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Correspondence: Accounting Principles; Percentage Depletion

Frederick B. Andrews

H. B. Fernald

Correspondence

ACCOUNTING PRINCIPLES

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: I have read with great interest Mr. George O. May's comments in the December issue of THE JOURNAL OF ACCOUNTANCY on the sense in which the word "principle" is used in the so-called standard form of accountants' certificates. Particularly interesting is his statement in this connection that he regards accounting as being essentially pragmatic.

Is it not clear, as Mr. Byrne points out at the bottom of page 367, that the use of the term "accepted accounting principles" implies, first, that there are accounting principles, second, that they are known to the certifying accountant, and third, that their recognition and acceptance by accountants have been so nearly universal as to be in effect authoritative? If so, how can we escape his conclusion that accountants stultify themselves by using this form of certificate unless such recognition and acceptance are veritable facts?

If we are not clear as to the very meaning intended to be attached to the word "principle," as used in the phrase which Mr. Byrne italicizes in his quotation from the certificate, is not the whole phrase of doubtful meaning and mere surplusage, adding nothing to the certifying accountant's own opinion that the statements "fairly present" what they present? This seems the more clear since the reference to "accepted" principles is hardly tenable at present if extended beyond his own acceptance.

It can scarcely be debated that if accountants' certificates are to be "not misleading" they must be unequivocal. If the use of the term "principles of accounting" in the certificate is to be defended against criticism by pointing out that, although the criticized meaning of the term is proper, there is also an equally proper meaning for it against which the criticism cannot lie, might not one wonder whether, in regarding accounting as essentially pragmatic, it is viewed as "officious, meddling, opinionated, dogmatic" or as "dealing with practical values or consequences"? The answer here of course lies in the context, but the certificate contains no contextual guide by which the reader is enabled to choose between two equivocal meanings.

In the interest of clarity, should not the term "accepted principles of accounting" be omitted from accountants' certificates until we accomplish, first, an agreement as to the intended meaning of the word "principle" and, second, an acceptance so general and so manifest as to be indisputable?

Yours truly,

Chicago, Ill. FREDERICK B. ANDREWS

PERCENTAGE DEPLETION

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: Mr. George J. Strong's letter of October 15 criticizes the editorial on percentage depletion which appeared in the October issue of THE JOURNAL, particularly because he considers "that percentage depletion allowances are merely a form of subsidy to mining interests," "a special privilege granted to those who are exploiting and gradually exhausting the natural resources of the country for private gain." At one point his letter seems to confuse percentage depletion and discovery depletion, although a reading of section 114 (b) (2) and (4) will show these are distinct and mutually exclusive provisions.

(1) The propriety of depletion allowances is admitted. Mr. Strong recognizes that percentage depletion has "the advantage of simplicity, directness, economy and ease of administration claimed," although he seems to feel this is largely lost because of the alternative provision which allows the taxpayer to claim depletion on a basis of cost.

(2) Percentage depletion has been a subject of repeated and extended consideration and investigation by Congressional committees over a series of years, with full record of open hearings which have resulted in the adoption and retention of this basis. The whole purpose of the provisions of the law relating to depletion of mines is to give to mines a reasonable allowance for depletion of their ore-bodies, and not to tax as ordinary income that which is simply a return of capital investment, or is at most a capital gain. Percentage depletion is simply a method of trying to give some fair and equitable treatment to those entitled to it.

Some mines are able to establish a reasonable depletion on the basis of cost. For other mines this is exceedingly difficult. The great majority of mines never recover an amount from operations sufficient to repay the total investment in them. For such mines and their stockholders, no real income or profits are ever realized, but the entire amount realized is merely a return of capital investment, and no part of it should be taxed as income. A few years of large operating yield does not represent true income if in the end the mine will not return enough to repay the investment.

There has never been any question that for the mining industry as a whole the total of depletion allowances will only serve to return a part of the total amount of capital invested in the industry. The mining industry certainly does not have returned to it, in depletion allowances, more than its aggregate investment. It cannot therefore be charged that the mining industry is receiving a tax benefit at the expense of other industry of the country.

Consideration must be given to the investment made by the stockholders as well as to the investment made by the corporation itself. The present stockholders have their real investment in the property, and this may be quite different from that of the corporation or of the original owners. Such stockholders have their equitable right to recognition of depletion of their investments. In this the stockholders of mining companies and their equitable rights are different from those of the stockholders of the ordinary corporation, which presumably is maintaining its assets unexhausted.

Mining is different from other industry in that it deals with a wasting asset. Other industry can replace its merchandise or raw materials and its plant and equipment, but a mine, as it proceeds with its operations, disposes of the minerals which form its asset. What a mine realizes from its operations is in whole or in part from the exhaustion of its assets. How much of its receipts may be from exhaustion of assets cannot be definitely told from year to year. The exact determination would have to await the full exhaustion of the ore-body. It would be a difficult, if not impossible, task to try under our income-tax laws to allow to each stockholder of a mining enterprise the depletion to which he might be entitled on his own particular investment basis. The best it has seemed we could do is to give some recognition of this through the allowance made to the corporation.

Percentage depletion was adopted after extended study as a fair means of granting a reasonable allowance for depletion. The mine which wishes to use the technical method of determining depletion on a basis of cost may do so. For some mines this offers the best assurance of recovery of investment. Percentage depletion does not place its limitation on the aggregate amount which may be allowed, but it does place drastic limitation on the allowance to be granted year by year. The percentage allowance is limited to certain stated percentages of the gross income, but not more than 50 per cent. of the net income. The Government is thus assured of its tax on 50 per cent. of the net proceeds from operations even though the mine owners may never recover their full investments in the property. Mines may elect either the technical basis of cost or the equitable basis of percentage depletion, and the election once made is binding. For the mine which has elected percentage depletion, the admitted simplicity, directness, economy and ease of administration of its percentage depletion deductions is in no way complicated by the fact that other mines may have their right to depletion on the basis of cost.

(3) As to Mr. Strong's reference to allowance of depletion to "those who are exploiting and gradually exhausting the natural resources of

the country for private gain," I can hardly believe that this is intended as a serious argument. Those who know the mining sections of the country understand what mining means to those sections and what it has meant in the development of the country. The mining states know that their prosperity rests, not on mineral resources which lie buried dead in the ground, but on those resources which are recovered in a form to be of current benefit to mankind. The wages of laborers, the business of the stores and supply houses, and the transportation enterprises of those sections are dependent on the recovery of these mineral resources. So, too, is the entire industrial life of the country. If mining ceased, our whole modern civilization would fall. Except for metal mining, we could have little of the comforts and conveniences of modern life, to say nothing of those things which we have come to consider necessities. If those who engage in a mining enterprise do so for private gain, this is simply the same motive which inspires those in other enterprises and it is this incentive to individual initiative which has given to us the material welfare which we have today.

I feel as earnestly as Mr. Strong does that there is relief which should be given to those whose earnings reflect the exhaustion of their life and abilities, and I believe the earned-income credit under the tax law should be much more liberal than it is, but the fact that just relief is here denied does not cause me to criticize an equitable relief provision which, as I see it, is granted to mining enterprises.

(4) Undoubtedly it is true that there are some, but relatively only a few, mining corporations that are under this law permitted to recover more in depletion than the investment that the corporations have made in the mining property. Possibly there are some cases where mining stockholders may recover more than their total investments in the property. If so, the most that can be said is that they have a capital gain from their investments. We recognize, however, that capital gains should not be subjected to the same tax as applies to ordinary income. Under our capital-gains schedule, we may have an exemption from tax up to 70 per cent. of the capital gain, whereas under percentage depletion the maximum exemption is only 50 per cent.

If I buy a piece of ordinary real estate for $100,000, hold it for ten years (during which the income simply meets the carrying charges), and then sell it for $300,000, taxable income therefrom will be recognized only to the extent of $60,000; viz., 30 per cent. of the $200,000 excess of the amount realized over the amount invested.

If I invest $100,000 in a mine and realize $300,000 from the exhaustion of its ores, under percentage depletion taxable income therefrom will be recognized to the extent of at least $150,000; viz., 50 per cent. of the entire $300,000 received.

If I held such real estate for only two years and then sold it as above indicated, taxable income would be recognized only to the extent of $120,000; viz., 60 per cent. of $200,000. The same is of course true if I bought a mine for $100,000, held it two years and then sold it for $300,000. In such case the taxable income would be only $120,000 as compared with at least $150,000 to be recognized as taxable under percentage depletion.

On the other hand, if I buy real estate for $100,000 and realize only $80,000 from its sale, I have no taxable income to be recognized. If I buy a mine for $100,000 and realize only $80,000 from exhaustion of its ores, under percentage depletion $40,000 will be taxed as income, although, in fact, it is only a return of capital.

Mines and mining investors do not generally receive under percentage depletion sufficient allowance to return to them their investments. In the occasional case where there is what might be considered as a capital gain, the percentage-depletion provisions do not give an allowance equal to that granted with respect to other capital gains.

I quite realize that the editorial in THE JOURNAL did not try to deal with all these arguments, but rested its position on the probable merit of a plan which had received the full and open consideration such as had heretofore been given to percentage depletion.

I cannot attempt here adequately to summarize all that has been or might be urged to justify percentage depletion, but I hope I have said enough to indicate that, if the present provisions for depletion of mines are subject to criticism, it is on the ground that they fail to give to mining the full relief it should receive, particularly if its capital realization is to be taxed no more than would be imposed on other capital realization under section 117 (a) of the income-tax law.

Yours truly,

H. B. FERNALD

New York, N. Y.