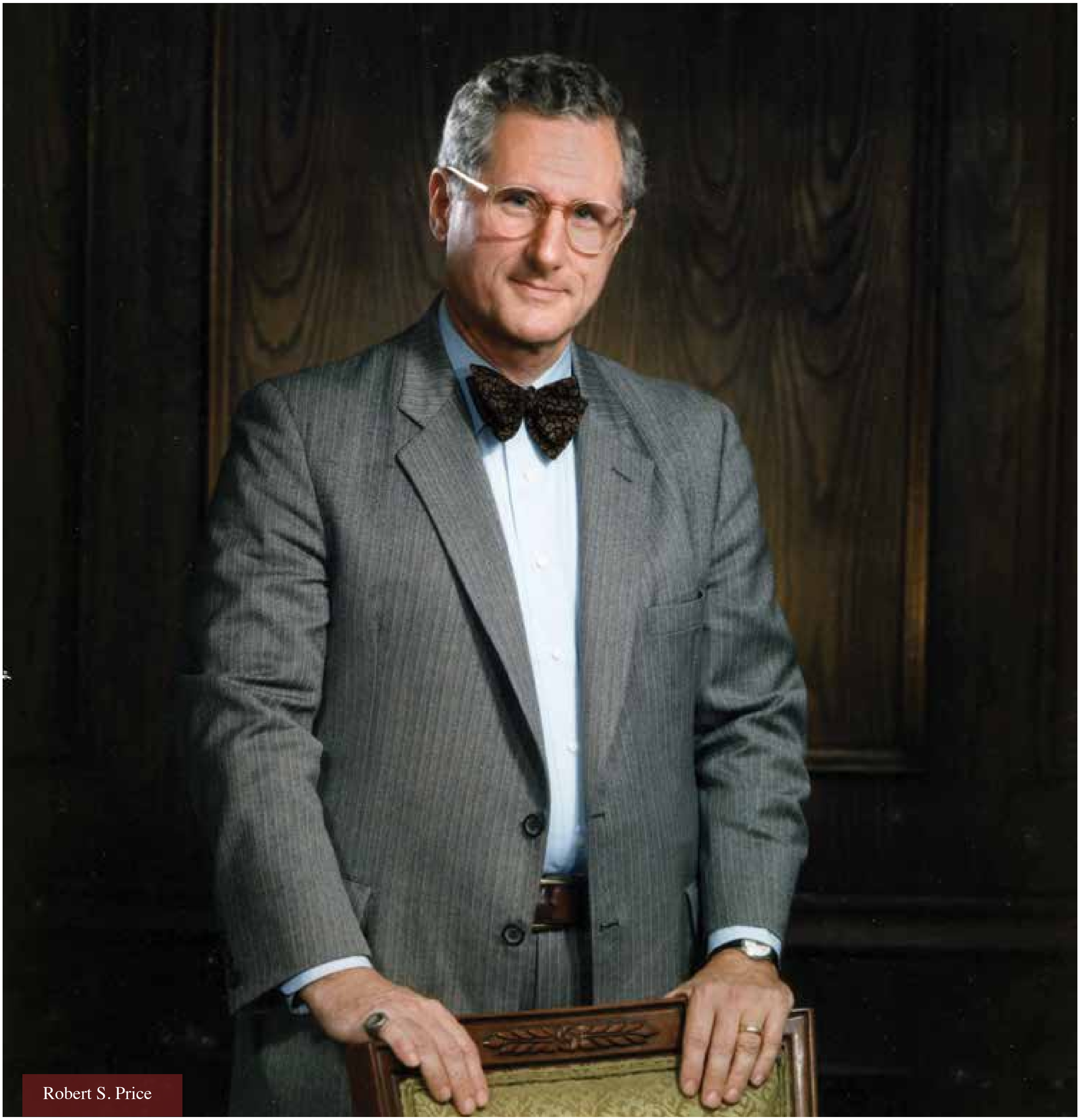
# Reminiscences of a Tax Lawyer for the Pennsylvania Railroad

By Robert S. Price

When I retired from Saul Ewing LLP 13 years ago, the firm graciously offered me a small office from where I could continue representing a charitable client. Among the few pictures I had room to hang was a June 2, 1967 letter hiring me as a tax attorney for the Pennsylvania Railroad (PRR). That job gave me a ring-side seat to the collapse of what had once been America's largest and most powerful corporation, a behemoth that had totally dominated Pennsylvania. I had been hired to handle what was probably the largest tax disallowance ever proposed to that time by the Internal Revenue Service. Bill Antoine, the PRR's vice president-taxation, hired me to work on the IRS audit of the PRR's 1953-61 federal income tax returns. An IRS engineer-agent had proposed to disallow $0.5 billion of tax deductions that the PRR had claimed on those returns. If the agent was right, the PRR was making money and owed Uncle Sam tens of millions of dollars. For me to defend its tax returns, the PRR had to open its books and its operations, hiding nothing.

I started out to determine what the facts were by picking three areas where the agent had disallowed enormous deductions. The first was New York Harbor. The agent had disallowed large expenditures for repairs on "float bridges," tug boats and piers. He decided that the expenditures had extended the life of those assets. An elderly PRR supervisor started me off with a tutorial on the float bridges. For freight cars from the South bound for New England, the PRR hauled the freight cars to the New Jersey side of the Hudson River where it loaded them onto barges. The PRR's tug boats pushed the barges across New York harbor to Bay Ridge, Brooklyn where they were unloaded on to the PRR's Long Island Railroad which delivered them to the northbound New Haven Railroad. Of course, it would have been cheaper and quicker to run the freight up the tracks of the New York Central Railroad on the west side of the Hudson to Albany and then turn east to New England, as is done today. But the PRR would never have given that business to the New York Central, a hated rival.

As I walked through the freight yard to the river, the supervisor explained that New York harbor had a 5-foot-high



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tide. Float bridges had to be used on each side of the harbor to connect the land rails with the rails on the barges. The float bridges were drawbridge-like contraptions that were hinged on the land-end and could be raised or lowered on the river-end. The river-end of the float bridge was supported by steel rods from overhead beams, with screws on their ends. As the tide went up and down, an operator mechanically turned the screws on the ends of the steel rods to keep the height of the float bridge's rails even with the rails on the barge. When the operator misjudged, the weight of the bridge with a freight car on it stripped the screws at the end of the rods. To avoid ruining the entire steel rod, the screws were made of bronze designed to give way, which happened often. Tens of thousands of dollars were spent each year replacing the expensive bronze screws, which did not extend the life of the float bridges as the agent argued, but merely kept them working.

It was harder to find any of the tug boats that had been repaired. To find the tug boat on which most of the disallowed money had been spent 10 years earlier, I walked along the river until I found it sitting in the mud where it had sunk, The PRR's depreciable lives confirmed that when the PRR built something, it built it to last a very long time with minimal maintenance. And, as required by the Interstate Commerce Commission, no depreciable life records were ever thrown away.

with its number clearly visible above the water.

Another $0.5 million dollars had been spent on repairs to a nearly 1,000-foot-long pier on the New Jersey side of the harbor. The agent was sure that money had extended the life of that 1917 pier. The pier had a depressed slot down the middle into which a locomotive would back load freight cars so that their doors were level with the platform. Freight would be unloaded and carted directly across the platform to a ship anchored along-side the pier. Obviously, only a limited number of freight cars could be backed into the slot. Unfortunately, one evening the railroader counting the cars being backed in was distracted. He had the locomotive back into the slot three more cars than its length permitted. The three extra cars knocked out the far end of the pier and dropped three freight cars into the harbor. The disallowed repair was spent to fish the freight cars out of the Hudson and to re-attach the back end of the pier.

On the Manhattan side of the Hudson, nearly an equal amount was disallowed for repairs to three finger piers that shared a common head house. A half million had gone into bracing the rotten head house floor where it had collapsed into the river. I could see the swirling Hudson river waters and the timbers preventing the rest of the head house from collapsing into the hole. And so it went with every disallowed repair. The agent had not recognized that the PRR was a hollowed out shell of what it had been. It was not only not improving its facilities; it was spending no more than was absolutely required to keep running.

I chose Sam Rhea Shops in Hollidaysburg, Pa., near Altoona, as the second area in which to investigate large disallowed repairs. The largest single disallowed invoice was for $0.5 million for roof repairs. The superintendent took me into the building, which turned out to be one-mile long. It contained an assembly line that started with parts coming in at various points and a completed freight car coming out at the end. A small roof patch every 50 yards or so was what the invoice had paid for – obvious leak repairs. What was once America's largest freight car assembly line had become a depressingly half-empty, slightly dilapidated facility.

Next was a trip to the Paoli, Pa., shop where the old Tuscan red steel cars for the Philadelphia commuter lines were receiving rebuilt electric traction motors. Most of those coaches had been built from 1909 to 1913 for the run between Philadelphia and New York City. Around 1932 they were retired from intercity service and were electrified for the commuter service into the newly built Suburban Station. There was no doubt that the cars were antiques, so the only question was why were the traction motor replacements classified by the PRR as repairs? The answer was that, with these antique cars, each replaced electric traction motor didn't last more than a year. The repair would have to be repeated the next year. The PRR was keeping those cars running with spit and baling wire.

So I could prove that the PRR was making repairs only to keep running, not to improve its properties. But to determine that the repairs were not extending their lives, I had to find out what depreciable life the PRR was using for each repaired facility. The answers astonished me. For example, the depreciable life for that enormous pier in New York harbor was 100 years. Even if the end of that pier had fallen off in the 1950s due to rust rather than error, the cost of putting it back would have been a repair. When the money was spent, the pier had not passed half of its depreciable life. The PRR's depreciable lives confirmed that when the PRR built something, it built it to last a very long time with minimal maintenance. And, as required by the Interstate Commerce Commission, no depreciable life records were ever thrown away.

I learned my final lesson about the culture of the ailing PRR, from the agent's treatment of the capital gain the PRR reported on the sale of the air rights at Philadelphia's Penn Center which was built above Suburban Station. Prior to its demolition in 1952, that was the site of Broad Street Station, an enormous soot covered red brick Victorian pile. The tax question turned on the March 1, 1913 amendment to the United States Constitution. It enabled the federal government to tax the income of individuals and businesses. The land under Broad Street Station had been bought by the PRR between 1879 and 1880. But it was unconstitutional to tax any of the gain in value of that land that occurred between its purchase date and March 1, 1913. While the PRR knew how much it had paid for the land and how much it had sold the air rights for in 1953, it had to determine gain or loss by using as its tax basis the value of that land on March 1, 1913. It hired an

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appraiser who had been in the real estate business in 1913, who said the value was $9 a square foot.

The agent was sure that $9 too high. He spent hours looking at deeds in City Hall to find lower purchase prices for sales in central Philadelphia. Unfortunately, all of the deeds said – as was then the custom - "One dollar and other valuable consideration." The agent's diligence was finally rewarded when he found a deed for the property on the northeast corner of 20th and Arch streets that reported paying $7 a square foot. He used the $7 number and increased the PRR's taxable gain by $10 million.

How could I prove that in 1913 the value of land at 20th and Arch streets was less than the value of land at 15th and Market streets? I knew that the clerks preparing tax returns in the bull pen outside of my office were all union men without a mandatory retirement age. I called in the oldest, Murphy (not his real name), and asked him when he came to work for the PRR. He replied that he started in 1911 at the General Office Annex on the northeast corner of 19th and Arch streets. He remembered that the building on the northeast corner of 20th and Arch streets was a bordello (not the word he used). When I asked him how he could be so sure, he told me that his boss took him there on his first day at the PRR. His boss was a Civil War veteran who welcomed the new boys, all from Roman Catholic High School, by taking them to lunch at the saloon across the street and then to the bordello at 20th and Arch streets where, despite his age, he joined in. I got two affidavits (the other from a clerk hired in 1912). They proved that in 1913 the commercial use and value of property at 20th and Arch streets was rather different than the commercial use and value of property at 15th and Market streets.

I eventually delivered all of the evidence I had gathered to a very wise senior IRS appellate conferee in his office at Two Penn Center. He recognized that the IRS had an embarrassing problem on its hands. I was invited to a meeting with the IRS's top audit personnel at the national office in Washington. I later understood that, as a result of the PRR audit, the procedures were changed to rein in a rogue engineer-agent.

Unfortunately, the resolution of the PRR audit itself was less satisfactory. In early June 1970, the appellate conferee and I reached an entirely acceptable proposed resolution of the largest Issue, the disallowance of more than $160 million in freight car repairs. I was elated as I sped back to Bill Antoine's office in Six Penn Center, since I knew that the proposed freight car repairs settlement would mean that no tax was due and we were only talking about the size of the tax loss carry forward. I burst into Bill Antoine's office and blurted out what I had negotiated. Bill punctured my balloon by saying "that's great but I can't talk to you now. I'm working on the Pennsylvania Company Debenture." He was right. I knew that if the proposed bond issue didn't sell the PRR would go bankrupt, which is what happened. The petition in bankruptcy was filed on June 20, 1970, and four months later I left to return to private practice, putting the railroad behind me.

A few months later, I got a call from a staffer at the Securities and Exchange Commission who wanted to subpoena me to testify about the bankruptcy. I had recommended, when what had become Penn Central was merging six trucking companies into Pennsylvania Truck Lines, that the disappearing companies dividend all of their retained earnings and profits to Penn Central and borrow back the same amount. The staffer thought that this non-cash dividend hid the desperate condition of the railroad from the public. I offered him two documents to help him examine me. The first was a letter from the Interstate Commerce Commission authorizing Penn Central to make the dividend/loan swap since it would save Pennsylvania Truck Lines around $1 million a year in Pennsylvania Capital Stock and Corporate Net Income Taxes. The second was the memo I had sent to Bill Gerstnecker, the number two financial man at Penn Central, asking whether the dividend/loan swap would deceive the shareholders by inflating the railroad's income. Bill had written across the top of my memo "No, we are going to report income of all of the Penn Central companies on a consolidated basis and that, as an intercompany transaction, the dividend will be eliminated in consolidation. Go ahead."

The staffer then asked me how many shares of Penn Central I owned or had ever owned? I said none. He asked why I had not joined the company's "thrift plan" to buy shares at half price? My answer summarized what I had learned. I said I had been hired to defend the losses that the PRR had reported for federal income taxes. "Frankly, as I conducted that defense, I never saw a price I thought that stock was any good at." He thanked me, hung up and I never heard from the SEC again. I had done my best, documented it and had fortunately taken copies with me. ■

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