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by

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T A B L E   O F   C O N T E N T S

INTRODUCTION

The Royal Commission on Taxation has asked me to make certain comments in regard to the taxation of the petroleum industry related to producing operations and also in regard to the difference in such taxation in Canada and in the United States of America.

The Commission has already received detailed reports from the Canadian Petroleum Association and the Independent Petroleum Association of Canada, each of which examined these matters in considerable detail and to which are attached certain schedules attempting to show the variation between taxation in Canada and the United States. It does not, therefore, seem reasonable to take the time to duplicate the detailed work that has been put into these briefs and consequently this memorandum will be based more on actual experience with the petroleum industry over the past eighteen years in Calgary.

As suggested by your Mr. Thompson, I propose to try to just "hit the highlights".

Every industry, of course, likes to think that its operations are more difficult than any other industry and, therefore, one can not take arguments in this vein too seriously. Certain facets of the petroleum industry are similar in most respects to other industry operations and here we have in mind specifically marketing and refining operations. This phase of the business requires importation of product as well as use of domestic product. It requires breaking down the raw materials into finished products used by consumers and it involves a country-wide distribution thereof. I am not here concerned with these phases.

PROBLEMS OF PETROLEUM PRODUCING OPERATIONS

The production of oil and gas does have certain peculiarities all of its own. This is an extractive industry of a product whose existence is unknown until a great deal of work and a great many dollars are expended. Agriculture and the forest industry are extractive industries of a type, but in these cases the product essentially can be seen on the surface of the earth and relatively small expenditures are made to determine whether or not the product will be there. Mining is more closely allied to the petroleum production business but here again the sums expended are relatively modest prior to the time that it is known whether or not minerals exist. A base metal mine requires large expenditures of money to bring it into operation but the largest portion of the expenditure is normally incurred after it is reasonably known that the ore body exists. As a general rule one company is formed for each major mine and it would be highly unusual for any one company to have more than a relatively few number of mines.

In the petroleum industry hundreds of thousands of dollars are frequently spent on pure exploration expense prior to the time that the first well is drilled. Depending on the area, a well may be drilled for anywhere from $20,000 to $2,000,000. There is no certainty in the business until such time as the first well has been drilled and oil or gas has been found. If the well hits salt water instead of oil, this is deemed to be good geology because at least there was a formation there which had trapped water and could possibly have trapped oil. This, of course, does not help the operator if he is unfortunate enough to obtain salt water instead of oil.

Even after the product is found the company then must make further expenditures in regard to development of the field and in bringing the product to market. Since a great deal of oil has been discovered in inaccessible areas, this has required further large expenditures to obtain rights of entry, including access roads, and the building of pipelines to reach the market. This, of course, is very true in the North West Territories and North Eastern British Columbia where conditions are most difficult.

When initial exploration is commenced on what is known as "reservations" or "permits" the company knows that even if it finds petroleum it will have to return some 50% of the productive lands to the province and then repurchase them from the province in competition with others. This involves further large sums of money which drain the resources of everyone, even the large corporations.

The oil-bearing strata in Western Canada has stretched from the Eastern part of British Columbia to the western part of Manitoba and from the Canada-United States border up to the Arctic Islands. This means, therefore, that any one company will be carrying on operations which are literally thousands of miles apart, all of which adds considerably to the expense of such operations. It has at times cost as much as $100,000 to move a drilling rig into location. When that rig is moved out of that area a further heavy cost is involved. This amount of $100,000 is not by any means the highest figure because the cost of moving a rig to the Arctic Island was several times this amount.

SHARING THE RISKS

Because of these huge costs with no guarantee of success, practically no company can "go it alone". The largest Canadian company has probably given more farm-outs than any other company. These farm-outs have been granted to other corporations so that this company did not have to bear the entire risk itself. The whole industry, therefore, is fully aware that they cannot put "all their eggs in one basket" at any time and that there must be co-operation between them. It is for this reason that the petroleum industry has entered into literally hundreds of various types of joint ventures. We do see other joint venture operations from time to time, particularly in the construction industry, but with nothing like the variations used in the petroleum production business.

These joint venture operations have resulted in certain terminology in the petroleum industry, which is peculiar to that industry. The main operation is known as a "working interest" which is owned by the person or persons who will be actually providing the funds for the exploration and drilling of the wells. This working interest is nearly always subject to "gross royalties". Gross royalties may be payable to the Crown or to other freehold owners, and, in some cases, may belong to previous owners of the working interest. For example, if one company acquired the entire working interest of a property subject to the initial owner's gross override, he might obtain 87-1/2% of the total interest. Having expended certain funds, or without expending certain funds, he may find that he does not have the resources to properly carry out the necessary work. He might, therefore, "farm out" this property to some other company or group of companies and retain, say, 2-1/2% off the top. This would mean, then, that he would get 2-1/2% of all production free and clear of any further expenditure but in turn the new working interest owners will have to pay all expenses out of their remaining 85%; or the agreement might read that he would get 2-1/2% of 87-1/2%.

Instead of retaining a gross royalty or override he might farm out the property to other operators who, if they find petroleum will retain all the production until they recover their costs, after which the production will be split in some ratio between themselves and the previous owner. The secondary owners may, or may not, have to bear all additional costs of further development drilling depending on the agreement made. In some cases the first owner retains what is known as a "carried interest" or a "net profits royalty", which means that the operators bear all expenses and give to the previous owner a percentage of income after all costs have been recovered.

We have seen certain parcels of land which have had as many as fourteen owners before someone actually drilled on the property and each of those owners retained an interest of some type.

This explanation is given merely to show some of the complexities of the business and to emphasize that the fear of most companies is that they may bankrupt themselves by taking too large a share of any particular operation. In other words, every operator fully realizes the tremendous risk that he is assuming and does his utmost to minimize the risk by not being too greedy at any one time. Sometimes, of course, he is faced with deadline drilling commitments and cannot find other persons to join with him in time because they have their funds committed elsewhere. In this case he must either take the plunge or abandon the property and thereby irrevocably lose all expenditures made to date as well as the possibility of revenue should the interest eventually turn out to be productive. There are many cases where an operator has had to abandon property interests only to have others discover petroleum thereon at a later date.

CO-OPERATION BETWEEN INDUSTRY AND GOVERNMENT

I have found in the past that in dealing with the officials of the Department of Finance and the Department of National Revenue there has justifiably been a lack of knowledge as to the detailed workings in the petroleum industry. We do believe that the petroleum associations have not spent a sufficient amount of time with those officials to bring them into proper contact with the various complexities and terminology of the business. We have discovered from time to time that the officials do not know the meanings of certain words used in the business and these are words which are in common every day use within the oil business itself. This, to some extent, arises from the fault of the English language where words have different meanings in different situations. We believe it is partly for this reason that the 1962 amendments came out in a form which did not satisfy the petroleum industry; we also believe that the government officials responsible for drafting the legislation tried to do their best.

This is a very strong reason for asking for closer liaison between the government and industry during the interval when the initial Budget is brought down in the house and the time that the first draft of the Act is brought before the House. We found out during the 1962 legislation that the Act, of course, is primarily written in the Department of Justice and, to the best of our knowledge, no member of the industry had a chance to talk to the responsible persons in that Department. Since it is doubtful that any person in the Department of Justice has ever had a chance to have a very close association with the petroleum industry, it follows that it must be most difficult for them to express in words the proper meaning.

SOURCE OF FUNDS

I have given above a very short résumé of various difficulties facing operating oil men and from this it may be seen that it is essential to obtain financing of all types and from all types of entities in order to produce the funds required to continue to find and produce petroleum products. Other briefs have outlined the magnitude of the sums involved.

Up to the present time these funds essentially have been available only from those entities which have entered the petroleum business per se. Some of those companies did receive funds from the general public through stock issues but, because of the high risk element, very few of the smaller public companies were successful and consequently the stockholders, as a group, suffered severe reverses. These smaller companies financed by public issues simply were not able to obtain sufficient production to offset their losses and, as a result, have gone out of business either through mergers or by selling the few productive properties which they were able to find. This has left a scar on the investor which will be difficult to overcome. The situation is aggravated, to some extent, because the oil play has been in Western Canada whereas our large population is in Eastern Canada. Since I have personally lived in both the East and the West for considerable periods of time I am well acquainted with the flare for investing in Ontario and Quebec mining ventures by the small investor who feels it is close at home. Having been bitten on the Western Oils, which he seems to feel is practically in another country, it will be quite difficult to bring him back into the picture.

During the main oil flurry in Western Canada the laws were somewhat different in so far that the cost of acquisition of rights represented a capital expenditure and could only be recovered out of tax-paid dollars. The 1962 legislation fortunately amended this but only from April 10, 1962 on. While this amendment will unquestionably be helpful in the future, something more than this is required in order to draw the public back into the business. This situation never developed to any great extent in the United States partly because of the variation in the income tax laws.

In Canada the deduction of exploration and drilling expenditures was, in effect, limited to those companies whose principal business was the oil business (and/or eventually the mining business) or to partnerships formed for the purpose of the exploring or drilling for oil or natural gas.

Even these partnerships were placed in a separate income tax category. A taxpayer normally can meld all his profits and losses from various businesses within a taxation year, but in this case he was not permitted to meld his losses in the oil business against his profits of other businesses. On the other hand if he were successful he was required to bring his profits of the oil business into taxable income.

Individuals and corporations other than those in the oil business were even more restricted. Even if they obtained income from their oil operations they were not permitted to deduct exploration or dry hole costs therefrom but could only deduct the cost of drilling a productive well from the income of that particular well. Since they were faced with paying tax before recovery of their expenses it followed that very few people were prepared to take this gamble on top of the natural high risk of the industry. This in turn meant that citizens of Canada were effectively blocked from joining in the oil play, with resultant protests from the Canadian government that our petroleum natural resources were being taken over by Americans. Unfortunately it just could not be otherwise.

SOME UNITED STATES TAX LAWS RE PETROLEUM EXPLORATION

In the United States, Congress recognized that it was essential for the well-being of the country to provide risk funds to continue to find oil to replace that which was being produced. This gave the country national security in times of war and also cut down on their outflow of foreign exchange. In addition to this, of course, there are many ancillary bonuses. The development of the oil industry sparks a tremendous development in steel mills, pipe mills, production of automotive vehicles, together with the relevant additional employment of staff etc. etc. There appears no need to elaborate in this area because you are well aware of such economics.

In the United States no distinction was made between companies and/or partnerships whose principal business was the oil business on the one hand and companies, partnerships or individuals whose principal business was not the oil business on the other. Any taxpayer had the right to deduct intangible expenses from his other income. This meant, therefore, that an individual who had a substantial income and was paying high rates of personal tax could put some of his money out at risk and deduct exploration and drilling costs for income tax purposes, completely regardless of whether or not he had any production. He was required to capitalize certain expenditures including any costs laid out to acquire an interest in the rights and, of course, any interest in depreciable assets were treated as capital expenditures. Certain geological and geophysical expenditures had to be capitalized but as a general rule this has been on an elective basis.

The capitalization of part of the expenditures did not represent a serious position to the United States taxpayer because, under their regulations, he was always assured of being able to claim his capital costs as an expense in one manner or another.

In regard to depreciables, he of course, could claim depreciation and if the operation were not successful he could always resell these physical assets.

In regard to the cost of acquisition of rights, he could always recover his costs taxwise in one of three methods. If the property proved to be unproductive he was then entitled to claim all property costs as an immediate expense. If the property were productive he could recover his costs through depletion. If the property were a marginal property he would elect to claim cost depletion. If the property were better than a marginal property he would elect to claim percentage depletion, which is based on 27-1/2% of the gross income not to exceed 50% of the net income. Cost depletion and percentage depletion can be claimed on a property interest basis without regard to any other properties owned by the taxpayer. Percentage depletion claimed will exceed the initial cost of the property and frequently by very substantial amounts. This is a compensatory feature to offset the high risk. Each year this risk increases because every time a new field is found the chances of finding additional fields are necessarily reduced.

The owner of a producing property could continue to take the production for the lifetime of the well or, after holding the property for a certain time, he could sell the production in toto and at this time realize a capital gain. He would already have claimed his intangible expenses in the taxation year in which they were incurred against his other income and, therefore, his only cost left would be any amounts which previously had to be capitalized. The difference between such amounts and the selling price would be taxed at the 25% capital gains rate.

There can arise certain situations where an United States individual can actually benefit from a relatively uneconomic operation. In the following example we are ignoring depreciable assets that must be placed on the property and, to this extent, our example is incorrect but it does not change the general principle. If a United States taxpayer drills a well for $100,000 and he himself is in a normal 80% tax bracket, this means that he is putting up $20,000 out of his own pocket. If the well is a marginal operation he could sell it after the proper amount of time to realize a capital gain for exactly the same price as his cost, namely $100,000. This sale would take place in a different fiscal year to that of the drilling. Since he has already expensed his $100,000 in a previous year then he has no cost left and, therefore, must pay capital gains tax on the full $100,000 which he receives. This would amount to $25,000 so he has $75,000 left from which he must deduct the $20,000 which he previously paid out of his own pocket for the drilling. The result is a net gain of $55,000. This is slightly exaggerated but all the same it is factual.

It should be pointed out here that if a taxpayer places himself in the position of being a trader he is not permitted to pay the capital gains rate of tax on his income.

Since the United States does not draw an artificial boundary on its citizens who wish to develop oil resources, it does not matter to the United States citizen whether he drills in the United States or in Canada or elsewhere. For this reason he is permitted to invest his funds outside of the United States which in due course is beneficial to the United States as far as the flow of international payments is concerned. This has brought about ownership of Canadian properties by United States citizens.

While this United States citizen is subject to Canadian tax rules on his operations in Canada, he normally is not hurt. In the example we gave above, his United States tax position would be identical if the well were in Canada. As far as Canada is concerned he would not have used his initial $100,000 of drilling expense in the year in which he drilled and, therefore, he would apply this expense against the selling price of the property. Since the two figures are the same in this instance, he would have no tax to pay in Canada. We should mention here that in cases such as this we make sure that he is operating in a partnership and not as an individual in Canada. This can be accomplished by having him in partnership with his wife so that he will qualify to offset his drilling expenditures against the sale price of the property. This particular subject will be discussed more fully below. 1/

The above example is not the best to cover a normal sale of a successful drilling venture. I, therefore, will change it slightly by increasing the sale price from $100,000 to $200,000. In this case he has to pay a capital gains tax in the United States of 25% of the $200,000, which results in a $50,000 tax. In Canada he has $100,000 of unused drilling expenses to apply against the sale price and, therefore, he pays tax on

$100,000 at graduated rates. This tax will amount to approximately $50,000 depending, to some extent, on his exemptions. He, therefore, would pay this tax to the Canadian government and in the United States would claim a foreign tax credit against his capital gains tax of $50,000. The net result is that he, in effect, only pays the capital gains tax which he would pay in the United States but in this case payment would be made to the Canadian government.

From this second example we find that he saved $80,000 in United States taxes when he drilled the well and wound up by paying $50,000. His total out of pocket costs are $70,000 ($20,000 plus $50,000) and deducting this from his $200,000 sale price he has in hand $130,000. If a Canadian had entered into this drilling venture he would have spent $100,000 against his sale price of $200,000, he would have paid at least $50,000 tax (assuming that he had no other income in Canada, which of course, will probably not be true) and, therefore, he is left with only $50,000.

It is for these reasons that senior executives of all types of businesses, professional men, actors, baseball players and other persons who have large incomes, have found it profitable to invest in the petroleum business in the United States. This has provided a tremendous flow of money in the United States and, of course, these same persons have invested considerable sums in Canada. The odds are so stacked against Canadian taxpayers that the investment by wealthy individuals in Canada in the Canadian petroleum business has been more or less negligible. It is these funds which the petroleum business would like to attract to provide the source of additional exploration and development in Canada by Canadians.

POSSIBLE PROGRESS IN CANADIAN TAX LAWS

Prior to the 1962 legislation Canadian government officials, more or less correctly, took the position that the government did not wish to involuntarily enter into wildcatting. The general feeling was that if drilling expenses could be charged against other income the government would be bearing a proportion of it and in due course the taxpayer would sell the property for a capital gain and would pay no tax thereon.

The 1962 legislation definitely altered this position. It is now clearly set forth that any sale of a property interest in the oil business results in taxable income in the hands of the taxpayer. For this reason, it is now impossible for a Canadian taxpayer to realize a capital gain on petroleum properties (except through inheritance which is a negligible factor). As a consequence, the argument that may previously have had some validity no longer has that characteristic. I also would like to point out quite strongly that while our government officials took this position, the same position was not taken in the United States and because of the broader approach used there that country has been able to develop its resources with its own citizens rather than requiring assistance from outside the country.

The examples used above have been restricted to individuals who pay tax on a graduated rate base. The same arguments apply to corporations whose principal business is not that of petroleum or mining but the differentials are not as great because the maximum corporation rate in Canada is 50%. The same general arguments apply to these corporations and if we wish Canadian companies to have a share in the economic development of our petroleum resources they, too, should be allowed to deduct exploration, drilling and development expenses against their ordinary income. The argument of certain departmental officials that this brings the Government of Canada into the picture as an unwilling partner has validity only on the surface. No corporate executive is going to throw away in a wasteful manner the 50 cents on the dollar which he would retain.

To the extent that additional monies are spent in exploration and development, both employment and taxes will be increased. Additional materials will have to be purchased and additional employees will have to be hired to perform this work, all of which results in greater sales taxes and income taxes as well as greater employment to the country as a whole. The Government of Canada has recently been considering various ways to provide incentive legislation to increase employment in the country and action along this line would certainly fit into this pattern of thinking. A further reason for this line of thought is to follow up the general trend in this country that Canadians should own more of their own resources. Because of the high level of taxation in our country there is certain difficulty in accumulating the funds for investment purposes. If we wish to accomplish ownership by Canadians then some assistance must be given to those people who are willing to co-operate along this line. If we wish to continue to penalize Canadians who want to assist in the economic development of the country, and particularly in the petroleum industry, then we should not change our present laws.

DEPLETION

Much has been written about depletion and the problem has been attacked from various angles. We have no intention of entering upon an argument as to the true meaning of the word "depletion". There is probably very little fact in the argument that depletion of petroleum resources is a natural right. It is true, of course, that for every barrel of oil produced there is no mechanical way to reproduce another barrel. There may be ways to find another barrel but that particular oil was already in existence.

In the final analysis we must come to the conclusion that the only reason for depletion is one of incentive to persuade people to risk their money. Today we have tax laws giving a benefit to taxpayers who will commence operations in so-called depressed areas which, in many instances, are probably uneconomic areas at the best. I do not wish to argue whether this is correct or otherwise but merely to point out that there is a school of thought which appears to believe in this method.

The present depletion allowance in the petroleum industry, taken together with the other rules and regulations which include the write-off of exploration, drilling, development and costs of rights to explore or drill, results in tax being applied on two thirds of the net income. For corporate purposes this means an effective rate of tax of approximately 33-1/3% as opposed to a normal rate of 50%. Individuals, whatever graduated rate of tax bracket they are in, will still only be paying tax on two thirds of the normal income compared to other types of business income. The mining industry has some similarities but we are essentially making a comparison here with commercial and industrial activities.

The thinking in the oil communities in Canada has been somewhat clouded because many of the leaders of the petroleum industry have come from the United States and fail to recognize the difference in the tax laws between the two countries. In the United States, because of the percentage depletion regulations, it is quite possible for an individual or corporation who confines himself to the production of petroleum products (leaving aside marketing and refining at the moment) to operate for many, many years at a profit without paying any income tax. The investor obtains his return out of percentage depletion. This has led to the general theory in the United States among certain parties that they must always drill up their taxable income position since they still have cash in their pockets to spend for their personal purposes out of the depletion allowance.

Since this thinking flowed through to Canada the producing companies here have tried to duplicate it and so drill up their income. By doing this they do not pay Canadian tax but also they do not have any extra funds left over to distribute to the owners. Obviously this means that the Canadian petroleum producing industry will have trouble attracting investors who feel that they should have a return on their investment. It will only attract the type of investor who is hoping to eventually resell his investment at a higher price. We believe that this has been one of the fundamental errors committed by the Canadian petroleum industry.

Our present depletion laws work in a rather peculiar manner. If a company confines itself to only exploration and production it cannot recover more dollars than it has put into its enterprise until such time as it pays tax. All of its expenditures must be charged to all of its income, completly regardless of whether or not any fields that it may have owned are entirely depleted or not.

The integrated oil company does have the benefit of charging its exploration and development expenses against its marketing and refining income. By doing this it will obtain depletion on its production at an earlier date than will the strictly producing company. In Canada we have, therefore, unwittingly distinguished between these two types of operations on a tax basis.

Depletion in the United States is based on a property interest and it makes no difference what type of business the taxpayer is in. Admittedly, intangible expenses can be charged against other income but this does not affect the depletion calculations. It is doubtful that the Canadian government initially intended that the depletion regulations would have different results depending on the nature of the company's business. For this reason the United States system appears to have more logic than the Canadian system.

The present Canadian depletion allowances are based only on net income. In order to be more consistent between enterprises it would appear necessary to move to a gross depletion basis where the depletion is a first charge against income. This would mean that, after charging lifting costs, depletion would then be allocated against the production income and only against the remaining income would the various exploration costs be charged.

A great many Canadian oil companies are not yet taxable, and, therefore, this change in basis would not change their tax payments at this moment. Tax revenues would not be immediately affected in such cases. We do believe, however, that there would be a considerable psychological effect which would result in certain additional investments in this industry with the other tangible benefits that accrue from such increased activities.

Because of the high cost of operating in this business, such as the acquisition of rights, the cost of general geological, geophysical, and other exploration work prior to drilling, the costs of drilling, etc., a company cannot expect to produce enough income to cover its costs in the early years of its existence. The petroleum industry in the United States has 60 or 70 years of substantial history behind it, whereas the Canadian industry essentially dates from the discovery of the Leduc oilfield in 1947. Companies are only now finding that their income from production is reaching a stage where it exceeds their annual expenditures, which expenditures had to be made in order to build up a basic annual production rate. Because of this, they are now drawing close to the time when they will become taxable and a change in the depletion allowance will have a much greater effect than it would have had several years ago. It is true, of course, that the large integrated companies, who have used their marketing and refining profits, have already been paying tax and have actually been receiving certain amounts of depletion; however, the total depletion received, as pointed out in the Canadian Petroleum Association brief, is relatively modest compared to the total investment by the industry. Because the large integrated company has, in effect, been the comparative winner with our present tax depletion laws, there has been a tendency for the independent producer to pass out of the picture. This, we believe, is bad for the economic development of our country. Anything that can be done to improve the position of the independent petroleum company should rebound to the benefit of the country as a whole.

By inserting a gross depletion allowance as a primary expense against income the producing company will have some surplus dollars which it can use for reinvestment or for paying a return on its shareholders' investment and it can thereby help to protect its financial integrity.

An alternative to a depletion allowance, which is substantially a first charge against income, would be the use of the investment credit concept. On this basis a company would be permitted to charge, say, 150% of its exploration and drilling expenses when computing its taxable income. This method has the advantage of precedent in the Income Tax Act in the sections relating to scientific research. If this were adopted there would be no change made in depletion on gross royalties but the depletion on working interests would be eliminated. Carried interests and net profits interests would receive no depletion which would be reasonable because they pay no costs and so assume no risks.

As mentioned above, we are considering depletion to be a tool to increase the expenditure of funds by Canadians in the exploration and development of the petroleum resources of this country and to keep as many companies in the business as possible. We are in no way advancing an argument that this represents an economic right; we would prefer to leave that discussion to the economists and are merely sticking to the basic facts of business.

DISPOSAL OF PROPERTY INTERESTS

Earlier in this memorandum we pointed out that it is probably not fair to expect government officials to have a full understanding of the petroleum industry. Even within the industry we find that there is a certain amount of disagreement, some of which arises from a lack of full understanding of the situation.

This lack of understanding in various quarters is exemplified by the wording and attempted interpretations of the wording of section 83A.

I referred above to the fact that the oil-producing company will be taxed at an approximate rate of 33-1/3% on its income. The rate would be exactly 33-1/3% (based on a 50% corporate rate) if the company's entire income were subject to depletion. We find, however, that this is not necessarily true. A producing company is dealing in petroleum, most of which normally is below ground, and it is not really dealing in land, as such. Because of the provisions of section 83A in regard to the disposal of "oil in place", or as some people would say, because of the sale of a property right, the company is not entitled to depletion on the proceeds from the sale of this oil. Therefore, to the extent that any producing company receives income from the disposal of oil in place, its effective rate of tax will exceed 33-1/3%.

In our opinion, these proceeds should be included in depletable income. The purchaser of the oil in place is required to deduct the cost of this oil from his income before he is permitted to receive depletion. Since his depletion is reduced thereby then it follows that the vendor should not also be denied depletion on this production. It is immaterial that the production does not occur immediately but for equity between the two parties the vendor should receive his depletion allowance when the purchaser's allowance is similarly reduced. This does not mean that all the oil in the country will result in a depletion allowance because, as previously pointed out, the depletion allowance is only obtained after costs are provided there against. This argument, however, is still valid even if the depletion provisions are changed in accordance with suggestions made above. If such change were made, depletion on the so-called gross basis would only be allowed after lifting costs and after charging off the cost of acquiring the right to explore and drill for petroleum.

When the 1962 legislation was enacted it differed somewhat from the initial budget resolutions. The resolutions, for the first time, recognized the fact that the cost of acquisition of rights represented a true operating cost and, to a very considerable extent, replaced royalties which were previously payable to the Province. The very expensive properties are, as a general rule, those portions of reservations or permits which must be returned to the Crown after a successful drilling programme thereon. Since these properties represent substantially proven acreage, the Crown had to find some manner in which they could be returned to the industry. Initially this was done through bids submitted on a gross royalty basis but, since this turned out to be an uneconomic method of operating, the Alberta government changed to a basis where a lump sum of cash was paid in lieu of such larger gross royalties. The Province of Alberta alone during the period 1949 to 1961 inclusive received in excess of $600,000,000 in this regard.

Prior to the 1962 legislation all such expenditures were deemed to be capital expenditures and could not be deducted for income tax purposes except in very minor instances. The 1962 legislation corrected this anomaly and any such costs incurred subsequent to April 10, 1962 are treated as exploration costs. (The initial resolutions did not have a restrictive date.) At the same time this legislation provided that the sale of a property interest was deemed to be ordinary income. The general position is quite sound that all costs are actually operating costs for taxable income purposes and that all income represents taxable income. However, because of the various dates included in the final legislation we have the peculiar position that a property acquired prior to April 10, 1962 is taxable when sold after that date but the cost of acquisition of that property may not be permitted as a deduction from the sale price. A taxpayer who is a trader in oil or any other property would be permitted the deduction of his costs from his sale price and, therefore, it would only seem to be equitable that the legislation should be amended to provide that when the proceeds from the sale of a property interest are brought into taxable income all initial costs of that same property interest should be deductible, providing no previous deduction has been made by the taxpayer in any other manner for these particular costs.

Without such a change in the Act it is almost impossible for a taxpayer to sell a property acquired prior to April 10, 1962, on a reasonable basis. By and large, the bona fide oil company will wish to retain all its productive properties for future production but cases are bound to arise where funds are required for other development and from a financial angle they can only be obtained by the sale of interests presently owned. Legally, this position does not appear to be clear and there are differences of opinion within the industry. We do not believe it would be difficult to make this equitable change in the Act in a clear and concise manner.

Section 17 of the <u>Income Tax Act</u> contains certain provisions to make sure that a corporate taxpayer, which is being liquidated, must pay his due tax. This section, together with the fact that the disposal of petroleum property interests now constitute taxable income, have interfered to some extent with proper business organizations and reorganizations.

A company may own or acquire a wholly owned subsidiary whose entire interest is in the petroleum production business. Certain savings of various types of costs could be effected if the subsidiary company were liquidated and all the assets and liabilities, in effect, transferred to the parent. Admittedly there are provisions for amalgamations in the Income Tax Act which can be used but they are restricted to companies incorporated in the same jurisdiction.

Under the present provisions, if the value of the properties of the subsidiary company exceeds any unused development expenditures, tax is payable on such excess. It would appear to be reasonably simple to correct this situation in a manner somewhat similar to that presently in effect in regard to the question of bad debts in accounts receivable when they are transferred between vendor and purchaser. In this instance, a form could be drawn up which would be signed by the parent company and, if necessary by the subsidiary company being liquidated, to the effect that the parent company will only deduct from its taxable income the actual cost of the properties to the liquidated subsidiary. It is quite possible that the parent company paid an amount in excess of this for the shares of the subsidiary company, but such excess would still be a non-deductible expense to the parent company.

In these instances there is no question of trying to obtain some additional benefit but merely a question of trying to operate on sound business principles and eliminate any unnecessary corporate structures and expenses.

When a petroleum property is sold the Act now specifies that the sale price must be brought into income. 2/ Companies who qualify as petroleum corporations under section 83A(3b) have the right to claim any unused drilling and development expenses against this sale price. Associations, partnerships or syndicates are in the same position under the provisions of section 83A(4) and (4a). Corporations who do not qualify as petroleum corporations may only claim their drilling and exploration expense against income from "operating an oil or gas well in Canada in which the corporation has an interest, and royalties in respect of an oil or gas well in Canada," under the provisions of section 83A(4b). This wording, therefore, would indicate that these types of corporations could not use any excess of drilling and exploration expenses against the sale price of properties for income tax purposes.

Individuals are covered under section 83A(4c) and here it is stated that they can deduct their expenses from "a business that consisted of the operation of an oil or gas well in Canada in which the individual had an interest, and royalties in respect of an oil or gas well in Canada". This wording is substantially the same as that under subsection (4b) but it does include the words "a business that consisted of" and also the subsequent word "had" instead of the word "has". The indication is that the individual could claim any excess expenses against the sale price of the property but departmental officials so far have not been able to give us a clear interpretation of this particular meaning.

Since the 1962 legislation specifically made provisions to tax the sale price of property interests, we would feel that the persons drafting the legislation anticipated that all costs of carrying on the petroleum business could be offset against all income from the petroleum business. We believe they were trying to say this by the words used in subsection (4c) and probably only failed to do so inadvertantly by not using a similar wording in subsection (4b). We take this approach because the wording is quite clear in the other subsection quoted above covering corporate petroleum businesses and partnerships formed for the purpose of exploring for and drilling for natural gas. We suggest, therefore, that subsection (4b) should be changed accordingly and that all doubt be eliminated in subsection (4c).

INTERPRETATION OF SECTION 83A

Considerable discussion has taken place during the last year or two in regard to the meaning of the words "amount paid" and "amounts received" in section 83A. Corporations are normally on an accrual basis as compared to a cash basis but because of these words it is indicated that if property interests are acquired the costs can be deducted in each year only to the extent of the amount that is actually paid thereon. For example, if the purchase price is $1,000,000 payable $100,000 down and $100,000 a year for the next nine years, it is indicated that only $100,000 per annum can be claimed as an expense rather than claiming $1,000,000 in the year of acquisition. The corollary to this is the vendor's position. Following the above line of argument the vendor will bring into income $100,000 each year as he received it rather than bringing in $1,000,000 in the year of disposal.

I have heard legal arguments pro and con covering this point and since there is no actual jurisprudence as yet we suggest that no taxpayer can be sure of his position. Situations such as this, of course, are a serious hindrance to the conduct of day-to-day business. We cannot see any reason why this type of situation cannot be quickly resolved by an amendment to the Act stating clearly the intention of the legislation. In view of the fact that where there is a buyer there is a vendor, the country's revenues will not be hurt as long as both sides are bound in the same manner.

We would suggest that the best method from a business standpoint would be to interpret them on the basis that an amount is claimed when paid (not payable) and that it is brought into income when received (not receivable). By handling it in this manner there would be no need to have recourse to section 85B of the Act which, in itself, does use in subsection 1(a) the words "amount received" and does use in subsection 1(b) the words "amount receivable".

We have seen certain situations where companies have purchased property for, say, $2,000,000, paying $25,000 down and the balance payable the following year pending clarification as to title, etc. If the company only claims $25,000 in its first taxable year and subsequently the courts hold that they should have claimed the full $2,000,000, then they could be in a position of not being able to claim the $1,975,000 in the subsequent taxation year because they initially filed incorrectly (unintentionally) and now have no recourse to amend the returns of the earlier taxation year. It is essential to bear in mind that very substantial sums of monies are involved in transactions of this type and it does not seem reasonable to put a taxpayer in a position such as this when it is not really necessary. This, we believe, is the type of situation that engenders bad feeling between the tax-paying public and the tax department when there is no real necessity therefor.

Section 83A uses the phrase "a right, a licence or privilege to explore for, drill for or take in Canada petroleum, natural gas or other related hydrocarbons (except coal)...." We firmly believe that this wording was inserted with the full intention that the acquisition of essentially all property interests would become deductible as exploration expenses and, in the corollary, that all such sales would be taxable. Here again we are running into technicalities of words because it is difficult to tell whether this includes a gross override or a carried interest or a net royalty interest where it is not specifically defined that the owner thereof actually has the right to take oil in kind. Similarly there is some confusion if oil and gas properties have a ratio of sulphur content. We believe it is now well known that considerable quantities of sulphur are extracted in certain areas, particularly from gas wells, sometimes containing as high as 87-1/2% sulphur. (It is now estimated that there are some 55,000,000 long tons of sulphur in reserves in Western Canada.) These matters can be clarified with proper wording and again we suggest that there should be greater liaison between the department officials responsible for drafting the Act and the persons who are closely familiar with the terminology and modus operandi of the industry itself.

RECOMMENDATIONS

The summary of our recommendations, therefore, is as follows:

1. Because of the community of interest of the tax department and of the taxpayer to have an intelligent and clearly understood tax law to avoid bad feeling, costly court cases etc., we believe that the lines of communication should be opened for mutual consultation prior to the final passing of any amendments in the statutes.
2. For general equity and to retain Canada's economic resources in the hands of Canadians, we believe that all taxpayers should be permitted to deduct their exploration and development expenses against any income which they might have. Because the sale of these interests now clearly produces taxable income there appears to be no reason to

withhold from Canadians a reasonable opportunity to participate in the petroleum business.

3. Depletion allowances should be granted on a primary gross basis rather than the present secondary net basis in order to give further incentive for Canadians to invest in this industry. This will tend to cut down the competitive advantage of United States entities operating in Canada. As an alternative an allowance of more than 100% of drilling and exploration expenses should be permitted as a deduction from income for incentive purposes.

4. Certain anomalies should be corrected:

   (a) Income from the sale of petroleum property interests is fundamentally the same as income from the production of petroleum and should be included as depletable income.

   (b) The cost of a right acquired prior to April 10,1962, should clearly be permitted as a deduction from the income from disposal when that same right is sold.

   (c) Provision should be made for consolidation of corporate structures without tax penalty or gain.

   (d) The sale of a right results in taxable income and it should be made clear that any exploration and development costs not previously claimed for tax purposes should be deductible by all taxpayers against this particular income. 3/

   (e) There should be clarification in section 83A as to whether "amount paid" and "amount received" mean just that or alternatively have the meaning of "amount payable" and "amount receivable".

   (f) The acquisition of all petroleum property interests should be allowable as an expense since their sale price now is treated as taxable income.

REFERENCES

1/ In 1965, the Income Tax Act was amended by Chapter 18, section 20(2), to allow individuals to claim such expenses against the sale price of property.

2/ The comments in this and the two following paragraphs have been covered by the 1965 amendments to the Income Tax Act, Chapter 18, section 20(1) and section 20(2).

3/ Covered by the 1965 amendments to the Income Tax Act, Chapter 18, section 20(1) and section 20(2).