ANALYSIS OF OIL AND GAS ROYALTY TRUSTS

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This study was requested by Congressman Robert Shuster of the House Budget Committee. It was prepared by Robert Lucke of the Tax Analysis Division of the Congressional Budget (CBO) under the supervision of Rosemary D. Marcuss. In accordance with CBO's mandate to provide the Congress with objective and impartial analysis, the report contains no recommendations.

SECTION I. INTRODUCTION

In the last few years, interest has grown in the use of royalty trusts as a means of distributing the income from oil and gas properties to investors. Income from mineral properties placed in such trusts is not liable for corporate income taxes, thus providing potentially large tax advantages for companies (and their shareholders) that use them. If many major oil and gas companies decided to form such entities, the implications for federal revenues might be fairly significant.

Most recently, attention has been focused on the efforts of Mesa Petroleum Corporation to induce the stockholders of the Gulf Oil Corporation to set up a trust consisting of a large share of Gulf's oil reserves. As a large shareholder of Gulf stock, Mesa is in a strong position to influence management decisions at Gulf. At this point, however, Gulf has resisted the efforts of Mesa, and does not currently contemplate setting up a royalty trust. As discussed below, the income tax consequences from the formation of a royalty trust are complex and raise several important tax policy issues. Because a royalty trust does not involve any new investment or development of oil or gas properties—it simply involves a change in legal ownership—any new wealth that is created for stockholders by the trust's formation is a result of lower net taxes paid to the Treasury over the life of the property.

This analysis reviews the mechanics of royalty trusts and the tax issues involved. The creation of an oil royalty trust is significantly affected by the tax law regarding corporate distributions of property and the differential tax treatment of corporate versus noncorporate entities. Section II describes how a typical oil royalty trust is formed and how it operates, and Section III discusses the relevant tax rules and their associated implications. Section IV presents an example of a hypothetical royalty trust and discusses the tax implications for various kinds of shareholders (for example, individuals or corporations). Lastly, Section V estimates the potential effect that widespread use of royalty trusts might have on revenues collected by the U.S. Treasury.

SECTION II. DESCRIPTION OF AN OIL ROYALTY TRUST

An oil royalty trust is a legal entity that owns "nonoperating" mineral interests and distributes substantially all its earnings directly to the holders of trust units.[1] (Trust units are similar to stock shares in that they represent investor ownership claims on the income of the trust and can be traded on the stock market.) For purposes of this analysis, attention is primarily focused on "spin-off" trusts—that is, trusts created by oil and gas corporations solely for the benefit of their stockholders. In a spin-off trust, the corporation usually remains an ongoing business enterprise, retains some interest in the trust properties, and often is the field operator. This type of royalty trust is set up by a corporation with the intention of distributing nonoperating mineral interests directly to its shareholders. In a typical trust, the firm allocates certain interests to the trust and simultanteously allocates trust units (shares) to the corporation's shareholders in proportion to their stockholdings. This mechanism avoids the so-called "double taxation" of corporate income—first, when the corporations pay corporate taxes and second, when the stockholders pay individual income taxes on any distributed dividends or capital gains.

For the trust to avoid taxation as a corporation, generally it must avoid any business activity and can own only "passive" investments. Nonoperating mineral interests are considered proper investments for a trust because of their passive nature. Investments in a trust are considered passive if (1) the trustees are not engaged in any business activities related to the trust properties, and (2) the trustees are restricted from changing the composition of the initial investment portfolio.[2] The passive classifi-

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1 Mineral interests can generally be classified into two categories: operating and nonoperating interests. The owner of an operating interest has the right to actively explore for, and produce, the oil and gas related to a property. In contrast, ownership of a nonoperating interest entitles the owner to receive a portion of a property's production or revenues, but the owner has no right to conduct exploratory or production activities related to the property. As a result, the owner of a nonoperating mineral interest has no control over the operations conducted by the owner of the operating interest associated with the property.

2 See Internal Revenue Service, General Counsel Memorandum #38791 (August 28, 1981).

cation of a nonoperating mineral interest is not affected by the fact that the income is generated by a firm that is in the business of producing oil and gas.

Nonoperating mineral interests can take the form of true royalties or net profits interests. A true royalty interest typically is defined as a percentage of the gross production or the value thereof. A net profits interest is usually stated as a share of net revenues—that is, gross revenues less certain specified operating and development costs of the owner of the operating interest. The difference between the two is that a royalty interest is not reduced by any production or development costs, whereas a net profits arrangement allows the operator to reduce the trust payout by certain agreed upon costs.

In general, the basic advantage of setting up a trust to distribute oil and gas income is that the trust revenues are not subject to corporate taxation before any dividends are distributed, even though the owners enjoy the benefit of limited liability. Generally, once the corporate tax has been paid, firms can retain their earnings and/or distribute them to their stockholders as dividends. Corporate dividends paid to individuals are subject immediately to the personal income tax at a rate of up to 50 percent. To the extent that the market value of stock is enhanced through retained earnings, the increased value is taxed as capital gains when stockholders sell their shares. Because of the 60 percent exclusion of long-term capital gains from taxable income, capital gains are taxed at a much lower effective rate than dividends. Although a royalty trust avoids the corporate income tax, its earnings are generally subject to full personal taxation because trusts distribute virtually all of their income on a current basis. Because trusts do not retain earnings, they do not generally provide a means of converting current income into more lightly taxed long-term capital gains. Thus, the corporate tax savings are in part offset by higher personal taxes.

It should be noted that a royalty trust is similar to a partnership in that both avoid the corporate tax. Indeed, limited partnerships are quite similar to royalty trusts. In theory, a corporation could spin-off a limited partnership that would involve many of the same tax advantages as royalty trusts.

SECTION III. THE RELEVANT TAX LAW

The tax law related to oil royalty trusts can be separated into two distinct categories: (1) tax aspects related to the ownership of the royalty trust units, and (2) tax aspects related to the initial distribution of trust units.

TAX ASPECTS RELATED TO OWNERSHIP OF ROYALTY TRUST UNITS

The basic purpose of a spin-off royalty trust is to eliminate the corporate tax burden, and, therefore, it is essential that the trust be properly established to qualify for federal income tax purposes. Since oil royalty trusts are not engaged in any active business operations or decisions related to their oil properties, they have been regarded as trusts and are not taxable as corporations.[3] Aside from agreed upon expenditure deductions, a royalty trust distributes virtually all its revenue to trust unit holders on a current basis. This income is generally subject to full income taxation the same as any regular corporate dividend. This is true for both individual and corporate trust unit holders. (Corporate unit holders, however, are not allowed to deduct the 85 percent of dividends received, which applies to other corporate share holdings.)

Depletion

The owner (individual or corporate) of an economic interest in an oil royalty trust is entitled to cost depletion.[4] Cost depletion allows unit

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3 Thomas Crichton IV, "Royalty Trusts and Other Exotic Distributions to Shareholders," New York University Law Journal, vol. 40 (1982), p. 12-27.

4 There are some circumstances in which a trust unit holder may be entitled to percentage depletion. Provided that the owner qualifies as an independent producer (that is, the owner has neither significant refining or retail sales of oil and/or gas products), percentage depletion is only allowed on properties that are proven after they have been acquired (that is, after the trust unit has been acquired). In addition, percentage depletion is limited to 1,000 barrels per day of oil production (or an equivalent amount of natural gas).

holders to deduct an amount equal to their current tax basis times the ratio of current production to remaining reserves, as estimated by the corporation. For example, if a holder's tax basis is $100 and 20 percent of the remaining reserves are produced in a given year, the cost depletion deduction would be $20 ($100 x 20 percent).

For individuals, the original tax basis upon distribution is the trust unit's initial market value. As explained later, the initial distribution may be treated as a dividend or as a return of capital. Each year the taxpayer reduces the initial tax basis by the amount of cost depletion previously taken. As royalty trusts generally have declining production over time, the market value of trust units should also decline over time.[5] To some extent, cost depletion allows taxpayers to recover this decline in value, just as other asset holders would recover depreciation from deteriorating physical assets. Thus, cost depletion is consistent with current income accounting of income and expense.

Note that for the corporate shareholder, the cost depletion deduction is based on the distributing company's adjusted tax basis because of the carryover provisions. That is, the distributing firm's old tax basis becomes the initial tax basis for corporate shareholders. Thus, the stream of cost depletion deductions taken by corporations does not change upon transfer of properties between corporations. Furthermore, although the corporate shareholder will usually recognize a lower dividend amount than an individual upon distribution, this advantage is offset by lower depletion deductions in future years.

Sale of Units

Once a trust has been formed and units have been distributed to stockholders, the units can be sold or bought on the stock exchanges. Generally, upon the sale of a unit, the owner will realize a gain or loss as measured by the difference between the unit's selling price and the owner's adjusted tax basis.[6] For individual sellers, the sale will be taxed as a long-term capital gain or loss if a unit has been held for more than one year. Under the rules for long-term gains, 60 percent of an individual's gain is excluded in the determination of taxable income. In the case of corporations, the sale is taxed at the long-term rate of 28 percent (or the

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5 Of course, if oil and/or gas prices should unexpectedly rise, the value of trust units would rise at the same time.

6 The adjusted tax basis is the initial tax basis upon distribution less deductions for cost depletion or abandonment losses.

corporation's ordinary marginal tax rate, if lower) if the holding period of the current owner plus that of the distributing corporation is longer than one year. This results from the carryover holding period on the distribution of property as specified in the tax code.

The new tax basis of both individual and corporate purchasers of trust units is the sale price. That is, new owners (both corporations and individuals) have an initial tax basis equal to a unit's market value. Future cost depletion deductions will be determined with reference to the new owner's tax basis.

Foreign Sales

The trust units may also be purchased by foreign individuals or corporations. The trust is required to provide an information report to the IRS on all foreign investors (both individuals and corporations) whose trust units have a market value over $50,000. In addition, foreign individuals or corporations are required to report information on their trust unit holdings if they exceed $50,000.[7]

Unit owners who are foreign individuals or corporations are subject to a 30 percent tax on the gross income (without any deductions) derived from oil royalty trust units, unless foreign tax treaties specify otherwise. This amount is withheld by the trustees and deposited with the Treasury. A foreign taxpayer will, however, generally find it preferable to elect to treat the income as connected with a trade or business in the United States. In this case, the income is taxed on a net basis, subject to all the same deductions (including depletion), rates, and rules that apply to domestic taxpayers. This treatment is available because royalty trust units are considered real property under the tax code, even though they are securities traded on the stock markets.[8] (Real property is subject to this election regardless of whether it is effectively related to the taxpayer's trade or business in the United States.)[9] Once the foreign owner has elected to treat royalty trust income as effectively connected to U.S. business, a foreign unit holder is required to file a U.S. income tax return in order to claim all relevant deductions.

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7 IRC Sec. 6039C.

8 IRC Sec. 897.

9 IRC Sec. 882(d)(1) and S. 871(d)(1).

There has been some concern that the royalty trust entities might allow foreign (possibly hostile) shareholders or countries to gain greater control over U.S. energy resources. Because trust units are traded on the stock exchanges, foreign interests could purchase controlling shares in the trusts, perhaps secretly through third-party intermediaries. Thus, it is argued that foreign countries might be able to impede the orderly development of the nation's resources.

This should not, however, be a major concern in the analysis of royalty trusts. First, trust holders are not entitled to any voice in the management of the trust's properties. Indeed, the trustees can take no part in the active management of the royalty properties. All the operating and management decisions regarding the royalty properties are made by the owner of the operating interest in the properties. In a typical royalty trust, the owner of the operating interest is the corporation that originally created the trust. Thus, even if foreign shareholders controlled a royalty trust, they would have no say regarding the development of the trust's properties.

Second, foreign control over U.S. mineral interests can already be achieved through purchases of oil company stock and/or outright purchase or leasing of properties. In both these cases, foreign ownership could result in some control over the development of U.S. energy resources. It does not appear, however, that the royalty trust vehicle offers any new advantage to foreign interests if their goal is to affect U.S. oil and gas production decisions.

Windfall Profit Tax Considerations

The Crude Oil Windfall Profit Tax of 1980 (P.L. 96-223) imposed an excise tax on the domestic production of crude oil. Under the Economic Recovery Tax Act of 1981 (P.L. 97-34), a two-barrel per day exemption (rising to three barrels per day in 1985) from the tax was allowed for private royalty owners. While this exemption applied to holders of royalty trust units already in existence, it does not apply to any trusts created after June 9, 1981, nor does it apply to trust units that were acquired after that date, regardless of when the trust itself was established. Thus, the exemption for royalty holders will not generally be available for trusts created in the future.

The creation of a royalty trust by an independent producer may result in higher windfall profit taxes than if the trust had not been formed. The formation of a trust could increase windfall profit taxes if it eliminated the benefit of lower tax rates now applicable to independent

producers.[10] In general, independent producers pay lower windfall profit taxes on their first 1,000 barrels of production per day and are exempt from the windfall tax on their stripper production.[11] If the corporation forming the trust is an independent producer, the creation of a royalty trust would disqualify the trust's production from lower tax rates. (Non-operating or royalty interests are not eligible for the lower windfall rates and the stripper exemption applicable to independent producers.)[12] Note that all holders of an economic interest in an oil property (including royalty holders or holders of trust units) are themselves liable for their pro rata share of windfall profit taxes attributable to the property's production.[13]

A trust created by a major oil company, and therefore subject to regular windfall profit tax rates, will not generally have any effect on future windfall tax receipts (This assumes that production from the trust properties would be the same under either form of ownership.)

TAX IMPLICATIONS OF THE DISTRIBUTION OF THE TRUST

Tax Consequences for the Corporation Forming the Trust

The tax code allows a corporation to set up an oil royalty trust and treats the assignment of a nonoperating mineral interest to a royalty trust as a distribution of property by the corporation to its shareholders on a pro rata basis.[14] In general, the corporation itself is not required by tax law to recognize a gain or loss on the distribution, even if the market value of the

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10 An independent producer is an oil and gas company that refines fewer than 50,000 barrels per day and has petroleum product retail sales of less than $5 million annually.

11 Stripper production is production from wells that produce an average of less than 10 barrels per day.

12 Nonoperating interests are taxed at the same rate as all other oil production, such as that produced by the major integrated firms.

13 In general, the windfall profit taxe is withheld by the producer or the first purchaser.

14 IRC S. 311 (a).

property exceeds its tax basis.[15] For example, if a corporation distributes oil royalty interests with a market value of $100 million and a tax basis of $60 million, it does not recognize a gain on the transaction.[16] The staff of the Senate Finance Committee did propose that such a distribution would trigger the recognition of a gain by the distributing corporation.[17] The distributing firm would be taxed under this proposal on the difference between the property's market value and its tax basis, or $40 million in this example. The proposal has not been enacted into law, however.

One possible exception to the general nonrecognition rule in the case of oil and gas properties is the recapture of intangible drilling costs on transfers of property. Under Section 1254 of the Internal Revenue Code, accumulated deductions for intangible drilling costs allocated to a transferred property are treated as ordinary income by the distributing firm.[18] Suppose that, in the above example, intangible drilling costs associated with the trust property were $10 million. The distributing firm would be required to recognize this amount (less cost depletion deductions that would have been allowed if the expenditures had been capitalized) as ordinary income and pay tax on it. This provision was adopted in the Tax Reform Act of 1976 (P.L. 94-455) and only applies to intangible drilling expenditures made after 1975.

Although the distribution of nonoperating mineral interests is considered a disposition of property, it is not clear whether intangible drilling costs are considered part of the property transferred. The Tax Reform Act of 1976 is unclear on this point and proposed Treasury regulations (Prop. Reg. 1.1254-1) do not clarify whether drilling costs are chargeable to

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15 The tax basis of a property is its original capital cost, less accumulated deductions for depletion, depreciation, or intangible drilling costs.

16 In the case of royalty trusts, the market value of the property is established by the intial market price of trust units on the stock market.

17 Senate Committee on Finance, Staff Report, The Reform and Simplification of the Income Taxation of Corporations, Committee Print (September 22, 1983), p. 76.

18 Intangible drilling costs are only recaptured to the extent that they are less than or equal to the gain resulting from the transfer. In addition, the amount of drilling costs is reduced by the cost depletion deductions that would have been allowed had the costs been capitalized.

distributed royalty interests. This issue will have to be resolved through future revised regulations and/or litigation.

Upon distribution of mineral interests into a trust, the company reduces its accumulated "earnings and profits" account by the tax basis of the distributed property. As discussed in the next paragraph, the balance of the earnings and profits account is important in determining whether a distribution of property to a trust is to be treated by stockholders as a dividend or a return of capital. For corporate tax purposes, earnings and profits are roughly the accumulated taxable income (less dividends) earned by the corporation over its existence. Regardless of the market value of the interests distributed, the corporation only reduces its earnings by its tax basis in the property.

Tax Effects on Recipient Individual Shareholders

The tax consequences of the distribution to individual shareholders are primarily related to whether the distribution is recognized as dividend income or a return of capital. For individuals, the amount recognized as a dividend (and taxed at normal rates) is the excess of the market value of the distributed property over the corporation's earnings and profits. To the extent that the value of the distribution exceeds earnings and profits, the distribution is treated as a return of capital, which is not taxable, rather than as a dividend which is.

For example, suppose a firm has earnings and profits of $20 per share and distributes royalty interests with a market value of $35 per share, but with a tax basis of $5 per share. In this case, the individual would recognize dividend income equal to $20 per share, and the remaining $15 ($35-$20) would be treated as an untaxed return of capital. Note, however, that the return of capital lowers the shareholder's tax basis in common stock by a like amount. (The tax basis in a share of stock equals its historical acquisition cost, less any return of capital.) If the return of capital exceeded the stockholder's tax basis, the difference would be taxed as a capital gain. For stocks held for over one year, 60 percent of the gain is excluded from income, as permitted for long-term capital gains in general. The above distribution would also reduce the corporation's earnings and profits account by its tax basis in the property ($5 per share), leaving a balance in the account of $15 ($20-$5) per share.

From the perspective of the individual taxpayers, royalty trusts are more desirable if created by firms with low accumulated earnings and profits. For example, a new firm with a relatively short earnings history can distribute royalty interests that would be treated as untaxed returns of capital or as lightly-taxed capital gains. In each of Mesa's two existing

spin-off trusts, for example, the company did not have any earnings and profits, and the full distribution was treated as a return of capital and thus untaxable. On the other hand, a mature firm might have much higher accumulated earnings and profits and so the distribution could be fully taxed to the shareholders immediately as dividend income.

Tax Effects on Corporate Shareholders

The tax effects on corporate shareholders are significantly different from those on individual shareholders. In the case of a property distribution, the corporate shareholder is deemed to have received the lesser of (1) the market value of the property, or (2) the distributing company's old tax basis in the property. For an oil and gas property, the tax basis is usually substantially less than the market value of the property. Thus, any dividend recognized for tax purposes to the corporate shareholder is usually much less than its market value. Furthermore, the new tax basis of the distributed property (trust units in the case of a royalty trust) in the hands of the corporate shareholder will be the old tax basis of the distributing firm. All future gains and losses on the trust units will be measured relative to that basis.

In addition to providing for a "carryover" tax basis, the tax code allows the corporate shareholder to include the holding period of the distributing firm in its calculation of its own holding period.[19] The importance of this distinction is that the carryover basis may allow the corporate shareholder's subsequent gain on any sale of the trust units to be taxed as a maximum long-term capital gain, even though the units may not have been held by the corporation for the requisite one year. (In the case of corporations, the maximum long-term capital gains tax rate is 28 percent, whereas the regular marginal tax rate for most corporations is 46 percent.) Because the market value of a royalty trust unit will normally exceed its tax basis, the shareholder corporation can often realize a long-term capital gain immediately upon the trust's formation.

As mentioned above, the distribution is generally valued as a dividend at its old tax basis amount. In general, the tax code also allows corportions to deduct from their income 85 percent of the dividends they receive. The rationale for this tax preference is to limit the double

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19 This only applies where the new tax basis is determined in reference to the old tax basis. When, the tax basis is determined to be the property's market value, the holding period is not carried over, but starts on the date of distribution.

taxaton of income in the corporate sector. Furthermore, as in the case of individuals, the distribution is only counted as a dividend to the extent that the distributing company has earnings and profits. Otherwise, it is treated as a return of capital, which is not taxable.[20]

Example

The distribution rules for corporate shareholders can be illustrated by an example. The distributing firm (Company A) is assumed to form a royalty trust whose units have a market value of $50 per unit and a tax basis of $30 per unit. Trust units are assumed to be distributed on the basis of one unit for each share of common stock. The stock sold for $90 per share just prior to the distribution and $40 after the distribution. (Note that the combined value of the pretrust value—$90—of the stock is equal to the posttrust value of the stock ($40) and associated trust unit—$50.)

The amount distributed by Company A to Company B, an owner of Company A's stock, is deemed to be $30, since the tax basis ($30) is less than the market value ($50) of the unit. Thus, assuming Company A has sufficient earnings and profits, Company B recognizes taxable dividend income of $4.50 (15 percent of $30) after taking into account the 85 percent deduction of received dividends. (Company B must hold the stock for a minimum of 15 days to take advantage of the dividends-received deduction.) Assuming the dividend income is taxable at the corporate rate of 46 percent, this transaction results in a tax payment of $2.07 (46 percent of $4.50). Also, Company B's tax basis in the trust units is $30 (the carryover basis from Company A), and its holding period includes the time that Company A held the property.

Note that if the royalty property earns the same income as it would have if held by Company A, there is no future change in total corporate tax payments. This is because the cost depletion deductions allowed Company B would be the same as those for Company A had the property not changed ownership. The transfer of property between the corporations changes the payor of taxes, but not the total amount. Therefore, the only tax effect of this transaction would be the tax payment by Company B of $2.07 from the recognized dividend income, and the Treasury gains that amount. This assumes that the property is retained by company B for the rest of its productive life.

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20 If the return of capital exceeds the shareholder's historical cost basis in the stock, however, the excess is recognized as a capital gain and taxed as such.

Tax Arbitrage

When corporate shareholders are concerned, there is a substantial opportunity for tax arbitrage in the case of property dispositions. (In general, tax arbitrage refers to transactions that are essentially riskless and generate a profit purely through certain provisions of the tax code.) Suppose that, in the example above, Company B bought Company A's stock for $90 just prior to the distribution of the royalty trust. Also assume that Company A had held the royalty property for at least one year prior to the distribution. If Company B sold both its stock and trust unit 16 days later, it would recognize a long-term gain on the trust unit of $20 ($50 market value less a $30 carryover tax basis) and a short-term capital loss of $50 ($90 stock purchase price less a $40 post-distribution price) on its stock. (It would also recognize $4.50 in dividend income as before.) The long-term capital gain would be taxed at 28 percent resulting in a tax of $5.60 (0.28 x $20.00). The short-term capital loss could be used to offset other short-term capital gains at the normal tax rate of 46 percent. Assuming that Company B has a net short-term gain, the value of the tax offset is $23.00 (46 percent of the $50 loss). These three tax effects yield a net tax saving of $15.33, even though on a pretax basis the cash flow to the firm from the transction was zero. The tax effects from this arbitrage example are shown below:

Transaction	Tax Saving
Dividend Tax (46% tax rate x 15% dividend inclusion x $30 dividend)	-$2.07
Long-Term Capital Gain Tax (28% tax rate x capital gain of $20))	-$5.60
Short-Term Capital Loss Tax (offset (46% tax rate x capital loss of $50):	+$23.00
Net Effect	+$15.33

Even though the transaction generated no tangible economic benefits, Company B was able to profit from such activities.

The above arbitrage possibility arises for two basic reasons: (1) the 85 percent dividend deduction, and (2) the carryover holding period.

Companies are allowed to take the 85 percent deduction for dividends received if they hold the stock for more than 15 days. This provision might allow corporations to buy stock immediately before a dividend record date, take the 85 percent dividends deduction, and deduct 100 percent of the short-term capital loss that occurs automatically on the stock's value as a result of the dividend. This is especially important in the case of extraordinary dividends that might occur as the result of an oil royalty trust. In order to reduce the potential for tax arbitrage that may occur from using the dividends-received deduction, it has been proposed that the minimum holding period be increased from two weeks to one year.[21]

The second source of tax arbitrage occurs because of the carryover basis combined with the carryover holding period. Because long- and short-term capital gains are taxed at different rates, firms can take advantage of the difference to reduce their overall tax burden. In the case of royalty trusts, the carryover holding period allows the firm reduced long-term rates on the gain from the trust units, while simultaneously allowing a full loss offset for the short-term loss on the stock. Because of the carryover holding period, the firm is required only to hold the distributing firm's stock on the date of record for the distribution to be eligible for long-term capital gains treatment on any sale of trust units, rather than the generally applicable one-year rule.

Two possible alternatives for reducing the arbitrage opportunity for transactions that involve the transfer of property between corporations are:

- <u>Proposal 1</u>. Eliminate the carryover holding period along with repeal of the dividend deduction for stock held for less than one year (the carryover basis would be retained). This would tax all gains and losses on stocks or trust units held for less than one year at regular corporate rates; stocks or trust units held for more than one year would be taxed at the long-term rate.

- <u>Proposal 2</u>. If a shareholder corporation held stock for less than one year, the stock's basis would be reduced by the market value of property distribution (less any amount considered taxable as a dividend). Furthermore, the holding period for property distributions could not exceed the corporation's holding period for stock in the distributing firm. The property carryover basis and the dividends-received deduction would be retained.

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21 Senate Committee on Finance, Staff Report, <u>The Reform and Simplification of the Income Taxation of Corporations</u>, p. 78.

The following table shows the effect of each of these proposals.

Type of Tax	Proposal 1: Stock Held Less Than One Year	Proposal 1: Stock Held More Than One Year	Proposal 2: Stock Held Less Than One Year	Proposal 2: Stock Held More Than One Year
Dividend Tax	-$13.80	-$2.07	-$2.07	-$2.07
Tax on Gain From Sale of Trust Units	-$9.20	-$5.60	-$9.20	-$5.60
Tax Offset on Loss From Sale of Stock	+$23.00	+$14.00	+$2.07	+$14.00
Net Effect	$0.00	+$6.33	-$9.20	+$6.33

In each case, the sale prices of both the stocks and trust units are the same as before—only the holding periods are varied. As the table indicates, there would no longer be any short-term prospects for arbitrage; any gains made for purely tax reasons would require the investor to hold the stock at least one year. Thus, firms would have to expose their investment to market risks for a significant period of time in order to take advantage of the tax law.

Tax Consequences for Nonresident Foreign Stockholders

In general, foreign stockholders (whether corporations or individuals) are treated the same as domestic unit holders in royalty trusts, if the distributed property is effectively connected with the taxpayer's business in the United States. Under the tax code, shareholders may elect to treat royalty trust units as real property, thereby establishing this linkage.[22] (Real property is treated as being connected with United States trade or business, regardless of whether it is in fact related to the foreign shareholder's business in the United States.) If a foreign corporation does not choose the real property election, it will be treated the same as a domestic or foreign individual investor—that is, the distribution amount is determined by the fair market value of the trust units.

22 IRC S. 882 and S. 871.

Foreign corporations and individuals may also be subject to a 30 percent withholding tax on the market value of the trust distribution. If foreign shareholders do not elect to treat their units as real property (thereby connected with U.S. business), withholding is required on the full amount of the distribution. Such stockholders, however, may file for claim of a refund of the portion of the distribution that is considered a nontaxable return of capital.

Tax Consequences for Tax-Exempt Institutions

Tax-exempt institutions that are shareholders in a corporation that forms a royalty trust should not be subject to any tax as a result of the distribution of trust units. That is, if the institution's ownership of corporate stock was already exempt from tax, the distribution of property (trust units) would likewise be nontaxable.

SECTION IV. A ROYALTY TRUST IN ACTION

In order to analyze the effect of the creation of a royalty trusts on overall federal tax revenues, it is useful to study the total tax effects of a hypothetical trust. First, a base case scenario is presented, followed by four alternatives to the initial assumptions in order to analyze the sensitivity of tax revenues to specific situations.

THE BASE CASE

The analysis begins with a description of the hypothetical royalty trust property and the tax status of the various parties. The following factors are assumed:

- The trust is created by Corporation A, which is not an independent oil producer under the tax code definition.
- The company distributes royalty property that has a 20-year production life to the trust.
- The distributing corporation is assumed to be in the marginal tax bracket of 46 percent.

- o The corporation discounts future cash flows at 15 percent.

- o The corporation has sufficient earnings and profits to cover all distributions.

- o The corporation's current tax basis in the royalty property distributed is $10,000.

Table 1 sets out the corporation's income statement for the royalty property. Net operating revenue is the firm's gross revenue from the property, less all operating costs and excise taxes. Taxable income is net revenue less cost depletion. Cost depletion is based on the tax basis of $10,000 and allocated to years according to the percentage of reserves produced in each year. The corporate tax is 46 percent of taxable income; net cash flow is net operating revenue less corporate tax payments.

From the firm's viewpoint, the property is worth $49,620. This is the discounted (at 15 percent) net cash flow of the property. Note that the value of the property exceeds its tax basis—the tax basis is only about 20 percent of the property's value—because the tax basis has been reduced by expensed intangible drilling costs in prior periods. The last column in Table 1 shows how the value of the property declines over time until it reaches zero by year 20. (The value of the property at any given time is the discounted present value of all future net cash flows.) The difference in the market value of the property from one year to the next is referred to as economic depletion—that is, it is the decline in market value that the asset experiences over time. For example, the first year's economic depletion equals $5,390, or $49,620 less $44,230.

From the perspective of the individual stockholder, the value of the property in the hands of the corporation is reflected by the market price of the firm's stock. For the purposes of this example, it is assumed that the corporation's stock price is determined by the individual investor in the 40 percent marginal tax bracket. Initially, it is also assumed that all stock is held by individuals in the 40 percent bracket; this assumption will be varied below. In order to determine personal taxes related to the holding of corporate stock, it is necessary to make several further assumptions:

- o The stockholder in the 40 percent tax bracket has a posttax discount rate of 11.1 percent.

- o Stockholders hold their shares for three years and then sell them.

- o Corporate net cash flow is distributed as follows: 50 percent of the excess of net cash flow over economic depletion is retained; the remaining 50 percent is distributed as dividends.