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Income-tax Department

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In the auditing of tax returns carried on by the treasury department, a taxpayer is subjected to much extra work and worry in revealing additonal facts as to his taxable income, not theretofore disclosed by the return submitted by him. Very frequently he finds as a result of his answering the questions propounded to him that he is about to be assessed with an additional tax. Some of these additional assessments are not justified or justifiable and arise from a misapprehension of the facts in the case. The taxpayer's first impulse in such an instance is to take the first train to Washington and have it out with the commissioner. If he yields to his impulse he is likely to incur unnecessary expense. The revenue act provides the rules for appealing against these assessments, and one of the rules is to the effect that the time for a hearing is to be set by the commissioner. If the taxpayer then studies the rules for appeals and hearings, he is struck with what seem to him unnecessary technicalities that must be observed before his tax question can be settled. To the ordinary taxpayer these rules seem to be given more importance by the treasury department than are the merits of his case. He knows that if the error is not revealed to the taxing officers he is likely to pay out a considerable additional tax, and this fact, of course, looms much larger to him than do the rules governing the manner and time in which his appeal is to be made. However, when he takes time to consider that the treasury department is doing business with several million individuals like himself and that many of them have like questions to be solved, he generally decides that the rules of procedure are really a protection of his interests. At this stage of his education in tax matters he begins to take great interest in sections 250 and 252 of the revenue act, and article 1006 of regulations 62 becomes reading matter of more than ordinary interest to him. Several treasury decisions recently issued (which will be published in next month's issue of THE JOURNAL OF ACCOUNTANCY) appertaining to appeals and hearings, claims for abatement, claims for refund, enjoining the collector from assessment of tax, etc., must be read if one is to keep in touch with procedure prescribed for such cases.

Treasury decision 3472 comprehends a decision by Judge Thompson of the district court of the United States, eastern district of Pennsylvania, with reference to the subject of depletion. The New Creek Co., the plaintiff, which had leased its mining property, contended that the royalty it received from the lessee for ore mined in 1917 should all be considered depletion and therefore deducted it in computing taxable income. Its contention was based on the assumption that the royalty received was a return of capital. In the facts set up it was shown that the company acquired the property from which the coal was mined in 1851; that at March 1, 1913, the property had a fair value of $199,875.00 and that the unmined coal underlying its property approximated 9,057,640 tons. These figures give a depletion rate of $0.022067 a ton. Inasmuch as the company was receiving a royalty of 40 cents a ton, it will be seen that the difference between the taxpayer and the collector of internal revenue as to the amount of depletion was not altogether one of principle.

From the viewpoint of the accountant it would seem that the plaintiff was not well advised in making such a claim, as it is difficult to conceive of a corporation's management considering that the mineral rights would be let upon a basis of obtaining only a return of its capital investment in any year and especially in the year 1917. However, it is interesting to note that this is not the first case that has been tested in court to establish the theory that the royalty received by a lessor of mineral rights really measures the amount of depletion of the investment in the mineral body.

TREASURY RULINGS

(T. D. 3472—May 3, 1923)

Income tax—Revenue act of 1916 as amended—Decision of court.

1. Income Tax—Income—Royalties from Ore Lands.

The entire amount of royalties received by the lessor of a coal mine for the right to extract coal from the land is gross income.

2. Deductions—Depletion.

A mining corporation which, in consideration of certain royalties, grants to another the right to extract ore from its land is not entitled as an inherent right to any deduction from income in the nature of a depletion allowance in computing its net income for income-tax purposes; hence only such depletion may be allowed as is specifically provided for by the taxing statute.

3. Depletion—Regulations.

The depletion allowance prescribed by articles 171 and 172 of regulations No. 33 (revised) is a reasonable one and applies to a mine owner who leases ore lands on a royalty basis as well as to one who himself mines and sells the ore.

4. Same—Measure.

The value of the ore in place in the year in which it is mined is not the proper measure of depletion in the case of a lessor of mines.

The attached decision of the United States district court for the eastern district of Pennsylvania in the case of *New Creek Co. v. Lederer, collector,* is published for the information of internal-revenue officers and others concerned.

District Court of the United States, Eastern District of Pennsylvania.

New Creek Co., plaintiff, v. Ephraim Lederer, collector of internal revenue for the first district of Pennsylvania, defendant.

[April 3, 1923]

Thompson, district judge: The plaintiff sues to recover from the defendant the sum of $5,952.80 with interest from July 19, 1920, income and excess-profits tax for 1917, paid under protest, and alleged to have been unlawfuly exacted. The facts not being in dispute, the parties have set them out in a case stated.

The plaintiff in 1851 became the owner of coal lands situate in what are now Mineral and Elk counties, W. Va. On March 1, 1913, it was the owner of part of that land which had been found to be underlaid with coal. The land was leased for coal mining on a royalty basis and during 1917 93,515.18 tons were mined for which the plaintiff received in royalties $37,565.25. In making its return for income tax the plaintiff charged that entire amount to depletion. The plaintiff had no interest in the mine equipment and the entire plant and machinery and all labor employed for the operation of the mines were furnished by the lessees. The fair market value of the coal land as of March 1, 1913, was $199,875 and the quantity of unmined coal underlying the land estimated as of March 1, 1913, was 9,057,640.32 tons.

The commissioner of internal revenue held that, under the provisions of the revenue act of 1916, as amended by the revenue act of 1917, the deduction for depletion allowable per ton mined was represented by the quotient found by dividing the total estimated number of tons of unmined coal on March 1, 1913, into the sum representing the fair market value of the lands as of that date, or $0.022,067 per ton. On that basis the plaintiff was allowed for depletion in 1917 the sum of $2,063.60 and the commissioner thereupon assessed additional income and excess-profits tax amounting to $5,952.87. That sum was paid by the plaintiff under protest on July 19, 1920. Claim for refund was duly made and rejected and suit brought.

The revenue act of 1916 provides as follows:

SEC. 12 (a). In the case of a corporation, * * * such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

Second. * * * (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in * * * (b) under rules and regulations to be prescribed by the secretary of the treasury: *Provided,* That when the allowance authorized * * * (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. * * *

Under the authority of the act, the secretary of the treasury prescribed rules and regulations the substance of which, as set forth in articles 171 and 172, permit the taxpayer to deduct in the year in which mined the actual market value as of March 1, 1913, of the coal mined during the taxable year based upon its proportion of the value of the entire estimated quantity in place as of March 1, 1913.

It is provided in article 172 of the regulations that the value as of March 1, 1913—must be determined upon the basis of the salable value *en bloc* as of that date of the entire deposit of minerals contained in the property owned, exclusive of the improvements and development work; that is, the price at which the natural deposits or mineral property as an entirety in its then condition could have been disposed of for cash or its equivalent.

The en bloc value having been thus ascertained, an estimate of the number of units (tons, pounds, etc.) should be made. The en bloc value divided by the estimated number of units in the property will determine the per unit value, or amount of capital applicable to each unit, which, multiplied by the number of units mined and sold during any one year, will determine the sum which will constitute an allowable deduction from the gross income of that year on account of depletion.

Deductions computed on a like basis may be made from year to year during the ownership under which the value was determined until the aggregate en bloc value as of March 1, 1913, of the mine or mineral deposits shall have been extinguished, after which no further deduction on account of depletion with respect to this property will be allowed to the individual or corporation under whose ownership the en bloc value was determined.

* * * * * * * * *

* * * The value determined and set up as of March 1, 1913, or the cost of the property if acquired subsequent to that date will be the basis for determining the depletion deduction for all subsequent years during the ownership under which the value was fixed, and during such ownership

there can be no revaluation for the purpose of this deduction if it should be found that the estimated quantity of the mineral deposit was understated at the time the value was fixed or at the time the property was acquired.

The plaintiff contends (1) that these rules and regulations do not properly apply to the owner leasing the land on a royalty basis but only to an owner who himself mines and recovers the coal; (2) that, if they do apply, they are illegal and void because under the rules and regulations a reasonable allowance for depreciation can not be fixed as required by the revenue act; (3) that the actual depletion in any year is the amount of royalty the mine owner receives and that it is unnecessary and unreasonable to resort to any artificial method of arbitrary valuation such as is described in the regulations in order to determine depletion.

The plaintiff contends that the royalty paid for each ton mined represented the value of the coal in the ground when it was mined; that, therefore, it had no element of profit in it but represented merely the naked value of coal which was part of the land at the moment when it was removed therefrom; that the royalties were, therefore, principal and not income. The question whether the proceeds of minerals taken out of the land by mining constitute income has been decided adversely to the plaintiff's contention in cases arising under revenue laws passed prior to the adoption of the 16th amendment. The corporation excise tax act of 1909 laid a tax with respect to the carrying on or doing of business by corporations to be measured by their net income after certain deductions. It was under consideration in the case of *Stratton's Independence v. Howbert* (231 U. S. 399). It was there held that in fixing the income by which the excise on conducting business should be measured, congress has power to fix the gross income even though such income involves a wasting of the capital as in mining ores, and that the proper method of computing depreciation by reason of taking ore from the premises of a mining corporation is not governed by the rules applicable to the liability of trespassers for taking ore. In that case the contention of the plaintiffs was that the depreciation was the difference between the gross proceeds of the sales of ores during the year and the monies expended in extracting, mining, and marketing the ores. The tax in that case was assessed against a corporation owning and operating its own mines, and the contention of the plaintiff was that the actual value of the ore extracted after deducting all the expenses of operation and labor was not a proper basis for a method of taxation, because the company was merely occupied in converting its capital assets from one form into another. That is essentially the contention of the plaintiff in this case and, in view of the decision in *Stratton's Independence* followed by *Von Baumbach v. Sargent Land Co.* (242 U. S. 503), and *Goldfield Consolidated Mines Co. v. United States* (247 U. S. 126), the question is no longer open to discussion.

Under the revenue act of 1916 the purpose of congress was to tax the profits from mining; that is, the income derived from mining after deducting the value of the ore in place and, if owned prior to March 1, 1913, the market value as of that date. This same principle is applied in relation to other income, such as profits upon sales of land, stocks and bonds, or other personal property.

I can see no substantial difference as taxable income between income derived from royalties and that derived from the proceeds from sale of minerals taken out of the land by the owner. In the latter case the owner has not separated the mineral rights from the ownership of the land, while in the former case he has transferred those rights to the use of another subject to payment of royalties. When he mines the ore himself he separates the mineral from the land and receives as the proceeds thereof the entire sales price of the ore and, after deducting the cost of mining, transportation, and sale of the ore, he has left its value as it was taken from the ground. When he executes a lease to another of the mining rights he receives the same thing; that is, the net present value of the ore, the other expenses being paid by the lessees. In either case the net present value of the ore is subject for taxation purposes to a deduction of its value in the land, as of March 1, 1913. The methods applied by the regulations of the secretary of the treasury for arriving at this figure as the net income is not in any manner inconsistent with the provisions of the revenue act, and I am unable to agree with the contention of the plaintiff that they are arbitrary or unreasonable. Upon the facts agreed upon in the case stated, the plaintiff has not, in my opinion, set up a good cause of action.

Judgment may be entered for the defendant with costs.

Benjamin J. Hurwitz and George L. Brutman announce the formation of the firm of Hurwitz, Brutman & Co., with offices at 1140 Broadway, New York.

M. D. Bachrach & Co. announce the removal of their office to Farmers Bank building, Pittsburgh, Pennsylvania.

Billings, Prouty & Tompkins announce the removal of their Des Moines offices to 710-720 Commonwealth building.

Sternrich & Siegel announce the removal of their offices to 24 Branford place, Newark, New Jersey.

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J. M. Jordan announces the opening of an office in St. James building, Jacksonville, Florida.

J. A. Rogers announces the removal of his office to 614 Millsaps building, Jackson, Mississippi.

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