

1950

Kennecott Copper Corporation and Bingham and
Garfield Railway Company v. State Tax
Commission : Plaintiffs' Reply to Brief of
Defendant in Answer to Plaintiffs' Petition for
Rehearing

Utah Supreme Court

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Recommended Citation

Reply to Response to Petition for Rehearing, *Kennecott Copper Corp. v. State Tax Comm.*, No. 7298 (Utah Supreme Court, 1950).
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**IN THE SUPREME COURT
of the
STATE OF UTAH**

**KENNECOTT COPPER COR-
PORATION, a corporation, and
BINGHAM AND GARFIELD
RAILWAY COMPANY, a cor-
poration,**

Plaintiffs,

vs.

STATE TAX COMMISSION,

Defendant.

**PLAINTIFFS' REPLY TO DEFENDANT'S BRIEF IN
ANSWER TO PLAINTIFFS' PETITION FOR
REHEARING**

FILED

DEC 20 1950

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CALVIN A. BEHLE,**

Attorneys for Plaintiffs.

Clerk, Supreme Court, Utah

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turbed by the opinion of the Court on the issues so far presented to the Court for determination, we venture to suggest that Kennecott's worst fears are still to be realized."

That prophecy is delivered with shocking presumption, assurance and effrontery. "Our worst fears" were those that the Court simply did not understand what this case was about. Now we are confidently assured by counsel that we must not expect the Court to understand what this case is about, which naturally defendant concludes will inure to defendant's benefit and that there is nothing we can do about it.

We have not despaired of this Court's purpose to be advised of what this case is about, notwithstanding this defendant's very consistent effort to confuse. Counsel strut naively, but if we are to be led to the slaughter, we prefer, and we think it our right, to have our case presented and considered by this Court upon all issues and on a record wherein all issues shall have been raised and tried.

Counsel's conclusion to Defendant's Brief in Answer to Plaintiffs' Petition for Rehearing is nothing more than a boastful threat of what this defendant is going to do to plaintiff upon the trial of other issues not here but hereafter to be raised. The impropriety of the dissertation contained within this so-called conclusion will be apparent, but we think this case is of sufficient seriousness to warrant thorough understanding before decision. We suggest that the only course to be taken in fairness to this plaintiff, to the Court and to all others

concerned will be the recall of the opinion rendered; and after correction when the Court shall have fully considered the limited issues presently before it, the remand of the case to the defendant without encumbrance and with instructions to embrace within the proper compass of the proceeding all issues properly to be raised therein and to try the case upon those issues. Upon the record so made, a review may be had.

Even the defendant, at pages 20 and 21 of its Brief in Answer to Plaintiffs' Petition for Rehearing, has stated that it "deems it most unwise to concede the validity of any of Kennecott's various 'allocation factors' and 'accounting formulas' unless and until this Court has spoken," when "this Court will be in the position where it can see this case as a finished product in fact and figures for 1942 and all succeeding years."

The Court should be informed before decision. This case started out as a friendly suit seeking the Court's constructive opinion on issues from which it was hoped and expected by the Commission's then counsel that settlement would be reached upon others not then before the Court. This controversy has now reached the point where there is nothing friendly about it; and this Court's present opinion is being made the excuse for unprecedented demands beyond the wildest imagination of any one; and upon which this defendant boasts before this Court, not only of its purpose but of its uncontrolled power to exact from this plaintiff the very maximum of its fantastic demands—to say the least a climate not friendly to great industry, investment and development.

I. Point.

Defendant's discussion of the relation of Federal statutes to depletion calculation under the Utah Corporation Franchise Tax Act is neither factual nor forthright; again consistently it is a part of this defendant's plan to confuse.

What nonsense is this. (Defendant's Brief in Answer to Plaintiffs' Petition for Rehearing, pages 6 and 7) :

“Whether depletion should be calculated on the basis of mill concentrates, as the Commission has concluded, or refined copper, as Kennecott has contended, depends on what the Federal law provides. Both Kennecott and the Commission, in effect, have rested their cases on what the applicable Federal law provides with respect to depletion.”

Let us look at the record.

It was here stipulated that the case might be submitted to the Court on an “agreed record.” We quote from that agreed record as follows:

“1. Section 80-13-8(8) requires the Commission to allow as a deduction ‘a reasonable allowance for depletion and for depreciation of improvements, 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.’ Two methods for computation of depletion are then prescribed: (1) cost (or value), a method which Kennecott has never used (Section 80-13-9(a)); and (2) a percentage formula based upon net income, which Kennecott has consistently used (Section 80-13-9(b)).

“2. These statutes in respect to the depletion allowance have not been amended, altered or revised by the legislature since the Corporation Franchise Tax Act was first enacted. The wording is in part identical with and modeled after the federal statute.* * *

“3. No rules or regulations have been promulgated by the Commission under the foregoing Section 80-13-8(8) except as hereinafter set forth. (R. 104)

* * *

“(1) In computing ‘net income from the property’ to which the percentage of $33\frac{1}{3}$ is to be applied to compute depletion under the percentage method, at no time since the effective date of the Corporation Franchise Tax Act has (R. 105) Kennecott or any other Utah mining company deducted from gross income any profit attributable to smelting, refining, transportation and selling.* * *

“(2) The federal statute, originally the model for the Utah provisions, was amended by Congress in 1942 to provide for such an allocation, but on a basis different than that contended for by the Commission in this case. (I.R.C. §114(b)(4)(B).)

“(3) For each year beginning with the effective date of the Utah Corporation Franchise Tax Act to and including the corporation franchise tax, instructions and returns for the taxable year 1942 the tax return forms and instructions issued by the Commission in accordance with law provided as follows:

“21. DEPLETION. The amount deductible on account of depletion in Item 21 in the case of metalliferous, coal and other hydrocarbon mines, and oil and gas wells,

may be based on (1) the cost of the property with respect to which depletion is claimed, or, if the property was acquired prior to January 1, 1931, on the cost or the fair market value of the property on January 1, 1931, whichever is greater, or (2) the net income from the property during the taxable year computed without allowance for depletion, at thirty-three and one-third per cent of such net income, as the taxpayer may elect. * * * (R. 106)

“(4) For the year 1943 the Commission amended said instructions to read as follows:

* * *

“Net income from the property as a basis for the percentage limitations must be computed by deducting from gross income from the property all deduction allowed by statute in computing taxable net income (excluding any allowance for depletion) to the extent that they are applicable to the property. The requisite deductions shall include overhead and operating expenses, development costs properly charged to expense, depreciation, taxes including Federal income taxes, losses sustained, etc. In cases where the taxpayer engages 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. * * * ”. (R. 107.)

Let us now observe the sequence in which these statutory enactments occurred.

The Utah Corporation Franchise Tax Act (Laws

1931, c. 39) was passed March 12, 1931, approved March 20, 1931, effective May 12, 1931, and provided that "the first taxable year shall be the calendar year 1931 or any fiscal year ending during the calendar year 1931."

The Federal law which was in effect in 1931 was the Revenue Act of 1928 (Act. of May 29, 1928, c. 852, 45 Stat. 791-883, 26 U.S.C.A. Internal Revenue Acts 1924 to date, p. 345) and this applied to the taxable year 1928 and succeeding taxable years 1929, 1930 and 1931. It provided for a reasonable allowance for depletion, according to the peculiar conditions in each case. Percentage depletion in case of mines was not allowed. Such depletion calculated for all mines discovered prior to February 28, 1913, was permitted only on the basis of cost or fair market value as of March 1, 1913, whichever was greater. In the case of mines discovered after February 28, 1913, the basis for depletion was fair market value at date of discovery—not to exceed 50 per cent of "net income of the taxpayer (computed without allowance for depletion) from the property upon which the discovery was made."

Under the Act of 1928 Regulation 74 was issued, Article 221(h) of which provided in part that "The phrase 'Net Income of the taxpayer (computed without allowance for depletion)' means the gross income from the sale of all mineral products from the discovery ore body less the deductions in respect to the property upon which the discovery is made, including overhead and operating expenses, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. If the

mineral products are not sold as raw material but are manufactured or converted into a refined product, the gross income shall be assumed to be equivalent to the market or field price of the raw material before conversion * * * ”.

The “market or field price of the raw material before conversion” could not exceed of course the ultimate sales price of the first commercially marketable product less all costs back to the raw material, the same principle applying as that applicable to mine evaluation discussed by us in Point I of Plaintiffs’ Petition for Rehearing at page 15 et seq.

The language of that part of the Revenue Act of 1932 (Act. of June 6, 1932, c. 209, 47 Stat. 169-289, 26 U.S.C.A. Internal Revenue Acts 1924 to date, p. 477 et seq) relevant to the controversy presently before this Court remained unchanged until passage on February 25, 1944 of the Revenue Act of 1943 (58 Stat. 21, 26 U.S.C.A. 114(b) (4) (B)). Percentage depletion in the case of mines was allowed for the first time by the Revenue Act of 1932; the allowance was 15 per cent of the “gross income from the property,” not to “exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property.” Neither gross nor net income was defined by any Act of Congress until passage of the Revenue Act of 1943 on February 25, 1944. By Regulation 77, Article 221(g), promulgated under the Revenue Act of 1932, it was provided that cost of processes beyond concentrating were required to be deducted. No mention of profit as attrib-

utable to any processes preceding sale of the first commercially marketable product occurs in any Federal act.

The basis behind Federal percentage depletion is the one stated by Under-Secretary Paul at the time the Bureau was pressing for allocation of profits to the processes beyond concentration. At that time Mr. Paul stated that the whole purpose of the attributable profits provision in the regulations was to bring the large producer who performs processing beyond the concentrating stage on a par with the small producer who customarily sold his product to the smelter (R. 69). As Kennecott deducts from the amount received for the sale of its product the amount charged by those who perform the smelting, transportation, and refining, that charge includes the profit of those engaged in the processes beyond concentration, and those making that profit would be taxed by the several states wherein that profit was earned (R. 66).

It is of course the practice of custom smelters in purchasing ores from independent producers to charge not only the actual cost of smelting, but a profit, and, likewise, the same situation exists with respect to transportation and refining. Having arrived at the cost of these operations and having determined the amount of profit which it wishes to make in performing this work, the smelter then deducts from the market or sales price of the metals contained in the ore purchased, the total of of these costs and profits and the result is the price the smelter will pay for ore purchased.

In Kennecott's case precisely that situation exists. The only difference is that Kennecott retains ownership in the metals, which it sells or has sold for it, and from the price received it deducts the amount charged for smelting, freight and refining, which deduction includes all the profit earned through the rendition of those services. Accordingly the amount upon which depletion is calculated in Kennecott's case is on precisely the same basis as is all ore purchased by the smelter from independent producers.

The only profit earned having been once deducted, will this Court approve a second deduction as profit, which is not profit at all, of some amount arbitrarily assessed by this defendant. If so, by what authority and why? The elimination from Kennecott's net income of this second deduction, which is not profit and which is not attributable at all to Kennecott's operation, could be nothing more than an arbitrary seizure, without rhyme or reason, of a part of Kennecott's net income for no purpose whatever except the arbitrary reduction of Kennecott's depletion factor and the resulting palpable discrimination against Kennecott. As quoted on page 23 of Plaintiffs' Petition for Rehearing, where Kennecott itself has engaged in the processing of its production beyond the concentrating stage, the Federal government has allocated profit to those operations, but otherwise it certainly has not, and this is exactly in line with the Federal regulations and the practice of the Internal Revenue Department.

The effort of this defendant to assign profit to these processes where they have not been performed by the taxpayer and where the only profit earned has already once been deducted as part of the cost, is contrary to the practice of the Internal Revenue Department itself and is without precedent or authority whatsoever. We know of no plainer case of administrative assumption of legislative powers. Now by its own statements defendant is caught red-handed, invoking a non-existent law in an attempt to confuse this Court into endorsement of the changes defendant proposes without legislative sanction and contrary to administrative practice.

It must be thoroughly understood by this defendant, and now evident to this Court, that the Utah Corporation Franchise Tax Act, passed March 12, 1931, could not have been "modeled" after any Act of Congress other than the Revenue Act of 1928. One will search that Act and all practices thereunder in vain for even the remotest thought of allocating to smelting, transportation, refining and sales, or any of those services, any item of profit. Congress attempted nothing of that kind by the Revenue Act of 1928, nor did the Utah legislature have even remotely in mind any such fantastic effort. The Utah Act passed March 12, 1931, could not have been "modeled" after an Act of Congress not then in existence.

II. Point.

This defendant proceeds further in the course of its plan to confuse.

On page 4 of Defendant's Brief in Answer to Plaintiffs' Petition for Rehearing it is stated that Kennecott did certain things in connection with the production of copper from its property at Bingham. It is important that it be clearly understood that, of the processes enumerated, Kennecott mined and milled the ore. The smelting, transportation and refining was done by others for Kennecott; and the selling was by a subsidiary of Kennecott, all profit by reason of sales being meticulously eliminated. The entire profit of the operation is realized only when the copper is sold. Kennecott does not engage in fabricating or manufacturing. Part of its production after sale as copper, is fabricated or manufactured into other forms by its subsidiaries, Kennecott Wire and Cable and Chase Copper and Brass. All copper is sold either in the open market or at the going market price. As none of the product is sold before the copper is refined, any computation of amount received must of necessity start with the refined product. Not only is that true in our immediate problem, but as well and equally of necessity in computing the value of mines for any purpose. The sales price for metal production must be the point from which all calculations are made whereby to arrive at value.

We question that even this defendant can understand that paragraph in the middle of page 13 of its

brief wherein it is stated that defendant's formula works in Kennecott's favor by attributing too much net income to the activities defendant chooses to denominate "post-mining." The reverse of course must be true on defendant's theory, for if upon that theory too much profit were attributed to those activities the depletion allowable to Kennecott would be correspondingly reduced.

On the bottom of page 14 and top of page 15 of defendant's brief reference is made to iron ore. The Federal regulations provide specifically that where there is such a field price that will be the basis for calculating the amount of depletion allowable instead of taking the sale of the finished product and deducting the costs or processes beyond the concentrating stage. Iron ore in that industry is the first commercially marketable product.

We must observe that the allocation factor of 66.926 referred to by defendant on page 20 of its Answer to Plaintiffs' Petition for Rehearing as "Kennecott's 'allocation factor' ", is no more Kennecott's factor than it is that of this defendant. That was the allocation factor to which defendant and this plaintiff agreed as part of their settlement of May 27, 1942, and as such applied the same in the franchise tax computations for the years 1934 to 1941, both inclusive. In harmony with that settlement the allocation factor was used by Kennecott for the purpose of its franchise tax returns for each the years 1942 et seq. Repudiating the principles adopted by the settlement of May 27, 1942, this defendant by letter of March 10, 1945 embarked upon a course of

redetermination, of which the present controversy is an incident. (R. 103).

On the bottom of page 15 some high sounding language is used. The legislature has not been generous to any extent. Depletion is an inescapable loss and must be deducted before profit can be determined. The amount of investment has nothing whatever to do with the total value subject to depletion; it is value as of January 1, 1931 which is subject to depletion.

This plaintiff seeks no special treatment, but it does demand that the same rules be applied to it as are applied to other mining companies. This plaintiff is entitled to and it must receive the same consideration accorded by law to those who sell their ores direct to the smelter.

Respectfully submitted,

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