the idea that something is very wrong with the results obtained by using these estimates of production instead of the actual production, because everyone knows that 1921 was the most depressing year, and it had a very great weight upon the minds of citizens, which would have a tendency to depress their estimates of what the future would be. That depressed feeling would tend toward minimizing production in 1922 and 1923 to such an extent that the Government was done great harm. Many of these big corporations made large claims for amortization; their profits were so large during the war period that additional taxes

based upon actual production, in justice to the Government, would not be a burden upon them, in my judgment, and I think the department ought to take a very active interest in recovering such revenues from those taxpayers.

Mr. HARTSON. Mr. Chairman, I have given a good deal of thought to the point which you now have in mind.

The actual figures of production of these several companies, of course, were unknown for the three-year postwar period, which was the period estimated by the bureau, until the close of 1923. These cases were up for settlement in the bureau immediately after the war, and there was an attempt made to settle and close these amortization claims. As the cases arose, they took them in order, and engineers were sent out to examine the facilities, starting with 1920, 1921, and 1922, and reports were made in an effort, Mr. Chairman, to close the cases at that time. If we did not close them as a going proposition, they would all have remained open for final adjustment at the close of 1923, when all actual production figures would then have been available.

The CHAIRMAN. But, as a matter of fact, most of these cases which were closed during that period, the earlier cases that were closed, were the smaller ones, the cases easily disposed of, and the difference in revenue would not be very material, perhaps. In other words, it has been shown here that there has been great speed in cleaning up the easiest cases first, so as to get them out of the bureau, and that the really important cases, such as have been presented to the committee, were not closed, some of them, until 1924, and in fact some of them are still not closed. So that, while what the solicitor says is true, I think too great emphasis is laid on what the result might have been to the Government, because most of them are small cases.

Mr. HARTSON. That is true, Mr. Chairman, to a considerable extent. Here is a fact, however, which should not be lost sight of: While these big cases which, as the chairman has suggested, were not closed during these earlier years, nevertheless, the amortization feature of the case, which may have been only one of a hundred disputed elements or items involved in the disposition of the case, was settled in 1921, 1922, or 1923, as the case may be, and the case is still open on other points. The engineers had to get in a report, and, based on that report, when it is finally approved, it becomes the basis for the audit, when other disputed items are finally settled, so that the whole thing is included in one final adjustment.

In the Steel Company case, the chairman will remember that the report of the engineer was put in in 1922. There was a final conference held in that case, in January, 1924, at which time the actual production figures were available, and the question in dispute, or up for consideration and settlement at that conference, was whether they would change the engineer's report, which was made two years or a year and a half before, and substitute the actual figures. At that conference, it was determined not to do this. We have since advised the chairman that it was our intention to substitute the actual figures.

The CHAIRMAN. I do not recall just why it was determined not to do it at that conference.

Mr. HARTSON. It was determined for administrative reasons, Mr. Chairman. The difficulty of reopening that case, reopening the amortization report on that case, based on these changed figures, would have involved a tremendous amount of work. On the other hand, there were other things which would have been thrown open and again have become the subject of dispute, if there was any disturbance on that point. There are many other cases—and I say this with knowledge—the amortization point in which had been settled two or three years. If they upset the Steel Co. case and substituted actual figures, as a matter of policy and equity between taxpayers, all cases which had been settled, so far as amortization was concerned, where estimated figures were used, would have to be reopened, and there would have to be a substitution of the actual figures for the estimated ones.

At that time, Mr. Chairman, I mean in January, 1924, as a matter of policy, they determined that this case should remain closed, so far as amortization was concerned, in order not to be inconsistent with the settlement and closing of other cases which had been determined in like manner.

The CHAIRMAN. I am in sympathy with the bureau's desire not to be inconsistent, but I am still confused and somewhat numbed, you might say, on the question of how you could arrive at any production figures in the case of the Aluminum Co. of America, which was before us yesterday, where there was nothing that we can find in the records to guide you, except the statement of the taxpayer himself.

Mr. HARTSON. In that case, if my information is correct, the report of the engineer was made in February, 1922. He had the 1921 production figures, he so informs me.

The CHAIRMAN. Is that in the record, Mr. Manson?

Mr. MANSON. Yes; I stated that yesterday.

Mr. HARTSON. He was trying to settle their amortization claim, at that time, when the actual figures, even up to the beginning of 1922, were not available, to say nothing of 1923. So he had to do in that case what was done in the Steel Co. case, namely, set down an estimate on a rising curve of increased production that would probably be expected by that company in 1922 and 1923. Those figures were not available, because the years had not yet been passed; but now, to-day, the figures can be ascertained, and I might add parenthetically that we are getting the figures in order to compare them with the estimates. The engineer tells us that he made rather liberal allowances for an increase production for those two estimated years. It may be that the estimated figures will not be materially different from the actual figures. I am unable to say, of course. But that was the trouble. They tried to close these cases as they came up, the amortization features of them, and they had to estimate a lot of figures in order to do it.

The CHAIRMAN. I recognize that, and I am not unduly critical of the bureau, as later developments indicate that these assessments were, perhaps, unduly low, and they ought to have been more vigorous, in view of the fact that the cases were not closed, in protecting the Government's interests when changed conditions appeared.

I would like to ask Mr. Briggs just what division he is chief of.

Mr. BRIGGS. The nonmetals section.

The CHAIRMAN. Has this investigation being conducted by the committee been hindering your work at all?

Mr. BRIGGS. Very little.

The CHAIRMAN. Very little. Has it been helpful in helping to fix policies in dealing with these cases?

Mr. BRIGGS. Well, I can not say that we have made any change since it has been up.

The CHAIRMAN. Has there been any indication of any desire for fewer appeals, or does there appear to be more stability of purpose?

Mr. BRIGGS. Of course, the question of appeals comes up when it comes to the question of the taxpayer being dissatisfied.

I might say this, that several men have remarked that they hoped the investigation would result in something, that the main objection our men had was to Mr. Shepherd's work, and I must say that they were demoralized by some of the work that he did, and I have heard them make the remark, "The taxpayer wants so much; he is entitled to so much; what is the matter with giving him a little bit more than he is really entitled to; perhaps we can hold him by that; and if we can not hold him by that and he goes beyond this, he will get a great deal more." I said, "No: don't do that; just give him what he is entitled to, and that is all, and if he is dissatisfied, let him take his appeal and get satisfaction beyond; but don't be influenced by the fact that you think he will be given a great deal more." After awhile they got that point of view; but, as I say, this action of Mr. Shepherd in those few cases has demoralized the work.

Mr. HARTSON. Mr. Briggs, you say there has been no change in administration, so far as you have been able to determine. How about the special conferee system?

Mr. BRIGGS. Oh, yes. That was done away with. We have been notified to that effect. We go ahead and have our conference with the taxpayer, and we make our conference memorandum, and we have been notified, in cases of disagreement, to write up in the corner, "Disagreed," simply to indicate that our section did not agree with the taxpayer, or the taxpayer did not agree with our section. We have had more success recently in getting the taxpayer to see our point of view. We have had one case within the last day or two where there were two brothers who came in. They were a partnership, and they wanted to charge to invested capital some items which had been written off as expense. We explained to them that if those items were restored, it would come out of their income; their income would be increased, and therefore it would increase their tax, but they would get a bigger invested capital.

At first they could not see it, but when my engineer came out he said they were talking to each other. One of them understood it and the other did not: but he said to his brother, "If you say so, that is all right."

The CHAIRMAN. We are going into the matter of the copper tomorrow, Mr. Manson, as I understand it?

Mr. MANSON. Yes.

The CHAIRMAN. For fear that any misunderstanding may arise in regard to what happened early in the morning with respect to con-

tractual amortization, the committee—that is, those of us who have heard the testimony—have been impressed with the absolute disposition on the part of the representatives of the bureau to cooperate in every way. I can not think of even one request that we have been denied or in regard to which we have not received at least an earnest expression on the part of the representatives of the bureau that they would endeavor to get us the record.

I am sorry that this disagreement has arisen, and I hope there will be closer cooperation between our counsel and counsel for the bureau from now on.

We will adjourn until 10.30 o'clock to-morrow morning.

(Whereupon, at 12.10 o'clock p. m., the committee adjourned until to-morrow, Friday, January 23, 1925, at 10.30 o'clock a. m.)

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

TUESDAY, JANUARY 27, 1925

United States Senate,
Select Committee to Investigate the
Bureau of Internal Revenue,
Washington, D. C.

The committee met at 11 o'clock a. m., pursuant to call of the chairman.

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

Present also: Mr. L. C. Manson of counsel for the committee, and Mr. Edward T. Wright, investigating engineer for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. C. R. Nash, assistant to the Commissioner of Internal Revenue; Mr. Nelson T. Hartson, Solicitor Bureau of Internal Revenue; Mr. James M. Williamson, attorney, office of Solicitor Bureau of Internal Revenue; Mr. S. M. Greenidge, head engineer division, Bureau of Internal Revenue; and Mr. Emil L. Koenig, appraisal engineer, Bureau of Internal Revenue.

The Chairman. Have you anything else that you want to present, Mr. Hartson?

Mr. Nash. I have a rather lengthy statement, Mr. Chairman, on this work that is being done in the War Department and the Navy Department, in checking up on contractural amortization. This statement is longer than I intended. I can submit it, if the chairman wishes.

Senator King. Or you can abbreviate it.

Mr. Nash. I can cut it down. It is still 13 pages long. It is about twice too long.

The Chairman. I got a memorandum from Mr. Manson last Saturday, I think it was, after our discussion, in which he reached the conclusion that we were not getting anywhere because the engineers or the employees of the bureau, who were doing this work for the committee, were the men who were charged with the responsibility in the first place of obtaining the contractual amortization, and therefore it was, in substance, a situation where the staff was checking itself.

Mr. Manson. The man in charge.

The Chairman. Yes; that is what I mean.

Mr. Nash. There are 10 men out of a total of 18 that are now on this work for the committee, and I have brought Mr. Koenig, who has been in charge of the work, before the committee this morning. Mr. Koenig was put in charge of the work because he was familiar with it.

The CHAIRMAN. Well, but he is the man who was charged with the responsibility for obtaining credit or gathering the information for the bureau during the time the contractual amortization was being considered.

Senator ERNST. You do not think there is any effort on the part of the bureau not to give us everything that is there?

The CHAIRMAN. Oh, no; there is no such inference at all, but the question is, if there had been any omissions in securing credit for contractual amortization, the men who were responsible for it should not be the men appointed to transmit it to us.

Senator ERNST. Were they the men who made the final decisions, or were they simply getting the information?

The CHAIRMAN. He may get the information or he may miss the information; we do not know.

Mr. NASH. If there is any question about Mr. Koenig's integrity in connection with this work, I will be glad to put another man in charge of it to-morrow morning.

The CHAIRMAN. I do not say any such thing, but I am talking about the procedure and the work it has worked out. I do not say it is dishonest, but we may not always be ready to point out errors made by ourselves.

Senator KING. And we may not be conscious that it was an error.

The CHAIRMAN. No; we may not be conscious that it was an error. I do think that the point is well raised, that the men who were in charge of finding out for the bureau what the actual amortization was for the other departments, should not be charged with the responsibility of finding out whether he himself made any errors.

Mr. NASH. Mr. Chairman, Mr. Koenig is now in charge of the amortization section. He has been checking up contracts in the other departments. He was in charge of this work for the committee under the general instructions of Mr. Thomas, because he is familiar with the routine in the other departments, and he knows where to go to search the files, etc. He is the one man in the amortization section that has specialized on this work. But, as I said before, I would be glad to substitute somebody else in place of Mr. Koenig, if there is any question as to his integrity.

Senator ERNST. If the representatives of the committee go right along with him in checking it up, what opportunity is there going to be for an error?

Mr. MANSON. That is the very thing I suggested, Senator. I think, in doing this work, there should be a little closer cooperation between the committee's engineers and the engineers of the bureau.

The CHAIRMAN. And you recognize, of course, Mr. Nash, that this criticism was made by Mr. Thomas?

Mr. NASH. Yes, sir.

The CHAIRMAN. Have you any fault to find with Mr. Thomas's criticism?

Mr. NASH. There seems to have been a general misunderstanding ever since the work was started. I understood that Mr. Thomas was to have general supervision of the work for the committee, and that certain engineers were to be assigned to him. It was also my impression that Mr. Thomas would work with those engineers. The reports that have come to me from interviewing each of the engineers

assigned to this work with Mr. Thomas are that Mr. Thomas was with these engineers once or twice and spent an hour or so with them each time, and from that time on he does not appear to have been in intimate touch with the work. The men have been working by themselves, and from time to time have been in touch with Mr. Thomas. I think once or twice a man by the name of Robbins, who was associated with Mr. Thomas, has come down where the men have been working, and has spent a few minutes with them, and has then left.

The CHAIRMAN. Do you think the work has now turned out so that we can proceed, Mr. Manson?

Mr. MANSON. I think so. I think the stirring up that it has received is going to help very much in getting it speeded up.

Senator ERNST. Don't you think that if Mr. Thomas's activities, as stated by Mr. Nash, are all that is required of him, he has been derelict?

Mr. MANSON. I do not think that Mr. Thomas has been derelict. He had had a great many other things to do, and up until very recently we have been mighty shorthanded in the way of engineering assistance, in view of the fact that we have been trying to keep this committee engaged in hearing these matters. I know that Mr. Thomas has made repeated efforts, as he has reported to the committee, to ascertain the status of this work, and he has received conflicting reports as to its status.

The CHAIRMAN. There is no necessity for Mr. Nash to read this statement unless he wants to.

Mr. NASH. I would read this, but, as I say, it is much longer than I intended to submit.

The CHAIRMAN. We do not want to hear it unless you want to present it. We are satisfied with what you have said unless you want to read it.

Senator ERNST. I would like to have that situation brought out unless you want to cut it down.

Mr. NASH. It can be boiled down 50 per cent.

Senator KING. I would suggest that Mr. Nash do that.

Mr. NASH. As to the conflicting statements that Mr. Manson has referred to I have asked the engineers, and it seems that Mr. Thomas asked one of the engineers one day, who was engaged on a certain portion of the work, as to how much was done, and that man told him that he had completed 10 or 12 cases. He was working in the War Department. He did not go to Mr. Koenig to find out what the status of the work was. Mr. Walton is the man who was talking with Mr. Thomas, and his information was only as to the cases in the War Department. The cases had not been checked in the War Department, so it necessitated further work on those cases, and they were not completed. The reply Mr. Walton made to Mr. Thomas was made in good faith, but it seems that Mr. Thomas ought to have asked the man who was in charge of the work as to the status, and not some man who was just on a certain portion of the work.

There also seems to have been a little misunderstanding as to certain of those cases. The men started work on 20 cases, and later on a second list of cases was referred to them, and three days later another list of cases was referred to them; so that there were cases in

various stages of development, and that work was stopped and they started working on this other list.

The CHAIRMAN. I would like to have Mr. Manson explain why that is.

Mr. MANSON. The reason for that was that the first list of cases was submitted to them in order to get started. Then we prepared a list of cases that we desired to submit to the committee with reference to amorizaion, and, of course, we desired to have information as to contractual amortization allowed by other departments with respect to those particular cases first. That is the reason.

The CHAIRMAN. In other words, the work that was done originally was not wasted, then?

Mr. MANSON. Oh, no.

The CHAIRMAN. I would like to ask Mr. Nash what progress is being made in the Standifer case? I had some correspondence with Mr. Blair about that matter.

Mr. NASH. I believe the attorney reviewing the case is in New York to-day to interview Mr. Schlessinger, who was formerly with the Shipping Board, and took part in the final conference over there, and that after this interview it will be closed up very soon. I think it is right in the final stages.

The CHAIRMAN. Has the taxpayer been heard on it, or has he been conferred with?

Mr. NASH. I think he has, Senator.

Mr. HARTSON. I can make a little further statement on that, Mr. Chairman, to give you the picture of the present condition.

This special committee that the commissioner designated to consider the Standifer case has prepared, if I am correctly informed, what we call an assessment letter, an A-2 letter, which frames the issues. The taxpayer will be furnished with a copy of that in the course of a day or two, and we will then hear him on that. He has had informal hearings with these men from time to time through his representatives, and I understand, personally, during the period of time that has elapsed since the committee was first designated, but he has not had any formal conference. Under the regulations, the prescribed procedure will be followed as soon as he gets this A-2 letter.

The CHAIRMAN. When will the A-2 letter go out, do you know?

Mr. HARTSON. I should say within the course of a few days, now. My information is that it is all prepared and ready to be transmitted.

Senator WATSON. Before I go, Mr. Chairman, I want the record to show that for the last five days, while this hearing was going on, I have been in attendance at the meetings of the Interstate Commerce Committee, which I thought a matter of sufficient importance to justify my presence there.

The CHAIRMAN. I hope the bureau will close the Standifer case at as early a date as possible so that the committee may have something concrete in the way of information as to whether our contentions in this particular case were justified or not.

Mr. HARTSON. Senator, in that regard, there will be no possibility of closing it up so that the committee or anyone can say definitely that the committee's conclusions with regard to the matter were correct.

The commissioner, under the present state of the law, can only make a determination of a deficiency. That is his conclusion with regard to it. The taxpayer is notified of it and litigates the correctness of the commissioner's conclusion before the Board of Tax Appeals. It is quite possible that before the assessment could be made, if one is proposed to be made by the commissioner, it would not be effective for another year, and it can not be said that the determination was a correct one until the Board of Tax Appeals has had an opportunity to pass on it.

The CHAIRMAN. Then, the best you can do is to tell us whether the commissioner makes the assessment.

Mr. HARTSON. Whether the commissioner determines that an assessment should be made?

The CHAIRMAN. Yes.

Mr. HARTSON. Then, before he can make it, the board has to approve his action.

Mr. MANSON. Do I understand that to-morrow the solicitor will continue with his answer in the case of the Aluminum Co. of America?

Mr. HARTSON. Yes, sir.

The CHAIRMAN. Will you take up the matter of the copper properties to-morrow, too?

Mr. HARTSON. No; I prefer to have the copper matter go over until Thursday, Mr. Chairman.

The CHAIRMAN. Very well.

(Whereupon, at 12 o'clock m., the committee adjourned until to-morrow, Wednesday, January 28, 1925, at 10.30 o'clock a. m.)

SAGINAW SHIPBUILDING COMPANY CASE

INVESTIGATION OF THE BUREAU OF INTERNAL REVENUE

WEDNESDAY, JANUARY 28, 1925

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

The committee met at 10:30 o'clock a. m., pursuant to adjournment of yesterday.

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

Present also: Mr. L. C. Manson, of counsel for the committee: Mr. L. H. Parker, chief engineer for the committee; and Mr. Raleigh C. Thomas, investigating engineer for the committee.

Present on behalf of the Bureau of Internal Revenue: Mr. Nelson T. Hartson, Solicitor Bureau of Internal Revenue; Mr. James M. Williamson, attorney, office of Solicitor, Bureau of Internal Revenue; Mr. S. M. Greenidge, head, engineering division, Bureau of Internal Revenue: and Mr. W. S. Tandrow, appraisal engineer, Bureau of Internal Revenue.

Mr. MANSON. This is the matter of the amortization allowance of the Saginaw Shipbuilding Co. It involves the question of contractual amortization.

The amortization claimed on the original return was $1,239,757.83. The amortization allowance was $1,078,316.73. The taxpayer then filed a revised claim in the same amount as originally claimed, upon which the Unit allowed $1,234,763.13.

The Shipping Board allowed amortization to this taxpayer of $685,171.34.

Senator WATSON. What case is this, now?

Mr. MANSON. This is the Saginaw Shipbuilding Co.

This amortization allowance by the Shipping Board was ignored.

I will supply the figures as to the difference in tax later, as I have not secured them yet.

I wish to say that we learned last night that after this case left the engineering division of the income tax unit and went to audit there was a further deduction of about $130,000, which did not involve this contractual amortization, but which, however, was an allowance of cost, as I understand it, rather than an allowance affecting the contractual amortization of $685,000 allowed by the Shipping Board.

This taxpayer received several shipbuilding contracts from the Shipping Board. Under those contracts the taxpayer built, as I understand it, 18 ships, and contracts for 6 ships were canceled.

The shipbuilding company, the taxpayer, submitted to the Shipping Board a claim in the net sum of $1,140,041.53. This claim, while not specifically mentioning "amortization," included an item for "Special facilities cost" in the sum of $657,981.89. This item was to reimburse the contractor for plant expenditures. These facilities were purchased and installed by the taxpayer in the performance of the contract, the material portions of which read as follows:

The CHAIRMAN. Let me ask at this point, do you contend that this claim for excess or special plant facilities amounts to the same thing as "amortization"?

Mr. MANSON. It does. Any amount allowed the contractor to reimburse the contractor for plant expenditure is an amortization of plant expenditures.

The CHAIRMAN. I asked that question because you mentioned that amortization was not specifically named in the taxpayer's claim to the Shipping Board.

Mr. MANSON. I stated that he did not set it up as amortization. He set it up as the cost of special facilities.

Senator WATSON. Is that very often done, Mr. Manson?

Mr. MANSON. Yes; it is very frequently done. The word "amortization" came in use in connection with some legislation, that is, so far as shipbuilding is concerned. It was not until the shipbuilders sought legislation, particularly with regard to wood ships, that the word "amortization" as coined, if you might use that term, for the purpose of having a term to apply to this particular class of claims.

I started to read this contract, but before doing so I would call attention to the fact that this claim was allowed by the Shipping Board for amortization, in the sum of $685,171.34, the total claim being $922,171.34, from which was deducted a residual value of $237,000, leaving the difference that I have mentioned. The plant cost was $1,576,763.13. The entire plant, including inventory, was sold for $500,000. The company set up a claim to the effect that of the $500,000, $158,000 was to cover inventory, leaving $342,000 to cover what it received for its plant.

The CHAIRMAN. In other words, the residual value.

Mr. MANSON. Yes; the residual value, and that amount of $342,000 was deducted from the actual cost of the plant of $1,576,763.13, leaving a difference of $1,234,763.13. This is the amount which was allowed by the engineers in determining amortization.

As I have stated, there has been subsequently deducted from this amount approximately $130,000, but that deduction, as I have also stated, is not made because of the disallowance by the Shipping Board. It will be seen that inasmuch as the amortization allowed is equal to the difference between the amount received by the company for the plant, and the cost of the plant, the $685,000 received from the Shipping Board could not have been considered, and was not considered.

Referring now to the contract under which the plant expenditures were made, I desire to quote as follows:

In view of the existing emergency, we are desirous of having you increase with the greatest expedition the capacity of your plants by making alterations and providing extra ways, equipments, and facilities, so that your company may deliver to us largely increased tonnages before the close of

navigation, 1919. We request that you prepare at your earliest convenience a statement of the manner in which you believe your plants can most advantageously be extended to serve the above purpose, and submit that list to us. We shall be guided very largely by your request and your judgment in this matter, and we shall express our approval as promptly as circumstances will permit.

We appreciate that the legitimate business needs of your company do not require these alterations and expansions which probably will be of little or no value to you after the completion of this contract. We understand, therefore, that what ever you do in this respect is done at our instance and for the sole purpose of facilitating the prompt production of the additional ships hereinafter ordered, and constituted a part of the cost to you of the construction of said ships.

You are to proceed immediately with the alterations and additions to your plants as soon as the list referred to has been approved by us. Additional lists of alterations and improvements may be furnished hereafter for approval.

We shall pay you $815,000 for each of said ships. Price is based on $800,000 as the price of the ship itself and $15,000 as a contribution to plant alterations and equipment. It is also based on a minimum expenditure of $275,000 for plant and equipment additional to that now being provided by you to carry out your other contracts. You are to submit proper proof of these expenditures to us.

It will be seen that under that contract the Shipping Board agreed to pay, as part of the cost of each ship $15,000 per ship, and the contractor agreed to spend a minimum of $275,000.

When it came to the cancellation of the six ships, the claim was made that they had spent in excess of that amount, and they were entitled to the full amount of their extra expenditures. The sum of $922,171.34, less the residual value of $237,000 was allowed by the Shipping Board.

The auditors have not furnished us with the computation of the difference in tax, but we are advised that the difference in tax would be approximately 30 per cent, which would be about $200,000.

The CHAIRMAN. Your contention is that the $200,000 excess was allowed, or the whole $685,000?

Mr. MANSON. No; my contention is that they allowed $685,171.34 too much amortization, which would make a difference in tax of approximately $200,000.

The CHAIRMAN. I see.

Mr. MANSON. In other words, I contend that this whole amount allowed by the Shipping Board should have been deducted.

What happened was this: The taxpayer sold his plant. In arriving at the amortization of $1,200,000, plus, they deducted from the cost of the plant the amount that the taxpayer received for the plant, and allowed him as his amortization, the difference, or his total loss. Of that total loss $685,171.34 had been borne by the Shipping Board.

The CHAIRMAN. Does an examination of the taxpayer's claim for amortization disclose that the Shipping Board claim was considered at all?

Mr. MANSON. I do not believe there is anything in the record at all to show it. We secured the information from the Shipping Board. I do not think there is anything in the record to show that the amortization allowed by the Shipping Board was ever investigated. Mr. Parker states that the subject of contractual amortization was not mentioned in the engineer's report.

The CHAIRMAN. Is that the entire presentation of your case, Mr. Manson?

Mr. MANSON. Yes.

Senator WATSON. Let me ask you one question about your method. I have never asked anybody about this, nor have I ever talked to anybody about it. When your men start in to investigate a case do they go in independently or do they work in collaboration with or in connection with the employees of the Treasury Department?

Mr. MANSON. We call for the record in the case. I will try to give you the steps of it, and if I do not give them right I wish the engineers would correct me. We call for the record in a case. We go over that record; that is, our engineers go over it. If there is something about the record that we do not understand—if there has been apparently a mistake made, or if there is something done that requires explanation, we call on the engineer who examined that case for the unit to explain what he did and why he did it.

Does that answer the Senator's question?

Senator WATSON. Then, after that, you go on and make your own independent investigation?

Mr. MANSON. Yes.

Senator WATSON. Do you then call anybody's attention to it before it is presented here?

Mr. MANSON. We do this: When it comes to determining the difference in tax, we call on the auditor who handled the case.

Mr. THOMAS. If he is there.

Mr. MANSON. If he is there, to make that computation. We check that computation. These engineers are not auditors, and we do not rely on our own computations when it comes to a checking of the difference in tax.

Senator WATSON. Take this particular case, for instance. Did Mr. Hartson, so far as you know, ever hear of this case?

Mr. MANSON. What is that?

Senator WATSON. I asked you whether Mr. Hartson ever heard of this case until just now?

Mr. MANSON. I do not suppose so.

Senator WATSON. That is what I wanted to get at. I wanted to know just your method of operating down there and how you worked.

Mr. MANSON. It is not our policy to go to any officer of the unit and criticize anything that they do.

Senator WATSON. I understand. I was just trying to get your method.

Mr. MANSON. We submit it to the committee and leave it to the committee to determine whether or not the bureau is to be criticized. We do not assume to do that.

The CHAIRMAN. I might say for the benefit of the Senators that the question has arisen a number of times as to how we land on specific cases or how we call for specific cases. An examination of last week's reports submitted to me by the engineers covering the progress of the work shows a whole list of cases which are under examination by auditors and some by engineers. In this memorandum nearly every case, or at least a great many of them, indicated the source of information or the source of the suggestion that we examine a specific case. Some of these cases are referred to us by engineers and auditors of the bureau, who have disagreed with the

conclusions, and they have asked our men to examine into it to see whether or not our men agree with their conclusions or with the final conclusions of the bureau. Other cases come to us in letters from citizens who apparently have some suspicion of some information concerning a case, and they draw our attention to what they think is a matter that justifies some criticism, and they ask us to examine that case. In that case the letters are referred to the staff. The staff looks into it; and if there is nothing to it, the case is dropped. If there is anything to it, it is presented to this committee; or if it is only a trifling thing, it is abandoned. In other cases citizens come to members of the staff or members of the committee and make, individually, complaints or suggestions. Those are taken up by the staff and investigated. Many cases which are suggested are not of sufficient importance to criticize, and we do not waste the time of the committee by presenting them.

Mr. MANSON. I wish to say in connection with this case that when the Standifer case was presented Senator Jones suggested that this matter of contractual amortization allowed by the Government departments be investigated. In pursuit of that suggestion we called upon the Shipping Board, the War Department, and the Navy Department for information. The Shipping Board has shown us a great deal of cooperation in that regard. They have supplied us with the names of cases in which they have allowed amortization, and when we look those cases up and find that the bureau has not considered them we then call upon the Shipping Board for full information as to their contractual relation with the taxpayer and the settlement that was made with him.

I assume that this particular case was commenced in that way. Is not that so?

Mr. PARKER. Yes.

The CHAIRMAN. I might say also that I do not think the Senators who are here now were here yesterday when we discussed generally this subject of contractual amortization allowed by other Government departments.

Senator WATSON. Yes; I was here yesterday.

The CHAIRMAN. The fact, however, seems to develop that there was no system or plan introduced or adopted by the bureau to systematically check contractual amortization allowances, because if there had been we would not now be involved in the long research that we are having to find those allowances. I do not know whether there is anybody here from the bureau who knows what plan was adopted or how thoroughly it was followed, to be sure that the bureau did not allow a duplicate allowance, after an allowance had been made for amortization by another Government department.

Mr. HARTSON. Mr. Chairman, a brief statement as to the history of the provisions in Regulations 62, which require that contractual amortization allowed by other Government departments should go to reduce cost, would be interesting.

When this subject was first discussed Mr. Manson pointed out that the regulations in existence prior to the promulgation of Regulations 62, which regulations were issued pursuant to the revenue act of 1921, contained no such provision requiring contractual amortization allowed by other departments to be used to reduce the cost of war facilities in computing income-tax amortization.

Senator WATSON. What did you do before that?

Mr. HARTSON. Before that, Senator Watson, the practice was to include in gross income receipts from the other Government departments, and without subtracting from those receipts in a sense, the amount allowed for contractual amortization. There was a great deal of complaint about that manner of treating it.

Senator WATSON. How did Regulations 62 happen to be issued?

Mr. HARTSON. Because of a very strong protest from taxpayers, because the tax on these amounts received during the excess-profits tax years was so excessive that it worked a great hardship on them. As a result, if I am correctly informed—and I have been investigating it recently—it was felt that to consider the entire amount received as income during the year in which it was received, was to defeat, in a sense, the purpose of the amortization allowances, which were provided by Congress as a relief measure to taxpayers, to write off war costs as against war profits. So this provision which we are now dealing with, namely, of requiring the bureau to consider contractual amortization allowed by other departments as a reduction of the cost of facilities, is, in a majority of cases, as I am informed, a relief to the taxpayer rather than the imposition of an additional burden on them.

Now, it will have this effect, Mr. Chairman, if I understand it correctly. If a taxpayer did not settle his claim with the Shipping Board until after the excess profits tax law was repealed, he would then get as income under the old regulations this money from the other Government departments, not subject to excess-profits tax, and it so happened in the Standifer case that that was the situation. In other words, I believe that is an instance where it has worked in favor of the taxpayer, but the usual case, as I understand it, which was presented to the bureau at the time Regulations 62 were under consideration, was of the type that taxpayers had received their money from other Government departments in settlement of their war contracts, which was all being taxed to them in those years under excess-profits tax rates, and it was felt that had the effect of defeating one of the primary purposes, if not the principal one, of allowing amortization to concerns that had installed facilities to produce articles for the prosecution of the war. So, if this provision of Regulations 62 involved in the case which counsel has just mentioned, the Saginaw Shipbuilding Co., is not folowed: in other words, if the amount allowed by the Shipping Board is not considered to reduce the cost, it is computed as income for the year in which received, and if it was received prior to the repeal of the excess-profits tax it would result undoubtedly to the taxpayer's disadvantage.

Mr. MANSON. That would depend upon the year?

Mr. HARTSON. That is my point exactly, Mr. Manson. As I say, in the Standifer case they have failed to consider any amount as being an allowance by the Shiping Board to the Standifer Co. as contractual amortization, and if any amount had been allowed by the Shipping Board on that item it worked to the advantage of the taxpayer.

The CHAIRMAN. In other words, had he received the settlement during the period before Regulations 62 were adopted, he would have

been charged at the excess-profits tax rate and would have paid much more than he did pay after Regulations 62 became effective?

Mr. HARTSON. That is my understanding. If the settlement were made before the 1921 act was passed.

Senator JONES of New Mexico. That is, assuming that net earnings would have brought them within the excess profits provision?

Mr. HARTSON. That is another assumption that must be indulged in, Senator; yes.

Senator JONES of New Mexico. Well, is that a proper assumption?

Mr. HARTSON. I believe it is.

Senator JONES of New Mexico. Is it something that is justified by the facts?

Mr. HARTSON. I believe it is, Senator.

Senator JONES of New Mexico. That these people, as a rule, notwithstanding this claim for amortization, and so forth, had made such earnings out of the proposition that they were subject to the excess-profits tax.

Mr. HARTSON. I believe it is, Senator. That is a general statement that we ought to be able to have verified. I shall be glad to try to do it.

Senator JONES of New Mexico. I am sure your judgment in the matter would be very valuable, because of your experience there.

Mr. HARTSON. The basis on which I make my statement is that these companies, for the war years, and the years immediately following the war, particularly 1919, were very prosperous. Some of them suffered in 1920, and that was the last year in which the excess-profits tax was effective.

Senator JONES of New Mexico. The thought I wanted to develop was this, that in these various matters we are not dealing with bankrupt concerns, and it is simply a question of whether the concerns shall profit to a greater or less degree out of war activities. There is no reason why anybody should be disposed to favor the business concerns in allowing what might be termed liberal amounts for amortization or otherwise, that is, it could be put on a strictly business basis and should work no hardship to the taxpayer?

Senator WATSON. I imagine that that was the object of the adoption of Regulations 62. Has it worked that way?

Mr. HARTSON. My answer to that, Senator Watson, is this, that the reason for the change in the regulations, which became effective when Regulations 62 were promulgated was not to be overly liberal to taxpayers, but was an attempt on the part of the officials of the bureau and the department, to interpret the will of Congress to make a reasonable allowance for amortization, the purpose of which, it was believed, was to permit taxpayers to write off war costs against excessive war profits, and to throw those allowances back against the war years, rather than to have taxpayers spend large sums of money for facilities, during the high-priced years, and then have to pay for them, you might say, out of the income from subsequent years, which represented income under quite different business conditions than had existed during the war.

Senator WATSON. Have you the exact phraseology of that article of Regulations 62 there?

Mr. HARTSON. Yes; I have it, Senator.

Mr. MANSON. It is in Regulations 62. I have forgotten the number of the article.

Senator WATSON. How long is it, Mr. Hartson?

Mr. HARTSON. Do you remember the section, Mr. Tandrow?

Mr. TANDROW. I believe it is article 182, Mr. Hartson.

Mr. HARTSON. I have it here. It is article 181.

The CHAIRMAN. Of Regulations 62?

Mr. HARTSON. Article 181 of Regulations 62:

> All allowances made to a taxpayer by a contracting department of the Government, or by any other contractor, for amortization specifically as such, shall be treated as a reduction of the cost of the taxpayer's plant investment. Further amortization is allowable only in respect of such reduced costs. Where no such allowance has been made, the amount of amortization to be allowed as a deduction from gross income for the purpose of the tax shall be computed in accordance with the provisions of articles 181 to 189, pursuant to which the deduction must be made, and not upon the basis of any amount contractually or otherwise determined.

The CHAIRMAN. I notice in that language it refers to governmental departments and others. Is that correct?

Mr. HARTSON. "Or by any other contractor."

The CHAIRMAN. "Or by any other contractor." That is meant to reach subcontractors, then. I assume that where it was a cost-plus system, and the subcontractor did the work for another contractor, who had a direct contract with a Government department, he might not again receive it in his income-tax returns. Is that correct?

Mr. HARTSON. That would be my understanding of it, Senator.

The CHAIRMAN. I would like to ask whether any member of the staff have looked into the purchases of the Saginaw Shipbuilding Co. plant to ascertain who they were?

Mr. THOMAS. I think I can answer that, Senator. That was gone into very carefully by the Income Tax Unit engineers, as there seemed to be some doubt as to whether there was a bona fide sale. That question was cleared up.

The CHAIRMAN. And it was determined to be a bona fide sale?

Mr. THOMAS. Yes, sir.

The CHAIRMAN. I was wondering whether it was anything like the situation in the case of the Northwest Steel Co., where it was sold to employees.

Mr. THOMAS. No; they sold it to the Ruggles Motor Truck Co.

Mr. MANSON. I understood there were no common officers until after the sale took place.

Mr. THOMAS. Yes.

Mr. MANSON. Or stockholders?

Mr. THOMAS. That is right.

The CHAIRMAN. So that our staff did consider that this was a bona fide sale?

Mr. THOMAS. Yes.

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

Mr. MANSON. No; that is all.

The CHAIRMAN. Have you anything more, Mr. Hartson?

Mr. HARTSON. I have not this morning, Senator.

The CHAIRMAN. Is Mr. Graton, who examined the copper cases, present now?

Mr. HARTSON. He is not, Senator. He went back to Cambridge in order to get some data, which he has in his own files there.

The CHAIRMAN. There is to be a meeting of the Interstate Commerce Committee to-morrow morning, which Senator Watson and I desire to attend, and if it is agreeable we would like to adjourn these proceedings until Friday.

Mr. HARTSON. It would be entirely possible to wire Mr. Graton not to come to-morrow, and to put it over until any day that is convenient. I think he would be very glad to come at any time that would be convenient to the committee.

Senator WATSON. To-morrow will be Thursday. We had better adjourn until Friday, then.

The CHAIRMAN. Yes; if agreeable to Senator Jones, and if it does not inconvenience the bureau we will adjourn over until Friday. Is that agreeable to you?

Mr. HARTSON. That is satisfactory to the bureau. In that event, may I be authorized to wire Mr. Graton to the effect that we will want him on Friday morning?

The CHAIRMAN. Yes, we will adjourn now until Friday morning, at 10.30 o'clock.

(Whereupon, at 11.30 o'clock a. m., the committee adjourned until Friday, January 30, 1925, at 10.30 o'clock a. m.)