TABLE 1. INCOME STATEMENT OF ROYALTY PROPERTY HELD BY CORPORATION A, UNDER THE BASE CASE (In dollars)

Year	Net Operating Revenue	Cost Depletion	Tax Basis	Taxable Income	Corporate Tax	Net Cash Flow	Current Market Value
0			10,000				49,620
1	22,854	1,068	8,932	21,786	10,022	12,832	44,230
2	20,672	971	7,961	19,701	9,063	11,610	39,255
3	18,649	882	7,079	17,767	8,173	10,476	34,667
4	16,773	802	6,277	15,971	7,347	9,426	30,441
5	15,033	729	5,547	14,304	6,580	8,454	26,553
6	13,420	663	4,884	12,757	5,868	7,552	22,984
7	11,925	603	4,282	11,322	5,208	6,717	19,715
8	10,538	548	3,734	9,990	4,595	5,942	16,730
9	9,252	498	3,235	8,753	4,027	5,225	14,015
10	8,059	453	2,783	7,606	3,499	4,560	11,557
11	6,953	412	2,371	6,542	3,009	3,944	9,346
12	5,928	374	1,997	5,554	2,555	3,373	7,375
13	4,977	340	1,656	4,637	2,133	2,844	5,637
14	4,095	309	1,347	3,786	1,742	2,354	4,129
15	3,278	281	1,066	2,997	1,378	1,899	2,849
16	2,520	256	810	2,264	1,041	1,478	1,798
17	1,817	232	578	1,584	729	1,088	980
18	1,165	211	367	954	439	726	401
19	560	192	175	368	169	391	70
20	0	175	0	-175	-80	80	0

- Dividends are taxed at the full 40 percent personal tax rate and capital gains are subject to the 60 percent exclusion because they are long-term gains. Note that the capital gain earned in a given year is equal to the excess of retained earnings over economic depletion. (Retained cash from economic depletion leaves the value of the stock unchanged.) Further, the capital gain earned in any given year is not taxed until three years later when the stock is assumed to be traded.

The cash related to economic depletion is assumed to be retained by the firm, thus maintaining the stock price. It is also assumed that the new investment resulting from corporate retentions earns the same 11.1 percent posttax return to shareholders as the royalty property. Because this return equals the investor's discount rate, the individual is indifferent between receiving the invested capital now or in the future. For simplicity of this analysis, it is assumed the taxpayers receive their return of capital in accordance with the pattern of economic depletion, even though they would not, in fact, receive it until they sold their stock. This assumption does not affect the following analysis.

The cash flow accounts of the individual investors are shown in Table 2. Net corporate cash flow is split between retained earnings and dividends. As a percentage of corporate cash-flow, dividends decline from 29 percent in year one to 6 percent in year 20. The retained earnings (in excess of economic depletion) are taxed as capital gains three years after they have been accrued at a rate of 16 percent (40 percent tax rate times 40 percent capital gains inclusion.)[23] Dividends are taxed at 40 percent. The discounted cash flow of the stock shares is $49,620--the same amount at which the firm valued the property. The personal discount rate (11.1 percent) is lower than the corporate rate (15 percent), because the personal income tax imposes a tax "wedge" between the discount rates of corporations and their shareholders.[24]

Total personal taxes are the sum of capital gains taxes plus dividend taxes. After tax income is the sum of current capital gains and dividend income less total personal taxes. Total personal cash flow is the sum of after-tax income plus the hypothetical annual return of capital. For the personal investor, the cash flow of the property is of primary importance in making investment decisions.

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23 In Table 2, the capital gains tax in each year equals 16 percent of each year's gain, discounted by three years.

24 The tax wedge of 3.9 percent reflects an effective personal tax (on dividends and capital gains) of 26 percent.

The last column of Table 2 totals all taxes related to the property, prior to formation of the trust, including both corporate and personal income taxes. The government is assumed to discount future tax payments at the same rate as individual shareholders—that is, 11.1 percent.[25] The total present value of taxes is $52,630—$44,649 in corporate taxes, $6,180 in dividend taxes, and $1,801 in capital gains taxes. The present value of the stock or property ($49,620) is by definition equal to the difference between the present value of pretax net operating revenues ($102,250) less the present value of taxes ($52,630). This is the market valuation of the property by the stockholders prior to the distribution of the royalty trust.

The tax implications of the creation of the trust can be broken into two parts: the taxes paid related to the distribution, and the taxes paid on the ongoing royalty income of the trust. Although all tax effects are interrelated, for simplicity it is easier to analyze their separate effects. For purposes of this analysis, it is assumed that all production revenues remain the same as if the property continued to be held by the corporation.

The new market value of the trust units is determined by the discounted value of its new future cash flows as evaluated by private investors. (Table 3 sets out the income accounts of the new royalty trust.) The trust generates the same net operating revenues as before. The investors (still all individuals in the 40 percent tax bracket) are allowed cost depletion based on their tax basis in the units. Their tax basis initially equals the market value of the units. The investors' cash flow is net operating revenues less current taxes. In the trust, all operating revenues are distributed when earned; all taxes are based on current income and are levied at regular rates. The new market value of the trust units (and the property) is $77,409; this is equal to the new present value (discounted at 11.1 percent) of the net cash flow of the trust.

The value of the property in the trust exceeds its initial value when held by the corporation by $27,789 ($77,409 - 49,620), an increase of 56 percent. This difference is entirely attributable to differences in taxes; the present value of total tax payments has been reduced by $27,789. This amount consists of reduced corporate taxes ($44,648 on a present value basis) and higher personal taxes of $16,859 (new income taxes of $24,840 less old dividend taxes of $6,180 and old capital gains taxes of $1,801). Thus, the trust vehicle allows the property to escape taxation at the corporate level, although this is offset in part by higher taxes at the

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25 The present value of the revenue loss or gain to the Treasury is sensitive to the interest rate used to discount cash flows. In general, a lower discount will result in a larger revenue loss (or a smaller revenue gain) than shown for this hypothetical trust.

TABLE 2. INCOME STATEMENT OF INDIVIDUAL INVESTORS IN CORPORATION A RELATED TO THE ROYALTY PROPERTY, UNDER THE BASE CASE (In dollars)

Year	Net Corporate Cash Flow	Current Market Value	Economic Depletion	Annual Capital Gain	Dividend Income	Capital Gains Tax	Total Personal Dividend Tax	Total Personal Taxes	Personal Cash Flow	Total Taxes (Including Corporate)
0		49,620							-49,620	
1	12,832	44,230	5,389	3,721	3,721	434	1,489	1,922	10,910	11,944
2	11,610	39,255	4,975	3,317	3,317	387	1,327	1,714	9,896	10,776
3	10,476	34,667	4,588	2,944	2,944	343	1,178	1,521	8,956	9,694
4	9,426	30,441	4,226	2,600	2,600	303	1,040	1,343	8,083	8,690
5	8,454	26,553	3,887	2,283	2,283	266	913	1,179	7,274	7,759
6	7,552	22,984	3,569	1,992	1,992	232	797	1,029	6,523	6,897
7	6,717	19,715	3,269	1,724	1,724	201	690	891	5,826	6,099
8	5,942	16,730	2,985	1,479	1,479	172	591	764	5,179	5,359
9	5,225	14,015	2,715	1,255	1,255	146	502	648	4,577	4,675
10	4,560	11,557	2,458	1,051	1,051	123	420	543	4,017	4,042
11	3,944	9,346	2,211	867	867	101	347	448	3,496	3,457
12	3,373	7,375	1,971	701	701	82	280	362	3,011	2,917
13	2,844	5,637	1,738	553	553	64	221	286	2,558	2,419
14	2,354	4,129	1,508	423	423	49	169	218	2,135	1,960
15	1,899	2,849	1,280	310	310	36	124	160	1,739	1,538
16	1,478	1,798	1,051	214	214	25	85	110	1,368	1,152
17	1,088	980	818	135	135	16	54	70	1,018	798
18	726	401	579	73	73	9	29	38	688	477
19	391	70	331	30	30	4	12	16	375	185
20	80	0	70	5	5	1	2	3	78	-78
Present Value[a]	---	---	---	---	---	1,801	6,180	7,980	49,620	52,630

a. Discounted at 11.1 percent.

TABLE 3. INCOME STATEMENT OF THE ROYALTY TRUST, UNDER THE BASE CASE (In dollars)

Year	Net Operating Revenues	Cost Depletion	Tax Basis	Taxable Income	Tax	Cash Flow	Total Taxes	Change in Taxes[a]
0			77,409				11,116	11,116
1	22,854	8,266	69,143	14,588	5,835	17,019	5,835	-6,109
2	20,672	7,514	61,629	13,158	5,263	15,409	5,263	-5,513
3	18,649	6,831	54,797	11,818	4,727	13,922	4,727	-4,966
4	16,773	6,210	48,587	10,563	4,225	12,548	4,225	-4,465
5	15,033	5,646	42,942	9,388	3,755	11,278	3,755	-4,004
6	13,430	5,132	37,809	8,288	3,315	10,105	3,315	-3,582
7	11,925	4,666	33,143	7,259	2,904	9,021	2,904	-3,195
8	10,538	4,242	28,902	6,296	2,518	8,019	2,518	-2,841
9	9,252	3,856	25,045	5,396	2,158	7,093	2,158	-2,517
10	8,059	3,506	21,540	4,554	1,821	6,238	1,821	-2,220
11	6,953	3,187	18,353	3,766	1,507	5,447	1,507	-1,950
12	5,928	2,897	15,456	3,031	1,212	4,716	1,212	-1,704
13	4,977	2,634	12,822	2,343	937	4,040	937	-1,481
14	4,095	2,394	10,428	1,701	680	3,425	680	-1,280
15	3,278	2,177	8,251	1,101	440	2,837	440	-1,098
16	2,520	1,979	6,272	541	216	2,303	216	-935
17	1,817	1,799	4,474	18	7	1,810	7	-791
18	1,165	1,635	2,838	-470	-188	1,353	-188	-665
19	560	1,487	1,352	-926	-370	931	-370	-555
20	0	1,352	-0	-1,352	-541	541	-541	-463
Present Value[b]	---	---	---	---	24,840	77,409	35,955	-16,674

a. Total taxes less total taxes from Table 2.

b. Discounted at 11.1 percent.

personal level. In terms of ongoing operations, the tax burden on the property has been reduced by $27,789 in present value terms. This amount represents the direct loss to the U.S. Treasury in this hypothetical case.

The initial distribution of the trust units, however, also has significant tax consequences. The distribution is valued at its new market price ($77,409) and is treated as a distribution of property. Assuming that the distributing firm has sufficient earnings and profits, the distribution is treated as a dividend and taxed at regular rates. For the investors, the distribution tax amounts to $30,964 (0.4 x $77,409). The current investors in the corporation's stock, however, will suffer a capital loss on their holdings equal to the old value of the property. That is, their stock shares will go down in value by $49,620 when the trust is distributed. Assuming these are short-term losses, they can be used to offset short-term gains (or ordinary income up to $3,000).[26] Thus, the losses result in tax deductions worth $19,848 (0.4 x $49,620) if the stock is sold after the distribution.[27] The net tax payments resulting from the distribution are the difference between the tax on the dividend amount and the short-term loss offset, or $11,116 ($30,964 - 19,848). If the stock had been held for more than one year, and the loss used to offset long-term gains, the loss offset would be only 40 percent of the short-term offset—$7,939 in this case. The total tax related to the distribution would then be $23,025 ($30,964 - 7,939), instead of $11,116. Both these effects are based on the assumption that the stock is not sold prior to the trust distribution.

In general, once formation of a trust has been publicly announced, the value of a firm's stock will change to reflect any appreciation that the trust vehicle induces. Once investors know a trust is to be formed, the price of a stock in the company will tend to reflect that fact. If stockholders sell their shares prior to the distribution, they will realize any capital gains associated with the trust's formation. Assume that the value of the firm's stock rises by $27,789 ($77,409 trust value less $49,620 pretrust value) prior to the distribution. If stockholders sell their shares prior to distribution they will owe a tax of $11,116 (0.4 x 27,789) if the gain is short term, and $4,446 (0.16 x 27,789) if it is long term. New individual

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26 In addition, short-term losses can be carried over indefinitely.

27 If the stock had been held for more than one year, the loss would be deducted as a long-term capital loss. To the extent that the individual had short-term gains, the long-term loss could be used to offset these gains just like a short-term loss. Long-term losses can also be used to offset long-term gains or ordinary income (but only 50 cents of ordinary income per dollar of loss), up to $3,000. Like short-term losses, long-term losses can be carried over indefinitely.

shareholders will purchase shares prior to distribution at a price of $77,409. Upon distribution of the trust, the new shareholders will be unaffected—that is, they will be taxed on dividends of $77,409, but will also record a short-term capital loss of an equal amount. Thus, the two tax effects of the distribution are $11,116 in the short-term case and $4,446 in the long-term case.

Total Revenue Effects

The combined effect on Treasury revenues is the difference between the reduced taxes on the ongoing operations of the trust less the taxes payable upon the trust distribution. Table 4 summarizes the total effects on the Treasury in the four situations discussed above.

TABLE 4. TOTAL TAX EFFECT ON TREASURY REVENUES IN FOUR SITUATIONS UNDER THE BASE CASE a/

Cases	Pre-Trust Taxes	Change in Tax Related to Ongoing Trust Operations	Tax on Distribution	Total Tax Effect	Total Effect As a Percent of Pretrust Taxes
Stock Not Traded Prior to Distribution					
Loss used to offset short-term gains	52,630	-27,789	+11,116	-16,673	-32
Loss used to offset long-term gains	52,630	-27,789	+23,025	-4,764	-9
Stock Traded Prior to Distribution					
Short-term gain recognized	52,630	-27,789	+11,116	-16,673	-32
Long-term gain recognized	52,630	-27,789	+4,446	-23,343	-44

a. All amounts are present values discounted at 11.1 percent.

In all these situations, the formation of the trust reduces the taxes paid to the Treasury, but by varying amounts. These tax reductions are direct gains to the pretrust shareholders—that is, the shareholders as a group have their wealth increased by the present value of reduced federal tax payments, all else being equal. For example, when short-term gains and losses are realized, the net loss to the Treasury (in present value terms) is $16,673; the net gain of the stockholders is the same amount.

SENSITIVITY ANALYSIS

In the base case, the present value of total tax receipts is reduced by $16,673 from the formation of the royalty trust. (This assumes that the loss on distribution is used to offset short-term losses—the first line in Table 4.) In this section, the sensitivity of this result to the base case assumptions is examined. Four alternative cases are analyzed below to study the effect of modified assumptions on the present value of federal Treasury tax receipts.

Case 1—50 Percent of Shareholders are in the 50 Percent Bracket, 25 Percent in the 40 Percent Bracket, and the Remaining 25 Percent in the 30-Percent Bracket[28]

All other base case assumptions are held constant. In addition, all taxpayers are considered to have short-term capital gains that can be reduced by capital losses upon distribution. The pretrust taxes are calculated at $53,129, or $499 more than in the base case. The posttrust taxes consist of $26,393 from trust operations and $11,811 from the initial distribution, yielding a total net present value of $38,204. This exceeds the trust taxes in the base case by $2,249. On net, the trust reduces the present value of federal receipts by $14,925, or $1,748 ($14,925 - $16,673) less than in the base case. The $14,925 reduction in taxes is equal to 28 percent of pretrust collections.

Case 2—The Distributing Corporation Has No Earnings and Profits for Tax Purposes

This implies that the full amount of the distribution is treated as a return of capital and is not taxed as a dividend. The return of capital

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28 It is still assumed that the market value of the property is determined by the investor in the 40 percent tax bracket.

simultaneously reduces the shareholders' tax bases and the market value of their stocks by the same amount. Thus, no gain or loss is recognized as a result of the distribution (this assumes that each shareholder's tax basis in the stock is not reduced to below zero). Maintaining the other assumptions in the base case, the present value of taxes is reduced by $27,789 (53 percent) from their pretrust level. This is the same reduction that is produced in the base case, except that the $11,116 in taxes resulting from the distribution are not included.

Case 3—The Stock Is Held Completely by Other Corporations[29]

The market value of the property is lower if held by corporations (which are assumed to be held ultimately by individuals in the 40 percent tax bracket), because of the taxes that must be paid on intercorporate dividends and intercorporate capital gains. In general, intercorporate dividends are subject to the 85 percent deduction, and thereby are effectively taxed at 6.9 percent (0.46 x (1 - 0.85)). Long-term gains earned by corporations are taxed at 28 percent. In the pretrust case, it is assumed that 50 percent of the cash flow (in excess of economic depletion) is retained and the other 50 percent is paid out as dividends. This is assumed to apply to the corporation that owns the property, as well as to the corporations that hold stock in the controlling firm. In the pretrust scenario, the tax burden (in present value terms) is calculated in the following table.

29 Again, the share prices of all firms are determined by individual stockholders in the 40 percent bracket.

	Present Value of Taxes a/
Corporate Tax on Owning Corporation at 46 Percent	$44,650
Corporate Tax on Intercorporate Dividends at 6.9 Percent	1,144
Corporate Tax on Intercorporate Capital Gains at 28 Percent	3,382
Personal Tax on Dividends (Distributed by the Holding Corporations) at 40 Percent	5,726
Personal Tax on Capital Gains (Accrued within the Holding Corporations) at 16 Percent	1,669
Total taxes (pretrust)	$56,571

a. All taxes discounted at 11.1 percent.

The total taxes in this scenario (pretrust) are $3,941 higher than in the base case. The market value of the property is, therefore, $3,941 less valuable to investors than in the base case.[30] The $56,571 in total taxes is the reference point for determining the change in tax revenues from the creation of a royalty trust.

The distribution of the royalty trust to corporate shareholders eliminates the intercorporate tax liabilities shown above. Because of the carryover of the tax basis, the distributing firm's tax liabilities are simply transferred to the new corporate holders of the trust units. In fact in this case, the posttrust taxes from ongoing operations are the same as in the pretrust situation in the base case. That is, posttrust taxes (corporate and personal) from the ongoing trust operations are $52,630. On net, the taxes

30 Note that if intercorporate dividends on capital gains were not taxed, the pretrust taxes would be the same as in the base case.

from the ongoing operations of the royalty property are reduced by an amount (-$3,941) that consists of reduced intercorporate taxes (-$4,526) and increased personal taxes of $585.

The distribution of the trust units, however, creates an offsetting tax increase. Since it is assumed that the distributing company has sufficient earnings and profits, the distribution is treated as a dividend by the recipient corporation. The amount of the dividend recognized is the old corportion's tax basis in the property because it is received by another corporation. Moreover, the dividend is subject to the 85 percent dividends-received deduction. The tax basis is assumed to be $10,000 (as it is for all cases), and the tax due on the distribution is therefore $690 (46 percent x $10,000 x (1 - 0.85)). This reduces the tax loss from ongoing operations and leaves a total reduction in taxes of $3,251 ($3,941 - $690), or 6 percent of pretrust tax revenues. The foregoing assumes that once the trust is distributed, it remains in the hands of the recipient firms.

As discussed in Section III, royalty trust distributions allow tax arbitrage opportunities by the shareholding corporations. Assume that a shareholding corporation purchased the stock of the distributing firm at the market price just prior to the distribution. In addition, assume that 16 days after the distribution the corporation sells both its stock in the firm, as well as its trust units. Because it would be well known that the trust was soon to be distributed, the price of the firm's stock just prior to the distribution would be bid up to its new expected value. The pre-distribution market value of the stock is assumed to be $77,409—an amount equal to the value that individual taxpayers in the 40 percent tax bracket would place on the trust. The purchase of stock shares and their subsequent sale (along with the trust units) would result in a capital loss of $77,409 on the stock shares, and a capital gain of $67,409 ($77,409 market value less carryover tax basis of $10,000) on the trust units. Because of the carryover holding period, the capital gain would be taxed at the long-term rate (28 percent) if the property had been held by the distributing firm for more than one year. The short-term capital loss would be used to reduce taxes owed on other short-term gains at the regular tax rate of 46 percent. The purchasing firm would also be taxed on the dividend distribution, but would be eligible for the dividends-received deduction if the stock was held for more than 15 days. The tax effects of this transaction are shown in the following table.

	Tax Effect (on Purchasing Company)
Tax Due on the Recognized Dividend (6.9 percent of $10,000)	$690
Tax Due on the Long-Term Gain (28 percent of $67,409)	$18,875
Tax Offset due to Short-Term Capital Loss (46 percent of $77,409)	-$35,608
Net tax effect	-$16,043

The arbitraging corporation could reduce its taxes by $16,043 even though the transaction is a break-even proposition on a cash basis—that is, the corporation bought stock worth $77,409 one day and sold it for the same amount 16 days later.[31] All other tax effects would be the same as in the base case in which the trust is directly distributed to individual taxpayers in the 40 percent tax bracket. Thus, the arbitrage profit is in excess of any other tax reduction that might occur as the result of the royalty trust.

Case 4—The Effective Corporate Tax Rate on the Distributing Firm is 20 Percent

The effective marginal tax rate on an oil and gas company may fall below 46 percent because of tax benefits, such as expensing of intangible drilling costs or accelerated depreciation. The lower the corporate tax currently being levied on royalty properties, the less attractive will be a royalty trust. In other words, the lower the federal corporate tax, the smaller is the advantage of escaping it. Assuming that the effective tax for an oil company is 20 percent, the pretrust market value of the property

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31 The firm could further reduce the riskiness of this transaction by selling the trust units the day after distribution, instead of waiting fifteen days. This would, however, make the firm ineligible for the dividends-received deduction. The tax due on the dividend distribution would then be $4,600 (0.46 x $10,000), thereby reducing the pure arbitrage profit to $12,134.

is $71,398—higher by $21,778 ($71,398 - $49,620) than in the base case, primarily because of lower corporate taxes. The total pretrust discounted taxes are $30,854, or $21,776 less than in the pretrust base case.

The taxes related to the ongoing trust operations (posttrust) remain the same as they were in the base case—that is, $24,839. The tax effect upon distribution is also the same ($11,116), resulting in total present discounted taxes of $35,955. (Note that no variable has been changed that would affect the posttrust tax liabilities.) The posttrust market value of the property is $77,409 (the same as in the base case), and the increase in the market value of the trust property is $6,011 ($77,409 - $71,398) or 8.4 percent. This is a result of lower taxes of $6,011 related to ongoing operations.

Such a trust, however, would not be attractive to shareholders of the corporation that forms the trust, since the decreased future taxes ($6,011) would be more than offset by the tax upon distribution of the trust amounting to $11,116, which occurs when taxpayers realize short-term gains and losses. This transaction would leave stockholders with a net loss in wealth of $5,105, clearly not an advantageous prospect. This results from the fact that the increase in trust value would not be sufficient to cover the fixed dividend charge levied upon the trust's formation. Thus, even though the value of the trust rises, the current stockholders could be worse off.

On the other hand, if the distributing firm does not have earnings or profits for tax purposes (not an unlikely occurrence), the distribution would be considered an untaxed return of capital. In this case, shareholders would receive a positive change in wealth of $6,011.[32] This amount is again the present value of the Treasury revenue loss.

In this sensitivity case, the Treasury revenue loss is likely to be quite small (or possibly even a gain), if the distributing companies have low effective marginal corporate tax rates. In fact, this appears to be the case; the Joint Committee on Taxation (JCT) has estimated that in 1982 large petroleum corporations paid tax at an average rate of 18.2 percent.[33] Thus, companies that have low tax rates may not find it in their shareholders' interests to spin-off trusts.

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32 This assumes that the return of capital does not reduce the shareholder's basis in the stock to below zero. If it does, the excess of the return over the current basis would be taxed as a capital gain.

33 Joint Committee on Taxation, Study of Effective Tax Rates of Selected Large U.S. Corporations (November 14, 1983), p. 13.

Table 5 summarizes the results of this sensitivity analysis. Note that all figures refer to the net present discounted value of total tax payments. Annual tax losses or gains would be substantially lower, as indicated, for example, by Table 3.

TABLE 5. SENSITIVITY ANALYSIS OF THE CHANGE IN DISCOUNTED FEDERAL TAX RECEIPTS FROM A ROYALTY TRUST, USING FOUR ILLUSTRATIVE ALTERNATIVES (In dollars)

Case[a]	Pretrust Taxes[b]	Posttrust Taxes[b]	Change[b]
Base Case	52,630	35,956	-16,673
Case 1. Individual Investors in Different Tax Brackets	53,129	38,204	-14,925
Case 2. Corporation Has No Earnings and Profits	52,628	24,839	-27,789
Case 3. Shareholders All Corporate	56,571	53,320	-3,251
Case 4. Corporate Tax Rate is 20 Percent			
The firm has earnings and profits	30,854	35,955	+5,101
The firm does not have earnings and profits	30,854	24,839	-6,015

a. For further explanation of cases, see text.

b. All taxes are present values discounted at 11.1 percent.

SECTION V. CURRENT STATUS OF ROYALTY TRUSTS

CBO has identified eight publicly traded oil and gas royalty trusts that have been set up in recent years.[34] The aggregate market value of the trusts ranges between $2 billion to $3 billion, depending on stock market fluctuations.

The federal income tax implications for these trusts are likely to be fairly small, since the trusts as a group are not very large. For example, if it is assumed that the trusts generate income at a pretax level of 15 percent, on the basis of $2.5 billion in assets, this would be an annual income stream of $375 million. If this stream was now taxed in full at 40 percent, the current tax liability would be $150 million. On the other hand, if the combined corporate and personal tax on the undistributed trust was 60 percent, for example, the old liability would have been $225 million, resulting in an annual tax loss of $75 million ($225 million less $150 million). If this level was maintained for ten years, and discounted at 10 percent, the discounted tax loss would be about $460 million.

The tax loss would have to be balanced against the tax levied upon the distribution of the trust units. If 33 percent of the value of the distributions was taxable as dividends, the tax would be $330 million on a basis of $2.5 billion.[35] Thus, the net present value tax loss would be about $130 million ($460 million - $330 million). On an annualized basis, this would amount to about $20 million per year over ten years. Note that these are illustrative calculations and are based on assumptions that are subject to substantial error.

Although the above calculations suggest that the aggregate tax loss from existing royalty trusts may be rather small, it could be much larger if the major oil corporations created such trusts. For example, in their 1982

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34 The trusts are: Mesa Corporation's Mesa Royalty Trust and Mesa Offshore Trust; Southland Royalty's San Juan Basis Royalty Trust and Permian Basin Royalty Trust; Tenneco's Houston Oil Royalty Trust and Houston Oil Trust; Sabine Corporation's Sabine Royalty Trust; and Louisiana Land and Exploration Company's LL & E Royalty Trust. Another trust has been announced by the Freeport-McMoRan Corporation, but has not yet been distributed.

35 Assuming dividend recipients were in the 40 percent tax bracket.

annual reports, Shell and Arco reported the present value of their domestic reserves (on a Securities and Exchange Commission standardized basis) at $14.7 billion and $12.5 billion, respectively. Two considerations, however, may weigh heavily against major corporations using the royalty trust vehicle. First, the older, established companies have significant earnings and profits and a trust distribution would probably be fully taxed as a dividend. Secondly, the average effective tax rate on oil corporations is probably low and therefore the advantage of escaping the corporate tax is small. As shown above, there may be a Treasury revenue gain if the corporate tax rate is low and the distribution is taxed in full. This is especially important because the trust vehicle results in full current taxation of the royalty income, unlike a corporation in which current income can be retained and subject to much lower capital gains rates when it is realized by shareholders.

PRODUCTION INCENTIVES

The royalty trust vehicle should not inhibit the production and/or the development of oil and gas resources. Although a trust would significantly reduce the distributing firm's future retained earnings, the total capital devoted to petroleum exploration and development might increase. This could happen if the posttax return in the industry increased (because of lower overall taxes) and investors chose to reinvest their trust earnings in oil and gas firms. Instead of raising capital from retained earnings, firms that formed trusts would have to place greater emphasis on the bond and stock markets for financing. As long as the posttax return in the energy industry remained competitive, royalty trusts should not impede the flow of capital to that sector.[36] Moreover, royalty trusts are not limited to the oil and gas industries, and could be extended to coal or other minerals. The same basic considerations that apply to royalty trusts for oil and gas would also apply in these other industries.

There has also been some concern that royalty trusts might affect federal revenues from federally leased lands. Although the royalty trust device could be used for properties under lease from the federal government, the revenue impact would be the same as with private properties. Federal royalty revenues should not be affected unless production from federal lands were to change. As long as the owner of the operating rights

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36 Royalty trusts might actually make capital markets operate more efficiently by removing the built-in incentive for firms to retain earnings. Thus, one result of oil royalty trusts could be to tilt investment decisions away from corporate managers and toward individual investors.

retained a significant interest in the royalty properties, the owner-operator would have an incentive to optimize production over time. Although royalty trusts themselves might affect federal tax revenues, the changes would be the same, whether the lands were held by federal or private owners, all else being equal. Thus, the concerns over royalty trusts are general and are not directly related to the status of the landowner.

CONCLUSION

Royalty trusts provide an opportunity for corporations and their shareholders to reduce their overall taxes on income from oil and gas properties. The creation of a royalty trust is strictly a paper transaction that entails a change in title and tax status of oil and gas interests. The spin-off trust is not economically productive—that is, it does not directly result in any additional oil and gas reserves or production. The overall tax reductions that occur because of the formation of a trust depend heavily on the interaction of several tax code provisions and the taxpaying status of the current corporate shareholders. Although the amount of tax revenues that could be lost through the formation of future trusts is uncertain, the revenue loss on current trusts is probably small. While it is possible that a trust could actually raise tax revenues, such an arrangement would be contrary to the best interests of the current shareholders and probably would not be undertaken. The potential for future oil royalty trusts is uncertain, but the existing trusts raise a number of tax policy issues that the Congress might want to consider in the future.