

1949

Kennecott Copper Corporation and Bingham and Garfield Railway Company v. State Tax Commission : Brief of Plaintiffs

Utah Supreme Court

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7298

Case No. 7298

IN THE
Supreme Court
OF THE
STATE OF UTAH

KENNECOTT COPPER CORPORATION, a corporation, and BINGHAM AND GARFIELD RAILWAY COMPANY, a corporation,
Plaintiffs,

vs.

STATE TAX COMMISSION

Defendant.

FILED

MAR 30 1910

BRIEF OF PLAINTIFFS

CLERK, SUPREME COURT, UTAH

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BRIEF OF PLAINTIFFS

I.

STATEMENT OF FACTS

The parties hereto have cooperated below in endeavoring to shape an inherently complicated tax record in such manner that there could be presented concisely for the determination of this court six questions of principle. The mathematical results to follow when these principles are determined may then be worked out with-

out, it is expected, subjecting the court to such details. Therefore the facts herein are stipulated in an "Agreed Record" (R. 101-113) amplified by a brief formal hearing before the Commission. (R. 39-100.)

A. As To The Parties

1. The Commission is a body politic created and existing in accordance with the Constitution of the State of Utah and authorized by law to administer Chapter 13 of Title 80 of the Utah Code, known as the Corporation Franchise Tax Act.

2 (a). Kennecott Copper Corporation is a corporation of the State of New York duly qualified to do and doing business there as well as in Utah and other states. It owns and operates the well-known Utah Copper Mine in Salt Lake County, State of Utah. Its ores from this mine are then transported to its mills at Magna and Arthur. This transportation at the time here involved was over the tracks of the Bingham and Garfield Railway Company, which is a wholly owned subsidiary. (The Utah Corporation Franchise Tax returns of that company are consolidated with Kennecott's and for all purposes herein this transportation operation will be included as part of the Utah Copper Division operations of Kennecott.)

(b). The mill concentrates of Kennecott are smelted at Garfield and other smelters in Utah and elsewhere under contract arrangements with the American Smelting and Refining Company and other smelting companies. Blister copper, the product of the smelting, is then trans-

ported by Kennecott through the service of various common carriers to refineries, all of which are outside of the State of Utah. Kennecott has no interest in any of these common carriers or in any of the smelting and refining companies.

(c). The refined product is then sold for Kennecott's account by Kennecott Sales Corporation, which is a wholly owned subsidiary and which receives an agreed commission for such services. Part of Kennecott's copper precipitates is neither smelted nor refined, but is sold by Kennecott as produced. (At all times until sale, the ores from the Utah Copper Mine remain Kennecott's despite changes due to milling, smelting and refining.)

(d). In the course of Kennecott's operations it engages the service of and pays a substantial number of employees in Utah and in the other states in which it is engaged in business. Kennecott purchases great quantities of equipment, materials and supplies both within and outside the State of Utah for necessary use and consumption in the course of its operations. (R. 101-3; Stip. par. I.)

B. As To The Deficiency Assessment.

1. Kennecott and the Commission were once before engaged in controversy with respect to the two main issues here, namely, the method of allocating a proper proportion of Kennecott's income to the State of Utah, and the method of computing the deduction to be allowed for depletion of its mining properties under the Corporation Franchise Tax Act. The taxable years involved were

1935 to 1941 inclusive. While this controversy was pending in the Supreme Court of the State of Utah, Case No. 6324, a mutually satisfactory settlement was agreed upon and by stipulation the proceedings were dismissed under date of May 27, 1942.

2. Under the terms of this settlement certain principles for computing Kennecott's franchise tax liability were mutually agreed upon and applied to each of the years 1935 to 1941 inclusive. The corporation franchise tax returns filed by Kennecott for the calendar years 1942, 1943 and 1944 were likewise prepared and filed in exact conformance with such principles; and in accordance therewith the tax was computed, levied and paid for each such year and for the taxable year 1942 in the sum of \$174,100.54.

3. Notwithstanding the foregoing settlement and the further fact that there were no changes in the personnel of the Commission, by letter dated March 10, 1945 the Commission proposed adjustments in the tax and assessed a deficiency or additional tax for the year 1942 in the sum of \$232,722.66. Kennecott objected to said deficiency by petition for redetermination timely filed, claiming a refund of the tax paid. (R. 103-4; Stip. par. II.)

C. Kennecott's Two Requests

Among other matters, the May, 1942 agreement involved the following:

(a). The taxpayer was to file, not for its entire operations, but on the basis of its Utah Copper Division

income alone; and it was to allocate to Utah a proportion of that income on the basis of certain variable but agreed factors. (T. 109-10; Stip. par. IV.)

(b). In computing the allowance for depletion, federal taxes were not first deducted. (T. 108-9; Stip. par. III (B).)

(c). Finally, in computing the depletion allowance, all Utah Mines Division net income resulting from production of metals was treated as "net income from the property." (R. 105-8; Stip. par. III (A).)

(Parenthetically it may here be noted that the principles under this agreement were a logical and reasonable development of the transition of the old Utah Copper Company into the Kennecott Copper Corporation with its manifold operations in addition to those in Utah. Kennecott does not contend that the agreement was legally binding on the Commission as to the returns subsequent to 1941.)

Subsequently the Commission chose, by its deficiency assessment made herein, to depart from the principles of the May 1942 agreement; whereupon Kennecott in turn, in connection with its petition for redetermination and the hearing thereon, contended *that it, too, had such a right* and made the following two requests or contentions:

First: That Utah's statutes require in the absence of agreement or a determination under subsection 8 of Section 80-13-21, that the tax be based upon a return reporting the corporation's over-all operations, and then

invoking the statutory allocation formula to determine the taxable Utah income. (R. 110; Stip. par. IV (3).) Since agreement seemed no longer possible in view of the Commission's change of attitude, on January 19, 1948 Kennecott filed its Amended Return on the corporate basis as required by Section 80-13-21 (1-7). (R. 110, 228-34.)

Second: That it be permitted to change to the Utah cost-or-value method of determining depletion (Section 80-13-9 (a)), or in the alternative preferably to the federal percentage method, since the state percentage method as then interpreted and applied by the Commission resulted in a denial of the required reasonable allowance for depletion. (R. 105; Stip. par. III.) The reasons given for this request were detailed in the testimony at the formal hearing and will be summarized hereafter in connection with the argument on this point.

Kennecott also raised other points now moot because conceded by the Commission, attacked the Franchise Act as the Commission would here apply it as unconstitutional, and objected to the inclusion of federal subsidies as gross income. (R. 131-147.)

D. The Commission's Decision

The Commission's decision is silent with respect to some of these matters, but it is not in dispute that by its decision and the accompanying schedules (R. 16-36):

First: The agreement of May, 1942 *was still invoked*

to the extent that the tax was still computed on the agreement basis, and not on the basis of Kennecott's amended return covering its entire operations and then allocating income to Utah.

Second: The agreement of May, 1942 *was not followed* in at least three respects:

(a). An allocation of total income to "mining" has now been made by a Commission-devised self-proving formula, thus eliminating such excluded part of the total income from the property in computing depletion. (Ex. 4, R. 226.)

(b). In computing depletion federal taxes have now first been deducted.

(c). While treating the Utah Copper Division as a separate tax unit for some purposes, the Commission on the other hand now uses Kennecott's entire operations in other respects, such as for the allocation of federal taxes to Utah.

Third: The position of the plaintiff that if the Commission were to depart from the May, 1942 agreement, Kennecott, too, would be freed therefrom, and its two requests above outlined would therefore be proper, *was completely ignored.*

E. Payment and Review

Within the time allowed by law plaintiff deposited with the defendant the amount found by it to be due, and applied for and obtained from this court the statutory writ of review. (R. 3-14.)

II.

STATEMENT OF ERRORS

1. The Tax Commission erred in refusing to follow the Utah Corporation Franchise Tax Act (§80-13-21) which in the case of a taxpayer doing business in several states requires that the tax shall be based upon a return including the company's operations in those states and then allocating to Utah its proportion of that total income in accordance with the statutory formula.

2. The State Tax Commission erred in that it has failed to allow the taxpayer the required reasonable allowance for depletion.

3. The Commission has misinterpreted the Utah statutes establishing the percentage formula for determining depletion.

4. The Tax Commission erred in that it has discriminated against this taxpayer and is attempting to take its property without due process of law in violation of the Fourteenth Amendment of the Federal Constitution, and Sections 7 and 24, Article I, of the Constitution of the State of Utah.

5. The Tax Commission erred in including in the tax base subsidies paid to plaintiff by the Federal Government.

III.

ARGUMENT

1. The Tax Commission erred in refusing to follow the Utah Corporation Franchise Tax Act (§80-13-21) which

in the case of a taxpayer doing business in several states requires that the tax shall be based upon a return including the company's operations in those states and then allocating to Utah its proportion of that total income in accordance with the statutory formula.

This question is the familiar one of how a fair proportion of the income of the multi-state corporation shall be assigned or allocated for tax purposes to any particular state. Utah has met the question with the statutory mandate of § 80-13-21 which requires reporting of the taxpayer's total income, and then after segregating and providing for the treatment of rents, interest, dividends and capital gains, provides:

(6) If the bank or other corporation carries on any business outside this state, the said remainder may be divided into three equal parts:

(a) Of one third, such portion shall be attributed to business carried on with this state as shall be found by multiplying said third by a fraction whose numerator is the value of the corporation's tangible property situated within this state and whose denominator is the value of all the corporation's tangible property wherever situated.

(b) Of another third, such portion shall be attributed to business carried on within this state as shall be found by multiplying said third by a fraction whose numerator is the total amount expended by the corporation for wages, salaries, commissions or other compensation to its employees and assignable to this state and whose denominator is the total expenditures of the corporation for wages, salaries, commissions or other compensation to all of its employees.

(c) Of the remaining third, such portion shall be attributed to business carried on within this state as shall be found by multiplying said third by a fraction whose numerator is the amount of the corporation's gross receipts from business assignable to this state, and whose denominator is the amount of the corporation's gross receipts from all its business.

Subsection (8) then provides:

(8) If in the judgment of the tax commission the application of the foregoing rules does not allocate to this state the proportion of net income fairly and equitably attributable to this state, it may with such information as it may be able to obtain make such allocation as is fairly calculated to assign to this state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation.

As heretofore noted, the taxpayer and the Commission through 1941 by agreement had invoked an alternative method to the standard three-part "Massachusetts formula." Now, can the Commission ex-parte change those agreed principles and without further ado substitute its own new allocation method; or is not such action arbitrary, capricious and contrary to law unless and until subsection (8) is properly invoked?

The Commission once before tried just this, and in 1939 was told by this court that the legislature intended the Commission to depart from the formula only whenever the application of its provisions does not allocate to the state the business fairly attributable to it. California

Packing Corporation v. State Tax Commission, 97 Utah 367, 93 P. 2d 463.

Amplifying this statement, Justices Wolfe and McDonough noted:

* * * In determining the "portion of net income assignable to business done *within* this state" the commission "may" use the rules set out in the main opinion. This does not mean that the Commission may ignore the rules and choose its own. "May" has the meaning of "should," i.e., should follow the rules unless the rules fail to accomplish the overarching purpose as revealed by subsection (8). It is only in case an application of the rules as laid down fails to "allocate to this state the proportion of net income fairly and equitably attributable to this state" (subsection 8), or, on the other hand, where the rules would subject the taxpayer to so-called double taxation that the Commission may depart from them. This conclusion is fortified by the fact that the word "may" is used, together with the fact that the entire purpose of the rule is to arrive at a figure "fairly calculated to assign to this state the portion of the net income reasonably attributable to the business done within the state and to avoid subjecting the taxpayer to double taxation." * * * (p. 380)

Also:

* * * If a corporation had much property here as compared to its total property, but did little business here, it would on the first third of its total net income from sales, under subsection (6) (a), pay a disproportionate tax, but this might be compensated for under subsection (6) (c), depending on how subsection (6) (e) (1st) is interpreted. Usually the proportions of its

total wages and salaries attributable to Utah, calculated under subsection (6) (b), related to the total wages and salaries paid everywhere would represent a fair proportion of net income allocable to Utah, compared to total net income from all sales. And frequently the inequities which might ensue from the use of just one of the fractions defined by subsection (6) (a), (b) and (c), would be compensated by the use of the three fractions each based on a third of the total net income (excluding that set out in subsections (3) and (4). But here and there by the use of all these fractions a marked inequity might still remain either against the state or against the taxpayer, in which case subsection (8) comes into play. (p. 384.)

In that case in applying the law the court held that the taxpayer was "the usual and ordinary manufacturing company and there is shown no reason for departing from the regular method of computation to determine the amount of its franchise tax." So, here, the taxpayer is the usual and ordinary mining company; it has property in Utah and elsewhere; has employees here and elsewhere; and makes sales here and elsewhere.

The record is silent as to why the Commission ignored Kennecott's return, which after this controversy, arose was based upon the statutory formula. It is apparent that the formula gives a less favorable result in total tax dollars due insofar as the State of Utah is concerned; but this court in its opinions has never sanctioned this end as justification for departure from legislative mandate. We would venture that the individual members of the Commission have never even looked at Exhibit 1 (R. 219-223), which was explained by the witness Par-

sons at page 51 of the record. On cross examination the Commission's counsel fluffed off the matter by suggesting that Kennecott had not first obtained "permission to change"; and Mr. Parsons admitted that he knew of no such request. (R. 55) However, to the extent such a request was necessary (we believe it not) counsel for plaintiff then made it clear that Kennecott did so submit such a request to the Commission. (R. 55) Furthermore this fact was apparent to any who had bothered to read Kennecott's letter of January 19, 1948 which accompanied the filing with the Commission of the amended return based upon the statutory formula. (Augmented Record, pp. 228-34.)

But without further ado the statute and return pursuant thereto were ignored by the Commission, which apparently by its decision in the main merely rubber-stamped the ingenious staff attempts designed to gain more revenue. In doing this the Commission acted regardless of the fact that the staff report disregarded prior commitments by the Commission, its own administrative practice over the years, and the statutes of the State of Utah as construed by this court.

2. The State Tax Commission erred in that it has failed to allow the taxpayer the required reasonable allowance for depletion.

a. Legislative History of Depletion.

An elementary principle peculiar to operations such as mining is that ore in place is a wasting asset. Like money in the bank, there is only so much; and when withdrawn pro tanto it is gone. Hence returns from mining

are "income" only to the extent that excluded from the gross is a proper allowance for depletion, and hence under both state and federal statutes based upon income there is afforded a deduction for depletion. 27 Am. Jur., "Income Taxes," §§ 122-125.

In *New Park Mining Company, et al v. State Tax Commission*, 196 P. 2d 485, this court said:

"* * * The theory upon which wasting assets corporations, such as mining companies, are allowed a deduction for depletion, is that the corporation franchise tax is a tax on income or upon the increment produced by capital, and not upon the capital itself. Hence, wasting assets corporations are allowed a deduction for depletion on the theory that the taxpayer thus recoups its capital investment. * * *"

The statutory wording requires the deduction of "a reasonable allowance for depletion *** *according to the peculiar conditions in each case*; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the tax commission." (§ 80-13-8(8), Utah Code Annotated 1943.)

(Parenthetically, it should here be noted that the Commission contends in effect that these words in the main are meaningless, since the taxpayer can utilize but two possible methods of depletion computation.)

This principle being clear, its administration becomes complicated only in the determination of what is the proper base for depletion "in each case." If excessive, the operator will not be paying his full income tax;

if deficient, the taxing authority will be attempting improperly to collect taxes based other than on income. It should be noted that in contrast with the Federal Government, the State Tax Commission has made no general rules and regulations covering depletion. (R. 104)

At first Congress established as the base for computing depletion the value of the particular mine (or its cost where that exceeded value) as of the effective date of the income tax laws, or its cost (today discovery value) at the time of acquisition if such occurred subsequent thereto. This method was likewise adopted by the Utah Legislature in 1931 (§ 80-13-8 (9a)), and is still the method prescribed by both state and federal governments for determining capital losses or gains in the event of sale of the mining property. (§§ 80-13-8 (9a), 80-13-14; Witness Earl, R. 59-60, 71-2.)

But mining ventures are both speculative and their value is often extremely difficult to determine as of any given date such as January 1, 1931. (R. 218) So Congress, after extensive studies of the problem, devised an alternative second method—15% of the gross proceeds, but not to exceed 50% of the net; and presently the taxpayer is permitted to make a choice each year of either method. (R. 73-4) This percentage method is not just an arbitrary allowance, but was adopted by Congress as fair to both the Government and the taxpayer. Based upon extensive studies and hearings, the precise percentage adopted was directly related to typical actually ascertained values. (R. 73-4) These studies indicated that the metal mining industry received in depletion allowances based upon cost-or-value an average deduction equiva-

lent to about 17% of their gross sales, reported the Joint Congressional Committee on Internal Revenue Taxation, p. 68, Vol. I, Part 8, submitted to Congress September 19, 1929. The Committee therefore recommended:

“From the study of this subject it is believed that 15 per cent of the gross sales value with a 50 per cent limitation to net income, would be a reasonable rate to allow the metal-mining industry for the future. This reduction by 2 per cent of the actual figures shown in the summary is thought advisable to offset the continuing effect of the percentage depletion method.

“The 15 per cent depletion allowance on gross sales is equivalent to a theoretical deduction of 30 per cent on net income. In actual operations the 30 per cent on net may vary 15 per cent above or below this figure, depending on the profits made by the particular operation.”

As the United States was amending its laws to carry into effect these committee recommendations, Utah in 1931 was adopting its own state corporation franchise tax as the result of the Professor Lutz tax studies under the Dern administration. A percentage method was likewise included as an alternative to value by § 80-13-8 (9) (b), but was set at 33 1-3 per cent of the “net income from the property *** computed without allowance for depletion.” After once making an election of method, however, the taxpayer cannot subsequently change without the Tax Commission’s consent.

b. History in Kennecott’s Case.

Kennecott (we include its predecessor) in 1931 made the election required by the new Utah statute. It accepted

the percentage method which it has consistently followed until the instant controversy. (R. 104) When in 1932 Kennecott, as well as other Utah mines, elected to invoke the state percentage method, it is important to note that the Tax Commission's initial return forms permitted, and those concerned invariably interpreted the statute to provide for: (1) no allocation of income from the mining property to "mining"; and (2), no prior deduction of federal taxes. (R. 106, 62). Kennecott, as well as others, filed its returns on this basis and these returns were accepted by the Commission from 1931 and for many years subsequent thereto. (R. 108)

In 1943, however, when the federal tax had become a most substantial factor, the Commission reviewed its practice; determined that the terms of the statutes required federal taxes to be first deducted before computing depletion if the percentage method were to be invoked; amended its return forms to so provide (Stip. III (B), R. 108); and successfully sustained this position in 1948 in the New Park Mining Company et al. cases supra. (R. 109) The court in that opinion, however, noted that the taxpayers there had elected to compute depletion under the percentage method; and the brief of the Commission in those cases constantly reiterated that the plaintiffs had not sought permission to change to a method other than Utah's percentage formula. In this connection, on March 14, 1944 the Commission had written:

"Please be advised that the Tax Commission has denied the request of the Utah Mining Congress for a change in the method of comput-

ing depletion. The Commission feels that the law makes it mandatory to deduct federal taxes before computing depletion.

“However, the Commission would be very sympathetic to a request for a change from the percentage depletion method to the cost method in determining depletion.”

(Ex. 5; R. 227.)

In the case now before the court Kennecott sought to make just such a change. (Ex. 3; R. 225.) But the effect of the decision was to deny that request. No reason is assigned for this action, which plaintiff attacks as arbitrary, capricious and contrary to law.

This request was in the nature of a third choice or preference, since the taxpayer primarily requested and still suggests as the fairest and most practical method the use of the Federal percentage method, to be available of course to all mines. Mr. Earl described the history and advantages in detail of that method and recommended that it be followed by the Commission. (R. 77) But the Commission apparently is of the opinion that Mr. Earl's remarks and Kennecott's request in this respect should be addressed to the legislature; i.e., in Utah, depletion under the law as it stands must be based upon one of only two alternatives. (R. 87)

Thus, also, the point is here presented as to whether or not this restrictive construction is correct. If it is, the words “according to the peculiar conditions in each case” are useless, as also is the standard of “a reasonable allowance” applied to the facts of this case.

The defendant by its decision reduced still further the proposed allowance of \$6,455,813.78 and determined that the allowance for depletion in this case should be \$6,089,670.26 (Schedule 8, R. 27), the gross Utah Copper Division income for that year being \$85,513,885.12. (Schedule 11, R. 31.) This figure is roughly 50 per cent of the allowance computed under any of the following recognized methods for determining a "reasonable allowance":

No. 1—Federal value method.....	\$12,438,135.57
No. 2—Federal percentage method..	\$10,650,822.81
No. 3—Utah value method.....	\$14,007,442.00
No. 4—Utah percentage method (before Commission's changes in interpretation)..	\$12,822,347.09
(Utah as allowed.....)	\$6,089,670.26)

(Ex. 3; R. 255.)

The witness Geo. C. Earl, plaintiff's Chief Engineer, is a man of extensive training and practical experience. He is intimately familiar with mining properties and particularly the mine in question, and an expert in the field of mine valuation. (R. 57, et seq.) Neither his qualifications nor the engineering determinations of value (or for that matter the percentage calculations) are in dispute. He expressed the opinion that any of the above four methods applied to the peculiar circumstances of this case would afford a reasonable allowance for depletion within the permissive limits of administrative judgment (R. 74); that a variation in the application of

these methods of from ten to fourteen million dollars was within the limits of judgment (R. 75); but that the diminution of the depletion allowance to the six million dollar figure used by the Commission, or less than fifty per cent, was "wholly unreasonable" and had "absolutely no relationship" to the actual operations and a fair allowance. (R. 76.)

Q. Now, Mr. Earl, do you recognize that a variation between some of these methods from Ten Million to Fourteen Million is within the limitations of judgment? This is correct, isn't it?

A. Yes, Sir.

Q. But with the diminution of that allowance to Six Million or less than 50% is, in your opinion, unreasonable?

A. Wholly unreasonable.

Q. And has no relationship to the fact of the actual operation out there as you know it to be?

A. It has absolutely no relationship.

(Tr. 37-8.)

Plaintiff's position accordingly is that this record shows an arbitrary and capricious attitude on the part of the Commission, resulting in denial to plaintiff of the required statutory deduction of a reasonable allowance for depletion. The commission should have granted the request of Kennecott to compute the allowance either and preferably on the federal percentage basis, or on the Utah value-of-January 1, 1931 method under the circumstances. It is, we submit, evident that the Commission's

staff's objective was to apply mathematics and to interpret the law to produce the lowest possible result in dollars assignable to this deduction, rather than to allow a reasonable amount. (R. 92)

(MR ALLISON) :

A. I don't feel in a position to express an opinion as to the reasonableness of this or any other depletion allowance. In our determination we have attempted to apply the statutory requirements for the depletion allowance, and we haven't, as Auditors, concerned ourselves with the reasonableness of the result obtained.

As will be noted from the rather brief record herein, the answer to these charges is largely silence. However, there did occur staff attempts to justify their action in that it was shown that from 1931 through 1941 the Commission had allowed \$52,240,744.01 in depletion (R. 94) on the taxpayer's own 1931 base of but \$11,419,540.00. (R. 83, 95) The latter was a hearsay figure at the time it was first utilized, confusing Commissioner Hammond, who said (R. 84): "How can you say that for one year the six million dollar charge for depletion is unreasonable when that is more than half the amount of the fair value of the property as reported by the Company****?"

Mr. Earl replied (R. 84-5) :

The figure to which you refer, Mr. Hammond, I am not at all familiar with it. I do not know the basis upon which it was reported, or anything else, and I cannot answer that question, but I do

know this, that the basis set out in your statute is the fair market value of that mine as of that date. There (that) would be hundreds of millions of dollars, and that is what we are concerned with on depletion, regardless of any other figures. Your statute says it shall be the fair market value of the property as of that date. Now, the rules for determining the fair market value of a mine have long been established. They have been recognized by the government, by purchasers of property, and people who have properties for sale. And the only thing about it, it is not subject to an exact determination because judgment has to enter into the factors used. Now, I say I don't know what that figure (the hearsay figure) is; I don't know the basis for reporting it. Investment and market value as of a date have no relationship whatever.

COM. HAMMOND: It just occurred to me it was necessary to have some explanation of that great discrepancy in view of the fact that I think we generally agree that the purpose of allowing a deduction from a gross in arriving at the net income of a mine is to look for the return of capital, and that here, this report seems to have two figures; One of them Eleven Million Dollars plus as a fair value of the mine, and another figure, Eight Million Dollars plus as the book value of the mine. Now, those figures as I understand it haven't yet been presented here, and I don't know just how sound the basis is upon which I am making that inquiry, but the figures seem to

be so far apart it seems to me you could make some explanation that would in some way justify your conclusions that the Six Million Dollar figure wasn't reasonable.

* * * * *

The next day (reporter not present) it developed that the figure in doubt was based upon the net proceeds mine valuation for the depression year in question (Ex. 6, Schedule "H", Items (1 and 6, R. 217); and thus, as stated by Mr. Earl, it was without relationship to the different statutory basis for depletion to be allowed for income tax purposes.

Here we can only speculate as to what was the true basis for the decision in this case which without explanation sustained the depletion but at a figure reduced even below that made before the hearing. It is appreciated keenly that in this instance the latitude of the Commission is extensive, and that the burden is upon Kennecott to persuade this court that the action taken was an abuse of discretion. *Chicago & N. W. R. Co. v. Commissioner of Internal Revenue*, 114 F. 2d 882.

But not only is the record barren of anything material and relevant other than Mr. Earl's undisputed testimony that the allowance was below the limits of judgment; affirmatively it is shown that the amount allowed is only about 50% of what would be "reasonable" under both of the Federal methods here applicable, the Utah cost-or-value method and the Utah percentage method as previously construed.

Further, an examination of the statutes and methods of other states reveals support for Kennecott's position. For example, the following states directly tie their depletion computation to the optional federal methods:

California—Sec. 8g, Bank & Corporation, Act of 1945

Connecticut—Sec. 419c, Supp., Conn. Gen. Statutes 1930

Idaho—Sec. 61-2407 (c-1), Idaho Code Ann. 1932

Montana—Sec. 2297 (Third), Mont. Rev. Statutes 1935

Oklahoma—Sec. 880 (g), 68 Okla. Statutes 1941

Oregon—Sec. 110-1508 (g), Oregon Comp. Laws Ann.

Vermont—Sec. 890, Vermont Public Laws 1933

Three states have accomplished the same result, since in Tennessee, Pennsylvania and Rhode Island the entire law is based upon the federal tax. And the following tie in to the federal method by regulation:

Georgia—Sec. 92-3109, Georgia Code 1933

Kansas—Sec. 79-3206 (11) Gen. Stat. Kans. 1953, Reg. 54

Louisiana—Sec. 8587.9 (m) La. Gen. Stat. 1939, Reg. 96

Maryland—Sec. 224(j-1) Ann. Code 1939, Reg. 4

Five additional states have delegated plenary regulatory powers to the administering agencies: Arizona, Minnesota, Missouri, New Mexico and North Carolina.

Eight appear to tie depletion into cost-or-value alone; two apparently do not recognize the depletion deduction; and the remaining eighteen do not appear to have a comparable tax.

Thus, we submit, we find support in the policies and practices of other states to a most substantial degree that:

a. The Utah Commission has failed to follow the legislative mandate to allow reasonable depletion in this case.

b. The Utah statutes intend to delegate to the Commission wide latitude by regulation applicable to all, to invoke *any* sound method whereby to compute that reasonable allowance. The Commission is not hamstrung between an unreasonable percentage formula, and a difficult single alternative.

c. The method—federal percentage—is reasonable, practical, simple, fair and recognized as sound.

d. In any event, Kennecott should be afforded the alternative of utilizing the Utah cost-or-value method of January 1, 1931.

Plaintiff suggests that subsections 8 and 9 of Sec. 80-13-8 are ambiguous and conflicting. Either alone would present a clear legislative policy. Together, the Commission's view would nullify subsection 8 leaving 9 alone. Plaintiff's view would give heed to the rule of construction "in pari materia" (50 Am. Jur. 342 et

seq., *Norville v. State Tax Commission*, 98 U. 170, 97 P. 2d 937.) and find the legislative intent to be to give effect to both. That is, the key criterion is a "reasonable allowance" under subsection 8; but two possible methods are then authorized as aids by subsection 9, without restricting the determination of the allowance to only those methods and thus preventing the Commission from utilizing modern improvements in computation. Either that was the legislative intent, or there has been set up a peculiar statute with less latitude than in practically every other state which has considered the problem; and as noted, subsection 8 might just as well have been omitted.

3. The Commission has misinterpreted the Utah statutes establishing the percentage formula for determining depletion.

Assuming for the purpose of argument that the defendant Commission acted within its prerogatives in denying plaintiff's request to change over to either the Utah value method or the federal percentage method; that is, that plaintiff is forced to remain within the percentage method straight jacket to which it submitted under administrative representations which turned out to be illusory. (R. 62)

We concede that under the *New Park* decision *supra* federal taxes must first be deducted in determining depletion when this method is invoked. But plaintiff submits that in making an allocation of the income from the property to various steps such as "mining," the Commission has misconstrued and therefore has violated the law.

The percentage method statute provides that the allowance for depletion shall be one-third of the net income "from the property." Plaintiff contends that all of its income from Utah Copper Division is from the property: namely, the Bingham Canyon mine.

This court noted at the end of the New Park decision that when § 80-13-8 (9b) qualified the words "net income" with the words "from the property," the legislative purpose was to prevent a wasting assets corporation from taking a deduction for depletion "from all income, from whatever source derived." It will be noted here that Schedules 7 and 12 properly excluded from the base to which the percentage was applied *all income other than from the Bingham Canyon mine.*

a. In the first place, the Commission's contention is here directly in the teeth of its own administrative interpretation of the Act from 1931 to date. It has never heretofore attempted to apply this novel accounting invention either as to Kennecott *or any other Utah mine.* (R. 106)

As noted on page 6 of the Agreed Record, the Commission's instructions with respect to depletion were not amended in this respect *until* 1943, which for the first time brought into the picture the requirement of allocating income to sources other than "mineral extraction." (R. 107)

b. Further, the federal statute which was originally the model for Utah's provisions, even as amended to define and delimit "from the property," has not been construed to require such an allocation. With respect to the

specific Kennecott properties here involved the federal counterpart has been given the same construction heretofore applied by the Utah Commission from 1916 to date. (Mr. Earl's testimony, R. 68-70.)

c. Finally, the accounting invention (Ex. 4, R. 226) is an admittedly self-proving formula. (R. 91,70)

The formula reads as follows:

$$D^2 + D \frac{(2TC + TNI)}{3} - \frac{TNI \cdot MC}{3} = 0$$

which its inventor, Mr. Allison, on page 91 of the record said was a quadratic equation which determined depletion by the particular formula "because the depletion itself allowable under the statute depends upon the amount of depletion allowable." Mr. Earl pointed out that "I was taught very early in my mathematics that a formula which defined anything in terms of itself should not be used. Now, this formula does that very thing***." (R. 70)

* * * *

It is respectfully submitted that here again is an illustration where the Commission is arrogating unto itself the power arbitrarily to create and apply mathematical formulae to the sole end that in the particular case a higher tax results. Only the Commission's accountants could conceive that when the legislature in plain words allowed depletion for the average mine operator, self-proving quadratic equations were contemplated.

In considering the words "gross income from the property" as used in the Federal statute, the United

States Supreme Court has said that "the term should be taken in its natural sense." Further: "Gross income from time to time may be more or less than market value according to the bearing of particular contracts. *We do not think that we are at liberty to construct a theoretical gross income by recourse to the expense of production operations.*"

Helvering v. Mountain Producers Corp., 303 U. S. 276, 82 L. ed. 907, 58 S. Ct. 623.

So here the plain and natural meaning seems to treat as the "net income from the property" the amount received from the sales of copper—the taxpayer's first marketable product which came from the Utah Copper Mine. This is what has been accepted without question by both state and federal taxing agents until the present attempt. This is what the legislature of Utah must have intended when it enacted the corporation franchise tax in 1931 as applied to mining operations well known to exist here for nearly a century. Certainly if the legislature had intended to substitute a theoretical income by the operator, it would have said so.

The question may well be asked at what point should the cut-off be made in cases such as Kennecott where conceivably expansion could continue into fabrication, and possibly even branch enterprises for the actual utilization of the product such as for copper roofs in homes. These indeed might entail *income* from activities other than "mining" in its "natural sense." We would submit that the natural cut-off point should be at the end of the *first normally marketable product*; and indeed

this is the rule of Section 114 of the Federal Internal Revenue Code, where by statute Congress amended the old law comparable to Utah's now to define "gross income from the property" as follows:

As used in this paragraph the term "gross income from the property" means the gross income from mining. The term "mining" as used herein shall be considered to include not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products.

Here as noted, the commercially marketable mineral products of Kennecott are sold when first possible in the normal course of operation—the copper after it is finally produced in marketable form by refining. (R. 102)

Further, the only Commission rule on this subject—in contrast with Federal Statute—is the 1943 change in Instruction 21 to read:

In cases where the taxpayer engaged in activities in addition to, or derives income from sources other than, mineral extraction, deductions not directly attributable to any particular activity or source of income shall be fairly allocated.

As stipulated and undisputed, such profits or income attributable to smelting, transportation, refining and selling the first marketable product have already been excluded by payments to the several companies performing those services. (R. 66-70, 102.) This practice has continued since long before Utah had an income tax, but

no one until this case had doubted that Kennecott's income from its sales of copper and other mineral products when finally sold in marketable form was income from its Utah Copper Mine.

* * * * *

In concluding the argument with respect to the depletion allowance, we summarize:

The Commission has violated the statutory mandate which requires the allowance of a reasonable deduction for depletion under the facts of Kennecott's particular operations, because:

First: a. The Commission acted arbitrarily and capriciously in summarily refusing Kennecott's request to depart from the state percentage method formula which it had originally accepted on the basis of two interpretations no longer existent; the first, the Commission's attempted change of the statute to base the percentage allowance on income from "mineral extraction" rather from the wording "from the property"; and the second, the unprecedented federal taxes which under this court's interpretation must first be deducted before computing depletion.

b. The Commission should have granted plaintiff's request under these circumstances to transfer either to the Utah cost-or-value method; or preferably to the federal percentage method for computing depletion, or at least some other method which would have afforded a reasonable allowance under the circumstances of this case.

Second: In any event, the Commission has acted arbitrarily, capriciously and beyond its authority by misconstruing the law to permit allocating a portion of Kennecott's net income from its Utah mining property to other processes on the basis of a self-proving formula.

4. The Tax Commission erred in that it has discriminated against this taxpayer and is attempting to take its property without due process of law in violation of the Fourteenth Amendment of the Federal Constitution, and Sections 7 and 24, Article I, of the Constitution of the State of Utah.

This point is directed to the action taken by the Commission outlined heretofore insofar as such action violates plaintiff's constitutional rights. Plaintiff with all others is to be afforded the equal protection of Utah's laws without discrimination and in accordance with those laws, under the well-known provisions of the state and federal Constitutions above set forth.

a. But here, of all corporations engaged in business in several states including Utah, Kennecott is to be saddled with the Commission's special rules for allocating income to this state for tax purposes. The record is silent as to the basis for such special treatment unless it is that the tax burden will be greater to the taxpayer.

b. And too, plaintiff alone is to be given the benefit of Exhibit 4—the self-proving quadratic equation—even though the result, as Inventor Allison candidly admitted, may or may not have any relationship to a “reasonable” allowance for depletion. (R. 92) No attempt—at least as of this date—has been made by the defendant to allocate

for depletion purposes any other mine's income "from the property" to such post-mine processes. (R. 106)

5. The Tax Commission erred in including in the tax base subsidies paid to plaintiff by the Federal Government.

During 1942 the Federal Government paid to Kennecott stipulated sums in connection with its Utah operations as subsidies under the authority of 50 U. S. C. A. App. 901-2. The Commission has included these amounts as part of Kennecott's "gross income" for Utah Corporation Franchise Tax purposes. (R. 112; Stip. par. VI.)

Plaintiff concedes that Utah's corporation franchise tax statutes are broad enough to include such subsidies as "gross income," in contrast with the more limited provisions of other Utah Tax statutes.

Overruling the United States District Court, the Tenth Circuit Court of Appeals has held that the Federal Government did not intend to exclude these subsidies from this type of state taxation. (Kennecott Copper Corporation et al. v. Salt Lake County, 163 F. 2d 484.) Admittedly it will therefore be difficult for this court to do anything other than to follow the Circuit Court. Thus while plaintiff submits the opinion of the Circuit Court is erroneous, extended argument now, except to preserve the point, would seem to serve no useful purpose.

CONCLUSION

In conclusion, § 80-13-47 provides that there shall be a plenary review by this court of the Commission's

actions based upon the record below, in effect as would be in an equity case.

A judge trying such a cause would of course have to make findings supported by competent evidence. (§ 104-26-2, 3) No jury would be permitted to ignore or disregard without cause competent and material evidence; (Leavitt v. Thurston, 33 U. 135, 143 P. 140; Karren v. Bair, U. 334, 225 P. 1094); and the action of administrative tribunals must be consistent with, and even discretion must be exercised "in accordance with established principles of justice and not arbitrarily or capriciously, fraudulently, and without factual basis." (42 Am. Jur. 380, Sec. 69.)

Plaintiff respectfully submits that based on the record below and in accordance with these principles, the decision of the defendant State Tax Commission should be set aside and the cause remanded with the following directions:

1. That plaintiff's amended return, filed in accordance with § 80-13-21, should be treated as the basis for computing the corporation franchise tax subject of course to the usual administrative review of its contents.

2. That there should be excluded from gross income the federal subsidies paid to Kennecott.

3. That in computing the required reasonable allowance for depletion:

- a. The Commission under Utah's law may give consideration to the advisability of permitting plaintiff and all other mine operators to invoke the federal per-

centage method for determining a “reasonable allowance,” subject to the Commission’s rules and regulations.

b. In the alternative, the plaintiff be afforded an election between the Utah percentage method (§ 80-13-8 (9b)) as construed by this court in *New Park Mining Co. et al v. State Tax Commission*, and the cost-or-value method of § 80-13-8 (9a).

c. That the Utah percentage method as applied to both Kennecott and other mine operators is to be construed to require as “net income from the property” the inclusion of the net amounts actually received from the operator from the sale of the mine products in their first normally marketable form, excluding income from sources other than those connected in the full and natural sense with the mining venture.

Respectfully submitted,

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