

"Oil and Gas: Unfinished Tax Reform."

~~"Unfinished Business: Tax Reform for Oil & Gas"~~

by Mason Gaffney, UCR. (Dec. 1981).

Intro.

In the heady early '70s many of us ^{sensed} ~~could~~ believe that tax reform was ^{finally} on its way. ~~But~~ The ~~One~~ of sleepy public had ~~finally~~ awakened to its true interests. One of the few solid results of that climactic was ~~the~~ victory over the depletion allowance. Here at least ~~was~~ is one dragon smitten & ~~be~~ felled, as we move on to new challenges.

~~But~~ For years this had been the quintessential loophole, ~~not just~~ the symbol ~~of the very~~ and a citadel of special privilege: it was preferential; the benefitting industry ^s contained the largest industrial corporations; & ~~it is~~ ^{is} ~~the~~ ^{our} major polluter, directly & indirectly;

oil income ~~is thought to~~ includes a high share
of unearned ^{cuts} rents; + the use of ^{industry} ~~wealth~~ wealth in
politics was feared as a corrupting ~~power~~ force.

Accordingly, the repeal of depletion in 1975 was
hailed with relief + satisfaction as a job well done,
a triumph for equity, efficiency + righteousness.

But alas, ~~today~~ we keep seeing disturbing news.

Occidental Petrol. Co. ~~+ a highly profitable corp.~~ is
selling its surplus tax credits to Murch + McWhannan Cos.
"Although Oxy is highly profitable, it has little U.S.
tax liability because of other tax breaks." (77) ①

The 26 largest energy firms paid an average U.S.
income tax rate of 12.4% in 1979, according to

DOE's Financial Reporting System, ~~which + the~~ (a

source of ~~this info~~ is now targeted for extinction.)

(2)

(68).

That suggests unfinished business of a

gross order. While we may not know all the specific ~~cases~~ devices by which the industry achieves these results, (over)

There is also a federal gas tax at 4¢/gal

of course. At 4¢/gal. it raises about \$ ^{4.4} ~~xxx~~ 6/yr. (3)

But the proceeds are earmarked for highways, making

this ~~more~~ a user charge rather than a tax, and

one that falls far short of paying for the ^{road} ways required to ~~use~~ ^{use} gas, especially the city streets where most gas is burned.

~~Some~~ One might regard WOT as an

~~The WOT affords some satisfaction to~~

~~those who think~~

at least ^{equipoise} ~~or~~ since

and imposition for part of 1980,
passage in 1979 and ~~with~~ until ^{it shall have been} ~~ridicled~~ with coded

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.

by exemptions and retired on or before schedule, as
 (1st's apparent impact is ^{already} halved by deductibility.)
 now seems likely. ~~One might~~ Or one might regard

it as a separable issue, a tax with its own rationale
 based on the extraordinary price increase in

which some industry elements were held to be complicit,

~~and~~ a price for deregulation, and ~~an effort to~~ ^{or more}
 a sort of "benefit assessment" to

recoup some of the high military costs of supporting

oil interests abroad. Either way, there is a case

for reforming ~~the~~ the income tax treatment of oil. From

the first viewpoint it is to replace WPT ~~which is a~~

with the structurally superior income tax. Few

economists support the structure of WPT, which is

a little different from an excise based on gross. From

the second viewpoint, WPT is irrelevant, and
the income tax should be ^{made self-contained +} neutral. In either
case, ~~WPT is to~~ income tax will be here long after
WPT shall have withered away, & we should ~~start~~ ^{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 WPT
and overlooking loopholes. ⁽⁴⁾ ~~Quadrant like~~
~~(4, 81) Roger Binneman of DRI~~ ~~do~~
~~not~~ who seems to regard this favorably, ^{low oil taxes} ~~as~~ as a
source of strength ^{for} ~~the~~ for ^{other} U.S. industry, to
which the benefits are allegedly shifted in lower
energy ~~prices~~ costs. (81).

~~Love cites marginal rates in Britain at 85% of gross. (64)~~
~~(64).~~

~~Industry supporters do not deny~~

As to industry size & power, the products of
 retained earnings, these continue to grow impressively.

While others at the top of Fortune's 500 falter
 & stumble, ^{more & more} oil firms work their way to the

(5)

top 10, 7 of which are now in oil & gas. Petroleum
 industry investment ~~is~~ now accounts for 20% of all non-residential construction ~~est.~~ (5)
 83,000 oil & gas wells are being drilled in the U.S. in

1981 (6) ~~(70)~~. The incremental revenue stream

from new U.S. petro-energy is forecast at \$250b/yr.

by 1990. (7) 20 major firms report having

^{million acres} 188 ~~million~~ (sic!) under lease — that is ^{5.2} ~~5.2~~ States of

Illinois — of which only 15% is developed. These

~~current rate of a~~
 firms are currently acquiring new leases ~~at~~
 rapidly, up 35% from 1976, ⁽⁸⁾ ~~(14)~~. This ^{land}
 move is reminiscent of the ~~great~~ gas station land
 rush of the ~~1970s~~ sixties, when some 40% (inc)
 of all the retail land use in a typical American
 city (Milwaukee) was in gas stations & their
 wide aprons, mostly held by majors; ⁽⁹⁾ but it occurs
 in spite of the ~~losses suffered in~~ ^{losses suffered in} ~~some results of the earlier~~
~~rush. when surplus stations had to be closed.~~
 when the retail space ^{became} ~~proved to be~~ excessive.

Failure to tax fairly & proportionately an
 industry so huge & dominating is therefore of more
 than symbolic meaning, ~~it is a matter of whose~~

~~absolute dimensions are~~

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. ~~That is,~~

~~Capital~~

Net worth per employee for ^{major} oil & gas firms ~~it~~ 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} ~~norm~~. (10) Preferential treatment for ~~the~~

this industry is ^{a form of} ~~therefore~~ preferential treatment for

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

For all those reasons, tax reform is unfinished business of high priority. While a hardened partisan might assume the subject was dead ~~for~~ during this Administration, ~~the~~ imperatives of fact & circumstance ~~are~~ generally bear alike on all regimes. There is a huge deficit to meet. There is a recognized over load 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 preempted revenues left by federal delections. And there is widespread intellectual recognition that low-cost oil ^{is} ~~means~~ high-rent oil, and high rent

means high taxable capacity. ~~Although~~ The last point is hardly new, being central to the doctrines of Francois Quesnay and his followers, (including Adam Smith) over two centuries ago. But it has had its ups and downs since then, and only recently ~~has~~ escaped from the traps laid by neo-classical economists and re-emerged in the ascendant, particularly w.r.t. oil & gas.

There are enough reasons to ^{get on with} ~~proceed~~ the unfinished business ~~to delay~~. Let us ^{begin by} ~~proceed~~ to inspecting the tax preferences enjoyed by oil & gas.

I. Remaining Loopholes for Income from Oil & Gas.

Some of the remaining loopholes are ~~widely~~ ^{deeply} ~~noted~~ ^{often} noted, perceived and ~~quite~~ frequently recited; ~~known~~; some are seen ^{only} through a glass darkly; and some are ~~totally~~ virtually unrecognized, being taken ~~as~~ for granted as ~~part~~ ^{the} of a natural order of things. I will ~~not~~ itemize all, and ~~focus~~ ^{expand} only on the more neglected ~~matters~~ loopholes.

A. Twice-told Tales: a standard ^{recitation} ~~list~~ ^{library} ~~of~~ tax preferences for oil & gas

1. Expensing intangibles. The "intangible" costs of drilling & equipping a productive well are expensible. Tax economists now generally recognize

expensing of investments in durable capital as being
entirely exempt 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 ~~the~~ similar privileges, but the ^{standard of} ~~best~~ comparison,
I submit, should ~~always~~ be the wage-worker with his W-2 Form, (cont.)
~~2. Foreign Tax Credits applied to royalties.~~

~~The acceptance of change in name of "royalties" to "taxes"
paid to foreign governments, ^{and IRS acceptance of same,} has served to ~~reduce~~
generate ~~great great~~ ^{fantitious} huge tax credits ^{for multinationals,} ~~unable to~~
offset taxes on ^{domestic} ~~other~~ income.~~

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

② ^{one} ~~the~~ advantage of expensing ^{intangibles} ~~has been~~ was partly abated ~~cost loss~~ in 1975 when ~~recapture~~ these outlays were made subject to recapture when leaseholds ^{are sold for a gain, (107)}. 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 ~~expensed~~ intangibles recaptured if there is no sale.

2. ~~34~~ Dry holes

If a well is dry, one expends it.

Of course had it produced one would have expended most of it anyway, as intangible, ~~so~~ what is added

here is expensing of the rest of it, the tangible part; and exemption from future recapture, to which "intangibles" (over)

~~Also added is a principle where for recapturing~~

4

The general issue is

~~consequences we develop later,~~ a denial of the

capital nature of all outlays that do not

result directly in production: exploration, research,

~~and~~ ~~acquisition.~~ ~~and~~ ~~leave, abandonment.~~

A reasonable man would

~~have no difficulty constructing~~ dry holes as part of the

capital ~~outlay~~ sunk in the producers finally located

have become vulnerable since 1975. ~~(107)~~

(12)

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

McDonald (over)
by the total process ~~per~~ Treasury spokesmen make
this very point when justifying ^{apparent} high returns on
questions when taken ~~individually~~ in isolation.
What they leave out is that the outlays should
be capitalized, not expensed for tax accounting.

notes, "... unsuccessful exploration costs
are an inevitable part of the total costs of acquiring
productive assets ..." and holds they should be
capitalized. (~~p. 23~~)

13

3. ~~Foreign Tax Credit~~ Royalties treated as Foreign Tax Credits.

In the beginning was the word, "~~royalty~~"; and the word was made "~~tax~~". ^{"royalty," meaning} Payments to certain lessors per unit of production. And the word was ~~foreign govt. for oil extracted from under their~~ ~~soil~~ made "tax" by ~~certain~~ several foreign governments who were lessors. The acceptance of this

Transubstantiation by the IRS ~~has~~ ^{added substantial flesh to} ~~just~~ ^{added}

~~fleshed out~~ the treasuries of a multinational ^{oil} corporation.

~~substant~~ ~~to~~ ~~has~~ generate^s huge fictitious tax credits for multinational oil corps. These are used to offset taxes on domestic income, dollar for dollar.

4. Profit shifting by controlling transfer pricing.

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

B. Through a glass backwards: matters seen

but miniaturized.

Heading on separate line.

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

persistent Melton-seekers cannot widen them to a major exception.

Leases or royalty-owners are the most glaring

?

~~that~~ ^{percentage} royalties qualify for depletion at 22%.

exemption. ~~that~~ Royalties today are no longer the modest

1/8 of gross: 25% ^{off the top} ~~on gross~~ is more typical. ^(66.1) (15)

is based on gross wellhead value, a value added to

by the lessees' wells which ^{are} ~~may be~~ normally much

deeper ^{and costlier} than before, ^{and} which the lessee writes off as well.

And of all the incomes in the business, lessees' royalties are ~~the~~ 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. (over)

It is hard to imagine any useful economic function, any increase of supply, any employment-creating investment, ^{or any measure of equity} that is, ~~forced~~ ^{enhanced} by this allowance.

An indirect benefit is possible if lessors are encouraged to substitute royalties for bonuses in negotiating with lessees. The benefit that many analysts see in this is reducing the capital barrier to entry, thus letting more & smaller lessees compete.

There is usually no opportunity cost or foregone gain in the usual sense, because traditional surface uses ~~usually~~ continue unimpacted by oil operations.

A second exception of note is the "small producer", who gets percentage depletion on the first ¹⁰⁰⁰ ~~to~~ 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." (~~22, p. 9~~) (16)

The value of the exemption is not negligible.

1000 bbl/d @ \$30 is \$30,000/d or \$11 million/yr.

6,000 Mcf/d @ \$5 is the same again, for a
16 wells are shut in (over)

total \$22 million/yr. n [In addition there are

4

interesting possibilities for multiplying this by dividing a property among several owners, using the partnership vehicle. The exemption goes

for part of the year there is no loss: the daily average
is allowed, i.e. 365,000 bbls/yr.

with ~~individual~~ persons, not properties, so 9 partners means 9 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. ~~not gone unnoted.~~

The tax code is of course complex

and filled with traps for the unwary, ~~and~~ but perhaps also with plans for the crafty. Public information from the IRS ^{on these points (Pub. 535)} is even more

opaque and evasive than the normal ^{by} adding to this kind of bureaucratic stonewalling invites one to surmise the worst. ~~a large~~ What is accomplished ~~there~~ by insiders

and specialists with private rulings and

"various special rules" alluded to but not specified by IRS ⁽¹⁸⁾ can only be surmised

is impossible to ascertain fully w/o being

heavily involved personally, by which ^{process} ~~time~~ one
is coopted + ^{influenced.} ~~unwillingly~~ to ~~squeal~~ ^{complain in public.} We

~~can only note~~ What is certain is that there

is a large tax shelter industry in oil partnerships.
~~Also~~ Besides stretching the loopholes this industry ~~also~~ consumes a
a waste of ^{potentially} ~~otherwise~~ useful people in an ~~parasitic~~
portion of the gains to support its own efforts which are,
~~unproductive pursuit~~ and a source of who ~~borrows~~
from a ^{nations} ~~society~~ viewpoint, a waste of capable talents.
~~What inflation of the basic loophole.~~

~~a third exception is~~

a third exception is for "stripper" wells,

b/d (barrels per day)

producing 10 ~~bbl/d~~ or less. Hence the ~~ex~~

effective cap is on a per well basis, not per person. But
wells may be grouped on a property, and some producing over
the production counted is the mean per well on a
~~to bbl/d~~ offset by others producing less. ~~100~~ 10
~~property.~~ The denominator of the mean is

~~10~~ 10 b/d

(19)

also inflatable by including water injection wells,

~~wells producing under 10 b/d, and perhaps by~~

other stratagems. Wells producing 15 or 20 b/d will of course be slowed down to qualify, as needed.

A fourth exception is for regulated sellers of ^{with old contracts predating Feb. 1975.} In the circumstances ~~gas and sellers under fixed contracts older than~~

~~Feb. 1, 1975. On the surface this is a reason~~

there is ~~some~~ equity in this, ~~as taking price~~

~~regul~~ as these sellers are being taxed by

regulation. There is also ~~some~~ efficiency, at the

production end, in offsetting the ^{disincentive} ~~depressing~~ effect of

~~regulation on~~ lower prices on old producers.

On the consumption side however this provision

merely ^{reinforces} ~~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 ~~cut~~ lower the coverage cost on which ^{customer} rates are based. It increases the spread between the low customer rates and the ~~extravagantly~~ ^{extravagantly} high prices paid for new field gas today. Looking through 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 who hold those 188 million acres, the major, and other speculators who have spent the last decade buying lease to lease, ⁱⁿ ~~dead to dead in~~ a gas-prone areas.

2. Capital gains

Profit ~~is~~ 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 these in order. Capital gains ^{treatment is general} ~~is general~~ is highly preferential, and ~~of all kinds are lacking~~ (over) With any real property, carrying costs (interest +

property taxes) ^{they are} are recognized as ^{expensed}, while the gain is not recognized until sale, ^{if won.} The expenses are

deductible in full from ordinary income, thus being ~~weighted~~ ^{weighted} ~~being worth~~ $2\frac{1}{2}$ times ^{heavier than} ~~as much as~~ the gain ^{the gain being only 40% recognized.}

~~which~~ they produce, ^{The sales price becomes}

It is ~~just~~ something they ^{just} want to do, ~~for reasons~~
~~they do not want to give~~ not to explain.

It has
in any deep rationale. ~~They have~~ no support among
tax economists, most of whom subscribe to the
Haig-Simons doctrine that gains are income, and should
be fully recognized as they accrue. ~~It has~~ ~~there~~
no Congressional rationale: "The capital gain
preference has never received a systematic exposition
in any official source." (Christenson, p. 260).

"The absence of a clearly articulated set of policy
objectives has been criticized by many. ... The sense
of its own goals. Congress has provided no more
than a sketch ... of what it wants. The

(20) courts & the IRS have ~~done the rest~~ ^{done the rest} (Christenson, p. 260-61)
~~They have~~ ^{It has} no Constitutional basis: "... Congress is free
to treat gains & losses as 'realized' pretty much
whenever it chooses." (p. 69). The usual rationales
are based on shallow ^{and incidental} procedural & administrative
matters; or on incentive arguments that have no
application to land values, the major values ^{whose nature}
it is to appreciate routinely over ~~time~~ an extended period of
ownership, and qualify for capital gain.

a new basis, so the process is repeatable. The owner can convert his gain to cash, ~~at with~~ tax free, by borrowing on ~~gains~~ are realizable in cash by borrowing ~~the~~ it. Cash flow from the ^{mortgaged} property, ~~property, with no tax. Property income~~

can cover the interest, freeing the borrowed cash for new ventures, with deferred recognition, new untaxed gains, and so ad infinitum.

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

better; and a host of related benefits that ~~accompany~~ are part of "capital gains treatment," which are reserved for the capital gains aristocracy. (22) is tender & solicitous in many aspects. the extreme, (Like Tax Exemption Inc.) These ~~all~~ stand in

vivid contrast with the ~~harsh & relentless~~ ^{harsh & relentless} imposition of compared to the harsh and relentless

impositions
~~full tax rates on "ordinary" income from working persons~~
~~and working capital.~~
~~productive labor, and ^{from} managing investing to generate~~
~~production.~~

~~In one way, oil leases are less preferred.~~
 A very ~~simple~~ + common way to avoid
 whose significance has entirely escaped scholarly
 taxes, one ~~whose~~ that seems to have slipped
 notice, is simply
~~under the radar of most critics, is to buy~~

land ~~for~~ in advance of one's own needs, when

~~it is cheap.~~ After a few years, one has a
 valuable ^{perpetual} asset ^{bought cheap.} for use, with never any tax on

the increase of wealth, and no prospect of one.

It is as
~~to~~ ^{that} the last point, oil leases are
^{than other land,}
 less preferred, because the corpus of the

^{does}
 enhanced oil value, becomes taxable income when

sold ⁱⁿ ~~at~~ units of production, and cost depletion
is limited to historical cost. ~~But~~ (we will see,

however, that this handicap is largely overcome by

timely sales, ~~a capital gain to seller, but~~

establishing a new high basis for cost

depletion by buyers.) 60% of the ~~seller's~~ ^{seller's} gain is

~~excluded tax-exempt, but all the new basis is~~

~~depletable deductible as cost depletion.~~ ~~± (over, future.)~~

In many ways, oil-leases enjoy more tax
preference ~~than~~ than other land. First, much of

the ~~tax~~ de facto cost of leasehold acquisition is

expensed: ^{much} exploration, dry holes, and abandoned leases.

Each of these is treated separately later. ~~on~~

Future. For corporations, rather than the 60% exclusion there is a low cap on the tax rate, achieving much the same effect. For brevity I do not ~~mention this as~~ treat corporations separately.

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, ⁽²³⁾ ~~or~~ because they are dry holes. because "intangible," ~~not~~ because "exploratory."

← Thus the asset value ^{that becomes a capital gain} is built up by an

accretion of fully deductible expenses. and finally is sold ~~as~~ ^{for} a capital gain.

(21) Now discovering & developing pay zones in

~~olefane~~ ^{oil} rock are the ordinary businesses of

oil firms, ^{not incidentals. byproducts} The pay zones are their inventory; ^(over) ~~To be declared a "dealer"~~ of goods for they are dealers. ~~in other~~

~~ordinary~~ real estate ^{is to lose} ~~are~~ ^{declared} capital gains.

(23) [†] This part is now subject to recapture, however.

Stephen M. Donald has noted that "... oil & gas deposits would seem to fall in this category..." (of assets ~~held for sale to~~ that in the ordinary course of business are regularly offered for sale to customers), (p. 93). (24)

In the well-known leading Corn Products case, ~~46 (1955) 3~~ ⁽²⁵⁾ ~~U.S. 46 (1955) 3~~, it was settled that ~~the category of 'capital assets' was to be interpreted narrowly applied and its exclusions broadly interpreted, since capital treatment is an exception.~~ (McNulty, p. 362).

"Since §. 1221 is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied..." (Chiodini, p. 291; McNulty p. 362), ⁽²⁶⁾ and it generally is. (27)

privileges. Oil firms do not have this problem. Only timber has achieved a comparable preference.

~~The FASB found that non-reporting of reserve accruals ~~was~~ seriously distorts the income + balance sheet of oil firms. They ruled in 197 that reports for 197 must switch to Reserve Recognition Accounting (RRA). This generated a volume of data from which we may ~~quase~~ gauge the weight of this factor.~~

Security analysts & accountants have become increasingly concerned about the distorted picture of oil firms that has developed because they do not report inventory increases, as other firms do. ^(over) Accordingly the FASB and the SEC ^{have} ~~moved to~~ required Reserve Recognition Accounting (RRA), ~~beginning~~ ^{for} (and perhaps ending) ~~with~~ 1980 reports.

Here, revenue is recognized at the time ~~proved reserves are~~ determined, as opposed to sold. 1980 reports contain a wealth of new data on the weight of this factor, which could ~~if studied~~ ^{and} ~~revolutionize~~ ^{basically change} the way we look at oil firms, in the age of OPEC.

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 net worth; ~~(McDonald, p. 25)~~.

(27)

Here is Getty Oil Co. as a sample. The increase in proved reserves in 1980 was \$3.3 b, or 3.78 times the Net Income otherwise reported. In 1979 the increase was \$6.3 b, or 10.43 times the Net Income otherwise reported. ⁽²⁸⁾ ~~(1980 Rep. pp. 62-65)~~

The value of proved reserves at 12/31/80 was \$17.2 b, or 2.07 times the Total Assets of all funds reported conventionally. ⁽²⁹⁾ ~~(p. 37)~~, and about 3 times the market valuation of Getty ^{Shares} shares (it has little debt.)

The reported reserves are net of royalties. (over)
The increases were the joint results of findings,

acquisitions, and ~~with~~ price hikes; and the greatest of these was price hikes, ^{according to Getty.} One could argue

Royalty owners bear no costs, so a 25% royalty could represent 50% ^{or ~~more~~ over 100%} of net income. So for every dollar of added value reported by Getty, the lessee, there is a good fraction of a dollar not reported, enjoyed by a royalty owner.

the details of SEC reporting rules, particularly the assumption of constant future prices, a myth somewhat offset by a 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" (p. 62, n. 2). A billion

up, a billion down, who knows? — but it is

clear we are dealing with big, big money and the ^{larger} ~~dominating~~ part of ^{the real} ~~net~~ income of oil firms.

Another authority which is challenging the traditional invisibility of reserves ^{appreciation} is the

Cal. State Bd. of Equalization. ~~Under~~ Prop. 13

~~assumes~~ ^{taken} a recognition-upon-sale posture towards
land values, for purposes of property tax assessment.

But new construction enters the rolls at ^{current} market.

The Board's Rule 468 treats new findings as

"new construction", and also ^{adds} the increase of economic
newer resultin, from higher price. (31) (51, 62). ~~The~~

NB

~~Board~~ ⁽³²⁾ ~~and~~ has prevailed in court; ~~and Calif.~~ is there will

be no public outcry, since exemption for oil

was ^{a totally} ~~an~~ unintended by-product of Prop. 13, the

"homeowners' revolt."

^{Shadow}
The Shadow of Eisner v. Macomber, ⁽³³⁾ 252

~~vs U.S. 189~~ (1920), hangs over any discussion

of ~~assess~~ recognizing income before sale. But

the application of this case hangs on whether ~~these~~ are a "capital asset" or an inventory.

If the latter, then other rules apply, and

increased inventory is routinely ~~included in~~

~~recognized~~ added to taxable income. If this

be, as I submit, the appropriate stance, then

the present treatment is a gross loophole indeed. (over)

~~Or if one insists on treating this as a ^{peculation} real estate~~ (over)

Another advantage that oil enjoys over

other land is that the buyer can deduct 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,

the new basis is only deductible upon resale; and

matter because of the learning aspect, the leading
Braun case, (1940), deter

34

In the ~~an somewhat~~ Braun case, 309 U.S. 461 (1940),
the court held that income in kind is income,
even though real estate. Just as Congress repealed
Braun by adding § 109, so it could legislate that
income in kind is realized upon discovery.

If ~~this~~ this ~~very~~ seems a shocking suggestion, that suggests
~~only displays~~ how conditioned ^{and mind bound} we are by entrenched
privilege, ~~errors~~ for anything less is preferential. ~~and worse:~~
it is preferential towards ~~rents~~ which should a kind of
unearned rent ~~income~~ which there is a strong rationale for
taxing heavier.

then from a capital gain.

Inflation, the price of oil leases, ^{on the other hand,} ~~however,~~
~~is an inviting route to convert~~ ordinary income

to capital gain: the buyer's ordinary income is
 reduced by the seller's capital gain, albeit with a

lag. There have been occasional press reports of "abuse"
 (35) ~~(481)~~, 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} ~~were~~ ~~united~~ fully 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, ~~is that~~ the land is

consumed physically; ~~But that~~ thus it differs

from other land. But that is only half the story. The other half is that

Oil pay zones are naturally limited & scarce: thus

they resemble other land, and thus they

appreciate in real terms over time and generate

value increments ~~capital gains~~ routinely and massively, ~~the~~ ~~in ads~~ and in times like the '70s, sensationally. (over) ~~exemption of~~

Capital gain privileges to ^{other} ~~ordinary~~ "unearned increments"

are in some small way compensated by non-

depreciability. Privileges to oil suffer no such

The exhaustion of old reserves makes it all the more certain that untapped ones will appreciate.

penalty.

It is perhaps largely to ~~use~~ ~~capital~~ ~~with~~ the capital gains privileges that ~~this~~ the highly vertically integrated oil firms have become disintegrated at the exploration end.

Oil firms are well positioned to use the capital gains privileges because ~~the vertical~~ they have become vertically disintegrated at the front, ~~or exploration~~ end: exploring has to a high ~~remarkable~~ degree been separated from production.

Only a small share of the funds spent ~~on~~ looking for oil + gas is spent by majors.

"Independents" are said to account for 88%.

of well completions now, ⁽³⁶⁾ ~~oil + gas~~

Drilling partnerships offered \$26 publicly in 1981, and an estimated \$86 privately. ⁽³⁷⁾ Subsidies and subcontractors are also involved, in fairly (over) 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⁾ ~~Spent 58% 1980 Am.~~

~~Spent~~ They spent more on acquisitions than on either exploration or development, with

acquisitions rising at a much faster pace,

1978-80 ⁽³⁹⁾ This is not to say they do not also acquire unproved leases, for we ^{have noted} ~~will see~~

(NB)

complicated ways. Thus, Marathon Oil is
"farming out" three blocks of raw acreage in the
Celtic Sea to a group led by Texas Gas, which
will ~~drill~~ ~~and~~ acquire half-interest in any block
drilled. (37A)

a vast acreage increase, too. But there
 seems to be a ~~constant~~ ^{regular} "churning" of appreciated
~~landholdings~~ ^{assets}, all of which would create gains for
 seller + new high bases for buyers. ⁽⁴⁰⁾ [Ex: One seller
 in 1981 was Occidental Petroleum, which
 sold for over \$200m its 17% interest in the
 Beta Field off San Pedro, an interest acquired
 for \$11.9m in 1975.]

There are ~~large~~ ^{more} gains to expect ahead.

The control of natural gas is probably coming;

the nuclear alternative is ~~so~~ nearly dead;

and the WPT is ^{programmed} ~~scheduled~~ to self-destruct in
 a few years; and ~~the present complexion of Washington~~ all three branches now in

Washington are more pro-oil than ~~any~~ in a
~~these~~ long time. ~~the~~ Royalty owners and strippers have

already been relieved of WPT, (69) &
 (41) New Arctic (over)
 WPT on new oil reduced, ~~to~~ 20 major oil

firms with 188 million acres under lease (42) (78)

are well positioned to gain from all this. ~~so~~ Fifty

thousand firms and a few thousand individuals, families,

trusts, partnerships, estates, institutions, local governments

and so on doubtless swell that ^{increase} figure much, if we had

the data. ~~to~~ 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

spotlighted, as Stephen Mc Donald predicted in 1962, (over)

production is totally exempt. (41A)

eliminating percentage depletion would have little effect on oil incomes unless capital gains, which is "a close substitute for percentage depletion," were modified too. (~~p. 5~~) (43)

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. ~~lightly taxed.~~ While this is a ~~universal~~ general ^{for all landowners,} loophole, 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 ~~One~~ preference involved in deducting interest is

compounded because borrowing on ^{appreciated leaseholds} ~~it~~ is a way

of realizing ~~cash~~ gains in cash w/o recognizing any

taxable income. In contrast, pity the poor working (over)

~~This is a wage worker. by contrast,~~ has to report a good deal of ~~income~~ putative income (over)

Borrowed funds are also used to explore &

develop leaseholds. The ~~enhanced value~~ proved developed

girl. She reports and pays current income taxes
~~that he~~

on a big chunk of supposed income which she
hasn't received, because it was withheld for
FICA. ~~She cannot~~ Some other pension withholdings have the
same effect. But pension rights are not bankable,
as appreciated Leachholds me. So the worker gets
a tax and no cash; the old firm gets cash and no
tax.

property, ^{increased in value,} may then be sold as capital gain, with the interest expensed (along with most of the principal.)

C. Invisible loopholes

Several loopholes have achieved an
go virtually unrecognized, even in
~~unstable invisibility, so perfect~~ They blend in with
a background of assumptions, of attitudes conditioned
by the interests of a dominant group, so as to
be camouflaged.

~~to~~ the reform literature. ~~neglects~~ ~~them~~ ~~entirely~~. Yet
they are in plain sight. It is rather a trick

of intellectual camouflage. They blend in with a background of assumptions tailored to the attitudes of ~~the~~^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, ~~some~~ several leases are taken for each that proves productive. It is a screening process. Sometimes like 4/5 are culled out and then abandoned.

a reasonable person would construe the cost
 of the 4 calls as part of the cost of acquiring
 the one producer, and this is the industry
 position when explaining the high returns on the
 producing lease. ^{in a 1965 auction} At Prudhoe Bay the lucky winners
 got ~~some~~ ^{scores of billions} ~~\$1000~~ worth of oil on leases costing ^{only} ~~at~~
^{\$6} ~~few~~ millions, ⁽¹⁴⁾ ~~only~~, and leases have been written
 justifying this ~~on the~~ by the costs of acquiring
 and lifting through other
~~unlucky~~ leaseholds, which were abandoned.

Now if the cost of abandoned leaseholds is
 part of the ^{real} cost of acquiring producing ones, then
~~they~~ it should be treated the same, tax-wise. But

~~the~~ instead, abandonments are expensed. The only outlay capitalized is ~~the specific program~~ 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, even} ~~to other~~ ^{avoidance avenue} ~~over~~ ^{over} Few other businesses have this ~~over~~ ^{avoidance avenue} ~~over~~ ^{over} walks of life land cost is, ~~never~~ ^{never} even depreciable; is much better than a capital loss. It

Abandonment is an ordinary loss deduction,

~~Other businesses and individuals~~
~~there are many~~

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, (Chir., p. 138). Most of this unrecovered capital is exploration cost allocated (over) ~~then picking up~~ a good deal of miscellaneous not like allocated overhead.

otherwise expensed, and there is no limit.

(NB)

where "the reasons"
were cited as the motive.

as in Baltimore Canyon recently, ⁽⁴⁵⁾
(I must para. on back of p. 46)

open to on such a scale of land
~~the~~ ^{the} ~~thing~~ because abandonment is not ~~normal~~
routine in other businesses. A comparable
privilege is enjoyed by orchardists who write
off their early thinnings as abandonments
and thus take off 3/4 of the capital cost
before a grove is even mature. But on the
whole ^{this} ~~we~~ ~~rank~~ ~~as~~ an extraordinary
privilege, open to few.

One writes off the abandoned trees pro rata, but
as the others grow into the space thus opened,
no offsetting appreciation is recognized. ~~42~~ 46A

to the lease, for exploration must be capitalized
until lease runs under. One may also pick up

There is no requirement to offset ~~losses~~ ^{losses} ~~the~~ ^{the gross amount is an ordinary loss.} gains 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. ⁽⁴⁸⁾ As to timing, one

can ~~abandon~~ or regulate this entirely for tax

advantage because no sale is involved. ~~Normally one~~

Putting it all together, the package of benefits

is extraordinary: capital gains for winners, ordinary loss

deductions for losers, no limits, no pooling, no recapture,

^{no constraints} ~~abandon~~ on timing. One ~~must concede~~ ^{One must concede} to be

sure, § 1231 assets enjoy a ^{small taste} ~~part~~ of the same advantage:

they, too, get capital gains ^{when they ~~win~~ rise,} ~~when they win and~~

and ^{unlimited} ordinary loss deduction. But ~~the~~ the

restrictions are much tighter. The class of assets excludes inventories held for sale to customers (oil deposits

are certainly that). Gain & loss are recognized on a

net basis only, not a gross basis.[‡] And excess depreciation

is recaptured. (49) 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. ~~It is~~ The comparable provision in

other businesses would be to allow expensing 80% of

capital and land costs. No one else makes out so well.

[‡] The net basis ~~that~~ means that if you take an ordinary loss, you must first report all your gains as ordinary income, — quite a difference.

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. ~~(50)~~ ~~(over)~~

2. Scouting

Costs of job-seeking are not generally deductible, with minor exceptions. ^{Costs incurred (over)} ~~Pre-leasing~~
Costs of unsuccessful pre-leasing exploration ~~costs~~, in contrast, are ^{fully} ~~fully~~ deductible.

"Unsuccessful" ~~means followed by abandonment~~

here means, in effect, ~~not further pursued at this time~~

or an area in which no ~~further~~ interest is acquired

(McD., p. 17). ~~Administrative overhead is allocated~~

~~and expensed, too.~~

The fruit of the "unsuccessful" effort is, of course, the successful effort. But the only

(Insert, back of p. 43, where indicated)

On top of the benefits for lessees, ~~the~~ lessors also gain from abandonment. ~~At this point time, expected royalties fall to zero.~~ 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. ⁽⁴⁶⁾ ~~Just as a lessee~~ A lessor who gets bonuses on five tracts, to get one producer, ~~the~~ can deduct 80% of his cost on the four abandonments, however large the royalties.

~~No search property for purchase must generally be added to its basis, not expensed; and ~~if~~ then only if the search succeeds. ~~Decision is not~~ to buy, one would ~~hardly~~ have trouble ~~success in establishing~~ the business purpose of a trip.~~

Established businesses fare better when searching property to expound, they can ^{often} ~~generally~~ deduct all the ^{searching} costs. (128).

expected on the producer.

2. Scouting.

~~Explor~~ A large share of exploration cost is expensed, or virtually so. Technically the cost is capitalized, and then deducted upon "abandoning the exploration project on the property." ⁽⁵²⁾ ~~(P.H., p. 2000)~~. ~~(cf. M.D., p. 111)~~

More preliminary 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 portion that is allocated to a ~~production~~ lease is either deducted on ~~abandon~~ lease surrender, or under cost depletion.

~~Some~~ Other established businesses may fare as well, when seeking property to expand ⁽⁵³⁾ ~~(108)~~, but not

routinely, on such a scale. New businesses must
 generally ~~add~~ capitalize costs of successful search, and
 forget the costs of
 Unsuccessful search. ~~is a personal expense.~~ Workers
 seeking jobs. Costs of job-search, ~~(that~~ ^{to} ~~of which~~
 Chicago economists attribute most of what used to be
 called "unemployment") are, with small exceptions, not
 deductible. Oil ^{search} ~~hunting~~ gets a much better break
 than job ^{search} ~~hunting~~, even though conservative economists now
~~let us hope that Chicago school~~
~~economists, who~~ attribute most ^{of what others call the problem of} unemployment to the
 cost of
 obstacles to job-search. ~~will join a move to redress~~
~~the balance,~~

~~cost~~ cost that ~~must be~~ cannot be expensed is the specific cost attributed to ~~leases~~ ~~acquired~~ [†].

Expensing of early routing forays is ~~way~~ ^{away} up front in time, and therefore ~~of~~ much weight in them the simple numbers reveal. Other businesses, ^{too,} succeed in expensing ~~the~~ this ^{or} ~~and~~ that which are really capital outlays that build up ~~a~~ ~~mainstream~~ assets, but not on such a scale, ^{so ~~legitimate~~ explicitly,} or so many ~~years~~ ^{decades} before taxable income results.

Substantial sums are involved.

~~But the simple numbers are large themselves.~~

~~As an indicator,~~

~~† Capitalized costs are then recovered through abandonment, or cost depletion.~~

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 Landolt, Geosat, Magrat

et al. ⁽⁵⁴⁾ ~~that~~ Exploration ranks after lease acquisition, and production expense as ^{one of the major} ~~the third largest~~ outlays of oil firms. ⁽⁵⁵⁾ ~~but I have not to is rising fast.~~

~~An interesting addition to this privilege is that capital assets acquired for exploration are also expensable. I have not discovered how many steps back one ~~can~~ may carry this, but the possibilities are fascinating. of course there~~

add
↓
development

Post-lease exploration means drilling, mainly, and dry holes are expensed, even on productive leaseholds. ^{Dry holes are an integral part of lease (over)} Other post-lease exploration is capitalized and recovered through abandonment or — finally — production. But overall, the larger share of exploration is written off before production begins.

3. ~~Field use.~~ Imputed income

Leaseholds generate substantial imputed income. More imputed ^{land} income in all industries escapes taxation.

What is peculiar to oil is the vast area — we

N3 have cited 188 million acres held by ²⁰ ~~10~~ firms ~~and~~ alone — and the information monopoly at the

improvement, as noted above, ~~and in other~~
Normally, such things must
1 ~~industries would~~ be capitalized for the term
of the lease.

lease lines.

The ~~exclus~~ ^{oil} The ~~drilling~~ lease gives exclusive rights to drill. Information gained is proprietary, ~~although~~ ^{not even} and ~~often~~ ^{usually} not even shared with the landowner, e.g. the U.S. Government. ~~So-called~~ dry holes, (all expensable & non-recapitable)

may be at the lease edge, giving the driller who keeps a "tight" ~~hole~~ (secret) hole a monopoly of data needed to bid on the adjacent tract. ⁽⁵⁶⁾ 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.

~~Prec~~ A related by-product may be Exploration data may also lead to finding,

other valuable minerals, as Exxon has found copper in Wisconsin.

~~An unexplored tract may also~~

There is also a free-riding ~~effect~~ 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 (over)}

(NB)

New pipelines and

(NB)

other infrastructure may ^{also give free riders. (over, top)} ~~do the same~~. Larger

firms that can afford to wait like to take

positions in many fields in many countries +

regions, maximizing the probabilities of getting ~~a~~

Favorable tax changes can give a free ride, as occurred when Congress exempted ^{new} Arctic production from WPT. "New" refers to the date of production, not lease acquisition, so extant leases stand to benefit.

~~The propensity to sit~~

advances in satellite scanning are making it cheap to glean at least some clues over the vastness of the whole earth. This lets the majors engage in a new kind of wild-cattling with clean hands, white collars and dry feet. The ~~the~~ incentive is to get ~~that~~ many tracks and sift through a coarse screen, rather than a few through a fine screen.

6. Miscellany

For completeness, ^{here are two} ~~I it ~~is~~ a few~~
^{special} more benefits; for brevity, I say little more.

Research related spending gets a 25%
^{it ~~has~~ remains expensable.}
 tax credit in the new tax bill. Research in
^{and recovery from unguished sources}
 exploration is a growing factor in oil and gas.

WPT is deductible from taxable income.

Individuals cannot deduct federal ~~taxes on~~ payroll or
 excise taxes from their taxable income.

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. Leaving up the learner is a good way to keep newcomers from getting established.

4. Field use of ~~it~~ crude oil & gas.

1- taken energy to extract energy. ~~loss~~

The share used in the field is surprisingly high, and growing higher as we get into heavy crudes and so on. Steam injection ^{can} consume ~~some~~ one ~~25-40~~ ⁽⁵⁷⁾ of third of the oil produced. (Time, 4/28/80, p. 41)

Gas is often reinjected, especially where it cannot ^{maintain}
 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. (58)

Field oil & gas are not taxable until sold.
 On the other hand, ^{field use is} ~~they are~~ not deductible either,
 but this is not quite a wash. For one thing,
 there is an ~~large~~ ^{normally large} excess of value over cost, which thus
 escapes tax. For another, field consumption speeds
 depletion, thus increasing the annual ~~to~~ depletion allowance.
~~As for~~ 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 & gas, adding to our dependence on OPEC.

⇒ 5. Cost depletion

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

The taxpayer solution is to establish a new basis by sale. ~~Nothing is~~ No prior ordinary deductions are recapturable save intangibles. The

buyer gets a new cost to recover from production.

It would seem logical to ~~at~~ transfer leaseholds

~~too~~ just before production, and ~~this does~~

this does seem to occur ^{regularly} ~~continually~~ on a large scale.

I have not examined to what extent

subsidiaries can sell to parents, to what extent

prices can be fudged, etc., but ~~there~~ the

situation invites avoidance on a grand scale and

may be one reason the IRS is ^{several} ~~ten~~ years behind

in auditing oil firms. (59)

The ^{oil owner's} ~~taxpayer's~~ next move is to accelerate

depletion. ^{Building owners may} ~~Other taxpayers~~ ~~also~~ accelerated depreciation, too,

but accelerated depreciation is recaptured on sale, unlike

(NB)

depletion.

Now that ~~other~~ buildings get 15 year life anyway, ~~accelera-~~
~~tion is hardly worthwhile, and~~ without acceleration and recapture,
 oil's ^{relative} advantage is not what it was. But ~~it still~~

the absolute advantage is still there, and worth a look.

With ordinary leases, ^{there is a definite term, 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 ~~cost~~ bonus or other cost is

deducted ~~up~~ ^(therefore "u.p.") $\frac{1}{2}$ per unit of production, ~~so~~ ^{so} one begins

by estimating the number of units in place. To

get ⁱⁿ ~~the~~ the fact lane for depletion, one low-balls

the reserves, so each unit is a higher percentage of

the "total". IRS looks the expertise to

challenge estimates by the industry & its

consultants, ^{so} there you are.

Industry practise is to define

"reserves" in the narrowest ways anyway, so there

is little resistance to acceleration at this point.

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

~~40~~ 59A

There is, ^{on the contrary, a} ~~never a~~ ^{change for} ~~possibility of some~~

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. ⁽⁶⁰⁾ ~~the original basis~~ In a rising market the prior depletion

allowed shrinks as a percentage of the new

basis. For example, owner A has 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 would obtain

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

Another route to lowballing reserves ^{could be} ~~is that of~~ factitious subdivision of tracts. One might plan to develop a field sequentially, divide it into ~~four~~ 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." (61)
~~discussing depletable properties)~~

Vast
~~Further~~ interesting possibilities

were opened up after 1956 by the ~~Southern~~
 Explorations Co. case ⁽⁶²⁾ ~~350 U.S. 708, 1956~~.

Here, owners of land without oil in it were
 allowed a depletion deduction because the access
 to others' oil was through their land.

⁽⁶³⁾
~~(Agria, p. 83)~~. Creative taxmen have presumably
 pursued this invitation since then. The
~~potentialities are vast.~~