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QUALIFYING AS AN OIL AND GAS LESSEE IN NORTHERN CANADA

by

Ivan Irwin, Jr.* and
A. B. Conant, Jr.**

*Lofty I stand from each sister land,
patient and wearily wise,
With the weight of a world of sadness
in my quiet, passionless eyes;
Dreaming alone of a people, dreaming
alone of a day,
When men shall not rape my riches,
and curse me and go away; . . .¹*

Canada is receiving widespread publicity this year, particularly by reason of its spectacular centennial year celebrations.² Canada is also receiving a great deal of attention from the oil and gas industry. In a sense, the rush for gold is on again, but this time the search is for black gold in Canada's Yukon and Northwest Territories, believed by many to contain some of the world's largest reserves of oil and gas. Many oil and gas producers now hold exploratory licenses or permits in this vast and sparsely settled region,³ and the chances appear excellent that major strikes will be made during this winter's drilling season.⁴ But if substantial quantities of oil and gas are discovered they will not be exploited at the expense of the Canadians. No longer need there be dreams of a day when men shall not rape these riches, and curse and go away. That day has come. The federal government in Canada, through its laws and regulations governing the exploration and production of oil and gas in the Territories, has seen to it that while foreign companies may easily qualify to perform the expensive and risky job of finding oil and gas reserves, Canadians will have an opportunity to participate in any profits which may result from this modern day rush to the Yukon.

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¹ R. SERVICE, *The Law of the Yukon*.

² The Dominion of Canada came into formal existence on July 1, 1867, following the passage of the British North American Act, 30 Vict. c. 3 (1867). Under the Act, the Queen in Council was empowered to declare by proclamation that what are now the provinces of Ontario, Quebec, New Brunswick and Nova Scotia were to form one Dominion in the name of Canada. Canada now consists of ten provinces and the Yukon Territory and Northwest Territories, a geographical area second only in extent to the vast territories of Russia.

³ The Yukon Territory and Northwest Territories lie to the north of the Canadian provinces, and extend east from Alaska to Greenland, and include all of the islands of the Canadian Arctic archipelago. The Territories comprise some 39 per cent of all Canadian territory. The population of the Territories is only approximately 41,000 out of a total Canadian population of approximately 20 million.

⁴ Strangely enough, in much of the Territories drilling activities are confined to the severe winter months when the ground is hard frozen. During the remainder of the year the presence of numerous deep muskegs makes drilling operations exceedingly difficult if not impossible.

I. EXPLORATION

The development of natural resources in the Territories is governed largely by the Territorial Lands Act,⁵ under which the federal government is authorized to sell, lease or otherwise dispose of all territorial lands which are vested in the Crown or of which the Government of Canada has power to dispose.⁶ Out of every grant of territorial land there is reserved to the Crown all mines and minerals which may be found to exist within, upon or under such lands, together with the right to work the same.⁷ The federal government is authorized to make regulations for leasing of mining rights in, under and upon the territorial lands and the payment of royalty therefor.⁸ Pursuant to this authority, the Canada Oil and Gas Land Regulations and Canada Oil and Gas Drilling and Production Regulations were promulgated in June, 1961.⁹ No one may search for or produce oil, gas or related hydrocarbons (other than coal or valuable stone) except as authorized by these Regulations.¹⁰

As will be seen, it is relatively simple for a United States oil company to qualify as a licensee or permittee under the Regulations and thereby explore for oil and gas, but it is quite another story for such a company to qualify as a lessee under the Regulations and thereby produce and market any oil and gas which have been discovered.

The Regulations cover the granting of non-transferable licenses for the purpose of searching for oil and gas on virtually any territorial lands.¹¹ These licenses expire on the 31st day of March next following the date of their issue. A licensee has, in general, the right to make geological and geophysical examinations, to carry out aerial mapping and to investigate the subsurface. A licensee is forbidden to drill a hole deeper than 1,000 feet without the consent of the federal government unless the lands are included in a permit or lease, in which case the written consent of the permittee or lessee must be obtained.

Further, the Regulations deal with the granting of permits to conduct exploratory operations on specific grid areas.¹² These permits have a term from three to eight years, depending on the location of the permit area, and may be renewed for a term of one year not more than six times. A permittee may do exploratory work for oil and gas and may produce from the lands covered by his permit such quantity of oil and gas as may be necessary for test purposes or for conducting operations on the permit

⁵ CAN. REV. STAT. c. 263 (1952).

⁶ *Id.* § 4.

⁷ *Id.* § 10.

⁸ *Id.* § 7.

⁹ SOR/61-253 CANADA GAZETTE, pt. 2, vol. 95, no. 12, June 28, 1961, amended by Oil and Gas Land Order No. 2-1961, SOR/61-461, and Oil and Gas Land Order No. 2-1961, SOR/61-462. These regulations, issued by the Governor General in Council, on recommendation of the Minister of Northern Affairs and Natural Resources, were also issued under the Public Lands Grants Act, CAN. REV. STAT. c. 224 (1952). The regulations are currently administered by the Minister of Indian Affairs and Northern Development, the Hon. Arthur Laing. [Hereinafter these regulations will be referred to as the OIL & GAS REGS.]

¹⁰ CAN. REV. STAT. c. 263, § 23 (1952).

¹¹ *Id.* §§ 24-29.

¹² *Id.* §§ 30-51.

area. Subject to the Regulations, a permittee has the exclusive option to obtain an oil and gas lease for a portion of the lands described in his permit.¹³

To qualify as a licensee or permittee, it is only necessary for the applicant to be either a person over twenty-one years of age or a company incorporated or licensed to do business in Canada or incorporated in a province of Canada. A foreign oil company can qualify to do business and carry on mining operations in the Territories by obtaining a license from the Secretary of State of Canada pursuant to the provisions of the Canada Corporations Act.¹⁴ The foreign company would file a certified copy of its charter in the office of the secretary of state, designate an agent or manager within the Yukon Territory authorized to represent the company and to accept process on all suits against the company, pay the fixed license fee, and, on penalty of default of its license for failure to do so, make a return to the Secretary of State of all business done by it under its license. Alternatively, the foreign oil company may organize a wholly owned Canadian subsidiary, either as a federal company under the Canada Corporations Act or as a provincial company under the statutes governing incorporation in one of Canada's ten provinces.¹⁵

The foreign oil company or its Canadian subsidiary can also easily meet local territorial requirements for doing business. In the Yukon Territory, the foreign company would register with the Registrar of Joint-Stock Companies,¹⁶ or the Canadian subsidiary would obtain a license from such Registrar.¹⁷ In the Northwest Territories, any company, including foreign companies, may do business upon obtaining a license under the Business License Ordinance.¹⁸ This Ordinance expressly does not apply, however, to businesses operating under a permit or license issued under any act of Parliament governing the administration of Crown lands in the Northwest Territories, so apparently the obtaining of a permit or license by either the foreign oil company, or its Canadian subsidiary, under the Territorial Lands Act would exempt the company from further territorial qualification in the Northwest Territories.¹⁹

¹³ *Id.* §§ 35(1), 56(2).

¹⁴ CAN. REV. STAT. c. 52 (1952); *id.* c. 53 (1952, as amended 1964-65). CAN. REV. STAT. c. 52, § 49 (1964-65) provides that §§ 203-07 are to be repealed on a day to be fixed by proclamation of the Governor in Council.

¹⁵ Provincial companies are organized under the following statutes: Alberta: The Companies Act, ALTA. REV. STAT. c. 53 (1955); British Columbia: Companies Act, B.C. REV. STAT. c. 67 (1960); Manitoba: The Companies Act, MAN. STAT. c. 67 (1960); New Brunswick: Companies Act, N.B. REV. STAT. c. 33 (1952); Newfoundland: The Companies Act, NEWF. REV. STAT. c. 168 (1952); Nova Scotia: Domestic, Dominion & Foreign Corporations Act, N.S. REV. STAT. c. 74 (1954); Ontario: The Corporations Act, ONT. REV. STAT. c. 71 (1960); Prince Edward Island: The Companies Act, PRINCE EDW. IS. REV. STAT. c. 26 (1951); Quebec: Companies Act, QUE. REV. STAT. c. 271 (1964); Saskatchewan: The Companies Act, SASK. REV. STAT. c. 131 (1965).

¹⁶ The Companies Ordinance, YUKON TERR. REV. ORD. c. 19, § 156 (1958).

¹⁷ *Id.* § 151.

¹⁸ NW. TERR. REV. ORD. c. 9 (1956).

¹⁹ It might be pointed out that, as a general rule, a company organized under the laws of one province must meet certain legislative requirements as to licensing or registering before it can do business in another province. This is not always the case, and reference should be made to the specific laws of each province to determine what steps must be taken for a company to conduct business extra-provincially. By virtue of the decision of the Privy Council in *Great W. Saddlery*

Presumably, a United States company and its Canadian subsidiary would be entitled to file in the United States a consolidated federal income tax return under the provisions of section 1504(d) of the Internal Revenue Code of 1954.²⁰ The statutory test would be met inasmuch as the United States corporation would own one hundred per cent of the capital stock of the Canadian subsidiary, and the Canadian subsidiary would be organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property.

II. PRODUCTION

Now let us suppose that ABC Oil Company, a United States corporation, or its Canadian subsidiary, drills a well under its permit which in the opinion of the Canadian federal government is capable of commercial production of oil or gas. The Regulations require a permittee to apply for an oil and gas lease of the area wherein the well is located within one year after notification that the federal government has ordered that the well contains oil or gas in commercial quantities.²¹ Until such application is made, no additional wells may be drilled within four and one-half miles of the well to which the order refers.²²

The Regulations forbid the granting of an oil and gas lease to an individual unless the Minister of Northern Affairs and Natural Resources is satisfied that such person is a Canadian citizen over twenty-one years of age and will be the beneficial owner of the interest to be granted.²³ The Regulations specifically prohibit the granting of an oil and gas lease to any corporation incorporated outside of Canada.²⁴ Thus, ABC Oil Company (together with any American subsidiary it may organize or control) cannot qualify as an oil and gas lessee, nor can legal title to an oil and gas lease be taken for it by any person.

The Regulations then state that an oil and gas lease may not be granted to any corporation unless the Minister is satisfied:

- (i) that at least fifty per cent of the issued shares of the corporation is beneficially owned by persons who are Canadian citizens, or
- (ii) that the shares of the corporation are listed on a recognized Canadian stock exchange and Canadians will have an opportunity of participating in the financing and ownership of the corporation, or

Co. v. The King, 58 D.L.R. 1 (1921), federal companies are on a somewhat different footing. By virtue of the fact that it derives its charter powers under an act of Parliament, a federal company may not be deprived of the right to do business in any of the provinces or territories of Canada. A federal company may be required to register in a province and to pay fees not exceeding those payable by provincial companies, or suffer daily penalties for failure to register, but its right to do business may not be prohibited. Also, a federal company may be required to pay income taxes to the province on income earned in the province. Again, reference should be made to the specific laws on the subject enacted in the various provinces. See also 2 J. MULLIN & R. DAVIES, CANADIAN CORPORATION PRECEDENTS § 18.1.1 (1962).

²⁰ INT. REV. CODE OF 1954, § 1504(d).

²¹ OIL & GAS REGS. §§ 66, 67 (1961).

²² *Id.* § 69.

²³ *Id.* § 55(2)(a).

²⁴ *Id.* § 55(2)(b).

- (iii) that the shares of the corporation are wholly owned by a corporation that meets the qualifications outlined in sub-paragraph (i) or (ii) of this paragraph.²⁵

Thus, as to oil and gas leases issued with respect to permits granted after the effective date of the Regulations, the leaseholder is going to have to be a Canadian corporation, in which (or in whose parent) Canadians have become new partners, either by virtue of a fifty per cent stock ownership or a public offering made to Canadian citizens of shares listed on a recognized Canadian stock exchange.

The Canadian subsidiary of ABC Oil Company cannot qualify, at this point at least, because none of its shares of stock are owned by Canadian citizens. A possible plan is for ABC Oil Company to surrender fifty per cent ownership of its Canadian subsidiary to Canadian citizens. Compliance with this portion of the Regulations certainly will create stockholder problems in the Canadian subsidiary and probably cause a surrender of voting control, for it is doubtful that the Minister would approve of a plan under which Canadians could acquire only non-voting shares, and the marketability of non-voting shares is questionable. Also, under this plan, Canadian investors must be found and a determination made of the selling price of the shares of the Canadian subsidiary, all of which may entail considerable expense and may require compliance with provincial securities legislation.²⁶ A slight variation on this plan would be for ABC Oil Company to syndicate with an already extant Canadian company in the formation of a Canadian corporation to pursue operations in the Territories. This would largely obviate the securities problems and the problem of promoting Canadian investors. Likewise, ABC and its Canadian partner could enter into an extensive agreement concerning the operation of the company which would help alleviate stockholder problems. Of course, ABC would still not be in complete control of its territorial operations and would be compelled to divide the proceeds from any strike on a more or less equal basis.

²⁵ *Id.* § 55(c).

²⁶ There is no Canadian equivalent to the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1933), or the Securities Exchange Act of 1934, 15 U.S.C. §§ 77b-77c, 77j, 77k, 77m, 77o, 77s, 78a-78o, 78o-3, 78p-78hh (1934). Sections 74, 75, 77, 79 and 82 of the Canada Corporations Act relate to the offer and sale of securities by a federal company, and provide for the preparation and filing of a prospectus. Under § 76A of this Act, however, these provisions become superseded by provincial or foreign securities laws. CAN. REV. STAT. c. 263, §§ 74, 75, 76A, 77, 79, 82 (1952).

In 1966 the Province of Ontario adopted The Securities Act, ONT. STAT. c. 142 (1966). In a speech delivered on August 10, 1966, to the North American Securities Administrators, the Hon. Manuel F. Cohen, Chairman of the Securities and Exchange Commission, described this Act as "one of the more sophisticated statutes of its kind in the world."

Modifications of the Ontario Act have been enacted in the Provinces of Alberta, British Columbia, and Saskatchewan, but the same have not been proclaimed in force as of the date of this writing. On the assumption that proclamation will not be long in coming, provincial securities legislation can be listed as follows: Alberta: The Securities Act, 1967, ALTA. STAT. c. 76 (1967); British Columbia: Securities Act, 1967, B.C. STAT. c. 45 (1967); Manitoba: The Securities Act, MAN. REV. STAT. c. 237 (1954); New Brunswick: Securities Act, N.B. REV. STAT. c. 205 (1952); Newfoundland: The Securities Act, NEWF. REV. STAT. c. 1939 (1952); Nova Scotia: Securities Act, N.S. REV. STAT. c. 261 (1954); Ontario: The Securities Act, ONT. STAT. c. 142 (1966); Prince Edward Island: The Security Frauds Prevention Act, PRINCE EDW. IS. REV. STAT. c. 146 (1951); Quebec: Securities Act, QUE. REV. STAT. c. 274 (1964); Saskatchewan: The Securities Act, SASK. REV. STAT. c. 81 (1967).

Another possible disadvantage of the above plans is that the income tax returns of ABC Oil Company and its Canadian subsidiary cannot be consolidated for United States tax purposes, if such subsidiary is owned at least fifty per cent by citizens of Canada.²⁷ Unless the subsidiary can finance operations in the Territories from income derived from other properties in Canada, unrecovered expenditures in connection with oil and gas operations in the Territories may be lost for tax purposes.

Under a second alternative, ABC Oil Company could cause the shares of its Canadian subsidiary to be listed on a recognized Canadian stock exchange and offer to Canadians an opportunity to participate in the financing and ownership of such subsidiary. The Regulations do not prescribe the percentage of shares which must be sold or offered for sale to Canadians or how such shares are to be distributed. The spirit of the Regulations is certainly that a nominal percentage is not intended; moreover, no stock exchange is going to list the shares for trading absent a reasonably wide distribution of the shares. But the authors believe that the minister will approve plans calling for less than fifty per cent of the shares to be offered for sale to Canadians. In any event, ABC Oil Company and its now publicly held Canadian subsidiary will not be entitled to file consolidated federal income tax returns in the United States under this alternative either, since the foreign corporation is not wholly owned by its domestic parent.²⁸ Under this plan minority stockholder problems may still arise, although control of the subsidiary may not be lost, and there obviously is the considerable expense of going public in Canada. Although theoretically it might be possible to register under any one of the securities acts in force in the Canadian provinces, as a practical matter distribution probably could only be accompanied in Ontario, Quebec, and possibly British Columbia, on an underwriting of any appreciable size.

A third possible plan would be to have the oil and gas lease issued under the Regulations to the Canadian subsidiary after ABC Oil Company itself makes a public offering in Canada and is listed on a recognized Canadian stock exchange. So long as ABC Oil Company retains complete ownership of the shares of the subsidiary, the consolidated income tax return problem should be overcome. However, ABC Oil Company is now faced with the problem of minority stockholders as well as the expense of registration of its securities. If ABC Oil Company is already a publicly held company, it may not have any violent objections to updating its current prospectus for Canadian registration purposes and in making the necessary disclosures under one of the provincial securities acts. On the other hand, if ABC Oil Company is a closely held company, it may have serious reservations in these respects.

ABC Oil Company can avoid going public itself under a dual-subsi- diary approach. ABC Oil Company could organize in the United States a subsidiary as Subsidiary A, which would become qualified to do business in

²⁷ INT. REV. CODE of 1954, § 1504(a).

²⁸ *Id.*

Canada. To Subsidiary A would be transferred the exploratory permits held in the Territories,²⁹ plus any other Canadian properties which ABC owned and wished to convey to the subsidiary. In exchange, ABC Oil Company would receive at least eighty per cent of the shares of stock authorized by the Articles of Incorporation of Subsidiary A. Subsidiary A would then cause to be formed a Canadian company, as Subsidiary B, for the purposes of exploring, drilling and acquiring leases in the Territories. Subsidiary A would then transfer to Subsidiary B the exploratory permits in the Territories, in return for which Subsidiary A would own one hundred per cent of the capital stock of Subsidiary B. If and when drilling operations conducted by Subsidiary B in the Territories are successful and production in commercial quantities obtained, and subject to approval by the Minister, the remaining twenty per cent or less of the shares of stock of Subsidiary A would be offered by that company to Canadian investors and the shares of Subsidiary A would be listed on one or more of the Canadian stock exchanges.³⁰ If the plan is consummated as set out above, the lease-holding company would be the Canadian Subsidiary B which has a parent, Subsidiary A, listed upon a Canadian stock exchange. Subsidiary A, being a domestic corporation, would not have to be wholly owned by ABC Oil Company in order to be an "includible corporation" for the purpose of filing a consolidated tax return, as long as ABC Oil Company retains at least eighty per cent of its voting power. In accordance with section 1504(b) of the Internal Revenue Code of 1954, the accounts of both Subsidiary A and Subsidiary B should be includible in a consolidated return with ABC Oil Company.³¹

If a public offering is made by ABC Oil Company or an American subsidiary, there might have to be a simultaneous registration with the Securities and Exchange Commission in the absence of a "no action" letter, in view of the 1964 Securities and Exchange Commission Release No. 4708.³² There the Commission states that "a distribution of securities by a United States corporation, through the facilities of Canadian stock exchanges may be expected to flow into the hands of American investors and may, therefore, be subject to registration."³³

It is submitted that registration under the Securities Act of 1933 should not be required of an American corporation making a public distribution of its securities in Canada in compliance with the Regulations, particularly

²⁹ Under § 74 of the regulations a permit may be transferred upon registration with the approval of the Chief, Resources Division, Northern Administration Branch of the Department of Northern Affairs and Natural Resources. OIL & GAS REGS. § 74 (1961).

³⁰ There are six operating stock exchanges in Canada as follows: The Montreal Stock Exchange, The Canadian Stock Exchange, The Toronto Stock Exchange, The Winnipeg Stock Exchange, The Vancouver Stock Exchange, The Calgary Stock Exchange. Steps are currently under way to establish the Atlantic Stock Exchange in Halifax, Nova Scotia. Of these, the Toronto Stock Exchange is by far the largest. In 1966, it handled 67.91 per cent of the value of all transactions on all Canadian stock exchanges, and 58.87 per cent of the volume of shares traded on all Canadian stock exchanges. It might be noted that trading on Canadian exchanges is confined to equity securities and that debt securities are left to the Canadian over-the-counter market.

³¹ INT. REV. CODE OF 1954, § 1504(b).

³² A "no action" letter exempts an offering from registration as a matter of administrative relaxation. SEC Release No. 4708 (July 9, 1964).

³³ *Id.*

if the securities have been registered with a provincial security commission, the securities are listed on a recognized Canadian stock exchange, and adequate safeguards have been provided to prevent the securities from coming into the hands of American investors during the course of primary distribution.³⁴ Some of the reasons why registration under the Securities Act of 1933 should not be required may be summarized as follows:

(1) Securities and Exchange Commission Release No. 4708 apparently has reference to primary distribution "through the facilities of Canadian stock exchanges," a practice once common in Canada and which deserves some attention. For example, until the 1966 Act, the province of Ontario had in force The Securities Act.³⁵ The Act required that a prospectus, containing certain disclosures relating to the security, be filed with the Ontario Securities Commission, before any person or company could trade in any security issued by a mining company where such trade would be in the primary course of distribution to the public.³⁶ Sales or offers to sell securities which were listed and posted for trading on any recognized stock exchange "where such securities are sold through such stock exchange" were exempted.³⁷ The majority of mining companies took advantage of this exemption, and used the facilities of the Toronto Stock Exchange, for example, to sell their securities without the necessity of filing a prospectus with the Ontario Securities Commission, or making any disclosures except for the information required to be furnished to the Toronto Stock Exchange in a filing statement. As a result, the stock exchange would act outside of its usual function of providing a market place for purchases and sales of securities, and actually would assist listed mining companies in the sale of their shares to the public. This system, in which primary and secondary distribution of securities might be going on at the same time, came into a great deal of abuse. Securities and Exchange Commission Release No. 4708 appears to have been primarily directed towards this practice.³⁸

The 1966 Ontario Act prohibits trading in the course of primary distribution to the public until there has been filed with the Ontario Securities Commission a preliminary prospectus and a prospectus with respect to the security.³⁹ This prohibition does not apply to securities that are listed and posted for trading on a stock exchange recognized by the Ontario Securities Commission if such securities are distributed to the public through the facilities of such stock exchange pursuant to the rules of such stock exchange and the requirements of the Commission and if a Statement of Material Facts is filed with and acceptable to the stock

³⁴ Restrictions on ownership and transferability of shares to prohibit Americans from participating in the initial distribution are not easily worked out in practice, since the substantive and mechanical aspects must be approved by the underwriter, transfer agent, stock exchange, SEC, and, last but not least, the issuer.

³⁵ ONT. REV. STAT. c. 363 (1960).

³⁶ *Id.* § 38.

³⁷ *Id.* § 41.

³⁸ See text accompanying note 32 *supra*.

³⁹ ONT. REV. STAT. c. 142 (1966).

exchange and the Commission.⁴⁰ Under the Regulations of the 1966 Act, the March 1967 Bulletin of the Ontario Securities Commission, and a statement of policy issued by the Toronto Stock Exchange,⁴¹ the information and financial statements required in such a Statement of Material Facts are almost as detailed as the information required in a preliminary prospectus and prospectus. Accordingly, the practice of making primary distributions to the public through the facilities of the Toronto Stock Exchange rather than by registration with the Ontario Securities Commission is no longer an inviting escape from customary registration and disclosure requirements and probably will become quite uncommon.

In any event, registration of the shares with the Ontario Securities Commission, for example, should render Release No. 4708 inapplicable.⁴²

(2) Since the American corporation making a public distribution in Canada would not be making a sale or offer to sell securities within the United States or to United States citizens, there should be no use for a prospectus prepared in accordance with the Securities Act of 1933. In this connection, should registration in the United States be required, two separate prospectuses would have to be prepared, because of different requirements of Canadian and American laws. For example, there are substantial differences in accounting and tax treatments and techniques in the United States and in Canada, besides the difference in monetary unit.⁴³

(3) United States policy considerations could be served by exempting the distribution from registration in the United States. These considerations are illustrated by the recommendations and comments contained in the *Report of the Presidential Task Force on Promoting Increased Foreign Investment in United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad*.⁴⁴ This task force was appointed by President Kennedy to investigate and make recommendations concerning methods by which the United States balance of payments deficit might be alleviated. The task force recommends that "[a]s long as adequate disclosures are made when issues are being offered abroad, there should be no need to go through the formality and expense of registration in the United States."⁴⁵

The task force also advises that "[e]fforts by the private business community to market corporate securities to foreign investors and to increase the availability of foreign financing for U.S. corporations operating abroad should be accompanied by U.S. Government efforts to produce existing deterrents to these activities which arise from practices, regulations and law here and abroad."⁴⁶

⁴⁰ *Id.*

⁴¹ *Id.* Statement of policy regarding primary distribution through the facilities of the Toronto Stock Exchange under the provisions of the Securities Act, 1966, Toronto Stock Exchange Release, May 1, 1967 (under the authority of W. L. Somerville, Executive Vice President).

⁴² E.g., Toronto Stock Exchange, Rul. No. 15 (July 30, 1965) provides that listing of a security of a mining or oil and gas company shall not be granted unless the security has been approved by or registered with a security commission either in Canada or the United States.

⁴³ See text accompanying notes 50-70 *infra*.

⁴⁴ 29 Fed. Reg. 9828 (1964).

⁴⁵ *Id.*

⁴⁶ *Id.*

A requirement by the Securities and Exchange Commission that securities be registered in the United States as well as in Canada under these circumstances could virtually double the cost involved and might well discourage American companies from engaging in the oil and gas business in the Territories. This result would not only foreclose the increased foreign investment in American companies found desirable by the task force, but, in the event of a strike in the Territories, would prevent proceeds thereof from being funneled into the United States.

(4) Finally, there are critical time factors involved in qualification under the Regulations, which registration in the United States would greatly hamper.⁴⁷

At least three other plans have, from time to time, been suggested by persons interested in territorial operation and development. These plans all entail the use of a "front" corporation which is qualified to be a leaseholder under the Regulations and which, after obtaining a lease, transfers beneficial interest in it to the United States corporation. The beneficial interest would be bestowed upon the United States corporation by (1) declaration of trust for the benefit of the United States corporation by the leaseholding corporation, or (2) sublease to the United States corporation by the leaseholding corporation, or (3) an assignment of all or substantially all of the net profits from lease operations to the United States corporation in consideration for the furnishing by the United States corporation of all or substantially all of the operating and development expenses. The validity of each of these plans depends upon the meaning of the word "transfer" as used in the Regulations, which forbid any "transfer" of a lease to one not qualified to have been an applicant for a lease.⁴⁸ It would appear that the sublease approach would clearly constitute a forbidden transaction under any interpretation of this term and would be void.⁴⁹ If the term "transfer" refers only to transfers of legal title and not transfers of equitable title, then perhaps the "trust" and the "net profits" plans might technically comply with the Regulations. However, each of these "front" company plans appears on its face to be counter to the obvious purpose of the Regulations, *i.e.*, to insure substantial Canadian participation in territorial development.

III. TAX CONSEQUENCES

While it is not the function of this Article to discuss in detail the tax consequences, United States and Canadian, which arise from the utilization of any of the plans discussed above, some unique features of Canadian tax law should be noted. First, the United States attorney will be surprised to find that the so-called "tax free reorganization" available in the United States under sections 351 and 354 of the Internal Revenue Code⁵⁰ does

⁴⁷ See OIL & GAS REGS. § 67(2), 69 (1961).

⁴⁸ See *id.* §§ 72-74.

⁴⁹ See *id.* § 73(2).

⁵⁰ INT. REV. CODE of 1954, §§ 351, 354.

not exist in Canadian law. This means, of course, that the transfer of any Canadian properties from ABC Oil Company to its subsidiary, Canadian or United States, will be treated as a sale in Canada. Section 139(1)(a) of the Canadian Income Tax Act indicates that the amount received from a sale would include "money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing."⁵¹ It appears, therefore, that the value of the subsidiary's stock received by ABC would be deemed to be the sales proceeds from the Canadian properties transferred to the subsidiary. In addition, section 17 of the Canadian Income Tax Act requires that, for the purposes of computing the taxpayer's income, purchases from and sales to persons with whom the taxpayer is not dealing at arm's length will be deemed to have been at the "fair market value" of the item purchased or sold.⁵² Thus, it would appear that all property and stock transferred between ABC Oil Company and its subsidiary must be conveyed at fair market value and not at cost or on some other basis. The sales proceeds will be treated as ordinary income in Canada to ABC Oil Company.⁵³

If ABC has a drilling and exploration expense carryforward in Canada equal to or exceeding the value of the Canadian properties which it transfers to its subsidiary, the transfer apparently may be effected without adverse Canadian tax consequences. It appears that ABC may use this carryforward to offset the income which it realizes from the transfer of assets to the subsidiary. If the carryforward exceeds the value of the properties transferred to the subsidiary and if ABC has transferred all or substantially all of its properties to the subsidiary, the excess carryforward may be utilized by the subsidiary in subsequent taxable years. On the other hand, if ABC has not transferred all or substantially all of its Canadian properties to the subsidiary, it will retain the excess carryforward.⁵⁴

United States attorneys and accountants will also be surprised to learn that the subsidiary may deduct, as a drilling or exploration expense, the value of its stock issued for the oil and gas properties acquired from ABC.⁵⁵ Thus, even if the subsidiary does not receive all or substantially all of ABC's Canadian properties and thereby acquire ABC's excess loss carryforward, if any, it does have an expense with which to offset future income.

If the value of the Canadian properties which ABC wishes to transfer

⁵¹ Canadian Income Tax Act, CAN. REV. STAT. c. 148, § 139(1)(a) (1952 as amended).

⁵² *Id.* § 17.

⁵³ *Id.* § 83A(5b).

⁵⁴ *Id.* §§ 83A(3b), (8a). The interpretation of these subsections given in the text is the consensus of tax authorities with whom the authors of this Article have conferred. Readers should be warned, however, that the interpretation is inferential only. An amendment to § 83A(8a), applicable to taxation years ending after April 10, 1962, deleted the words which, according to the decision of the Exchequer Court of Canada in *Hargal Oils, Ltd.*, 1962 C.T.C. 534, prohibited a predecessor corporation from deducting any drilling and exploration expenses in the taxation year in which its property was acquired by a successor corporation. Because of this amendment, Canadian tax experts reason that a predecessor corporation may now offset its expense carryforward against income realized from the sale in the year of the sale.

⁵⁵ Canadian Income Tax Act, CAN. REV. STAT. c. 148, § 83A(5a) (1952 as amended).

to its subsidiary exceeds the value of its drilling and exploration expense carryforward, ABC would realize taxable income in Canada.⁵⁶ As an alternative, it has been suggested that these properties be transferred to the subsidiary as a "contribution to capital." The theory is that, inferentially, under section 83A(5b) of the Canadian Income Tax Act, ABC Oil Company may "gift" its subsidiary with the properties and, having received no consideration, realize no income.⁵⁷ This so-called "gift" appears to the authors to be more semantic than real, particularly if stock is issued to ABC at or about the same time as the properties are transferred or if ABC is the only shareholder of the corporation at the time the "contribution to capital" is made. Again, section 17 might have some bearing on the validity of this plan, although it does not specifically refer to gifts.⁵⁸ The authors have been told, however, that such an approach has been successfully utilized in a similar situation. In any event, it is suggested that a ruling on the subject be sought from the Department of National Revenue of Canada before the contribution is made.

There is no provision in Canadian law for consolidated tax returns, but, under some circumstances, a subsidiary may "renounce" expenses to its parent. Sections 83A(3d) and (3e), Canadian Income Tax Act, provide that a "joint exploration" corporation may renounce part or all of its geophysical, drilling and exploration expenses to certain of its shareholder corporations.⁵⁹ A "joint exploration" company is defined as a "petroleum" corporation which has never had more than ten shareholders since the time of its incorporation, excluding persons holding shares to qualify as directors.⁶⁰ A petroleum corporation is a corporation whose principal business is production, refining or marketing of petroleum, petroleum products or natural gas, or exploring or drilling for petroleum or natural gas.⁶¹ The shareholder must also be a petroleum corporation and must have made payments to the joint exploration corporation in respect to the expenses incurred by it.⁶² The amount of expense renounced to the shareholder corporation may not exceed the payments made by such shareholder to the joint exploration company and any income received by the subsidiary must be deducted from its expenses prior to such expenses being renounced to the shareholder.⁶³

The provisions regarding the joint exploration company do not, of course, solve the tax problem which will occur if the subsidiary makes a large strike and generates income in excess of its expense carryforward. It is assumed that, in Canada, this income will be ordinary income subject to the Canadian depletion allowance, which is 33 1/3 per cent of net in-

⁵⁶ *Id.* § 83A(5b).

⁵⁷ *Id.*

⁵⁸ See text accompanying note 52 *supra*.

⁵⁹ Canadian Income Tax Act, CAN. REV. STAT. c. 148, §§ 83A(3d), (3e) (1952 as amended).

⁶⁰ *Id.* § 83A(3e)(a).

⁶¹ *Id.* § 83A(3b).

⁶² *Id.* § 83A(3e)(b).

⁶³ *Id.* §§ 83A(3c), (3d).

come to operators⁶⁴ and 25 per cent to non-operators.⁶⁵ In addition, a 15 per cent withholding tax will be payable on dividends declared by the subsidiary.⁶⁶ This tax reduces to 10 per cent if not less than 25 per cent of the subsidiary is owned by, and not less than 25 per cent of its board of directors is comprised of, Canadian residents.⁶⁷ If ABC has theretofore done business in the provinces, through a branch operation, it will find the withholding tax somewhat offset by the fact that it will no longer owe the 15 per cent branch tax.⁶⁸ Should the strike be so large that the consolidated return in the United States is substantially affected, ABC Oil Company should investigate the possibilities of its subsidiary qualifying as a "western hemisphere trade corporation" under sections 921 and 922 of the Internal Revenue Code.⁶⁹ These provisions, in brief, provide for a lower tax rate on a domestic corporation⁷⁰ which does its entire business in any country or countries in North, Central or South America, and derives ninety-five per cent or more of its gross income from sources outside the United States.

The above survey of tax consequences which arise from operation in the Northwest Territories is by no means intended to be comprehensive, either with regard to United States or Canadian taxes, but merely to suggest the myriad problems with which ABC's attorneys will be faced.

The oil and gas attorney can readily see that if his client wishes to operate in Northern Canada, he must rapidly retain or become an expert in many fields. While he can no longer rape the riches of the Yukon, he may yet curse it as a many faceted conundrum.

⁶⁴ *Id.* § 11(1)(b)(2a); Income Tax Regulations, Order-in-Council 1954-1917, SOR/54-682, pt. XII, § 1201(2), dated Dec. 8, 1954, published Jan. 12, 1955, applicable to 1954 and subsequent taxation years [hereinafter referred to as Income Tax Regulations] (1954 as amended).

Id. pt. XII, § 1201(1)(b) (1954 as amended), defines an operator as one who has an interest in the proceeds of production from a resource, under an agreement providing that he shall share in the profits remaining after deducting the costs of operating the resource.

The future of the Canadian depletion allowance is somewhat cloudy. The recent Report of the Royal Commission on Taxation, popularly called "The Carter Commission" (Kenneth LeM. Carter, Chairman), recommended to the federal government that the operator's depletion allowance be abolished. 4 REPORT OF THE ROYAL COMMISSION ON TAXATION, 331, 333, 335-38, 347 (1966). This recommendation was severely criticized by G. David Quirin on the grounds that it was confiscatory as to presently producing properties and would diminish incentive to develop marginal properties. CANADIAN TAX FOUNDATION, REPORT OF THE PROCEEDINGS OF THE 19TH TAX CONFERENCE (April 1967).

An article in the Toronto Globe & Mail, Aug. 2, 1967, reports that Imperial Oil, Ltd., has suspended its exploration program in the Northwest Territories because of uncertainty about the government's position with regard to the depletion allowance.

⁶⁵ Income Tax Regulations, pt. XII, §§ 1202(1), (2) (1954 as amended).

⁶⁶ Canadian Income Tax Act, CAN. REV. STAT. c. 148, § 106(1a)(a) (1952 as amended).

⁶⁷ *Id.* §§ 106(1a)(b), 139A.

⁶⁸ *Id.* § 110B(1).

⁶⁹ INT. REV. CODE of 1954, §§ 921-22.

⁷⁰ A "domestic corporation" is not only one incorporated in the United States, but also a wholly owned Canadian or Mexican corporation if it is organized and maintained solely for the purpose of complying with the laws of either country as to title and operation of property, and if so treated for consolidated return purposes by a United States corporation owning or controlling 100 per cent of its capital stock. Rev. Rul. 55-372, 1955-1 CUM. BULL. 339.