INCOME TAX CONSIDERATIONS AFFECTING THE DRILLING FUND—A PRACTITIONER'S VIEWPOINT

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*The author reviews federal income tax considerations involved in structuring a drilling fund, particularly where the organizational form is the limited partnership. He discusses classification, allocation and deduction of partnership costs, including management and other fees; the use of partnership borrowings; factors to take into account in timing particular deductions; and the requirements for disclosure of tax consequences in a drilling fund offering. Practices and policies of Revenue Canada are referred to throughout the paper.***

I. INTRODUCTION

Until recently the Canadian tax laws offered little in the way of encouragement to Canadian individuals who wished to invest in the oil and gas industry. In response to industry pressure the Minister of Finance, in the Budget Speech of May 25th, 1976, proposed amendments designed to encourage outside investment in the oil and gas industry. He said:

> As we are all aware, both the federal and provincial governments have had some very difficult decisions to make in recent years concerning our petroleum and mining industries.
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> I believe it is important to maintain a stable tax system for these industries and I am not proposing any significant changes affecting them. I am encouraged to see that the provinces, which impose by far the larger fiscal burden on the resource sector, are offering significant new incentives to seek out new reserves or to enhance recoverability from known reserves.
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> However, I feel the federal government can make an additional input to help encourage this exploration activity. Historically, our tax system has distinguished between those whose principal business is resource oriented and other taxpayers. Principal-business taxpayers have been permitted to claim their exploration costs at a rate of 100 per cent whereas other taxpayers have been able to write them off at a rate of only 30 per cent per year. In an effort to attract funds from Canadians for resource exploration which is so critical in our national development, I am proposing that all taxpayers be allowed to write off immediately 100 per cent of their exploration costs incurred after tonight and before July 1st, 1979. This three-year period will provide an opportunity to determine the effectiveness of this new incentive.[1]

Under section 66.1 of the Income Tax Act,[2] all individuals are now entitled to deduct Canadian exploration expenses to the extent of their Canadian natural resource based income. If the taxpayer's natural resource income is less than 30% of the taxpayer's undeducted balance of Canadian exploration expenses at the end of the year, he may deduct the larger amount. In addition, the taxpayer may deduct against income from all sources the Canadian exploration expenses incurred by him between May 25th, 1976 and June 30th, 1979. The taxpayer must in effect keep a memorandum account for these qualified Canadian exploration expenses; and where the deduction otherwise permitted is less than his income from all sources he will be entitled to deduct his qualified Canadian exploration

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** This paper does not reflect changes in the law or the existence of judicial or administrative rulings published after June 1, 1977.

1. (1976) 119 H.C. Deb. No. 308, 13830.

2. R.S.C. 1970 c. I-5 as amended (referred to herein as either "the Act" or "I.T.A.").

expenses to the extent of his cumulative Canadian exploration expenses at the end of the year. The amount claimed under this rule is deducted from his qualified Canadian exploration expenses and the balance is carried forward for use in subsequent taxation years. Individual taxpayers, unlike principal business corporations, are under no obligation to deduct their cumulative Canadian exploration expenses in any particular year. As well, such taxpayers may claim an amount in excess of their income, creating a non-capital loss which may be carried back one year and forward five years.

The opinion was generally held that the proposed changes would attract significant amounts of oil and gas exploration and development capital. The experience in the United States was viewed as indicative of the direction that the equity market would follow in Canada.[3] In that country individuals participating in oil and gas exploration are entitled to elect to deduct intangible drilling costs when paid or accrued[4] which, in the absence of such election, would otherwise have to be capitalized and recovered through a combination of depletion and depreciation.[5] It was argued that high-tax-bracket Canadian taxpayers would invest in oil and gas exploration operations as a new tax shelter, as had their American counterparts. That there has, as yet, been no rush to invest in these operations is undoubtedly attributable in part to the conservative nature of the Canadian investor. A more probable reason for his reluctance, however, is the fact that the cost of producing oil properties is a deductible item under the Act.[6]

Consequently, while the amendments introduced by Mr. MacDonald focused the attention of the investment community on the oil and gas drilling venture, relatively few individuals have invested in the exploration phase of the industry. Instead, it would appear that much of the capital has been applied to the purchase of producing oil and gas properties. Thus, the true "drilling fund" as it is known in the United States is relatively uncommon on the Canadian scene. Rather, most "drilling funds" in Canada are, in fact, property acquisition funds which contemplate only limited drilling operations, or hybrids where a portion of the capital is applied to the purchase of proven or producing oil and gas properties, with the balance of the capital being applied to further development of these or other properties.

In the United States, most of the drilling funds where public participation has been sought have been organized as limited partnerships intended to be treated as partnerships subject to the provisions of sub-chapter K of the Internal Revenue Code of 1954 (herinafter referred to as the Code) so that limited partners may take

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3. It was recently reported that in 1976 a total of $359,000,000 in oil and gas exploration and development capital was raised through public offerings of interests in oil and gas drilling funds registered with the Securities and Exchange Commission. *A Report on the Oil and Gas Program Industry Resource Programs Inc.* Newsletter (January 1977).

4. Internal Revenue Code of 1954 (referred to herein as the United States Code), section 263(c), *see also* Department of Treasury Regulation (referred to herein as Treas. Reg.), section 1.612-4. I.D.C.s are defined to include among other things, wages, fuel, repairs, hauling and other costs incurred in the exploration and development of oil and gas properties including drilling, shooting and cleaning wells, clearing and draining ground, road making, survey and geological works necessary and appropriate for the drilling of wells and the preparation of wells for production, but excluding expenditures which in themselves have a salvage value.

5. Absent the election under section 263(c), I.D.C.s not represented by tangible property are recoverable through cost depletion, Treas. Reg. section 1.612-4(b)(1). I.D.C.s attributable to tangible structures are capitalized costs recoverable through depreciation claims, Treas. Reg. section 1.612-4(b)(2).

6. The cost of a Canadian resource property (I.T.A. paragraph 66(15)(c)) is viewed as a Canadian development expense (I.T.A. subparagraph 66.2(5)(a)(iii)), and deductible on a 30% declining balance basis (I.T.A. subsection 66.2(2)).

advantage of the special tax treatment afforded the oil and gas industry.[7] Insofar as the treatment of partnerships under the Canadian Act is not dissimilar to the United States treatment, it is not surprising that many of the Canadian drilling funds have been organized as limited partnerships.[8] This paper will focus primarily on this organizational form and the issues presented through the use of such limited partnerships under Canadian income tax law. It is not intended as a general review of the taxation of oil and gas operations in Canada,[9] nor is it intended to be exhaustive in its treatment of the taxation of partnerships.[10]

II. CLASSIFICATION AND DEDUCTION OF PARTNERSHIP COSTS

(A) General

Under the Act, each partner is entitled to include in his cumulative Canadian exploration expenses[11] or his cumulative Canadian development expenses[12] his share of Canadian exploration expenses or Canadian development expenses incurred by a partnership in a fiscal period of the partnership, if at the end of that fiscal period he was a member thereof. He will be entitled to deduct his cumulative Canadian exploration expense or cumulative Canadian development expense at the end of the year in accordance with the provisions of sections 66.1 and 66.2 of the Act. Each partner is also required to recognize his share of partnership income or loss for a fiscal period of the partnership ending with or within the partner's taxation year.[13]

Thus, if the taxpayer is not a member of the partnership at the end of its fiscal period he is entitled to no benefit for Canadian exploration expenses or Canadian development expenses incurred by the partnership during that fiscal period, even though he may be economically responsible for such expenditures. The entitlement of a partner to recognize his share of partnership income or loss for a fiscal period during which he ceased to be a member of the partnership is less clear under the Act, but it would appear to depend upon the terms of the partnership agreement. Consequently, the classification of costs incurred by the partnership, as well as the terms of the partnership agreements allocating economic and fiscal responsibility for partnership costs, will be of vital importance to the investor in determining the entitlement of the partner to deduct those costs.

(B) Classification of the Expenditure

If the expenditure is a Canadian exploration expense or Canadian development expense, each partner (as to his allocable share thereof) will be entitled to deduct such costs without reference to how such costs are

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7. Close, *Drilling Funds: The 1977 Perspective*. This paper was delivered at the 28th Annual Institute on Oil & Gas Law and Taxation of the Southwestern Legal Foundation, and was unpublished at the time of writing. The author has relied extensively on Mr. Close's paper for the analysis of United States tax aspects.

8. Under the present administrative practice of Revenue Canada, certain other provisions of the Act may be relied upon to permit individuals to deduct expenses incurred by them in drilling and exploring for oil and gas on lands owned by a corporation in consideration for which the individuals receive shares of the corporation. An example of a proposed arrangement along these lines is the proposed offering of Rangeco Oil & Gas Ltd. described in a preliminary prospectus dated March 11th, 1977 as filed with the Alberta Securities Commission.

9. For a general discussion of this topic *see* Katchen & Bowhay, *Federal Oil and Gas Taxation* (2nd ed., 1977). *See also* Carten, *Federal Income Taxation of Oil and Gas Operations*, (1977) 15 Alta. L. Rev. 455.

10. For a general discussion of this topic, *see* Eddy, *The Taxation of Partnerships*, (2nd ed., 1977).

11. I.T.A., s. 66.1(6)(a)(iv).

12. I.T.A., s. 66.2(6)(a)(iv).

13. I.T.A., ss. 12(1)(j) and 96(1)(f) and (g).

being treated by his partner. All other costs are deductible at the partnership level in calculating partnership income or loss, which income or loss is allocated to the partners as such and taken into account in calculating their respective taxable incomes for the taxation year.[14] As a result, each partner is governed by the treatment of such costs by the partnership, a matter that is usually left to the discretion of the general or managing partner.[15]

It will virtually always be in the partner's interest to classify costs as Canadian exploration expenses since such costs are, in most cases, currently deductible in calculating the partner's income;[16] such a classification will serve to increase the partner's earned depletion base and will not adversely affect his claim to a resource allowance for oil and gas profits.[17] Failing classification as Canadian exploration expenses, it is usually preferable to treat costs as Canadian development expenses.[18] While the current deduction is less attractive,[19] the costs (other than land acquisition costs), will form part of the partner's earned depletion base[20] and will not affect his claim for a resource allowance.[21] This is not always the case, however, since many costs will be viewed as operating expenses and fully deductible on a current basis. Even if the expenses are viewed as equipment costs, the rate of depreciation may be sufficiently attractive to outweigh the benefits of a deduction as Canadian development expenses. For example, the costs of gas processing facilities may be included in class 29 and are depreciable on a 50% straight-line basis over two years.[22]

It is apparent that there are basically four classes of operating expenses, namely, Canadian exploration expenses, Canadian development expenses, equipment costs, and operating costs. The Canadian exploration expense, as it relates to the oil and gas industry, is defined in subparagraphs (i) and (ii) of paragraph 66.1(5)(a) of the Act. It is any expense incurred after May 6th, 1974 that is:

> (i) any expense including a geological, geophysical or geochemical expense incurred by him (other than an expense referred to in subparagraph (ii)) for the purpose of determining the existence, location, extent or quality of an accumulation of petroleum or natural gas (other than a mineral resource) in Canada.
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> (ii) any expense incurred in drilling an oil or gas well in Canada, building a temporary access road to the well or preparing the site in respect of the well.

The Canadian development expense as it relates to the oil and gas industry is defined in subparagraphs (i) and (iii) of paragraph 66.2(5)(a) of the Act. It is any expense incurred after May 6th, 1974 that is:

> (i) any expense incurred by him in:
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> (a) drilling or converting a well in Canada for the disposal of waste liquids from an oil or gas well
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> (b) drilling an oil or gas well in Canada, building a temporary access road to the

14. I.T.A., s. 96(1).

15. Where the partnership is a limited partnership, calculation of partnership income including the exercise of judgment as to the capital cost allowance claim is arguably a management function which must be vested with the general partner if limited liability is to be maintained.

16. This assumes that the Canadian exploration expenses are qualifying Canadian exploration expenses. *See* n. 35, *infra*.

17. Income Tax Regs. S.O.R. Cons. 1955, 1872, as amended, s. 1205(a)(ii), hereinafter cited as "Reg."

18. Canadian exploration expenses and Canadian development expenses are specifically not deductible in calculating resource profits upon which the resource allowance is based. Reg. 1211.

19. The deduction is essentially on a 30% declining balance basis. *See* discussion at 211, *infra*.

20. Reg. 1205(a)(iii).

21. *Supra*, n. 18.

22. Reg. 1100(1)(y).

well or preparing a site in respect of the well, to the extent that the expense is not a Canadian exploration expense

(c) drilling or converting a well in Canada for the injection of water or gas to assist in the recovery of petroleum or natural gas from another well, or

(d) drilling for water or gas in Canada for injection into a petroleum or natural gas formation.

(iii) notwithstanding paragraph 18(1)(m), the cost to him of a Canadian resource property, but for greater certainty not including any payment made to any of the persons referred to in any of subparagraphs 18(1)(m)(i) to (iii) for the preservation of a taxpayer's rights in respect of a Canadian resource property or a property that would have been a Canadian resource property if it had been acquired by the taxpayer after 1971, and not including a payment to which paragraph 18(1)(m) applied by virtue of subparagraph (v) thereof.

In other words, the costs of drilling an oil or gas well will be regarded as Canadian exploration expenses if within six months after the end of the year during which the costs are incurred, the well is completed, and it is determined that the well is the first well capable of production from the area, or that the well will not come into production within twelve months of its completion. Otherwise, the costs will be regarded as Canadian development expenses. If the well is not completed within six months of the end of the year, costs incurred during the year will be classified as Canadian development expenses, subject to reclassification as Canadian exploration expenses when the well is completed and the necessary determinations are made. The reclassification takes place by way of a negative adjustment to the taxpayer's cumulative Canadian development expenses and characterization of the cost as a Canadian exploration expense for the year in respect of which the determination is being made.

Costs incurred in operations that are undertaken to increase production from a then-producing horizon, such as well recompletion costs in the same formation, well stimulation treatments such as fracturing, acidizing, chemical treatment and thermal stimulation, will be regarded by the Department of National Revenue as current operating expenses unless they are being incurred in drilling or converting a well to assist in the recovery of petroleum or natural gas from another well. If so, they will be treated as Canadian development expenses. In addition, mechanical workover costs, consisting of repairs inside and outside the casing and repairs to and within the tubing, will also be treated as current operating expenses unless they can be regarded as resulting in a substantial improvement to the asset. In that case they must be treated as the cost of depreciable equipment.

To the extent that enhanced recovery operations comprise the drilling and completing of injection wells and water source wells, and the conversion of producing wells to injection wells, the drilling costs will be treated by Revenue Canada as a Canadian development expense. The balance of such intangible costs will usually be treated as operating expenses.[23]

The cost of acquisition of a Canadian resource property is, as indicated, a Canadian development expense. The expression "Canadian resource property" is defined in the Act,[24] but insofar as the oil and gas

23. *See* Carten, *Financing the Development of Oil and Gas Reserves*, 381 at 382, (1976 Conference Report, Can. Tax. Found.).

24. I.T.A., s. 66(15)(c) provides as follows: "'Canadian resource property' of a taxpayer means any property acquired by him after 1971 that is: (i) any right, licence or privilege to explore for, or take petroleum, natural gas or other related hydrocarbons in Canada; (ii) any right, licence or privilege to prospect, explore, drill or mine for, minerals in a mineral resource in Canada; (iii) any oil or gas well situated in Canada; (iv) any rental

industry is concerned basically includes all petroleum and natural gas rights. In many cases, the taxpayers will incur drilling and exploration costs to earn an interest in another person's lands. In these cases, the costs incurred are arguably the costs of acquisition of the interest and Canadian development expenses. Although this argument has had some currency in the United States,[25] the costs will be classified according to the nature of the work performed, and not as an acquisition cost, if the work is done in fact by the taxpayer. A distinction must be drawn, however, between that situation and the situation where a taxpayer merely pays an amount to the other person who performs the work for his own account and not as agent for the taxpayer. In the latter case, the taxpayer's costs will be viewed as a land acquisition cost and a Canadian development expense, even though the amount paid may relate to the amount expended by the drilling party.[26]

Equipment costs generally must be capitalized and depreciated under the capital cost allowance system.[27] The rate of depreciation will depend upon the class into which the equipment falls. Classification of the various surface facilities is presently a matter of some debate within the industry. Equipment used in the production of oil and gas, other than well casing, is classified as a Class 10 asset.[28] If the equipment is used in refining oil or in gas processing, or if it is pipeline other than the gathering system of a gas plant, it will be classified under Class 8[29] in the case of refinery and gas processing structures and under Class 2[30] in the case of pipeline.

The argument as to classification relates to the distinction between producing and processing. To the extent that facilities are said to be used in the production of oil and gas, the capital cost allowance claim in respect thereof will reduce the taxpayer's resource profits for the purposes of calculating his earned depletion deduction and resource allowance.[31] If, however, the facilities are regarded as being related to manufacturing or processing,[32] not only will the capital cost allowance claim not reduce the taxpayer's resource profits; in addition, the asset may be eligible for inclusion in Class 29, thereby permitting capital cost allowance on a straight line basis over two years.[33]

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or royalty computed by reference to the amount or value of production from an oil or gas well, or a mineral resource, situated in Canada; (v) any real property situated in Canada the principle value of which depends upon its mineral resource content (but not including any depreciable property situated on the surface of the property or used or to be used in connection with the extraction or removal of minerals therefrom); or (vi) any right to or interest in any property (other than property of a trust) described in any of subparagraphs (i) to (v) (including a right to receive proceeds of disposition in respect of a disposition thereof."

25. The problem arises in a different context but is interesting by way of comparison. Under a farmout agreement where the farmer earns an interest in surrounding acreage as well as in the drill site, the Internal Revenue Service was threatening to require an allocation of drilling costs to the surrounding acreage and requiring that such costs be treated as non-deductible leasehold acquisition costs. This argument has apparently been disposed of to the benefit of taxpayers under Rev. Rul. 77-176, 1977 I.R.B.; *see also* G.C.M. 22730 1941-1.

26. *Farmer's Mutual Petroleums Ltd.* v. *M.N.R.* [1966] C.T.C. 286, 66 D.T. 5222 (Ex. ct.) Aff'd, [1967] C.T.C. 396, 67 D.T.C. 5277 (S.C.C.).

27. I.T.A. s. 20(1)(a); Reg. 1100.

28. Schedule B Class 10(j); Reg. 1104(2)(e).

29. Schedule B Class 8; Reg. 1104(2)(e).

30. Schedule B Class 2. *See*, however, paragraph (b) permitting reclassification as Class 8 if it can be established that the source of supply for the pipeline will be exhausted within 15 years from the commencement of pipeline operations.

31. Reg. 1204(1)(c).

32. Reg. 1104(9). "For the purposes of Class 29 in Schedule B, 'manufacturing or processing' does not include: (a) farming or fishing; (b) logging; (c) construction; (d) operating a gas or oil well; (e) extracting minerals from a mineral resource; (f) processing of ore from a mineral resource to the prime metal stage or its equivalent; (g) producing industrial minerals; (h) producing or processing electrical energy or steam, for sale; or (i) processing gas, if such gas is produced as part of the business of selling or distributing gas in the course of operating a public utility."

33. Reg. 1100(1)(y).

In *Texaco Exploration Inc.* v. *The Queen*,[34] the Federal Court was called upon to decide where the production of oil or gas ceased and where processing began for the purposes of determining what profits were reasonably attributable to the production of oil or gas under the depletion regulations. Texaco had calculated its production profits according to a formula developed by Revenue Canada on the premise that the production of petroleum or natural gas ceased at the point of fractionation in a gas plant. Although this formula had been accepted by Revenue Canada until 1966, it was amended to reflect cessation of production at the point where marketable oil is separated or extracted from raw gas, in this case, at the downstream side of the inlet separators in Texaco's gas plant.[35]

At trial Texaco argued that production of gas ceased, not at the point of fractionation, but at the final outlet in the plant where sales gas was sold or made marketable, or in some cases, was fed directly into pipelines. In finding for the Crown, Mr. Justice Collier volunteered that production in fact terminated at the wellhead and that subsequent treatment of the gas was gas processing. He said:[36]

> On this first issue I conclude, therefore, that production of gas by Texaco ceased at the wellhead, or to put it another way, at the upstream side of any separator, be it a field separator, or an inlet separator in Texaco's gas plants.
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> My conclusion may, for all I know, cause difficulty in precise calculation of profits. It may be more convenient, and easier from an arithmetic point of view to determine the profits attributable to production at the downstream side of the inlet separator (as contended by the defendant) or at the fractionation point, or alternatively, the sales outlets (as contended by the plaintiff). Convenience or ease in making arithmetical calculations cannot, however, influence the meaning to be assigned to the phrase here in controversy. It seems to me the drafter of the regulation had that imprecision of calculation in mind when he described the profits as 'reasonably attributable to'.

If the Texaco decision is upheld, one might reasonably expect to find more offerings involving the purchase of surface facilities. From the investor's point of view, he is offered an exceptional deduction in the form of a straight line depreciation over two years coupled with the relative security of hard assets. From the operator's point of view, he can avoid the investment of capital in the production phase of the industry, concentrating instead on exploration where presumably he may anticipate a higher rate of return on his investment.

(C) Allocation Questions

As earlier adverted to, partnership income or loss from a particular source is viewed as the partner's income or loss from that source for the taxation year of the taxpayer in which the partnership's taxation year ends, to the extent of the partner's share thereof. Similarly, Canadian exploration expenses and Candian development expenses incurred by the partnership during a taxation year are regarded as having been incurred by the partner as to his share thereof. The Act is, however, virtually silent as to what a partner's "share" will be, presumably leaving the question to be determined by reference to the common law, that is, determined by the agreement of the partners as expressed in the articles of partnership or implied from their actions.[37]

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34. [1975] C.T.C. 404; 75 D.T.C. 5288 (F.C.).

35. It is understood that Revenue Canada has not changed its position as a result of *Texaco*.

36. *Id.*

37. *See M.N.R.* v. *Strauss* [1960] C.T.C. 86, 60 D.T.C. 1060 (Ex. ct.); *M.N.R.* v. *Sedgwick* [1963] C.T.C. 571, 63 D.T.C. 1378 (S.C.C.).

In the absence of a specific agreement to the contrary, logic dictates that each partner's share of particular items of partnership revenue and expenses will be determined in accordance with the general profit and loss sharing ratio of the partners.[38] A reference to this rule will not always produce a satisfactory result. For example, one partner may wish to invest in a particular aspect of partnership operations, receiving in exchange therefor a disproportionate share of partnership profits. Under such circumstances, it is not unreasonable that he should seek to obtain the tax advantages associated with the particular investment. A problem also arises where a partner sells his partnership interest prior to the fiscal year end of the partnership. While the Act clearly states that the selling partner may not deduct his share of Canadian exploration expenses or Canadian development expenses incurred by the partnership during that fiscal year,[39] it does not provide that the incoming partner will be entitled to recognize the particular costs incurred prior to the date of sale. A reference to the general profit and loss sharing ratio of the partnership is of no assistance in these circumstances.

It is essential, therefore, that the draftsmen provide specifically for the allocation of partnership income or loss in these and other anticipated circumstances. As a partnership is essentially a contractual arrangement, it is axiomatic that in the absence of a statutory or public policy restriction there is no qualification as to the manner of allocating partnership profits and losses among the partners. The more difficult question facing the draftsmen is whether the allocation will be effective for income tax purposes in determining the partner's respective entitlement to particular items of expense or credit.

Typically the articles of limited partnership of the drilling fund will provide for two classes of disproportionate allocations. The "special" or "functional" allocation involves the allocation of a specific item of revenue or expense to a particular partner on a basis that differs from his allocated share of profits and losses generally. The term "retroactive allocation" refers to the situation where an incoming partner receives a share of partnership income or loss based on the partnership's entire taxation year, notwithstanding that the new partner was a member for only part of the year.

Special allocations have been used frequently by United States drilling funds to permit the allocation of currently deductible costs to investing partners, reserving non-deductible costs for the account of the sponsor.[40] A standard means of articulating such an allocation is to provide that the cash contributions of the limited partners will be applied to pay for intangible drilling costs and that the contribution of the general partners will be used to defray non-deductible capital costs.[41]

In Canada, special allocations of deductible expenses are a less

38. *Id.* at 575 per Martland J.: "Unless he were able to establish that his income from the partnership was less than that established by the agreement, it would appear that he is liable for income tax in respect of it."

39. The rule arises from statutory language that states that a partner's Canadian exploration expense or Canadian development expense is his share of such expenses incurred by the partnership during a fiscal year only if at the end of the fiscal year he was a member of the partnership. I.T.A. s. 66.1(6)(a)(iv); s. 66.2(5)(a)(iv).

40. The statutory basis for the allocation is found in United States Code s. 704(c) which provides that a partner's distributive share of partnership items of income gain, loss, deduction or credit is to be determined by reference to the partnership agreement. It is subject, however, to the additional criterion that it have "substantial economic effect". United States Code s. 704(b)(2).

41. Close, *supra*, n. 7. The allocation must have substantial economic effect; that is the limited partners must bear the economic cost giving rise to the deduction by assuming an appropriate charge to the capital accounts and an appropriate effect for capital account balances on liquidation distributions. *See also* Rev. Rul. 68-138, 1968 I.C.B. 311 and example 5 of section 1.704-1(b)(2) of the United States Treasury Regulations.

common occurrence. That is probably attributable to the fact that, in most Canadian drilling funds, the general partner's contribution is nominal. In this country, special allocations have been used to permit partners to withdraw their share of partnership oil and gas assets from the partnership on a tax-free basis.[42] This is effected by allocating to the withdrawing partner the proceeds of disposition that are deemed to arise on the distribution of the assets. The partner who is viewed as having acquired the property at a cost equal to the fair market value thereof is thus entitled to offset the cost against the proceeds of disposition resulting in a wash transaction for tax purposes.[43]

The retroactive allocation has been used most frequently in the United States tax shelter area where the promoter is willing to transfer a portion of the deductions accumulated in the first year of operation of the partnership to individual taxpayers in high tax brackets, in exchange for the capital contributions of these new members prior to the partnership year end.[44] Although seldom used in the United States oil and gas industry where publicly offered drilling funds are involved,[45] the retroactive allocation is an essential, if less objectionable, element in the Canadian oil and gas drilling fund.

Although it is clearly possible to use a retroactive allocation to achieve objectives similar to those mandating its use in the United States, its purpose in Canada is to clarify the effect, for tax purposes, of an assignment of a partnership interest whether *inter vivos* or testamentary. Where the partner assigns his interest prior to the fiscal year end of the partnership, there is, in the absence of a dissolution of the partnership,[46] uncertainty as to who will be required to recognize items of partnership income or loss arising as a result of operations prior to the date to transfer.[47]

It is clear, for example, that the withdrawing partner is not entitled to deduct his share of Canadian exploration expenses or Canadian development expenses incurred by the partnership during the partnership period.[48] Thus, unless the incoming partner or the continuing partners may deduct these items, the deduction is effectively lost.[49] Yet it is not clear whether the withdrawing partner will be required to recognize his share of partnership income to the transfer date. If he is required to include an amount in income, the possibility exists that he will be subject

42. A similar procedure is required for the contribution of oil and gas property to a partnership that is not comprised solely of Canadian residents and this is not eligible for elective tax-free treatment under subsection 97(2). Where the partnership is a Canadian partnership the same result can be achieved without the withdrawing member pursuant to ss. 97(3) and (6) of the Act.

43. The Act as presently amended is ambiguous as to the true effect of this transaction. It has, however, been recognized by Revenue Canada in a number of private rulings. If clauses 29(3) and 43 of the House of Commons Bill C-56 given first reading June 15, 1977, are enacted, this procedure will have a clear statutory basis.

44. Willis, *Partnership Taxation*, 24.01 (1976).

45. This is because such funds usually prefer a single closing where investors become limited partners simultaneously with the commencement of operations. *See* Close, *supra*, n. 7 at 127.

46. Whether the assignments of a partnership interest operates to dissolve a general partnership is in the absence of an agreement on the point a matter of doubt. *See Emanuel* v. *Symon* [1967] K.B. 234 per Channell J. at 241; *Cole* v. *M.N.R.* [1964] C.T.C. 219, 64 D.T.C. 5141 (Ex. ct.); *M.N.R.* v. *Strauss*, *supra*, n. 37.

47. Where the assignment results in the dissolution of the partnership the income tax consequences are relatively more certain and it would appear that the withdrawing partner will be responsible for the income tax consequences of the operations to the date of transfer.

48. *Supra*, n. 39.

49. This is to be contrasted with the situation where the partner receives partnership property in consideration of his withdrawal from the partnership. In such a case it would seem that he will be viewed as a continuing partner until the fiscal year end, thereby entitling him to claim a deduction for these expenses. I.T.A. s. 98.1(1).

to taxation on income which, had he not ceased to be a partner, would otherwise have been available to him.

Although there has been no conclusive determination by a senior court on the question, it appears that the courts will recognize a retroactive allocation of partnership income or loss to the incoming partner for the whole of the fiscal period if the allocation is expressly provided in the agreement.[50] Thus, a partner can effectively sell his right to income earned, or deductions incurred by the partnership, to the date of transfer. Proceeds of disposition will be regarded usually as a capital gain item very much on the analogy to shares of a corporation. The retroactive allocation of income must, of course, be provided for in the partnership agreement, since the withdrawing partner would in its absence presumably have some claim to partnership profits for the year in recognition of his participation for part of the year.

The situation is different where the partner deals with the partnership rather than his partners. In this case he is viewed as a continuing member of the partnership and any amount received by him in respect of partnership profits will be taxable as his share of partnership income.[51] If, at the end of the year, he has received from the partnership an amount that is in excess of partnership income, the excess will be regarded effectively as a capital gain.[52]

The principal restriction on disproportionate allocations is contained in section 103. It states:

> (1) Where the members of a partnership have agreed to share, in a specified proportion, any income or loss of the partnership from any source or from sources in a particular place, as the case may be, or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of any of the members thereof, and the principal reason for the agreement may reasonably be considered to be the reduction or postponement of the tax that might otherwise have been or become payable under this Act, the share of each member of the partnership in the income or loss, as the case may be, or in that other amount, is the amount that is reasonable having regard to all the circumstances including the proportions in which the members have agreed to share profits and losses of the partnership from other sources or from sources in other places.
>
> (2) For the purposes of this section, the word 'losses' when used in the expression 'profits and losses' means losses determined without reference to other provisions of this Act.

The legislative purpose of section 103 is self-evident. Parliament does not wish to permit the allocation of partnership income or loss in a manner that abuses the purposes of the statute. Yet it is clear from the foregoing that disproportionate allocations of partnership income and

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50. *Marksim Storage Limited et al.* v. *M.N.R.* [1973] C.T.C. 2185, 73 D.T.C. 158, (T.R.B.). This conclusion proceeds from the principle that an assignment of a right to income is the assignment of a capital item. *M.N.R.* v. *Sedgwick* [1963] C.T.C., 63 D.T.C. 1378, 571 (S.C.C.). *Rutherford* v. *C.T.R.* (1926) IOT.C. 683; *Van den Berghs Ltd.* v. *Clark* [1935] A.C. 431, and that the partnership interest is just such a right, *M.N.R.* v. *Strauss.* [1960] C.T.C. 86, 60 D.T.C. 1060, (S.C.C.). There does not, however, appear to be any case where the issue was faced squarely (*see however* the dissenting judgment of Spence J. in *Sedgwick* case and *Nathaniel C. Brewster* v. *The Queen* [1976] C.T.C. 107, 16 D.T.C. 6046, (F.C.) where it was assumed that such an allocation was effective). The conclusion is to be contrasted with the recent treatment of such allocations in the United States. In *Rodman* v. *Commission*, 542 F.2d 845, 857-58 (C.A. 2nd Cir 1976) rev'g in part *Norman Rodman* 32 C.T.M. 1307 (1973), the Court of Appeals for the Second Circuit concluded that the retroactive allocation of income attempted by the taxpayer violated the fundamental "common law of taxation" prohibition against the assignment of income. Under the Tax Reform Act of 1976 Pub. L. No. 94-544, 90 Stat 1520 *et seq* (Oct. 4, 1976) recent amendments to sections 704 (sec. 213(c)(2)) and 706 (sec. 213(3)(A)) of the United States Code, clearly prohibit the practice of retroactive allocations.

51. I.T.A. s. 98.1(1).

52. Mechanically the gain arises through a negative adjustment to his adjusted cost base for the distribution that is in excess of the positive adjustment for partnership income—in effect a return of capital. The negative adjusted cost base is recognized as a capital gain at the end of the year.

loss, as well as specific partnership expenses, will occur. Indeed, such allocations may enhance the efficiency of the statute.[53] It is also undoubtedly true that a major reason, and in fact the principal reason, for many allocations of this nature will be the reduction or postponement of tax that might otherwise have become payable. Yet section 103 does not prohibit such allocations; it merely provides for a reallocation on the basis of what is reasonable. Thus, "reasonable" disproportionate allocations are permissible.

The use of the term "reasonable" is disarming, implying an objective standard. But what is reasonable to a promoter of oil and gas funds may be entirely unreasonable in the eyes of Revenue Canada. Given the absence of judicial authority on this question, it may be difficult for counsel to form an opinion on the matter. In the author's view, the United States experience is instructive in this area.

Prior to its amendment by the 1976 Tax Reform Act,[54] section 704(b)(2) of the United States Code provided for the non-recognition of an allocation provision of a partnership agreement if its principal purpose was to evade or avoid tax. Treasury Regulations issued under the prior law indicated that whether an allocation had "substantial economic effect" would be considered in determining the acceptability of an allocation.[55] In commenting on the 1976 amendment to section 704(b)(2), the Senate Finance Committee stated:[56]

> The [amendment in question] provides generally that an allocation . . . of any item of income, gain, loss deduction or credit (described under section 70(a)(1)8(8)) shall be controlled by the partnership agreement if the partner receiving the allocation can demonstrate that it has 'substantial economic effect' *i.e. whether the allocation may actually affect the dollar amount of the partner's shares of total partnership income or loss independent of income tax consequences.* Regs. Sec. 1,704-1(b)(2). Other factors that could possibly relate to the determination of the validity of an allocation are set forth in the present regulations (Regs. Sec. 1, 704-1(b)(2)) (emphasis added).

A respected authority in the field has concluded that, as a result of the 1976 amendments to the United States Code, "substantial economic effect" is the principal, if not the determinative criterion, in the recognition of an allocation for United States tax purposes.[57] Whether an allocation has substantial economic effect will be governed by the partnership capital accounts. It necessitates an examination of the agreement to ascertain whether the allocation requires a corresponding financial accounting adjustment to the partner's capital account, and whether the account in fact determines the partner's share upon liquidation.[58]

It is submitted that in the absence of any dispositive authority as to what is reasonable in the context of section 103, application of the

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53. It is arguable that section 103 does not apply to the allocation of partnership Canadian exploration expenses or Canadian development expenses insofar as it only refers to income or loss and these items have no relevance in determining partnership income or loss. Whatever the merits of this argument it appears arguable as well that the principles expressly stated in s. 103 are in fact implicit in the statute itself.

54. The amendment which is technical in nature had the result of changing the focus of s. 704(b)(2) to an evaluation of "the partner's interest in the partnership". Previously it had used as its reference the partner's distributive share of "taxable income or loss".

55. The other tests used by the Treasury Regulations include whether a business purpose for the allocation exists; whether normal business considerations were disregarded in making the allocation; whether related items were similarly allocated; whether the amount of the allocation could reasonably have been estimated prior to the decision to allocate; the duration of the allocation and its overall tax consequences. Treas. Reg. section 1.704-1(b)(2).

56. S. Rep. No. 94-938, 94th Cong. 2nd Sess. (Calendar No. 891) at 100 (1976).

57. Close, *supra*, n. 7.

58. *Id.*

"substantial economic effect" is the most acceptable criterion in deciding upon the propriety of a particular allocation for Canadian income tax purposes.

III. PARTNERSHIP BORROWINGS

The use of borrowed funds by an oil and gas partnership is not an uncommon event. Almost without exception the partnership formed to purchase producing oil and gas properties will borrow a substantial portion of the required funds. The drilling fund which purchases semi-proven properties with a view to drilling development wells will probably attempt to borrow a portion of the monies required. Even the exploration fund will likely obtain financing for the development of reserves that have been discovered as a result of its exploration activities.

The tax objectives of partnership borrowing are the same as those associated with any conventional transaction. The borrower is entitled to anticipate the receipt of future income in the form of loan proceeds without the recognition of income. He is thereby entitled to utilize, for tax effect, expenditures in excess of his own equity, by currently expending anticipated future income. If the loan is repaid out of ordinary income, the effects are simply those of timing, in that the deductions are taken at an early stage and the income is recognized later.[59]

Notwithstanding the very conventional nature of these results, the fiscal authorities have looked askance at the use of leverage by a partnership where the partners have not committed their personal net worth beyond the assets of the partnership. Where partnerships have entered into financial arrangements of this character, Revenue Canada has sought to deny the partners the right to claim a deduction for tax purposes unless the partner has committed his personal net worth in an amount at least equal to the expense or cost incurred.[60]

(A) Non-Recourse Loans

A non-recourse loan may be described as one in which the rights and obligations of the lender and the borrower are limited contractually or otherwise to a specified portion of the borrower's assets and net worth or to a limited portion of the borrower's future income or both. The fact that the recourse is limited to certain properties may in fact have no material effect on the economic realities and financial expectations of the parties.[61] In many cases the non-recourse loan is, except for the absence of a promise to pay, virtually indistinguishable from a true recourse loan.

Revenue Canada does not, however, view a non-recourse loan as equivalent, for tax purposes, to a true loan. Instead they have taken the position that if a taxpayer uses funds obtained through a non-recourse loan to defray expenditures, he will not be entitled to recognize such costs for tax purposes unless he has repaid the loan. Where the loan has been obtained by a partnership, the application of this rule produces anomalous results. As the expenses are viewed as not having been incurred, there is no adjustment to the partner's adjusted cost base of his partnership interest. Similarly, if the partnership sells his interest in the

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59. Fielder, *Drilling Funds and Non-Recourse Loans—Some Tax Questions*, 527 at 532-3 (Southwestern Legal Foundation).

60. *Interpretation Bulletin I.T. 164.* The intention of Revenue Canada to apply this bulletin to the oil and gas industry has been confirmed by a private ruling received by the author.

partnership prior to repayment of the loan, he apparently is viewed as having assigned the right to claim the deductions that will be recognized on payment of the loan to the new partner.[62] It would also seem to follow from this analysis that characterization of the expenditures as eligible for treatment as qualified Canadian exploration expenses will now depend on then the loan is repaid, rather than when the expenditure is in fact made.

Revenue Canada apparently relies upon the decision of the Federal Court in *Mandel* v. *The Queen*[63] in support of their decision. In that case a group of professionals arranged to produce a feature film. Costs in excess of their initial outlay were to be repaid only out of profits from the distribution of the film. The court held that the costs paid for with such borrowings were non-deductible. It said:[64]

> While the obligation clearly existed in the sense that the partnership could not unilaterally withdraw from it, and I have concluded that there was no sham involved in that in 1971 there always existed a reasonable possibility of the film eventually producing income, I am nevertheless of the view that the question of whether any further payments above $150,000 would ever be made on the obligation was sufficiently uncertain, both as to time of payment and whether sufficient profits would ever be generated to allow such further payments to be made, that the preferable practice would be to treat this as a contingent liability directing attention to it by footnotes as Mr. Bonham suggests. When and if the film generates profits and additional payments are made on account of the liability, as now appears possible in view of the distribution of the film which is now commencing, the partnership can at that time set up these further payments as part of the capital cost and plaintiff can benefit by claiming capital cost allowance against same in the year or years in which such additional capital cost is created. As I indicated previously, however, I do not consider it proper to equate the capital cost of $577,892 incurred or committed for by the vendors with the capital cost of the film to the purchasers, who, while they undertook to pay this sum, only actually paid $150,000 with the balance being contingent on the generation of profits by the film.

It is apparent that Mandel does not offer broad support for the Minister's position. The ratio of the case is that where a liability is sufficiently uncertain (both as to the time of payment and the likelihood that it will ever be repaid) that it should not be recognized for accounting purposes, then it will not be recognized for tax purposes.[65] In fact, the Court was unable to choose between conflicting evidence of accounting experts, and appears to have accepted the Minister's evidence as determinative on the grounds that the burden of proof in the case fell on the taxpayer.[66]

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61. Fielder, *supra*, n. 59 at 535-6.

62. This appears to be the present attitude of Revenue Canada on the basis of correspondence the author has recently had with them on the matter.

63. *L. H. Mandel* v. *The Queen* [1976] C.T.C. 545, 76 D.T.C. 6316, (F.C.) (appeal pending).

64. *Id.* at 566.

65. This rule is not dissimilar to that adopted by the court in the United States. *See Crane* v. *Commission* 331 U.S.1 (1946). *See* R. A. Epstein, *The Application of the Crane Doctrine to Limited Partnerships*, (1973) 47 So. Cal. L. Rev. Rev. 101.

66. The court said on this point: "In the present case the court had the benefit of two expert accountants' opinion, one from Mr. Robert Fraser, C.A., a partner with the well-known firm of Thorne, Riddell who supported the accounting method adopted by the auditors of the partnership, the equally well-known firm of Deloitte, Haskins & Sells, and on the other hand the opinion of Mr. David Banham, FCA, an accountancy professor and author of a textbook on the subject who would merely have set up the $150,000 down payment for capital cost allowance purposes, treating the balance of price a contingent liability to be shown by footnotes on the balance sheet to set up for capital cost purposes only when and if future payments were made. There is certainly no prohibition in the governing income tax law against either method and the matter is sufficiently controversial that it may be said that either method is an accepted system of accounting. In view of the difference of opinion between the experts, however, it devolves upon the court to determine which system was most appropriate to the business in question and most accurately reflects plaintiff's income tax position, always bearing in mind as President Thorson stated that there is a statutory presumption of validity in favour of an income tax assessment until it is shown to be erroneous and that the onus of doing so lies on the taxpayer attacking it."

(B) "At Risk" Rules

In a comparatively recent private ruling, Revenue Canada adopted a series of complicated rules to determine the amount of Canadian exploration expenses or Canadian development expenses deductible by a limited partner where such expenses were incurred by the limited partnership with funds obtained through partnership borrowings. These rules, which apply only to full recourse loans of a limited partnership, are, for want of a better term, referred to as the "at risk" rules.

Under the proposed rules,[67] a limited partner would only be entitled to recognize Canadian exploration expenses or Canadian development expenses incurred by the partnership to the extent of his equity interest in the partnership. Each partner is required to keep two memorandum accounts representing respectively his "equity interest" in the partnership and his as yet unrecognized costs under the rules. Each year he will be entitled to include in his cumulative Canadian exploration expenses or cumulative Canadian development expense the lesser of the two accounts at the end of the year, and to deduct the amount in accordance with the general rules.

The "equity interest"[68] will be increased by:

(a) all amounts which the partner has paid or unconditionally agreed to pay for his partnership interest;

(b) all amounts required to be added in computing the adjusted cost base of the partnership interest to that point in time;

and will be decreased by:

(c) all amounts required to be deducted in computing the adjusted cost base of his partnership interest for adjustments in respect of Canadian exploration expenses or Canadian development expenses of the partnership during that period; and

(d) his share of partnership Canadian exploration expense or Canadian development expense that has been recognized in previous years under the proposed rules.

In effect, the partner's equity interest will be his adjusted cost base of the partnership interest except that no adjustment will be made for unrecognized Canadian exploration expenses or Canadian development expenses. Thus the partner's equity interest (which has as its starting point his original capital contribution) is increased by his undistributed share of partnership income or gain which are committed to the risk, but is reduced by distributions of partnership cash or property (as these are no longer subject to economic loss). The reduction provided for partnership losses, Canadian exploration expenses or Canadian development expenses recognized by the partner is merely intended to keep the "equity interest" current.

If Revenue Canada is able to sustain its position in the courts (a doubtful proposition), it will have effectively foreclosed the advantages associated with limited partnership borrowings. In fact, its application results in a significant loss to the limited partner where the restricted expenses are not currently deductible. The rule does not, as is sometimes assumed, restrict the amount of the deductible expense to the extent of the

67. Brown, *Equity Financing in the Oil and Gas Industry*, 371 at 374, (1976 Conference Reports, Can. Tax. Found.).

68. *Id.*

"equity interest". Rather, it restricts the cost that may be recognized. If, as is the case with Canadian development expenses, the cost is deductible on a less than current basis, the partner may be required to recognize income while all the revenue is in fact applied to repay the lender.

Revenue Canada's statement of policy is unfortunate. First, it is an attempt to apply rules that have no basis in law. Unless it is prepared to test these rules in court, it should withdraw and apply the law in accordance with its terms. Secondly, by failing to obtain legislative changes in support of its views or at least publish its position, it permits the unscrupulous or ill-advised operator to raise funds from investors who may not have a proper appreciation of the risk of reassessment by Revenue Canada. While disclosure of this aspect is arguably a function of the appropriate regulatory bodies, it is submitted that Revenue Canada does have some responsibility to publish its views on an *a priori* basis.

More significantly, the rules are by admission of Revenue Canada designed to deal with the abuses of tax shelters and they fail to recognize the economic reality of many situations. It is understandable that Revenue Canada objects to a taxpayer deducting the full cost of acquisition of an oil and gas property while only committing his personal net worth as to a small portion of such costs; but their application of these rules in other contexts will produce unfair results. They give no recognition, for example, to the fact that a commitment of unpledged assets of the partnership to secure borrowed money required to develop the properties involves a commitment of equity. It is only to be hoped that if the rules are applied in future they will be subject to considerable refinement to reflect a more realistic approach.

IV. SPECIAL PROBLEMS

(A) Organization Costs and Syndication Fees

The income tax treatment of organization and syndication costs for federal income tax purposes is less than satisfactory. Typically the organization costs will include costs incurred in assembling the initial prospectus, if any, tax planning and formulating and drafting the incorporating documents. Syndication costs usually include marketing costs, including professional fees, printing costs and where applicable, fees paid to the regulatory bodies in connection with the issuance of a prospectus and commissions paid to underwriters.

Although the point does not appear to have been decided in Canada, partnership organization costs should, on the analogy to corporate organizational expenses, be regarded as non-deductible capital expenditures.[69] The expenditure should be treated as an eligible capital expenditure of the partnership deductible on a basis similar to corporate organizational costs under section 14 of the Act.[70]

Syndication expenses represent part of the cost of raising capital for use in the business. Thus they are distinguishable from organization expenses, which are more correctly attributable to the structure of the organization formed with such funds. Although there is no direct authority on the subject, the expenses are clearly capital in nature and

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69. This is the approach taken by the United States courts. *See Meldrum* v. *Fewsmith Inc.*, 20 T.C. 790-807, (1953) Acq.; *Abe Wolkowitz* 8 T.C.M. 754, 772.

70. I.T.A., s. 14(5)(b). *See generally* Interpretation Bulletin I.T. 143R.

generally non-deductible, in the absence of a specific provision permitting the expense. Paragraph 20(1)(e)[71] permits a deduction for expenses incurred "in the course of issuing or selling shares of the capital stock of the taxpayer". A share, however, is defined to mean "a share or fraction thereof of the capital stock of a corporation", thereby precluding the application of paragraph 20(1)(e) to partnerships. Revenue Canada has indicated in a private ruling that it is not prepared to extend paragraph 20(1)(e) to partnerships, but will regard such expenditures as eligible capital expenditures deductible under section 14 of the Act.

It is submitted that these costs could arguably be capitalized as Canadian exploration or Canadian development expenses as they relate essentially to the cost of exploration operations which could not otherwise have been engaged in by the partnership.[72] The argument has particular weight where the sole purpose of the partnership is the acquisition of a Canadian resource property and the financial costs are a prerequisite to the acquisition of a particular property. If these costs must be capitalized, they ought to be regarded as part of the acquisition costs of the land and accordingly a Canadian development expense of the partnership.

(B) Management Fees

Of necessity the manager of a drilling fund is entitled to compensation for services rendered. The manager will supply the business judgment and technical expertise necessary to the success of the fund's operations. In fact, the investor will be primarily interested in the quality of the manager. The manner in which such fees are paid will, however, affect their treatment for income tax purposes.

The usual method of compensating a manager of a drilling fund calls for a lump sum payment, by the partnership, of a fixed percentage of the capital raised through sales of partnership interests. The treatment of this item depends upon a number of issues relating to the characterization of the payments. First, Revenue Canada may argue that the management fee is in fact a reimbursement of items that would otherwise be non-deductible to the partnership. Secondly, where the fee is payable to a general partner, Revenue Canada may choose to regard the fee as a disproportionate distribution of profits rather than as a deductible item in computing partnership income or loss. Thirdly, even if Revenue Canada accepts the deductible nature of the item, it may choose to challenge the

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71. I.T.A., s. 20(1)(e) states:

(1) Notwithstanding paragraphs 18(1)(a), (b) and (h), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

. . .

(e) an expense incurred in the year,

(i) in the course of issuing or selling shares of the capital stock of the taxpayer, or

(ii) in the course of borrowing money used by the taxpayer for the purpose of earning income from a business or property (other than money used by the taxpayer for the purpose of acquiring property the income from which would be exempt),

but not including any amount in respect of

(iii) a commission or bonus paid or payable to a person to whom the shares were issued or sold or from whom the money was borrowed, or for or on account of services rendered by a person as a salesman, agent or dealer in securities in the course of issuing or selling the shares or borrowing the money, or

(iv) an amount paid or payable as or on account of the principal amount of the indebtedness incurred in the course of borrowing the money, or as or on account of interest.

72. Such costs are a necessary aspect of raising capital to buy a property or participate in a prospect of an economic nature that would otherwise not be available to individuals acting alone. As such they ought to be viewed as equivalent in stature to fees paid to agents who assume projects for investors acting outside the partnership form. If these latter costs are deductible so then should syndication costs.

classification for tax purposes, thereby affecting the earned depletion and the resource allowance deductions.

Unless Revenue Canada could actually trace the application of the management fee to the payment of non-deductible capital costs—a difficult task—it should not be able to establish that the arrangement is a sham. An alternative challenge would appear to be on the basis that the fee should be allocated as between capital costs and services to be rendered by the manager. Unless the organizational costs were separately covered in the partnership agreements, an assessment of this nature would be difficult to disprove. If, however, the organizational and syndication fees are paid to third parties directly, it would seem to follow that the management fee is for services to be rendered in connection with partnership operations.

Although Revenue Canada could apply this principle to non-recurring management fees, it would represent a very technical and strained application of the law. In any event, this kind of problem should be easily handled by ensuring that the fee will not be earned until the partnership actually commences operations.

If the management fee can be regarded as having been paid for expertise in the exploration phase, it should, as to the allocable portion thereof, be regarded as a Canadian exploration expense or Canadian development expense of the partnership. If so regarded and a deductible item, it will not reduce the resource profits for the purposes of the partnership's resource allowance deduction, all of which may be referable to the limited partner's accounts.[73] If, on the other hand, it is a profit distribution, the resource allowance deduction is the same but a portion thereof is effectively allocable to the general partner to the detriment of the limited partners. This question could be avoided entirely by farming out the management services to a third party on a similar fee basis. Another method which should be acceptable to the Department of National Revenue is to have the general partner contract in a separate capacity with the partnership and carefully articulate exactly what the services are for.

In the case of a production fund, it seems beyond question that a management fee to a third party based upon the income from the properties is a current deduction and cannot be regarded as Canadian exploration expenses or Canadian development expenses. Similarly, recurring management fees in a drilling fund may be challenged on the basis that all or a portion thereof is attributable to operations and may not be treated as Canadian exploration expenses or Canadian development expenses. Since there are advantages in characterizing the management fee as Canadian exploration expenses or Canadian development expenses, it would appear advisable to split the fee into separate components clearly referable to the type of services to be rendered. Although it is unlikely that the contract would be determinative of the question, it would at least be persuasive should Revenue Canada choose to challenge the treatment of the fees.

V. TIMING CONSIDERATIONS

Ideally, the tax shelter investment will provide the maximum deduction for amounts paid in the year, while at the same time permit the

73. Reg. 1211.

taxpayer to retain the use of the funds until the last possible moment. This objective has produced a number of practices that are peculiar to the drilling fund industry. It has also caused the extension of practices common to the oil and gas industry generally, the effects of which are presently in doubt.

The general rule is that a partner will be entitled to his share of Canadian exploration expenses or Canadian development expenses incurred by the partnership during its fiscal year if he was a partner at the end of the fiscal year. Similarly, a partner will be entitled to recognize his share of partnership losses for the fiscal year of the partnership ending with or within the partner's taxation year. Since individual taxpayers are on a calendar year basis, it is axiomatic that the partnership will choose a calendar year basis as its fiscal period as this maximizes the amount of expenses that may be incurred by the partnership and recognized by the taxpayer in his current taxation year. Whether the partnership has incurred an expense is a mixed question of accounting practice and law.[74] An expense, generally, will be regarded as having been incurred by the partnership at the point in time when the expenditure is accrued for accounting purposes.[75] Accounting practices will, however, only be persuasive as to the timing of the deduction and will be subject to the operation of specific provisions of the Act and the effect of any case law on the question.[76]

(A) Capital Cost Allowances

Where the partnership acquires depreciable property it will be entitled to claim capital cost allowance in calculating partnership income or loss for the year. In most cases this will not present any difficulty as the depreciables will usually only be acquired upon completion of the well and only if the partnership is responsible for these costs. Where the drilling fund is a mixed fund and a substantial portion of the investment is being applied to purchase producing properties (part of the cost of which includes the cost of equipment), timing of the creation of the partnership will be a significant factor in determining the capital cost allowance claim of the partnership.

Subsection 1100(3) of the Regulations provides that where the taxation year is less than twelve months in duration, certain capital cost allowance claims must be proportionately reduced according to the number of days in the taxation year. Thus, if the partnership is formed only on December 1 and a calendar year is chosen, the claim is 30/365 of the claim otherwise permitted. Interestingly, there is no reduction in the claim for capital cost allowance on Class 29 assets.[77] The effect of the general rule may be avoided by formation of the partnership prior to the commencement of the calendar year, combined with the judicious use of retroactive allocation clauses.

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74. *See M.N.R.* v. *Publishers Guild of Canada Ltd.* [1957] C.T.C. 1, 57 D.T.C. 1017 (Ex. ct.); *Dominion Taxicab Association* v. *M.N.R.* [1954] C.T.C. 34, 54 D.T.C. 1920 (S.C.C.); *Canadian General Electric Co. Ltd.* v. *M.N.R.* [1961] C.T.C. 512, 61 D.T.C. 1300 (S.C.C.).

75. *M.N.R.* v. *Tower Investment* [1972] C.T.C. 182, 72 D.T.C. 6161 (F.C.T.D.).

76. *See generally* Harris, *Timing of Income and Expense Items*, 84 (1975, Corporate Tax Management Conference, Can. Tax. Found.).

77. This is because s. 1100(3) of the Regulations refers to deductions claimed under s. 1100(1)(a). The accelerated allowance for Class 29 assets is by virtue of s. 1100(1)(y).

(B) Prepaid Drilling Expenses

In the United States it is not uncommon for the partnership to prepay drilling costs that will be performed in the following year. In Revenue Rulings 71-252[78] and 71-579,[79] the Internal Revenue Service has indicated that it will accept the current deduction of such costs by a cash basis taxpayer where there is a business purpose for the prepayment. Acceptable business purposes include the need to provide the drilling contractor with funds to proceed with the work[80] or where the work required to be performed is commenced in the year in which prepayment is made and continued until completion of the terms of the contract.[81]

A similar practice is apparently developing in Canada although in the author's view, there is some doubt as to the applicability of the principle to Canadian taxpayers. First, costs incurred by a partnership must be reported on an accrual basis,[82] requiring a reference to the point in time when such costs are incurred, not when the payments are made. Although an expense is incurred when the obligation to make a payment in respect of the item has been ascertained, this principle is usually applied to permit the deduction of costs incurred prior to the date of payment. It is by no means certain that it applies to a prepayment. Secondly, to deduct the expense one must incur the drilling costs directly.[83] Whether the well is being drilled on a cost plus or turnkey basis the deduction of the drilling costs is based on the principle that the drilling contractor is incurring the costs for the account of the taxpayer. If the well has not been drilled it is difficult to see how it can be said that the costs have been incurred by anyone.[84] Instead, the prepayment is probably more correctly susceptible of characterization as an advance on account of costs to be incurred.

Revenue Canada's attitude is ambiguous. The author has received at least one private interpretation disallowing the deduction of prepaid costs. It is understood that the current assessing practice is to permit prepaid costs as deductions only to the extent that the contractor has actually made the expenditure. Nevertheless, it is rumored that the national office may be revising its opinion and taxpayers may wish to seek a ruling on the subject. In light of the potential for abuse it can reasonably be anticipated that Revenue Canada will, in the absence of dispositive authority on the question, ultimately come out against deduction of such prepayments.

(C) Effective Date Clauses[85]

Typically, production funds will purchase oil and gas properties near the end of the calendar year. This is sensible and a perfectly acceptable method of obtaining deductions for the cost of acquisition of Canadian resource properties.

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78. (1971) 1 Cum. Bull. 146.

79. (1971) 2 Cum. Bull. 225.

80. Rev. Rul. 71-252, *supra*, n. 78.

81. *Id.*

82. I.T.A., s. 9.

83. *Farmers Mutual Petroleums Ltd.* v. *M.N.R.* [1966] C.T.C. 282, 66 D.T.C. 5225 (Ex. ct.); aff'd [1967] C.T.C. 396, 67 D.T.C. 5277 (S.C.C.).

84. *See Sunshine Mining Co.* v. *The Queen* [1975] C.T.C. 223, 75 D.T.C. 5126 (F.C.T.D.); aff'd without reasons, 1-12-1975 (F.C.A.).

85. For a general discussion of the law on the interpretation of "conditional" agreements, *see* Davies, *Some Thoughts on the Drafting of Conditions in Contracts for the Sale of Land* (1977) 15 Alta. L. Rev. 422.

A problem arises where the acquisition of property has an effective date prior to the closing date. Usually such agreements provide that the operations carried on between the effective date and the closing date will be for the account of the purchaser if the transaction closes and for the account of the vendor if it does not close. Thus it would be possible for a partnership to enter into an agreement for the acquisition of proven properties effective a few months prior to closing, with the vendor conducting drilling operations on the lands during the interim period. If the effective date arrangement were recognized for tax purposes, a portion of the cost of acquisition would be regarded as the reimbursement of drilling costs incurred for the purchaser's account includible in the partner's earned depletion base and possibly treated as Canadian exploration expenses.

Such agreements are undoubtedly effective for income tax purposes provided there is substantial agreement on the effective date with no significant conditions precedent to closing. The use of this arrangement combined with the judicious use of retroactive allocation clauses could, in theory, produce an attractive package. In fact, it is impractical. The partnership will of necessity require as a condition precedent to the closing of the land acquisition the obtaining of a minimum subscription to the partnership. The condition would be of sufficient effect to negative the "effective date" clause and transform it into a price adjustment clause, thereby classifying all of the costs as land acquisition costs for tax purposes. Of course if the receipt of investment capital is not a condition to closing the effective date clause should be recognized for tax purposes. To ensure that the drilling expenses will be deductible by the partners, the partnership should be in existence at the effective date and should provide for retroactive allocations of such expenses to partners substituted before the year end.

VI. DISCLOSURE

A significant aspect of any prospectus or offering memorandum prepared in connection with the public or private offering of a drilling fund is the summary of anticipated federal and provincial income tax consequences of the proposed transaction. To date there are no published guidelines, issued by provincial Securities Commissions having jurisdiction over any public offerings of drilling funds, that are indicative of the nature and degree of disclosure considered appropriate.[86] There are arguments that a one sentence tax section to the effect that no investor should acquire a limited partnership interest without first having consulted competent tax counsel would be more helpful to the investor than the more detailed summaries presently found in public offering materials; but it is unlikely that such an approach would be acceptable to the Securities Commissions.[87]

Having chosen to describe some of the income tax consequences of the proposed transaction, tax counsel is faced with the unenviable task of describing enough of the income tax considerations to facilitate intelligent investment decisions without summarizing all of the relevant federal and provincial income tax legislation.

86. The Oil and Gas Program Guidelines of the North American Securities Administrators Association are reported to have been adopted by the Alberta Securities Commission.

87. A technique that is currently in vogue is to have the investor represent that he has received independent legal and tax advice as a condition to investment. This should resolve tax conflicts of interest problems providing the sponsor is prepared to disclose to the investors' counsel all material, documents and correspondence.

As a minimum, it is submitted that the tax statement ought to include an opinion of counsel that the organization will be taxable as a partnership and that the allocation of expenses and revenues are sustainable should the matter be presented to a court. Where the proposed program involves a number of different classes of expenditures this ought to be disclosed, as well as the basis for the deduction of such costs by the partnership or the partners according to the classification of the expenditures. Because the non-deductability of Crown royalties and other similar items differs so radically from the concept of profit in any other context, this fact and, it is submitted, an estimate of the range of Crown royalties payable by the partnership, must be revealed without ambiguity.

An interesting question arises in connection with assessing policies of Revenue Canada and the extent to which these policies should be disclosed. Where the limited partnership is borrowing or intends to borrow funds to finance some of its operations, one would normally assume that a statement of the present attitude of Revenue Canada is called for. However, the position of Revenue Canada is not presented in any official publication and public knowledge of their views has to date been primarily by word of mouth. Similarly, the question of prepaid drilling expenses presents a dilemma. The position of the national office has not yet been articulated in any public manner and it may vary according to the particular official contacted. Yet there is reason to believe that assessors at the District level have been reassessing taxpayers and disallowing deduction of prepaid expenses where the work had not been conducted in the year of payment. Failure to disclose this information, notwithstanding strongly held opinions of counsel as to the propriety of the particular policy, may be grounds for an action should the fund be reassessed by Revenue Canada.