CURRENT DEVELOPMENTS IN OIL AND GAS TAXATION

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Canadian tax law reform which began with the Carter Royal Commission on Taxation has culminated in Bill C-259. This article summarizes the current law with respect to income taxation of oil and gas production and then outlines and analyzes the changes in the taxation of the oil and gas industry contained in Bill C-259. The article discusses exploration and development expenses, depletion allowances, the purchase and sale of oil and gas rights, oil and gas drilling funds, and concludes with the comment that the new law would not appear to unduly impede the growth and development of the Canadian oil and gas industry.

A. INTRODUCTION

On June 18, 1971, the Minister of Finance presented a Budget to the House of Commons and at the same time tabled a Notice of Ways and Means Motion respecting an Act to amend the Income Tax Act and other Acts. The tabled Motion, followed by Bill C-259 tabled on June 30, 1971, represents the final phase of the most comprehensive tax review undertaken since the income tax system was introduced in 1917, and represents the Government's conclusions after considering the recommendations of the Royal Commission on Taxation, the White Paper proposals for tax reform, the House of Commons and Senate Committee reports and the submissions of organized groups and individual taxpayers.

Bill C-259 repeals, in effect, the current Income Tax Act and substitutes a new Act containing 257 sections which the Government intends to become effective on January 1, 1972. Although the Bill retains much of the current law, it adds extensive and complex new provisions. It is the purpose of this paper to outline the provisions of the Bill relating to the oil and gas industry in Canada and to describe the more important ramifications of the proposed changes to the industry. This paper deals with each principal subdivision within the subject of oil and gas taxation, and each subdivision deals generally with a summary of current law, an outline of the proposals of the Bill that affect income derived from oil and gas production and an analysis of the Bill's proposals in this area.

B. EXPLORATION AND DEVELOPMENT EXPENSES

1. Exploration and Development Expenses (Current Law)

(a) Principal Business Corporations

A corporation whose principal business is production, refining or marketing of petroleum, petroleum products or natural gas or exploring or drilling for petroleum or natural gas, or operating a pipeline for the transmission of oil or natural gas, may deduct in computing income, drilling and exploration expenses, including all general geological and geophysical expenses incurred in exploring or drilling for petroleum or natural gas in Canada. Drilling and exploration expenses also include the cost of drilling a salt water disposal well in Canada, a water or gas injection well in Canada, and the cost of

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drilling or converting an oil or gas well in Canada into a water or gas injection well. However, any subsidy paid to a taxpayer under the Northern Mineral Exploration Assistance Regulations made under an Appropriation Act that provides for payments in respect of the Northern Mineral Grants Program may not be included by a taxpayer in computing his drilling and exploration expenses. The exploration and development expenses deduction must be taken in each taxation year to the extent of income for that year, and the balance of undeducted drilling and exploration expenses may be carried forward to future years indefinitely, provided that deductions are taken in each subsequent year to the extent of income. In effect, the deduction is an indefinite loss carryover.

(b) Other Corporations

A non-principal business corporation may deduct in computing its income for a taxation year the aggregate of the drilling and exploration expenses incurred in exploring or drilling for petroleum or natural gas in Canada to the extent of the corporation's income from operating an oil or gas well in Canada, from royalties in respect of an oil or gas well in Canada and from the proceeds of any disposition of Canadian oil and gas rights. As in the case of a principal business corporation, the balance of undeducted drilling and exploration expenses of a non-principal business corporation may be carried forward to future years indefinitely, provided that deductions are taken in each subsequent year to the extent of income from its oil and gas business, as defined.

(c) Foreign Resource Properties

Where an individual or corporate taxpayer has income for a taxation year from an oil or a gas well that is outside Canada, section 1204 of the Income Tax Regulations permits the deduction of the lesser of income from the well for the taxation year or the aggregate of drilling costs incurred in the year and in previous years in respect of the well (not including the cost of land, leases or other rights and not including indirect expenses such as general exploration, geological and geophysical expenses). The deduction of foreign drilling costs is computed on a well by well basis.

(d) Partnership

A member of an association, partnership or syndicate formed for the purpose of exploring or drilling for petroleum or natural gas may deduct, in computing income from all associations, partnerships or syndicates formed for such a purpose, the aggregate of his share of the Canadian drilling and exploration expenses, including all general geological and geophysical expenses incurred, to the extent of his aggregate income from the businesses of all such associations, partnerships or syndicates for the taxation year. In addition, an individual is permitted to deduct the aggregate of drilling and exploration expenses, including all general geological and geophysical expenses, incurred by him in Canada after April 10, 1962, to the extent of the aggregate of:

(i) His income from the production of oil or gas from wells in Canada in which he has an interest;

(ii) His royalty income based on Canadian oil or gas production; and

(iii) The proceeds of sale of Canadian oil or gas rights acquired by him after April 10, 1962.

(e) Successor Corporations

Under the current Act, a principal business corporation ("successor corporation") which acquires from a principal business corporation ("predecessor corporation") all or substantially all of the property of the predecessor corporation used by it in carrying on that business in Canada, may deduct the balance of undeducted drilling and exploration expenses of the predecessor to the extent of income reasonably attributable to the production of petroleum or natural gas from wells situated on property of the predecessor corporation. The current Act makes a similar provision for a second successor corporation situation.

2. Exploration and Development Expenses (New Law)

Bill C-259 retains the basic provisions of the current Act relating to drilling and exploration expenses, but contains a number of new concepts, the most significant of which relate to non-principal business corporations and the treatment of foreign exploration and development expenses.

(a) Individuals and Non-Principal Business Corporations (Canadian Exploration and Development Expenses)

Subsection 66(3) of the Bill provides that an individual or a corporation, other than a principal business corporation, may deduct the aggregate of his or its Canadian exploration and development expenses to the extent of the greater of:

(i) 20% of the aggregate of his or its Canadian exploration and development expenses incurred before the end of the taxation year to the extent they were not deductible in computing income for a previous taxation year, or

(ii) The aggregate of his or its income for the taxation year from operating an oil or gas well in Canada, from royalties in respect of an oil or gas well in Canada and from the proceeds of disposition of a "Canadian resource property."

A "Canadian resource property" is defined by paragraph 66(15) (c) 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, drill 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 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 principal value of which depends upon its mineral resource content (but not including any depreciable properties 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 described in any of subprargraphs (i) to (v).

Therefore, any taxpayer who does not meet the principal business test may offset any income from mineral and petroleum properties with undeducted exploration and development expenses, or may deduct from other income 20% of his undeducted exploration and development expenses. Although subsection 63 (3) increases the extent to which exploration and development expenses may be deducted by an individual or non-principal business corporation, it is submitted that it does not go far enough. All taxpayers should be entitled to deduct exploration and development expenses to the same extent as taxpayers engaged in other forms of commercial activity are permitted to deduct business expenditures. Because the proceeds of disposition of oil and gas rights received by an individual or non-principal business corporation are taxable at ordinary rates, it is inequitable that exploration and development expenses, which include the costs of acquiring oil and gas rights, are only deductible to the extent of the greater of an individual's or non-principal corporation's oil and gas production income or 20% of his or its undeducted exploration and development expense.

To illustrate the application of subsection 66 (3), assume the following facts for a non-principal business corporation:

	Year 1	*Year 2*
Gross income	$100,000	$50,000
Canadian exploration and development expenses	40,000	20,000
Canadian oil and gas production income	10,000	5,000

In year 1 the corporation will deduct $10,000 of its Canadian exploration and development expenses, because its Canadian oil and gas production income of $10,000 is greater than 20% of $40,000 (i.e., $8,000). Thus after year 1 the corporation has a Canadian exploration and development expense carryover of $30,000. In year 2 the corporation will deduct 20% of its aggregate Canadian exploration and development expenses of $50,000 (i.e., $10,000), because it only has Canadian oil and gas production income of $5,000 in the year.

(b) Individuals and All Corporations (Foreign Exploration and Development Expenses)

The Bill provides for a more liberal treatment of foreign exploration and development expenses. Subsection 66(4) permits a taxpayer, individual or corporate, to deduct from his income each year the greater of:

(i) An amount equal to 10% of the aggregate of his undeducted foreign exploration and development expenses, or

(ii) An amount equal to the aggregate of his income from operating an oil or gas well outside Canada, from royalties in respect of an oil or gas well outside Canada and from the proceeds of disposition of a foreign resource property, but before any deduction for foreign exploration and development expenses.

Foreign exploration and development expenses are defined by paragraph 66(15)(e) as follows:

> "foreign exploration and development expenses" incurred by a taxpayer means (i) any drilling or exploration expense, including any general geological or geo-

physical expense, incurred by him after 1971 on or in respect of exploring or drilling for petroleum or natural gas outside Canada,
(ii) any prospecting, exploration or development expense incurred by him after 1971 in searching for minerals outside Canada,
(iii) the cost to him of any foreign resource property acquired by him, and
(iv) his share of the foreign exploration and development expenses incurred after 1971 by any association, partnership or syndicate in a fiscal period thereof, if at the end of that fiscal period he was a member or partner thereof.

Paragraph 66(15) (f) defines a foreign resource property to be ". . . any property that would be a Canadian resource property of the taxpayer if paragraph (c) [S. 66 (15) (c)] were read as if the references therein to 'in Canada' were read as references to 'outside Canada'." Thus an individual or corporation, regardless of its principal business, will be entitled to deduct 10% of its foreign exploration and development expenses from other income. Additionally, the deduction of foreign exploration and development expenses may be computed on a consolidated basis rather than on the well by well basis required under the current Act.

To illustrate the application of subsection 66(4) assume the following facts for a taxpayer:

	Year 1	*Year 2*
Gross income	$100,000	$50,000
Foreign exploration and development expenses	40,000	30,000
Foreign oil and gas production income	10,000	5,000

In year 1 the taxpayer will deduct $10,000 of its foreign exploration and development expenses, because its foreign oil and gas production income of $10,000 is greater than 10% of $40,000 (i.e., $4,000). Thus after year 1 the taxpayer has a foreign exploration and development expense carryover of $30,000. In year 2 the taxpayer will deduct 10% of its aggregate foreign exploration and development expenses of $60,000 (i.e., $6,000), because it only has foreign oil and gas production income of $5,000 in the year.

(c) Successor Corporations (Canadian Exploration and Development Expenses)

Subsections 66 (6) and (7) of the Bill retain the basic provisions of subsections 83A (8a) and (8d), respectively, of the current Act, except that all or substantially all of the property of the predecessor corporation used by it in carrying on *in Canada* its principal business must be acquired by the successor corporation at any time after 1971. Subsections 29(25) and (29) of the Income Tax Application Rules, 1971, deal with property acquisitions prior to 1972 as under the current Act.

(d) Successor Corporations (Foreign Exploration and Development Expenses)

Subsections 66 (8) and (9) provide that where at any time after 1971 a successor corporation or a second successor corporation has acquired all or substantially all of the property of the predecessor corporation used by it in carrying on *outside Canada* its principal business, the successor corporation may deduct the aggregate of the undeducted foreign exploration and development expenses of the

predecessor corporation to the extent of income as may reasonably be regarded as attributable to the production of petroleum or natural gas from wells, or the production of minerals from mines situated on property of the predecessor located outside Canada. Subsections 66 (8) and (9) thus add foreign exploration and drilling expenses to the class of expenses deductible by successor corporations and would appear to permit a principal business corporation to segregate its drilling and exploration expenses into Canadian and foreign, and to dispose of all or substantially all of its Canadian property to one corporation and to dispose of all or substantially all of its foreign property to another corporation. Thus, a single predecessor corporation could be a predecessor corporation for two separate and distinct successor corporations.

(e) Stop-loss Provision

Subsection 66 (11) of the Bill provides that where control of a corporation is acquired when the corporation was not carrying on an active business, the corporation's exploration and development expense carryover will be reduced to nil. The subsection states:

> Where control of a corporation has, between a time when the corporation ceased to carry on active business and a time when it commenced to carry on active business again, been acquired by
> (a) a person, or
> (b) a person and other persons with whom that person does not deal at arm's length,
> who did not control the corporation at the time when it so ceased to carry on active business, all of the Canadian exploration and development expenses and foreign exploration and development expenses incurred by the corporation before the time when it commenced to carry on active business again shall be deemed to have been deductible in computing its incomes for taxation years ending before the time when such control was so acquired.

Presumably "control" means *de jure* control and not *de facto* control and "ceased to carry on active business" means a *de facto* cessation of a corporation's business. Subsection 66 (11) is obviously intended to preclude the acquisition of dormant principal business corporations having substantial unabsorbed exploration and development expenses.[1]

(f) Delay Rental, Salt Water Disposal and Injection Wells

"Canadian exploration and development expenses" and "foreign exploration and development expenses" are defined by paragraphs 16 (15) (b) and (e), respectively, as including "any drilling or exploration expense". This inclusion of "drilling or exploration expense" is defined by paragraph 66(15)(d) as follows:

> "drilling or exploration expense" incurred on or in respect of exploring or drilling for petroleum or natural gas includes
> (i) any annual payment made for the preservation of a Canadian resource property, a foreign resource property or any property referred to in paragraph 59(1) (c), and
> (ii) any expense incurred on or in respect of
> (A) drilling or converting a well for the disposal of waste liquids from a petroleum or natural gas well,
> (B) drilling for water or gas for injection into a petroleum or natural gas formation, or

[1] *See Gustavson Drilling (1964) Ltd.* (1970) 24 D.T.C. 1736.

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

Therefore foreign exploration and development expenses include any of the expenses enumerated in paragraph 66 (15) (d).

(g) Amalgamations

Where there has been an amalgamation of two or more corporations after 1971 and the amalgamated corporation is a principal business corporation, subsections 87(6) and (7) of the Bill permit the amalgamated corporation to deduct not only the aggregate of undeducted Canadian exploration and development expenses but also the aggregate of undeducted foreign exploration and development expenses incurred by each amalgamating corporation, to the extent of income as may reasonably be regarded as attributable to the production of petroleum or natural gas from wells, or the production of minerals from mines, situated on property in Canada or outside Canada of the amalgamating corporation.

(1) Restricted E & D Carryover (Canadian and Foreign)

Subsection 85I (3) of the current Act restricts the deduction by an amalgamated company of undeducted Canadian drilling and exploration expenses of the amalgamating companies to the extent of income from the oil and gas properties of the amalgamating companies. Where the amalgamating companies have undeducted lease acquisition costs, which by subsection 83A (5a) of the current Act are deemed to be drilling and exploration expenses, the amalgamated corporation is deemed by paragraph 85I (2) (1a) to have acquired the leases under an agreement, contract or arrangement described in subsection 83A (5a). Because the amalgamated company is deemed for the purpose of Section 83A to have acquired the leases, and by subsection 83A (5a) the amount paid in respect of the acquisition thereof is deemed for the purposes of subsection 83A (3b) to be a drilling or exploration expense of the amalgamated company, deductions by the amalgamated company of undeducted lease acquisition costs of the amalgamating companies under subsection 83A (3b) are not restricted by reference to production income derived from property acquired from the amalgamating companies.

Paragraph 85I (2) (1a) disappears in Bill C-259, with the result that, upon an amalgamation, the restricted exploration and development expense carryover of the amalgamating companies includes the cost to the amalgamating companies of lease acquisitions. However, paragraph 87(2)(p) of the Bill provides that the proceeds of disposition of lease acquisition costs included in computing the income of an amalgamating company under subsection 83A(5ba) of the current Act "shall be deemed to have been included in computing the income of the new amalgamated corporation for a previous year." This demand inclusion is stated to be for the purpose of computing a deduction from the income of the new corporation for a taxation year under Section 64 of Bill C-259, so that the amalgamated corporation is, in effect, entitled to reserve deductions in respect of the proceeds of disposition *receivable* by an amalgamating company.

(2) New Designated Surplus Rules

Under the provisions of paragraph 87 (2) (gg) and Section 192 of Bill C-259 the designated surplus of amalgamating companies in an horizontal amalgamation are continued in the amalgamated company. Where a controlled corporation is merged with its parent in a vertical amalgamation, a tax of 25% of the designated surplus of the controlled corporation is payable by the parent. If, as a result of an amalgamation, control of a predecessor corporation changes, its surplus will become designated as a result of the amalgamation.

Designated surplus created before the end of the 1972 taxation year of a controlled corporation can be distributed to the controlling corporation subject to payment of an elective tax of 15% of the 1971 undistributed income on hand of the controlled corporation.

C. DEPLETION ALLOWANCES

1. Depletion Allowances (Current Law)

Under the current Act, a taxpayer may deduct in computing income for a taxation year such amount as an allowance in respect of an oil or gas well, if any, as is allowed to the taxpayer by regulation. Parts XII and XIII of the current Income Tax Act Regulations set forth the deductions permitted in respect of depletion allowances for operators, non-operators and shareholders.

(a) Operators

Operators of oil and gas wells are generally entitled to deduct one-third of their annual net production profits from such wells, and non-operators are generally entitled to a percentage depletion deduction of 25% of royalties or rentals received. The operator of an oil or gas well computes his depletion deduction on a consolidated net profits basis from all oil and/or gas wells operated by him, and under the current Regulations aggregate net profit is computed after all Section 83A expenses available for a taxation year, including Section 83A expenses carried forward from prior years, have been deducted to the extent of income for the year.

(b) Non-Operators

Non-operators' depletion is based upon gross income rather than consolidated net profit from all oil and/or gas wells in which the taxpayer has an interest.

(c) Shareholders' Depletion

Part XIII of the current Income Tax Regulations permits shareholders of a corporation resident in Canada to deduct between 10%, 15% or 20% of ordinary dividends received where the oil and gas profits of the corporation exceed 25%, 50% and 75% (respectively) of the corporation's total income. Dividend depletion deductions are not permitted in respect of stock dividends or amounts received out of the retained earnings of a corporation upon winding-up and distribution of its assets. Only cash dividends and dividends in kind qualify for the dividend depletion deduction.

2. Depletion Allowances (New Law)

The Government has conluded that the present system of depletion allowances is both inefficient and unfair. Instead of the current system

of automatic percentage depletion allowances, the Government is introducing an "earned depletion" system, which will limit depletion allowances to one-third of consolidated net income and to one-third of "eligible expenditures" incurred after November 7, 1969. The earned depletion system will permit depletion which has been earned but unclaimed to be carried forward indefinitely in determining future depletion deductions.

(a) Earned Depletion

The tax reform measures proposed by the Government for the mining and petroleum industries include important changes which will be implemented by amendment of the Income Tax Regulations rather than by changes in the Income Tax Act itself.

On July 6, 1971, the Department of Finance released a paper outlining proposed regulations to apply to the mining and petroleum industries. The paper states that eligible expenditures incurred after November 7, 1969, will earn depletion at the rate of $1 of depletion for every $3 of eligible expenditures, and that eligible expenditures will include Canadian exploration and development expenses in the mining and petroleum industries, except for, *inter alia,* the acquisition cost of Canadian resource properties and capitalized interest deemed to be included therein by virtue of paragraph 21 (2) (b) of the Bill. Earned depletion will become deductible in 1977 and subsequent taxation years at a maximum annual rate equal to 33 1/3% of:

> (A) production profits for the taxation year as defined in paragraph 1201(2)(a) of the present Regulations, plus royalties from Canadian resources not operated by the taxpayer,
> minus,
> (B) deductions as provided by subsections 1201(4) and 1201(4a) of the present Regulations.

The maximum annual rate of earned depletion will also apply to royalty income received from Canadian resources by non-operators. In addition, the paper states that where there has been a statutory amalgamation of mining or petroleum corporations (presumably an amalgamation as defined by subsection 87 (1) of the Bill), or where a principal business corporation has acquired all or substantially all of the property of another principal business corporation used by it in carrying on its principal business in Canada, earned depletion of an amalgamating or a predecessor corporation which has not been absorbed against its production income may be assumed by the amalgamated or successor corporation to be claimed against production income from the properties acquired from the amalgamating or predecessor corporation.

(b) Shareholders' Depletion

The Department's paper confirms previous official statements that Part XIII of the present Income Tax Regulations will be repealed in respect of dividends received after 1971. The Government's stated reason for withdrawing the shareholder's depletion allowance is that the wasting nature of mining and petroleum properties (and the fact that each dividend received by a shareholder is partly a return of capital) is more accurately recognized by the deduction granted for one-half of capital losses. This reasoning is unsound because it

cannot be assumed that a new company is incorporated to develop every new property, and that every shareholder realizes aggregate capital gains at least equal to his capital losses accruing because of depletion.

D. PURCHASE AND SALE OF OIL AND GAS RIGHTS

1. Purchase and Sale of Oil and Gas Rights (Current Law)

(a) Sale of Oil and Gas Rights

With the exception of oil and gas rights acquired before April 11, 1962 and disposed of before November 9, 1962, the current Act requires the proceeds of disposition of Canadian oil and gas rights to be included in computing the income of principal business corporations and associations, partnerships or syndicates formed for the purpose of exploring or drilling for petroleum or natural gas. The courts have ruled that whenever Canadian oil or gas rights which were acquired (otherwise than by inheritance or bequest) prior to April 11, 1962, and are disposed of after November 8, 1962, the taxpayer is not entitled to deduct the cost of acquiring such oil or gas rights and that the entire proceeds of sale must be included in income. Individuals and non-principal business corporations are taxable on the proceeds of disposition of Canadian oil and gas rights which were acquired after April 10, 1962.

(b) Acquisition of Oil and Gas Rights

An individual or association, partnership or syndicate formed for the purpose of exploring or drilling for petroleum or natural gas that acquired Canadian oil or gas rights after April 10, 1962, is entitled to deduct the cost thereof as an exploration and development expense.

Under the current Act the costs of acquiring oil or gas royalty interests are not deductible, and similarly proceeds realized on the sale of such royalties are tax-exempt.

2. Purchase and Sale of Oil and Gas Rights (New Law)

Bill C-259 retains the basic provisions dealing with the purchase and sale of oil or gas rights, but extends this treatment to the cost of acquiring and the proceeds of disposition of oil and gas royalty interests, and to the cost of acquiring and the proceeds of disposition of a foreign resource property.

(a) Royalty Interests and Foreign Oil and Gas Rights

Section 59 of the Bill provides that:

(1) Where in a taxation year a taxpayer disposes of
  (a) a Canadian resource property,
  (b) a foreign resource property, or
  (c) any right, licence or privilege described in subsection 83A(5a) of this Act as it read in its application to the 1971 taxation year, that was acquired by the taxpayer,
    (i) in the case of
      (A) a corporation that is a principal-business corporation within the meaning assigned by subsection 66(15) or that was, at the time it acquired the property, such a principal-business corporation, or
      (B) an association, partnership or syndicate described in subsection 83A(4) of this Act as it read in its application to the 1971 taxation year,
  before 1972, and

(ii) in any other case, after April 10, 1962 and before 1972,
under an agreement or other contract or arrangement described therein,
the amount receivable by the taxpayer as consideration for the disposition thereof shall be included in computing his income for the year, notwithstanding the amount or any part thereof may not be received until a subsequent taxation year.

(2) There shall be included in computing a taxpayer's income for a taxation year any amount in respect of
(a) a Canadian resource property,
(b) a foreign resource property, or
(c) any property referred to in paragraph (1)(c) or paragraph (3)(a) or (b),
that has been deducted under section 64 in computing his income for the immediately preceding taxation year.

(3) Where a taxpayer has made a disposition after 1971 of property owned by him on December 31, 1971 that
(a) is property described in any of subparagraphs 66(15)(c)(i) to (vi) ["Canadian resource property"] and is not property described in paragraph (1)(c), or
(b) would be property described in subparagraphs 66(15)(c)(i) to (vi) if the reference therein to "in Canada" were read as references to "outside Canada" ["foreign resource property"],
the following rules apply:
(c) the relevant percentage of the amount receivable by the taxpayer as consideration for the disposition thereof shall be included in computing his income for his taxation year in which the disposition was made, notwithstanding that the amount or any part thereof may not be received until a subsequent taxation year; and
(d) where the taxpayer and the person who acquired the property were not dealing with each other at arm's length, for the purposes of this section, section 64 [reserve in respect of consideration for disposition of resource property not receivable until subsequent year] and section 66
(i) the cost to that person of the property shall be deemed to be the amount included in the taxpayer's income by virtue of paragraph (c) in respect of the disposition by the taxpayer of the property, and
(ii) when that person subsequently disposes of the property or any right or interest therein, the amount receivable by that person as consideration for the disposition shall be deemed to be the relevant percentage of the amount actually receivable by that person as consideration therefor.

(4) For the purposes of paragraphs (3)(c) and (d), the "relevant percentage" of any amount receivable as consideration for the disposition of property is 60% plus the percentage (not exceeding 40%) obtained when 5% is multiplied by the number of full calendar years in the period commencing at the end of 1972 and ending with the end of the calendar year in which the disposition was made.

(5) In this section, "Canadian resource property" and "foreign resource property" have the meanings assigned by section 66.

The special transitional rule described in subsection 59(3) relating to the disposition of a "Canadian resource property", *other than* any right, licence or privilege described in subsection 83A(5a) of the current Act or a "foreign resource property", means that the proceeds of disposition of mining properties and mineral or oil and gas royalties will be taxable to the extent of 60% if sold in 1972, 65% if sold in the second year and so on until the ninth and subsequent years when all of the proceeds will be included in income.

(b) Deferred Revenue Reserve Provision

Section 64 of the Bill permits a taxpayer to deduct a reserve equal to the unpaid balance of consideration receivable in respect of the disposition of a resource property.

(1) In computing a taxpayer's income for a taxation year (in this subsection referred to as the "current year"), where

(a) by virtue of subsection 59(1) or (3), an amount has been included in computing the taxpayer's income for the current year or a previous year, or
(b) by virtue of subsection 83A(5ba) or (5c) of this Act as it read in its application to a taxation year before the 1972 taxation year, an amount has been included in computing the taxpayer's income for that previous year,

in respect of the disposition of any property and that amount or a part thereof is not receivable until a day that is after the end of the current year, there may be deducted as a reserve in respect of that amount the lesser of

(c) the part thereof that is not receivable until a day that is after the end of the current year, and
(d) any amount deducted under this subsection in respect of the disposition of the property in computing the taxpayer's income for the taxation year immediately preceding the current year,

and for greater certainty, no deduction may be made in respect of that amount by virtue of paragraph 20(1)(n) [the general deferred revenue reserve allowance].

(2) Subsection (1) does not apply to allow a deduction in computing the income of a taxpayer for a taxation year if the taxpayer, at any time in the year or in the immediately following year,

(a) ceases to be a resident of Canada;
(b) becomes exempt from tax under any provision of this Part; or
(c) if a non-resident, ceases to carry on business in Canada.

The provisions of Section 64 of the Bill are basically the same as those contained in paragraphs 85B(1)(da) and (6)(c) of the current Act. The combined effect of subsections 59(2) and 64(1) of Bill C-259 where the consideration for disposition of a resource property is not receivable until a subsequent year, and the amount of the consideration is included in the vendor's income for the current year or a previous year, is that if after the total amount deducted in year 1 has been returned to income under subsection 59(2) in year 2, a deferred liability still exists for year 3 and a repeat deduction may be made in year 2 to the extent of the deferral. For example, if a taxpayer disposes of a Canadian resource property for $10,000 payable in equal instalments over a five year period, $8,000 may be deducted as a reserve in year 1 (the year of sale), under subsection 64(1), $8,000 is returned to income in year 2 but $6,000 is re-deducted in respect of the unpaid balance due in years 3-5, and so on through year 4, with a taxable balance of $2,000 in year 5.

(c) Contributions to Capital

Under the current Act, the Department of National Revenue has permitted the contribution of oil and gas rights to a company for no consideration by way of contribution to capital. Such a contribution has been considered not to be subject to tax under subsection 137(2) of the current Act as a benefit conferred upon the company and non-taxable under the provisions of subsection 83A(5ba) of the current Act. This treatment of contributions of oil and gas rights for no consideration is based upon subsection 118(2) of the Canada Corporations Act.

Bill C-259 would appear to exclude non-taxable contributions of oil and gas rights by way of gift. Where a taxpayer, individual or corporate, has disposed of anything to a person with whom he was not dealing at arm's length for no consideration or for proceeds less than the fair market value at the time of disposition, or to any person by way of gift *inter vivos*, paragraph 69(1)(b) of the Bill provides that the taxpayer is deemed to have received proceeds of disposition equal

to the fair market value. Additionally, paragraph 69(1)(c) provides that where a taxpayer has acquired a property by way of gift he is deemed to have acquired the property at its fair market value at the time of acquisition.

E. OIL AND GAS DRILLING FUNDS

1. Partnerships (Current Law)

Under the current Act partnerships are not taxed as separate entities, but the partners are taxed on their share of the partnership's income as if they had personally received the income. Subsection 83A(4a) of the current Act permits each partner of a partnership formed for the purpose of exploring or drilling for petroleum or natural gas to deduct his share of the partnership's Canadian drilling and exploration expenses, including all general geological and geophysical expenses, to the extent of his aggregate income from the businesses of all such partnerships for the taxation year. Additionally, the current Act permits each partner to claim capital cost allowance on his share of the partnership's depreciable assets.

2. Partnerships (New Law)

Subdivision j of the Bill deals with partnerships and their members. Under the Bill a partnership will be treated as a separate entity for the purpose of computing its taxable income, but there will be no tax imposed on the partnership itself and the partners will continue to be taxed on their share of the partnership's taxable income.

(a) "Partnerships" and "Canadian Partnerships"

Subdivision j of the Bill distinguishes between a "partnership" and a "Canadian partnership". Section 102 of the Bill defines a Canadian partnership as "a partnership all of the members of which were, at any time in respect of which the expression is relevant, resident in Canada". Because the term "partnership" is not defined in the Bill it may be concluded that the term necessarily includes a "Canadian partnership" and does not necessarily exclude a "Canadian partnership" for the purposes of Subdivision j of the Bill.

(b) Exploration and Development Expenses

Subsection 96(1) of the Bill provides that where a taxpayer is a member of a partnership, his income, net capital loss, or non-capital loss, if any, for a taxation year, or his taxable income earned in Canada for a taxation year, as the case may be, shall be computed as if the partnership were a separate person resident in Canada, and as if each income or loss of the partnership for a taxation year were computed as if no deduction were permitted by subsection 65(1), section 66 or the provisions of the Income Tax Application Rules, 1971, relating to exploration and development expenses. Sections 65 and 66, respectively, deal with depletion allowances and exploration and development expense deductions. The Income Tax Application Rules, 1971, apply to exploration and development expenses incurred prior to January 1, 1972.

Subsection 96(1) also provides that income and loss shall be computed as if the income of a partnership for a taxation year from any source were the income of the taxpayer from that source "to the extent of the taxpayer's share thereof".

The provisions of subsection 96(1) do not mean that partners are not entitled to deduct exploration and development expenses, because subsections 66(3) and (4) permit an individual or a non-principal business corporation to deduct Canadian and foreign exploration and development expenses incurred. Canadian and foreign exploration and development expenses are defined by paragraphs 66(15)(b) and (e), respectively, in the case of an individual or non-principal business corporation, to be the taxpayer's share of the Canadian and/or foreign exploration and development expenses incurred after 1971 by any association, partnership or syndicate during its fiscal year, *if* at the end of that year the taxpayer was a member or partner of the firm or syndicate.

It follows that although partnership income is computed on an "entity" basis, members of an oil and gas drilling fund may deduct Canadian and/or foreign exploration and development expenses in computing taxable income after attribution to them of the income or loss of the partnership of which they are members. The deduction is limited to the greater of a partner's annual income from Canadian production of oil and gas or 20% of his allocable share of Canadian exploration and development expenses. Foreign exploration and development expenses are deductible up to the greater of a partner's annual income from foreign production of oil and gas or 10% of his allocable share of such expenses.

(c) Contribution of Oil and Gas Properties to a Partnership

(1) Non-Canadian Partnerships

The basic rule under subsection 97(1) of the Bill is that where at any time after 1971 a partnership has acquired property from a taxpayer who was immediately after that time a member of the partnership the partnership is deemed to have acquired the property at an amount equal to its fair market value at that time and the taxpayer is deemed to have disposed of the property for the same amount.

Where at any time after 1971 a partnership has acquired property from a taxpayer who was, immediately after the acquisition, a member of the partnership, and:

(i) his share of the income of the partnership from any source for the taxation year of the partnership in which the property was acquired exceeds ½ of the income of the partnership from that source for the year, or
(ii) the amount he would receive if the partnership was wound up immediately after the acquisition (otherwise than his share of any income of the partnership) exceeds ½ of the aggregate of all such amounts that would be so paid to all persons as members of the partnership,

subsection 97(3) of the Bill provides that his loss, if any, arising from the acquisition of the property by the partnership:

(i) is not deductible in computing his income, net capital loss, or non-capital loss for any taxation year, and
(ii) shall, where immediately before that time he was a member of the partnership, be included in computing the adjusted cost base to him of his interest in the partnership, and in any other case, be included in computing the cost to him of his interest in the partnership.

(2) Canadian Partnerships

Subsection 97(2) of the Bill provides that if all the partners

by joint election in prescribed form agree upon the amount or value of property contributed to a *Canadian* partnership by a partner after 1971, the agreed amount is deemed to be the partner's proceeds of disposition and the amount for which the partnership acquired the property. If a partner receives no consideration for oil and gas properties transferred to a Canadian partnership other than his interest in the partnership, the agreed amount will be included in computing the adjusted cost base to the partner of his interest in the partnership, provided that the agreed amount cannot exceed the fair market value of the properties transferred. If the fair market value of a particular property transferred to a Canadian partnership is less than the partner's cost basis (Valuation Day value) the partner will incur a deductible capital loss.

(d) Adjusted Cost Base of Partnership Interests

Section 40 of Bill C-259 provides that a taxpayer's gain for a taxation year from the disposition of any property is the amount, if any, by which the proceeds of disposition exceed the adjusted cost base to the taxpayer of the property so sold or disposed of.

A partnership interest is capital property for the purpose of the capital gains tax, and the cost base of the partnership interest is keyed to the cost of the underlying partnership assets. For the purpose of computing the taxable capital gain of a partner who disposes of his partnership interest, subsection 100(2) of the Bill provides that there shall be included, in addition to the amount of the gain determined under subsection 40(1), the amount, if any, by which all amounts required by subsection 53(2) to be deducted in computing the adjusted cost base to the partner exceeds the aggregate of the cost to the partner of his interest in the partnership and all amounts required by subsection 53(1) to be added in computing the adjusted cost base to him of his partnership interest. Upon disposition of a partnership interest, in computing a partner's gain, exploration and drilling expenses allocated to him are treated as deductions in computing the adjusted cost base of his partnership interest. To the extent that exploration and drilling expenses incurred and allocated to a partner exceed the original cost of his partnership interest, such excess is "recaptured" as part of any taxable capital gain upon the disposition of his partnership interest.

(e) Dispositions of Partnership Property

Where at any time after 1971 a partnership disposes of property to a taxpayer who was, immediately before that time, a member of the partnership, subsection 98(2) of the Bill provides that the partnership shall be deemed to have disposed of the property at its fair market value at that time, and the taxpayer shall be deemed to have acquired the property for the same amount.

(f) Capital Gain or Loss Treatment of Non-Resident Partners

Subsection 115(1) of the Bill provides that a non-resident person's taxable income earned in Canada for a taxation year is the amount of his income for the year that would be determined under Section 3 if ". . . the only taxable capital gains and allowable capital losses . . . were taxable capital gains and allowable capital losses from dispositions of property each of which was a disposition of a prop-

erty (in this Act referred to as a "taxable Canadian property") that was real property situated in Canada or an estate or interest therein . . ." Subsection 115(1) goes on to include within the definition of a taxable Canadian property:

> (v) an interest in a partnership, if at any time during the 12 months immediately preceding the disposition thereof the fair market value of such of the partnership property as was property described in this paragraph was not less than 50% of the aggregate of
> (A) the fair market value at that time of all of the partnership property, and
> (B) the amount of any money of the partnership on hand at that time . . ..

Thus if more than 50% of the fair market value of the property held by a partnership is real property situated in Canada, a non-resident partner will be subject to the capital gains tax provisions of the Bill.

(g) Allocation of Income or Loss of a Partnership

Subsection 103(1) of the Bill provides that 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 the activity of the partnership that is relevant to the computation of the income or taxable income of any of the partners 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 the Bill, the share of each partner 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 these circumstances including the proportions in which the partners have agreed to share the profits and losses of the partnership from other sources or from sources in other places.

The purpose of this provision is to prevent artificial or unreasonable allocation of profits and losses of the partnership to the partners. Presumably if the allocation of profits and losses of the partnership to the partners is made on a basis obviously unrelated to the contributions of capital and/or services to the partnership by the partners, the allocation would be unreasonable and subsection 103(1) would be invoked by the Department of National Revenue.

(h) Termination of Partnerships

(1) Partnership Fiscal Period

For income tax purposes, termination of a partnership involves termination of the partnership's fiscal period, subject to an elective continuation provision available to individual partners (not corporations) resident in Canada, under Section 99 of the Bill. Subsection 99(2) of the Bill permits a resident individual partner to elect that for the purpose of computing his income for a taxation year, the partnership's fiscal period ended immediately before the time when the fiscal period of the partnership would have ended if the partnership had not been terminated.

Notwithstanding termination of a partnership's fiscal period upon termination of a partnership at any time after 1971, subsection 98(1) provides that the partnership is deemed to continue until all the partnership property has been distributed to the partners.

(2) Termination of Canadian Partnerships

Subsection 98(3) then lays down elective rules which may apply when a Canadian partnership terminates. Where at any particular time after 1971 a Canadian partnership has ceased to exist and all of the partnership property has been distributed to the partners, if all partners jointly so elect the partnership may distribute its property to its partners without realizing a taxable capital gain (provided that each partner receives the same undivided interest in each asset as he receives in every other asset distributed), and the partnership's cost amount of each asset is allocated to the partners.

The partners must then recognize gain or loss for capital gain tax purposes. If the allocated cost of assets received by a partner is greater than the cost of his partnership interest, the excess is treated as a capital gain realized by the partner, and if the allocated cost of the assets received is less than the cost of the partnership interest, the loss is deductible. In both cases the adjusted cost base to the former partners of the assets distributed is equal to the prorated cost of such assets to the partnership.

(3) Termination of Non-Canadian Partnerships

The members of a non-Canadian partnership are not permitted to adopt the elective rules provided by subsection 98(3). When a non-Canadian partnership is terminated the partnership is deemed to have disposed of its property for proceeds equal to their fair market value at that time. Thus the partnership itself, and not its members, will realize gains and/or losses on termination.

(4) Rollover on Transfer to New Canadian Partnership

Where a Canadian partnership has ceased to exist (e.g., because of the death or retirement of a partner) and before the time the partnership ceased to exist all of the property of the predecessor partnership has been transferred to another Canadian partnership the only members of which were members of the predecessor partnership, subsection 98(6) of the Bill deems the new partnership to be a continuation of the predecessor partnership and there will be no recognition of gain or loss for tax purposes.

F. CONCLUSION

Except for technical changes, it is the intention of the Government that Bill C-259 will come into effect on January 1, 1972. While it is possible that a number of amendments may be made before it is passed by Parliament, it is unlikely that these amendments will alter any of the basic provisions relating to the oil and gas industry. Subject to whatever amendments may be made to the Bill and to the provisions of the new Income Tax Regulations, it is fair to say at this stage that on the whole the new law does not unduly impede the growth and development of the Canadian oil and gas industry.