INCOME TAX LAW AND CANADA'S PETROLEUM INDUSTRY

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With the aim of conscientiously avoiding an overstatement of its importance or rhapsodizing upon its complexities, it is nevertheless true that income tax law has and will continue to exercise a powerful effect upon the destiny of Canada's petroleum industry, as its does upon other Canadian industries. It has altered and frustrated executive planning on countless occasions, with the result that it is a truism to say today that most decisions in our petroleum industry are affected by, and some decisions are guided by income tax considerations. Whether or not this is a bad thing, no opinion is here ventured, since the petroleum industry is not different from other industries in this respesct, but it is an undoubted fact which we are obliged to face.

Representatives of Canada's petroleum industry have perhaps eloquently and certainly vociferously contended that special tax treatment must be accorded its operations, due to two peculiarities of its nature which make it almost unique. First, in common with the mining industry, it deals with a constantly wasting or depleting asset which cannot be replaced, and therefore it is contended that the petroleum industry should not be looked upon in the same tax light as is applied to industries which are not engaged in extractive operations. Second, the risk factor in the petroleum industry is enormous, since huge sums of money must be spent in most cases before any profit is realized, and this without the incentive of three income tax free years of production which has been granted to the mining industry under Section 83 (5) of the Income Tax Act, if production is ever commenced. In recognition of these two peculiarities, special legislation has been passed to deal with the petroleum industry. The remarks here deal largely with this special legislation, but touch also upon some of the decisions of the courts which bear upon the petroleum industry in Canada, and upon some of the steps which are taken in the drafting of agreements to accomplish various tax objectives.

The Deduction for Exploration and Development Expenses

Undoubtedly the greatest tax boon to the petroleum industry in Canada has been the deductions allowed under subsections (1) and (3) of section 83A of the Income Tax Act, for the expenses incurred by a petroleum corporation in the course of conducting geophysical, geological, drilling or development operations in search of or in the recovery of petroleum or natural gas. If an operator has no income against which to claim the deduction, it may be carried forward indefinitely until the operator's fortunes prosper to the extent necessary to realize upon the deduction. Similar deductions are available under subsection (4) of this section to associations, partnerships or syndicates formed for the purpose of exploring or drilling for petroleum or natural gas.

Much has been said in favour of extending these deductions to individuals in the hope that some at least of Canada's wealthy individuals

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would thereby be induced to invest directly in our petroleum industry. Parliament, in its wisdom, has heretofore not seen fit so to extend the provisions of section 83A, a fact bemoaned by many investment-hungry oil operators. Of course there is no assurance that the extension to individuals of the advantages now available to corporations and partnerships under section 83A would stimulate a substantial increase in the flow of private funds into the petroleum business. In the first place, anyone who is definitely interested in direct investment in the petroleum industry can very easily form a corporation, association, partnership or syndicate to do so, thereby indirectly availing himself of the deductions allowed under section 83A. In the second place, when the average earnings of investors in the petroleum industry are compared with the average earnings of investors in the steel, electronics, paper and several other industries during the past few years, an extension of the benefits of section 83A to individuals may well, by itself, prove to be much less tantalizing to investors than some would seem to believe.

This is not to say that the Income Tax Act is completely devoid of inducements to individuals to invest in Canada's petroleum industry. Section 1204 of the Regulations does permit an individual to deduct either the aggregate of the drilling costs (as distinguished from bonus costs and general exploration expenses, which are not deductible by an individual) incurred by him in respect of a well drilled in Canada, so long as such expenses were not previously deductible by such individual, or his income for the taxation year from the well, whichever is the lesser. The individual must be circumspect in casting the arrangements by which he contributes to the drilling costs of a well, to make certain that he actually incurs "drilling costs" and not just an obligation to pay money which may be used for drilling or for other purposes in an exploration venture, if he is to secure the deduction allowed under section 1204 of the Regulations. In this connection, the case of *Werier* v. *Minister of National Revenue*[1] decided by W. S. Fisher of the Income Tax Appeal Board, provides a stern warning. Mr. Werier had arranged to pay Eureka Oils Limited the sum of $10,000 towards the drilling costs of a particular well, in return for which he was to receive 10% of the gross production from the well. He was denied the right to claim a deduction for this contribution under section 1204 of the Regulations on the ground that there was no evidence that the $10,000 was in fact spent on drilling. Evidence indicated that the money was received by Eureka Oils Limited and placed in its capital surplus account. In concluding that the appeal should be dismissed, Mr. Fisher said:

> "I am unable to concur in the appellant's submission that the drilling costs of Eureka Oil Limited were incurred by him as is required by the express provisions of paragraph (a) of subsection (1) of section 1204. It is true that he contributed $10,000 to Eureka Oils Limited by the agreement of August 26, 1955, between the limited company and himself and that at that time no drilling had been done by Eureka Oils on the well in question. However, the agreement states that the $10,000 was paid to the limited company by the appellant 'towards the drilling costs of a well to be drilled' . . . There was no agreement, however, that all of the $10,000 would be spent on drilling costs."[2]

Subsections (1) to (4) inclusive of section 83A, while not simple in their language or purport, are nevertheless quite readily understandable

[1] (1960) 25 Tax A.B.C. 373.
[2] Id. at 377.

and are therefore not deserying of further comment here. However, subsection (5) of section 83A has proven to be nettlesome to many taxpayers. In effect, this subsection prohibits the deduction of any sum as payment for a right to explore for, drill or take petroleum or natural gas, "other than an annual payment not exceeding $1 per acre". Most taxpayers consider this an allowance which permits the deduction of the $1 per acre per year ordinarily paid as delay rental due under a freehold lease or ordinary rental under a reservation, permit, license or lease of Crown petroleum and natural gas rights. But what of the lease which requires two payments of rental of 50 cents per acre in each year? Since this arrangement does not call for an annual payment, perhaps the lessee has disentitled itself to any deduction therefor. As a further corollary to this restriction, the acquisition of a lease under an arrangement whereby all of the rentals due for the entire primary term of the lease are paid at the time the lease is executed, an uncommon but not unknown type of deal, will in all likelihood result in a loss of the right to a deduction by the lesse of any amount paid as rental upon the said lease, because it does not recur and therefore may not be an "annual" payment as required under the terms of the statute. In this connection, the recent decision of Thorson, P., in *Western Leaseholds Ltd.* v. *Minister of National Revenue*[3] held that payments which do not have the quality of recurrence are not annual payments.

The word "annual" in subsection (5) of section 83A has itself been the cause of much perplexity. The Shorter Oxford English Dictionary defines "annual" to mean "recurring once every year; repeated yearly". Black's Law Dictionary defines "annual" to mean "returning every year; coming or happening yearly". These definitions clearly demonstrate that the language of subsection (5) will be closely studied by taxpayers and tax gatherers alike.

There are further ramifications of the application of subsection (5) of section 83A which will bear scrutiny. Let us assume that a lessor grants to a lessee company a lease which is non-cancellable during the primary term thereof, with a requirement that the annual delay rental shall be 10 cents per acre rather than the usual $1 per acre, and that the bonus consideration shall be payable in equal instalments over the ten year period of the primary term of the lease. The question then arises as to whether or not the Department would permit the lessee to deduct the 10 cents per acre payable as delay rentals each year during the primary term of the lease and 90 cents per acre on account of the bonus consideration which is payable in equal annual instalments during the primary term of the lease. Would the Department insist that only the 10 cents annual delay rental is deductible, and that the remaining 90 cents is really a payment on the purchase price and therefore not deductible? The language of the section leaves this an entirely moot point.

The Department has also taken the position, in the case of certain petroleum companies which are presently paying income tax in Canada, that some of the administrative operating costs may be properly allocable to the cost of acquiring a "right, license or privilege to explore for . . . . petroleum or natural gas". It is common knowledge that the deduction

[3] [1961] C.T.C. 490.

of $1 per acre per year is ordinarily fully utilized to cover the rental payments made to hold a lease from year to year until drilling commences, in the case of freehold leases, or until the lease is surrendered in the case of Crown leases. The expenses of administration of an oil company have historically been considered by taxpayers as deductible under either subsection (1) or subsection (3) of section 83A, whichever is applicable. If the position taken by the Department on this point is maintained, much of the administrative expense of oil companies will become non-deductible altogether. This is indeed a serious situation involving huge sums of money.

Subsection (6) of section 83A also contains some potential surprises for the unwary. In effect, this subsection allows a corporation, association, partnership or syndicate, which has paid an amount to the Government of Canada or to the government of any province in Canada for a right to explore for petroleum or natural gas, to deduct such payment, provided that the taxpayer surrenders the right to the government from which it was acquired without having discovered any production of petroleum substances in reasonable commercial quantities therein or thereon, and "without receiving any consideration therefor or repayment of any part of the amount so paid". The language of this subsection would apparently proscribe any right to claim a deduction for any bonus payment made by a given holder of an interest in a Crown petroleum and natural gas right, if such holder received such right, not from a government in Canada directly, but rather by way of a farmout from the grantee thereof. The same result might be anticipated if the subsection was strictly construed and applied to a company which had received a Crown petroleum right by way of an assignment from an individual or subsidiary company which had made the actual acquisition of such right pursuant to a trustee or agency arrangement with the company which was to become the ultimate holder of the interest in question, but no ruling on this point has yet been made. The deduction would apparently also be lost if the holder receives any contribution of cash or acreage from any other party toward the conduct of exploration operations upon the lands contained in the Crown petroleum right in question. It appears that if the grantee of such a right were to allow Company X to earn an interest in the Crown petroleum right by drilling a well at the sole risk and expense of Company X upon the lands included in such right, and if after the well proved dry, a surrender of the right in question was made to the appropriate government, the deduction for the bonus costs paid to such government would be lost because the grantee of the right in question would in fact have received consideration from an outside party in respect of the said right prior to its surrender. Stated another way, the grantee of the right in question in this example was obviously not prepared to surrender the right in question until a certain amount of exploration had effectively condemned the Crown petroleum right. So long as the grantee paid for all of this exploration itself, there is no doubt that the grantee would be entitled to claim the deduction allowed under subsection (6). However, in the case of the arrangement with Company X which is postulated above, it appears that the Department would be able to argue that the grantee had not itself paid for all of the exploration work necessary to condemn the right acquired by it and that therefore the grantee is not entitled to a deduction for the bonus costs paid in acquiring the right in question. This is admittedly a narrow interpretation of this subsection but nevertheless one which the language permits. To the writer's knowledge, no rulings have yet been made which would cast any light upon the position which the Department will take in connection with subsection (6) of section 83A.

With the exception of subsection (8a), those of the remaining subsections of section 83A which are applicable to petroleum companies in Canada are reasonably straightforward and it is not proposed to comment further upon them. Subsection (8a) and its corollary, subsection (6a) are concerned with the question of reorganizations which will be dealt with later.

Depletion

Although the allowance for depletion in Canada is not as great from a dollar standpoint as the deductions permitted under section 83A of the Income Tax Act, it is still a very significant allowance, which unfortunately has become the subject of a chronic controversy between the oil industry and the federal government. The oil industry in Canada has often complained of the inadequacy of Canada's allowance for depletion because it denies depletion to the operator which is not receiving sufficient income to attract an income tax, even though depletion of this operator's oil and gas properties may be going on apace. There can be no doubt that our Canadian depletion allowance falls far short of the allowances for depletion granted in the United States, and that on this basis alone, the United States oil company is in a better position to compete for markets for its products than is the Canadian oil company. The Department of National Revenue has countered these criticisms with the argument that Canada does not propose to attempt to meet the world's highest standard of deductions offered to oil companies but rather to provide what it considers a reasonable allowance for the depletion of a wasting asset.

Clearly the allowance for depletion, as an abstract principle, cannot be thought of under any tax laws as a means of recovering cost or investment because it is not measured as a function of cost or investment, but rather as a function of income. In its extreme manifestations, as its critics point out, where good fortune attends the efforts of an oil operator at an early juncture, the depletion allowance can result in deductions being allowed such operators in excess of its cost. However, this is a rare if not unheard of result in Canada, although it does happen in the United States but much less frequently than the detractors from the depletion allowance would lead us to believe. Much more common is the case of the oil operator in Canada who has incurred large costs before production is encountered, and since his costs must be deducted from his gross income before his depletion is computed, he is allowed no deduction for depletion until his income is sufficiently large to exceed his costs, both current and deferred. This unhappy operator, of which there appear to be many in Canada today, has no incentive to spend any more money upon exploration and development in Canada until his profits exceed his costs because he recognizes that he can never realize any deduction for depletion until his costs have been recovered. The objective of the allowance for depletion is to provide an incentive to invest in Canada's oil industry, but this objective is being frustrated so long as our depletion allowance is computed on a net basis after the deduction of costs. But then some people in Ottawa will argue, "Why do you need an incentive, since you are presently very active in the field of exploration for and development of oil reserves, of which Canada already has more than can be handled in present-day markets?" The answer to this latter argument has been long coming and it is not proposed to expound upon it here. Suffice it to say that the last word has not yet and perhaps never will be said on the subject by taxpaper or tax gatherer.

The allowance for depletion in Canada is authorized under section 11 (1) (b) of the Income Tax Act and granted in Part XII of the Regulations. The owner of a non-operating interest in oil and gas (i.e. a person receiving a royalty or rental computed by reference to production and not to costs) may deduct 25% of the amount received from such interest in each taxation year. The computation of this deduction is simple and non-contentious because it is computed upon the basis of gross income from oil or gas wells without regard to costs. However, the deduction for depletion which may be claimed by the owner of an operating interest in the oil and gas property (i.e. a person having an interest in the proceeds of production under an agreement which provides that he shall share in the profits remaining after deducting the operating costs) has been extremely controversial. In the first place, it is not always an easy matter to establish whether a given oil and gas operator's interest is an "operating" interest as defined in section 1201 (b) of the Regulations, as distinguished from a "non-operating" interest as defined in section 1202 of the Regulations. This problem was much more difficult to resolve in the years prior to 1958 when the description of an "operating" interest was imprecise and vague, thus precipitating some weird and wonderful nomenclature in operating agreements in efforts to secure for the parties which were sharing the risks and expenses an "operator's" depletion allowance. Sections 1201 and 1202 are now more precisely drawn and much of the previously existing confusion and doubt has been removed.

But even yet puzzles exist in the grey areas between section 1201 (1) (b) and section 1202. For instance, consider the case of oil operator A, who has by agreement covenanted to assign an undivided one-half interest in certain very valuable oil and gas interests he holds unto B, in return for B's covenant to defray all the risks and costs of drilling, developing and operating such lands. Clearly B may deplete at 33-1/3% of net income because he is paying the costs thereof. As for A, in view of the fact that he has given up one-half of his valuable reserves in return for a covenant by B to drill, develop and operate such reserves for A and B as tenants in common, free of risk and expense to A, it is not surprising that A will not be very sympathetic to an assertion by the Department that he is not an "operator" on the grounds that he pays no share of the costs of operating and in fact shares in gross production rather than in what remains after operating expenses have been deducted. A will certainly argue that both he and B have contributed something vitally necessary to the oil and gas operation, since he contributed the land and

B contributed the money to develop it. The problem is exacerbated by throwing in the further fact that A may be obliged in some agreements to contribute his share of operating costs after the wells have produced for a given time or have produced a given amount of oil or gas solely at the expense of B. What then does A deduct for depletion during the intervening years before he begins to contribute to the costs of operations?

Litigation has swirled around the question of how an operator computes his depletion allowance in Canada, whether on a well-by-well basis, or on an over-all basis. Usually, the result of computing on a well-by-well basis will be enormously different from the result which will obtain through computation on an over-all basis. The cases on this point have been very closely studied by the entire oil industry, due to their widespread effects.

In 1948 the Regulations provided that for the taxation year 1949 and afterward a taxpayer operating an oil or gas well would be granted an allowance for depletion of 33-1/3% of the net profits reasonably attributable to the production of oil or gas from an oil or gas well, after deducting development expenses, operating expenses and depreciation. The petroleum industry contended that the words "profits . . . . from an oil or gas well" in the Regulations during those years permitted the taxpayer to ascertain the profits from each well separately, and to calculate depletion on a well-by-well basis. In 1955, the decision of the Supreme Court of Canada in *Home Oil Company Limited* v. *Minister of National Revenue*[4] upheld this view on the ground that the Regulation clearly connoted the singular when it referred to "profits from an oil or gas well". Rand, J., in reversing the decision of the Exchequer Court in favor of the Minister, held as follows:

> "The use of the word 'profits' and of the expression 'from the well' is, in the general context of the Act, singular, and to me they bear a signification that differentiates them from both 'income' and 'well' or 'oil' . . . . Certainly the partitioned allowances to the lessor and lessee under Section 11 (3) must be related to the profits strictly of at least the wells of the lessor: . . . . I am not in doubt, therefore, that the 'profits' of a 'well' are not intended to be identical in the sense claimed [by the respondent] with the income of a company from its total oil operations remaining after the deduction of the allowance under section 53."[5]

With respect to the deduction of costs incurred in drilling non-productive wells before the depletion allowance is computed, Rand, J. said:

> "Subsection (4) of the regulation speaks of a deduction equal to that made from income under section 53 [now section 83A] 'in respect of the well' from the profits 'reasonably attritutable to the production of oil or gas for the purpose of this section (1201)'. I take this to imply that the outlays charged against the income under section 53 must be "reasonably attributable' to the wells that have produced the profit and that means especially or directly related to them."[6]

This decision made it certain that for the taxation years 1949 and 1950 depletion could be computed on a well-by-well basis.

In 1959 the case of *Imperial Oil Limited* v. *Minister of National Revenue*[7] was heard by the Exchequer Court on an appeal which turned upon the amendments made to section 1201 of the Regulations for the taxation years 1951 to 1955 inclusive. These amendments were made with

[4] [1955] C.T.C. 192.
[5] Id. at 196.
[6] *Ibid.*
[7] [1959] C.T.C. 29.

a view toward establishing beyond a doubt that depletion would be permitted only on an "over-all" basis. The chief amendment to section 1201 in 1951 consisted of the addition of a new subsection (4), which of course did not apply in the taxation years under consideration in the *Home Oil* case, and which provided:

"Where the taxpayer operates more than one oil or gas well, the profits referred to in subsection one shall be the aggregate of the profits minus the aggregate of the losses of the taxpayer for the year reasonably attributable to the production of oil and gas from all wells operated by the taxpayer."

A further important amendment to section 1201 at that time was the deletion of the words "in respect of the well" from the end of new subsection (5), formerly subsection (4), of the Regulation.

Thorson, P., speaking for the Exchequer Court, clearly felt himself bound by the decision of the Supreme Court of Canada in the *Home Oil* case. In a very closely reasoned judgment he found that although certain changes had been made to section 1201 of the Regulations since the taxation years affected by the *Home Oil* case, these changes still did not have the effect of requiring the computation of depletion upon an "aggregate" basis. He said:

"I have no hesitation in finding that in determining the base for the computation of the appellant's deductible allowance under the present section 1201 of the Regulations it is just as important that each producing well should be dealt with individually as it was under the section in its former state."
"The importance of the words 'reasonably attributable' in subsections (1), (4) and (5) of section 1201 cannot be too strongly stressed. It is concerned only with producing wells."[8]

And further on he held:

"Moreover, the use of the words 'amounts, if any', in subsection (5) further points to the need of an individual well basis for the computation of the allowance and negatives the contention of counsel for the respondent that subsection (5) requires the deduction of the total of the amounts that were deducted under section 53 for income tax purposes, regardless of whether they are attributable to the production of oil or gas from a well or not."[9]

Thorson, P., also held that the new subsection (4) "plainly points to the necessity of dealing with each producing well individually", since it required that in the case of each well it had to be determined whether or not it made a profit or sustained a loss and that the aggregate of the profits of the profitable producing wells as so individually determined was then reduced by the aggregate of the losses of the loss producing wells as so individually determined to establish the profit made by the taxpayer.

The Minister's appeal to the Supreme Court of Canada was allowed by a divided Court.[10] Judson, J. held that the drilling, exploration and other costs of the respondent which were not related to a producing well were required to be aggregated with the costs properly attributable to producing wells in determining the profit against which the depletion allowance was claimed, by virtue of the provisions of new subsection (4) of section 1201. He stated:

"The reasonably attributable profits mentioned in subsection (5) are not on a well-by-well basis, taking only profitable wells, but on the composite basis as

8Id. at 43.
9Ib. at 45.
10[1960] C.T.C. 275.

required by subsection (4). Then all section 53 items must be deducted—not, as formerly, only those 'in respect of the well'."[11]

In commenting upon the meaning to be given to subsection (5) of section 1201, Judson, J. had the following to say:

> "It simply means that whatever amounts the taxpayer deducts for determining taxable income must be deducted under Regulation 1201. The presence of these words ('the amounts, if any') in subsection (5), far from reinforcing "the company's submission on the construction of the new Regulation, seems to me to be entirely consistent with the Minister's submission and to support the assessment. A taxpayer who deducts these section 53 items in one place for the purpose of determining taxable income, must do so in another for the purpose of determining the allowance under Regulation 1201."[12]

This appears to be a much more labored and less logical interpretation of the meaning of the words "the amounts, if any" than the explanation offered by Thorson, P. in his decision on the case when it was before the Exchequer Court.[13] However, the majority of the court agreed with Judson, J.

The reasoning of Martland, J. anent the meaning to be ascribed to new subsection (4) of section 1201 is consistent with the approach taken by Thorson, P. and in the writer's mind captured the correct inference of the language of that subsection. He said:

> "When this subsection refers to the 'aggregate' of profits and the 'aggregate' of losses reasonably attributable to the production of oil or gas from all wells operated by the taxpayer it must mean the aggregate of the profits and the aggregate of the losses attributable to the individual oil or gas wells from which oil or gas production was obtained. It is speaking of an aggregate of individual items. Consequently the computation must still be on a well-by-well basis, but subsection (4) added a new feature to the Regulation in that losses on a per well basis in respect of wells operated at a loss had also to be deducted from the aggregate of the profits earned by the individual profitable wells."[14]

Martland, J. also held that the removal of the words "in respect of the well" from the end of old subsection (4), upon which the majority of the court laid such stress, was simply done for the purpose of making it conform with the provisions introduced in the new subsection (4), a conclusion which seems entirely reasonable when the language of the two subsections is perused. With the greatest of respect, it is submitted that the decision of the majority of the Supreme Court of Canada, having regard to its conclusion upon similar facts in the *Home Oil* case, does violence to the new language introduced in section 1201 of the Regulation for the taxation years under appeal, and that the minority views expressed by Martland and Ritchie, JJ. and concurred in by Cartwright, J. are much more compatible with the Regulation as it then read. Nevertheless, the die has been cast by the *Imperial Oil* case for the computation of depletion for the taxation years 1951 and 1952 at least. The amount of depletion allowances which could have been claimed by Imperial Oil Limited and other companies in a similar position during those years was reduced through this decision by amounts which some have estimated at upwards of $60,000,000 and therefore it is small wonder that the outcome of this appeal was so anxiously awaited by taxpayers and tax gatherers alike.

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[11] Id. at 286.
[12] *Ibid.*
[13] See note 9 *supra*.
[14] Id. at 292.

For the taxation years 1953 to 1955 inclusive, the provisions of section 1201 of the Regulations were again amended to make it even more clear that depletion must be claimed upon an "over-all" basis and not on an individual well basis. For the taxation years 1956 and afterwards a further amendment to section 1201 has gone even further by setting out the actual mechanics by which the depletion allowance shall be computed upon an "over-all" basis, placing it beyond any doubt whatsoever that depletion upon an individual well basis in Canada is now purely history.

The calculation of depletion allowances for products of gas plants or sulphur plants is rapidly becoming the tax problem of the day for the petroleum industry in Canada. Some American writers, in discussing how depletion is allowed under the tax laws of the United States, have stated that for the purpose of computing depletion, plant operations can be characterized by four operative phases: separation, absorption, fractionation and injection.[15] Profits attributable to any phase which is essentially a producing function should attract a depletion allowance, they argue, and this will include the separation of the gas from the ground in all cases and the injection of plant residue in the ground in all cases. However, profits attributable to a manufacturing operation will quite understandably not be reduced by a depletion allowance. Fractionation in a plant is almost invariably a manufacturing operation because the gas entering the plant is converted into new products through the fractionation process. Also, in most cases the absorption function will qualify as a manufacturing operation.

Canada has not closely followed the American scheme of creating a sharp dichotomy between producing and manufacturing functions in gas or sulphur plants for the purpose of establishing what is and what is not subject to depletion under our laws, but indications from the Department of National Revenue are that the principles to be followed will not be too dissimilar from the American practice in this respect. One reason for a somewhat different approach in Canada is the provisions of Section 1201 (5) (d) of the Regulations, which are as follows:

> ". . . . profits reasonably attributable to the production of oil or gas from a well or bituminous sand deposit shall not include profits derived from transporting or processing the oil or gas."

Apparently the Department is prepared to allow depletion in respect of certain basic or elementary separation operations in the field, such as the removal of water from the gas, on the basis that these are producing and not "processing" operations. However, profits made from any more advanced plant operation will be considered "processing", in respect of which the Regulation prohibits a depletion allowance. Furthermore, the Department feels that the injection of plant residue in a "re-cycling" process is closely related to the production of plant products and therefore will not allow the costs of injection to be set off against the value of sweetened gas for sale in determining the profit therefrom. This is a partial departure from American practice in the same circumstances but its results are not in ordinary cases particularly severe to the taxpayer. The rules for the computation of depletion allowances for plant operations in Canada are still really in their nascent stage and there is every

15Raymond Myers, *The Law of Pooling and Unitization*, (1957) 286 ff.

indication that negotiation between taxpayers and the Department upon the formulas that will apply to the depletion of plant profits for individual plants will produce a reasonable result.

In concluding the remarks concerning the depletion allowance under Canadian tax laws, it is fair to say that this is the one area in which taxpayers in the oil industry feel genuinely aggrieved. Complaints are registered from time to time by taxpayers in the petroleum industry concerning other parts of the Income Tax Act, as these parts might affect a particular taxpayer in particular circumstances, and undoubtedly this will always be with us. But in the case of our depletion allowance all taxpayers raise their voices in unison in denouncing its inadequacies. Even members of the federal government have from time to time over a span of ten years admitted that something will have to be done about it but no change in its essentials has manifested itself. If one accepts the basic philosophy that some incentive should be granted to a taxpayer in an extractive industry engaged in the very expensive business of exploring for and recovering an irreplaceable substance like petroleum, the success or failure of which business is markedly affected by the fortunes that the taxpayer enjoys and the reserves of capital that he may be able to draw upon to sustain him through barren years, it is indeed a paradox to hinge the incentive offered him upon the costs which he has incurred in the course of his search. The depletion allowance in Canada for many taxpayers has become a will-o'-the-wisp; it is there but they cannot have it. Surely it is patently necessary that a change should be made to a basis whereby the depletion allowance can be claimed by any taxpayer who is in fact depleting his assets as he recovers his oil regardless of whether or not he has incurred large costs in searching for and finding the substance upon which he depends for his existence.

Income Tax on Profit Realized from the Disposition of Petroleum Interests

It is not the purpose to attempt here to discourse upon the distinctions between capital gains and income in Canada. Naturally the possibility of realizing capital gains is attractive to all oil companies to the same extent as it is to any other taxpayer. However, in the normal course of events, an outright sale of an interest in oil and gas property is not a particularly common transaction although it may become much more common in future years. Usually, oil companies disposing of interests held in oil and gas properties will reserve some overriding royalty or profits interest from the disposition. This type of transaction begs the question of whether an outright disposiiton for profit results in capital gain or income.

Before any disposition of an interest in an oil and gas property is made for cash, some attention will be given to the principles laid down in *Anderson Logging Company* v. *The King*[16] and more recently in *C. W. Logging Company Limited* v. *Minister of National Revenue*,[17] which have become rather of the category of "old chestnuts" in determining whether a given profit should be considered income or capital gain. However, of much more direct concern to oil companies are some of the recent cases in Canada dealing with capital gains. One case which causes

[16] [1925] S.C.R. 45.
[17] [1956] C.T.C. 15.

some concern is that of *McMahon and Burns Limited* v. *Minister of National Revenue,*[18] a decision of Dumoulin, J. in the Exchequer Court of Canada. In this case the appellant company was an investment dealer and stockbroker, authorized under its memorandum of association to purchase securities as a principal or agent. In 1949 the appellant acquired certain debentures for sale to its customers in the ordinary course of its business and at the same time purchased some of the same debentures on the open market for its own investment account. In 1950, when the Korean war broke out, the appellant became apprehensive of the effect which the war might have on the market and sold large blocks of these latter debentures. A profit was realized on the sale and the Minister assessed the profit as income. An appeal to the Income Tax Appeal Board was dismissed. The Exchequer Court of Canada dismissed a further appeal, holding that the appellant's intention to place the debentures in its investment account, which intention was not disputed by the court, was not a decisive factor. In the opinion of the court the disposal by the appellant of its own holdings after a lapse of nine to fourteen months was still consistent with a commercial and speculative venture. According to that decision, if a particular transaction, viewed objectively, is within the company's normal business operations, any profit therefrom is subject to income tax, even though the transaction involved may be considered by the company to be an investment. In effect, the decision holds that the intention of a body coporate is inconclusive in determining whether or not a given profit is income or capital gain, the real determinant being the actual course of conduct.

The decision in the *McMahon* case poses an obvious threat to any company which is obliged to sell its interests in oil and gas leases for one reason or another. Since oil and gas leases are ordinarily an investment and probably the chief capital investment of many oil and gas exploration companies and since oil and gas companies must be empowered to deal in oil and gas leases, the application of the decision in this case to a disposition of a part of the capital investment of an oil company is a most uninviting prospect.

A case offering an equally ominous threat from the opposite direction is the decision of the Income Tax Appeal Board in *Great West Exploration Limited* v. *Minister of National Revenue.*[19] In this case, the appellant company purchased various leases of petroleum and natural gas rights and conducted certain operations upon them. After some years, the company found itself in such a difficult financial position that it was without any working capital available for exploration purposes. For this reason, the appellant decided to dispose of certain properties, including leases and wells, the proceeds from which disposition were to be used for further development of the appellant's remaining properties and for the repayment of shareholders' loans. Pursuant to this plan, the appellant sold four lots, thereby earning a profit of approximately $117,000 which it viewed as a capital gain made in transactions extraneous to its regular business. R. S. W. Fordham ruled as follows:

> "Moreover, the appellant herein is in what is known as the oil-well development business and 'leases', as they are inaccurately termed, relative to lands believed

[18] [1956] C.T.C. 183.
[19] (1957) 17 Tax A.B.C. 416.

> to have oil thereunder were virtually a part of what might be called the appellant's stock-in-trade. They were not, for instance, in the category of capital assets such as buildings used by a company wherein to operate its business. Without leases, concessions and other rights of the kind, the appellant would not have been able to conduct its business operations. When, as it did, it saw fit to part with some of its improved assets, at a profit, it appears to me that it did *nothing* more or less than take a normal, even if not frequent, step in its business. That being so, it follows, of course, that the gain thereby made constituted income . . . ."[20]

Whereas the decision in the *Great West Exploration* case may have turned to some degree upon other facts elicited before the Board which are not referred to or reflected in the report of the decision, it appears to the writer that the holding that leases are a part of the stock in trade of an oil company and not capital assets should give any oil company pause. Although Mr. Fordham may be unaware of it, there are taxpayers which do a thriving business dealing with interests in the production of oil and gas without ever owning any leases or concessions, and these interests, it as agreed, could be considered the "stock-in-trade" of such taxpayers. But it cannot be categorically stated that "without leases, concessions and other rights of the kind", a taxpayer such as the appellant in this case would have been out of business. Furthermore, there are other taxpayers whose sole capital assets consist of oil and gas leases which are retained strictly as a long term investment, without any intent to buy and sell leases as a part of the course of business of such taxpayers. It is submitted that it is most inaccurate and unfair to this last mentioned group of taxpayers to rule that their investments are "stock-in-trade" simply because they do not choose to invest in buildings, which Mr. Fordham considers the classic form of capital investment, for the reason that they do not need buildings in their businesses. Perhaps Mr. Fordham did not intend his remarks for taxpayers in this last mentioned group, but he painted with such a wide brush in his decision in this case that one is left with the inevitable question: "What is left after a ruling of this scope is applied?"

Nil Assessments

For many years one of the most trying tax problems with which the petroleum industry in Canada has had to grapple has been the question of whether or not the "Notice of Assessment" form issued by the Department of National Revenue upon receipt of a return from a taxpayer from which no tax is payable, is in fact an "assessment" under the provisions of section 46 of the Income Tax Act. A great many oil companies have not yet earned any taxable income from their operations in Canada due to the fact that their expenditures upon exploration and development exceed their revenues. Consequently the returns which they are obliged to file under section 44 of the Income Tax Act merely show the revenue that has been received during the current year, counterbalanced by deductions for exploration and development expenditures incurred in the same taxation year or carried forward from previous years under Section 83A, to the extent necessary to wipe out any tax upon such revenue. The Department of National Revenue acknowledges receipt of these returns on a form marked "Notice of Assessment", which stipulates that the assessment for the year in question is nil. The Department

[20] Id. at 417-18.

has contended that a nil assessment is no assessment at all, with the result that the four year period within which a taxpayer may be re-assessed by the Minister pursuant to the provisions of subsection (4) of section 46 of the Income Tax Act never begins to run. Under this theory, the taxpayer is in jeopardy of re-assessment at any time for any given taxation year in its history until such time as it is able to earn sufficient income to attract an income tax, and is able to maintain this record of earnings thereafter.

This situation has proven an extremely difficult one. For those oil companies which have accrued deductions against income taxes in excess of taxable income—and this would still include the majority of Canadian oil companies—no guidance is offered by the Department as to whether or not the returns which they have filed are correct, because the Department will not audit the accounts of a company from which no tax is due. Returns are therefore filed by these companies year after year upon a basis which they hope and believe is correct, but which if later proven to be incorrect, will not affect just a single taxation year but every taxation year since operations were commenced. The adjustments in such cases could be enormous and might prove to be disastrous in the case of some companies. It is patently a hardship upon any taxpaper to allow him honestly to mislead himself year after year in the compilation of his returns, compounding the results of his misapprehensions of the law until he gets himself in a perilous financial position, simply because guidance by the Department is denied him until he earns enough income to attract a tax.

The contention of the Department that a nil assessment is no assessment at all was given support in the case of *Okalta Oils Limited* v. *Minister of National Revenue*,[21] decided by the Supreme Court of Canada. In this case the appellant claimed the right to appeal an assessment made under the Income War Tax Act. Fauteux, J. held that the word "assessment" in sections 69a and 69b of the Income War Tax Act meant the actual sum of money payable by the taxpayer as tax for the taxation year and not the method by which the assessed tax is arrived at, with the result that ". . . . there was no assessment if there was no tax claimed".

The doctrine laid down in the *Okalta* case seems to have been accepted by taxpayers throughout Canada until the case of *Anjulin Farms Limited* v. *Minister of National Revenue*[22] came along. In the hearing of this case by the Exchequer Court, the wording in subsection (4) of section 46 of the Income Tax Act was carefully perused by Cameron, J. He cited with approval the words of Viscount Simon, L.C. in *Income Tax Commissioners (City of London)* v. *Gibbs* in reference to the meaning of "assessment", wherein the Lord Chancellor said:

> "The word 'assessment' is used in our income tax code in more than one sense. Sometimes, by 'assessment' is meant the fixing of the sum taken to represent the actual profit for the purpose of charging tax on it, but in another context the 'assessment' may mean the actual sum in tax which the taxpayer is liable to pay on his profits."[23]

In the *Anjulin* case the court held that the word "assessment" clearly did not relate to an amount of tax, since new subsection (2) of section 46

21 [1955] S.C.R. 824.
22 [1961] C.T.C. 250.
23 [1942] A.C. 402, 406.

requires the Minister to send a Notice of Assessment to any person who has filed an income tax return, whether or not such return indicates that a tax is payable. In this Notice of Assessment, the Minister is obliged to state that the return has been assessed and if the tax is stated to be nil dollars this is nonetheless an "assessment" under the Income Tax Act. In this case, since the original assessment had been made more than four years prior to a proposed re-assessment by the Department, the court allowed the appeal and rejected the Minister's contention that he be permitted to re-assess upon the grounds that the four year period had not yet commenced to run against the taxpayer.

Unless the decision of the Exchequer Court of Canada in the *Anjulin* case is upset upon appeal to the Supreme Court of Canada, it will provide encouragement to a host of taxpayers in Canada, not the least of whom are those oil companies which have not yet been able to earn any taxable income. Of even greater comfort to the taxpayer should be the new language of subsection (4) of section 46 of the Income Tax Act, as amended in 1960, which effectively provides that the Minister may re-assess or make additional assessments, in the absence of fraud or misrepresentation, only within four years from the date of mailing of a notice of original assessment, or of a notification that no tax is payable for a taxation year. This subsection will require the Department to either audit tax returns on a reasonably current basis, thus giving many would-be taxpayers the guidance which they have so long sought, or, in the absence of fraud, allow returns that become more than four years old to pass beyond the period during which re-assessments are possible. In the writer's view the introduction of this provision into our Income Tax Act was long overdue.

Reorganizations

Prior to the enactment of section 851 and of subsection (8a) of section 83A of the Income Tax Act, a reorganization among oil companies, particularly those which had accumulated deferred deductions for exploration and development expenditures, was virtually stymied.

It is well known that there has been considerable pressure exerted by the federal government in Canada in recent years to induce a reorganization of foreign companies doing business in Canada, insofar as their Canadian operations are concerned, into Canadian companies, and therefore the provisions of subsection (8a) of section 83A, and of section 851 are particularly important to oil companies at this time. The classic form of reorganization under subsection (8a) of section 83A is one whereby one company (which is referred to in the section as the "predecessor corporation") disposes of all its assets to another company (in the section called the "successor corporation") either in return for shares of the capital stock of the successor corporation, or as a result of the distribution of the property of the predecessor corporation to the successor corporation upon the winding up of the former, after the necessary share exchanges have taken place between the predecessor and successor corporations. The benefits of this section can also be employed to absorb the property of the predecessor corporation into the successor corporation if the predecessor corporation was at all times material to the transaction a wholly-owned subsidiary of the successor corporation. The subsection applies only to transactions consummated after 1954. It then goes on to indicate that the successor corporation may utilize in the computation of its own income the deferred deductions which were accumulated by the predecessor corporation and were not deductible in the hands of the latter prior to the reorganization. As is well known, the successor corporation must apply the deferred deductions which it acquires under subsection (8a) of section 83A from the predecessor corporation against income received from lands formerly held by the predecessor corporation. It is also a well known fact that no deductions may be claimed under section 83A by the predecessor corporation in the taxation year in which its property is acquired by the successor corporation. It would therefore appear that a reorganization under this particular subsection should be made as soon after the termination of a taxation year as is possible.

Paradoxically, although the federal government appears to have been making various attempts to induce foreign corporations, including many oil companies, to reorganize into Canadian corporations, the Income Tax Act itself and various interpretations placed upon its provisions by the Department have inhibited rather than encouraged such reorganizations. As a result of these inhibiting factors many companies which might otherwise have reorganized into Canadian corporations have sedulously avoided doing so when some of the untoward results of such a reorganization were made clear to them.

It is agreed that trafficking in tax deductions in Canada should be prevented under the law and it seems that the Income Tax Act adequately protects against such a practice by the wording of subsection (8a) of section 83A, wherein it is clearly stated that deferred deductions transferred by a predecessor corporation to a successor corporation may be claimed by the latter only against income from lands formerly held by the predecessor corporation. However, the difficulties do not stop there.

While it is only fair to state that recent rulings of the Department have indicated a general relaxation of the standards for a reorganization, some of the stumbling blocks which the Department has placed in the path of reorganizations include the following:

(a) The Department has interpreted subsection (8a) of section 83A to mean that since the consideration for an acquisition made thereunder is shares and not cash, the transaction must involve shares exclusively. The Department has stated in several instances that no liabilities may be transferred to the successor corporation because liabilities are not reflected in the shares of the company. Under this interpretation, unless the predecessor corporation can liquidate all of its liabilities before the acquisition, a reorganization into a successor corporation is forestalled. If long term, non-redeemable bonds have been issued by the predecessor corporation to finance its operations, a fairly common form of financing, the predecessor cannot liquidate this debt and therefore the transfer of the accumulated deductions cannot be effected. It is almost redundant to add that the accumulated deductions held by a company in many cases are of such a value that without their preservation the reorganization becomes pointless to both parties concerned. However, in the case of one very recent reorganization of a foreign company's Canadian branch into a Canadian company, the Department did permit the transfer of liabilities from predecessor to successor corporation, a ruling which would indicate that the Department may be relenting on its earlier position on this point.

(b) The predecessor corporation is prevented from claiming any deductions for tax purposes in Canada in the year in which its assets are acquired by a successor corporation under section 83A (8a). This position is clearly set out in the provisions of paragraph (f) of subsection (8a) and has been given further emphasis in the recent case of *Hargal Oils Ltd.* v. *Minister of National Revenue.*[24] The reason for such a restrictive provision cannot be seen. If a deduction is to be allowed under the Income Tax Act at all, it should be immaterial to the Department whether the successor corporation or the predecessor corporation claims it, so long as a double deduction is not taken.

(c) Until the addition of subsection (6a) to section 83A in 1961, any bonus costs paid by the predecessor corporation to any Crown agency and allowed as a deduction to the predecessor corporation under the provisions of subsection (6) of section 83A, could not be claimed as a deduction by the successor corporation under the provisions of subsection (8a) of section 83A.

(d) Section 851 covers mergers between two or more companies and substantially follows the provisions of section 83A (8a) but restricts the employment of deferred deductions accumulated by one of the companies merged to income produced from the lands formerly owned by that company only. Such deduction cannot be used to reduce the income of the new company from properties which the new company may acquire itself, althought the same deductions could obviously have been used by any predecessor corporation against any of its income, whether from previously acquired or after acquired lands, if the merger had not taken place.

These restrictive features clearly compromise the efficacy of the federal government's program of reorganizing foreign operations in Canada into Canadian companies. At the same time, the benefits to Canada of the limitations to which reference has been made above is certainly questionable when the whole picture is examined since they do not in themselves increase tax revenue to the fiscus in any way.

Oil Payments

From time to time the question is raised in Canada as to the feasibility from a tax standpoint of arranging for the financing of operations upon a given lease by means of the sale of an oil payment. Oil payments can take a variety of forms but all are devoted to one purpose, namely, the purchase of property believed to be capable of producing petroleum in commercial quantities for a reasonably small amount of cash, with the remainder of the purchase price being paid to the vendor of the property over a period of time out of the production recovered from the lands in

[24] 61 D.T.C. 594.

question. In the United States, the financing of oil and gas operations by means of oil payments has reached a high degree of sophistication, and "retained oil payments", "carved-out oil payments" and "ABC oil payments" have become household words in the petroleum industry. The catalyst that makes oil payment financing possible in the United States is the allowance under the laws of that country for cost depletion, pursuant to which the party which borrows money to buy the oil payment is permitted to recover the costs of repaying his loan, free of tax.

Oil payment financing has never become a reality in Canada, chiefly due to the absence of an allowance for cost depletion under Canadian tax law. In addition, section 6 (1) (j) of the Income Tax Act states that ". . . . there shall be included in computing the income of a taxpayer for a taxation year . . . . amounts received by the taxpayer in the year that were dependent upon the use of or production from property, whether or not they were instalments of the sale price . . . .". Under these provisions, the Canadian taxpayer will not only be taxed on the profit which he makes from the investment of his capital in an oil payment, which is entirely reasonable, but also on the recovery of his capital through the production of oil and gas from the property in question. This is the coup-de-grace for oil payment financing in Canada.

In this connection, the well-known case of the *Calgary and Edmonton Corporation Limited* v. *Minister of National Revenue,*[25] decided by the Exchequer Court, is entirely on point. In this case, three sisters disposed of their entire interest in the hydrocarbons within certain lands for the sum of $75,000 in cash payable at the time the agreement was consummated, and a further $75,000 payable out of 10% of the gross proceeds from the sale of petroleum substances produced, sold and marketed from the lands in question. The appellant became the owner of a portion of the operating interest in the lands subject to this disposition. Fournier, J. held that the entire proceeds of production received by the appellant from the lands in question were taxable in its hands notwithstanding the fact that a portion of this production was pledged to the three sisters until the further sum of $75,000 was paid to them. In the course of his judgment, Fournier, J. said:

> "In my opinion, the words 'ten percent of the gross production of the leased substances that were produced, sold or marketed' were put in the agreement not to give the sisters a right or title to a share in the proceeds of the production, but merely to indicate how, when and where the sum of $75,000 would be paid to them."[26]

The court was unable to accept the contention of the appellant that it was a mere conduit pipe, insofar as the monies received from the sale of production which were pledged to the three sisters were concerned, because the sisters had transferred all their rights and interests without reservation of any kind. Fournier, J. stated his conclusion as follows:

> "Furthermore, I find that the aforesaid amounts were received by the appellant pursuant to the agreement of September 22, 1948, and represented instalments of the appellant's share of the proceeds of production of petroleum from the lands mentioned in that agreement."[27]

The court further held that the payments made by the appellant to the three sisters were capital payments under section 12 (1) (b) of the

[25] [1955] C.T.C. 161.
[26] Id. at 167.
[27] Id. at 168.

Income Tax Act, for which no deduction was allowed the payor, and dismissed the appeal.

The very unfavorable tax treatment accorded the taxpayer in the *Calgary and Edmonton* case is undoubtedly within the law, as it read in the taxation years under appeal and as it reads today. Armed with the knowledge of the consequences of a complete disposition of the owner's interest in a petroleum and natural gas property in return for a covenant by the purchaser of the property to pay an oil payment, a competent draftsman today will avoid the disaster experienced in the *Calgary and Edmonton* case by drafting his agreement in such a way that the oil payment is reserved to the vendor of the property. The purchaser should then be able to argue successfully that he is not taxable upon that portion of the production which is paid over to the vendor in satisfaction of the oil payment, because he is a mere conduit pipe through which the payment is channelled to the vendor, who never parted with his interest therein.

However, in the absence of radical changes to the law, most draftsmen in Canada will not be faced with the task of preparing an agreement under which an oil payment will be secured to any vendor, for the tax reasons already stated. Undoubtedly, oil payment financing would generate a substantial increase in investment in Canada's oil industry if the stimulation afforded the American oil industry through this means of financing is any gauge whatever. But the dislocation to our contemporary tax structure to accommodate the common forms of such financing presently in use in the United States would be massive indeed. The required changes would include the following:

(a) An exception to the provisions of section 6 (1) (j) would be required to allow payments made pursuant to approved oil payment arrangements to escape its tentacles.

(b) Most awesome of all, a tax upon capital gains would be introduced with corresponding allowances for capital losses. One realizes that there are persons who favor the introduction of a capital gain tax in Canada for altogether other reasons, the merits of which it is not proposed to consider here. However, solidly entrenched against these crusaders are the majority of Canadians who fear the introduction of a new tax in any form, particularly a capital gains tax which is alien to the basic philosophy of our tax system.

(c) If a capital gains tax should be introduced in Canada, an allowance for cost depletion would be required to permit oil payment financing to work on a predictable and reasonable basis in such a manner that lending institutions would be ready and willing to make the desired loans and investors would willingly purchase oil payments without fear of violent tax consequences.

In summary, it is probably safe to say that the employment of oil payment financing would unquestionably benefit Canada's oil industry from the standpoint of increasing investment therein. But when the other consequences of its introduction, together with the prerequisites to its inception, are considered objectively and cold-bloodedly as they bear upon not only the oil industry but the entire tax-paying public, one would have to be a visionary indeed to expect oil payment financing to materialize in Canada, at least for many years to come.

United States Income Tax Law Involvements

This article would not be complete without a few remarks about American income tax law as it bears upon operations in Canada. As a consequence of the substantial number of companies with affiliations in the United States which participate in Canada's oil industry, it is a commonplace to encounter provisions in operating and farmout agreements which are designed to preserve certain tax advantages under the Internal Revenue Code and its attendant Regulations in the United States. These provisions are readily understandable and should not cause any particular concern to a Canadian oil and gas company when it finds them contained in an agreement.

Perhaps the most common provision included in operating and farmout agreements primarily for United States income tax purposes is the so-called "Disposal of Production" clause. This clause ordinarily stipulates that each party to the agreement shall own and at its own expense take in kind or separately dispose of its proportionate share of the petroleum substances produced from the lands subject to the agreement, and that if any party to the agreement shall fail or refuse to take in kind or separately dispose of its proportionate share of such petroleum substances as produced, the operator may contract for the sale of such production pursuant to the terms of a contract which shall be for some reasonable period of time but in no event shall such term exceed one year. This clause is an outgrowth of the provisions of three rulings issued by the Commissioner of Internal Revenue for the United States, and designated I.T. 3930, I.T. 3933 and I.T. 3948. The terms "partnership" and "corporation" in section 3797 of the 1939 Internal Revenue Code[28] are defined to include any organization or association carrying on business, financial operations or ventures for the joint profit of the associates. The organization or association is classified for tax purposes as either a partnership or a corporation, depending upon which of the two it more nearly resembles, and without regard for the fact that no certificate of incorporation or declaration of partnership has ever issued in respect of such venture. If a given venture is to be taxed as a corporation, the deductions for the costs of drilling and development and the allowances for depletion will then be available only to the venture as a corporation, rather than to each of its members individually, a situation which in most cases is highly undesirable for tax purposes.

Revenue Ruling I.T. 3930 states as follows:

"Read together, the cited opinions indicate that in order to classify an organization as an association taxable as a corporation,

1. there must be associates;
2. the object of the organization must be joint profit;
3. there must be continuity of life; and
4. there must be centralized control of group affairs."[29]

The first, third and fourth of these requisites are elements which are, to a degree, common to all forms of business organizations and therefore

[28] See section 761 of the 1954 Internal Revenue Code.

[29] Issued by Geo. J. Schoeneman, Commissioner of Internal Revenue and approved October 18, 1948.

cannot be used disjunctively to distinguish between an organization which is taxed as a partnership and an organization which is taxed as a corporation. However, the ruling goes on to state that since profits do not arise from the extraction or from the processing of minerals, including oil or gas, but rather from the sale thereof, then so long as there is a division of the production in kind or for sale for the account of each individual participant in the organization, the test of a venture for joint profit is thereby not met. The provisions of Revenue Ruling I.T. 3948 specifically state that the status of an organization, not otherwise taxable as a corporation, is not altered by the operator selling that portion of production to which any other party may be entitled in the organization for short periods of time, so long as such arrangements are always cancellable within a period not exceeding one year.[30] The participants in such an arrangement individually own interests in the oil and gas in place and therefore individually report the proceeds therefrom, subject to their respective deductions for drilling and development expenses and for allowable depletion. Since most Canadian oil companies prefer to have a call upon their own proportionate shares of petroleum substances produced for a variety of other reasons, quite apart from income tax considerations, this "Disposal of Production" clause is readily acceptable by Canadian companies.

Most American companies doing business in Canada's oil industry will also attempt to avoid provisions which establish a rigidly centralized control of the affairs of any venture in which they might participate as tenants in common, such as a permanent management committee which can never be changed and upon which representation is fixed. This is chiefly for the reason that, if it should appear questionable as to whether or not a given organization would be taxable as a corporation, centralized control of the organization's affairs may possibly swing the balance in favor of treating it as a corporation for tax purposes.

Another provision which is common in operating agreements involving American oil companies is that which obliges those parties to the agreement which are taxable in the United States to elect to be excluded from the application of Subchapter K of Chapter 1 of Subtitle "A" of the Internal Revenue Code. This clause is inserted in operating agreements simply for the purpose of requiring the Operator, if the Operator is a company paying taxes in the United States, to file the necessary elections under United States tax law on behalf of itself and other parties to the Agreement to be taxed other than as a partnership. If a given association is not taxable as a corporation, it may be taxed as a partnership unless it elects under the above mentioned Subchapter K of Chapter 1 of Subtitle "A" to be excluded from the partnership provisions of the Internal Revenue Code. Here again, the purpose is to secure for each party individually its proportionate interest in deductions for drilling and development expenditures and in allowable depletion, rather than have such deductions accrue to the association as a partnership, in which case they will usually be much less beneficial to each individual company. This provision should not alarm the Canadian oil company either, since it has no effect upon the status of a Canadian

[30] Issued by Geo. J. Schoeneman, Commissioner of Internal Revenue on April 18, 1949.

company from either a tax or a legal standpoint, being specifically restricted in its application to companies which file income returns in the United States.

Another provision commonly encountered in farmout and operating agreements in Canada provides for an assignment of the drill-site surrounding a test well to the drilling party in a case where the drilling party is drilling a well at its sole risk and expense in order to earn for itself a fractional interest in certain lands theretofore owned by the non-drilling party. The period of the assignment of the drill-site to the drilling party may vary from the time that is necessary to drill the test well in question, to the period of time which is necessary for the drilling party to secure a complete "pay-out" of all of its costs incurred in the drilling of such test well, during which period the non-drilling party retains a rather minor interest in production from lands so assigned to the drilling party. At the expiry of this period, the non-drilling party may elect to acquire a working interest in the drill-site equivalent to its interest in the balance of the lands subject to the agreement. Without going into great detail as to the relative merits of these clauses and the strange, and sometimes very complex forms which they take, these arrangements are ordinarily requested by companies in an effort to secure for themselves a deduction for U.S. tax purposes of all so-called "intangible drilling and development expenditures" incurred in the course of drilling a test well which is drilled entirely at the risk and expense of the party drilling it. Since an American company is limited in its claim for a deduction for "intangible drilling and development expenditures" to that percentage of the total costs incurred in drilling the test well which is equivalent to the interest earned by the drilling party as a result of such drilling, it is obviously of advantage to the drilling party to secure for itself the greatest possible interest in the drill-site surrounding the test well at the time that it is being drilled, if it is to take full tax advantage of the risks and costs which it must incur through the drilling of the same. Again this clause need cause Canadian operators no particular concern, since under Canadian tax law the non-drilling party can claim no deduction in respect of a test well drilled at the sole risk and expense of another party, even if on the lands of the non-drilling party. The principle applied by the Department is "no risk, no write-off", an axiom of undoubted merit in oil and gas operations in Canada.

Other arrangements are often employed by American companies to secure maximum deductions for the "intangible drilling and development" expenditures incurred in drilling wells at their sole risk and expense upon the lands of another company, including such arrangements as the setting up of what is known as a "limited tax partnership" to conduct the operations of the joint venture.[31] While some of these arrangements could have legal consequences in Canada, quite apart from tax considerations, which might prove untoward to a Canadian company, in the main, although they are sometimes complex, they are basically innocuous to the Canadian oil company which becomes involved with them. The profusion of divergent views on the part of U.S. oil companies as to which of these may arrangements is the most desirable results from the

[31] See section 704 of 1954 Internal Revenue Code.

absence of clear regulations or rulings from the Internal Revenue Service as a guide to the taxpayers involved with the problem. Consequently, almost every American oil company displays its own ingenuity in setting out the means which it deems best in the circumstances.

Needless to say, this discussion of some of the salient tax problems in Canada's petroleum industry today has ignored many questions which are not less difficult than those commented upon, but time and space limitations require an eclectic coverage of the subject. We can never expect to establish such comity between the oil industry and the Department of National Revenue that taxpayers will passively pay their taxes without gripes or controversies since both have a powerful affinity for the same dollars. For this reason, too much should not be made of frictions which develop between taxpayer and tax gatherer under well conceived and fairly administered provisions of the Income Tax Act.

But as the writer has attempted to point out, the Income Tax Act and its attendant Regulations do not deal equitably or logically with the depletion problem in Canada. Reorganizations, which are highly desirable in the view of taxpayers and of the federal government alike, have been frustrated through unnecessarily stringent legislation and through needlessly strict interpretations of this legislation by the Department. New problems for taxpayer and tax gatherer are confronting us as the oil industry matures into the complexities of handling secondary recovery, recycling, gas storage and gas plant operations, to which existing tax legislation is not particularly suitable. Only time will tell whether these problems will continue to beset us, or will be resolved through legislative amendments which recognize the need of some adjustment in the tax impact upon the Canadian petroleum industry if it is to be able to compete effectively for national and international markets for its products.