

PHELPS DODGE CORPORATION

40 WALL STREET

NEW YORK

July 18, 1941.

PERSONAL

Mr. Marriner S. Eccles,
President, Federal Reserve Board,
Washington, D. C.

Dear Marriner :

Referring to our conversation the other day regarding our Morenci development, the facts as we see them are :

1. We have spent \$ 35,000,000.
2. We have no base earning period because that ends January 1, 1940 and this plant will not start operating until November or December 1941.
3. Our invested capital (even including one-half the borrowed money) is not sufficient to free any portion of the prospective Morenci earnings from the high excess profits tax.
4. We feel this inequity can be corrected by amending Section 731 (after the naming of the strategic metals) to include earnings from copper ores mined from a mine or deposit that was in the development stage or undeveloped as of January 1, 1940.

I would appreciate anything you can do to bring this case to the attention of those interested in making up the Revenue Law.

I am enclosing print of the mine and an engineer's diagrammatic sketch of the 25,000 ton mill, smelter, power plant and auxiliary buildings. Also a more detailed discussion of our problem.

With very kind regards, I am,

Most sincerely,


P r e s i d e n t .

Encls.,

The problem of developing mines to bring them into production and of erecting and equipping the plants and facilities required to treat the ore to make available additional copper production has a tax aspect which probably has not been recognized. At least its full significance does not seem to have been fully appreciated.

For example,-

1) Sec. 722 of the Excess Profits Tax Act of 1940 as amended in March 1941 recognizes the principle that adjustment and relief is proper in cases where the "character of the business" is "different" from the character of the business engaged in during the base period (1936-1939); and it defines "character of the business" as "different" if "there is a difference in the capacity for production or operation" - a definition which would fit the case described above of a mine being developed and plant built and equipped to treat the ore mined so as to result in an increased capacity for production or operation. But, this relief provision is narrowed by two limitations;

(a) The taxpayer's first taxable year must "begin in 1940;"

(b) The "character of its business" on January 1, 1940 must be different from that during one or more of the years in its base period,

2) Sec. 722 does not afford any relief in the case of an undertaking such as the developing and bringing into production

of the open-pit mine of Phelps Dodge Corporation at Morenci, Arizona. The work of developing this mine and of erecting the necessary plant and facilities is a large undertaking. The Morenci project comprises the development of a large porphyry ore-body for open-pit mining, the erection of a crushing and flotation concentrator plant and a complete smelter, together with all of the collateral facilities necessary such as a railroad connecting the open-pit mine with the reduction works, water supply plant with pumps and pipe lines, power plant, power lines, shops, housing for employees, hospital facilities, etc. This work was started in 1937 and has been carried on continuously since that time; it is expected that it will be completed by the end of 1941. The cost of this work will be approximately \$35,000,000. The plant has been designed and the mine has been opened up so as to give an annual production of about 75,000 tons of copper.

3) This Morenci project was started in 1937 - two and one half years prior to January 1, 1940; it will not be completed and producing until two years subsequent to January 1, 1940. Because it was not producing as of January 1, 1940 the relief otherwise afforded by Section 722 is not available. Section 721 affords no practical measure of relief; there is no section in the present law which affords relief.

4) While the invested capital of Phelps Dodge Corporation may not be determined definitely for some time, it is certain that the expenditures at Morenci will add to this invested capital a comparatively small amount, namely one-half of the

amount borrowed for such development, (about \$6,000,000 for the year 1942). The invested capital credit, therefore, is not likely to be such as to free any portion of Morenci earnings from excess profits taxes. And, as Morenci is a new and additional undertaking, with a large "difference in the capacity for production" there are no similar earnings included as part of the base period (1936-1939) income credit.

5) Quite probably, judging from published accounts of the 1941 revenue law as proposed, the effect will be that the profits which it is hoped will result from such an undertaking as the Morenci project referred to, will all be subjected to the highest brackets excess profits tax rates. This rate, coupled with the normal tax rate, will mean an effective rate as to this project of approximately 70% of net earnings exclusive of State income taxes.

6) The need of the Government for additional revenue and high taxes is recognized. But it would seem to be only reasonable for the law to provide that the earnings from a new undertaking such as the Morenci project shall not all be subject to excess profits taxes, especially when the effective rate of the excess profits taxes, plus normal Federal taxes (but exclusive of State income taxes) will amount to as high as 70%. At the same time, the price of copper has been fixed by the Government at 12¢, and no ceiling has been placed on the cost of wages and supplies. This leaves Morenci, for example, little leeway to pay its own way in retiring debentures issued to help pay for the cost of this project and in providing funds with which to continue development.

7) As stated above, no section of the present law affords relief for this situation. It is not known whether it would be possible to introduce a section into the law providing for consideration and equitable treatment of special cases like the Morenci project. One possibility which would at least give some partial relief lies in the amendment of Section 731. This section of the Excess Profits Tax Act of 1940, as amended March, 1941, provides a measure of relief in connection with "mining of strategic metals". Strategic metals include tungsten, quicksilver, manganese, platinum, antimony, chromite, and tin. This section might be amended to include earnings from copper ores from a mine or deposit that was in the development stage or undeveloped as of January 1, 1940, thereby affording a measure of relief in a case like that of the Morenci project discussed herein.

Some positive action of this nature would seem to be in the interest of the National Defense Program. It would appear that there should be an incentive rather than a penalty to explore, develop and bring into production additional copper properties.

PHELPS DODGE CORPORATION

PRODUCERS, REFINERS & FABRICATORS OF COPPER

Subsidiary Companies:

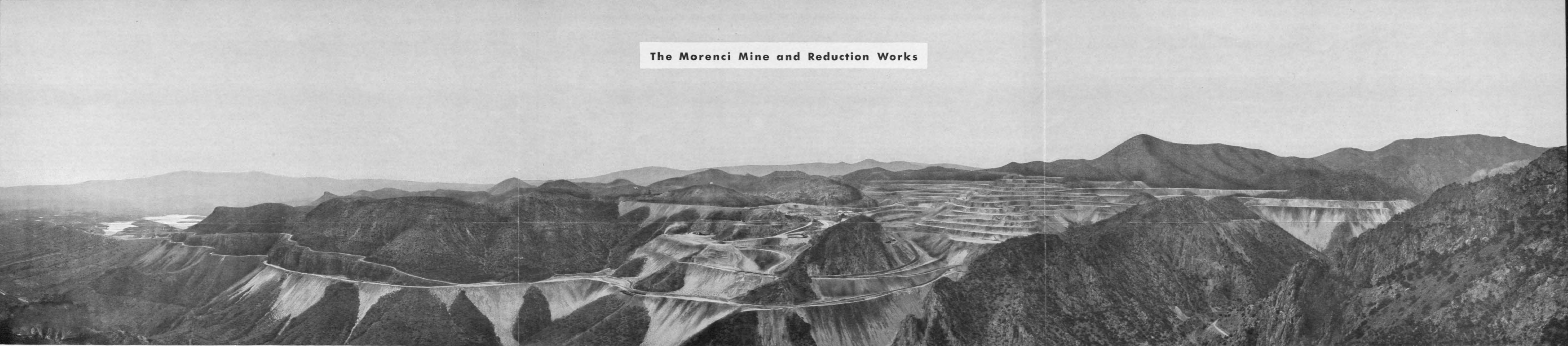
PHELPS DODGE REFINING CORPORATION

PHELPS DODGE COPPER PRODUCTS CORPORATION

General Offices:

40 WALL STREET • NEW YORK

The Morenci Mine and Reduction Works



MORENCI REDUCTION WORKS

Plant under construction is visible in the background.

MINE-MILL RAILROAD

Length about 1 1/2 miles about half of which is in final location. Sharp curves will be eliminated by filling gullies with waste rock from pit.

4% SWITCHBACKS

Mine Yard in Middle Background.

PIT BENCHES

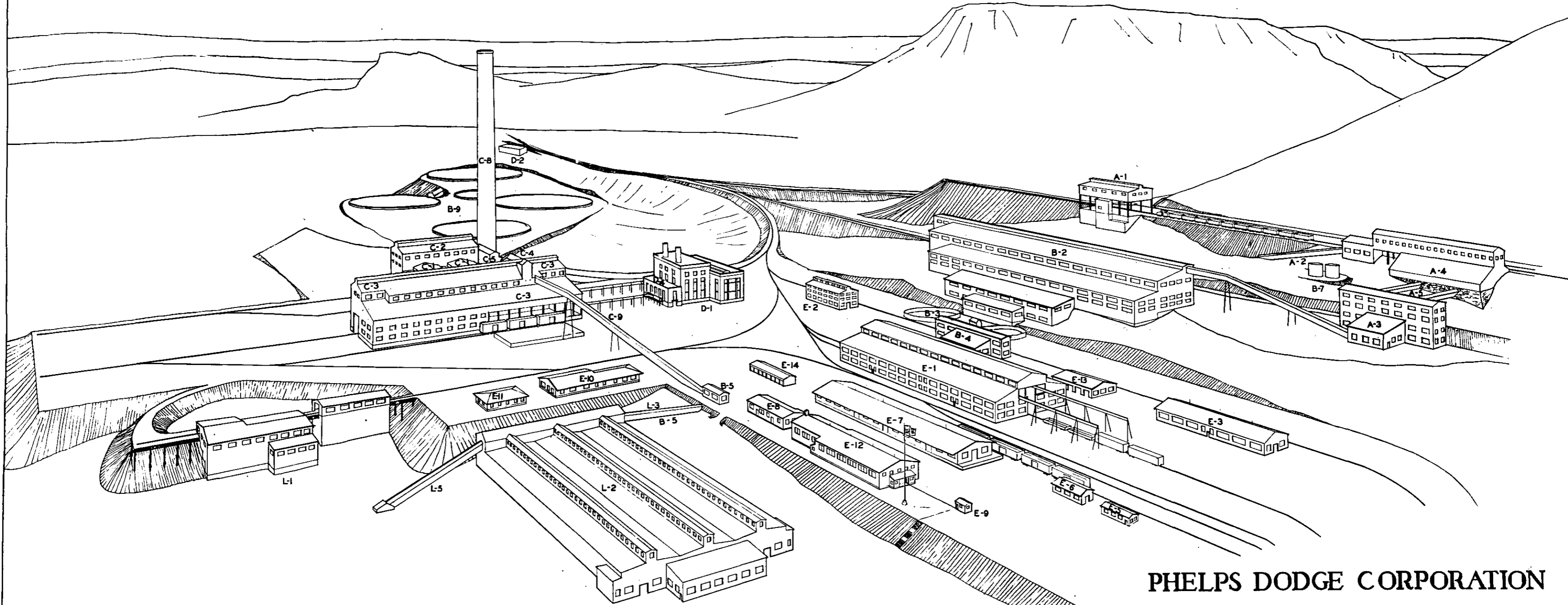
Thirteen 50-Foot Benches are now opened.

DUMPS FOR WASTE DISPOSAL

Thirteen mining benches have been established in the open pit. To date (June 1) 37,000,000 tons of waste overburden have been stripped. About 9,000,000 tons more of waste must be removed before ore production starts. The top of the ore body is now exposed. Tracks are electrified from the ore benches to the primary crushing plant at the reduction works. The machine shop, electric shop, carpenter shop, change room and time office at the reduction works are completed and in use. The primary crushing plant and ore bins are nearly complete. Steel erection is complete on the bedding plant and well advanced on the smelter and concentrator. The smelter stack which will be 600 feet high when finished has been built to a height of 180 feet. Work on the thickeners for tailings and concentrates is well advanced.



One of the electric locomotives to be used for haulage between the Open Pit Mine and the Reduction Works.



PHELPS DODGE CORPORATION
MORENCI REDUCTION WORKS

MORENCI, ARIZONA

CONSULTING ENGINEERS' OFFICE - NEW YORK, N.Y.

DRAWING NUMBER J-12

MAY 20, 1940
 REVISED NOV. 4, 1940
 REVISED JUNE 10, 1941

APPROPRIATION NUMBERS	
A-1 PRIMARY CRUSHING PLANT	B-9 TAILINGS THICK'RS PUMP STA. & LINES
A-2 CONVEYORS NO. 1-A & NO. 1-B	B-10 TAILINGS LAUNDERS, TRESTLE, DAM, PUMPS *
A-3 SECONDARY CRUSHING PLANT	C-1 REVERBERATORY PLANT
A-4 SECONDARY CRUSHING PLANT BINS	C-2 WASTE HEAT BOILERS
A-5 CONVEYORS NO. 2-A & 2-B	C-3 CONVERTER PLANT
B-1 CONVEYOR NO. 5	C-4 FLUES
B-2 CONCENTRATOR	C-5 MULTICLONES
B-3 2-100' CON. THICK. TANKS	C-6 SLAB & DUST HANDLING
B-4 FILTER PLANT	C-7 AUX. FUEL OIL (SMELTER)
B-5 CONVEYORS NO. 10 & NO. 19	C-8 OUTSIDE FLUES & STACK
B-6 CONCENTRATOR HEAD TANKS	C-9 CONVEYOR NO. 20
B-7 REAGENT MIX & STORAGE	D-1 POWER PLANT
D-2 COOLING TOWERS	D-3 AUX. FUEL OIL (POWER PLANT)
D-4 COMPRESSOR PLANT	D-5 POWER DISTRIBUTION
D-6 EAGLE CREEK PUMP TRANS. LINE	D-7 TIE-IN FOR NEW & OLD POWER PLANTS *
E-7 WAREHOUSE	E-8 TIME OFFICE
E-9 GATE HOUSE	E-10 ASSAY OFFICE
E-11 BUCKING ROOM	E-12 CHANGE HOUSE
E-13 TRUCK GARAGE	E-14 OFFICE GARAGE
F-1 PLANT R.R.	F-2 TRACK SCALES
F-3 ROLLING STOCK	G-1 FRESH WATER PUMPING
G-2 RESERVOIR	G-3 FRESH WATER DISTRIBUTION
H-1 FUEL GAS DISTRIBUTION	H-2 GAS METERS, BURNERS, REGULATORS, ETC.
H-3 FUEL OIL STORAGE & DISTRIBUTION	J-1 GENERAL & MISC. CONSTRUCTION
J-2 PLANT LIGHTING	J-3 COMMUNICATION SYSTEM
J-4 SEWERAGE & SANITATION	J-5 CONSTRUCTION CAMP
K-1 MINE HAULAGE - ROLLING STOCK	K-2 MINE TRANSMISSION LINES
K-3 D.C. TROLLEY SYSTEM	K-4 A.C. & D.C. SUB-STATION
K-5 A.C. & D.C. SUB-STATION TRANS. LINE & TRANSF'S *	L-1 SMELTER CRUSHING PLANT
L-2 BEDDING SYSTEM	L-3 CONVEYOR NO. 18
L-4 LIME BURN & HYD. PLANT	L-5 CONVEYOR NO. 17
* NOT SHOWN	

7/25/43

Mr. L. S. Cates, President,
Phelps Dodge Corporation,
40 Wall Street,
New York, New York.

Dear Lou:

I referred the tax matter you brought to
my attention to a member of our staff. I am passing
on his report to you for your information.

Yours sincerely,

M. S. Eccles,
Chairman

NY:rh
Enclosure

APPLICATION OF EXCESS PROFITS TAX TO COPPER COMPANY

by
Martin Krost

Mr. Cates spent a few minutes talking with me and then asked Mr. Drysdale, Treasurer of the Company, to come to my office in order to outline the situation in greater detail. I asked Mr. Solomon to join us and we advanced several suggestions, none of which, however, seemed to be practical from the point of view of both the immediate tax situation and the long run interests of the company. I have also studied the memorandum submitted to you by the company. The following statement is based upon impressions gathered from this memorandum, from the previous conversation and from reference to the published financial statements of the corporation. Statements as to the corporation's accounting procedures followed for tax purposes are, of course, my own guesses.

A basic obstacle to the corporation's use of the invested capital method is the fact that the corporation for purposes of its published financial statements and probably in still greater degree for tax purposes has followed extremely conservative accounting procedures. It is probable that for a very long period of time the corporation has taken advantage of the percentage depletion provisions of the income tax statute under which charges for depletion are fixed not in terms of a percentage of the value of ore properties but as a percentage of the gross income derived from the sale of minerals. A peculiarity of the way in which this provision operates is that the amount which can be charged to depletion over a period of years is not limited to the original discovery value of the ore; depletion continues to be charged as long as there is any output from the property. It can be seen that the value of this company's properties may have been written down to a negligible figure as a result of the operation of this provision over a long period of time.

Possibly more important with respect to the immediate situation is the fact that a relatively small part of the developmental costs of the Morenci property seems to have been capitalized since work began on it in 1937. The greater part of the \$35 million developmental expense seems to have been charged to current expense. This procedure resulted in a conservative statement of net income during the years that development was proceeding and resulted in a tax saving to the corporation. But the fact that this property is coming into operation at a time when a high excess profits tax is in force has very unfavorable consequences for the company. Because of the accounting practices followed in the past there is a negligible invested capital base attributable to the property which will shortly begin to yield income.

The present excess profits statute makes it theoretically possible for the company to reopen its past tax returns and to claim that past procedures had been mistaken, thus securing a higher current invested

capital base. But it is easy to see the force of the objections to such action. In the first place there would be back taxes to pay on the addition to the net income of past years that would result from charging a greater share of developmental costs to capital. In the second place the procedure that was followed may have been sanctioned by the Treasury Department only after considerable negotiation and it would be highly embarrassing to the company to argue now that its past position had been mistaken. In the third place, there is a reasonable presumption that the excess profits tax will not continue on the statute books indefinitely and it would be against the long run interests of the mining industry to change the special procedures with reference to percentage depletion and the treatment of development costs that have now become embodied in the income tax law.

The various relief provisions provided under the average earnings option will not make any substantial change in the company's situation. Section 711(b)(1)(I) may allow the company to charge some of its development expenses to future taxable years instead of the years in which they were actually incurred thus raising base period income and lowering taxable period income to some extent. Under Section 721 it may be possible for the company to allocate some of the gross income from the new property to previous years when the excess profits tax was not in effect. Under Section 722 the company might be able to argue that the nature of its business as reflected in productive capacity had changed between the base period and the taxable period if it were not for the limitation that such change must have occurred on January 1, 1940.

It is also possible that for the company to secure an addition to its average earnings base by issuing new equity capital on which it would be allowed a return of 8 per cent. Reluctance to dilute the equity of existing stockholders may be a decisive consideration against such a step.

KK:rhs