

Mason Gaffney MS

~~"Unfinished Business: Tax Reform for~~

"Oil + Gas: Unfinished Tax Reform."

To Debbie Webster

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MS for typing, "Unfinished Business"

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CASE: ³ City of Burbank v. Lockheed Air Terminal, 411 U.S. 624, 626 (1973).

STATUTE: ⁴ National Environmental Policy Act of 1969, § 101(a), 42 U.S.C. § 4331 (1970).

REPORT: ⁵ HOUSE COMM. ON UN-AMERICAN ACTIVITIES, GUIDE TO SUBVERSIVE ORGANIZATIONS AND PUBLICATIONS, H.R. DOC. NO. 137, 82d Cong., 1st Sess. 12 (1951).

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Outline

"Oil + gas: the unfinished tax reforms."

~~App O: Intro~~

~~A. Deficit out -- satisfied, on to other things.~~

~~6~~

~~B. Low rates remain. ^{was} 50, ^{was} 58, ^{would} 64, 68, 71, 75, ^{training} 78, ^{would} 81~~

~~C. Growing size + ascendancy of indy. 86, ~~70~~, 72, 78, 80~~

~~D. To unfinished bus.~~

~~E.~~

~~Current conjuncture hopeless? No -~~

~~- Deficit: rev. needs. Overburden on payroll taxes.~~

~~- Gas dereg. price to be higher taxes. 3~~

~~trend~~

~~- States move in, esp. Cal. 56, 57b~~

~~- Growing understanding that low-cost oil means limited~~

~~oil, + rent = taxable capacity. To get taxes, must get to source of rent. 1~~

~~F. Remaining Loopholes~~

~~A. Widely acknowledged + discussed~~

~~1. Expensing intangibles 36~~

~~2. FTC~~

~~3. xfr. price, bidding~~

~~B. Through a glass darkly~~

~~Cap. gains~~

I.

B. ~~Cap.~~ Thru a glass darkly half-noon

1. Cap. gains. X, 10, 20, 44, 44A, 47, 48b, 51. Big gains ahead, 54, 55. 60, 62, 69, 79, 74
2. % Deph., remaining. 19, 22, 24, 41, 60, 66, 90, 94

~~3. Day holes 15~~

4. Interest 28, 44A, 48a

C. ^{Things} Unseen: background "givens" that should be taken

back. Not unseen but invisible, but achieved camouflage. Exposed not by info. but by taking thought.

1. Abandonment of households. 13, 14, 43

Is big matter, 45. 52, 53, 54

Unlimited, unlike cap. losses. 71

At time of choosing.

Occurs regularly, despite building comm. average. 91

oldest ^{desired} 31, 35, 37, 83

2. Pre-learning expln., "Scouting"

big stuff rigid choice 8, 17, 30A

(Post-learning?) 34B, 35, McDon. 14

38, (39, 39A
used rethinking)

(5) Cost depn., a) surf. level base 11, 12

b) ^{lowball} ~~handwritten~~ v. numbers. 14, 21, 33. ^{Fast, type writ. off.} 15.

c) allowed for wiggle room! 32

→ (6a) ITC, plus cost depn. 85

Cost depn. is not SL, but no recapture.

(6) Misc.

(6e) ~~other?~~ 26,

~~6. Delay rentals. 27~~

(6d)

~~WPT etc.~~

deductible. 53

~~7. Post leasing expl. 30B, 35~~

(6B) ~~R & E~~ 29, 76.

Effects on efficiency.

~~(6c) Field use 40. (exp. from recap)~~

~~(6c) Prop. tax 46 to 1st pref.~~

~~(6c) Imputed inc. 46, 93, 90~~

II.

A. Inequity is manifest. Defense not on eff. + macro.

B. Allocative effects, micro

0. Bias for larger firms. 36

~~to spread + scatter. Extensive + intensive search.~~

1. Bias to build expensable K -- pre-pipe casing. ^{casing head}

1 1/2. Bias to scouting (8) big stuff. 83

78, 83, 84
90

2. Bias to buy leases. (Adam Smith says ^{business} they are bad. 49)
(Zero-sum? No, but is inc. to lessee.)

Free-rider problem. Fred Peterson saw one side of this. Other side is huge prop. to hoard acreage. Tax bias did discourage the free rider; but does the opposite.

67. Too slow to explore + dev.

3. Sub. field govt oil for labor 40

4. Royalty preferred to delay rental, but take cost depn.
 Worsen acreage - ~~problem~~ freezing problem. 42, 82a
 86

5. Unitize. penalized 82b

6. Churning to a cost depn. e.g. 79. The fear of
 acreage buildup doesn't mean no selling.

Nor does it mean no abandoning. Lottery system
 means abd. hundreds.

7. Bias to use coalition bases first. A negl. strike
 can't be sold clear, so might as well use; a low-cost, hi-rent
 deposit will be held back until a buyer is found. 81

Except 88

8. Abt. increases indy. support for bonus system - 88, which A. Smith
 C. Macro effects condemned, 49

1. Sub. energy for labor

2. Promote a K-int. indy.; deprive indin
 where K has higher valence for labor. 81

3. Make the indy. more K-int. spread-out. 84

III.

Conclusions, recommendations.

A. More fed. taxn. in some form.

1 dead form is on net rent, hi rate.

But base is as important as form — a base that generates rent.

B. State taxes

Move into preempted zone. 65-

Cap. gain - outline

Sale of lease, cap. gain

In some aspects, same as other v.e.

- CL. expensed

Int.

~~Rent~~

Prop. tax if any.

Take price is new basis 7

~~Net. cost expense~~

Tax deferred until sale

Can cash by bank, deduct int. 44 A, 47

In ^{these} ways not as good. Can defer tax forever on other hand.

In other ways, better

2. Selling rental -- no contingent w. other v.e.

3. { Net. cost expensed, large part.

{ Explan, post lease, expensed ?

4. Is like ordy. inc. in other bus. 51, 67, 68, 44

No loss limit

5 B Land not depreciable, elsewhere

1. Much acqn. cost expensed (+ rented separately)

Explan. pre-lease

Any holes

Abandoned leases

5A Buyer can deduct cost from ordy. inc.; + not wait until sale, but u.s. By stating price, convert ordy. to cap. gain. 48 b, but probably occurred "there is evidence that this has occurred".

Hi degree of separation of expl. from prodn. 50, 60
79, 74

Big gains ahead. 54, 55. 69
Leachholden w. 180 m.a. or so, well positioned

Cost deple., outline,

- a. ~~Just~~ Not much left as basis. Bonus, ^{some} expln., ~~with, ~~any~~~~.
- But inflate by rate.
- Seems to be routine.

Not clear to what extent controlled firms can sell to parents.

Or if prices are reasonable.

- b. accelerating deple. (all deprec. is too fast, \$L)
- ~~2.~~ 2. Low ball reserves for fast - some write-off
1. Other basis, term of lease is definite.

3. Prior deple. on cash basis, lower price level pp. 5-6

4. (Fictitious subdwn?) (24?)

~~Result:~~ "accel. deple."

- c. No recapture when errors discovered, or on resale.

d. There sh. be another rule, new basis

e. Sellers who receive bonuses write off basis on bad ones. 39A. If one is good, ~~the~~ haven't really lost 7/8 of basis!

Write off from orig?

Topic, Claude article

- ✓ 1. To capture rent, one of 2 requisites is to find source of rent.
Every Taxes do this.
- ✓ 2. Oxy Pet. pays no Taxes, U.S.
Is ∴ among sellers of ITC
- ✓ 3. Malignant result of forcing to tax rents is reduce. then
anti-conservation measures.
4. Purpose of rent taxes is to lower other taxes.
Or to sustain govt. after they've been lowered.
- ✓ 5. Non-parallel
 - gov. lessor gets bonus, this is taxable income.
 - " lessee pays " " not deductible.
 - Same true of all K' outlays, actually.
- ✓ 6. For yrs., dep'n. allowance was symbol of tax leniency.
~~How.~~
Partly b/c. profit; partly b/c. of size; ^{partly b/c. of} partly b/c. of
nature of the inc., largely thought to be unearned.
Accordingly, ¹⁹⁷⁵ ~~pressure built up to repeal of dep'n.~~ repeal of dep'n. hailed
w. great relief, as triumph for equity. Alas, +
righteousness.
One may wonder, however, how full the triumph

~~Fragment: Oxy selling ITC, also profitable. less use
available. Reports of majors w. too much -~~

~~Several ~~can~~ backup, loopholes are still w. us:
ITC (as int-imp.): expensing intangibles; exp. dry holes;
cap. gains; ~~shift~~ xfr. price to shift profit.~~

~~The ~~flaw~~ here is that there is another loophole,
never mentioned in lit., not recognized as such; (even
by the indy) ~~exp~~ that is looking into max. relative importance
expensing household abandonment.~~

7. Cap. gains:

~~Discovering creates value. This is like ordy, i.e.
in other businesses, i.e. discovering is the ordy. bus.
of explorers.~~

~~But ~~you~~ finder sells for cap. gain. Then
buyer takes cost depletion on acq. price~~

~~This is not as bad as 70 depletion; there, a 10 value
became ~~part of~~ ~~exp. depletion~~ deductible w/o even
being ~~bu.~~ taken into inc. first. Here, ~~the~~ taken
40% into inc.; then B deducts 100%.~~

~~In other indies, this ~~was~~ routinely happens to land.~~

but:

- a) Not if held as inv.
- b) land not depreciable.
- c) Acq. cost not exensible

✓ 8. a) ~~Exploration, too, is exensible. Pre & post leasing. Q.30~~
~~(How about buying expl. equipment?)~~

~~This is a 2d aspect of loophole.~~

~~b) - Technology: 2d largest user of computers, & growing fast. 3-D imaging. Uses data from geophones. Now, add satellite imaging from Landsat, Seasat, & MagSat.~~

✓ 9. ~~Leased acres - staggeringly vast~~
~~Citrus Grove, 10.4 m.a. (1/3 area of 7M.)~~

✓ 10. ~~Many big oils have left expl.~~
~~1980, only 12% of funds expended looking for oil & gas in U.S. was by big oil. (∴ small ones find, take cap. gains; big take cost depln.) (Also, small guys subcontract the work on leaseholds held by big.) (Also, some have expl. subs.)~~

✓ 11. ~~Lottery system, oil firms buy from specs. -- deduct.~~

✓ 12. ~~Inventorial rev. stream from new U.S. energy act.~~
~~\$250 b / yr. by 1990. Requires massive K inv.: value added from oil service cos.~~

But how much of this cap. invt. will be treated as K?

- ✓ ~~13.~~ More ~~cos.~~, land acqu. ~~never~~ neither deductible nor depreciable. Oil, is both, & much is expensable.
- ✓ ~~14.~~ Other businesses, if pay bonus for lease, must amortize over term of lease (SL)
- ✓ ~~15.~~ Expensing dry holes isn't worth much if you can expense intangibles anyway?
But: you can here take a loss on
 - a) Tangibles, if not salvagable.
 - b) Leasehold bonus.

And: you can elect to cap. intangibles grossly, but expense those in dry holes.

- ✓ 16. Is ITC available on Tangibles? **Probably.**

- ✓ ~~17.~~ Exploration is all expensable. Unlimited. But you must then expense all. (but you can set up subs.)

But when a mine "reaches the producing stage", these prior deductions are recaptured, reducing the deple. deduction (p. 21, Pub. 535, complex & vague, mainly vague.)

✓ 18. Many still qualify for 7% depln.

✓ 19. Depln. is figured separately for ea. prop'ty. (p. 26)
Can a large owner thus divide himself + get lots of 7% depln? Probably not.

✓ 20. Reserve recognition accty. Move to it, results from
F-USB seeing overriding importance of ^{this} ~~account~~
setty date

cf. 33.
21. (a) Cost depln. is on 7% of total removed. It presumes
you can ascertain.

(How blithely they ^{dominant reformers} accept this re inc. tax! How
different from prop'ty. tax attitude!)

✓ b) Std. coord. prop. tax asmt. + cost depln. valuation.
Owners will ~~even~~ low ball for 1st, + also for 2d.
So, owners gain from low balling both.

They probly accepted shift to cost depln. in part
by knowing they cd. lean on ^{low} prop'ty. valuations to ~~act~~
support "accr. depln." (de facto)

✓ c) Basis is your cost, less prior depln. allowed. But prior
depln. is allowed on cash basis, at lower price level.

Thus, owner A takes \$1000 depln. for 10% of units.
(Price double, retail. +) field price quadruples. He sells for
20000. New owner can deplete 19,000, or 95%.

- ✓ ~~26.~~ 70 depln. still allowed for:
also p. 7
- Royalty owner. (No 1 royalty, reduce bonus)
 - "Qualified indep" production.
Up to 65% of "gross taxable inc."
 - Nat. gas under fixed contract
(Rate: 22%)
 - ~~2dry & tertiary recovery~~ ?
 - Regulated nat. gas.
 - ("Reg." old oil?)

✓ ~~27.~~ Title: "Unfinished business: an agenda for tax reform."

✓ ~~28.~~ "Various special rules let you ... treat such properties as
separate." p. 26. This looks like an invitation to
create fictitious divisions to qualify as "indep."; or
to sell among subsidiaries at prices calc. to min. tax
burdens.

22 (reexamined).

"Small producer" gets 22% p. deple. on 1,000 b/d,
or 6,000 c.f. = 6 MCF nat. gas. (This must be 6000 MCF.)

To qualify, must not refine or retail
" " " have bought after '74 -- but
many exceptions, p. 27, including "xfr. between businesses
under common control" etc.

But you must divide the small producer exemption
among all props. in which you have an interest.
✓ But if a property has several owners, ea. owner
gets the exemption, the full exemption

Thus, a "property" w. 9 partners can get 9,000 b/d on
9% deple. At \$32/b, that's \$180,000/day, or
\$105 m/yr.

Per partner, that's 32,000/day, or \$11.7 m/yr.

Thus, "medium-size indep. drillers" (- & Brannon) are
"protected" (+ they do most drilling? -)

25. A bonus is only income, bcs. you keep a continuing or
reverting interest in the property. p. 28

(But if you sell the lease to 3d party --- a cap. gain,
I suppose. ?)

✓ 26. Lessors ~~must~~ include bonus in income, ~~but~~

You can take cost depln. on bonus, to the extent there is prodn. in that year. p. 28

(to: a. spread out bonus over 4 yrs.

b. Understate reserves, deplete fast. Bonus is an advance royalty, & royalty is reduced by depln.)
taxable

Not clear, but Pub. 535 hints that lessors deduct a good deal of depletion from bonus in advance of prodn., and there is no check on this until lease is abandoned.

✓ ~~27.~~ Delay rental

Expensed by lessee -- in advance of income, & even in absence of income.

✓ ~~28.~~ Interest. Always expensed, even tho used to pay bonus, etc. While this is unusual, nature of oil bus. makes it esp. strong effect here.

✓ ~~29.~~ R+E (res. + experimental)
Expensed.

✓ ~~30.~~ A.E. Exploration.

Pre-leaseing, is part of acq. of lease.

to y. costs of job search

~~8.~~ Post-learning.

of lease improvement by other lessees, capped for
time.

✓ ~~31.~~ Adm. overhead allocated to expl. co., all expensed.

This may be a general problem. all indy.
salaries all expensed, regardless of fr.

But this general bias espdy. favors ^{oil} firms whose
major activity is invest. ahead of payout.

✓ ~~32.~~ "Externalities" allowed

Owners of land adjacent to offshore oil leases have an
ec. interest, & can take dep'n! Agric. p. 83.

✓ ~~33.~~ Cost dep'n. on u.p. basis is too fast
Actual decline of value is proper basis.
Bldgs. get this, too.

~~34.~~ Sources.

6.63

~~McDonald et al.~~

~~Anderson~~

~~Agric~~

~~Schaefer~~

Rummen, Growth & Change, 1/79.

{ Clark, Breeding, Burke + Benton
Miller's Oil & Gas Tax. CCH
C. Brannon
Kaltin + Vasey, Energy Supply ...
Bennett + Hunt, 42 NTJ 337

- ✓ 35. Most expln. is expensible. Details get muddled -
 Aguirre, pp. 90-92, 78. Cf. Shaffer, 14-2, clearer.
 But "other than oil & gas" keeps cropping up - check this.
- ✓ 36. Expensing favors large ind. firms, always have a use
 for deductions. (Same for abandonments.)
 The expensing option is binding, you lose flex. with small firm.
- ✓ 37. Deducting exp. on expln. was limited until '69. Thence forward,
 unlimited. Shaffer, 14-2
- ✓ 38. 70 depln. was a way of recovering land costs; others were
 expensed, or deprec'd.

But now, land cost gets cost depln. u.p. basis. [Same
 as tangibles & surface deprec.? Or are these time-deprec?]
 If same as K, then distinct treatment of land less ben.
 lost.

~~Hecht~~ 39.
 rethinking

'75 Act, ended 70 depln. on bonus.
 Now, takes cost depln. on bonus. There is a special
 formula for this: Shaffer, 14-3.

$$\text{Cost Depln} = \text{Adj basis} \times \frac{\text{Bonus}}{\text{Bonus} + \Sigma \text{future expected royalties}}$$

This has 2 fudge elements!

1. Adj. Basis - how separate, when mineral rts. were

acquired w/o separate valuation:

2. "Expected future royalties" — no basis for this when you sell ~~for~~ before drilling, as is normal.

But basically this is ~~just~~ ok in concept. Bonus less basis is income. If royalty is zero, you deduct entire basis then. If you have a firm expect. of future royalty, then you aren't putting w. all yr. rts. by selling bonus, so you prorate by u.p. later.

✓ In practice, firms royalty expectns. are rare, so they may be assumed to place low value on them, as they are "speculative".

✓ ~~39A.~~

\$ Let a lessee sell 8 leases. 7 are abandoned, & he gets full basis write-off. The 8th hits gas. But he has written off 7/8 of his basis. This is the source of the major problem.

✓ ~~40.~~

Oil & gas used in the field, no inc.

a. Subs. for tangible. implicit expenses,

b. No royalty pd. — no tax i.

c. Speeds deple.

Under 7. deple., less incentive for this.

Cap. gain aspect.

✓ 41. % depln. is gross, + moves over time.
Double recovery of capl. ∴
Grows more serious w. deep gns. etc.

✓ 42. Bias vs. delay rental?
No depln. allowed.

✓ ~~43.~~ Abandonment is an only loss claim. Chirelet. p. 138
Basis is handhold cost, + all unrecovered cap. inv. allocated
to the lease.
(But sale gets cap. gain.
cf. limit on losses, rule of r.e.)

✓ ~~44.~~ When discovering "creator" an asset, this sh. be construed as
income to lessee + lessor both.

Chir. p. 82 1940 Braun case, e.g., S. Ct. held it is inc. when a
lessor acquires bldg. at end of lease. Thus, ~~the~~ Eisner-Macomber
does not force cash to pass. Inc. in kind is inc., as
in many other cases, e.g. benton.

Conf. repealed Braun, § 109. But ^{the other issue} never arose, re
discovery.

" " No, inc. in kind is realized upon discovery. But
this Δ is not taxed, (unless sold,) at time of receipt
in kind ~~realize~~. Is taxed as cashed (unless cash is borrowed)

✓ ~~44A.~~ The infancy of int. expensing is ^{doubled} ~~increased~~ when we think of lease borrowings on approved, discovering value is way of taking out cash w/o tax.

✓ ~~45.~~ '75, API survey, — 9. spent on lease acqu.

'81, lease sale, Pt. Conception, drew \$4.96.
181 tracts, 201 bids Times, 5/29/81.

✓ ~~46.~~ Intangible asset from expln.: info to help bid on neighboring tract. Value of this is inc. in kind, too. No tax.

✓ ~~46A.~~ Intangible wealth from expln. escapes prop. tax. So do most assets (over)

✓ ~~47.~~ The apprec. is not recognized until sale.

W. other land buy ahead of needs. Never have to sell.
After 75 yrs or so, you have a usable asset,
current value of $10x$, inc. of x , acquired for $2x$.

Can take out cash by borrowing; pay int. from inc. of x ;
invest the cash anywhere else.

✓ In most indus, this is incidental. In oil, it is the main business.

It was worse when you had to deple. minimally. But:

a) Many still do

b) Can establish higher basis by sale

c) Can deduct ^{most} ~~least~~ of all factors hist. basis by loss on abandonment.

has. of location, & has. few states across, & the major
one that does, Cal. has P-13.

✓ 48. a) Until '76, leverage worked for drillers, you cd. borrow a lot, + deduct a lot based on gross spending.
(Using non-recourse loans?)

b) Value of drilling rts. "often vastly overstated" for tax loss. BW. 6/26/79. (stated to German rev. agency, but evidently also in U.S. before '76 "clung down".) Since seller gets cap. gain, (+ buyer can expense from if he resells a lease only?) there is ~~strong~~ big gain in his price, which cd. be fictitious. We wd. have a poor opinion of the ingenuity of tax ^{shelter} avoidance indy. not to assume that ~~this~~ ^{ag} loophole ^{is} ~~was~~ ^{so inviting} is aggressively used.

✓ 49. Adam Smith opposed bonuses, wanted heavier tax on them. p. 783, quote.

Our ~~trust~~ ^{trust} has reverse effect.

Delay rents are only inc. no deple. Bonuses are more favorable to lessor, but ~~esp.~~ ^{esp.} to lessee.

✓ Why not more indy support for alt. bidding systems? Favored ~~trust~~ ^{trust} of bonus.

✓ 50. WPT is severe, but, being an excise, rates cannot ~~top~~ be hi enough to top most rent. Also it is structured w. diff. rates.

anyway, WPT is a separate issue. My topic is inc. tax.

✓ ~~51.~~ Cal. Rule 468, ^{by Bd. of Equ.} a provision of Prop. 13, treats new finds as "new construction."

Also, Dec. reserves resulting from higher prices.

✓ ~~52.~~ "Factionism abandonment" ^{roughly} analogous to lease case is in thinning fruit trees. One deducts the "abandoned" trees pro rata, but as the others grow ^{in the space then released,} no apprais. is recognized.

✓ ~~53.~~ Is a fed. tax deductible from fed. inc. tax?

Not payroll tax, etc. (but wpt is!)

But bonuses, upon abandonment, etc. Then, cor. benefit from having lease profits. Not called taxes. But ~~offshore~~ ^{royalties} Treas. accommodates them by calling royalties taxes!

On shore invs. one should w. states, but offshore one all fed.

- ✓ 54. Decoupling of oil prices will create cap. gains.
Future gas decoupling likewise.

$\$35/\text{bbl oil} = \$6/\text{mcf nat. gas}$, but ceiling on
nat gas is $\$2.50$.

- ~~✓ 55.~~ WPT is to be phased out, late 80s. More cap. gains.

- ✓ 56. Cal.'s low severance tax was offset by its hi use of prop. tax for oil, cf. to other states.
Prop. 13 clearly calls for an oil tax!

Prop. tax being local, Kern Cty. got $\frac{1}{2}$ the \$!
Now we can all share!

- ✓ 57. a) Under price reg, severance taxes are passed thru.
So is N.Y.'s 2% on gross sales (but N.Y. was
contesting this, 11/80.)
b) 2% of gross is \$230m in N.Y. $\therefore$ gross = \$11.56
Inc. tax in N.Y. is \$60m, or .52% of gross.
BW, 11/10/80.

- ✓ 58. WPT passed in winter, '79.

~~✓ 59.~~ Abandonment loss is ordinary & deductible in full.
A sale is a cap. loss, limited deductions.

~~✓ 60.~~ Indeps. account for 88% of U.S. well completions -
PW, p. 2, 3/6/81

61. Indeps. "reinvest" a higher % of wellhead costs than
majors - i.e. in more drilling? PW, p. 2, do.

~~✓ 62.~~ Cal. assess. add to the rolls new ex. revenues created by higher
wellhead prices. Love, n. 21, p. 57, from p. 13.

~~✓ 63.~~ Re expln. to drilling deductions. see:
Pechman, Fed. Tax Policy, Fed. ed., '77, ch. 5
Blair, Control of Oil, ch. 8
Shelton, Robt. Study Director, Energy Tax: an Analysis
of Selected Taxes, Energy Policy Study, Vol. 14, DOE, 9/80.

~~✓ 64.~~ World levels of oil taxes are higher than U.S.
Love, n. 66, p. 61, from p. ~~44~~ 45, cites Eng.
higher than 85% of gross, on many fields, incl.
of U.S., inc. tax & wpt at highest rate is
65% of gross, incl. rate -- and we have loopholes, and
wpt is to end, and our K flows to N. Sea anyway.

✓ 65. Solutions? a. More fed. then.
b. If fed. leaves unpreempted, S+L.
Cal. esply, no sev. tax anyway, no adj. after 1-13.

✓ 66. Landowners today get 25% royalties - Forbes,
6/22/81. (These get ⁷⁵dupln)

✓ 67. Case of slow work: King Ranch. ^{Humble (now} Exxon) got
long leases.

1933: 20 yrs. 12 $\frac{1}{2}$ %
1945: First successful well, 2d largest reserves in T.S.
1953: 2 extensions

a. 10 yrs.

b. 50 yrs. 16 $\frac{2}{3}$ % royalty.

Robert R. Melton, a Kleberg heir, sues Exxon for
slow performance, etc.

Exxon ~~was~~ source cited. They neglected King bcs. others were
pressing them.

Add this to Rothschild evidence: Too much
sitting on unexplored acreage.

✓ 68. The 26 largest energy firms pd. an ave. U.S. inc. tax rate as follows:

1978: 11.9 %

1979: 12.4 %

Source: DOE, Fuel Reporting System. PE, 6/6/81, Sect. A-3, p.1, UPI, "Energy Giants Taxed at Middle-class rate."

Fuel Rptg. System is targeted for extinction by budget cutters.

✓ 69. Summer '81 new tax bill, relieved royalty owners of wpt. Strippers also exempted.
WOT on new (after 1/1/79) oil reduced.

Value of exemption above:

Royalty - \$5.6 b

Strippers: ?

New oil: 3.2 b

BW, 8/17/81

✓ 70. No. of oil & gas wells drilled in U.S.

1980: 64,000

1981: 83,000

1982: 88,000 forecast

dr.

- ✓ ~~71.~~ Oxy selling ITC to Munk & Mc Lennan Cos.
" Although Oxy is highly profitable, it has little U.S.
tax liability bcs. of other tax breaks --- "

BW, 11/23/81, p. 45

- ✓ 72. 1¢ tax on gas/gal = \$1.16 fed. revs.

$$1/135 \times = 1.16$$

$$x = \$148.5 \text{ b gross sales of gasoline -}$$

- ✓ ~~73.~~ Gas taxes are not really on oil, bcs. earmarked for
highways. More like a benefit amount.
Nat. defense budget also cd. be called partly earmarked
for oil.

- ✓ ~~74.~~ Oil & gas drilling persps. for the future are
growing fast.
1981, \$2b in "publicly offered" programs.
+ probly \$4-6b in "privately"
 $\Sigma = \$6-8b$

75. Seismology is now the largest part. use of computers,
+ grows very fast, for 3-d underground
mapping. ~~also~~
Also Landsat, Seasat, + MagSat give data.

BW, 7/6/81

✓ 75. a) Oil's pref. don't look so good, relative to '81
tax law, w. 15-10-5-3.
But 15-3 applies to 15; oil gets it for land
b) also, oil has no recapture problem. Anyone else
~~who was acc. deprec. (but not SL)~~
is as a practical matter forced into SL, to avoid recapture.

✓ 76. New ^{tax} credits of 25% for R&D spending, '81.

✓ 77. Cap. losses, max. \$6,000 (net of gains), ~~count 5-yr~~
max. of \$3,000 off/set vs. only, inc. (Also, Brown, p. 55)
It wd. be reasonable to ~~assume~~ infer ^{from this fact} that major firms have overcome the 5-yr. limit.
✓ 78. ~~Lease 5-yr. terms~~ are evidently ineffective in speeding
dev't., bcs. oil firms ~~are~~ have acquired reserves of
~~to~~ under. acreage for greater than they can handle in
5 yr.
20 major firms ~~have~~ ^{report having} 160 m.a. under, vs. 27.6 m
dev., 1980. These rep. Δs from '76 of 43% + 2.5%.

This is reminiscent of the great gas station land rush of the sixties, when 40% of all retail land in a typical major city, later, was used by gas stars, mostly owned by majors.

<u>Date</u>	<u>Acres (m)</u>			<u>Dev. / Total</u>
76	<u>Dev.</u>	<u>Under.</u>	<u>Total</u>	
76	26.9	112.1	139.0	.19
80	27.6	160.2	187.8	.15
80/76	1.026	1.429	1.35	

Source doesn't say where acres are; or what "dev." means — (they may be getting seismic once-over, e.g. ?)

→ It figures that satellite scanning reduces cost of extensive gambling, puts majors back into a sort of wildcatting, the new wildcatting, clean hands, white-collar wildcatting. It is also even money that this spec. will ~~go~~ end as badly as the gas sta. boom of the 60s. But if so, they are better covered by the tax law of abandonment.

Favorable extent of abt. need not hurt abt. in a boom. It makes acqu. more attractive, for those w. K.

✓ 29. Cap. gain by Oxy. Times, 1/9/81

Beta field, off/shore of San Pedro, a 17% interest.

Cost: \$11.9m, 1975 (Oxy's share)

Sale: 200m, 1981. ("more than 200m")

Est. reserves: $.17 \times 150m = 25.50m.b.$

$\$200m / 25.5m.b. = \7.84 per b. in ground

Prodn. to begin 1/81. ~~at~~ 15khd to be reached in 3 yrs;
25 khd in 5 yrs.

15 khd = 5.8 mby

25 khd = 9.1 mby

Res. = 150 mb, est. by Shell, the op., w. 10% interest.

$150mb / 9.1mby = 16.5$ yrs. This is fastest rate.

But will begin + end slower.

Oxy has sold producing props. before.

Fed. lease. Drilling begun '80 (5 yrs. after purchase).
No restriction on sale of fed. lease, evidently.

✓ 80. Petrol. indy. invt. is now, 1981, 20% of all non-resid. countr. BW, 11/2/81

✓ 81. Is genly. recognized U.S. takes oil less than other countries. Advocates cite benefits, lower cost to U.S. indy. BW, 11/2/81, p. 22, citing Roger Brinner, DRI.

✓ 82. a) A cost of tax system is, it biases lessors + lessees vs. delay rentals + work commitments, thus encourages piling up unworked leaseholds.

Delay rental is expensed, ok for lessor - but only inc. to lessor.

✓ Delay rental to be offset vs. future royalties, however, is even stronger, but is not expensable, but held to be an advance royalty. Phillips p. 2

Work commitment, bids. wells are 100% capitalized.

✓ b) If field is unitized, is treated as one property. Then all intang. are capd.

Abandonment. of some surplus wells when fld. is unitized, may not be claimed as abandoned. (Avo. trees treated better!)

✓ 83. Pre-lease expl. "and dev." (Phillips, p. 3) costs are expensed.

Favorable treatment of such "scouting" (+ of course acqu.) costs encourages build up of acreage.

Then, after well ^{pipe} coming is in, "all" surface cap. is exp., not expensed. (pre- & post "Xmas Tree" distinction.)

✓ 84. The incentive is to lease large areas & refine them a coarse screen, rather than small ones thru fine screen - but the more you abandon, the better.

✓ 85. Depletable cap. gets ITC

✓ 86. Delay rental treated genly. as delayed bonus. must be cost depleted. Phillips, p. 6

✓ 87. Cost deple. incentive w. to allocate prodn. to leases of hi bonus - & v.v. Cheaply bought is slowly used.

But all cost deple. is from low unit, bcs. $1/8$ is recovered by abandonment. Thus minimizing incentive from cost deple. - until sell.

✓ 88. A ungu. lease is worth more abandoned than producing, bcs. of immediate write-off.

✓ 89. Lessees might seem to prefer royalties to bonus bcs.
of tax advantage — + even delay rentals.
Until you consider abt.

✓ 90. In calc'g stripper wells, can ~~the~~ average per-well output
over a field, evidently. Even water-injection wells
can be included in denominator. DOE reg!

✓ 91. 1980, case of several majors abandoning tracts in
Balt. Canyon "for tax reasons".

✓ 92. Reasons for holding leases:
— In case others strike nearby. Free-riding.
— "Last-minute exploratory drilling" cd. yield
geol. ~~clay~~ "to the area"

Interp.: Want to last minute bcs of over-
commitment; + hope of Technol. advance

Churn to area — buy cheap wildcat
leases to get info. for next bid.

✓ 93. Imputed inc. — preclusion of suits.

— other minerals, e.g. Exxon in W. Va.

~~94~~

Day-hole expensing takes care of most exploring post-learning, but that is what they do, drill. "Expln. costs" used by Mcd. to include day holes p. 16 u.

But other ~~exp~~ costs of unsuccessful expln. are current + ordy. p. 10

95.

Some losses go out of business.

Winners who ask favors based on expng. indy. spending are then trying to claim the losses of others, including those already deducted by others.

96.

By letting buyers deplete from their cost, we have in effect returned to "discovery value depletion", only worse, but DVD had been inapplicable to bought props.

~~97~~

Expln. costs are expensed whenever shown to find workings.

a. If not on an "area of interest" meaning an area ⁱⁿ ~~in~~ which there is further interest.

1. On areas of int., expensed when int. ceases, i.e. when no further expln. is contemplated.

1. Pre-learning, when you move on w/o nominating, 1 summary.

2. Post-learning, on surrender of property p. 17

cf. 98.

- ~~98.~~ Can even write off $\frac{1}{2}$ expln. before abandoning lease, upon final detmnt. of worthlessness. p. 17
- ~~99.~~ Expln. costs allocable to producers are capd. This is a small %!
- ~~100.~~ Capd. bonus & capd. expln. are treated the same. p. 16
- ~~101.~~ Cost of buying is cost-depleted. p. 16, u. 15.
102. Tangibles on producing wells
Recovered thru depreciation, not u.p. p. 17
103. No. for other eqpt. on prodng props.
- ? ~~104.~~ ~~Unanswered: What happens to K bought for expln?~~
- ~~105.~~ Allocated o'head is expensed from prodn. wells.
~~Other~~ o'head, allocated to non-producing props.
is also deducted on a lower line, p. 20
- ~~106.~~ There is no entry on balance sheet of oil firm for oil reserves. Capd. invt. is merely symbolic. Indep. ests. of reserves are needed to est. net worth. This is "well known" p. 23

107. Flies in ointment.

- a. When sell lease for a gain, intangible, ^{drilling} expenses are recaptured as ordy. inc. Gilbert, I, § 341, 9; PH, p. 2106
(w/o inc.
w/o infln adj.)
(w/o recapture of dry holes, expln.
" " " bonuses)

Change widely occurred, 1975.

- b. "Expln. must be capt." PH, p. 2114. But this is something of a misleading technicality. They are then deductible upon "abandoning the exploration project on the property."

- c. On reaching producing stage, previously deducted expln. exps. are recaptured. p. 2114. But how ab. there be any previously deducted, if expln. must be capt? Text unclear, mixes minerals w. oil & gas.

108. "Costs incurred by an existing business investigating possible expansion into a new line are usually deductible." Gilbert I, § 269 p. 49 Others not.

~~109.~~ Movable expln. equipment is capt; its deprec. is expensed.

110. Expensing intangibles in wells is probly duplicated in other businesses that build them and capt.

~~111.~~ Tax Treatment of Land Income, etc.

Notes

Rebke: Place in text simply the numbers, consecutive from #1, as superscripts.

On a separate sheet, type all the notes, which will include the full citation.

There will be no separate biblio.

The above is NRJ style. (They break up the notes and print them on the corresponding pages.)

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58

56. ~~56~~

"Clair Ghylin, general manager of Chevron's Land Department, Western Region, said Chevron's bids on the four southernmost tracts (Santa Maria Basin sale) were based on information obtained from wells drilled on adjacent Chevron lease-holdings acquired in a previous sale." J. Sweeney, op. cit. Texas Oil & Gas Corp. "drills mostly on prospects right next door to (its) own and other companies' finds." T. Mack, The Low Rollers, ~~Forbes~~

FORBES 117 (Feb. 1, 1982)

59 56A-1. Larry L. Smith of Shell Oil "said Shell and (over)
60 56A. The GAO has determined that exploratory drilling has occurred on only 17% of the federal tracts leased on the Pacific Shelf, 1970-79.

61
~~56A~~ (over)

Outer-Continental Shelf Leasing, L.A. TIMES 1, July 24, 1981. ~~(over)~~

other oil companies are keeping other leases ...

because of the possibility a competitor will strike oil or gas nearby. He said companies also hold onto leases because last-minute exploratory drilling could yield important geological clues to the area."

Oil Firms Give up Offshore Leases, op. cit.

61. ~~56B~~. Bagamery, op. cit.

~~56A~~ cont.

64 59. Federal auditors finished their work on the
 1967 tax return of Socal in 1976, ^{9 years after the audit;} California
 auditors in 1977. Socal appealed the California
 audit. The case came to the ~~Frontier~~ Board
 of Equalization in October, 1981. R. Fairbanks,
\$4.9 - million Tax Appeal Case to Open,

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I. R. S. ^{experts interviewed in 1977} ~~presented~~ in the Oil and Gas Unit, Los Angeles (over)

65 59A. SCHAFER → W. LOVEJOY + P. HOMAN, (over, top)

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office, ~~a~~ ^{were thoroughly} familiar with conditions three years ~~ago~~ past,
but only generally ~~are~~ aware of current changes
in this rapidly changing body of law.

Guy Phillips, Memo to writer, Jan. 25, 1977.

68 ~~62~~. 350 U.S. 308 (1956).

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Mason Gaffney, January, 1982

Introduction

In the heady early '70s, many of us sensed that tax reform was finally on its way. The sleepy public ^{had} awakened to its true interests. One of the few solid results of that climactic^{er} was victory over the depletion allowance. For years this had been the quintessential loophole, the symbol and a citadel of special privilege: it was preferential. The benefitting industry contains the largest industrial corporations; ^{the industry} and is our major polluter, directly and indirectly; oil income includes a high share of unearned ^{rents} ~~cuts~~; and the use of industry wealth in politics was feared as a corrupting force. Accordingly, the repeal of depletion in 1975 was hailed with relief and satisfaction at a job well done, a triumph for equity, efficiency, and righteousness.

But alas, we keep seeing disturbing news. Occidental Petroleum Company is selling its surplus tax credits to Marsh and Mchennan ^{ie} ~~Company's~~. "Although ^y ~~Oxy~~ is highly profitable, it has little U.S. tax liability because of other tax breaks." ⁽¹⁾ The twenty-six largest energy firms paid an average U.S. income tax rate of 12.4% in 1979, according to DOE's Financial Reporting System, (a source now targeted

(2)
for extinction). That suggests unfinished business of a gross order. While we may not know all the specific devices by which the industry achieves these results, the results themselves would seem to represent for the tax avoiders the substance of things hoped for and, for inquiring public citizens, the evidence of things unseen.

There is also a federal gas tax, of course. At 4¢/ gallon it raises about \$~~xxx~~^{4.4 B.}/year. (3) But the proceeds are earmarked for highways, making this a user charge rather than a tax, and one that falls far short of paying for the roadways required to use gas, especially the city streets where most gas is burned.

One might regard WOT as an equipoise, at least since passage in 1979 and imposition for part of 1980, and until it shall have been eroded by exemptions and retired on or before schedule, as now seems likely. (It's apparent impact is already halved by deductibility.) Or one might regard it as a separable issue, a tax with its own rationale based on an extraordinary price increase in which some industry elements were complicit, a price for deregulation, and a sort of "benefit assessment" to recoup some of the high

Use U.C. "B"
for "billion",
whenever L.C. "b"
now appears.

4 military costs of supporting oil interests abroad. Either way,

there is a case for reforming the income tax treatment of oil.

From the first viewpoint it is to replace ^PWOT with the structurally

superior income tax. Few economists support the structure of ^PWOT,

which is ^{too much like} ~~little different from~~ an excise based on gross. From the

second viewpoint, ^PWOT is irrelevant, and the income tax should be

made self-contained and neutral. In either case, income tax will

be here long after ^PWOT shall have withered away, and we should

begin now to set it right, for it will take many years. And almost

all hands agree that U.S. taxes on oil are below world levels, even

including ^PWOT and overlooking loopholes. ⁴ ~~_____~~

As to industry size and power, the products of retained

earnings, these continue to grow ^{re}impressively. While others at the

top of Fortune's 500 falter and stumble, more and more oil firms

work their way to the top ten, seven of which are now in oil and

gas. Petroleum industry investment now accounts for 20% of all non-

residential ^{struction} ⁵ contributions. Eighty-three thousand oil and gas

wells are being drilled in the U.S. in 1981. ⁶ The ^{incremental}

revenue stream from new U.S. petro-energy is ^eforecast at \$250 ⁸ ~~1~~/year

by 1990. ⁽⁷⁾ Twenty major firms report having 188 million acres (sic!)

under lease--that is 5.2 States of Illinois--of which only 15% is

developed. These firms are currently acquiring new leases rapidly,

^{to 1980. (8)} up 35% from 1976. This move is reminiscent of the gas station

land rush of the sixties, when some 40% (sic) of all the retail

land use in a typical American city (Milwaukee) was in gas stations

and their aprons, mostly held by majors, ⁽⁹⁾ ~~but it occurs in spite of~~

~~the losses suffered when the retail space became excessive.~~

Failure to tax fairly and proportionately an industry so huge

and dominating is of more than symbolic meaning. The absolute

dimensions are staggering. In addition, the value-added by the

industry is much less the product of labor and much more the product

of accumulated wealth than is the norm. Net worth per employee for

Standard Oil of California was reported (over) ~~the new~~

~~major oil and gas firms runs well over \$100,000, even before reserve~~

~~recognition accounting comes in to multiply reported net worth.~~

~~For other industrial firms, \$15,000 is the median.~~ ⁽¹⁰⁾ Preferential

treatment for this industry is a form of preferential treatment for

property income vs. labor income, and for large firms vs. small.

at \$234,300 in 1979, ~~is~~ 46 times higher than Singer
Sewing Machine at \$5,100, a labor-intensive firm. (10)

For all those reasons, tax reform is unfinished business of high priority. While a hardened partisan might assume the subject was dead during this Administration, imperatives of ^{ct}fair and circumstance generally bear alike on all régimes. There is a huge deficit to meet. There is a recognized overload on payroll taxes, limiting recourse to this well. There is a readiness to trade gas price deregulation for higher taxes. ~~There is the threat of~~ rapid expansion by states into the vacuum of unpreempted revenues left by federal dereliction. And there is widespread intellectual recognition that low-cost oil is high-rent oil, and high rent means high taxable capacity. The last point is hardly new, being central to the doctrines of François Quérnay^s and his followers (including Adam Smith) over two centuries ago. But it has had its ups and downs since then, and only recently escaped from traps laid by neo-classical economists and re-emerged in the ascendant, particularly ~~w.r.t.~~ ~~NOT~~ oil and gas. These are enough reasons to get on with the unfinished business. Let us begin by inspecting the tax preferences enjoyed by oil and gas.

with respect to

I. Remaining Loopholes for Income from Oil and Gas

Some of the remaining loopholes are ^{widely known} clearly perceived and frequently recited; some are seen only through a ^{mist;} glass darkly; and some are ^{invisible, although gross,} virtually unrecognized, being ^{camouflaged} taken for granted as the natural order of things. I will itemize all, ^{but} and expand only on the more neglected loopholes. ^{points. The invisible loopholes are not that by virtue of being tiny or uninteresting.}

A. Twice-told Tales: a standard list of tax preferences for oil and gas.

1. Expensing Intangibles

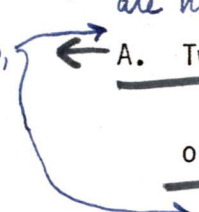
The "intangible" costs of drilling and equipping a production well are expensible. Tax economists now generally recognize expensing of investments in durable capital as being tantamount to 100% exemption of the income imputable to the capital, except for small, undiversified firms that bunch up unusable expenses in some years when other income is low. Some other industries, notably agriculture, enjoy similar privileges, but the standard of ^{reason} compassion, I submit, should be the wage-worker with his W-2 Form, the

④

Indent headings only! ~~These~~

~~These~~

Leave extra line above ~~major~~ headings, both major and minor.



Indent Headings only!

This applies throughout.



median American who bears the full sting of the nominal tax rates and for whose presumed benefit we have a "progressive" income tax structure.

One advantage of ^{expensing} ~~expressing~~ intangibles was partly abated in 1975 when these outlays were made subject to recapture when leaseholds are sold for a gain. 11 Recapture of a fixed number of dollars still leaves a substantial advantage, because interest and inflation are unaccounted for. Note that other expensed items like dry holes are not recaptured; nor are intangibles recaptured if there is no sale.

2. Dry Holes

If a well is dry, one expenses it. Of course had it produced one would have expensed most of it anyway, as intangible. What is added here is expensing of the rest of it, the tangible part; and exemption from future recapture, to which "intangibles" have become vulnerable since 1975. 12

Dry holes on dry leases would be deducted anyway upon abandonment. Dry holes on producing leases are the issue here. A field is developed by "stepping out" until the pay area is defined by a ring of dry holes, which are a normal part of the producing lease.

The general issue is a denial of the capital nature of all outlays that do not result directly in production: ^{outlays like} exploration, research, and lease acquisition. A reasonable man would construe dry holes as part of the capital sunk in the producers finally located by the total process. McDonald notes, ". . . unsuccessful exploration costs are an inevitable part of the total costs of acquiring productive assets . . ." and holds they should be capitalized. ⁽¹³⁾ Industry spokesmen make this ^{same} ~~very~~ point when justifying ~~apparent~~ ^{out of context.} high returns on gushers when taken in ~~isolation.~~ What they leave out is that the outlays should be capitalized, not expensed for tax accounting.

3. Royalties Treated as Foreign Tax Credits

In the beginning was the word, and the word was "royalty," meaning payments made to lessors per unit of production. And the word was made "tax" by several foreign governments who were lessors. The acceptance of this transubstantiation by the IRS generates huge factitious tax credits for multinational oil corporations. These are used to offset taxes on domestic income, dollar for dollar.

4. Profit Shifting by Controlling Transfer Pricing

Vertically integrated firms, often with many subsidiaries, have substantial latitude to shift profits to lower-tax jurisdictions by adjusting transfer prices on goods moved between tax jurisdiction. Tax authorities wage constant battle on this front but, in the nature of the case, often lose, compromise, or give up. (14)

← B. Through a glass backwards: matters seen but ^{mini}unnaturalized.

1. Residual Percentage Depletion

There are "a few minor exceptions" to the repeal of percentage depletion. It is not clear that they are so minor, or that ^{er}presistent shelter-seekers cannot widen them to a major exception.

Lessors or royalty-owners are the most glaring exemption. Royalties qualify for percentage depletion ^{at} of 22%. Royalties today are no longer the modest 1/8 of yore: 25% off the top is more typical. ⁽¹⁵⁾ That is based on gross well-head value, a value added to by the lessees' wells which are normally much deeper and costlier than before, and which the lessee writes off as well. Of all the incomes in the business, lessors' royalties are the purest windfall of rent, representing no functional effort of any kind, but only prior ownership. The royalty owner bears no costs of finding or production. There is normally no opportunity cost or foregone gain in the usual sense, because traditional

surface uses continue unvexed by oil operation^s. It is hard to imagine any useful economic function, any increase of supply, any employment^{cr}-eating investment, or any measure of equity that is enhanced by this allowance.

✓ A second exception of note is the "small producer" who gets percentage depletion on the first 1,000 bbl/d of oil and the first 6,000 MCF/d of gas. To qualify for this, one must not refine or retail downstream. The effect is to protect the "medium-size independent drillers," 16.

The value of the exemption is not negligible^{si}. One thousand bbl/d at \$30 is \$30,000/d or \$11 million per year. Six thousand MCF/d at \$5 is the same again, for a total of \$22 million per year. If wells are shut in for part of the year there is no loss: the daily average is allowed, i.e. 365,000 bbls/year.

In addition, there are interesting possibilities for multiplying this by dividing a property among

several owners, using the partnership vehicle. The exemption goes with persons, not properties, so nine partners means nine exemptions. The cap on percentage depletion for each partner is 65% of taxable income. The tax shelter for limited partners with outside income is evident.

The tax code is, of course, complex and filled with traps for the unwary; but ~~perhaps~~ also with plums for the crafty. Public information from the IRS on these points (Pub. 535) ⁽¹⁷⁾ is even more opaque and evasive than the norm. This kind of bureaucratic stonewalling invites one to surmise the worst. What is accomplished by insiders and specialists with private rulings and "various special rules" alluded to but not specified by IRS ⁽¹⁸⁾ is impossible to ascertain fully without being heavily involved personally, by which process, however, one is coopted and silenced. What is certain is that there is a large tax shelter industry in oil partnerships. Besides stretching

the loopholes, this industry consumes a portion of the gains to support its own effort^s, which are, from a national viewpoint, a waste of ~~capable~~ talents.

A third exception is for "stripper" wells, producing 10 b/d (barrels per day) or less. Here the effective cap is on a per well basis, not per person.

But wells may be grouped on a property, and some producing over 10 b/d offset by others producing less.

The denominator of the mean is also inflatable by including water injection wells, and perhaps by other stratagems. Wells producing 15 or 20 b/d will, of course, be slowed ^{down} to to qualify, as needed.

A fourth exception is for regulated sellers of gas with old contracts predating February 1975. In these circumstances there is equity in this, as these sellers are being taxed by regulations. There is also efficiency, at the production end, in offsetting the disincentive effect of lower prices on older producers. On the consumption side, however,

this provision merely reinforces the anti-conservation bias inherent in the price ceiling. It passes the depletion allowance through to consumers. It increases the supply of old gas at old prices, which utilities "roll in" to lower the average cost on which customers' rates are based. It increases the spread between the low customer rates and the extraordinarily high prices paid for new field gas today. Tracing through the whole system, then, the end result is a highly leveraged rise in the *demand* for new gas, a transfer of wealth to the majors who hold those 188 million acres, and other speculators who have spent the last decade laying lease to lease *and deal to deal* in gas-prone areas.

2. Capital Gains

Profit realized upon sale of leasehold enjoys capital gains ~~(CG)~~ status, with all that implies.

In some ways this is no more preferential than the treatment of other real estate; in one way less so; but in many ways more so. We take those in order.

Capital gains treatment in general is highly preferential, and lacking in any deep rationale. It has no support among tax economists, most of whom subscribe to the Haig-Simmons doctrine that gains are income, and should be ^{ideally} fully recognized as they accrue. It has no Congressional rationale: "The capital gain^s preference has never received a systematic exposition in any official source." It is something they just ^awent to do, not to explain. "The absence of a clearly articulated set of policy objectives has been criticized by many. . . . Unsure of its own goals, Congress has provided no more than a sketch. . . ." of what it wants. The courts and the IRS have done the rest. ²⁰ It has no Constitutional basis: "Congress is free to treat gains and losses as 'realized' pretty much whenever it chooses." ²¹ The usual rationales are based on shallow and incidental procedural and administrative matters; or on incentive arguments that have no application to land values, the major values

whose nature it is to appreciate routinely over an extended period of ownership, and qualify for capital gain.

With ^h any real property, carrying costs (interest and property taxes) are recognized as they are expensed, while the gain is not recognized until sale, if ever.

The expenses are deductible in full from ordinary income, thus being weighted two and a half times heavier than the gain they produce, the gain being only 40% recognized. The sales price becomes a new basis, so the process is repeatable. The owner can convert his gain to cash tax free, by borrowing on it. Cash flow from the mortgaged property can cover the interest, freeing the borrowed cash for new ventures, with new untaxed gains, and so ad infinitum.

There is also step-up of basis at death; deferral of tax on sale, by various routes; tax-deferred

barter; and a host of related benefits that are part of "capital gains treatment," which is tender and

solicitous in the extreme, compared to the harsh and relentless impositions on "ordinary" income from working persons and working capital.

A very common way to avoid taxes, one whose significance has escaped scholarly notice, is simply to buy land in advance of one's own needs. After a few years, one has a valuable perpetual asset for use, bought cheap, with never a tax on the increase of wealth, and no prospect of one.

It is as to the last point, that oil leases are less preferred than other land, because the corpus of the enhanced oil value does become taxable income when sold in units of production, and cost depletion is limited to historical cost. (We will see, however, that this handicap ^{can be} ~~is largely~~ overcome by timely sales, establishing a new high basis for cost depletion by buyers.)

In many ways oil leases enjoy more tax preference than other land. First, much of the de facto cost of

leasehold acquisition is expensed: ^{most of} ~~much~~ exploration, ^{all} dry holes, and ^{all} abandoned leases. Each of these is treated separately later.

Second, delay rentals are expensed. There is no counterpart to this in ordinary land acquisition.

Rentals are expensed before there is any income, and even in the absence of taxable income. Third, most

of lease development costs are expensed, because

"intangible," ⁽²³⁾ or because they are dry holes. ~~This~~

~~part is now subject to recapture, however.~~ Thus,

the asset value that becomes a capital gain is built up by an accretion of fully deductible expenses.

Now discovering and developing pay zones in oil rock are the ordinary businesses of oil firms, not incidentals. The pay zones are their inventory; they are dealers. In the leading ⁿ ~~Cory~~ Products case, ⁽²⁴⁾ 350 U.S. 46 (1955), it was settled that "Since § 1221 is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital

4

Indicates a footnote.

~~Accretion is~~
~~vital.~~

25

asset must be narrowly applied. . ." (~~Chirelstein,~~

~~p. 271; McNulty, p. 362~~), and it generally is. Stephen

McDonald has noted that,

" . . .oil and gas deposits would seem to fall in this category. . . (of assets that in the ordinary course of business are regularly offered for sale to customers)" ~~(p. 93)~~.

26

To be declared a "dealer" in other real estate is to

lose capital gain privileges. Oil firms do not

have this problem. Only timber has achieved a

comparable preference, *with breeding herds coming in a distant third.*

Security analysts and accountants have become concerned about the distorted picture of oil firms that has developed because they do not report inventory increases, as other firms do. There is no entry on the balance sheet of oil firms for oil reserves. Capitalized investment is merely symbolic, and independent reserve estimates are needed to find

27

net worth (~~McDonald, p. 23~~). Accordingly, the FASB

finally
and the SEC have required Reserve Recognition

Accounting (RRA) for 1980 reports. Here, revenue is recognized at the time reserves are determined, as opposed to sold. Nineteen-eighty reports contain a wealth of new data on the weight of this factor, which could basically change the way we look at oil firms, in the age of OPEC. Here, is Getty Oil Company

4 as a sample. The increase in proved reserves in 1980 was \$3.3b, or 3.18 times the Net Income otherwise reported. In 1979, the increase was \$6.3b, or 10.43 times the Net Income otherwise reported. ²⁸ The value of proved reserves at 12/31/80 was \$17.2b, or 2.07 times the Total Assets of all kinds reported conventionally. ²⁹ ~~and about three times the market valuation of Getty shares (it has little debt).~~

The reported reserves are net of royalties. Royalty owners bear no costs, so a 25% royalty could represent 50% or over 100% of net income. So for every dollar of added ^{reserves} ~~value~~ reported by Getty, the

lessee, there is a good fraction of a dollar not reported, enjoyed by a royalty owner.

The increases were the joint results of findings, acquisitions, and price hikes; and the greatest of these was price hikes, according to Getty. One could argue the details of SEC reporting rules, particularly the assumption of constant future prices, a myth somewhat offset by a ^{low} 10% discount rate. But Getty is careful to note that these estimates "should not be construed as implying in any way a price at which Getty would sell the assets." ⁽³⁰⁾ A billion up, a billion down, who knows?--but it is clear ^{that reserves} we are ^{represent} ~~dealing with~~ big, big money, and ^{a major} ~~the larger~~ part of the real income of oil firms.

increments



Another authority which is challenging the traditional invisibility of reserve appreciation is the California State Board of Equalization. Proposition 13 takes a recognition-upon-sale posture towards land

values, for purposes of property tax assessment.

But new construction enters the roles at current

market. The Board's Rule 468 treats new findings as

"new construction," and also adds the increase of

economic reserves resulting from higher price. ⁽³¹⁾ The

~~Board has prescribed in court, and there will be no~~

public outcry, since exemption for oil was a totally

unintended by-product of Proposition 13, the "home-

owners' revolt"

The shadow of ⁿEisner v. Macomber, ⁽³²⁾252 U.S. 189

~~(1920)~~ hangs over any discussion of recognizing

income before sale. But the application of this case

^{depends}~~hangs~~ on whether reserves are a "capital asset" or

an inventory. If the latter, then other rules apply,

and increased inventory ^{in other industries} is routinely added to taxable

income. If this be, as I submit, the appropriate

stance, then the present treatment is a gross loophole

indeed. In the ^uBrun case, ⁽³³⁾309 U.S. 461 (1940), the

court held that income in kind is income, even though

real estate. Just as Congress repealed Bru^uin by adding § 109, so it could legislate that income

in kind is realized upon discovery. If this seems a

shocking ^{idea} ~~suggestion~~, that suggests how conditioned ~~we are~~

~~by custom~~ and mind-bound we are by ^{custom} ~~entrenched privilege~~, for

anything less is preferential.

Another advantage that oil enjoys over other land

is that ^{a new} ~~the~~ buyer can deduct ^{his} ~~the~~ cost from ordinary

income, as cost depletion; and he can begin right away,

on a unit-of-production basis. With other land, of

course, ^{a new} ~~the new~~ basis is only deductible upon resale;

and thus from a capital gain, ^{and after a (normally) long period of ownership.}

^{ng} Inflation, the price of oil leases, ^{upon resale} ~~on the other~~

~~hand~~, converts ordinary income to capital gain: the

buyer's ordinary income ^{will be} ~~is~~ reduced by the seller's

capital gain, ~~albeit with a lag~~. There have been

occasional press reports of "abuses", ⁽³⁴⁾ but it is the

basic concept that is abusive, and we would have a

poor opinion of our tax shelter industry not to assume that the possibilities are heavily exploited by brilliant minds that might otherwise be ^{usefully} employed, ~~in useful pursuits.~~

A last advantage that oil leases enjoy over other land is that they can be written off at all. Other land is not depreciable (except illicitly by allocating part of it to a depreciable building on it). Of course, the tax depletion of oil has a rationale, the land is consumed physically; thus it differs from other land. But that is only half the story. The other half is that oil pay zones are naturally limited and scarce; thus they resemble other land, and thus they appreciate in real terms over time and generate value increments routinely and massively, and in times like the '70s, ^{ens} situationally. The exhaustion of old reserves makes it all the more certain that untapped ones will appreciate. Capital gain privileges to other "unearned increments" are in some

write out
billions

small way compensated by non-depreciability.

Privileges to oil suffer no such penalty.

Oil firms are well positioned to use the capital gains privileges because they have become vertically disintegrated at the front end: exploring has to a high degree been separated from production. Only a small share of the funds spent looking for oil and gas is spent by majors. "Independents" are said to account for 88% of well completions now. (35)

Drilling partnerships offered \$2^b publicly in 1981, and an estimated \$6b privately. (36)

Subsidiaries and subcontractors are also involved. Large firms, in turn, acquire proved properties. Getty, for example,

spent 58% of its 1980 acquisitions budget on proved properties, and more than 73% of its 1979 budget. (38)

They spent more on acquisitions than on either exploration or development, with acquisition rising at a much faster pace, 1978-80. (39)

This is not to say they do not also acquire unproved leases, for we have

in fairly complicated ways. Thus, Marathon Oil, itself being swallowed by U.S. Steel, is "farming out" three blocks of raw acreage in the Celtic Sea to a group led by Texas Gas, which will acquire a half-interest in every block drilled. (37)

noted a vast acreage increase, too. But there seems to be a regular "churning" of appreciated leaseholds, creating gains for sellers and new high bases for buyers. ⁽⁴⁰⁾ ~~(Footnote here, p. 37 of 145)~~

There are more gains to expect ahead. Decontrol of natural gas is probably coming; the nuclear alternative is nearly dead; the WPT is programmed to self-destruct in a few years; and all three branches now in Washington are more pro-oil than in a long time.

Royalty owners and strippers have already been relieved of ⁽⁴¹⁾ ~~by~~ WPT, and WPT on new oil reduced. ^{Twenty} ~~20~~ major oil firms with 188 million acres under lease ⁽⁴³⁾ ~~are~~ ^{set} well positioned to gain from all this. Fifty lesser firms and a few thousand individuals, families, trusts, partnerships, estates, institutions, local governments and so on doubtless swell that acreage figure much if we had the data. We never will, but it is clear that capital gains for oil is a large matter. Long lost in the shadow of percentage depletion, it should now be

New Arctic oil is now ⁽⁴²⁾ totally exempt.

spotlighted. As Stephen McDonald predicted in 196³/₇,
eliminating percentage depletion would have little
effect on oil incomes unless capital gains, which is
"a close substitute for percentage depletion," were
modified too. ⁴⁴ ~~12~~ ~~12~~

3. Interest

Interest is always expensed, even though borrowed
funds go to acquire "capital" assets like leaseholds
whose gains are mainly tax-exempt, when they appreciate.
While this is a general loophole for all landowners,
it is of greater consequence in oil because the nature
of the major assets is to appreciate in situ, as old
oil is exhausted. The preference involved in deduct-
ing interest is compounded because borrowing on
appreciated leaseholds is a way of realizing gains in
cash without recognizing any taxable income. In
contrast, pity the poor working girl. She reports and
pays current income taxes on a big chunk of supposed
income which she hasn't received because it was

withheld for FICA. Some other pension withholdings have the same effect. But pension rights are not bankable, as appreciated leaseholds are. So the worker gets a tax ^{without} ~~and no~~ cash; the oil firm gets cash ^{without any} ~~and no~~ tax.

Borrowed funds are also used to explore and develop leaseholds. The proved developed property, increased in value, may then be sold as capital gain, with the interest expensed (along with most of the principal).

Extra line
above heading

→ C. Invisible Loopholes

Several loopholes go virtually unrecognized, even in the reform literature. Yet they are in plain sight. It is rather a trick of intellectual camouflage. They blend in with a background of assumption^s tailored to the attitudes of a dominant group, and so escape notice. Even the beneficiaries are likely unaware of them, but regard them as the natural order of things. They may be exposed not so much by sleuthing as simply by taking thought.

1. Leasehold Abandonment

In the nature of exploration, several leases are taken for each that proves productive. It is a screening process. Something like fourth-fifths are culled out and then abandoned. A reasonable person would construe the cost of the four culls as part of the cost of acquiring the one producer, and this is the industry position when explaining the high returns on the producing leases. At Prudhoe Bay the lucky winners got some ^{\$50 Billions}~~\$1000~~ worth of oil on leases costing ^{only 6 millions, (45)}~~a few million only~~, and reams have been written justifying this by the costs of acquiring and sifting through other leaseholds, which were abandoned.

Now if the cost of abandoned leaseholds is part of the real cost of acquiring producing ones, then it should be treated the same, tax-wise. But instead, abandonments are expensed. The only outlay capitalized is that for the specific lease that produces. Thus, some 80% of the de facto cost of land acquisition is

expensed at an early date. Disappointing leaseholds are abandoned regularly, as in Baltimore Canyon recently, with "tax reasons" given as the motive. (46)

On top of the benefits for lessees, lessors ^{also} do gain from abandonments. There is a formula for diluting a lessor's cost basis by the amount of expected royalties, and abandonment reduces the diluting factor to zero. (47) A lessor who gets bonuses on five tracts to get one producer, can deduct 80% of his cost (on the four abandonments,) however large the royalties expected on the producer.

Few other businesses have this avoidance avenue open to them on such a scale because abandonment of land is not routine in other businesses. A comparable privilege is enjoyed by orchardists who write off their early thinnings as abandonments and thus take off of three-fourths of the capital cost before a grove is even mature. (48) One writes off the abandoned trees pro rata, but as the others grow into the space thus

opened, no offsetting appreciation is recognized.

But on the whole, this ranks as an extraordinary privilege, open to few.

Abandonment is much better than a capital loss.

It is an ordinary loss deduction, even though the producing leases are "capital" assets when sold. The basis for abandonment loss is leasehold cost, plus any unrecovered capital allocated to the lease. ⁽⁴⁹⁾ Most of

this unrecovered capital is exploration cost allocated to the lease, for exploration must be capitalized until lease surrender. One may also pick up a good deal of miscellany not otherwise expensed, like allocated overhead. And there is no limit. There is no requirement to offset losses first against capital gains: the gross amount is an ordinary loss. There is no \$3,000 limit, as under § 1211 for net capital losses. There is no recapture, as with § 1231 assets. ⁽⁵⁰⁾

As to timing, one can regulate this entirely for tax advantage because no sale is involved.

Putting it all together, the package of benefits is extraordinary: capital gains for winners, ordinary loss deduction for losers, no limits, no pooling, no recapture, no constraints on timing. To be sure, § 1231 assets enjoy a small taste of the same advantage: they, too, get capital gains when they rise, and unlimited ordinary loss deduction. But the restrictions are much tighter. The class of assets excludes inventories held for sale to customers (oil deposits are certainly that). Gain and loss are recognized on a net basis only, not a gross basis.

Capital loss for the year

[The net basis means that to take an ordinary loss, you must first report all your gains as ordinary income,-- quite a difference.] And excess depreciation is recaptured. ⁽⁵¹⁾

4

More fundamentally, the abandonment "loss" comes at the front end: it is really part of the cost of acquiring assets, rather than a loss on selling them. The comparable provision in other businesses would be to allow expensing 80% of capital and land

The relative weight of lease purchase in oil industry costs may be judged by these data from the Joint Association Survey, ~~(50)~~ ~~(50)~~ (Table 1).

Kind of outlay Kind of Outlay	1970		1974		Increase	
	\$B	%	\$B	%	\$B	%
Exploratory Wells	.815	12.7	1.647	11.0	.832	102
Acquiring Undeveloped Acreage	.714	11.1	5.659	38.0	4.945	693
Geological & Geophysical	.349	5.4	.640	4.3	.291	83
Development Wells	1.733	26.9	2.686	18.0	.953	55
Lease Equipment	.443	6.7	.770	5.2	.327	74
Production & Overhead	2.379	37.0	3.508	23.5	1.129	47
Total	6.433	99.8	14.910	100.0	8.477	132

Table 1. Domestic Expenditures by 364 Reporting Oil and Gas Firms. ~~(50)~~ (52)

By 1974, lease acquisition had jumped to 38% of the total spending of the industry. ~~and~~ ~~but~~ what about now?

(Santa Maria Basin)

In 1981, one single lease sale brought \$2.27 B
in winning bids on 81 tracts. In 1980 a
Gulf of Mexico sale brought \$2.6 B. ⁽⁵³⁾ ~~(54)~~ These
two sales are ^{a small} ~~only a~~ fraction of total acquisitions
currently, but together add up to 86% as
much as 364 reporting firms spent in 1974.

~~It is clear that~~ The ~~tax~~ treatment of leasehold
payments is the ^{weightiest} ~~single most important~~
question in oil tax law, in dollar values.

costs. No one else makes out so well. The reform literature neglects abandonments entirely, so far as I know. It is a gross oversight, especially now that lease acquisition has become the largest single outlay of oil firms.

Insert pp. 33A + B

2. Scouting

A large share of exploration cost is expensed, or virtually so. Technically the cost is capitalized, and then deducted upon "abandoning the exploration project or the property." ⁽⁵⁴⁾ Most preleasing exploration passes over vast properties before a lease is taken, and we may surmise that most is soon deducted, under the favorable treatment of abandonment. The position that is allocated to a lease is either deducted on lease surrender, or under cost depletion.

Other established businesses may fare as well, ⁽⁵⁵⁾ when seeking property to expand, but not routinely, on such a scale. New businesses must generally capitalize costs of successful search, and forget the costs of

unsuccessful search. Costs of job-search are, with small exceptions, not deductible. Oil search gets a much better break than job search, even though

conservative economists now attribute ~~most~~ of what *we used*

To consider the number one social-economic problem,
~~others call the problem of unemployment,~~ ^{high} to the cost of job search.

Expensing of early scouting forays is away up front in time, and therefore much weightier than the simple numbers reveal. Other businesses, too, succeed in expensing this or that which are really capital outlays that build up assets, but not on such a scale, so explicitly, or so many decades before taxable income results.

Substantial sums are involved. Seismology used in exploring is the second largest user of computers, after the federal government, and growing fast, for three-dimensional imaging of the underground, and interpreting data from Land ^{sat} ~~ed~~, Geosat, Magsat et al. (56)

Exploration ranks after lease acquisition, ^{development,} and

production expense as one of the major outlays of oil firms. ⁽⁵¹⁾

Post-leasing exploration means drilling, mainly, and dry holes are expensed, even on productive leaseholds. Dry holes are an integral part of lease improvement, as noted above. ^{In other businesses,} ~~Normally,~~ such things must be capitalized for the term of the lease. Other post-leasing exploration is capitalized and recovered through abandonment or--finally--production. But overall, the larger share of exploration is written off before production begins.

3. ^m ~~I~~puted Income

Leaseholds generate substantial ^m ~~i~~puted income. Most ^m ~~i~~puted land income in all industries escapes taxation. What is peculiar to oil is the vast area-- we have cited 188 million acres held by ²⁰ ~~50~~ firms alone--and the information monopoly at the lease lines.

The oil lease gives exclusive rights to drill. Information gained is proprietary, and usually not

Favorable tax changes are also good for the free ride, as occurred recently when Congress exempted new Arctic production (from old leaseholds) from WPT.

even shared with the landowner, e.g. the U.S. Government. So-called dry holes, (all expensable and non-recapturable) may be at the lease edge, giving the driller who keeps a "tight" (secret) hole a monopoly of data needed to bid on the adjacent tract. ⁽⁵⁸⁾ This valuable product (or sometimes by-product) is not taxable income. The extra security costs of guarding these valuable secrets are expensable, and they are treated like the Crown Jewels. Exploration data may also lead to finding other valuable minerals, as Exxon has found copper in Wisconsin.

There is also a free-riding motive. Finds and production on other tracts may raise the value of unexplored leaseholds. A steady stream of new exploration technology may enhance the value of any leasehold.

Revolutionary advances in satellite scanning (over)
New pipelines and other infrastructure may ~~do the~~
also give lessees a free ride.

Insert p. 36 A

same. Larger firms that can afford to wait like to

4

take positions in many fields in many countries and regions, maximizing the probabilities of getting the

have created new incentives to get more land to sift
~~through~~ through a coarse screen, instead of sifting less
land through a fine screen. Favorable tax treatment
of abandonments further encourages this. This is a
new kind of wildcatting, with white collars and
dry feet.

free ride. Each added tract leased raises the system diversity, lowers the aggregate uncertainty, and gives one another option. This benefit is universally recognized, but never recognized as taxable income.

For these benefits it may even pay one to buy and hold a lease and finally abandon it undrilled. Better is to hold it as long as the landowner allows, then drill at the last moment. Major lessees today have acquired acreage well in excess of their drilling capacity, and we may reasonably infer that holding leases for the pure gains of holding has become a major element in the business.

Insert p. 37A



In some areas, the monopoly factor may also rear its head. Precluding unwanted interlopers can be an advantage, where a few comradely firms have things under control. ^werving up the leases is a good way to keep newcomers from getting established.

41 It always has been an ^{element.} ~~factor.~~ Humble Oil,

for example, sat on the ~~the~~ King Ranch twelve
1933-45,
years, before drilling its finding there the second

bringing in the second largest reserves in

Texas. They neglected King because other

lesons were pressing harder, and they still are,

according to disaffected King heir Robert R.

(61) ~~(568)~~ The propensity to sit on land and
Melton.

~~pray has a long American history is nothing
in America,
new, but now there are ~~new~~ heavenly forces
orbiting ~~around~~ ~~prayer~~, ~~the propensity to ~~pray~~ in this way~~
in action to answer the prayers of athletes. ~~And~~
~~redouble the effectiveness of prayer~~
~~is redoubled~~
this propensity to pray has a new scope.~~

the free ride. Each added tract leased, ^{lower} ~~raises~~ the

system diversity, ~~to~~ lowers the aggregate uncertainty, and gives one another option.

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Better is to hold it as long as ~~the~~ the abandonment allows, then drill at the last moment. (56 A-1)

Major lessees today have acquired acreage well in excess of ~~the~~ their ^{drilling} capacity, and ~~the business~~

we may reasonably infer that holding leases for the pure gains of holding has become ~~the~~

a major element in the business. (56 A) (over)

pray has a long history in America. But ~~now~~

~~the ^{devotions} ~~prayers~~ now rise to the new Gods of the Satellites~~
~~which join~~
~~who as well as the Traditional Heavenly Forces, to give~~
~~help answer prayer, bringing~~
~~giving new converts, and a new world scope to~~
~~this ancient propensity to prey.~~

the prayers now rise to new Gods of the Satellites

which join the Traditional heavenly answering

service, to bring new converts, and ~~to new Kingdoms~~

worldwide scope new Kingdoms within the scope

of this ancient propensity to prey.

4. Field Use of Crude Oil and Gas

It takes energy to extract energy. The share used in the field is surprisingly high, and growing higher as we get into heavy crudes ^{natural gas liquids,} and so on. Steam injection can consume one-third of the oil produced. (62)

Gas is often reinjected to maintain pressure drive.

In Alaska's Kuparuk field, 71% of the gas will be reinjected; 29% will serve the field's own fuel needs. (63)

Field oil and gas are not taxable until sold. On the other hand, field use is not deductible either, but this is not quite a wash. For one thing, there is an excess, normally ^{large}, of value over cost, which thus escapes tax. For another, field consumption speeds depletion, thus increasing the annual depletion allowance. We may assume there is scope for substitution between field use and hardware items, but the latter are tangible and must be capitalized, thus creating a tax motive to prefer burning field crude and gas, adding to our dependence on OPEC.

5. Cost Depletion

✓ remains By the time we get to production, not much cost to recover, but there is the bonus, and any exploration allocated to the producing lease. As for tangible well costs, and leasehold equipment after the "Christmas tree" (casinghead control), these are recovered separately through depreciation and will not concern us further.

The taxpayer solution is to establish a new basis by sale. No prior ordinary deductions are recapturable save intangibles. The buyer gets a new cost to recover from production. It would seem logical to transfer leaseholds just before production, and this does seem to occur regularly. I have not examined to what extent subsidiaries can sell to parents, to what extent prices can be fudged, etc., but the situation invites avoidance on a grand scale and may be one reason the IRS is ^{several} ~~ten~~ years behind in auditing oil firms. (64)

The oil owner's next move is to accelerate depletion. Building owners may accelerate depreciation, too, but accelerated depreciation is recaptured on sale, unlike depletion. Now that buildings get 15 year life anyway, without acceleration and recapture, oil's relative advantage is not what it was. But the absolute advantage is still there, and worth a look.

With ordinary leases there is a definite ^{term,} ~~turn,~~ and a bonus paid is deducted pro rata over the term of the lease. With oil leases the term is indefinite and ends only when commercial production ends. The bonus ^r or other cost is deducted per unit of production, so one begins by estimating the number of units in place. To get in the fast lane for depletion, one low-balls the reserves, so each unit is a higher percentage of the "total." IRS lacks the expertise to challenge estimates by the industry and its ^{consultants} ~~its~~, so there you are. Industry practice is to define

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"reserves" in the narrowest ways anyway, so there is little resistance to acceleration at this point.

After a few years of this, we have an interesting problem when it becomes evident that the original estimate was low. One runs out of depletion units, but the wells still flow. At this point one might expect a recapture of prior excess depletion, but there is no provision for this.

There is, on the contrary, a chance for double depletion, when a flowing lease is sold in mid-life. The buyer's basis is his cost, less prior depletion allowed, which sounds reasonable on the surface. But prior depletion is figured on a cash basis, not a physical basis. In a rising market the prior depletion allowed shrinks as a percentage of the new basis. For example, owner A has a ^a basis of \$10,000. He takes depletion of \$5,000, then sells to B for \$40,000. B's new basis is \$35,000 instead of the \$20,000 that

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would obtain if we figure that A used up half the cost depletion units.

Another route to low-balling reserves could be factitious subdivision of tracts. One might plan to develop a field sequentially, divide it into tracts 1, 2 and 3, and declare only the reserves in tract #1. I have not determined how common this is, but the regulations seem to invite it. "Various special rules let you. . . treat such properties as separate." (67)

Vast interesting possibilities were opened up after 1956 by the Southwest Exploration Company case. (68)
~~(350 U.S. 308, 1956)~~. Here, owners of land without oil in it were allowed a depletion deduction because the access to other's' oil was through their land. (69)

Creative taxmen have presumably pursued this invitation since then.

6. Miscellany

For completeness, here are two more special benefits; for brevity, I say little more.

Research related spending gets a 25% tax credit in the new tax bill. It remains expensable. Research in exploration and recovery from marginal sources is a growing factor in oil and gas.

WPT is deductible from taxable income. Individuals cannot deduct federal payroll or excise taxes from their taxable income.

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~~Summary~~ Major findings & their meaning

Major finding is that, ~~despite the partial~~
~~the cutback in~~ ~~no depletion~~ ~~but not~~
the ~~tax~~ inc. tax ~~remains~~ preferential
toward oil & gas income. ~~in~~ This
treats more lightly on oil & gas income than
on most other property income & a portion,
than on work income. This remains true
in spite of the abatement of depletion allowance,
recapture of expensed intangibles, & a few other

minor reforms; & in spite of the ~~easy~~ easier treatment given
to other property income by the 1981 act.

Each standard list of loopholes accounts for
will-be-known
some of ~~that~~ the preference for oil. These ~~are~~ ^{are} the

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foreign tax credit; expensing intangibles; expensing,

dry holes; + ^{creative} ~~ingenious~~ transfer pricing.

A second set of ^{known but ~~often~~ forgotten} loopholes, are shown to ~~be~~ ^{deserve} as much or more scrutiny. The remnants of 90 de-
~~too~~ consequential to belittle. There ~~are~~ ^{are} is
nothing are not negligible.
~~the~~ ^{the} ~~remnants~~ ^{remnants} of 90 depletion of ~~to~~ cap. gains.

~~the~~ ^{the} ~~latter~~ Cap. gains treatment in general is

preferential. & for whatever income receives it;

& cap. gains treatment, ^{is esp. important} for oil & gas, ~~it~~ & it is

~~shown to~~ preferential ~~of~~ to that for

other property. ^{The bulk of costs are expensed from ordinary income.} Oil deposits are property ~~are~~ ^{are}

inventory item, which ~~in~~ ^{is} ~~other~~ yielding

only ordinary income.

The expensing of interest, while ~~a~~ ^{pre} universally allowed,

is especially preferential for oil & gas ^{working in} ~~when viewed in~~ ~~because of~~
 tandem with
 eq. gain allowed to the basic inventory being financed
 on borrowed money.

A third set of loopholes ~~have~~ are virtually invisible
 to reformers. The greatest of these is expensing of
 leasehold abandonment, a process by which
 some 80% of the de facto cost of lease acquisition
 is ~~taken~~ expensed from ordinary income at an
 early date. Lease acquisition is now the
 largest industry outlay, by a wide margin.
 Abandonments are treated much more favorably than
 capital losses.

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Exploration is also mostly expensable from ordinary income: pre-lease outlays via abandonment, and post-lease outlays via the dry-hole provision.

Imputed income on leaseholds is tax exempt.

This includes the monopoly of information ~~from~~ from the lease, used to bid on ~~the next one~~. ~~The~~ ~~near the lease~~ ~~inner~~ edge.

others. ~~But~~ Twenty firms alone hold 188 million acres, making this a ^{major} ~~substantial~~ item.

There is a free-riding motive, to gain value in the lease from the finds of neighbors; from price hikes; from ~~new~~ advances in technology (notably today with computers + satellites); from new pipelines; and from new tax breaks; and from

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covering local markets.

Question, for the free ride accounts for a rapid increase in holdings of undeveloped acreage.

Field use of oil + gas, ^{a growing %} it is not taxed.

(This could include fuel used ~~to pump~~ in ~~the~~ pipeline pumps, as well.)

← Finally, the residual undeducted costs are ~~depletable~~ depletable per unit of production, ~~and~~ inflatable by acceleration w/o recapture, followed by resale and redepletion of ~~more than~~ a large part at an advanced price.

The inequity of these preferences is manifest.

~~unless we assume the benefits are all passed through to buyers.~~ The industry oil & gas firms are

~~large,~~ clustered at & near the top of Fortune's

500; & corp. shares in general are the most

concd. asset held by individuals. ^{over} ~~Even~~ The

~~gains~~ ^{shifted} to buyers are much less concd., altho

I put no credence in ^{studies} ~~data~~ alleging price hikes

to ^{be} ~~have a~~ negative impact. Energy is a

"superior good" overall, & studies alleging the ^{methodologically} ~~reverse~~ of a piece w. an earlier spate

of studies on the property tax, flawed by basic PFP blunders in ~~so~~ statistical technique.

Royalties ^{+ bonuses} go to prior owner of land. Drilling tax
shelters partnerships are for ~~the wealthy~~.
those with high outside income.

~~Tax pay~~

The inequity is offset to the degree that benefits are shifted or "passed through" to buyers in lower prices: offset, ~~yes~~ but traded for misallocation of resources + overall national inefficiency. If supply (and demand elastic, ~~as~~ as we now know it to be) is inelastic, benefits accrue to sellers and we have inequity. If supply is elastic ~~+ demand is elastic~~ ^{there is} we have a big increase ^{oil + gas} of production ^{rises} at the cost of a decline in other production ^{falls}, + we have waste + inefficiency, including pollution + environmental damage, urban sprawl, traffic deaths, ~~or~~ aimless Mariotering, premature exhaustion of world reserves, + several other ~~unpleasant~~ by-products of cheap energy.

In fact, ~~we~~ get some combination of inequality
+ inefficiency

Optional

Elastic supply also means another kind of
inequality: ^{high} energy consumers gain at the expense of
other consumers. Energy is probably a superior
good overall to consumers. Studies purporting to show
~~the~~ otherwise are of a piece with a spate of earlier
studies ~~on the~~ purporting to show the property tax to be
~~as~~ negative, driven to their conclusion by
biased statistical ~~blunders~~ blunders of statistical method
which that pre-ordain the finding. (P.T.P.)

And in production energy encourages the substitution
of ^{land} ~~it~~ for labor. (Bunker)

Besides drawing too much R into the industry, tax favors

~~There are~~

~~We have also identified several tax-induced~~
also include serious
distortions within the industry.

Expensing is inherently biased against small, new & marginal firms that often lack outside other cash flow against which to take the expense. A nasty little ^{hooker} ~~provision~~ makes expensing a binding (over) Capital gains preference one of greatest value to those with the financial ^{to review & waiting} power to hold the ^{leases} ~~most assets~~ the longest time. Most tax benefits entail some interplay of early expensing and deferred rates, a game reserved mainly for ^{players} ~~those~~ with deep pockets. Tax factors like these are bound to bias the structure of industry toward the top.

companywide
option, once chosen, denying flexibility in timing

to the small firms that need it most.

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← That ^{persuasive} general bias is ~~somewhat~~ ^{partially} counteracted by
the ^{cap specific cap} ~~specific set~~ upper limits on percentage depletion,
altho ~~it is argued~~ this cap is arguably too
low to help firms large enough to threaten
the majors, and mainly helps ~~those~~ ^{small} their dependences.
The ^{most (over)} ~~large unambiguous~~
There is a bias ~~to~~ invest upstream. "before the
Christmas Tree". Lease improvements ^{on the surface,} after the
Free — stock tanks, ^{cleaning, roads, drainage,} pipes, living quarters, etc. —
receive no special favors. It is drilling, ^{pumpjacking,} exploring,
+ holding
+ acquiring ^{leases} that set the ^{big} breaks. These
are the ^{most purely} acquisitive and appropriative activities in
the business, the ones that wrest ~~the~~ ^{capture} ~~capture~~
raw resources from nature & ^{grab} ~~capture~~ ^{from} other men, the ones

consistent, pervasive + glaring bias is in favor of

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~~that are most~~ with the largest element of land-grabbing
+ the smallest element of capital formation. the ones with the

most ~~marked~~ like ^{oklahoma "soon-ism"} racing to win a fixed prize,
and least like nurturing, ^{husbanding, storing,} conserving, processing +

upgrading the prize once taken. This set of biases
in the law

~~tells an ugly tale~~ speaks volumes about the ~~cowboy~~

~~social psychology that~~ ^{grade} fosters them, + which they

~~inspire~~

Congresses that made them. ~~the cowboy~~ ⁺ ~~inspires~~

~~social that~~ psychos that undergirds feeds, + is

fed by them.

~~atavistic impulses that have guided the Congress.~~

~~speak through the laws.~~

land-grabbing social psychology of the ^{people} nation's leaders.

who shape, + are shaped by ~~such~~ them.

Some defend favor to exploration by ~~pl~~ placing the
 spillover benefits to neighboring ~~lands~~ lands. ~~It is not~~

Perhaps there is such a case, altho, if so, ~~then~~ it applies
 equally to ^{new city} bldgs that ^{upgrade their neighborhoods,} ~~raise rents next door.~~ (+ to ~~the~~ ^{the} ~~house~~ ^{house} skilled
 workers in labor pools that enhance urban land values.)
~~then shall we say of the free riders who hold~~

then about the free-riding neighbor? They shld. they not

be the ones to pay the subsidy? ~~through differentially~~

~~heavy taxes on unearned increments.~~ Here is where

the tax law fails utterly. Free riders ^{with unearned} get the
 best breaks of all ^{through} the ~~combs.~~ of expensing abts. + cap. gains.
 The industry has responded by
 directing most of its invt. into
 hoarding up hundreds of millions of acres of undeveloped

leaseholds which are held undevd, ^{just bitch-hiking.} ~~waiting for lightning~~

~~to strike someone else to make lightning strike twice and.~~

In a nation of birds-hickens, no one goes ~~for~~ rides.

Another bias is in favor of bonus bidding for households. Reformers have worked hard there last 20 years to promote alternative ~~bidding~~ learning ^{policies} systems for public lands, ones that would ~~help smaller firms~~ defer payments for households, thus opening the door to more bidding from smaller firms w/o bid have a fair chance to bid by deep cash reserves. ~~reduce the "front-money bias" in bidding by deferring~~ ~~payments.~~ ^{Reformers} They have been stymied by ~~a~~ solid

~~code of industry resistance.~~ One reason for this is: the ~~industry~~ favorable tax treatment of ^{bonuses} ~~abandonment~~. These are largely expensed by abandonment ~~them~~ ~~that~~ This lets bonuses be largely expensed long well before there is taxable income. But royalties & other deferred profits ~~are~~ just get no special break.

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This goes far to explain why, ^{learning} reformers have
 gotten so little support
~~looked in vain for support~~ from ~~smaller~~ smaller
 the presumed beneficiaries of reform: small,
 unorg. firms who wd. benefit from lower within-
 w. deferred profits. The whole industry is

locked into ~~the~~ the bonus system for its tax
 benefits. An ancient critic of bonus bidding, one Adam
 Smith, ^{found} ~~finding~~ it harmful to lessor, lessee, & the whole
 community, ⁺ recommended we discourage it by ~~not~~ ~~means of~~
~~taxing~~ ~~has~~ ~~unfair~~ taxing bonuses heavier than
 deferred rents. [○] Our tax laws do the opposite.

○ ADAM SMITH, WEALTH OF NATIONS, 783
 (1776, 1937 ed)

Tax law specifically discourages use of ^{certain} lease provisions, designed to penalize lessees who ^{sit on} ~~board up~~ idle leases for a free ride. One is the delay rental. ~~this is liable to be construed as a defined bonus, and capitalized, denied as a current expense.~~ A simple annual rental of moderate size is probably expensible, as noted earlier. But the privilege is precarious and can be lost in 2 ways. a large rental is easily construed as a substitute for a bonus, hence part of lease acquisition, hence to be capitalized. (Phillips, 11/11, p. 2).

An ^{advance} rental which is to be credited against later royalty profits. — a double incentive to action —

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is considered an "advance royalty" + must ~~be~~ not
be expensed, (Phillips, 1/1/77)

But there ~~are~~ delay rentals remain current (over)

Another device of lessor is the work commitment;

a lease is auctioned or negotiated ~~with~~ subject to

the lessor's commitment to spend a given sum on

exploration or development, or to perform specified

acts. Tax calamity! all the expensable items become

lease acquisition costs: expensing denied. (1bid)

Tax law is also hostile to field unitization.

Wells surplus wells ~~about~~ shut in upon unitizn. ~~they~~ ^{are} not
allowed to be ~~elect~~ abandoned. One source says that
~~Worse~~, all intangible outlays

must then be capitalized, but I have not confirmed

this. It is certain, though, that unitizn. slows ~~production~~

ordinary income to the lessor, ↓ If the lessor is
a govt. ^{makes no difference} ~~that is inapplicable~~ But industry customs

grew up at an earlier time when most lessors were

private. ~~they die hard~~ Bonuses & royalties are also only
inc., but they
get depletion offsets, which delay rentals do not.

~~These old customs die hard, & the result is~~

~~that delay~~ Both lessor & lessee suffered tax-wise

by using large delay rentals, & so this most

constructive of lease provisions has been a poor cousin

to bonus & royalty. Custom dies hard, & it
remains a poor cousin today.

~~reduces~~ cost depletion. The whole ~~unit~~ pay zone, & perhaps more, are now treated as a unit.

Cost depletion creates the principle that "cheaply bought is ^{ill} ~~cheaply~~ used." Tax avoiders will naturally allocate production to leaseholds of higher cost basis. Those of lower basis can be held for sale. Negotiating a sale may take years, in the narrow mkt. that characterize many fields. A lease may be held by producing a token flow. ^{Bohns are} ~~is~~ often extended by complaisant officials. One abandoned lease ^{of Sta. Barbara} was ~~was~~ returned, ^{to Pauling Oil, was} after several years when oil was found next door. O

But ~~almost~~ all most big finds are
 cheaply bought under our bonus bidding system of
 shooting in the dark. Most of the true cost
 basis is written off by abandoning ^{losers} ~~dry~~ leases. The
 funds remaining tied up in the winners are custom
 below their value. Not until the market has
 crashed a few times are many leases ready to write,
 for ^{the greatest} tax advantage. Meantime the lease speculator sits
 on ^{his} ~~valuable~~ assets with minimal holding costs.

The sum of these tax-induced biases is
 extremely distorting, & patently inequitable. It is
 as though the laws were written by & for the
 free-riders at the expense of ~~the entire~~ ^{all} ~~the entire~~ ^{Thoroughgoing} reform is

is order. In a nation of hitch-hikers, no one
rides.