

FEDERAL INCOME
TAX CONSIDERATIONS IN
OIL AND GAS COMPANY ACQUISITIONS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION

OF THE

COMMITTEE ON FINANCE

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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. FEDERAL INCOME TAX POLICY.....	4
III. PRESENT LAW	7
A. Forms of Acquisition.....	7
1. Taxable asset acquisitions	7
2. Taxable stock acquisitions.....	9
3. Tax-free reorganizations.....	14
B. Certain Financing Aspects.....	14
IV. POSSIBLE CHANGES IN THE APPLICABLE TAX RULES.....	18

INTRODUCTION

The Subcommittee on Energy and Agricultural Taxation of the Committee on Finance has scheduled a public hearing on April 5, 1984, on Federal income tax considerations in oil and gas company acquisitions. This pamphlet, prepared in connection with the hearing, provides a description of some of those considerations.

The first part of the pamphlet contains a summary of recent acquisition activity involving oil and gas companies and of present law. The second part provides a brief discussion of the role of Federal income tax policy in oil and gas company acquisitions. The third part describes present law in more detail. The fourth part discusses possible changes in the applicable Federal income tax rules.

I. SUMMARY

Recent activity involving oil and gas company acquisitions

Recent years have seen a large increase in the number of acquisitions, and proposed acquisitions, of large, publicly-held corporations engaged in exploration for and development of oil and gas properties and in refining. Some of the acquiring corporations have not been engaged in oil and gas activities, while others have been. In at least most cases, the price paid or to be paid for the stock of the acquired company reflects a substantial premium over recent New York Stock Exchange prices for such stock.

One recent widely-publicized acquisition was the acquisition of Marathon Oil by U.S. Steel in 1982. Others include Shell's acquisition of Belridge Oil, Dupont's purchase of Conoco, and Occidental Petroleum's acquisition of Cities Service. More recently, Texaco Oil has announced plans to acquire Getty Oil, the Standard Oil Company of California (Socal) has tendered for all the stock of Gulf, and Mobil Oil has announced plans to acquire Superior Oil. Finally, just last week, Marathon disclosed a plan to buy the U.S. operations of Husky Oil, and Shell Oil announced that a proposal for the acquisition of 30 percent of its stock by its European parent, the Royal Dutch Shell group, was inadequate. If Socal acquires all the stock of Gulf, the transaction, at \$80 per share, would total over \$13 billion, the largest corporate combination in history.

This activity obviously raises a number of issues. They include: (1) why do potential acquiring corporations value potential acquired companies substantially higher than does the public market; (2) what are the anti-trust implications of a particular acquisition or a pattern of acquisitions; (3) what will be the effect of the acquisitions on oil and gas exploration and development activities; (4) whether, given the nature of the oil and gas business, acquisitions of oil and gas companies may in fact be in the public interest; and (5) whether various applicable Federal policies may not be in conflict with one another. Another issue concerns what effect, if any, Federal income tax laws have on the recent activities involving oil and gas companies. Many believe the current Federal income tax laws subsidize or encourage the acquisition of oil and gas companies.

Present law

Most of the recent activity appears to involve taxable transactions. That is, sellers receive either cash or installment obligations from the acquiring corporation. Frequently, the acquiring corporation borrows from third-party lenders much of any cash to be paid. In any case where the buyer borrows money to do the transaction, from the sellers or a third party, interest paid or accrued on the debt is deductible. Furthermore, the allocation of such interest ex-

pense to domestic or foreign source income can affect allowable foreign tax credits. In a case where installment obligations are issued, recognition of gain to the sellers is deferred although the acquiring corporation will frequently be entitled to current tax benefits with respect to the purchase price payable. Sometimes the installment obligations bear stated interest at a below-market rate.

In the case of most taxable acquisitions of oil and gas companies, the parties can structure it so that the transaction will not be fully taxable to the target company but the acquiring corporation will be able to obtain a new fair market value basis in the assets involved, with resulting future tax benefits. Whether the transaction will be structured in that fashion depends on a great number of factors.

The acquisitions can also be done as tax-free reorganizations, in which the acquiring corporations generally issue shares of their stock to the sellers. Generally, reorganization transactions are tax-free to all parties involved. Furthermore, the acquiring corporation generally succeeds to the acquired corporation's basis in the property acquired. Finally, dividends paid on any stock issued in the reorganization will give rise to a dividends received deduction for most corporate holders of such stock.

II. FEDERAL INCOME TAX POLICY

As indicated in Part I, an important issue raised by the recent acquisitions of oil and gas companies is the extent to which the Federal income tax laws have encouraged such acquisitions. Another is whether the economic impacts of such acquisitions are beneficial or harmful.

Effect of Federal income tax laws

The Federal income tax law contains a number of rules that affect oil and gas company acquisitions. Some of them may encourage acquisitions, and others may discourage them. The principal tax disadvantage from a taxable takeover is that it generally triggers taxation of capital gain to the shareholders of the acquired company, a tax which might otherwise have been deferred or eliminated. Naturally, the impact of the capital gains tax depends on the tax situation of the shareholders: it does not affect tax-exempt shareholders, like pension funds, and it is less of a deterrent to shareholders in lower tax brackets. The principal tax advantages of a taxable acquisition are the ability of the acquiring corporation to elect to step up the basis of the assets of the acquired company to reflect appreciation and write that higher basis off through future depreciation or depletion deductions without a corporate-level tax ever being paid on much of the appreciation; the ability of the companies to file consolidated tax returns (which they can do after certain tax-free reorganizations as well); the ability of the acquiring corporation to take interest deductions with respect to debt incurred to finance the transaction; and the ability of domestic corporate shareholders to claim dividends received deductions with respect to any stock used by the acquiring corporation in connection with the acquisition. Furthermore, certain Federal income tax laws, such as those relating to royalty trusts,¹ have had the effect of encouraging proxy fights or tender offers that have driven a company to look for a "white knight" to take it over.

Under these circumstances, while it may be desirable to have an income tax law that is neutral with respect to oil and gas company or other acquisitions, neutrality is likely to prove to be an elusive goal. The net effect of the income tax law is likely to be to encourage some acquisitions and discourage others, depending on the tax

¹ In addition to the Federal income tax laws directly affecting oil and gas company acquisitions, various other features of the tax law have had a significant indirect impact. For example, the tax advantages associated with royalty trusts have encouraged investors to accumulate stock in major oil companies with the intention of spinning off a royalty trust. Because of the tax laws, individual shareholders may be hurt when a royalty trust is created; therefore, they are motivated to sell their stock to corporations or tax-exempt investors. Once the company's stock is heavily concentrated in the hands of a relatively small number of institutional investors, many of whom are interested in short-run profits or tax advantages, the company is easy prey for a takeover bid and thus is forced to search for a "white knight" company to take it over. Relevant provisions of the law are addressed in tax reform bills agreed to by both tax-writing committees and are not discussed in this pamphlet.

profiles of the companies involved and their shareholders. Therefore, in practice, the question is whether to tilt the present system more or less toward encouraging or not encouraging acquisitions, recognizing that changes that will reduce the existing tax incentives in certain cases may increase the tax penalties in other cases.

Effect of tax treatment of dividends

Present law generally imposes a double tax on corporate-source income distributed as dividends. The income is taxed first to the corporation and again to ultimate shareholders (unless they are tax-exempt) when it is distributed (assuming the corporation has earnings and profits). However, when a corporation has appreciated property (like oil and gas reserves), the corporate-level tax on significant appreciation can often be avoided in an acquisition.

These rules have two principal impacts on acquisition incentives. First, a corporation with earnings in excess of what it needs in its own immediate business is faced with at least the following choices: paying out high dividends; repurchasing its own stock; or acquiring another company. Oil and gas companies have been doing all three of these things, but the tax system discourages the payment of dividends, and, from the standpoint of the managers of a corporation, stock repurchases, which involve shrinking the company, may not be as attractive as an acquisition. Second, for a company with appreciated assets, a corporate-level tax on the appreciation can be avoided, in certain cases, by being taken over. Furthermore, the shareholders of a company which is taken over will generally realize capital gain, rather than dividend income, in the transaction.

To a large extent, the double tax system gives rise to these incentives.

Economic impact of oil and gas company acquisitions

Oil and gas company acquisitions have a variety of economic impacts. Acquired companies may function more or less efficiently together than they did apart, depending on the situation. Since the main gains or losses from changes in efficiency are likely to devolve upon the shareholders, this is not necessarily an issue for tax or other public policy. Also, there may be antitrust issues affecting particular wholesale or retail markets. These also vary from case to case and are best addressed through antitrust, not tax, policies.

A significant nontax motive for acquisitions has been that the stock market, in recent years, has placed a relatively low value on the oil and gas reserves of major oil companies. This may be a result of the double tax on dividend income, since ordinarily the income an oil company would earn from these reserves normally would be subject to both a corporate-level tax and a shareholder-level tax. The low valuation of these oil and gas reserves may also be a result of the market's judgment that the oil and gas companies, for nontax reasons, are not likely to be sufficiently profitable in the long run.

When the market valuation of oil and gas reserves is low, and the expected yield on oil and gas down, the incentive for drilling is reduced. Why should an oil company spend, say, \$10 to find a barrel of oil when the stock market is going to value that barrel at

only, say, \$6? Instead, oil reserves may be obtained more cheaply by acquiring an oil and gas company than by actual exploration and drilling activities. Under these circumstances, oil and gas company acquisitions may perform a valuable function of raising the market value of many oil and gas companies, in relation to the costs of finding oil, giving them a larger incentive to drill for new oil and gas.

III. PRESENT LAW

A. Forms of Acquisition

Assets held by a corporation can be acquired by another corporation by means of a taxable acquisition of assets, a taxable acquisition of stock, or a tax-free reorganization.

1. Taxable asset acquisitions

Acquisitions from non-liquidating corporations

An acquiring corporation can acquire part or all of an acquired corporation by acquiring the assets of such corporation. Such an acquisition can take the form of a purchase in exchange for cash, notes, stock of the acquiring corporation, or other property, or any combination of the foregoing, in a transaction that is taxable to the acquired corporation.

In the event the acquired corporation is not liquidated as part of the transaction, it will recognize gain or loss in an amount equal to the excess of the amount realized with respect to each asset sold (on the amount of money plus the fair market value of other property received for each such asset over the corporation's adjusted basis in such asset). To the extent the assets transferred are capital assets in the hands of the acquired corporation, any gain is generally capital gain except to the extent of any recapture income under sections such as sections 1245, 1250, and 1254. The recapture rules treat part or all of any gain as ordinary income to the extent of deductions previously taken against ordinary income with respect to particular property.

Under sections 1245, 1250, and 1254, part or all of the gain, if any, recognized on the transfer of section 1245 property (certain depreciable personal property and real property), section 1250 property (certain depreciable real property), or section 1254 property (certain oil, gas, or geothermal property), is recaptured and treated as ordinary income to the acquired corporation.

Under section 1245 the recapture amount is generally the lesser of the gain on the disposition of the property or the depreciation taken with respect to such property. Under section 1250, the recapture amount is generally the lesser of the gain on the disposition of the property or the depreciation taken with respect to such property in excess of straight-line depreciation. However, for post-1980 nonresidential rental property, the recapture amount under section 1250 is the lesser of the gain on disposition or post-1980 depreciation taken unless the property was depreciated on a straight-line basis, in which case there is no recapture. The recapture amount under section 1254 is generally an amount equal to the intangible drilling costs deducted with respect to such property in excess of the amount of such costs which would have been recovered had

they been capitalized and recovered through cost depletion. However, there is no recapture with respect to intangible drilling costs deducted before January 1, 1976. In the case of a disposition of mineral property, there is no recapture other than recapture under section 1254. Neither cost nor percentage depletion, for example, is recaptured.

Furthermore, some or all of the assets sold may have qualified for the investment tax credit when originally acquired by the acquired corporation. If such property is disposed of prior to the close of the useful life taken into account in computing the amount of the credit (or the recovery period in the case of property eligible for ACRS), a portion of the investment tax credit is recaptured and included, dollar-for-dollar, in the acquired corporation's tax liability. This recapture occurs whether the property involved is sold at a gain or a loss.

In the case of a taxable acquisition of assets from a non-liquidating acquired corporation, the acquiring corporation takes a cost basis in the acquired assets. As a result, it will realize tax benefits in the future through, for example, higher depreciation and cost depletion deductions than would have been allowed to the acquired corporation in the absence of an acquisition. The acquiring corporation does not succeed to the tax attributes (e.g., net operating losses and earnings and profits) of the acquired corporation, which remain with that corporation. However, the acquired corporation, for example, can use its net operating losses to offset income from the sale.

Acquisitions from liquidating corporations

The tax cost to the acquired corporation in a non-liquidating sale of assets that have appreciated is likely to be great, since all gain or loss is recognized. Therefore, acquired corporations selling all or most of their assets usually do so, in bulk, as a part of a liquidating sale. In the case of certain taxable liquidating sales by acquired corporations, gain or loss is generally not recognized to the acquired corporation on the sale of its assets (sec. 337).² Furthermore, as a general rule, no gain or loss is recognized to the acquired corporation on its liquidation, although gain or loss is recognized on the liquidation by the shareholders of the acquired corporation, usually as capital gain or loss.

However, gain is recognized to an acquired liquidating corporation on the sale of its assets (or on the distribution to its shareholders of any retained assets) to the extent that there is recapture income under sections such as sections 1245, 1250 or 1254, as discussed above. In general, amounts recaptured on the sale or liquidation are taxed to the acquired corporation at ordinary income rates. In addition, if the acquired corporation used the LIFO method to account for inventory, the acquired corporation recognizes ordinary income in an amount equal to the LIFO recapture

² Under section 337, gain or loss is generally not recognized to an acquired corporation on a sale or exchange of property if the sale or exchange occurs within a 12-month period beginning on the date the corporation adopts a plan of complete liquidation and, within such period, all of the assets of the acquired corporation, less assets retained to meet claims, are distributed in complete liquidation of the acquired corporation. Section 337 is not applicable to a corporate subsidiary unless all corporations in the chain above it are also liquidated.

amount (in general, the amount by which the FIFO carrying costs of such inventory would exceed their LIFO amount had they been accounted for on a FIFO basis) with respect to such inventory assets. In addition, investment tax credits may be recaptured, as described above.

As in the case of an acquisition from a non-liquidating acquired corporation, the acquiring corporation takes a cost basis in the acquired assets. Furthermore, the acquiring corporation does not succeed to the tax attributes of the acquired corporation, even though the acquired corporation is liquidated as part of the transaction.

The rules applicable to liquidating sales of assets are much more generous than those applicable to non-liquidating sales. In either case, the acquiring corporation takes a cost, or fair market value, basis in the acquired assets. However, in the case of a liquidating sale, only recapture items are recognized as income. As a result, if the assets involved have appreciated substantially in value, much of that appreciation will go untaxed at the corporate level. Moreover, as described above, recapture income may not include all previously taken ordinary income deductions although, in particular cases, recapture income may be onerous.

2. Taxable stock acquisitions

Acquisitions treated as stock acquisitions

An acquiring corporation can acquire a corporation by acquiring the stock of such corporation from its shareholders in exchange for cash, notes, stock of the acquiring corporation, or other property, or any combination of the foregoing, in a transaction that is taxable, generally at capital gains rates, to the acquired corporation's shareholders. In such event, absent an election to treat the stock acquisition as an asset acquisition (described below), no gain or loss is recognized to, and no amount is recaptured by, the acquired corporation.

Absent the election, the acquiring corporation takes a cost basis in the stock of the acquired corporation. However, the basis to the acquired corporation of its assets is not affected by the transaction. Furthermore, the acquiring corporation does not directly succeed to any of the tax attributes of the acquired corporation, although the corporations in certain cases may join in the filing of consolidated returns for Federal income tax purposes, in which case the acquiring corporation will indirectly succeed to those tax attributes. Furthermore, use of a consolidated return will permit the acquiring corporation to deduct future tax losses it may have against future taxable income of the acquired corporation.

Acquisitions treated as asset acquisitions

An acquiring corporation can acquire the stock of the acquired corporation in a transaction that is taxable to the acquired corporation's shareholders as described above, and, in certain cases, elect to treat the transaction for tax purposes as if it had acquired the assets of the corporation directly from the acquired corporation as part of a larger transaction in which the acquired corporation is

being liquidated.³ In such an event, gain or loss is generally not recognized to the acquired corporation to the same extent that gain or loss would not have been recognized if there had been an actual liquidating sale. However, as in the case of a liquidating sale, the recapture rules are fully applicable.

In such a transaction, the acquired corporation is treated as if it sold and repurchased all its assets for an amount approximately equal to the acquiring corporation's basis, as adjusted, in the stock of the acquired corporation. Thus, the acquired corporation's basis in all its assets is generally stepped-up to their fair market values.⁴ The acquiring corporation does not succeed to any of the tax attributes of the target corporation. The corporations may join in the filing of a consolidated return for Federal income tax purposes except that recapture income may not be offset by losses of the acquiring corporation.

The tax consequences of a taxable acquisition of stock coupled with an election to treat the transaction as an acquisition of assets are very similar to the tax consequences of a liquidating sale. However, in either case, the tax cost of recapture may outweigh the benefits of a stepup in basis of the assets involved. The parties can avoid that cost (and relinquish the benefits) by structuring the acquisition as a taxable stock acquisition and not making the election. In that case, as indicated, there would be no recapture and no change in asset basis.

Acquisitions of stock followed by partial liquidations

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a corporation could acquire the stock of an acquired corporation in a transaction that would be taxable to the acquired corporation's shareholders and then cause a partial liquidation of the acquired company.

Prior to TEFRA, the tax consequences of a partial liquidation were generally the same as those of a complete liquidation. No gain or loss was recognized to the distributing corporation (i.e., the acquired corporation), except to the extent of any recapture with respect to the distributed property. Furthermore, under the consolidated return regulations, a distribution in partial liquidation was considered a deferred intercompany transaction. Thus, any recapture income was deferred and recognized only as the acquiring corporation wrote off its basis in the distributed assets (or, if earlier, on the disposition of the distributed assets outside the affiliated group). Finally, under the consolidated return regulations, no investment tax credit was recaptured.

³ Under section 338, an acquiring corporation can generally elect within 75 days after a qualified stock purchase (or within such other period as may be provided for in regulations) to treat an acquired subsidiary (i.e., the acquired corporation) as if it had adopted a plan of complete liquidation and then sold and repurchased all of its assets. The election is available only if, among other things, the acquiring company has acquired 80 percent or more of the stock of the acquired company.

⁴ The assets of the acquired corporation are treated as sold and repurchased for an amount equal to the acquiring corporation's basis in the stock of the acquired corporation on the acquisition date as adjusted to reflect liabilities of the acquired corporation and other relevant items. If, as of the acquisition date, the acquiring corporation owns less than 100 percent by value of the stock of the acquired corporation, the deemed purchase price is grossed-up to reflect 100 percent ownership by the acquiring corporation. However, unless the target corporation is actually liquidated within one year after the acquisition date, nonrecognition treatment is limited to the highest actual percentage by value of acquired corporation stock held by the acquiring corporation.

On receipt of the distribution in partial liquidation of the target corporation, the acquiring corporation, as a shareholder of the acquired corporation, was treated as receiving the distributed property in exchange for an allocable portion of its shares of stock of the distributing corporation. Thus, gain or loss was recognized in an amount equal to the difference between the fair market value of the distributed property and the basis to the acquiring corporation of the allocable shares of its stock in the distributing corporation. However, because the acquiring corporation had just acquired the stock of the acquired corporation for, presumably, fair market value, generally there would have been no gain or loss.

After the transaction, the acquiring corporation was able to achieve a fair market value basis for the assets distributed in the partial liquidation. At the same time, recapture was avoided with respect to the assets retained by the acquired corporation. With careful planning, it was possible in many cases to distribute only those assets that did not give rise to substantial recapture but which had substantial appreciation in value. Oil and gas properties, particularly older ones, often fit that description.

The U.S. Steel-Marathon oil transaction

One highly-publicized transaction that involved an acquisition of stock followed by a partial liquidation was the acquisition in 1982 of Marathon Oil by U.S. Steel. It appears that Federal income tax laws applicable at the time of that transaction provided U.S. Steel and Marathon with substantial tax benefits.

In the U.S. Steel-Marathon transaction, a newly-formed subsidiary of U.S. Steel acquired the stock of Marathon from the Marathon shareholders in exchange for cash and installment notes in a transaction that was taxable (with some deferral) to the Marathon shareholders. Shortly thereafter, Marathon distributed certain of its oil and gas properties in a transaction qualifying as a partial liquidation.

The distribution by Marathon was not taxable to Marathon except to the extent of recapture, including recapture of post-1975 intangible drilling costs under section 1254. Under the circumstances, it is likely that recapture income was fairly small. Furthermore, under the consolidated return regulations, the distribution was treated as a deferred intercompany transaction and the recapture income was deferred.

The distribution was taxable to the acquiring corporation. However, because the acquiring corporation had just acquired the Marathon stock for fair market value, it is probable that little gain or loss was recognized.

By structuring its acquisition of Marathon in this manner, U.S. Steel was able to obtain a stepped-up basis in certain of Marathon's highly valuable oil and gas assets, the future depletion of which was likely to offset substantial amounts of income generated by such assets and other assets. At the same time, U.S. Steel avoided substantial amounts of recapture which would have resulted with respect to other Marathon assets, such as its LIFO inventory and its depreciable assets, from a complete liquidation of Marathon.

The impact of TEFRA

In TEFRA, the treatment of a partial liquidation was modified so that only certain noncorporate shareholders of the distributing corporation would be treated as receiving the amount distributed in partial liquidation as in exchange for stock. One of the principal effects of this change was to deny an acquiring corporation a step up in the basis of properties distributed to it by a newly-acquired corporation in partial liquidation (sec. 301(d)(2)(B)). This TEFRA change has taken away from acquirers of oil and gas companies significant tax-saving opportunities.

Example

Under post-TEFRA law, the parties to an oil and gas company acquisition may or may not wish to step up to fair market value the basis of the assets of the acquired company. As indicated, there is a tax cost to such a step-up—recapture income to the acquired company. Since those results are automatic in the case of a liquidating sale of the assets by the acquired company, most taxable oil and gas company acquisitions are structured as purchases of stock. In a purchase of stock, step up and recapture will occur only if the parties so elect. Furthermore, the law gives the parties some period of time to determine whether the election should be made. Finally, as the examples below show, there will be many cases in which a step-up election is inappropriate.

The decision to elect to step up the basis of all assets and pay recapture taxes or, alternatively, to have basis carry over and have no recapture tax, generally is determined with reference to several tax and financial attributes of the acquiring corporation and the acquired corporation. The following example illustrates the net tax benefits and costs of a step-up election under a limited and simple set of assumptions.

Assume that the acquired corporation acquired all its assets on January 1, 1981, and that all its stock is sold on January 1, 1984. Five types of assets are involved in the transaction:

- (1) Section 1245 equipment, in the 5-year ACRS class;
- (2) Section 1250 structures, depreciated under the straight-line method;
- (3) Section 1254 intangible drilling costs, three-tenths of which would have been recovered through cost depletion;
- (4) Lease acquisition costs (three-tenths of which have been recovered through cost depletion); and
- (5) LIFO inventories.

Both parties are assumed to be fully taxable at a 46% marginal rate. The acquired corporation has no liabilities.

Assets	Original cost— Jan. 1, 1981	Jan. 1, 1984—			
		Tax basis	Purchase price	Recapture income	Recapture tax
Section 1245 equipment.....	\$10,000	\$4,200	\$8,000	\$3,800	\$1,748
Section 1250 structures.....	10,000	8,000	12,000		
Section 1254 IDCs.....	1,000	0	1,000	700	322
Lease acquisition.....	1,000	700	1,000		
FIFO inventory.....	1,750	1,750	1,750		

Assets	Original cost— Jan. 1, 1981	Jan. 1, 1984—			
		Tax basis	Purchase price	Recapture income	Recapture tax
LIFO inventory (excess over FIFO).....		75	75	75	35
ITC					400
Total	23,750	14,650	23,825	4,575	2,505

The original cost of the assets was \$23,750. After 3 years, their purchase price (and fair market value) is \$23,825, while their tax basis has been reduced to \$14,650. If the basis is stepped up, recapture tax of \$2,505 must be paid. The net tax benefit of a step-up transaction (determined without regard to present value considerations), after payment of recapture tax, is \$1,681 (assuming that no tax benefit is to be realized with respect to the inventory and disregarding the effect on purchase price of the recapture tax liability). However, because recapture tax generally is payable in the first year and the tax savings will occur over the remaining tax lives of the assets, present values must be considered. With the future cost of funds and yield on investments unknown, the parties should consider the transaction under a range of reasonable discount rates. At a 10-percent discount rate there would be a net loss of \$143. At higher discount rates, the loss from a step-up transaction would be greater. No step-up election is indicated.

Net Benefit of Step-Up

Discount rate	Zero	[In percent]			
		10	12	15	20
Net tax savings.....	\$1,681	-\$143	-\$334	-\$562	-\$831

On the other hand, if the facts were changed so that the fair market value (and purchase price) of the assets created by the IDC's and the lease was increased to \$4,000 each, a step-up election would be indicated under any reasonable discount rate.⁵

⁵ Prior to TEFRA, the parties, as discussed, could selectively step up the basis of some assets and not others. If, prior to TEFRA, carryover basis were elected only for section 1245 property and all remaining assets in this example were stepped up in basis, net tax savings would be increased, as indicated.

Net Benefit of Partial Step-Up

Discount rate	Zero	[In percent]			
		10	12	15	20
Net tax savings.....	\$4,841	\$2,423	\$2,158	\$1,835	\$1,439

Net Benefit of Step Up with Higher FMV

Discount rate	Zero	[In percent]			
		10	12	15	20
Net tax savings.....	\$4,442	\$1,553	\$1,225	\$823	\$326

The parties may not make a step-up election under present law even though the amount of projected tax savings may indicate that a step up would be beneficial. There are a number of reasons for this. First, the acquiring corporation may have borrowed substantial sums of money to make the acquisition. It may have difficulty raising affordable additional funds to pay the tax liability attributable to recapture. Second, the IRS, on audit, may challenge the claimed results. In few areas of the tax law is there more opportunity for controversy. As a result, there may be significant uncertainty as to the final costs and benefits. Third, no benefits will be available unless the acquiring corporation or its group has taxable income in the future against which to apply those benefits. An acquiring corporation that assumes without question that it will be able to use those benefits as they are available will be taking on some risk.

In sum, it is likely that in at least several post-TEFRA acquisitions of oil and gas companies, a step-up election, even where available, will not be made. Furthermore, the election may not be available in every case. For example, *Socal* is tendering for all of the Gulf stock but may end up acquiring less than 80 percent of it. If it acquires less than 80 percent, no election will be available, and the parties will be required to treat the transaction as carrying over the basis in the acquired corporation's assets.

3. Tax-free reorganizations

Oil and gas companies can also be acquired in tax-free reorganizations. While there are many forms of reorganizations, they generally involve the issuance by the acquiring corporation of new shares of its stock to the acquired corporation or its shareholders in exchange for either the assets or stock of the acquired corporation.

To be treated as a reorganization, a transaction has to satisfy many requirements. If the transaction does qualify as a reorganization, generally no gain or loss is recognized to either the acquiring corporation, the acquired corporation, or the shareholders of the acquired corporation. Furthermore, there is no change in the basis of the acquired corporation's assets, and, in most reorganizations, the acquiring corporation succeeds to the acquired corporation's tax attributes. Finally, if the acquired corporation remains an entity separate from the acquiring corporation, they can commence filing a consolidated income tax return.

B. Certain Financing Aspects

The form of acquisition selected by the acquiring corporation depends, in part, on the consideration to be used and the source of

any financing. If the consideration to be used in the acquisition is cash or other property (rather than stock of a party to the acquisition), the transaction will be a taxable one.

In the case of companies owning depreciable or depletable property, the tax laws relating to cost recovery (e.g., those relating to accelerated depreciation, investment tax credits, intangible drilling costs, and, where applicable, percentage depletion) contribute to the availability of net cash flows that can be used to assist in making cash acquisitions. Another source of financing is the use of installment obligations of the acquiring company. These can secure a deferral of tax for the shareholders of the acquired corporation. Alternatively, the acquiring corporation can use external borrowings to raise funds for the acquisition. In the latter two cases, generally interest paid or accrued on the debt is currently deductible. Furthermore, in the latter two cases, if the acquiring corporation is a member of an affiliated group of corporations with foreign operations, it may be possible to structure the borrowings to artificially inflate foreign tax credits allowable with respect to foreign source income.

Cost recovery

The tax laws provide a number of benefits for taxpayers acquiring or developing tangible business property. These include accelerated depreciation, investment tax credits, deductions for intangible drilling costs, and, in certain cases, percentage depletion. An effect of these rules is to permit taxpayers to take tax deductions and benefits more promptly than would be tax case were those laws to permit write-offs and other benefits only over, and in relation to, the economic lives of the property involved.

The early tax write-off of these costs results in a mismatching, for tax purposes, of expense and the income attributable to those expenses, which income is generally not recognized for tax purposes until later years.

Tax-deferred installment sales

The consideration to be paid may consist of installment obligations of the acquiring corporation. The advantage of this approach, under section 453, is that the sellers would recognize gain (and pay tax thereon) only as and when principal under the indebtedness is received. If the issuer of the indebtedness is a U.S. corporation, interest payments would be deductible in computing the issuer's tax liability. Furthermore, that issuer would, for basis purposes, be treated as having paid the full price currently.

International aspects of borrowings

Foreign lenders.—In general, nonresident alien individuals and foreign corporations that are not effectively connected with a U.S. trade or business conducted by the foreign person are subject to a 30% withholding tax on the gross amount of interest income derived from sources within the United States (secs. 871 and 881). Subject to certain limited exceptions, interest paid by a U.S. corporation on its debt obligations is treated as income from U.S. sources and subject to withholding (secs 861(a)(1), 1441, and 1442). However, tax treaties between the United States and other countries fre-

quently reduce or eliminate withholding taxes on interest. Thus, fully deductible interest may be paid to persons not subject to significant, if any, U.S. taxation.

Advantage of allocating interest expense to the United States.— Because multinational oil and gas companies often derive significant highly taxed earnings from foreign operations, the utility of foreign tax credits (FTCs) is of particular concern to them. Under current Treasury regulations, in the case of an acquisition by a corporation that is a member of an affiliated group with foreign operations, it may be possible to manipulate the limitations on the use of FTCs by incurring the acquisition indebtedness in a domestic corporation whose assets generate only U.S. source income. This result could occur even if the funds are borrowed from a foreign source and even though the indebtedness relates (in whole or in part) to foreign operations.

In general, foreign taxes are allowed in full against the U.S. tax liability of a taxpayer. However, the use of FTCs is limited to the total U.S. tax liability multiplied by a fraction the numerator of which is foreign source taxable income and the denominator of which is worldwide taxable income. For purposes of computing the FTC limitation, interest expense is generally apportioned between gross U.S. source income and gross foreign source income on the basis of the relative values of the borrower's (rather than the group's) assets that generate each category of income (Treas. reg. sec. 1.861-8(e)(2)(v)). To avoid having interest expense reduce foreign source income (and, thereby, the utility of FTCs), the members of an affiliated group could isolate the interest expense relating to acquisition indebtedness in a corporation whose assets produce only U.S. source income. For example, a parent corporation the sole asset of which is a U.S. holding company with predominantly foreign assets may be able to allocate all its interest expense to U.S. source income. Alternatively, on the basis of a court case, the acquiring corporation might take the position that interest on the acquisition indebtedness should be apportioned between U.S. source and foreign source income as if the members of the affiliated group were one taxpayer. See *International Telephone and Telegraph Corp v. United States*, 79-2 USTC para. 9649 (Ct. Cl.) 1969 (decided under the law in effect prior to the effective date of the applicable Treasury regulations).

Dividends received deduction

Acquisitions of oil and gas companies can be done as reorganizations. Generally, in a reorganization, the acquiring corporation issues shares of its stock to the acquired corporation or its shareholders.

A corporation unable to use interest deductions will have a tax incentive to issue stock, perhaps preferred stock, instead of debt to finance an acquisition. By issuing stock, it can to a significant extent pass the tax benefit of interest deductions on to its shareholders: to the extent such stock ends up in the hands of a domestic corporate shareholder, the holder will generally be entitled to an 85-percent deduction on any dividends received with respect to such stock. However, the issuing corporation will not be entitled to any deduction on account of the dividends paid.

The acquiring corporation could also float a new issue of stock to raise funds with which to make the acquisition. While such an acquisition would not qualify as a reorganization, the dividends received deduction would be equally available.

IV. POSSIBLE CHANGES IN THE APPLICABLE TAX RULES

Some of the Federal income tax rules described above may in part motivate the acquisition of an oil and gas company by another company. On the other hand, any such acquisition may not be motivated to any significant extent by tax considerations. Furthermore, the rules described are generally applicable in the case of any corporate acquisition, not simply those involving an oil and gas company. Therefore, the possible changes described below, although they are generally described in terms of oil and gas company acquisitions, might be considered in the context of corporate acquisitions generally. Of course, possible changes could be limited in their applicability to oil and gas company cases.

The following changes, among others, in the rules applicable to oil and gas company acquisitions might be considered.

Mandatory asset acquisition

In many respects, the acquisition of a substantial, controlling stock interest in an acquired oil and gas corporation is the acquisition of the assets of that corporation. The acquiring corporation indirectly gains control of those assets.

One possible change would be to require the acquisition of such a stock interest in a transaction not qualifying as a reorganization to be treated as a direct acquisition of the assets of the acquired corporation rather than as a stock acquisition. The result would be to require the acquired corporation to recognize gain or loss with respect to its assets. This required recognition might be limited to present-law recapture items or it might be expanded (in which case a change in the rules relating to liquidating sales of assets would also be appropriate). Another result would be to require the acquirer to take a fair market value basis in those assets. A third result would be to prevent the acquiring group from succeeding to any tax attributes (e.g., net operating loss carryovers) of the acquired company.

Present law, which provides the parties with an election to achieve the results indicated, may be viewed as unduly generous.

Effect of election to treat as an asset acquisition

Alternatively, the law could be changed to modify the Federal income tax consequences of electing under present law to treat a qualifying stock acquisition as an asset acquisition. For example, one consequence of such an election could be full recognition of all gain or loss with respect to the acquired oil and gas company's assets. Present law permits the acquirer to step up to fair market value all the assets of the acquired company but does not require the acquired company to recognize as taxable income any appreciation in the value of its assets (except for certain recapture items). This result is inconsistent with a pure two-tier tax system.

More narrowly, the recapture rules applicable under present law in the case of an election could be tightened. For example, the acquired company could be required to recognize all gain or loss on property which if sold by it outside of an acquisition context would generate ordinary income or loss (e.g., all inventory, including FIFO inventory). Gain on all section 1250 property (certain real property) could be required to be included in income to the extent of prior depreciation deductions allowed. This would conform the section 1250 rules with those of section 1245 (relating to personal property and certain real property). Gain on all mineral property could be required to be included in income to the extent of prior intangible drilling costs with respect to such property which were deducted, regardless of whether they were deducted before or after January 1, 1976, or whether the deductions exceeded what could have been recovered through depletion deductions had they been capitalized. Finally, gain on all mineral property could be required to be included in income to the extent of prior depletion deductions allowed, or, alternatively, to the extent percentage depletion deductions allowed exceeded those that would have been allowed under cost depletion, with respect to such property.

It is argued that there is little justification for permitting an acquired oil and gas corporation to avoid being taxed on the value of its ordinary income assets in excess of their basis. As for tightening the recapture rules, the acquired corporation, in claiming depreciation and depletion, became entitled to tax benefits. Appropriate recapture rules would do nothing more than require an acquired company to return those tax benefits to the Federal government at the appropriate occasion.

Interest expense

Many have argued that the income tax law motivates the acquisition of oil companies by permitting acquirers to deduct currently interest paid or accrued on debt (including installment debt) incurred in connection with the acquisition. Many acquirers are in a position to use the deductions to offset income that would otherwise be taxable at a rate at or near 46 percent. Meanwhile, the lender (which may be a foreign person, a tax-exempt entity, an insurance company, or a domestic financial institution) may not be taxable at a 46-percent rate on the interest income.

Another possibility would be to disallow deductions with respect to all or part of the interest paid or incurred on debt (including installment debt) incurred in connection with the acquisition of an oil and gas company.

A possibility would be to correct the rules to require, in appropriate cases, that interest paid or accrued by a member of a consolidated return group on debt incurred in connection with the acquisition of an oil and gas company (or any other debt) be allocated between domestic and foreign sources on a group basis. This might prevent an acquiring corporation from allocating interest expenses away from foreign sources merely because the acquiring corporation uses subsidiaries rather than divisions to conduct business abroad.

Installment sales

Under present law, the acquiring corporation can use installment obligations to make the acquisition. Under the installment sale rules, the sellers defer recognition of gain, recognizing it only as principal payments on the installment obligations are received. On the other hand, the acquiring corporation gets a new basis in the acquired property equal to the total amount of principal payments to be made over time. Particularly if the acquiring corporation elects to treat the transaction as an acquisition of assets, that basis will produce short-term tax deductions for the acquiring corporation.

This mismatching of gain and deduction, which may be offset to some extent by recapture, might be corrected. One possibility would be to give the acquiring corporation the benefits of a new tax basis only if and as principal payments on the installment obligations are made.

Dividends received deduction

The corporate dividends received deduction was intended to limit multiple taxation of corporate income prior to its distribution to ultimate noncorporate shareholders. However, under present law, the corporate dividends received deduction can lead to minimal taxation on such income. This can happen, for example, when the payor does not have taxable income but does have dividend-paying capacity (i.e., earnings and profits).

The dividends received deduction could be eliminated in the case of stock of an acquiring corporation issued in connection with an oil company acquisition. In its place, there may be substituted a dividends paid deduction. This would more closely conform present law rules relating to dividends to those applicable to interest.

Consolidated returns

Under present law, a corporate acquirer of stock can begin immediately to file consolidated returns with an acquired company in most cases. If the acquired company is profitable and if the acquirer uses debt in the acquisition, the acquirer will be able to deduct interest on that debt against taxable income of the acquired company. The benefit will be particularly great if no election to treat the acquisition as an acquisition of assets is indicated.

The rules might be changed so that the acquired company could not join the consolidated return group of the acquirer until, say, 5 years after the acquisition. Present law contains a similar rule for newly-acquired domestic life insurance companies.