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FEDERAL INCOME TAX CONSIDERATIONS IN OIL AND GAS COMPANY MERGERS AND ACQUISITIONS

A Report of the Senate Committee on Finance

COMMITTEE ON FINANCE
UNITED STATES SENATE

ROBERT J. DOLE, *Chairman*

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I. INTRODUCTION

On March 28, 1984, the Senate agreed to a sense of the Senate resolution directing the Energy, Finance, and Judiciary Committees to study the issue of oil and gas company mergers and acquisitions and the impact of the nation's energy, tax, and antitrust laws upon such activity. The resolution was in recognition of the fact that the proliferation of merger and acquisition activity involving oil companies raised important questions that required careful consideration by the Senate. The Committees were directed to report back to the Senate by July 1, 1984. This report represents the study of the Committee on Finance regarding the impact of Federal income tax laws upon oil and gas company mergers and acquisitions.

II. HEARINGS

The Finance Subcommittee on Energy and Agricultural Taxation held a hearing on April 5, 1984 on oil company mergers. The hearing focused on the effect of current Federal income tax laws upon the merger and acquisition of oil and gas companies, such as recent activity involving Texaco/Getty, Socal/Gulf, Mobil/Superior, and Marathon/Husky. Among the questions raised was whether the Federal tax laws improperly subsidize large oil and gas acquisitions.

A total of 10 witnesses testified at the hearing, including Senator Arlen Specter (R., Pa.), Deputy Assistant Secretary Ronald A. Pearlman of the Department of the Treasury, representatives of certain of the major oil companies and the independent petroleum producers, academicians from the fields of both law and economics, and representatives of an investment banking firm. Written testimony was also received. A transcript of the hearing and all testimony, along with the Joint Committee on Taxation print prepared for the hearing, are attached.

III. SUMMARY OF PRESENT TAX LAW PROVISIONS AFFECTING MERGERS AND ACQUISITIONS

Under present law, an acquisition can be structured as a taxable asset acquisition, a taxable stock acquisition, or a tax-free reorganization.

In a taxable asset acquisition, if 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 over the corporation's adjusted basis in such asset. If the assets transferred are capital assets in the hands of the transferor, the gain will be capital gain, except to the extent of any recapture gain that may be triggered. In the case of the acquisition of certain oil and gas property, section 1254 generally recaptures 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 deducted had they been capitalized and recovered through cost depletion. However, there is no recapture with respect to intangible drilling costs deducted prior to January 1, 1976. The acquiring corporation generally takes a cost basis with respect to the assets acquired and does not succeed to the tax attributes of the acquired corporation.

In the case of a taxable asset acquisition where the acquired corporation liquidates as part of the same transaction, gain or loss is generally not recognized to the acquired corporation pursuant to section 337 of the Code. Moreover, no gain or loss is generally recognized to the acquired corporation on the distribution of its assets in complete liquidation (sec. 336), although the liquidation is a taxable transaction to the shareholders of the acquired corporation. Certain recapture provisions override the nonrecognition treatment on the sale or liquidation of the acquired corporation's assets. As in the case of a non-liquidating sale of assets, the acquiring corporation takes a cost basis in the assets acquired, and does not succeed to the tax attributes of the acquired corporation.

In the case of a taxable stock acquisition, gain or loss is generally taxable to the shareholders of the acquired corporation and if the stock is a capital asset in their hands, such gain or loss will be capital gain or loss. If no section 338 election is made, not gain or loss (including no recapture gain) is recognized to the acquired corporation. Further, although the acquiring corporation obtains a cost basis in the stock of the acquired corporation, the basis of the assets of the acquired corporation is unchanged by the transaction. The acquiring corporation does not directly succeed to the tax attributes of the acquired corporation, except the filing of a consolidated return may permit some sharing of attributes.

If a section 338 election is made, the acquired corporation generally does not recognize any gain or loss in the same manner as a liquidating sale of assets (sec. 337), except for recapture gain. The acquired corporation, however, gains a higher, stepped-up basis (generally, fair market value) in the assets in its hands, although its tax attributes are lost.

Finally, the acquisition may be structured as a tax-free reorganization, generally involving the exchange of shares of the acquiring corporation for the assets or stock of the acquired corporation. In that case, no gain or loss is recognized to either the acquired corporation, the acquiring corporation, or the shareholders of the acquired corporation. The basis in the assets of the acquired corporation is not changed, although its tax attributes generally survive the transaction.

IV. PROVISIONS IN DEFICIT REDUCTION ACT OF 1984 AFFECTING OIL AND GAS COMPANY MERGERS AND ACQUISITIONS

On June 23, 1984, the Committee of Conference completed its action on the Deficit Reduction Act of 1984 and submitted its Conference Report, which included a number of provisions relating to the income taxation of corporations and their shareholders. On June 27, 1984, the House and the Senate approved the Conference

Report. Among the provisions agreed to by the conferees that may affect oil and gas company mergers and acquisitions include the following:

A. Debt-Financed Portfolio Stock (sec. 51 of the Conference Report)

Under the conference agreement, the dividends-received deduction is generally reduced if interest is paid or incurred on indebtedness that is directly attributable to investment in the underlying portfolio stock. Thus, highly-leveraged purchases of portfolio stock (including stock in oil and gas companies) may result in the reduction of the dividends-received deduction of corporate distributees for dividends received with respect to such stock.

B. Extraordinary Dividends (sec. 53)

Under the conference agreement, if a corporate shareholder does not hold stock for more than one year, the fair market value of the nontaxed portion of any extraordinary dividend reduces its basis in the stock. Extraordinary dividends are generally dividends received within any 85-day period with a fair market value equal to or greater than 10 percent (5 percent in the case of certain preferred stock) of the taxpayer's basis in the stock.

Thus, for example, corporate shareholders will no longer be able to acquire stock, receive a largely tax-free extraordinary dividend (such as a royalty trust distribution) with respect to such stock, and then sell such stock within one year, often at a capital loss to reflect the receipt of the extraordinary dividend. Unless the stock is held for over one year, the transaction will result in a reduction in the corporate shareholder's basis in the stock acquired and sold.

C. Nonliquidating Distributions of Appreciated Property (sec. 54)

The conference agreement provides that nonliquidating distributions of appreciated property will generally be taxable to the distributing corporation. Exceptions are provided in cases where stock of the distributing corporation is closely held, and in certain other cases. Therefore, under the conference agreement, a distribution of a highly appreciated asset, such as an interest in a royalty trust, will generally no longer be able to escape a corporate-level tax.

D. Holding Period for Property Distributed by One Corporation to Another (sec. 54)

Under current law, if an acquiring corporation acquires the stock of a target corporation and receives a distribution of property with respect to such stock, the acquiring corporation's holding period in such property generally includes the period during which the target corporation held the property, thereby permitting the acquiring corporation to convert what is essentially a short-term investment into long-term capital gain. The conference agreement provides that a corporate shareholder's holding period in property distributed to it may not exceed the period during which the shareholder holds the stock with respect to which the distribution is made, and the holding period generally will begin on the date of distribution. Hence, under the conference agreement, conversion of short-term investment into long-term gain will no longer be permitted.

E. Earnings and Profits (sec. 61)

Under the conference agreement, the definition of earnings and profits is modified to make it more closely conform to a corporation's true or economic income. This will reduce the ability of corporations, including oil and gas companies, to make distributions of tax-free dividends even though the corporation has economic income and is not making a liquidating distribution.

F. Golden Parachutes (sec. 67)

The conference agreement restricts, and potentially eliminates, the use of so-called "golden parachute" agreements. These agreements typically provide highly lucrative arrangements to corporate executives, contingent upon a change, or threatened change, in ownership or control of the corporation. Often, such agreements are effected during a takeover or threatened takeover period, and operate at the expense of the shareholders of the corporation. For example, a number of Gulf executives received well-publicized golden parachute payments as a result of the takeover of Gulf by Socal.

The conference agreement modifies the tax treatment of payments made pursuant to a golden parachute agreement. Under the agreement, certain of the payments in excess of historic compensation will not be deductible by the payor, and the recipient will be required to pay a nondeductible 20 percent excise tax with respect to such amounts.

G. Definition of Affiliated Group (sec. 60)

The conference agreement redefines "affiliated group" for all federal income tax purposes. In general, corporations will not be considered affiliated with one another (and, therefore, will not be eligible to join in filing a consolidated return) unless one owns stock possessing at least 80 percent of the voting power and 80 percent of the total value of all of the stock of the other corporation. Thus, to the extent the filing of a consolidated return provides certain advantages under current law, such as the sheltering of income of one corporation with losses of another corporation in the group, the ability to file will be limited to those corporations which are, in essence, a single economic unit.

H. Transfers of Partnership and Trust Interests by Corporations (sec. 75)

Under current law, it has been argued that the corporate recapture provisions do not apply to the distribution or liquidating sale of an interest in a partnership that holds recapture property. Under this view, an oil and gas company that desires to sell or distribute recapture items could contribute those items into a partnership and then make a distribution or liquidating sale of the partnership interest, thereby avoiding the recapture gain.

The conference agreement clarifies current law that a corporate distribution or liquidating sale of a partnership interest is treated as a transfer of the distributing corporation's proportionate share of recapture items held by the partnership. Thus, recapture gain will be triggered upon the transfer of the partnership interest.

I. Deprecation Recapture and Installment Sales (sec. 112)

Current law permits an acquiring corporation to gain an immediate step-up in the basis of assets acquired in a taxable transaction, even though gain to the acquired corporation may be deferred through use of an installment sale. This mismatching of income and deductions has been utilized to a great advantage in oil and gas company acquisitions as well as other corporate acquisitions. The conference agreement provides that all depreciation recapture income realized must be recognized at the time of the installment sale, regardless of when the installment obligation payments are made. Thus, recapture gain in a taxable acquisition can no longer be delayed through use of an installment sale.

V. POSSIBLE ADDITIONAL MODIFICATIONS TO CURRENT LAW

The Deficit Reduction Act of 1984 contains a number of provisions which are designed to prevent certain of the potential tax abuses involved in oil and gas company mergers and acquisitions as well as other corporate transactions. The provisions strive to make the tax laws neutral with respect to such acquisitions. Among the other possible modifications to the tax laws involving oil and gas company acquisitions which might be considered include the following:

A. Mandatory Treatment to Stock Acquisition as Asset Acquisition

Under current law, the acquisition of all or substantially all of the stock of an oil and gas company may or may not be followed by a section 338 election. If no election is made, then, as discussed above, no gain or loss is recognized to the acquired corporation, and no recapture gain is triggered. This is the case even though the transaction closely resembles a complete transfer of assets. One possible change would be to make the section 338 election mandatory in this case, so that the tax treatment of an acquisition of stock and an acquisition of assets would be conformed.

B. Recapture Rules

Certain present law inconsistencies in the application and operation of the recapture rules could be rectified. For example, recapture gain on the transfer of certain oil and gas property could be required to the extent of all prior intengible drilling costs deducted with respect to such property, and not just those costs deducted after January 1, 1976 nor those which exceed what could have been deducted had the costs been capitalized. Similar changes could be made to the other recapture rules.

C. Gain on Liquidating Sales and Distributions

Recognition treatment of all gain or loss could be required upon the liquidating sale or distribution of appreciated assets. Current law nonrecognition treatment in those two situations often may result in a complete avoidance of the corporate level tax. Alternatively, recognition treatment could be limited to that portion of gain representing original basis over adjusted basis, and to all gain on certain ordinary income items (e.g., all inventory, including FIFO inventory).

D. Dividends Received Deduction

The Deficit Reduction Act change with respect to debt-financed portfolio stock could be expanded to encompass a broader class of transactions. For example, in lieu of the narrow "directly attributable" standard, a broader fungibility test could be utilized whereby the dividends-received deduction of corporate shareholders would be proportionately reduced, depending upon the level of indebtedness of such shareholder. In addition, regardless of whether the stock investment is debt-financed, consideration may be given to the continued appropriateness of the dividends-received deduction for a corporate shareholder, at least in the case where such shareholder's portfolio stock investment closely resembles that of an individual investor.

E. Installment Sales

Current law permits the acquiring corporation in an installment sale of assets to gain an immediate step-up in the basis of the assets acquired, even though the gain to the acquired corporation on the sale may be deferred. The change in the Deficit Reduction Act reduces this anomaly, but only with respect to depreciation recapture gain. One possible modification would be to extend the Deficit Reduction Act change to all recapture gain. Another possibility is to impose an interest charge on the deferral of taxes due from the acquired corporation. A third possible change would be to defer the acquiring corporation's step-up in basis until there is gain recognition on the part of the acquired corporation.

F. Consolidated Returns

The Deficit Reduction Act modification primarily addresses the nature of corporations entitled to file a consolidated return, and generally does not affect the timing of such consolidation (except in a deconsolidation-reconsolidation case). In certain corporate acquisitions, the ability of the acquiring and the acquired corporations to file a consolidated tax return immediately after the acquisition may present inappropriate tax advantages to the affected corporations. Thus, the rules regarding the timing of consolidation following a corporate acquisition may need to be reconsidered.

OIL COMPANY MERGERS

THURSDAY, APRIL 5, 1984

U.S. SENATE,
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:34 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable Malcolm Wallop (chairman) presiding.

Present: Senators Dole, Wallop, Durenberger, Symms, Long, Bentsen, Boren, and Bradley.

[The press release announcing the hearing and Senator Dole's statement follow:]

[Press Release No. 84-129]

SENATE FINANCE SUBCOMMITTEE SETS HEARING ON OIL COMPANY MERGERS

Senator Malcolm Wallop, Chairman of the Subcommittee on Energy and Agricultural Taxation announced today that the Subcommittee will hold a hearing on the tax aspects of oil company mergers.

In announcing the hearing Senator Wallop noted that "with the controversy surrounding the announced mergers of Texaco/Getty, Socal/Gulf, and Mobil/Superior, it is important for the Committee to address the issues of whether these transactions are tax motivated, and what impact they may have on the ability of oil and gas companies, including the merger companies, to continue the exploration and development activity we have assumed as a national priority."

The hearing will begin at 9:30 a.m. on Thursday, April 5, 1984 in Room SD-215 of the Dirksen Senate Office Building.

PREPARED STATEMENT OF SENATOR DOLE

I am pleased that Chairman Wallop has scheduled this hearing on the tax issues involved in oil and gas company acquisitions. The recent proliferation of activity involving Texaco/Getty, Socal/Gulf, Mobil/Superior, and Marathon/Husky has raised questions as to whether the Federal tax laws improperly subsidize such acquisitions, and whether this activity is tax-motivated.

Large corporate acquisitions have serious repercussions in the market place and have a significant impact, in human terms, on the health and welfare of our country. These transactions may result in the loss of jobs, the modification of health and pension benefits for employees of companies involved, and the financial disruption of local communities. For example, I understand that as part of the FTC's tentative approval of the Texaco/Getty acquisition, Texaco must, within a certain period of time, divest itself of a Getty refinery, along with supporting pipelines and retail organization, located in El Dorado, Kansas. This requirement could present a serious hardship for the community involved if, for example, the facility cannot be sold as a complete operating package. For these reasons, it is important that we carefully examine the laws relating to mergers and acquisitions, to insure that they do not provide unnecessary and inappropriate incentives or disincentives for such activity in the business community.

Last week, the Senate agreed to an amendment co-sponsored by Senators Boren, Bentsen, myself, and others that would require the Judiciary, Energy, and Finance Committees to hold hearings on the oil merger issue and to report back to the Senate by July 1 on the effect of such activity on our country's national interests. This Finance Subcommittee hearing will focus upon the tax aspects of the merger activity, including specifically whether our tax laws are neutral with respect to such activity or whether tax loopholes provide an inappropriate incentive to encourage mergers and takeovers.

I would hope that our distinguished group of witnesses would be able to comment today on a number of tax issues raised by the acquisition activity, including:

1. Whether the tax cost for obtaining a fair market value basis in acquired assets is adequate under current law;

2. Whether the recapture rules adequately provide for recovery of previously claimed deductions and credits; and

3. Whether provisions of current law including the deductibility of interest, the dividends-received deduction, and the installment sales provision provide tax incentives for making highly leveraged corporate acquisitions.

I again commend Senator Wallop for holding this hearing on these important issues.

Senator WALLOP. Good morning. The purpose of this morning's hearing is to receive testimony on the economic, tax, credit, and energy policy implications of oil company mergers. Last week we spent a great deal of time on the floor of the Senate debating the so-called Johnston amendment, which would have imposed a 6-month moratorium on mergers and acquisitions affecting the top 50 domestic oil companies.

The Senate, in a fairly decisive manner, rejected that proposal in adopting a substitute amendment developed by Senator Dole and Senator Boren. That amendment expresses the sense of the Senate that the Senate Finance and Judiciary Committees should undertake a thorough examination of the impact of oil company mergers and report back to the Senate with recommendations, if any, by July 1 of this year.

It is no great secret that I did not support the Johnston amendment, and that between claim and counterclaim we all discovered anew that statistics can be quoted in almost every instance to prove whatever point desired by the quoter. And when all was said and done, virtually nothing was resolved but at the same time, the concerns raised deserve the attention of the committee. We hope this hearing will aid us in providing answers to the claims raised during the course of the floor debate on the Johnston amendment. I hope that many of you noticed that in the press release announcing this hearing that I highlighted not only the possible tax issues, but the possible energy policy implications of the merger activity as well. One of the ongoing frustrations I have with the Senate legislative process or structure is the extent to which each committee protects its jurisdictional turf by which we create—indeed we embrace—tunnel vision. A committee rarely takes an overall view, and when it does, the turfcats begin to yell. It is my hope that during this hearing we will focus not only on the tax issues involved, but also other economic and energy policy considerations which should be weighed in the context of the Finance Committee recommending any changes to the full Senate with respect to oil company mergers or mergers in general.

During the course of the floor debate on the Johnston amendment, there were often flambuoyant predictions and statements about not the possible but the certain impacts of the current and anticipated oil company mergers. We should attempt to address some of these fears logically and calmly. Do large mergers have a serious impact on our credit markets and our ability to finance capital expansion? Are these mergers driven by favorable tax treatment or are they, to the contrary, a natural reaction to current economic circumstances? Will these mergers reduce total expenditures on oil and gas exploration development, or will the economies of scale be such that the aggregate expenditures will actually increase? If so, is there an enhancement of ability to commit resources to the high risk prospects? Do these mergers decrease competition and increase cost to the consumers, or do they more likely result in more efficient operations that reduce the ultimate consumer costs? By allowing an interest deduction for stock purchases, do we subsidize mergers and acquisitions? If so, is it necessary inconsistent with the congressional intent in allowing the interest deduction in the first place? In sum, is there a real threat to be dealt with and who—if there is—is being threatened?

This committee by this hearing cannot answer all those questions, but there is more involved here than simply tax consideration. Public interest, stockholder interest, market interest, economic interest, and energy interest—to name but a few. I believe it is fair to characterize the past activities on the floor as an attempt to single out oil company mergers as harmful to our economy. To make that case leads to probably the most difficult question of all. If we are going to put ourselves in a position of deciding that, yes, some mergers are beneficial and, no, others are not, what standard separates them and who devises it?

I certainly am not here to volunteer any suggestions nor am I convinced that such a standard is necessary, but that, in reality, is the issue we must ultimately examine. Senator Dole? Senator Long?

Senator LONG. No questions. I think that is a good statement you made, Mr. Chairman.

Senator DOLE. I would just like to make a brief statement and then place in the record my statement. I think Senator Wallop has sort of set the stage for these hearings, and I would say that we had a rather spirited debate on the Senate floor, and contrary to the beliefs of some, we didn't prevail because we were just trying to sweep all this under the rug. We are serious about these hearings. I am serious about trying to determine whether or not there are certain advantages in the code that ought to be corrected. We were sincere when we made that representation on the Senate floor, and I think many of our colleagues supported our position based on the assumption that we weren't just going to try to delay this and not look at the public interest and some of the real questions that should be addressed.

I think Senator Wallop has laid out for the most part areas that we can properly deal with in this committee. Obviously, some we have no jurisdiction of—that may be the Energy Committee or the Judiciary Committee—but our responsibility is quite clear, and I know that—in fact, I have been told by a number of my colleagues—they supported our position based on what they felt to be an honest representation that we were serious about looking into it, and we are. And this will be the first hearing. We will have others, and of course we are a little more concerned when they start hitting our own States, and we are in the process of, one, in my State of Kansas, which deals with the refinery in El Dorado.

There are a lot of people there concerned about the Texaco Getty acquisition and the reluctance of Texaco to be very forthcoming in what we consider to be a rather important matter in our State. It may not be important to Texaco, but it is important to us. So, we are looking for ways to either amend the FTC order or do something to protect the interest we have, and I assume every member of this committee and others will do the same. But I think primarily we have to take a look at the tax areas—whether the recapture rules adequately provide for recovery of previously claimed deductions and credits, whether the tax costs for obtaining a fair market basis and acquired assets is adequate under current law, and I think—as Senator Wallop indicated—whether provisions of current law including the deductibility of interest, the dividends received deduction, and the installment sales provision provide tax incentives for making highly leveraged corporate acquisitions. That is not the purpose of the Code, and if in fact we find that that has been the case, then I would hope this committee would respond very quickly in changing the law in those areas.

Senator WALLOP. Thank you very much, Senator Dole. The first witness is our colleague from the State of Pennsylvania the junior Senator, the Honorable Arlen Specter.

STATEMENT OF HON. ARLEN SPECTER, U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Thank you, Senator. I very much appreciate this opportunity to testify before the Committee on Finance and commend you, Mr. Chairman and Senator Dole and Senator Long for convening these hearings. This subject is of special concern to the State of Pennsylvania, but it really states a national problem. It has come into sharp focus in Pennsylvania with respect to the activities as they relate to Gulf Oil, where there was an effort made by Mr. Pickens for Mesa to take over, and later the merger with SoCal, raising very difficult questions which affect the Nation and very specifically Pennsylvania with the headquarters of the Gulf operation being in Pittsburgh and being threatened and jeopardizing some 700 jobs. More recently, there has been a major issue on Quaker State Oil Co. which was the target of the takeover effort, and that has now been abandoned, but only after a payment of some $10 million by Quaker State to those who sought to acquire the corporation. These circumstances raised very material questions in the line of public policy as to what our laws should be, and in grappling with these matters while consulting a number of tax experts and a number of authorities in the field, including the very able staff of the Finance Committee, I have introduced two proposals—S. 2447 and S. 2448—in an effort to deal with these problems. One of the legislative proposals is before the Banking Committee—Senator Garn's committee—which will change the laws as they relate to the Securities and Exchange Commission to provide that, when someone seeks to acquire 20 percent of stock, there must be a tender for all of the stock so that the shareholders who have stock to sell are not caught in the manipulative practices which surround the tender offers. I am hopeful that Senator Garn will schedule hearings promptly on that line. I would second what Senator

Dole said earlier that the effort for the moratorium was thrust aside in the Senate because there were many of us who felt that it was unwise to have a moratorium and to undertake consequences which were unforeseen on what would happen on the Stock Market on the assurances that these hearings would go forward and that there might be a cutoff date which would not be the date of some later enacted legislation but an earlier date so that people who proceeded would be on notice that what they were doing would be subject to change in law and they could not rely upon existing laws once the Senate and the Congress had touched these matters.

Now, I believe it is important that, as we make changes, to have the earlier dates so that that principle will be established. This is an item which Senator Dole emphasize and upon which many of us rely. I had voted against tabling Senator Johnston's moratorium proposal when it was before the Senate some 2 or 3 weeks earlier, and then I voted in favor of tabling it. I think there were many who saw it as I did—perhaps the majority—so this is a test area as to whether there is sufficient action now to justify such future holding back, depending on what is done here.

Mr. Chairman, I would ask consent that my full statement be incorporated in the record, and I would like to summarize if I may just a few of the highlights.

Senator WALLOP. By all means.

Senator SPECTER. The first provision in S. 2447 would reduce the allowable deductions for dividends received with respect to debt finance portfolio stock. It is well known under current law, the corporate shareholder can deduct 85 percent of dividends received from other corporations. When this is applied against the maximum corporate tax rate of 46 percent, the maximum effective tax on corporate dividends is only 6.9 percent. Where takeovers are highly leveraged, this double deduction generates a negative tax, it therefore yields considerable taxfree income to the acquiring corporation. This provision is already present in Section 31 of the Deficit Reduction Act of 1984. There is a significant change in S. 2447, that is it would make it applicable to stock obtained after March 20, 1984, the date S. 2447 was introduced. I have no private authorship of that date—perhaps it ought to be the date that we defeated the Johnson moratorium. But I think we ought to establish a date earlier than the final enactment of this bill, assuming that it is enacted. The second provision of 2447 would prohibit a corporation which owns the stock of another corporation from claiming a short-term capital loss when the corporate shareholder sells the stock after receiving an extraordinary dividend. These provisions under current law allow the corporation to take a loss of the stock sale if the stock has been held for more than one year, as it is currently proposed.

My sense is that the one-year provision ought to be changed, and S. 2447 would make that change. Again, it would establish the date of March 20, 1984, as I say, I am not wed to that date—it could be some other date—as long as it were an earlier date. The third provision in S. 2447 would apply only to integrated oil companies. It would require that, for tax purposes, an integrated oil company recognizes appreciation on assets in liquidating or nonliquidating distributions. Without this kind of provision, the appreciation of assets while held in corporate situation, can escape tax completely. Now, I understand that there is a problem as such a provision would apply especially to small corporations when they would reach—the provision in the bill currently as proposed by the Finance Committee—would apply to all corporations but reach only nonliquidating distributions. I can understand the reluctance to propose a provision that could, for example, impose a large tax burden on the liquidation sale of the small business. I believe that this concern could be adequately addressed by limiting this provision to integrated oil companies. There is one other suggestion which I have for the committee. I may introduce legislation on it specifically so it will have a number and date in the record. I propose to disallow the deduction in arrangements where these leveraged acquisitions are made. There is currently disallowance of interest deduction where somebody borrows to attain—to purchase—taxfree securities. I believe that analogy should hold here—there ought to be a disallowance of the interest deduction. The Judiciary Committee held extensive hearings on this subject about 3 weeks ago.

Senator LONG. Could I just ask a question, Mr. Chairman at this point?

Senator WALLOP. Yes.

Senator LONG. If you assume that what is being done here is an ordinary, legitimate business operation, and that it is not contrary to public interest, then why should you deny the interest deduction?

Senator SPECTER. I would disagree with the assumption, Senator Long. I do not think it is.

Senator LONG. But if you want to assume that the transaction is against the public interest, then perhaps you ought to put a punitive tax on it, or maybe even prohibit it, but if you assume for the sake of argument that this is just an ordinary situation where someone is buying a company, would you want to put a punitive tax on it in that case?

Senator SPECTER. I am not suggesting a punitive tax, Senator. What I am suggesting is a modification of the law as to deductibility. There are some circumstances in existing law where we disallow deductions for interest paid. In general, we say that that is something that there ought to be a deduction on, but if someone is borrowing money for taxfree securities, we disallow the interest deduction. As these transactions have evolved, they have been very manipulative. They have worked through the curly-cues of the tax laws to take advantage—as they have every right to do—of the dividends received credit, deductibility for interest. It is my sense that we ought not to have these beneficial tax advantages for these kinds of transactions. If they are leveraged, then it is essentially a declaration that they are against public policy, and we are just not going to allow the tax laws to subsidize them. I would not call that a punitive tax. I would say that it simply doesn't give them the benefit of the deduction.

Senator LONG. You are proceeding on the assumption that this is a transaction contrary to the public interest. If that is the case, you probably ought to prohibit it, far more than just tax it. It seems to me, however, that you are assuming the merit of the case, and to me that hasn't been proved yet.

Senator SPECTER. Yes, Senator. That is why we are here. To my thinking, it has been established at least on prima facie proof.

Senator LONG. You have a witness coming along behind you who is involved in one of these mergers who is going to dispute that. We will have someone testifying for Standard Oil of California who is going to take issue with you on this.

Senator WALLOP. If I may say, I don't think it has been established as a prima facie case. And that is not the reason we are having the hearings. The reason we are having the hearings is to determine if there is public interest that is being misserved, badly served, or if the public interest is adequately protected. But we haven't determined that yet. I think the case has to be made before we can make that assumption. I mean, to date nobody has—to my satisfaction, or even to my knowledge—yet made the case as to why the public interest is badly served. I think that is step No. 1, and so I would say the purpose of the hearing is to find out whether the public interest is being served, or misserved? I don't think it has been established, and I would hope that before we did anything different than the status quo, that we would do it on the basis of something that has been established.

Senator SPECTER. The question which is addressed to me is what is my opinion. That is all that I can offer, and it is my opinion and my judgment that it is contrary to the public interest. I base that conclusion on the hearings which were held before the Judiciary Committee about 3 weeks ago, where many of the witnesses who will testify here appeared before the Judiciary Committee. Mr. Keller from SoCal was present. Mr. Lee from Gulf was present. Mr. Boone Pickens from Mesa Petroleum was present. I presided at those hearings. During the testimony of Mr. Keller and Mr. Pickens, and as the scenario unfolded—for example, as it relates to Gulf Oil—there you have a corporation which has a book value at $118 a share, you have the market value as low as $38 at some point and rising when Mr. Pickens comes into the picture and exercises his rights in a free market society to make that acquisition. My opinion is that it is undesirable to have large segments of the capital and credit in this country being devoted to acquisitions of oil companies. It costs something like $10 to $15 billion for each one when you have an acquisition of Getty by Texaco, and about that range when you have SoCal acquiring Gulf. I understand the consideration that the stockholders get this money and have it available for reinvestment, but it seems to me that when we have about $240 billion available in the credit market, aside from what the Government borrows—because of the large deficits—that there is a very big dilution of available credit. My conclusion is—after hearing Mr. Keller testify and Mr. Pickens testify—that where these purchases are made by SoCal, that there are going to be fewer assets available for exploration. The public interest is served in my judgment where the assets are used for exploration as opposed to acquisitions in these kinds of arrangements where you can buy oil for $4 or $5 or $6 a barrel as opposed to exploring for it for twice the amount of money.

I understand that the oil is still in place, and when it is necessary we may go out and get it, but I think the consequences are undesirable. When Mr. Pickens testified and I asked him the question as to what would be the consequence if we modified the dividends received credit and what would be the consequence if we disallowed interest, he said, in his own words, that it would substantially change the deal. That he might not be able to make these acquisitions if the tax laws were changed. Now, the Internal Revenue Code is a very complex document, which has developed over decades. Each time we add a provision, we do so because we think it makes sense as we see the facts in a specific case. Then there are astute attorneys and astute businessmen who use their rights as free citizens in a free enterprise society to find ways to utilize the law, which they have every right to do. As a result we have hearings. The conclusion that I have come to is that the efforts by Mr. Pickens and Mesa—we use the word "predatory"—whether that advances the cause very much I don't know, but I believe it is against public policy to have that kind of an acquisition. The acquisition is really possible because of the provisions of the Internal Revenue Code, and that is a form of public subsidy—they have the dividends received credit and the deductions. This committee is going to have to decide whether it is against public policy or not. I would suggest to this committee that probably a majority of the U.S. Senate—when this matter was considered 2 weeks ago—concluded that these acquisitions were against public policy.

Senator Johnston got 39 votes. I think the vote was 54 to 39. I can tell you that I think they are against public policy. I think a lot of you other Senators who voted to table the Johnston moratorium thought so too. So, when I say there is a prima facie showing that they are against public policy, my sense is that I speak for a majority of the Senate. I don't expect you to agree necessarily, Mr. Chairman—but the hearings which we had in Judiciary—and we are going to have more—explored this further.

[Senator Specter's prepared statement follows:]

STATEMENT OF HON. ARLEN SPECTER, SENATOR FROM PENNSYLVANIA

On March 20, 1984, I introduced S.2447 the Corporate Distribution Tax Reform Act of 1984 to discourage predatory corporate takeovers for the purpose of liquidating corporate assets. This legislation would inhibit such takeovers by better ensuring that distribution of corporate assets do not escape tax at the corporate level.

The recent rash of mergers between big oil companies - and the fear that additional mergers may be imminent - has generated concern that these mergers may not be in the public interest. In the past few weeks debate in the Senate has centered around the question of whether or not to impose a moratorium on these mergers. I voted against a moratorium because in my judgment the Senate had not yet had a sufficient opportunity to consider all the consequences of a moratorium. Instead, as I stated then, I believe the preferable course was to hold hearings and act on specific bills, like S.2447, which are designed to inhibit harmful takeovers.

Given the Senate action of last month, it is unlikely that legislation will be enacted which will bar the proposed merger between the Gulf-Oil Corporation and Standard Oil of California (SoCal). However, that merger - and other similar mergers which may follow - pose a number of potential problems:

First, will the merger lead to foreign interests replacing domestic ownership? No one needs to be reminded that our economic well being and even our national security would be severely undermined if petroleum supplies were disrupted. Major American energy companies now hold millions of barrels in reserve. We cannot allow these reserves to be bought out by foreign interests. Nor, should we allow our drilling and refining capacities to become captive to foreign owners who may decide to divert supplies away from American markets.

Second, will the merger tie up large amounts of credit, driving up interest rates and closing off credit supplies from other business interests? Texaco payed $10.1 billion to purchase Getty. Arco recently arranged for $13 billion in credit to bid for Gulf, while SoCal's credit arrangements totalled $14 billion. Although much of this money will eventually be reinvested, with only $216 billion available to cover all of this nation's private transactions, even the temporary dislocation caused by these multibillion dollar mergers is unacceptable.

The enormous debt incurred to support these mergers leads to another basic problem - decreased research and exploration. In the SoCal-Gulf context for example, the debt service on this $14 billion will exceed Gulf's earnings by $200 million a year. Although, I understand that SoCal has pledged that the merger will not lead to a decrease in exploration, I do not understand where the revenue will come from to support exploration in a combined SoCal-Gulf entity equal to SoCal's and Gulf's existing spending for exploration.

Indeed, I believe the greatest danger presented by these oil mergers is that their potential for a reduction in new exploration and development efforts. Oil companies are attractive takeover objects because they offer an opportunity to purchase oil and gas reserves at a fraction of current production costs. For example, by acquiring Gulf, SoCal would double its crude oil supply - at a price of about $4.52 a barrel. Today, the average exploration and production costs for purchasing a barrel range between $10 and $15.

It is not only the mergers between giants like SoCal and Gulf, Texaco and Getty which threaten to deplete petroleum reserves and cut back on exploration and development. The Mesa Petroleum Company's bid to purchase control of Gulf and convert its production assets into royalty trusts is premised upon drawing down existing resources and limiting exploration spending.

In addition to considering the broad economic and security implications of the foreign ownership, credit lock ups and reduced exploration, I believe these mergers must also be evaluated in two other ways. First, will the merger result in a disruption of supply to retailers and consumers? The proposed merger between Mobil and Marathon was barred in large part because the merger threatened Marathon's position as an important supply source for independent retailers. SoCal is a major source of supply for independents in a number of states where SoCal's supplies are not needed by its retail operation. If SoCal merges with Gulf, will Gulf retailers take the place of those independents now supplied by SoCal?

Disruption of supply can, in fact, be encouraged as merging companies struggle to meet antitrust concerns. In order to obtain FTC clearance, Texaco was forced to give up Getty's interest in selected pipelines and refineries, and to sell nine Getty wholesale terminals and 1900 gas stations. According to the Wall Street Journal, Saudi Arabia and Kuwait rate high among the prospective purchasers for entities spun off in engergy mergers.

A fifth and final factor which I believe must be considered in determining whether or not oil mergers are in the national interests is the impact on employment a merger will have. Except in the rarest of circumstances mergers cost jobs. Not all of the Getty assets which Texaco was forced to spin off continued as going concerns. As a result in more than one case, jobs disappeared. As I have noted, I have no doubt that a Gulf merger will cost my constituents in Pittsburgh jobs.

One way to prevent such mergers - and the attendant adverse consequences - is to enact legislation to eliminate the motivation for the mergers.

The Gulf-SoCal mergers was caused by Mr. Boone Pickens' and Mesa Petroleum's attempt to gain control of Gulf in order to liquidate substantial corporate assets. According to press reports, Mr. Pickens, Mesa Petroleum and affiliates will receive a profit of approximately $780 million from SoCal for their Gulf stock. I think it likely that Mr. Pickens will reinvest this new capital in another oil company, thus setting the stage for yet another merger unless the Congress acts promptly.

My legislation, S.2447, contains three provisions which if enacted would, in Mr. Pickens words, "change the economics" of the royalty trust takeover in which Mr. Pickens specializes.

The first provision would reduce the allowable deduction for dividends received with respect to debt-financed portfolio stock.

Under current law, a corporate shareholder can deduct 85 percent of dividends received from other corporations. When this is applied against a maximum corporate tax rate of 46 percent, the maximum effective tax rate on corporate dividends is only 6.9 percent. This low tax rate is further diminished where the acquisition of the dividend producing stock was debt financed since the interest on the debt is deductible against ordinary income.

Where takeovers are highly leveraged, this double deduction generates a negative tax, yielding considerable tax free income to the acquiring corporation.

This bill would restrict the dividends-received deduction by the extent to which the purchase was debt financed. A merger would therefore offer a much less attractive opportunity for generating tax free income.

This same provision - with one exception - is contained in Section 31 of the Deficit Reduction Act of 1984 recently reported by the Senate Committee on Finance and in Section 51 of the Tax Reform Act of 1984 reported by the House Ways and Means Committee. Both the Senate and the House bills would make this provision applicable to stock obtained after enactment. S.2447 would apply to stock obtained after March 20, 1984 (the date S.2447 was introduced). In my opinion, if this provision is to have the needed impact in dampening the current merger fever it must have immediate applicability.

The second provision of S.2447 would prohibit a corporation which owns the stock of another corporation from claiming a short term capital loss when the corporate shareholder sells its stock after receiving an extraordinary dividend.

Currently a corporation may take control of another corporation and liquidate its most valuable properties by spinning off a royalty trust. When the corporation then sells the stock for a price that reflects the royalty trust distribution, the decline in the stock value is deductible as a short term capital loss against corporate income. At the same time, the royalty trust distribution would be largely tax-free to the corporate shareholder because of the dividends-received deduction. For example, if Corporation A paid $50 a share for Corporation B's stock and distributed a portion of B's production assets as a royalty trust interest worth $20 a share, B's stock would then be worth approximately $30. If A then sold this stock for $30 it would have a $20 short term capitål loss deduction to be applied against its corporate income, while the $20 royalty trust disbribution would be largely tax-free. S.2447 would eliminate Corporation A's ability to claim this loss for all stock acquired after March 20, 1984.

Similar provisions are contained in the Senate's Deficit Reduction Act of 1984 at Section 35 and in the House's Tax Reform Act of 1984 at Section 53. Those provisions, however, allow the corporation to take a loss on a stock sale if the stock has been held more than one year and will only be applied to stock acquired after the bills are enacted. Again, I believe that unless this provision is applied immediately, its untimely effective date will limit its beneficial impact.

The final provision contained in S.2447 applies only to integrated oil companies. It would require that for tax purposes an integrated oil company recognize appreciation on assets in liquidating or nonliquidating distributions. Without this provision, the appreciation of assets while held in corporate solution can escape tax completely.

Under current law when a corporation distributes appreciated assets through a royalty trust, for example, the corporation pays no tax on that distribution. If the law were amended to require that the corporation pay tax on this appreciation, estimates suggest that any significant royalty trust spinoff from large oil companies (as for example the spinoff of certain Gulf assets proposed by Mesa) could generate tax revenue in excess of $1 billion.

Section 36 of the Deficit Reduction Act of 1984 and Section 54 of the Tax Reform Act of 1984 contain a provision similar in concept to my proposal but with a different scope. The provision in those bills apply to all corporations but reach only nonliquidating distributions. I understand this Committee's reluctance to propose a provision that could, for example, impose a large tax burden on the liquidation sale of a small business. But, I believe this concern could be adequately addressed by limiting this provision to integrated oil companies.

In closing, I would like to commend the Chairman for holding these most timely hearings and for focusing attention on our need to react responsibly and expeditiously to the current explosion of merger activity. Whether it is S.2447, The corporate Distribution Tax Reform Act of 1984 that I have introduced or the language of similar proposals reported by the Committee, it is important that we act promptly and remedy this continuing problem by the passage of effective legislation.

Senator LONG. I simply looked at the letter by the Attorney General. The best I could make of it, was that, if the merger or the acquisition does not have the effect of reducing competition in any meaningful way, so that it does not result in a concentration that would conflict with the intent of the Sherman Antitrust Act, or any other antitrust act dealing with concentration, then the Attorney General's view was that there is nothing improper about the acquisition. There is nothing contrary to public policy about it, any more than if you went out and bought the majority of stock in Sears, Roebuck & Co. In the absence of showing any concentration of economic power—which the Attorney General says is not the case—that is adequate under the antitrust laws as they stand today, and I fail to see where it is against the public interest.

Senator SPECTER. Senator Long, the antitrust laws are only one definition of public policy. As we debated this matter on the Senate floor, representations were made—I do not know whether they are true or not—that if you had a merger of seven major oil companies, you wouldn't trigger the concentration necessary that would constitute a violation of the antitrust laws. Whether it triggers a violation of the antitrust laws or not, I think hardly anybody would say that a merger of seven major oil companies would be in the public interest.

Senator LONG. Now, I challenge that. I just don't believe that it is correct that, if you merged those seven major companies, you would not trigger those antitrust laws. I think that is completely in error when you say that, and I suggest that you see if you can find some support for that. People would contend, I should think, that Exxon is as big as the next three companies put together, and that if two companies of lesser size should merge—the No. 2 or 3 should merge with the No. 8 or 9—that that is really putting them in a position to compete with the No. 1 that is the largest. Even that is not a monopolistic concentration that is going to adversely affect competition.

The Federal Trade Commission has the job of looking at that, and my understanding is that they are going to do their job. Where there might be any one company dominating a market in a certain area, the company would have to spin those operations off and sell them to someone else. But I would weigh with interest any argument establishing or proving that this merger is against the public interest because, if it is, it seems to me that you have laws in effect right now, requiring the Justice Department, the Federal Trade Commission, or both to proceed against it.

Senator SPECTER. Senator Long, I was careful in my statement that the representations which were made in the debate that the merger of the seven companies would not trigger violation of the antitrust laws. I do not know whether that is so or not, but I do say this emphatically and would defend this proposition that the antitrust laws are only one statement of public policy. There are other concerns of public policy, and if these acquisitions and mergers discourage exploration, then that would be a significant factor which would be counter to public policy and ought to be discouraged.

Senator WALLOP. If they did, that would be the case, but there is no demonstration that that has been the case. There has been one instance—and one instance alone. I think somebody has to give us more than a ghost on the horizon that that might be the case.

In only one instance has it proven to be the case, and in the others it has been exactly the opposite—exploration budgets have actually increased.

Senator SPECTER. Mr. Chairman, these are judgments which each of us who has to vote on these measures makes, depending on our evaluation of the facts and what motivates conduct. They are not susceptible to mathematical certainty. My judgment, after having studied this subject at some length, is that it does discourage exploration. It may be that even the statement of the antitrust laws in their current form do not discourage some mergers, we may have to revise the antitrust laws. When Senator Long says that the laws ought to be in existence at the present time to prohibit it, we are not wise enough to anticipate in 1983 all the things that are going to happen in 1984. That is what keeps us in business.

Senator WALLOP. Thank you very much.

Senator DOLE. I don't have any questions, but I do think that Senator Specter has rather properly stated the responsibility that we have in this committee. There is no doubt in my mind that there would be an 11-month moratorium in place had it not been for the substitute that was offered. So, I don't think anybody ought to make—there is no question in my mind that we ought to have a moratorium around here, and if you turn the House loose on it, it is hard to tell what you have. They would like to put oil companies out of business all together, a lot of them in the House.

So, we have a rather serious responsibility and we are going to obviously approach it that way. It seems to me that the primary question is maybe, if in fact there are depleting reserves, is it better to acquire another company or go out and look for them? And they take a look at the tax advantages in each case. Maybe there are greater advantages taxwise through mergers than there are through explorations. There will be later witnesses. Texaco didn't pay any tax at all in 1982, so they will say, well, it wasn't tax motivated. On the other hand, SoCal paid a fairly high tax rate, so I think we have to look around and determine whether or not there is anything that should be done.

I do think your testimony has been very helpful.

Senator SPECTER. Senator Dole, as I understood you, you stated that you thought there would have been an 11-month moratorium had your substitute not been offered. I agree with you. I think there would have been a moratorium, and I believe that the moratorium was not voted by the Senate because of concern of widespread disruption of the stock market, the consequences of which we could not figure out.

A lot of people hold stock, and if there had been a moratorium, we just wouldn't know all those consequences and those ramifications. If you approach the threshold question as to whether a majority of the Senate prima facie has concluded or feels that these mergers are contrary to public policy, I would assert before this committee that there are more than 51 Senators who feel that they are contrary to public policy. What the Senate has done by tabling the Johnson amendment is to say to the Finance Committee and the Energy Committee and the Judiciary Committee "You go take a look; maybe we are right, and maybe we are wrong. You tell us, and if it is contrary to public policy, and our feeling is correct, you tell us what the answer should be, and we won't disrupt the market by this moratorium which is a drastic remedy that we don't want to undertake without that kind of study." But I believe the consensus of the Senate is that these mergers are contrary to public policy.

Senator DOLE. I think there is a majority in the Senate and unanimity in the media that they are contrary to public policy, which has some impact on members from time to time. But that is a problem we have to deal with, and I think you have stated the case very well.

Senator SPECTER. Sometimes the Senate has some impact on the media.

Senator WALLOP. Can I just ask one question? Energy is clearly one of the basic industries in this country, but so, too, is steel. And steel has a concentration factor which far exceeds that in the energy industry, and yet it is my understanding that it is your feeling that public policy is better served by mergers within the steel industry, which would increase that concentration. How do we devise a standard that works for the steel industry and is consistent with the standards that we would apply to the energy industry?

Senator SPECTER. Senator Wallop, I am not sure that mergers within the steel industry are desirable. I think that is something that has to be explored further, and there are other considerations on public policy as to the merger impact. It may be that in a failing industry, when you have companies like Republic and Jones and Locklin that there ought to be some different application of the antitrust laws—that concentration is not the final answer. We need a steel industry for basic industry in time of defense, and we are finding that our steel industry is being eroded by foreign imports, so that steel has many different considerations.

But I am not prepared—and I haven't jumped to the conclusion—that we ought to have mergers in the steel industry. That is something that requires a lot of careful thought.

Senator WALLOP. Thank you very much.

Senator SPECTER. Thank you.

Senator WALLOP. Just a moment, please.

Senator BENTSEN. Senator Specter, I don't happen to share the viewpoint that mergers are against public policy. I think what you are seeing is a recognition of undervalued assets in the marketplace—investors understand that.

I think the undervaluation is self-correcting. Mergers are a consequence—or a result—and not a part of the problem. I think some of the mergers are obviously justified. During the debate on the floor last week I listed a group of companies that had been acquired and mergers made where there had been an absolute increase in drilling.

Robert Samuelson in his article in the Washington Post about a month ago made a comment that there was a lot of fuzzy thinking about mergers, and he made a very valid point. One of the situations that you are seeing today is that many management groups are trying to protect not just the shareholders, but in many instances, they are just trying to protect their jobs. We have seen situations where they will rotate the board one-third each election to try to deter any kind of an acquisition. We have also seen them establishing golden parachutes for themselves.

I can recall in times past when investment trusts, when pension funds, when mutual fund management companies—if they had a management of a company they were investing in that really wasn't doing its job, they just sold the stock.

Now, you are seeing a much more active group of investors that are putting a new discipline on the management. And I think that is good. It's making them shape up in many instances. The greatest defense against a tender offer is to get the price of your stock up, that is to get your price earnings multiple high, and to increase the profits of that company. Now, if you get into an industry that is having a decline—as the oil industry is—you are going to have some mergers and acquisitions, and I think that can serve a useful purpose. When you get into a position where competition is perhaps hindered, then I think that is for the FTC, the Justice Department to decide whether that merger should continue.

I don't happen to share the view with the chairman that we did not have the votes to defeat the Johnston amendment. He is an awful good head-counter. But I think we might have won that vote. On the other hand, the risk of having it pass and having an 11-month moratorium, which would have had, I think, a most disruptive effect on the marketplace and on investors, led to the prudent option as sponsored by the chairman. I was delighted to have co-sponsored it with him.

Mr. Chairman, we have taken a number of steps, in the Finance Committee markup of the Tax bill which, frankly, I didn't agree with. In particular, I did not like the idea that you could tax a corporation on the nonliquidating distribution of property. I think that was bad economics. By adopting such an amendment you are locking a lot of property into a corporation. In addition, we did some other things, like disallowing part of the corporation's 85 percent dividend received deduction—when a corporation receives dividends on portfolio stock and pays interest on a directly related debt. We saw some abuses there, and I think we made some real progress with that provision. We did some other things that had to be done. But overall, I would argue with you, Senator, that the marketplace makes a pretty good adjustment on these things.

And finally, we have seen where if you bid up the price on these particular undervalued stocks, and they reach a point where it is self-correcting, they are no longer decent takeover candidates.

Senator SPECTER. Senator Bentsen, I agree with you about reliance on the marketplace. The issue is whether there are unfair advantages possible through the Internal Revenue Code, which make some of these actions possible where they ought not to have that kind of a boost. I agree with you also on the complexity of the matter. I know that from my own State—within the course of the past couple of months—we have had two incidents which require a lot of study. I do not like what has happened to Gulf Oil, not only as a Pennsylvanian but as an American. I think that there has to be a close look at the events which lead to Gulf seeking a white knight in SoCal because they are about to be taken over by what they consider to be a predatory takeover. Before you arrived, I referred to a situation involving Quaker State where Mr. Quentin Wood, the president, contacted me about a week ago raising concerns about a takeover effort against his company. There was a venture into the field, some of the stock was acquired, and there ended up with a profit of $10 million to those who had made the initial steps toward a takeover. The cost to Quaker State of $10 million. That is very involved, and I have asked him for the details, and I intend to take a look at it. But I think this is a matter which requires our very close attention. I have a sense that if there is something wrong with the construction of our laws which make some of these activities possible.

Senator BENTSEN. Senator, let me give you an example of the other extreme. I now refer to the State of the Chairman, Kansas. I can recall looking at a company that I frankly thought the management was doing a very poor job, where the company was not growing, so I decided I wanted to make an offer on that company to the stockholders. I couldn't even get the stockholder list. What the management of those various companies did was to go to the State legislature and convinced them that, in order to stop any offers that would disrupt their situation, that a law should be enacted preventing the stockholder list from being given out. Now, that is the other extreme of how far management sometimes goes to try to protect their jobs, and not necessarily their investors.

Senator SPECTER. We agree. We have got to stop the extremes.

Senator DURENBERGER. Mr. Chairman, before Arlen leaves, let me just add a compliment and a comment—a compliment to his thoughtfulness—I don't necessarily agree with all the conclusions, and it just may be that you are farther, much farther ahead on this process than I am—but on the last question that the Chairman asked you—the comparison of steel mergers and oil mergers as one who has dealt with the former industry more than the latter, I would say there is quite a difference in the approach, and differences that are most appropriate for the consideration of this particular committee. I don't know that there is an oil merger that isn't, in some way—at least in part—tax motivated—and I don't know a lot of steel mergers that are. This committee has done its best to make sure that that would be the case by getting rid of any access to tax benefits in the steel industry from safe harbor to the various financing rules, and we have made sure that the steel industry is as far from the oil industry in this economic playing field out there as possible. And as one member of this committee, if they were both on the same playing field, then we both had the same tax treatment and both had the same economic environment in this country in which to operate, I wouldn't mind having the same rules for both of those industries.

Senator WALLOP. Thank you very much, Senator Specter.

Senator SPECTER. Thank you.

Senator WALLOP. The next witness is Deputy Assistant Secretary for Tax Policy, the Honorable Ron Pearlman.

STATEMENT OF THE HONORABLE RONALD A. PEARLMAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC.

Mr. PEARLMAN. Thank you, Mr. Chairman. Good morning. I appreciate the opportunity of being here this morning to address both the question of whether tax motivations are the principal incentive to the rash of oil mergers to which this committee is giving attention, and in addition, to discuss certain tax provisions relating to corporate acquisitions in general. Our analysis to date does not indicate that these mergers are primarily tax motivated.

They may be motivated by decreases in demand for oil, and therefore reduction in oil prices——

Senator WALLOP. Mr. Pearlman, would you state that again? I am sorry. I didn't hear it—was it your statement that they are not motivated?

Mr. PEARLMAN. That they are not primarily motivated by tax considerations. They may be motivated by increased exploration costs or simply by the undervaluation of oil reserves in the stock market. For this analysis, I think it is best for us to defer to others with greater industry expertise. I would like to focus my comments on the tax aspects.

Generally, corporate acquisitions involve either the direct acquisition of target corporation stock or assets and may either be tax free if the reorganization requirements of the Internal Revenue Code are met, or taxable to the selling corporation or its shareholders. If the transaction is tax free, the basis of the target corporation's assets will carry over—that is, there will be no upward or downward adjustment in the bases of assets to reflect the purchase price paid for the target corporation's stock. The purchase price is normally in the form of stock of the acquiring corporation—or another corporation that controls the acquiring corporation.

In a taxable asset acquisition, gain generally will be recognized to the selling corporation, including recapture and other tax benefit items, and the basis of the target corporation's assets will be adjusted to reflect the purchase price.

In a taxable stock acquisition, gain generally will be recognized to the selling corporation's shareholders currently and the purchase price of the stock becomes the basis for the target stock in the hands of the purchasing corporation. Here there is no step-up in the basis of the assets and no recapture of any tax benefits items unless the purchasing corporation makes the so-called section 338 election which I will come back to momentarily. Shortly before TEFRA, considerable publicity was given to major corporate transactions in which the partial liquidation and consolidated return rules were utilized to attain a step-up in the bases of assets following a taxable stock acquisition but without current recognition by the Target Corporation of recapture or other tax benefit type income. TEFRA responded to this publicity—to these transactions—by precluding basis step-up without the recognition of recapture and tax benefit items. TEFRA also provided a new system for governing when and how a purchasing corporation may obtain a step-up in basis following a taxable stock acquisition. These rules are contained in section 338.

Without going into the details of that section, essentially the approach of section 338 is to provide an election to the purchasing corporation to either adjust the tax basis of the assets of the target corporation to reflect the purchase price paid for the stock at the cost of recapture and the inclusion of other tax benefit items in income or to choose not to pick up any income items and to retain the target corporation's historic basis in its assets. N~w, these rules apply on an all-or-nothing basis, that is, the purchasing corporation is not permitted to pick and choose which assets are to be adjusted and which are not. These are referred to as the consistency or the antiselectivity rules.

If one oil corporation purchases the stock of another, section 338 normally would apply and the purchasing corporation would have the option of either carrying over the historic basis of the target corporation's assets or making the section 338 election and stepping up the basis. We understand that in one or more of the recently announced oil corporation acquisitions, the purchasing corporation may choose not to make a section 338 election and thereby step-up basis because of the tax cost of recapture. In these transactions, it appears therefore that the consistency rules of section 338 are achieving their intended purpose.

Even when an election is made under section 338, there is not a full corporate level tax imposed in exchange for the basis step-up. Only recapture and certain other ordinary tax benefit income items are recognized. Other unrealized gain is not. This result stems from the codification in sections 311, 336, and 337 of the Code of the Supreme Court's 1935 decision in the *General Utilities* case. The *General Utilities* doctrine has received considerable attention over the past several years, and indeed Congress has reduced, and both the Finance and the Ways and Means Committees have proposed further reductions in, the scope of this doctrine. For example, distributions of appreciated property in certain redemptions are taxable to the distributing corporation. TEFRA extended that treatment to distributions of appreciated property in partial liquidations, where again the appreciation is taxable in full to distributing corporations, and in both the Ways and Mean Committee bill (H.R. 4170) and the Finance Committee's Deficit Reduction Act of 1984, dividends of appreciated property generally will result in gain recognition by the distributing corporation, with the exception for distributions to certain qualified stockholders—an exception which was designed to respond to the concern that Senator Bentsen mentioned a moment ago. We are pleased that the administration was able to propose these changes, which I should note were based in large part on the preliminary report of the staff of the Finance Committee on the reform and simplification of subchapter C.

We think those are constructive changes, and we are pleased that they are contained in both the Ways and Means and the Finance Committee's bills. One major remaining area in which the general utilities doctrine remains in the law, is the complete liquidation and the deemed asset sale in connection with the 338 election. It has been suggested that the repeal of the general utilities doctrine is appropriate here as well.

While we recognize that such repeal would aid in the simplification of the corporate income tax, as we have indicated in previous testimony before the Finance Committee, we believe consideration of the repeal of general utilities in liquidating transactions must also include consideration of relief from the double taxation of liquidating proceeds.

Under current law, one of the assets which can be distributed without corporate level gain is the royalty trust. The restriction on general utilities imposed by H.R. 4170 and the Finance Committee's proposed legislation would subject the royalty trust, and any other distribution of appreciated property, to corporate level taxation. As a result, if H.R. 4170 and/or the Finance Committee proposal is enacted, there will be little remaining tax incentive although there might be other incentives for the distribution of such interests.

Under current law, the gain on the disposition of mineral property is taxable as ordinary income under section 1254 of the code to the extent intangible drilling costs were deducted after December 31, 1975. No recapture exists with respect to mineral property for which intangible drilling costs were deducted prior to that date. Similarly prior to 1975, integrated oil companies were able to deduct percentage depletion at a rate of 22 percent with respect to mineral property. Since 1975, integrated oil companies have been required to use cost depletion. Upon the disposition of the mineral property however, current law does not require recapture of either cost or percentage depletion.

Some have suggested that recapture rules should be applied to the intangible drilling costs deducted with respect to mineral properties regardless of when the deductions were taken. We cannot support such a change. The recapture of intangible drilling costs was considered extensively by the Congress in connection with the 1976 legislation. Congress enacted legislation to preclude the continued deduction of intangible drilling costs without the benefit of recapture. We believe it would be inappropriate to revisit that legislation in which Congress established an effective date, by retroactively, if you will, imposing recapture.

With respect to percentage depletion, although integrated oil companies are no longer permitted to utilize percentage depletion, and even though there are no recapture provisions in the code with respect to percentage depletion as it relates to any taxpayer, some have suggested that it would be appropriate to impose a recapture of pre-1975 percentage depletion deducted in excess of bases on the disposition of mineral properties by integrated oil companies. In 1975 when Congress dealt with the subject of percentage depletion for integrated oil companies, it determined that subsequent to that date, percentage depletion would not be available. Again, we believe that it would be inappropriate to go back now and seek to reduce the benefit of percentage depletion prior to that date by imposing a recapture rule on pre-1975 percentage depletion.

Others have suggested that the income tax law encourages highly leveraged buy-outs of oil corporations by permitting the acquiring corporation to deduct interest paid or accrued on debt incurred in connection with the acquisition. Currently, section 279 disallows an interest deduction under very limited circumstances where certain types of debt are used to acquire stock or assets of another corporation. I might note that section 279 is really directed to the kind of debt that looks somewhat like an equity investment—convertible debt or debt that has other features that are more in the nature of equity investments.

Outside of the limitation of section 279, there are no unusual tax consequences to using debt for acquisitions. The corporation is entitled to an interest deduction on the acquisition debt, and such interest is paid to a bank or some other person who generally is subject to tax on the interest income received. Because the use of debt for acquisitions is not significantly different from debt used for other corporate purposes, we do not believe there should be any unusual tax consequences to using debt for acquisitions.

I do want to point out that in the case of acquisitions in which installment sale treatment is used, while we are not talking about a concern for the interest deduction, there is a problem we believe where the installment treatment to the selling shareholder gives the shareholder the benefit of deferring the gain on the sale whereas, at the same time, the purchasing corporation has the ability to obtain an immediate step-up in the basis of the assets, and begin immediately to depreciate or deplete those assets. This is we believe a mismatch, which is somewhat reduced to the extent recapture income is recognized, but a mismatch which is not unique to oil company mergers but, rather, is present throughout the system in installment sales. We believe this problem is appropriate for subcommittee consideration.

Senator BENTSEN. Is it appropriate to ask questions as we go along?

Senator WALLOP. Surely.

Senator BENTSEN. Didn't we address that problem in another field as part of the installment sales, which I recognized as an abuse?

Mr. PEARLMAN. That is correct, Senator Bentsen. In the real estate provisions of the Senate bill, there is a provision that excludes recapture income from installment sale treatment so that the recapture income has to be recognized immediately even if the seller sells property on the installment sale basis.

Let me just suggest that the mismatch goes beyond depreciation recapture.

Senator WALLOP. Just for the sake of what brings us here, is installment sales method being used in any of the oil mergers that we are talking about?

Mr. PEARLMAN. Senator, as best we can determine, the installment sale option is an option described in the offering materials that we have reviewed. That is, the purchasing corporation has retained the opportunity to issue bonds or notes or installment obligations as a form of consideration. Whether in fact those transactions will be consumated as purely cash transactions or not, I simply cannot answer you.

I would like to mention very briefly some aspects of the dividends received deduction because that, too, is one or the items that is referred to frequently in connection with oil merger acquisitions. In general, the Internal Revenue Code allows corporations, other than a subchapter S corporation, the deduction equal to 85 percent of a dividend received. A 100 percent dividend received deduction is allowed for dividends paid by affiliated corporations and, in addition, if corporations file a consolidated return, intercompany dividends are totally eliminated. The purpose for the intercorporate dividend received deduction is to preclude multiple taxation of income at the corporate level. If a corporation borrows funds for the purpose of making a portfolio investment in stock of another corporation, interest on the borrowing generally is deductible under current law by the corporation making the investment, and that creates the opportunity in effect for double deductions to the extent of the dividends received deduction. This is not an inconsistency with respect to controlled corporations or where consolidated returns are filed, but to deal with the portfolio investment situation, both H.R. 4170 and the Finance Committee's Deficit Reduction Act of 1984 contain an administration proposal which, in addition, was the subject of discussion by the preliminary staff report on subchapter C, to disallow interest on debt that is directly attributable to portfolio investment in stock provided that the stock ownership is not greater than 80 percent. Let me note that I think that that proposal, as I understand it, is the same as Senator Specter's proposal, with the exception of the effective date provision that he mentioned to you earlier.

I should note, however, that this proposal generally would not—according to our understanding—impact on the most recently publicized oil corporation mergers because to the extent that those corporations acquire 80 percent or more of the stock of the target corporation, this leveraged portfolio stock deduction restriction would not apply.

It has also been suggested that in the acquisition of an oil corporation, there is an advantage to be gained under the windfall profit tax through a transfer of oil producing properties. I don't intend to go into the details of that orally. We have included a discussion of that in our statement. Let me just say that we do not think that is the case, and we are neutral or indifferent to the transfer of assets among taxpayers as far as the windfall profit tax goes.

In conclusion, let me say that the current tax rules do not appear to be propelling the recent flurry of oil corporation acquisitions. We do not believe that the Congress should amend the tax laws for the purpose of discouraging these mergers. Nevertheless, we think that, if the subcommittee should determine as a result of these hearings, that improvements in the tax laws generally are appropriate with regard to corporate acquisitions, without regard to whether current law serves as an incentive to oil corporation mergers, we certainly look forward to working with the subcommittee in trying to develop and improve the law. Thank you very much.

Senator WALLOP. Thank you, Mr. Pearlman.

[Mr. Pearlman's prepared statement follows:]

For Release Upon Delivery
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STATEMENT OF
RONALD A. PEARLMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to discuss some of the more significant Federal income tax consequences affecting acquisitions of oil and gas corporations. The number of highly publicized acquisitions (and proposed acquisitions) of large, publicly held corporations primarily engaged in the oil and gas business has renewed concern that our tax laws may encourage these transactions. Although we do not know the motivations for the recent flurry of merger activity, we doubt that it is primarily tax motivated. Rather, these acquisitions may be motivated by sucn other factors as a decrease in demand for oil, an increase in costs of exploration for new oil and the shrinking of reserves, the undervaluation of such reserves in the stock market, or any number of other factors. The determination of the anticompetitive aspects of these acquisitions is a matter for the Justice Department and the Federal Trade Commission, and we defer to their expertise in that area.

The first part of my testimony summarizes the alternative structures that are most frequently employed to effectuate these acquisitions and the associated tax consequences of those structures to the acquiring corporation, the target corporation and the shareholders of the target corporation. The second part of my testimony describes those provisions of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") that were directed at unwarranted tax benefits attainable under prior law in corporate mergers and acquisitions, and describes the effect of those provisions on oil and gas corporation acquisitions. Finally, the third part of my testimony describes other provisions of the Internal Revenue Code that have a direct bearing on acquisition transactions.

I. Tax Treatment of Corporate Acquisitions

The acquisition by one corporation of the business of another corporation can be accomplished in a variety of ways, and the tax consequences of each alternative acquisitive structure may differ significantly. Most acquistions, however, involve the direct acquisition of the target corporation's assets or its stock. In either case, the acquisition can be structured either as a tax-free "reorganization" or as a taxable transaction.

A. Tax-Free Reorganizations

If a transaction qualifies as a statutorily defined "reorganization," it generally will be tax-free to the target corporation, even if that corporation has appreciated assets. Depending on the application of sections 381, 382, and 383, the tax attributes of the target corporation generally will survive the reorganization and carryover to the acquiring corporation. Most significantly, the target corporation's tax bases for its assets "carryover" to the acquiring corporation and are not "stepped-up" (or down) to fair market value. Furthermore, no gain or loss will be recognized by the selling shareholders to the extent of qualifying consideration received (generally stock of the acquiring corporation). Receipt of qualifying consideration permits these shareholders to defer recognition of the gain or loss that was built into their stock.

B. Taxable Asset Acquisitions

If a transaction is a taxable acquisition of assets from a non-liquidating corporation, gain or loss will be recognized by the selling corporation. If, however, the sale is an installment sale, gain is deferred and reported as the installment payments are made. In either case, the tax bases of the assets acquired are adjusted to reflect the purchase price paid for those assets. The acquiring corporation does not succeed to any of the target corporation's tax attributes. The shareholder of the selling corporation generally does not recognize gain or loss, unless the proceeds of the sale are distributed.

If a transaction is a taxable acquisition of assets from a corporation that has adopted a plan for complete liquidation within a 12-month period, generally no gain or loss is recognized by the selling corporation (except to the extent of recapture income and other tax benefit items). Gain or loss is recognized, however, by the shareholders of the liquidating corporation based upon the difference between the amount of the liquidation proceeds received and their stock basis. If the corporation sells its assets for installment notes and distributes the notes in liquidation, the shareholders of the liquidating corporation can report the gain on the installment basis to the extent they receive installment notes. The tax consequences to the acquiring corporation are the same as in the case of an acquisition of assets from a non-liquidating corporation.

C. Taxable Stock Acquisitions

If a transaction is a taxable acquisition of stock of the target corporation, gain or loss generally will be recognized by the selling shareholders. In addition, recapture income and other tax benefit items may be taxed to the target corporation, depending on whether the purchasing corporation makes an election to adjust the bases of the target corporation's assets. If no election is made (or deemed made), the target corporation, which becomes a subsidiary of the purchasing corporation, continues its historic asset bases, along with its other tax attributes. An election gives the purchasing corporation cost bases for the acquired assets and generally extinguishes the other tax attributes of the target corporation.

II. TEFRA

A. Corporate Partial Liquidations

TEFRA altered the tax rules for corporate acquisitions to eliminate some unwarranted tax benefits obtained in corporate acquisitions and to align more closely the tax consequences of taxable asset and taxable stock acquisitions. For example, prior to TEFRA, a common scheme involved the acquisition of the stock of a target corporation in a taxable transaction followed by a distribution by the target corporation of a portion of its assets in a partial liquidation. If the plan were structured properly, the distribution to the acquiring corporation might be treated as a payment in exchange for stock rather than as a dividend distribution, with the result that (i) the bases of the distributed assets in the hands of the acquiring corporation would be stepped-up to their fair market values, (ii) neither the target nor the acquiring corporation would currently recognize any recapture or other gain on the transaction (the recapture income generally would be deferred and recognized only in future periods pursuant to the consolidated return regulations), and (iii) the tax attributes of the target corporation would continue to be available. In TEFRA, the tax treatment of these corporate partial liquidations was changed to ensure that the acquiring corporation generally would not obtain a step-up in the bases of assets distributed unless recapture income were recognized.

B. Section 338

TEFRA also contained measures to simplify and improve the tax treatment of taxable stock acquisitions. These improvements, found in section 338, provide that where a corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period, the purchasing corporation may elect to adjust the bases of the assets of the target corporation as though the target corporation sold all of its assets to a new corporation in connection with a plan for complete liquidation within a 12 month period. The price at which the assets are deemed sold is generally the purchasing corporation's basis in the target's stock at the acquisition date. The target generally will recognize the recapture income and other tax benefit items corporations usually recognize when they sell their assets pursuant to a plan of liquidation.

Section 338 also contains a number of consistency rules designed to prevent a purchasing corporation that acquires the stock of a target corporation from obtaining a step-up in bases for some of the target's assets, while preserving target's tax attributes and historic bases for other assets. The typical case addressed by these rules is one where target has one group of high value, low basis assets which are more valuable to a purchaser than to target by reason of the purchaser's ability to take cost recovery and depletion allowances on a stepped-up basis, another group of assets which may carry a significant recapture or other tax cost upon disposition, and valuable tax attributes (such as net operating loss or credit carryovers). If the purchasing corporation were to acquire all of target's assets, all assets would receive stepped-up bases, target (assuming target liquidated within a 12-month period) would be taxed only on the recapture and tax benefit items on all assets, and the tax attributes of target would be extinguished. From a tax planning perspective, the purchasing corporation would like to step-up the bases of the first group of assets (for instance, by a direct asset purchase), yet avoid the recapture tax and maintain a carryover of bases for the second group of assets and the valuable tax attributes of target (by acquiring all of the target stock and not making a section 338 election).

To prevent tax motivated manipulation in cases of this type, the consistency rules require that with respect to all of target's assets acquired, the purchasing corporation must elect either to step-up the bases of all acquired assets (with the associated recapture and loss of tax attributes) or to carryover the bases of all acquired assets (generally with the continuation of tax attributes). Section 338 generally provides that a step-up in bases (and attendant recapture and other tax consequences) will be triggered automatically if, within the period ("consistency period") beginning one year before the beginning of the acquisition and ending one year after 80 percent control is acquired, any member of the purchasing group acquires the stock of any corporation affiliated with the target corporation (target group) or an asset from any member of the target group, other than in certain defined transactions. The excepted transactions included transactions in the ordinary course of business, carryover basis transactions, pre-effective date transactions, and other transactions to the extent provided in regulations. */

C. Application of Section 338 to Oil Corporation Acquisitions

If the acquisition by one oil corporation of another is structured as a taxable stock acquisition, section 338 would be applicable to the transaction if at least 80 percent of the target corporation's stock is purchased within a 12-month period. Accordingly, the acquiring corporation will have to decide whether it wishes to obtain carryover bases in all of the target's assets acquired or obtain step-up in bases in such assets and pay tax on the recapture and other tax benefit items that would be triggered by the acquisition. We understand that in one or more of the recently announced oil corporation

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*/ In some cases, the consistency rules can operate to require taxpayers to take a step-up in basis and pay recapture taxes or suffer other tax detriments where no manipulative scheme exists. Treasury is considering allowing taxpayers to elect carryover bases (or cost basis when less than carryover basis in a particular asset) in all assets that a corporation acquires during the consistency period. We do not believe that the providing of this "carryover basis election" would create any significant new tax incentives for corporate acquisitions. Although Treasury may have the authority to provide such an exception to the consistency rules in regulations under current law, this would create the possibility of a whipsaw against the Treasury. If such an election were provided in regulations, a taxpayer may be able to elect a carryover basis for purposes of section 338 to avoid a deemed election under the consistency rules, and yet later claim the higher cost basis under the general rules governing the determination of asset basis. We believe that an appropriate statutory carryover basis election would eliminate this whipsaw potential.

acquisitions, the acquiring corporations may not make section 338 elections to step-up the bases of all of the assets of the target corporations because the amount of the recapture tax liability is disproportionate to the benefit of the step-up in bases. In these transactions, it appears that the consistency rules added by TEFRA are achieving their purpose.

D. General Utilities Doctrine

Some have argued that the section 338 rules and the liquidation rules conflict with the general scheme for taxing a corporation and its shareholders. Generally, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock with a section 338 election, there is a step-up in bases of assets with only a partial corporate level tax; recapture income and tax benefit items are taxed, but other potential gains are not. This result stems from the rule attributed to *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336, and 337. Under those provisions, a corporation recognizes no gain (other than recapture and tax benefit items) on distributions, including liquidating distributions, made to its shareholders. These rules may give an additional incentive to a corporation to sell assets in some cases because it increases the likelihood that some assets may be more valuable to a buyer than to a corporation that owns the assets. This could occur whenever the present value of the tax benefits that go along with property ownership (e.g., depreciation and depletion deductions) exceed the seller's tax detriment incurred on the sale.

Congress has reduced this incentive to sell corporate properties by limiting the scope of the *General Utilities* rule. For example, TEFRA made distributions of appreciated property in a partial liquidation taxable to the distributing corporation. In addition, H.R. 4170 and the Finance Committee's Deficit Reduction Act of 1984 will impose the same treatment on dividend distributions of appreciated property. One major aspect of the *General Utilities* doctrine remains, however. Nonrecognition of gain by the selling corporation continues to be the general rule in connection with a complete liquidation and a deemed asset sale in connection with a section 338 election (although recapture and tax benefit items are taxed). While repeal of this last major exception would simplify the tax laws, we do not believe that the failure of the corporate tax regime to impose two levels of tax on liquidation transactions should be viewed as motivating oil corporation acquisitions. Further, as we have indicated in prior testimony before the Finance Committee, we believe that in considering the repeal of *General Utilities* in liquidation transactions, relief from double taxation of liquidation proceeds must also be considered.

III. Other Tax Aspects of Oil Corporation Acquisitions

A. Corporate Level Tax on Distributions of Royalty Trust Interests.

As noted above, under current law the General Utilities doctrine applies when a corporation distributes appreciated property to its shareholders as a dividend. The failure of current law to tax dividend distributions of appreciated property to the distributing corporation causes a reduction in the corporate income tax base and is inconsistent with the treatment accorded nonliquidating sales of appreciated property, since, in effect, the amount of the appreciation occurring while the asset is in corporate solution is never subject to corporate income tax. Thus, when a corporation distributes property with a basis to it of $100 and a value of $300, the resulting $200 of appreciation is removed from the corporate income tax base. Further, that appreciation may be removed entirely from the income tax base, since a recipient individual shareholder takes a fair market value basis for the asset received. Finally, all of the future income to be derived from the assets distributed are removed from the corporate tax base.

To deal with this problem, both H.R. 4170 and the Finance Committee's Deficit Reduction Act of 1984 contain an Administration proposal, which was greatly influenced by the preliminary report prepared by the Staff of the Finance Committee on The Reform and Simplification of the Income Taxation of Corporations, to subject dividend distributions (other than to an 80 percent controlling corporation and certain other cases) of appreciated property to corporate level taxation. This proposal would subject the distribution of an appreciated mineral property interest held in a royalty trust to corporate level taxation. If this provision is enacted, there will be little remaining tax incentive for the distribution of such interests.

B. Corporate Level Recapture Tax on Mineral Property

Under current law, gain on the disposition of mineral property is taxable as ordinary income under section 1254 to the extent of intangible drilling costs that were deducted after December 31, 1975. However, no such recapture exists with respect to mineral property for which intangible drilling costs were deducted prior to that date. Consequently, on the sale or exchange of mineral properties, gain attributable to expenses deductible against ordinary income as intangible drilling costs prior to 1976 is taxable at capital gain rates even though the drilling expenses were deducted against ordinary income.

Prior to 1975 integrated oil companies were able to deduct percentage depletion at a rate of 22 percent with respect to mineral property. Percentage depletion deductions were not limited to the taxpayer's basis in the mineral property. Since 1975 integrated oil companies have been required to use cost depletion. Upon the disposition of mineral property, however, current law does not require the recapture of either cost or percentage depletion allowances; this rule applies equally to that portion of percentage depletion allowances taken in excess of the taxpayer's basis.

Some have suggested that recapture rules should be applied to intangible drilling costs deducted in respect of mineral properties regardless of when the deductions were taken. We cannot support such a change. The recapture of intangible drilling costs was considered extensively by Congress in connection with legislation in 1976. Congress enacted a recapture provision at that time and settled upon what it considered to be a fair transition rule. We do not believe that it is appropriate to change that transition rule retroactively.

Suggestions also have been put forth to apply recapture rules to percentage and cost depletion allowances. The cost depletion allowance is unlike other recapturable deductions such as depreciation or cost recovery allowances in that it more closely approximates economic depletion. Any gain realized upon a sale or other disposition of mineral property with respect to which cost depletion was allowed relates mainly to an increase in value of the undepleted remaining minerals and not to excess tax benefits claimed with respect to the depleted minerals. Finally, with respect to percentage depletion, Congress dealt with the policy considerations involving the availability of this special tax incentive to integrated oil companies by limiting such taxpayers to cost depletion for taxable years ending after December 31, 1974. We would not support a retroactive limitation on these taxpayers' pre-1975 percentage depletion benefits.

C. Tax Aspects of Acquisition Indebtedness

Some have suggested that the income tax law encourages highly leveraged buy-outs of oil corporations by permitting the acquiring corporation to deduct interest paid or accrued on debt incurred in connection with the acquisition and to deduct cost recovery and depletion allowances even though gain is deferred by the seller through the use of the installment sale rules.

Section 279 disallows an interest deduction, under very limited circumstances, where debt is used to acquire stock or assets of another corporation. Outside of this limitation, there are no unusual tax consequences to using debt for acquisitions. The corporation is entitled to an interest deduction on the acquisition indebtedness, and such interest is paid to a bank or other person who generally is subject to tax on such amounts. Because the use of debt for acquistions is not significantly different from debt used for other corporate purposes, there should be no unusual tax consequences to using debt for acquisitions.

However, the use of installment debt may lead to a mismatching of the gain that is deferred by the seller and the allowance to the purchaser of cost recovery or depletion deductions. This mismatching of income and deductions may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquistion (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income generally is recognized immediately.

The mismatching problem with respect to installment debt is present throughout our current tax system and is not unique to oil corporation acquisitions. It should be noted that the Finance Committee's Deficit Reduction Act of 1984 contains a provision which precludes recapture income with respect to real property from being reported on the installment method.

D. Dividends Received Deduction

In general, the Internal Revenue Code allows corporations (other than an S corporation) a deduction equal to 85 percent of dividends received. A 100 percent dividends received deduction is allowed for dividends paid by affiliated corporations (where the recipient corporation has an ownership interest of 80 percent or more), and in the case of dividends paid by certain small business investment companies. In addition, where such corporations file a consolidated return, intercompany dividends are eliminated.

The purpose of the intercorporate dividends received deduction is to prevent multiple taxation of income as it flows from the corporation that earns the income to the ultimate noncorporate recipient of the income. If a corporation borrows funds for the purpose of making a portfolio investment in stock of another corporation, interest on the borrowing generally is deductible by the corporation making the investment. The opportunity to create double deductions for the receipt of dividends and the payment of interest in these transactions is inconsistent with the purpose for the intercorporate dividends received deduction. However, this is not an inconsistency with respect to stock investments in controlled corporations, both where a consolidated return is filed and where separate returns are filed.

To deal with this problem, both H.R. 4170 and the Finance Committee's Deficit Reduction Act of 1984 contain an Administration proposal to disallow interest on debt that is directly attributable to a portfolio investment in stock (which does not include 80 percent or greater interest in the stock of another corporation). This matter also was discussed in the preliminary report prepared by the Staff of the Finance Committee on The Reform and Simplification of the Income Taxation of Corporations. This proposal generally would not impact oil corporation mergers, although it could discourage leveraged acquisitions of minority stock investments that are made with a view to an eventual takeover or merger.

E. Windfall Profit Tax

There has been a suggestion that in the acquisition of an oil corporation, there is an advantage to be gained under the windfall profit tax through a transfer of oil producing properties. This is not the case.

The amount of windfall profit subject to tax is the difference between the base price of the oil and the price for which the oil is sold, reduced by a severance tax adjustment. The lowest base price and the highest rate of tax is applied to tier 1 oil, which generally is oil produced from a property that was in production before 1979. For integrated oil companies the highest base price and the lowest tax rate applies to newly discovered oil in tier 3, which is oil produced from a property which began producing after 1978. Accordingly, under the windfall profit tax, the amount of windfall profit subject to tax is primarily determined by the character of the property from which it is produced.

In general, transfers of producing properties do not alter the tax status of oil produced from those properties. Indeed, certain transfers of producing properties may result in the loss of the independent producer preference for the transferee. The net income limitation (which is designed to apply the tax only to properties where income exceeds expenses) is the only provision in the tax that might be affected by an increase in an acquiring taxpayer's basis in property. However, that provision specifically provides that for purposes of calculating the expenses attributable to a property, the transferee is required to use the transferor's basis in property. Thus, for windfall profit tax purposes, the Treasury is indifferent to the transfer of assets among taxpayers. The tax burden is the same on the transferee as it would be on the transferor.

IV. Summary

In conclusion, the current tax rules would not appear to be propelling the recent flurry of oil corporation acquisitions. We do not believe that Congress should amend the tax laws for the purpose of discouraging these mergers. Nevertheless, we look forward to working with the Subcommittee should it determine as a result of these hearings that improvements in the tax laws are appropriate without regard to whether current law serves as an incentive to oil corporation mergers.

This concludes my prepared remarks. I would be happy to respond to your questions.

Senator WALLOP. Senator Dole.

Senator DOLE. I just wanted to ask one question. I know you have a long witness list. You indicated at the outset that there—I can't remember your exact statement—but primarily you concluded that they were not tax motivated. Is that correct?

Mr. PEARLMAN. That is correct.

Senator DOLE. You haven't looked at the specific mergers, have you?

Mr. PEARLMAN. We have reviewed the public information that we have been able to obtain, including some materials from the Securities and Exchange Commission, on several of the recent acquisitions. We have looked at those. Now, I have to tell you that our analysis has not been the type of analysis that could occur over a longer period of time, and that is why I made the statement the way I did—that based on what we have done to date, we do not see indications that they are being primarily motivated.

Senator DOLE. Is there some way that—I think that may be the crux of what finally may happen the next time we have a vote on the floor. Somebody is going to take a look at the mergers. Is there any way you can give us either privately, off the record—I mean, in private session—an analysis of what the tax benefits were and how you arrived at the conclusion that they were not primarily tax motivated?

Mr. PEARLMAN. Yes, we would be happy to do that.

Senator DOLE. You probably wouldn't want to do that in open session, but I think that might be helpful if, in fact, that is your conclusion. Because we are going to need to make the case, if that is the conclusion of the subcommittee and the full committee—the majority in the committee—then obviously, that would be very important.

Is it because there are so many tax benefits now that it is not tax motivated?

Mr. PEARLMAN. No, I don't think so. Let me say that we are making an assumption, that is, that section 338 is working. What Congress did in TEFRA was extremely significant in evaluating these mergers. If it weren't for TEFRA perhaps we wouldn't be saying that. Basically, what we are saying is that we think TEFRA is working.

Senator DOLE. At this point, you recommended maybe one minor change. Otherwise, you don't see any need for an across-the-board approach. It is your conclusion, and I assume it is the administration's conclusion, that TEFRA is taking care of some of the areas, and that maybe only minor changes need to be made at this time. Is that correct?

Mr. PEARLMAN. That is correct. We certainly look forward to the enactment of the legislation pending currently because it does contain several provisions that are important to this subject. Assuming the enactment of legislation currently, then I would say that what we are talking about are minor changes and ones that should be looked at across the board, as to whether they make sense from a tax policy standpoint with respect to all acquisitions.

Senator DOLE. What is the effective date of the change we made in the Senate bill? Do you know?

Mr. PEARLMAN. The effective date on the intercorporate dividends received deduction, I think, is stock the holding period for which begins after the date of enactment. The effective date on the distributions of appreciated property is distributions declared after the date of committee action.

Senator DOLE. That may be something you will want to check on.

Senator WALLOP. Senator Bentsen?

Senator BENTSEN. I want to congratulate Mr. Pearlman on what I think is a very evenhanded presentation on a tough subject. Let me ask you one specific question. Senator Specter has suggested that distributions of appreciated property for oil companies that all—not just those in liquidation—should be taxed at the corporate level tax. Do you think that kind of a special rule makes sense from a tax policy perspective?

Mr. PEARLMAN. No. We would not support a special rule from a tax policy standpoint. Further, as I mentioned a moment ago, we have some problems with that rule unless it deals—even on an across-the-board basis—with the very difficult issue of the double taxation of liquidating distributions.

Senator BENTSEN. I know the juices get flowing when we talk about oil companies, so what you are saying is that they should not be singled out for that kind of treatment?

Mr. PEARLMAN. That is correct.

Senator BENTSEN. If you are talking about doing it overall, well, that is quite another subject.

Mr. PEARLMAN. That is correct.

Senator WALLOP. Senator Durenberger?

Senator DURENBERGER. Nothing.

Senator WALLOP. Senator Symms?

Senator SYMMS. I want to thank you also for a very thoughtful report, and I have just one brief question, Mr. Chairman. I know you want to get moving on here. On your—page 9—statement, I would like to just go back on this 85-percent dividend—the 85-percent dividend received that you pay a tax on. Now, is this when one company buys another company stock, then the one company pays the dividend? Could you explain to me how that works?

Mr. PEARLMAN. Sure. If one corporation buys a second corporation's stock—it doesn't make any difference what the percent of the stock is as long as it is under 80 percent—then to the extent dividends are declared on that stock, the recipient corporation—the corporate shareholder, if you will—will be entitled to an 85-percent deduction—a deduction equal to 85 percent of the dividend that that corporation receives.

Senator SYMMS. But the corporation that pays the dividend is still double taxed?

Mr. PEARLMAN. The corporation that pays the dividend receives no deduction. That is correct.

Senator SYMMS. Somehow or another, that doesn't sound right to me. I thought that where I have seen it, if a corporation owns stock in another corporation, they have to pay tax on the dividends.

Mr. PEARLMAN. The way current law operates the payor corporation would include its earnings in income and then, when it makes a dividend distribution to another corporation, it receives no deduction, and the recipient corporation pays a tax on 15 percent of that dividend.

Senator SYMMS. Yes. I don't know whether you have had a chance to look at the Joint Tax Committee's Report on Tax Considerations of Oil and Gas Acquisitions, but on page 5, they make a point here that the present law generally imposes a double tax on corporate source income distributed as dividends. And to a large extent, the summary of it is that the double tax system gives rise to these incentives. Would you want to comment on that? Senator Specter talked about doing away with the deduction on interest on oil takeover mergers. If we are going to do that, maybe we ought to do away with the tax on dividends, and then it would at least equalize it.

Mr. PEARLMAN. Yes, Senator. We think it is desirable that there not be two taxes at the corporate level, that is we think the legislative objective of the 85-percent dividend received deduction, which was to make sure that there is just one corporate level tax on corporate earnings, makes sense. And so, we would not be in favor of an elimination of the intercorporate dividend received deduction. We can quarrel with whether the percentage is correct, that is, it is conceivable that maybe 85 percent is not the right percentage of deduction, but the concept that is reflected in that provision is one with which we agree, and we would not be in favor of changing it.

Senator SYMMS. I think what the Joint Tax Committee—if I understand what their point is—is that where there is an undervalued stock with an asset out there, if the corporation pays out dividends to the stockholders, it is taxed twice. So, there is a disincentive for any corporation to pay dividends as far as capital accumulation is concerned in the whole American system—whether oil companies or widget companies—it really doesn't matter.

Mr. PEARLMAN. You are talking about distributions to individual shareholders presumably?

Senator SYMMS. Yes, but one way to equalize this whole thing would be to do away with the tax on dividends, and then there wouldn't be this big gap—isn't that correct?

Mr. PEARLMAN. Certainly, one of the things that is frequently discussed in terms of broad-based—I am reluctant to use the word "reform," so I will say changes—changes in the corporate tax system is the so-called integration of the individual and corporate tax system which would provide some kind of relief from the double taxation of corporate income.

Senator SYMMS. Yes. Thank you, Mr. Chairman. And thank you, Mr. Pearlman, for an excellent presentation.

Senator BENTSEN. Isn't it a clear case of abuse that you would be directing that at?—I think you have made a valid point there. Isn't what you are concerned about is where one corporation is buying stock from another on margin?

Mr. PEARLMAN. Yes, and that is why we were supportive of the——

Senator BENTSEN. They get the full deduction on one side and then 85-percent credit on the other?

Mr. PEARLMAN. That is right. We think in any case in which the debt is related to the acquisition, then, yes, you have to look at the interest deduction as well as the dividends received deduction.

Senator BENTSEN. All right.

Senator WALLOP. Mr. Pearlman, thank you very much. I just would say that your testimony has been helpful. Again, the level of misunderstanding that swirls around this is devoted more toward emotion than sometimes is the fact, and your statement tends to lessen the effect of the point that was made here this morning and was made on the floor—that you know of no oil company merger that is tax motivated. That is not to say that there are not tax consequences from mergers, but to say that they are strictly motivated by tax consequences is certainly an untruth. There are other factors in that equation that are there, and I appreciate your testimony. Thank you, sir.

Mr. PEARLMAN. Thank you.

Senator WALLOP. The next panel is Mr. George Keller, chairman and chief executive Officer, Standard Oil Co. of California and Mr. James Murdy, executive vice president, Gulf Oil Corp., Pittsburgh, PA.

Good morning to you both. Mr. Keller?

STATEMENT OF GEORGE KELLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, STANDARD OIL CO. OF CALIFORNIA, SAN FRANCISCO, CA

Mr. KELLER. My name is George M. Keller. I am chairman and chief executive officer of Standard Oil Co. of California. I am here to provide any information I can about the merger of Standard Oil Co. of California and Gulf Corp. I have submitted a prepared statement and request that it be made part of the record. Accompanying me is Jim Murdy, executive vice president of Gulf Corp., who has his own statement. In my prepared statement, I discuss several aspects of the merger that I believe will be of interest to the subcommittee. First, why conditions in the oil industry make mergers desirable. Second, why SoCal merged with Gulf. Third, some general thoughts on taxes and mergers. And fourth, how SoCal plans to implement the merger, and fifth, the effects of the merger on various groups and on the national interest.

In this oral statement, I would like to focus on four aspects of the merger that I think may be of particular interest. The first is the role tax considerations played in the merger. I would like to start off by saying unequivocally that the merger with Gulf was not made for tax purposes. In fact, the situation was exactly the reverse. Our tax considerations about the merger centered on determining whether taxes would stand in the way of a merger that we saw as beneficial for both companies and the Nation as a whole, but the idea of gaining tax benefits from the merger played absolutely no part in our thinking.

There has been some concern in the past over the way taxable corporate acquisitions have been structured in order to step up the tax basis of the acquired corporation's assets as much as possible for purposes of taking greater future tax deductions, while minimizing the required recapture of tax benefits previously taken on the assets of the acquired corporation. These benefits include, among others, accelerated depreciation, intangible drilling costs, and investment tax credits. Past approaches have permitted picking and choosing assets on which to take a stepped-up basis, thus avoiding certain undesirable tax recaptures as well as deferring tax recaptures on the assets selected.

I believe this approach is no longer possible under the Tax Equity and Fiscal Responsibility Act of 1982. TEFRA substantially tightened the rules for stepping up assets. This new law provides that, in corporate acquisitions which involve buying 80 percent or more of the stock of a corporation, the acquiring corporation may elect to have the value of the corporation's assets stepped up to the purchase amount. However, the election must be made on an all-or-nothing basis. More significantly, in order to take advantage of the step-up election, the acquired corporation must pay recapture taxes on previously taken tax benefits.

The all-or-nothing approach precludes picking and choosing which assets to step up in the acquired corporation and addresses the concerns of the past. I can personally attest to the strictness of these new laws from our own company's experience. As a matter of fact, this all-or-nothing approach tends to impede certain normal business transactions between acquiring and acquired corporations and their affiliates. I am hopeful that realistic regulations will be written that will bring this potential overkill back into reasonable perspective. We plan not to elect a stepped up basis for the SoCal-Gulf merger because of the amount of recapture taxes that would be due. Accordingly, we will be taking future tax deductions on Gulf's substantially lower tax basis. I would also like to mention that we will not receive special tax benefit carryovers from Gulf when it is consolidated with SoCal on our Federal income tax returns.

The present tax consolidation laws and regulations materially curtail the use of an acquired corporation's premerger tax benefits by the acquiring corporation. To sum up, I believe the current tax laws—including TEFRA—minimize any special tax benefits that might arise from friendly mergers of continuing businesses. A second aspect upon which I would like to comment is whether we will be reducing our exploratory efforts as a result of the merger.

Some people have said that we will be cutting back on exploration because, now that we have drilled on Wall Street, we don't need to drill anywhere else. Others have said that we will be paying so much money in interest that we won't have enough left for a strong exploratory program. Neither statement is true. We view the reserves we will acquire in our merger with Gulf strictly as an addition to our normal effort to add to our reserves by exploration. We have what I believe is one of the oil industry's most efficient and successful exploration organizations. We plan to keep it fully employed. Gulf's reserves are simply a valuable asset that we were able to acquire for our shareholders at an attractive price. We also expect to have plenty of money to fund large exploratory programs. Gulf's earnings last year were $978 million. Their normal operations generate a positive cash-flow. We expect that Gulf's cash-flow will be sufficient to help meet our interest payments and continue to finance a strong exploratory program. I believe the bottom line on this question is a statement I have made in my written submission to the subcommittee and also testified to before three other committees. We plan to carry on an exploratory program for the combined companies that is at least equal in effort to the programs the two companies would have carried on by themselves. The third aspect of the merger that I would like to address is its effect on competition. The petroleum industry is well known for its absence of economic concentration. After our merger with Gulf, we will represent about 7 percent of U.S. oil production, 14 percent of U.S. refinery capacity, and 11 percent of product sales. These are hardly numbers to cause concern. And the latter two percentages will be smaller if—as seems likely—the Federal Trade Commission requires us to divest some of Gulf's refining and marketing operations. My written statement submitted by economists at earlier hearings on the merger, provides additional information on this subject.

Finally, I would like to comment on the idea that the U.S. Treasury is subsidizing this merger, because interest payments are tax deductible. It seems rather farfetched to me considering all the borrowing that is done in this country and all the interest that is taken as tax deductions to single out this legitimate business transaction as the one on which tax deductibility of interest payments represents a subsidy. The criticism of the deductibility of interest payments on funds borrowed for mergers really arises out of concern over the use of borrowed funds in mergers. This apprehension is usually based on two faulty premises—that borrowing to finance mergers reduces the amount of credit available for other productive uses, and that using credit for this purpose drives up interest rates. The first premise is false because such borrowing does not reduce the amount of credit available, but rather recycles the proceeds to the shareholders of the acquired corporation, who, in turn, reinvest or otherwise acquire assets. The second premise is false because even an amount as large as $13.2 billion represents only one-twentieth of 1 percent of the $30 trillion gross transactions undertaken in the equity market last year, as Mr. Leif Olson, chairman of the economic policy committee of Citibank, testified at a recent hearing.

Also, I think it is very questionable whether the Treasury will lose money by this transaction. The main tax event from this merger will be the payment by Gulf shareholders of the better part of $2 billion in taxes on their gains. Also, we should remember that our tax deductible interest payments are in most cases the lender's taxable income, and that Gulf shareholders will no doubt put most of the proceeds from their sale of Gulf shares into other investments yielding taxable income. So, while no one has enough information on the money flows and tax payments to calculate exactly how this will come out, it seems reasonable to expect that the Treasury will do very well. In short, I believe this merger will be beneficial to all of the parties involved and to the national interest. I will be glad to answer any questions members of the subcommittee may have.

Senator WALLOP. Thank you, Mr. Keller.

Mr. Murdy.

[Mr. Keller's prepared statement follows:]

Written Submission of Mr. George M. Keller, Chairman and Chief Executive Officer, Standard Oil Co. of California

My name is George M. Keller. I am Chairman and Chief Executive Officer of Standard Oil Company of California. I am here to provide any information I can about oil industry mergers and the merger of Standard Oil Company of California and Gulf Corporation.

I appreciate the opportunity to appear today and to discuss what I understand are some of the subcommittee's concerns.

Because of the subcommittee's interest in energy taxation, I would like to begin today by saying unequivocally that in no way was our merger with Gulf made for tax purposes. To the contrary, our tax considerations about the merger centered on determining whether taxes would stand in the way of a merger that we saw as being beneficial to both companies and the nation as a whole. But the idea of gaining tax benefits from the merger played absolutely no part in our thinking. I will elaborate on this point later in my statement.

I believe we can show that the merger of Standard Oil Company of California and Gulf Corporation is an excellent merger and that it will benefit the nation as well as the parties involved. My reasons are as follows:

- The merger will bring together the exploration and producing resources of our two companies in a new combination that we believe will be stronger than the sum of its parts. We believe it will result in a more effective exploratory program, both in the United States and abroad. We plan to continue an exploratory program comparable in effort to the total of the programs our two companies would have carried forward individually. However, we hope the program will be even more effective because of the stimulating effects of combining our technical and research organizations.

- The merger will provide for a reorientation of Gulf's refining and marketing operations in a way that offers the best opportunity to preserve their viability as going businesses. It will also conform to all government requirements.

- The merger will preserve more jobs than any other realistic alternative.

- The merger will preserve the competitiveness of the existing industry structure. The oil industry is widely known for its absence of economic concentration. This will not be significantly affected by the merger.

- The merger will not significantly affect either the cost or the availability of credit.

- The merger will not have an adverse effect on taxes paid to the U.S. Treasury.

We believe that mergers are in the national interest provided they meet the test of antitrust limitations required by existing legislation. New laws prohibiting or delaying mergers that do not adversely affect competition would be a serious mistake.

As Assistant Attorney General, J. Paul McGrath, said in a recent speech,

> "Government merger policy strongly affects the economy. The free movement of business assets is critical to economic growth. For that reason, business managers must be free from irrational antitrust constraints in deciding whether to acquire or divest businesses. Antitrust enforcers should only block mergers when they conclude, based on sound economic analysis, that a particular transaction will adversely affect competition."

You are aware that the FTC is studying the merger to see if there are any adverse competitive consequences. We filed our Hart-Scott-Rodino pre-merger notification on March 8. The FTC has asked us for additional information. We have met their initial requests and are responding promptly to their final request. We will do whatever may reasonably be required to meet any antitrust concerns.

I am here today to provide any information I can on the merger. I do not, however, consider myself an authority on mergers other companies have made or may make in the future. I plan, therefore, to confine my remarks to the facts surrounding our merger with Gulf, and to the conditions in the petroleum industry that I believe make such mergers desirable.

I would like today to testify on five subjects:

- Why conditions in the oil industry make mergers desirable.

- Why Socal merged with Gulf.

- Some general thoughts on taxes and mergers.

- How Socal plans to implement the merger.

- Effects of the merger on various groups and on the national interest.

Why Conditions in the Oil Industry Make Mergers Desirable

Most economists believe that mergers are a normal and healthy part of our free economy. Through mergers, companies can become more efficient, thus benefiting the consumer. Mergers are a part of the process of reassessing the nation's resources of capital and manpower and redeploying them to the most productive uses in our changing economy. This process is not without risk to the managements of the companies involved. Recent events in the oil and other industries show that even the managements of very large companies - probably including my own - are not immune to this process. However, I believe this represents a healthy process of competition and renewal which the Congress should encourage.

A number of recent mergers have involved oil companies. I believe this is a desirable trend. There are two basic conditions that have brought this about.

The first is the increasing difficulty and cost of finding oil. I said publicly two years ago that I believed we in Socal could find and develop oil and gas reserves more cheaply than we could buy them. I am not sure that is true today, particularly in the United States. We have in our company what I believe is one of the most efficient and successful exploration organizations in the oil business. Nevertheless, our oil and gas reserves have been gradually declining. The difficulty and cost of finding oil have increased rapidly in recent years for several reasons.

- First, the onshore continental U.S. has been pretty extensively prospected. While many more worthwhile reserves of oil and gas will be found onshore and offshore in the U.S., it seems likely that most large oil and gas fields will be found in higher-risk, higher-cost frontier areas. But even in these areas, recent exploratory results have been disappointing, as the dry hole at Mukluk on Alaska's North Slope showed. So the oil industry is finding fewer good prospects for discovering new oil reserves in the United States today.

- Second, actions by the United States government - and, to some extent, other levels of government - have withdrawn large areas of government land from exploration. As an example, some 85% of the California offshore area is now off-limits to oil and gas exploration because of moratoria. Thus government has denied access to some of the more promising areas where the industry was hoping to discover more oil and gas. We believe government restrictions play an important role in reducing the number of prospects available in the U.S. today.

- Third, host country governments in foreign countries where we try to negotiate exploratory concessions are making demands that often make it uneconomic to do business. And even those terms are often later changed to our detriment in countries where exploratory efforts are successful. Host governments in some cases have taken over our operations entirely.

These factors, combined with the belief that oil prices are not likely to increase in the medium term, have led to a decline in the number of active rigs in the United States from over 4,500 in 1981 to under 2,500 today.

Nevertheless, our company is continuing to carry forward a very large exploratory program. We currently have active exploration operations in 21 states and 38 foreign countries. And as I said earlier, we plan after the merger to conduct a major exploratory program.

At this point, I would like to put to rest the concern of those who see this merger as merely "drilling for oil on Wall Street."

It is far from that. I am enormously proud of our company's technical capability and track record as a leader in exploration for oil and gas, and in the research that supports this program. This capability, combined with the resources of Gulf and the financial strength of the merged operations, will be applied to Gulf's extensive reserves and landholdings. As a result, we will be able to carry out an outstanding exploration program that will combine the resources of both companies. I believe consumers are well served when a merger of this kind results not only in the acquisition of reserves, but also in a more effective exploratory program than the two companies would have had on their own.

Beyond what we can accomplish by our own strong exploratory program, we are constantly looking for opportunities to add to our oil and gas reserves in other ways.

This brings me to the second reason why a number of oil company mergers have taken place in recent years. That is, the depressed price of the common stock of many oil companies. These shares are depressed for several reasons:

- First, most government and industry economists believe that demand for oil in the U.S. will increase only very gradually for many years.

- Second, there is a very large surplus of oil producing capacity around the world today.

- And finally, there is a great deal of excess refining and marketing capacity which must be consolidated if consumers are to be served efficiently.

The chart attached to this statement (Attachment 1) shows why there is so much excess refining and marketing capacity in the U.S. today. It shows demand for petroleum products in the U.S. since 1950 and our estimate for the future. The different bands show the major types of products.

As you can see, demand for petroleum products in the United States rose almost continuously from 1950 until 1978. Since then, it has declined sharply from a peak of almost 19 million barrels per day to about 15 million barrels per day in 1983. This is a drop of almost 20%. The decline was caused by the consumers' response to the large petroleum price increases triggered by the Arab Oil Embargo and the Iranian Revolution. These increases brought about more conservation, more efficient use of petroleum products, and greater use of other fuels.

As the chart shows, we expect demand for petroleum products to increase less than 1% per year through the year 2000, when it will still be well below the 1978 peak.

Thus the U.S. has a good deal of excess refining and marketing capacity that was built to meet the nation's needs when demand was higher - and some built in the expectation that demand would continue to grow - that won't ever be needed.

Some of this excess capacity has already been shut down, and more will be shut down in the future. Eventually this will leave the U.S. with a modern and efficient refining and marketing plant sized to its needs - including some reserve capacity. I would say that some restructuring and consolidation of the oil industry is both desirable and inevitable, and that mergers of this kind are an efficient and humane way to accomplish it.

This has been a digression in my comments on why the prices of oil company stocks are low. To sum up, they are low because demand has flattened out and there is so much surplus capacity, which led to lower earnings and earnings projections. Oil stock prices tend to reflect this situation rather than underlying asset values.

However, we, and apparently some others, believe that the true value of the shares of some of these companies is considerably greater than the value the market now places on them. Thus, we have been alert for some time to the possibility that we might be invited to participate in a friendly merger that would increase our shareholders' values at an attractive price.

Why Socal Merged With Gulf

We went into this merger because we saw it as having a number of advantages:

- It was made on a friendly basis, in response to an invitation from Gulf. Thus, we look forward to good and productive relationships with Gulf's management and employees.

- It substantially increases our company's assets - particularly oil and gas reserves - at an attractive price.

- The merged companies are an excellent match geographically and functionally in most important categories. In terms of oil and gas reserves, both Socal and Gulf are active in the North Sea. Socal has a major position in Indonesia, Australia, and the Sudan, and important historic ties in Saudi Arabia, while Gulf's other foreign activities are concentrated in West Africa. Domestically, Socal is an industry leader in exploration in California, Louisiana, and in the Wyoming Overthrust area. Gulf is strong in Texas, and both have significant operations in the Gulf of Mexico. In marketing, Socal is the largest gasoline marketer in the Southeast and on the West Coast. Gulf is strongly represented in the Northeast and Southeast.

- The merger creates a stronger energy firm, technically and financially able to compete more efficiently in the domestic and international petroleum business.

  Technical research on how to find and produce oil more effectively will be a key to increasing the nation's oil and gas supplies in the years ahead. We believe the combination of Socal's and Gulf's advanced research efforts will enable us to show outstanding results.

  The increasing costs and risks of developing reserves in frontier areas, both in the United States and abroad, require that companies be larger and stronger technically and financially if they are to explore and develop these prospects. In my view, large companies clearly serve the national interest in developing these frontier areas. It is also in the national interest to have companies that are strong enough to compete with large foreign oil companies - many supported by their governments - in acquiring and developing concessions abroad.

These were the chief business and economic considerations that motivated us to merge with Gulf. As I mentioned earlier, the role of tax considerations was simply to assure that they did not get in the way of the business considerations. I would like, however, to address the general subject of taxes and mergers briefly because there seems to be some misunderstanding on the subject.

Taxes and Mergers

There has been some concern in the past over the way taxable corporate acquisitions have been structured in order to step up the tax basis of the acquired corporation's assets as much as possible for purposes of taking greater future tax deductions, while minimizing the recapture of tax benefits previously taken on the assets by the acquired corporation. These benefits include, among others, accelerated depreciation, investment tax credits, and intangible drilling costs. Past approaches have permitted picking and choosing assets on which to take a stepped-up basis, thus avoiding certain undesirable tax recaptures as well as deferring tax recaptures on the assets selected.

I believe this approach is no longer possible under the Tax Equity and Fiscal Responsibility Act of 1982. TEFRA substantially tightened the rules for stepping up assets. This new law provides that, in corporate acquisitions which involve buying 80% or more of the stock of a corporation, the acquiring corporation may elect to have the value of the corporation's assets stepped up to the purchase amount. However, the election must be made on an all-or-nothing basis. More significantly, in order to take advantage of the step-up election, the acquired corporation must pay recapture taxes on the previously-taken tax benefits. The all-or-nothing approach precludes picking and choosing which assets to step up in the acquired corporation, and addresses the concerns of the past.

I can personally attest to the strictness of these new laws from our own company's experience. As a matter of fact, this all-or-nothing approach tends to impede normal business transactions between acquiring and acquired corporations and their affiliates. I am hopeful that realistic regulations will be written that will bring this potential overkill back into reasonable perspective.

We plan not to elect a stepped-up basis for the Socal-Gulf merger because of the amount of recapture taxes that would be due. Accordingly, we will be taking future depreciation and depletion deductions using Gulf's substantially lower basis.

I would also like to mention that we will not receive special tax benefit carryovers from Gulf when it is consolidated with Socal in our federal income tax returns. Present tax consolidation laws and regulations materially curtail the use of an acquired corporation's pre-merger tax benefits by the acquiring corporation.

To sum up, I believe the current tax laws, including TEFRA, minimize any special tax benefits that might arise from friendly mergers of continuing businesses.

<u>How Socal Plans to Implement the Merger</u>

Our merger agreement with Gulf was signed only a very short time ago. I hope, therefore, that the subcommittee will understand if I am not able at this time to provide a detailed plan on how we will proceed from here.

We have, however, developed some guidelines that we believe will result in an efficient and humane redeployment of Gulf's assets and people.

- We believe that Gulf has a value as a going concern in excess of the value of its assets alone. We mean to protect this value by maintaining Gulf's operations as going concerns until they are integrated with our own operations or absorbed into some other company's operations.

- Socal may be required to divest itself of some of Gulf's refining and marketing operations in order to comply with the antitrust laws. We plan to work with the Federal Trade Commission and other government agencies to do whatever is reasonably required to be in compliance.

- If it becomes necessary to divest business operations, we believe it is desirable to do so in "packages" designed to be commercially viable, rather than in pieces that may not have the strength to survive. To do this we may divest some additional parts of Gulf beyond those required to comply with antitrust laws.

- So far as we know, there are no antitrust problems associated with merging all of Gulf's exploration and producing operations with ours. As I indicated earlier, we expect to conduct a very strong exploratory program in the future. We view the acquisition of Gulf's reserves as an <u>addition</u> to our ongoing exploration program.

- Gulf Corporation has been negotiating for the sale of its 60% interest in Gulf Canada. We will continue to explore this possibility.

- We have not had the opportunity to determine how Gulf's coal, chemical and nuclear operations may fit with Socal's operations. We will be giving this careful study as soon as possible.

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Effects of the Merger

I would like to say a few words about some groups of people that will be affected by the merger. I would also like to comment on its effect on competition in the oil industry, on the cost and availability of credit, and on tax payments to the U.S. Treasury.

First, the people involved in the merger. Mergers of this kind inevitably involve some consolidation of operations. Also, the FTC may require Socal to divest some of Gulf's operations to comply with the antitrust laws.

It is impossible to know now just how employees will be affected. But I would like to assure you - as well as Gulf's employees - that we will do all we can to make the changes required with full consideration for the people involved. Our company has a long-standing reputation for treating its people well, and for handling people involved in organizational changes of this kind with consideration. We value this reputation, and we intend to handle this merger in a way that will entitle us to keep it.

I would also like to comment on the impact of the merger on Gulf's jobbers, retail dealers, and customers. Gulf serves gasoline markets in 26 states. As with other aspects of the merger, it is impossible now to say exactly what arrangements will be made with respect to these operations. But I would like to assure the subcommittee - as well as Gulf's jobbers, retail dealers, and customers - that we will attempt to assure, insofar as we reasonably can, that they will continue to have access to an adequate supply of petroleum products. All of Gulf's current supply contracts with jobbers and dealers will be honored by Gulf and Socal consistent with FTC requirements.

The impact of a merger on competition is, of course, a matter of public concern. The petroleum industry is well-known for its absence of economic concentration. After our merger with Gulf we will represent about 7% of U.S. oil production, 14% of U.S. refinery capacity, and 11% of U.S. petroleum product sales. These are hardly numbers to cause concern. The latter two percentages will be smaller if, as seems likely, the FTC requires us to divest ourselves of some of Gulf's refining and marketing operations.

As I believe you know, the United States oil industry is very unconcentrated in terms of the percent of the market held by the larger companies. It also has an extremely large number of participating companies. There are about 10,000 active exploration and production companies of all sizes. There are over 130 separate companies that own and operate refineries. There are about 15,000 wholesalers and countless independent trucking companies involved in distributing and marketing petroleum products. And finally, the vast majority of the nation's 140,000 retail service station outlets are operated as separate businesses by independent dealers. These high participation rates suggest that barriers to entry are relatively low and that smaller companies can compete effectively in all phases of the business.

Many oil companies, of course, are large. They are large because vast amounts of capital are needed to find and develop reserves of oil and gas, to refine crude oil into useful products, and to make it available wherever it is needed.

The oil industry as a whole is large because the energy needs of the nation are large. The value of petroleum products shipped from this nation's refineries amounts to over half a billion dollars a day - nearly three times the value of the cars and trucks shipped daily from our automobile factories.

Moreover, U.S. oil companies compete with very large oil companies headquartered abroad. Many of these companies are backed by the resources of their governments. It is interesting to note that Japan has recently discussed requiring a number of its oil companies to combine so that each group will have a <u>minimum</u> of 10% of the market. Similar trends toward increasing size can be seen in other foreign oil companies.

I would also like to comment on the concern which has been expressed that Socal's borrowing in connection with the merger will deprive other borrowers of credit and drive interest rates up -- a concern which usualy is translated into arguments that we enjoy a tax "subsidy" because interest on our borrowing is deductible against our income taxes.

With respect to the tax "subsidy" argument, it seems rather far-fetched to me, considering all the borrowing that is done in this country, and all the interest that is taken as tax deductions, to pick out this legitimate business transaction as the one on which the tax deductibility of interest payments represents a "subsidy."

We believe Socal's borrowing for the merger will have a negligible effect on the credit markets, even if we borrow the entire $13.2 billion required.

First, such borrowing does not reduce the amount of credit available, but rather recycles the proceeds to the shareholders of the acquired corporation. Gulf's shareholders will pay federal and state taxes on the $13.2 billion they receive. Of course, we do not know the exact amount of taxes that will be paid, but we estimate that they will be approximately $1.5 to $2 billion. These taxes will reduce government borrowing, so they will not add to credit demand. The rest of the $13.2 billion will continue to be regarded by Gulf shareholders as capital, and will be reinvested in the capital markets, including oil exploration and production ventures. Acquisitions, whether they are made for stock or cash, do not destroy capital. The capital is still there. Stockholders are not going to put the cash they receive from selling their stock in the attic and take it out of circulation. They are going to reinvest it. The proceeds will remain a part of the nation's capital resources, available to meet other capital needs.

Second, the impact on interest rates of borrowing even an amount as large as $13.2 billion will be minimal since even this amount represents only one-twentieth of one percent of the $30 trillion gross transactions undertaken in the equity market last year, as Mr. Leif Olsen, Chairman of the Economic Policy Committee of Citibank, testified at a recent hearing.

Moreover, I think it is very questionable whether the Treasury will lose money by this transaction. The main tax event from this merger will be, as I mentioned earlier, the receipt of the better part of $2 billion in taxes on the gains of Gulf shareholders. It should be remembered that our tax-deductible interest payment is in most cases some lender's taxable income. Also, as I mentioned earlier Gulf's shareholders will no doubt put most of the $13.2 billion they will receive, after paying their taxes, into other investments. Income from most of these investments will be taxable, so here again the Treasury will gain.

No one has enough information on the money flows and tax payments resulting from the merger to estimate accurately how this would come out. Even without such a calculation, however, it should be clear that the "subsidy" question is much more complex than its proponents believe, and there is reason to believe the Treasury will do very well.

With respect to a further argument that the interest we will pay on our borrowings will somehow shortchange our exploration programs, let me say two things:

The first is that I have already assured the subcommittee that we place a very high priority on exploration, and that we plan to conduct an exploratory program in the future comparable in effort to the programs the two companies would have carried forward by themselves.

The second is that, as you can imagine, we have done rather careful cash flow studies to be sure the merger is financially feasible. Gulf's earnings last year were $978 million. Their normal operations generate a positive cash flow. Also, we will not be paying dividends to Gulf's shareholders after we purchase their stock. Thus we anticipate a strong positive cash flow from

Gulf's operations that will help meet our interest payments <u>and</u> finance a very strong exploratory program.

Some people seem to feel that a merger between oil companies should be viewed with suspicion because of a general misunderstanding that all oil companies are unusually profitable. I wish that were true. The fact is, however, that the average rate of return on equity for U.S. industry as a whole in 1982, the most recent year available, was 11.0%. The figure for Socal was 10.6%, and for Gulf 9.1%. The relationship is similar if one measures the return on total capital employed. Thus Socal and Gulf were slightly less profitable than U.S. business as a whole.

Conclusion

I would like to close by expressing my view that the interests of all the parties concerned, and the national interest, are better served by a merger between Socal and Gulf than by any other realistic alternative.

As I said earlier, the Socal-Gulf merger will result in an exploratory program of at least the same level of effort as the combined programs of the two companies before the merger, strengthened by the stimulating effects of combining our technical and research resources. Gulf's refining and marketing organizations will be operated as going businesses until they are merged into Socal or reoriented in new directions. A large number of Gulf's employees will continue to enjoy stimulating and productive jobs in the merged companies, and all employees affected by the merger will be provided for in keeping with Socal's long-standing personnel practices. Gulf's jobbers, dealers, and customers will be assured that Gulf's contracts will be honored and that insofar as possible they will have a reliable supply of petroleum products.

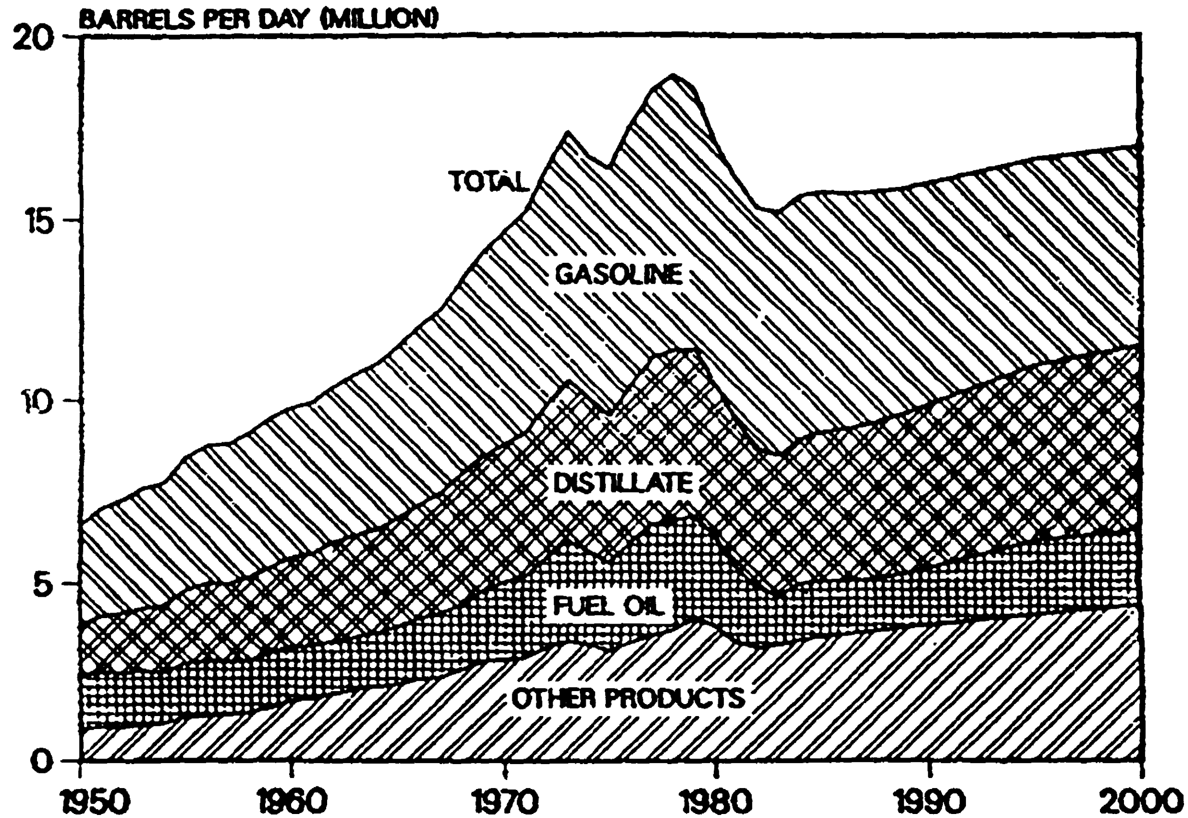
Looking at the nation as a whole, there will be no change in the very active competition that exists at all levels in the oil industry. There will be no significant impact on the nation's money supply, or on the cost or availability of credit. The tax deductibility of our interest payments represents no more of a subsidy than the deductibility of interest payments on other business and personal borrowing. And there snould be no loss of revenue, and perhaps even a gain, in payments to the U.S. Treasury.

And finally, and perhaps of particular interest to the subcommittee, tax considerations were not a motivating factor in the merger, and in fact were significant only in that they proved not to be a deterrent.

I will be glad to answer any questions members of the subcommittee may have.

Attachment 1

U. S. PETROLEUM DEMAND



STATEMENT OF JAMES L. MURDY, EXECUTIVE VICE PRESIDENT, GULF OIL CORP., PITTSBURGH, PA

Mr. MURDY. Good morning. I am Jim Murdy, executive vice president of Gulf Corp. Thanks for letting us give our views on Federal tax laws and mergers. I have prepared a written statement that discusses the benefits of the SoCal-Gulf merger from our point of view, and I request that that statement be included in the record.

For this hearing, my remarks will be only on the tax aspects of mergers. Although the SoCal-Gulf deal was not driven by tax considerations, the circumstances that led Gulf to seek a friendly merger with SoCal were largely a result of tax considerations which Congress is already trying to change. The provisions this committee recently adopted and those adopted by the House Ways and Means Committee amendment to H.R. 4170 would correct the tax provisions which were used over the past several months to put Gulf in play in the market.

We looked for the friendly merger with SoCal because speculators had forced the market price of our stock to a level that couldn't be sustained by current earnings or by near-term prospects. Gulf was forced to realize that its survival as a strong independent company was no longer a viable alternative. My board of directors faced two choices. One was the partial offer of $65 a share. The other choice was a friendly merger with SoCal, which provided fair value at $80 per share to all of our shareholders. It also assured continued employment for most of our people and offered maximum protection to our jobbers, dealers, suppliers, and customers. The friendly merger with SoCal was the only sensible choice. As I mentioned, tax rules did play a major role in the earlier attempts to take over Gulf. That attempt got the attention of the investment community by demanding that Gulf spin off most of its production into a royalty trust. This proposed maneuver was touted as a tax dodge to avoid the corporate tax on production. For Gulf, it meant eventual liquidation by taking away the heart of the cash-flows necessary to maintain a strong oil company.

What really attracted speculators were the big advantages they thought they would receive in the royalty trust distribution. Those advantages come from special dividends and capital gain and loss rules that are available only to corporations, not to individual shareholders. A corporate speculator was able to buy stock in a corporation like Gulf just before it made a royalty trust distribution and then sell the trust units and the remaining stock right after the distribution and get three tax breaks. First, the corporation would pay a very small tax when the trust unit was distributed. Second, the corporation would receive a long-term capital gains treatment at a 28-percent rate on the subsequent distribution—or the subsequent sale—of the trust units. And third, it would get a deduction worth 46 percent when they immediately turned around and sold the stock in the remaining corporation. They get that deduction because the stock in the corporation would drop in value after the creation of the trust. Those are the key characteristics of the tax arbitrage play that looked so attractive in our situation.

In essence, those provisions attracted speculation in Gulf stock based solely on liquidation value. Now, once short-term profiteers entered the bidding contest, our share price was driven to a point where a merger with SoCal was the only acceptable answer to give fair value to all of our shareholders and assure that Gulf's critical operation would continue in strong hands. The tax bill recently approved by the Committee on Finance will for all practical purposes put an end to royalty trust by taxing the corporations that establish them. Also, the tax arbitrage play will be closed down by the proposed amendment. These changes will make short-term profiteers look for gains in economics rather than simply in the tax tricks in something like a royalty trust.

Thanks for your attention, and I will be pleased to answer any questions you may have.

Senator WALLOP. Thank you, Mr. Murdy.

[Mr. Murdy's prepared statement follows:]

WRITTEN SUBMISSION OF MR. JAMES L. MURDY, EXECUTIVE VICE PRESIDENT, GULF CORP.

THE GULF/SOCAL MERGER

A WHITE PAPER

BY

GULF CORPORATION

The Merger

On March 5, 1984, the Standard Oil Company of California (Socal) announced its intention -- after full and in-depth negotiations with the management of Gulf Corporation (Gulf) -- to purchase all outstanding shares of Gulf's stock. Through a friendly tender offer, Socal agreed to pay $80 for each share of Gulf stock. This followed a decision in principle by Gulf's Board of Directors on February 24 to explore the possibility of a merger. The Socal cash offer of $80 per share is a strong, fair offer to all of Gulf's 260,000 shareholders.

Gulf's decision represented the best available alternative to a liquidation plan, which a minority shareholder was trying to impose on the company. Gulf's Board of Directors approved the proposed merger, recognizing that it would preserve and utilize the company's assets for their full, long term economic potential and prevent the liquidation of the company for short-term financial gain. Both companies believe that the merger will provide the maximum possible benefits to their shareholders and the nation.

Gulf's decision, and those before and after it, was guided by underlying management philosophies to which it is deeply committed. One is to protect the investment of its stockholders and to increase the value of their investment. Another is a commitment to strengthen the energy security of the nation.

The Companies

Gulf has played a central role in the petroleum industry during its 83 year history. Headquartered in Pittsburgh, Pennsylvania, Gulf markets products primarily in the eastern and southern United States. Its domestic exploration and production activities have centered in Texas and the Gulf of Mexico. Gulf's foreign producing operations currently are concentrated in West Africa and the North Sea.

Socal is a major producer, refiner and marketer of petroleum, with operations throughout the world. Headquartered in San Francisco, California, Socal markets refined products primarily in the western United States and in the Southeast. Socal's domestic exploration and production activities are concentrated in California, Louisiana, the Gulf of Mexico and the Wyoming Overthrust area. Its international activities have focused on Indonesia, Australia and the North Sea.

The merger of Socal and Gulf will result in a single company with more than $50 billion in annual sales and assets of $42 billion. For comparison, in 1983, Exxon had sales of $95 billion and Mobil Oil Corporation's sales exceeded $58 billion.

The Origins of the Merger

The energy industry experienced a tremendous economic upheaval throughout the 1970s. Dependence on insecure foreign oil, dramatically higher fuel prices, and the threat of the "oil weapon" moved Congress to enforce price and allocation controls on the petroleum industry.

Following decontrol, the return to a market-driven system for oil permitted the nation and the petroleum industry to make necessary adjustments. Higher prices spurred oil drilling rates to record levels, halting the decline in domestic production.

However, along with decontrol came the Windfall Profits Tax. Rather than permitting the industry to make full use of the cash flows a competitive market produced, those dollars were siphoned away from both increases in exploration and development, and from the returns earned by investors.

While oil decontrol is recognized as contributing to national energy security, the industry is still significantly directed by government policies. Natural gas remains controlled under the Natural Gas Policy Act. Dollars which should be earmarked for future development, such as alternate fuels, have been redirected to other projects. Severe restrictions have been placed on some of the most promising areas for exploration, especially in offshore federal lands in Florida, California, and New England.

And still, the free-market continues to operate. Decontrol permitted petroleum prices to rise to world levels. The reaction to higher prices was reduced demand. Reduced demand has forced prices back down in the world market. Increased security of supply has further reduced the risk premium for that supply. Ample supply, although a temporary phenomenon, exists in world crude markets today.

The same supply and demand forces acting on crude markets have forced price reductions in product markets. Retail margins which were never large are now miniscule or nonexistent. Refineries, distribution systems and marketing properties -- built in the days of ever-growing demand -- are being shut down or now operate at a fraction of their capacity. This rationalization of operations also includes market withdrawals, divestiture of low-profit or marginal operations, and mergers and acquisitions.

Gulf's Response to a New Market Place

During the last two years, Gulf made significant progress in its efforts to restructure itself in line with the marketplace. In 1983, it replaced over 60 percent of its U.S. production and, thanks to recent discoveries, the estimate for 1984 is a replacement rate of more than 80 percent.

Gulf also is turning around its refining and marketing business. New refining equipment now permits the processing of some of the world's cheapest crude oils, while extensive belt-tightening is improving competitiveness at the gasoline pump. Gulf also eliminated over $100 million a year of administrative and overhead costs in 1983 and sold marginal or unprofitable businesses such as European refining and marketing operations.

The Stock Market's Response to Gulf

Yet, this progress did not significantly affect Gulf's short-term profitability. These steps were chosen for their long-term effect on future Gulf operations. The redirection was based on a belief that the long-term appreciation of shareholder's value and the long-term energy security of the nation were the most important goals.

Although Gulf was making great strides, market forces and events overtook it. Gulf stock remained undervalued and the company became the target of a well-financed and aggressive group of speculators.

Speculative Attacks

The centerpiece of the speculators' plan was the formation of a royalty trust. Under their plan, Gulf would have spun off at least 50 percent of all its domestic oil and gas production. The income stream from those properties would have been diverted from Gulf to avoid corporate taxes. The revenue loss to the federal government would have been about $1 billion over the next four years and $5 billion over the life of the oil and gas reserves.

However, Gulf was not solely concerned about the impact on the Treasury Department's receipts. Rather, it was the effect such a plan would have had on its stockholders and on its long-term viability that mattered most. Because of the difference in the way that shareholders would be taxed compared to arbitrageurs and corporate holders, Gulf concluded that royalty trusts were a disservice to most of its shareholders.

If Gulf had been forced to distribute 50% of its U.S. production to its shareholders in the form of a royalty trust, there would have been an extreme difference between the tax treatment of the distribution for individual shareholders and for corporate speculators. The individuals would pay a tax based on the fair market value of the distribution, while the corporate speculator would pay a tax based on Gulf's tax basis in the distributed profits.

If you assume a royalty trust unit is worth $30.00, the individual's tax would be based on $30.00 while the corporate speculator's tax would be based on only $1.33 - Gulf's basis. Moreover, corporations are provided with a dividend received deduction of 85% which results in only taxing 15% of the $1.33 or 20 cents. In other words, on a distribution worth $30.00 the corporate speculator would pay a tax of only 46% of 20¢ or less than a dime.

The rules permitting receipt of a $30.00 dividend for less than a dime is only one of many beneficial tax rules granted the corporate speculator. When the corporate speculator sells the $30.00 trust unit, the approximately $29.00 of gain would be taxed as a capital gain. Also, the sale of the stock of a diminished Gulf would produce a short term capital loss which would have a substantial offset value to the corporate speculator.

The aggregation of all the tax benefits accorded the corporate speculators insured that, if the speculators' royalty trust liquidation plan is adopted, the corporate speculator would realize a significant after tax profit even if its original investment did not appreciate in value.

Each and every one of the preferential tax provisions which drew the corporate speculators to the Gulf situation are to be eliminated under the corporate tax reforms recently approved by the House Committee on Ways and Means and the Senate Committee on Finance. If that legislation is enacted, the royalty trust-corporate speculator scheme will be eliminated and, in the future, major corporate decisions will reflect the interests of historic individual shareholder groups rather than those of the corporate speculators.

While the royalty trust was technically not the issue of a proxy fight waged with the speculator group last year, Gulf felt that the results of that battle upheld its views on the royalty trust's inadvisability for Gulf. However, the attention generated by the battle, and a subsequent tender offer of $65.00 per share by this group for additional Gulf stock, created a frenzy on Wall Street. Gulf's stock price was forced up to a point that could not be sustained by current earnings or near term prospects.

It has become almost a cliche to say that oil can be found cheaper on Wall Street today than by drilling. Still, that fact is causing investors -- particularly institutions -- to drive up the economic rent on their positions in oil stocks. If oil stocks don't fully reflect the value of a company's underlying reserves, the financial community is demanding that corporate managements take drastic action -- even including their own liquidation -- to close that gap.

Gulf's management was compelled to recognize that Gulf's survival as an independent company was no longer a viable alternative. After weighing the alternatives, Gulf's best option was a friendly merger consistent with its philosophies of increasing stockholder value and strengthening the nation's energy security.

Why didn't Gulf erect elaborate defenses instead? In the stockholder's interest, the company decided that it could not buy out the speculators at a premium while ignoring long-term investors. From that same perspective, Gulf determined that any acquisition of another oil company simply to save Gulf's in-place management was equally unfair and inconsistent with the company's philosophies.

The Merger's Compliance with Applicable Law

Socal and Gulf will satisfy all requirements of Federal and State law regarding their merger. Socal has submitted information to the Federal Trade Commission (FTC) with respect to its tender offer and the companies will comply with all requests for information from that agency and all other Federal and state agencies.

The companies have reviewed their current operations and have determined that the merger provides an excellent fit with very little significant overlap in exploration, production, refining or marketing activities. Historically, the companies have concentrated their exploration and production activities in different areas of the world and they are currently active in distinct areas of the United States. In refining and marketing, the two companies have concentrated their activities in separate regions of the country.

Although the management and legal counsel of the two companies believe the merger has no significant anti-competitive aspects, it is anticipated that the FTC may require Socal to dispose of certain marketing and, possibly, refining assets of Gulf or Socal where there is any degree of potential concentration of operations in a particular local market. Socal and Gulf are fully prepared to comply with all reasonable requirements established by either the FTC or the Department of Justice.

In addition, Socal has initiated an internal review of the combined company's operations and may proceed to negotiate the sale of marketing assets in any local or regional area where there appears to be any potential for market concentration in excess of Federal guidelines. During the transition period, Gulf's jobbers, retail dealers, and customers will continue to have access to an adequate supply of petroleum products. All of Gulf's current supply contracts with jobbers and dealers will be honored, consistent with FTC requirements.

The Need For Large Oil Companies

It has been claimed that large companies, especially oil companies, are inherently bad solely because of their size. However, people who believe this find themselves on the other side of well-respected opinion. For example, when the New York Times commented on the Texaco-Getty merger, it said that the potential for takeovers at premium prices is a valuable incentive to look for energy resources.

This energy search requires large oil companies, like a combined Gulf/Socal, that can generate the needed investment capital, and can develop new frontier technology.

The positive technological implications of the Gulf-Socal merger should not be overlooked, especially because of the increasingly important role of technology in finding new reserves. For example, research found only at companies such as Gulf and Socal now enables the production of oil and gas from water depths that were uneconomic two or three years ago.

The synergism created as a result of the merger of Socal and Gulf research and development groups will lead to more and better research discoveries. Larger budgets will permit more ambitious research programs. The nation will enjoy the benefits of a higher level of expertise over a wider spectrum of fields. Moreover, a longer term commitment to research will be possible.

Employees

Gulf employees have been a major concern in this situation from the very start. As this merger moves forward, there will be attrition among the 42,000 people who work for Gulf. Every merger involves attrition to achieve greater productivity.

For Gulf's part, the assets of all the benefits that Gulf employees and annuitants have accrued over the years...pensions, savings plans and various others...have been secured. Severance packages for use in the event of employee terminations have been established. Socal has said that when these two companies are combined, they will draw from Gulf's excellent workforce. The merger assumes continued employment for most of Gulf's people.

Senator WALLOP. Senator Long?

Senator LONG. No questions.

Senator WALLOP. Senator Durenberger?

Senator DURENBERGER. No questions.

Senator WALLOP. Senator Bentsen?

Senator BENTSEN. No questions.

Senator WALLOP. Mr. Keller, if the Congress were to enact, as some have suggested, legislation which would deny the interest deduction for loans on acquisition, what impact would you anticipate that having on future merger activities and what impact would it have had on your decision to acquire Gulf?

Mr. KELLER. Certainly, one of the key considerations is that we could have afforded to pay a lower price to the Gulf shareholders for Gulf. We would have had a cost—a legitimate business cost—which under the premise you make would not be considered a legitimate business cost, and therefore it would be punitive really either to the acquiror or to the shareholder of the acquired company, and obviously, it would be the latter because we couldn't afford to offer the same price if there was a penalty associated with such an acquisition.

Senator WALLOP. Given that statement, even with this acquisition, based on what other people have said is the underlying value of the reserves of Gulf, the shares are still not to the $113 or $118 value figure, so that the stockholder in essence would have had less of an opportunity than presently to acquire reasonable value for the interest he held.

Mr. KELLER. May I comment on that $118 number? There is an organization known as Harold's which, using a series of artificial devices, comes up with a value periodically for the shares of various companies. The only companies who, in my experience, have actually traded near that price have been those which are domestic producing businesses only. There is a serious distortion because of the necessity to estimate what the value of future crude reserves will be—what the price will be in the year 2000. For example, Harold's number happens to be twice as big as ours. So, what happened here was the marketplace, represented by my company and another major company and another group, which concluded that this was the maximum value that we could assign. This other series of numbers, as I say, is more an index than a value. I think Gulf shareholders are getting full value for their share.

Senator WALLOP. Whatever, they are getting a better value than they would have had, had the interest deduction denial been in place.

Mr. KELLER. Yes.

Senator WALLOP. Or were it to be in place at some future time, it would be denying other stockholders opportunities to realize the full value of their shares. Given that, though, could either you or Mr. Murdy give us some indication as to what happens that keeps a stock in the $30 range that ultimately ends up at the $80 figure?

Mr. KELLER. I think both of us can, Senator, because my shares are in the same position. My shares were at $37 a share yesterday. Our liquidation value is probably 2½ times that. The problem is that the stock market in our industry at the present time is willing to pay the participants in the market a relatively low price earnings factor on earnings which are relatively low. The industry, at the moment, is on the margin of being cutthroat, and the reason is the tremendous excess of capacity that we have in both refining and marketing. This is the negative part of our shareholding value.

Senator WALLOP. One other thing in your full statement that is of interest to me, and I think is not related to tax policy but is related to energy policy, and one of the reasons why we are having a difficult time replacing reserves is because of the policy of withdrawing the most prospective—or most promising prospects—for finding significant reserves, and that is the new exploration that could take place offshore of the United States. Could you comment a little more fully?

Mr. KELLER. I would be delighted, Senator. I think people often forget—particularly people not directly involved in the industry—that the degree of exploration is a function, first of all, of the prospects that are available for acquisition. Second, the value of the commodity that you hope to find—in other words, what is the future value of crude oil. And third, the cost and tax environment that will apply when those reserves are produced. We have some 85 percent of the west coast now under a moratorium—the offshore west coast. We have tremendous restrictions on many public lands. The net result is that the number of opportunities is not what it should be, and of course, the price end of it is something which we have to judge, and frankly we don't anticipate very sharp increases in the value of the crude oil in the next 10 years.

Senator WALLOP. But that withdrawal also ultimately has a significant effect—perhaps a greater effect—on the consumer of these products in the country than does merger activity.

Mr. KELLER. I don't know that I can quite say that in that I think the big effect that this withdrawal has is on the amount of oil which we will import. In other words, the consumer may not pay a very different price in the short term. In the longer term, he will.

Senator WALLOP. I am glad you used the word ultimately.

Mr. KELLER. You are certainly right, Senator, with the word ultimately. I very much agree.

Senator WALLOP. Isn't there yet another aspect of the cost of discovering new reserves which is the incredible sort of bureaucratic jungle that is laid on top of it once you do get an opportunity to prospect offshore to a greater extent than onshore, but in either instance?

Mr. KELLER. Senator, you must have been reading some of my press conferences in California. We have an almost insurmountable problem with the combination of agencies, both Federal and State, particularly State, in the west coast—particularly as contrasted with the gulf coast—in the permitting process, and the real problem is delay.

The enormous amounts of money that are spent in developing an offshore resource are essentially all spent before there is any revenue. We are talking billions of dollars in looking at the Point Arguelo discovery, the large discovery we have made off California. And we are looking at 6 to 8 years to bring that into a revenue position. If that were in the gulf coast, it might be at least 2 years less.

Senator WALLOP. That is 6 to 8 years after it is opened for prospecting in the first place?

Mr. KELLER. Yes, sir.

Senator WALLOP. And to the extent that that doesn't take place, surely that adds to the cost of finding new reserves. Mr. Murdy, you might want to comment on the difficulties that you have faced in your company and especially with the very high cost of the Mukluk dry hole——

Mr. MURDY. Those are the very same factors that Mr. Keller has commented on. They affect every company trying to prospect in the business today.

Senator WALLOP. Senator Long?

Senator LONG. First, let me ask Mr. Keller: Can you explain why oil in the ground would be selling so cheaply? My impression is that it is selling for around $5.00 a barrel, and oil sells for a great deal more than that above the ground. As I understand it, you have got the wells, but it is going to take some time to get the oil out of the ground. In many instances it comes out by pressure.

Why does the oil in the ground sell for so much less than what it is worth above the ground?

Mr. KELLER. Senator, as I am sure you know very well——

Senator LONG. Now, wait a minute. Don't assume anything. I want an answer that I can go tell a layman out there who doesn't know anything about the oil business.

Mr. KELLER. All right, Senator. What we are looking at here is a series of barrels in the ground, as you described, which will typically be produced over perhaps a 20-year period. So, the first effort that has to be made in appraising the value of oil in place is to estimate what the production rate will be. In other words, how many barrels do I get this year, next year, and over the 20-year period.

Senator LONG. Aren't they pulling it out a lot faster than that now? My impression is that in the United States now the depletion goes a great deal faster than that.

Mr. KELLER. Senator, we are depleting our current reserves in the typical field at perhaps 10 percent a year, but the second year that means you would only have 9 percent of what you started with. In other words, it is a decline curve. An oilfield with 100 units would produce at something like 10, 9, 8.1, 7.3 per year. It is the value of that flow of oil which we attempt to appraise. Having done so, of course, a great many of the barrels and therefore the associated dollars are 5, 10, or 15 years down the road.

We have to bring those values back today. We have the same thing to do, of course, with regard to costs—the operating costs—and then the biggest costs by far are a combination of royalty, income taxes, and the so-called—I hate to say it—windfall profits tax, which is just an excise tax. And that combination says that we are effectively having a cost in the 70 to 75 percent range typically of the revenue going to various agencies—either the royalty owner if it is a private person, the State, or the Federal Government, and then of course we have severance taxes in many areas, as well as the typical income taxes and the excise taxes.

Senator LONG. But my impression is that a barrel of oil at your refinery would be what—about $29?

Mr. KELLER. For a typical light crude oil, yes, sir. Let me give an indication here because I asked my people to do it for me. In looking at Gulf's reserves and appraising their current value, there were fields in which the current appraisal worked out to less than $2 per barrel, others in which it was as high as $9, and the difference had to do with the crude oil quality, the cost of production, the tax environment, and also the time over which it would be produced. And by the way, there is considerable misunderstanding, too, in looking at the cost to find and produce oil versus this oil in the ground. We are looking at two different kinds of numbers. Somebody says you found oil on Wall Street for $6 and it costs you $12 or $13 to find—using your own annual report records—and produce it. Both of those numbers are right, but they have no relation to one another. The one number is a cost. It is typically a before-tax investment or expenditure cost. It occurs at a different time. It results in an income stream over a different period, and those numbers can be very competitive. Order of magnitude again—they can vary as much as by a factor of 2 in a competitive situation. In this instance, because of the nature and extent of Gulf's reserves, we were able to justify a particular value and assign that along with the value of their other assets to an $80 share price. If we had anticipated a significantly higher oil price in the future, we could have offered a significantly higher price, but the price and tax environment are the key items in the valuation of these reserves.

Senator LONG. It may be covered in your statement—I had to go make a speech myself while you were making your statement—but would you respond for my benefit to the suggestion that you are borrowing a huge amount of money for this acquisition—which money will not be used in drilling and which would be better used for drilling or housing or some other purpose. The argument is that that is helping to push up interest rates and denying the money that could be used more effectively somewhere else. What is your reaction to that?

Mr. KELLER. Senator, I have addressed that both in my written and oral statements. But to summarize, I guess one word would be nonsense. We are dealing here in the first place with an insignificant amount of the transactions which occur in the markets in the United States in the course of a year. The $80 which the shareholders of Gulf will receive isn't removed from the market at all. Presumably, if any of us here own Gulf shares, we would reinvest that in some sort of asset and very probably a good part of it in either the stock market or in lending source funds. So, as far as affecting the credit market, it is de minimis, and as far as affecting interest rates, I guess if one looked at what happened to Treasury rates or other comparable figures a few days after this transaction, they went up a little, but interestingly enough they have gone down a litte more than that since. To me, $13 billion is the most I have ever talked about in my life, but nevertheless, it is insignificant in the credit market.

Senator LONG. What is your thought about the economic concentration that results?

Mr. KELLER. This is one that I guess sheer size is the factor, Senator. I found it interesting in some of my conversations with some of the proponents of the moratorium legislation that they had a problem deciding whether there were 50 or 100 giant oil companies. It seems to me that either number is more than enough to provide a rather satisfactory element of competition in the marketplace, and whether 5, 10, or 15 of the 100 merged with one another in order to improve their efficiency, in an environment in which we do, particularly in the refining and marketing business, have an enormous excess of capacity, I think it is a matter for business judgment for the market to determine, and I think it will do so.

Senator LONG. I have not been too impressed by the argument because one simple matter affects me as an individual. Exxon is bigger than the two merged companies put together, is it not?

Mr. KELLER. By quite a bit, sir, yes.

Senator LONG. All right. I hate to say this because I like your company, and I like Gulf. I think they are both good competitors. I like Texaco. I have nothing against Getty. I think they are all nice people, but as a practical matter, Exxon is bigger than the whole bunch put together, is it not?

Mr. KELLER. I think they would probably be about the size of the four that you have described.

Senator LONG. So, by the time you get through with this merger, if you merged again with Texaco, and you would then be about the same size as your No. 1 competitor.

Mr. KELLER. Yes, sir. And I can assure you that is not in our plan. [Laughter.]

Senator LONG. I am not advocating that you do that, but one simple fact sticks in my mind. Most companies—and I guess yours as well as Gulf—have credit cards. And I would be happy to do business with any of you, but as a practical matter when I go down the highway, I don't want to carry a whole pocketful of credit cards—it loads down my wallet. [Laughter.]

So, I am not going to carry 15 credit cards for 15 different companies. and my wife is the same way. We carry one. And I hate to say it. I know it might be discouraging to you, but I carry Exxon for the simple reason that they have got more filling stations out there than anybody else. So, if I am low on gas, the chances are that if I am anywhere in this area, I can find an Exxon station. The same thing is true in Louisiana. So, if you want to really be an even-steven competitor with Exxon, you need as many filling stations as Exxon has, so that your filling station will help the customers just as much as theirs will. I can't say that you have created any monopolistic problem as long as you are only half the size of your No. 1 competitor. It seems to me that if they want to go after somebody, they ought to go after them. Bless their hearts—they are laying low. They are not taking any position about all this, and I don't blame them at all. [Laughter.]

I find difficulty in thinking that here people have quietly sat there and said nothing while all these railroads merged—they had mergers all over the place. Connecticut General merged with INA in the insurance business—and who said anything about it? Nothing. Not a word. It was just as quiet as a tomb. And then, somebody in the oil industry merges, and all of a sudden, you would think the world was going to come to an end. So I don't understand why if the interest expense is a legitimate expense of doing business, and if you can borrow money to buy something, why you can't borrow money to buy an oil company as well as borrowing money to buy something else. Can you explain to me what the difference is?

Mr. KELLER. Obviously, I can't, Senator. I think if I were to be asked again for a very simple answer I would say it is that six letter word BIG OIL. It is kind of in the sam category as damned yankee and a few others that I won't mention. As a result, the fact that we are big and have to be—just look at the amount of inventories, the amount of assets, the number of people that are involved in conducting a competitive oil business in this country—and you end up with a very large number of very large companies. And it is the shear size, I am sure. It is not the fact that the competition is remotely being reduced.

Senator LONG. Thank you very much, Mr. Chairman.

Senator WALLOP. Thank you, Mr. Keller and Mr. Murdy. A couple of other Senators would like to ask some questions. Senator Bentsen and Senator Bradley would like to. I have asked that whoever comes back from the vote—we have a vote on the floor right now—merely start us back up again and begin to ask the questions, in the interest of time.

So, if you will forgive us, we will stand in recess for just a couple of minutes, and the first Senator back I hope will begin to ask questions.

Mr. KELLER. Fine, Senator.

[Whereupon, at 11:20 a.m., a short recess was held.]

AFTER RECESS

Senator BOREN. We will now resume. Mr. Wallop will be back very briefly and other members of the committee will be returning, too. In the interim, I think I will take advantage of this opportunity to go ahead and lodge some questions. Let me just ask this question: there are many of us on this comittee who have worked very hard when we had the windfall profits tax up for consideration to reduce the burden of that tax, which we felt was unfair. One of the arguments that we used was that we would have increased exploration as a result of reductions in the windfall profits tax. We constantly provided the committee with production response figures, as we were able to cut the rate, for example, for new oil. I can understand, in the independent sector, we were able to show something like a 105 percent ratio of funds being put back into additional exploration and production from any reduction in the tax. Now, we are having the argument thrown up to us that, well, what do you have to say now about the windfall profits tax and other tax incentives—the large companies are simply taking the money and they are not doing any additional exploration. In fact, they are cutting back on their exploration budgets so they can acquire other companies. How would you answer that argument that is now thrown up to so many of us? Are you simply using this to acquire each other or to acquire nonenergy related companies and the production response figures which you have been giving us simply don't hold any water. How would you answer that political challenge that is lodged to some of us on this committee?

Mr. KELLER. Senator, I have tried to answer that in my written submission, but let me comment orally. The borrowing of funds for the purpose of major exploration efforts, such a we carry out, is something that just isn't in the cards for us. We are borrowing money here to acquire known reserves. In other words, we have a more or less known interest bill, a bill to pay back principal, and we have acquired assets in refining and marketing and then very sizable assets in the form of oil in the ground. The efforts in exploration are almost completely related to the combination of opportunity and net cash recovery from the venture. The reason that the fluctuations have taken place in recent years have revolved to a very considerable extent around the opportunities, the moratorium for a large part of the offshore, the withholding of very significant domestic lands. And then, on the other side of the fence, two items—one the anticipated value of oil when produced. If you go back a few years, there were a great many people looking at $50.00 oil—we haven't sold any in that ballpark for a long time—we never have, in fact. And we don't anticipate that we will see it before some time after the year 2000. So, the economic driving force in terms of value is lower, and then the tax burden is very considerable. The windfall profits tax is a very major factor in the marginal exploration that might or might not take place, if there were another dollar or two, net, available to the producer. Exploraion particularly in the frontier areas—the areas where it is more expensive—is seriously inhibited by tax policy.

Senator BOREN. What about the combined exploration budgets of Gulf and Standard? What has been the effect of the combined exploration budget under the merger? Has it gotten to be as large as the premerger exploration budget of the two companies?

Mr. KELLER. I have assured this committee and three others that our exploration effort will be at least comparable to the two. Now, you can't add the $2 together and come out with quite the right answer because there are some overlaps. But setting that aside, I have no doubt that, based on the opportunities available to both companies from the prospects which we have at hand and plan to acquire, the additional technological support that the two companies working together can bring to bear, and the financial strength of the going business. I can assure you that we are going to maintain the same aggressive program that the two companies planned previously.

Senator BOREN. On the question of the amount of credit consumed—when you look at credit supply—something like $400 million and some, or close to $500 million, and the Government taking something like $270 or $280—if we look at the total of these mergers in recent times, I think it comes to something like $29 million, which is about 10 percent of credit—available credit—that has not been consumed by the private sector, so it has to be a rather significant amount. I heard you say that there is no loss of credit at all because it immediately turns around and flows back in. Have you had an economic model run on that to see in what way it flows back in, or how rapidly it flows back in, at least in terms of short-range effects on the credit market?

I find it a little hard to believe that it is instantaneous or that it flows back in quite the same way when you look at the interest rates—at least the short-term rate—it is certainly a product of supply and demand in credit, just like it is in anything else. Have there been some studies made based on economic models?

Senator WALLOP. Let me just say that—and I would be interested in your answer, Mr. Keller—we do have a couple of witnesses who are sort of designed to address themselves to that question.

Senator BOREN. Yes. All right.

Mr. KELLER. We have asked Leif Olson of Citibank—their chief economist—to comment on this point. In fact, he has delivered a paper to an earlier hearing in the Judiciary Committee. His conclusion—and I certainly assume that you will hear some similar comments from those behind me—are that you are looking, in terms of the total amount, at an insignificant time, whether it is days or weeks is really quite immaterial. For example, I guess one could argue that the optimum place for this cash flow in terms of credit would be if everybody put it in the bank. As a practical matter, maybe for a short time, that is what will happen.

And at that point, it is in the credit market. To the extent one reinvests elsewhere in stocks or bonds or other financial instruments, it again is in the credit market in one form or another. So, realistically, I think there are only two kinds of transactions where borrowings tend to disappear. One is if someone buys a desert island somewhere and the money stays there, and the other is with the Government. [Laughter.]

Senator BOREN. I will turn it back to you, Mr. Chairman. [Lauqhter.]

Senator LONG. Let me see if I understand what you are saying. You are saying that for most people, they will deposit it in their bank.

Mr. KELLER. I think that would be my circumstance if I happened to own any Gulf shares, which I am sorry to say I don't.

Senator LONG. So, the first impact would be that the people get money for the stock. The money is borrowed out of the bank, and then it goes right back in the bank.

Mr. KELLER. That is the first cycle, yes, sir.

Senator LONG. So, in general terms, it goes right back where it came from.

Mr. KELLER. Sure. Different banks, different circumstances.

Senator LONG. It came from the bank, and it is going right back to the bank. So, assuming that at that the borrowed funds came right back to the bank, there is no disruption at that point. Thereafter, I should think that one would tend to invest the money. Down my way in Louisiana, I don't know of anybody who is rich who didn't make it in oil—there may be some, but I just don't know of anybody. You might find a plantation owner or a sugarcane planter. If he is rich, it is because they found oil underneath that plantation. So, generally speaking, in my part of the world, if people in that kind of business make a lot of money somewhere—or sell something—where are they going to put it? Right back where they made it to begin with—right back in the oil industry. There are those kind of people, and that is exactly what they have been investing in.

Mr. KELLER. I think that is exactly right, Senator, and of course, no matter what it is invested in, there again, here is a new recipient of income who is going to put it someplace else. Money is a tremendously fundgible commodity—it just moves all through our society, fortunately.

Senator WALLOP. I think it might be fair to say that this $13 billion—if it had been expended to construct some kind of a capital asset whereby the money wouldn't flow so immediately—it might have had a greater impact—I don't think in either instance the effect would have been great on interest rates, but it might have had a greater one in that instance than it does going directly to a pocketbook to a market to a pocketbook and so on.

Mr. KELLER. Right. This was basically a financial transaction. The funds will move that way, and in the other case, we have the other very valuable contributions, of course, to the economy and through services and materials.

Senator WALLOP. Right. The others haven't come back. I would simply ask that if they have questions that they feel are overriding that they would be able to submit them to you in writing and you would respond to them. There is just one last question, and it goes to Mr. Murdy. As you know, Mr. Pickens will testify in a later panel, but from the perspective of the board of directors, could you tell me what you think would have happened to Gulf had that tender offer been successful? And at the same time, would you comment whether it is appropriate for corporations to adopt so-called "shock repellant" provisions in order to prevent acquisition?

Mr. MURDY. Just to respond to your last question first, Gulf did not have any——

Senator WALLOP. No, I am not accusing you of having had them. I am just bringing that up as a general thought.

Mr. MURDY. I just want to say that that was considered, and we felt that in the best interests of the shareholders and others that those kinds of provisions were not necessary, and therefore they weren't put in place. On the options that the Gulf Board had to consider, with the tender offer from the Mesa group and out in the marketplace, from the very beginning, the way we looked at the suggestion from Mesa, we considered that to be, in effect, liquidation, and in this business you can liquidate in any number of ways. You can liquidate by selling off assets. They had a specific proposal that they were using to raise money in the marketplace that called for the sale of all Gulf assets by the end of 1986. So, that was a document that we had to see and consider.

Now, whether they would have done that or not, who knows? But that was that document. Another way is to simply cut way back on your capital programs and not try to renew your reserves but produce out over the life of the current reserves, and then increase your dividend payouts, which is again a degree of liquidation. Another way was the spinoff of the royalty trust. And as proposed in our case, it would have involved more than half of our domestic crude oil reserves which is the most significant source of cash flow in the company, and would have significantly reduced the ongoing earnings of Gulf—our earnings by about $400 million a year, and our cash flow by about maybe as much as $1 billon—$700 million to $1 billion. So, we saw those proposals as one way to run an oil company, but they weren't consistent with the strategies that our board had put in place, and we felt that there were better ways to get the value for shareholders and, therefore, never adopted those proposals.

Senator WALLOP. Senator Bentsen. Thank you, Mr. Murdy.

Senator BENTSEN. Thank you very much. Mr. Chairman. Mr. Keller, there are a lot of charges that mergers reduce drilling. It seems to me that over the last 3 or 4 years there has been a reduction in drilling because you have had a lowering of the price of oil, you have had fewer good prospects, and you have had a substantial increase in the cost of drilling. That is a pretty tough hill to climb. Isn't that about the net result of why you have seen such a substantial reduction?

Mr. KELLER. Senator, there is no question about it. I commented on that in your absence, and exploration is without a doubt the most volatile of all the activities an oil company involves itself in. It is also one in which we and thousands in the industry are always looking for new opportunities. But they do have to meet some reasonable economic test.

Senator BENTSEN. I noted in your statement that you said that, assuming this merger goes through, your overall drilling budget—combined budget of Gulf and SoCal—will actually probably be at least as much, and maybe a net increase. Is that correct?

Mr. KELLER. Senator, yes. I have assured this committee and three others that our combined effort will be at least as great, and I would expect, certainly as we get to know each other and work together better, to be greater. When you consolidate the resources economically and resources technologically that the two companies have—and it is our plan to maintain an effort at least as great as the sum of the two.

Senator BENTSEN. Mr. Chairman, I would like to introduce into the record a series of acquisitions—U.S. Steel of Marathon, Dupont Steel of Conoco, Shell's acquisition of Belridge—in each of these instances, they actually ended up with an increased exploration budget. I would like, if I may, to put this in the record.

Senator WALLOP. By all means.

Senator BENTSEN. Now, Mr. Murdy, educate me a little on one of your comments. You cited a number of reasons why you felt a royalty trust was a problem. One of the reasons, I thought I heard you say, was that a distribution of an interest in such a trust would be taxed more heavily through individual shareholders than it would be for the corporate shareholder, with the 85-percent exclusion. But isn't that the case of all dividends?

Mr. MURDY. There is another difference in this case.

Senator BENTSEN. Isn't that the case with all dividends—the 85-percent exclusion to corporations—it is not just to a royalty trust.

Mr. MURDY. That is right. But could I explain the difference in this, though, Senator?

Senator BENTSEN. Sure.

Mr. MURDY. The value of this dividend would also be different, because for the individual he would have to value it at the market value of the royalty trust. That would be the measure of the dividend. For the corporation, he simply—the corporation simply—recognizes the tax basis of the properties included in that. And that was a very large difference in our case.

Senator BENTSEN. I see. Thank you very much, Mr. Chairman.

Senator WALLOP. Thank you both very much. I think you have provided a good insight in some of the issues that I had highlighted at the beginning.

Mr. Keller. Thank you, Senator.

Senator WALLOP. The next witness is Prof. Martin Ginsburg of the Georgetown University Law Center in Washington.

Good morning, Professor Ginsburg.

[The prepared acquisitions from Senator Bentsen follow:]

ACQUISITIONS FROM SENATOR BENTSEN

Mr. Bentsen: Mr. Chairman, if we look beyond the rhetoric and examine the reality we can see that mergers do not diminish exploration activity. When U.S. Steel acquired Marathon in January 1982, it saddled itself with $5.5 billion in new debt, an increase of nearly 200%. Its debt/equity ratio went from 46% to 134%. Yet, its 1982 exploration expense budget increased over 20% to a record high $211 million. When DuPont acquired Conoco in August 1981, it added over $6 billion in debt and the debt/equity ratio increased from 31% to 78%. Yet, expenditures for U.S. exploration increased from $185 million in 1980 to $371 million in 1981. Shell's acquisition of Belridge Oil in 1979 is even more convincing, Mr. Chairman. Belridge had extensive reserves, especially heavy oil, but, as a private company, could not finance the huge development expenditures and did not have access to the appropriate technology to exploit those reserves. Despite incurring a huge debt burden to complete the acquisition, Shell's development cost soared from $485 million in 1978 and $640 million in 1979 to $1.153 billion in 1980 and $1.409 billion in 1981. Its exploration costs increased from $369 million in 1978 and $372 million in 1979 to $499 million in 1980 and $611 million in 1981. Output per day from Belridge's oil fields more than doubled due to Shell's efforts and expenditures.

STATEMENT OF PROF. MARTIN D. GINSBURG, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, DC

Professor GINSBURG. Good morning. Mr. Chairman. Having the advantage of the testimony of the prior speakers, I thought it might be useful if I set aside my written statement and focus on a few of the matters that the committee has discussed with these people.

Senator WALLOP. That will be fine. The written statement will be made part of the record in its entirety.

Mr. GINSBURG. Thank you. Mr. Pearlman said this morning that oil mergers in the Treasury's view are not primarily tax motivated. I think that is true. I think that even if the tax advantages to be gained from the acquisition of one large oil company by another large oil company were greater than they are, these transactions still would not be primarily tax motivated simply because the marketplace differentials are such that the acquisition is just plain attractive as a commercial matter. I think more generally that there are problems in the tax field with respect to the acquisition by one company of another, not at all focused in a particularized way on oil company acquisitions, and those are the issues that really merit consideration here this morning. That is, if the question on the table is whether as a tax matter there is something special in the acquisition of one large oil company by another large oil company, something that merits some sort of special legislative response—a tax response—then as I said in my written statement, the answer seems to be no. There is not. So, if I may turn to what I believe are the more generally interesting issues. The committee has this morning, in its questioning of prior witnesses, fairly focused these. The first I think is acquisition indebtedness—the interest expense on acquisition indebtedness when there is a large corporate acquisition. My own view and it is one of the few notions I have a quite clear view on, is that there is no reason to disallow the interest expense deduction as a matter of proper tax law. There is a problem, but it is a different kind of a problem. And it is not too difficult to see really.

If large X corporation is selling off a division to large Y corporation for $100 million, it really doesn't make any difference whether Y corporation has borrowed that money or is purchasing those assets out of funds accumulated in prior operations The transaction is wholly taxable to the seller. X corporation will take the money it receives, invest it, make more money, and pay tax. Y corporation, if it has borrowed the $100 million, ought to be able to deduct the interest expense because it is going to get taxed on the income from the business it has acquired. It seems to me that, in terms of the interest expense deduction, you can generalize across the board the conclusion in favor of deductibility. The real problem in the acquisition field is when Y corporation is buying all of a target company—buys all of its assets and the target liquidates, or buys all of the stock of the target whether or not Y makes a section 338 election. The problem is that money, in the form of borrowed funds or accumulated funds, has left corporate solution, has gone out to the shareholders—the individual shareholders—of the target company, and we tax that as a capital gain transaction. Now, nobody is here today to propose a cosmic change in all of the corporate tax field, generally to eliminate shareholder capital gains. But if there is a discontinuity here, it is not that we have created an interest expense deduction for borrowed money—that is what interest expense is for—it is that we have allowed money to come out of corporate solutions on a capital gain basis rather than on an ordinary income dividend basis, and unless we are prepared to address that question, then I think we ought to just put this whole issue aside. And I take it we are not prepared to address that question.

Senator WALLOP. I would agree with that. I am not prepared to raise that issue. [Laughter.]

Mr. GINSBURG. I take it too that Treasury is of the same mind. The second issue that was focused—I think it was Mr. Pearlman who focused it in part of his testimony—has to do with a particular kind of acquisition indebtedness. It is the installment obligation problem, which is addressed in a small way in the pending legislation in the Senate. This is the case in which somebody sells an asset, sells the stock of a target corporation to a purchasing company, and takes back a nice debt obligation—something attractive—a $100 million note, secured by a standby letter of credit, that will remain outstanding for 12 years at 12 percent interest. That is a very attractive transaction. Mr. Pearlman pointed out that we have a discontinuity here in that the buyer can immediately step up basis because the buyer is treated as having paid $100 million. On the seller's side there is a deferral of gain recognition; in my example if the $100 million were all gain, there would be about a $20 million tax, but on the installment method the tax will not be paid for about 12 years.

It is quite true this is a discontinuity. It is approached in the pending bill by saying that, to the extent of depreciation recapture on that sale, we will disallow the installment method to the seller. My own view is that is an unfortunate way to approach this problem—one, because it only picks up a narrow part of the problem, and two, there will really be people in the world who do installment sales and won't have the money with which to pay the tax up front.

Senator WALLOP. I was going to ask you, Professor Ginsburg, if you could enlighten a genuine novice in this thing. Accepting the fact, and I do, that there is a discontinuity, is that bad tax policy because the consequences to one are quite different than the consequences to another, anyway?

Mr. GINSBURG. The fact that there is a discontinuity doesn't automatically mean that you are dealing with bad tax policy, but in fact, in this case, you are. But, given the balance of our system, it is not on the buyer's side. There is no reason to propose—that I can think of—that the buyer should be denied asset the basis for the borrowed money if he is borrowing in effect from the seller, but gets basis if he borrows from a bank. It is hard to see how we would make that distinction. I think the real problem here lies in the way the neat piece of arithmetic works—if you take the $100 million transaction that I just did, and I regret that it is hypothetical—and think about the $20 million I didn't pay in tax today because I received that good 12 year note. If I had paid the tax, I would have had $80 million left tc invest. Because I received a note and was awarded installment treatment, I am allowed to invest not only my $80 million but the Government's $20 million, and I invest that for 12 years by holding the note. You know, if I can invest $20 million for 12 years at 12 percent interest, and pay my tax on the interest every year, and compound, at the end of the 12th year my accumulated post-tax interest income earned on that $20 million is going to be another $20 million. And so, you see, what happens here is that in a practical sense nobody ever pays the $20 million capital—gains tax, at least the seller doesn't truly pay it. Out of the $20 million I accumlated over 12 years investing the Government's money, the Government pays itself the $20 million deferred tax at the end of 12 years. That is what is wrong. It hasn't got anything to do with the buyer's side of the transaction. Now, if you want to raise a lot of revenue to good purpose, you would make one change in the tax law in this area. And it wouldn't just focus on corporate acquisitions; it would focus any long-term installment obligation transaction. You would tax the privilege of deferral. You would say that every year when I invest the Government's $20 million, the yield on that deferred tax sum is the Government's earnings, not my earnings. If you did that, I would hazard that you would pick up, oh, $3 to $6 billion a year in revenue. I think it is not a bad way to raise revenue if we are out to do that. But to disallow the buyer's interest expense deduction, or to tell the buyer that it can't have asset basis until the seller pays the deferred capital gain tax, just doesn't make a lot of sense.

The last concern I would like to address is one Mr. Pearlman spent a good deal of time on, and to which I devote much of my written statement. It is the General Utilities problem. The committee must be so tired of hearing of the General Utilities problem, you get it in almost any good corporate tax hearing, but in truth it is a very major problem. It is not essentially different in the oil company situation from any other, and it comes down to this. If a target corporation is acquired in a cost-basis acquisition—its assets are purchased, or its stock is purchased and a section 338 election is made by the purchasing corporation—the purchasing corporation is going to get a full basis in the assets. Now, that seems to me perfectly fine if a fair price—a fair tax price—is paid. A fair tax price is recognition by the target company of the proper amount of gain on the sale of its assets. As to what is proper, I would break down the assets of target, and the appreciation in the value of those assets, into three categories.

First, purely capital appreciation. It is often attributable to inflation. The company bought a capital asset for $100 and the asset shot up in value to $500. That exemplifies the first case. That we do not now, in a corporate acquisition, tax the target company on this capital gain does not seem to me wrong. That is, if we wish to change that rule, as Mr. Pearlman was suggesting this morning we should change it only incident to a major restructuring of the corporate tax law that would afford some kind of reasonable relief to the shareholders from what would otherwise be really oppressive double taxation.

But the important thing is that this is just one class of problem. The polar case that we do not now tax involves just plain ordinary income assets, such as Fifo inventory. It is very hard to see why we say that if the target company's Fifo inventory has appreciated in value from, let's say, $1 to $1.5 million, in a corporate acquisition the buyer will get asset basis of $1.5 million and the seller won't pay the tax on the $0.5 million gain. And surely there is little justification for present law's declaration that, in a corporate acquisition or distribution, Lifo inventory we tax, but Fifo we don't. We ought to tax it all. Inventory profit, after all, is operating profit.

The interesting case is the middle case, and here the oil companies are implicated, although not in a terribly special way. We recapture depreciation under our tax law, completely with respect to personal property, partly with respect to real estate. In part, since 1976 we recapture intangible drilling costs that were previously deducted. To the extent we are focused on the difference between the adjusted basis of the property, written down to reflect these tax benefits, and a higher value up to but not in excess of a original cost, then it seems to me there is a very strong argument for saying that in a corporate acquisition. as in any transaction in which the basis of the property is stepped up, to the extent of that prior tax benefit we ought to tax that gain. In most cases, it would be capital gain, and I would not propose to change that rule. What I am saying is simply that it is difficult to see why this tax benefit gain should be wholly tax exempt.

The remaining point I would like to address relates to what Mr. Pearlman said about prior history. I think he is quite right—that changes in the tax law were made in 1976 in which various industries, including the oil industry, gave up things and got things. It is not entirely appropriate to redo bargains. But I do not suggest redoing the 1976 bargain. I do not propose to change the rules for the oil companies or any other specific class of taxpayers. I would change the rules, explicitly the General Utilities rule, for everybody or for nobody. To me, that is not essentially different from what we do here regularly, beginning in 1913.

Those are the three things I wanted to talk about this morning.

Senator WALLOP. Thank you very much, Professor Ginsburg.

[Professor Ginsburg's prepared statement follows:]

STATEMENT OF MARTIN D. GINSBURG
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE
SENATE FINANCE COMMITTEE

ON OIL CORPORATION MERGERS
APRIL 5, 1984

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

MY NAME IS MARTIN D. GINSBURG. I AM A PROFESSOR OF LAW AT GEORGETOWN UNIVERSITY LAW CENTER WHERE I TEACH VARIOUS SUBJECTS IN THE FIELD OF FEDERAL TAXATION. OVER THE PAST FIFTEEN OR SO YEARS IT HAS BEEN MY PRIVILEGE TO TESTIFY BEFORE THIS COMMITTEE ON A NUMBER OF OCCASIONS, AT TIME AT YOUR REQUEST, AT TIMES ON BEHALF OF A BAR ASSOCIATION GROUP, MORE OFTEN SIMPLY OUT OF AN INTEREST IN THE SUBJECT, BUT NEVER ON BEHALF OF A CLIENT. I APPEAR TODAY AS AN ACADEMIC BUT, I TRUST, NOT A DISINTERESTED WITNESS.

THE COMMITTEE TODAY IS CONSIDERING WHETHER, AS A MATTER OF FEDERAL TAX LAW, SOMETHING SPECIAL IN THE ACQUISITION OF ONE LARGE OIL COMPANY BY ANOTHER LARGE OIL COMPANY MERITS A SPECIAL LEGISLATIVE RESPONSE. TO THAT NARROW QUESTION, FOR REASONS I WILL BRIEFLY SUMMARIZE, I WOULD ANSWER NO.

IF THAT WERE ALL I COULD THINK TO SAY THIS MORNING, I WOULD NOT BURDEN YOU WITH THE PRONOUNCEMENT. BUT THE CURRENT CONCERN ENGENDERED BY THESE GIGANTIC TRANSACTIONS, COUPLED WITH THE PROPOSED TAX REFORM ACT OF 1984 NOW BEFORE CONGRESS, OFFERS AN UNUSUAL OPPORTUNITY. AS A TAX MATTER, WHAT TROUBLES US ABOUT OIL COMPANY

ACQUISITIONS IS PRETTY MUCH WHAT TROUBLES US, OR OUGHT TO, ABOUT CORPORATE ACQUISITIONS IN GENERAL. I AM NOT HERE TODAY TO URGE A COSMIC RECONSTRUCTION OF SUBCHAPTER C -- THAT OVERDUE REVISION, IN WORK IN THE COMMITTEE'S STAFF, TREATS ISSUES OF FAR GREATER DIFFICULTY THAN TODAY'S CONCERN -- BUT I DO URGE THAT THE COMMITTEE CONSIDER TAILORED CHANGES IN THE GENERALLY APPLICABLE PROVISIONS GOVERNING CORPORATE ACQUISITIONS.

ALTHOUGH THE HEADING OF TODAY'S HEARING REFERS GENERICALLY TO MERGERS, ARRANGEMENTS WHICH FOR TAX PURPOSES MAY BE ACCOUNTED EITHER REORGANIZATIONS OR PURCHASES, REALISTICALLY WE ARE FOCUSED ON THE LATTER. CLASSICALLY, REORGANIZATIONS IMPLICATE NO GAIN TO THE TARGET CORPORATION AND CARRYOVER ASSET BASIS TO THE ACQUIRING CORPORATION. ABSENT ENHANCED UTILIZATION OF A NET OPERATING LOSS, NOT THE PROBLEM OF THE MOMENT, NO SPECIAL TAX ADVANTAGE INHERES IN A CARRYOVER BASIS TRANSACTION. ACQUISITION BY PURCHASE IS ANOTHER MATTER, AND IT IS VERY MUCH THE MATTER OF THE MOMENT.

WHEN PURCHASING CORPORATION ACQUIRES THE ASSETS OF A TARGET CORPORATION THAT LIQUIDATES, OR BUYS THE STOCK OF TARGET AND FILES A SECTION 338 ELECTION, ASSET BASIS IS STEPPED-UP TO REFLECT PURCHASE PRICE. THAT, OF COURSE, WOULD BE WELL AND GOOD WERE TARGET CORPORATION FULLY TAXED ON THE GAIN.

BUT IT IS THE NORMATIVE RULE IN OUR SYSTEM, THE SO-CALLED <u>GENERAL UTILITIES</u> DOCTRINE, THAT NONRECOGNITION IS THE RULE, RECOGNITION OF GAIN THE EXCEPTION. COMMENCING IN 1954, AND MORE RECENTLY AT AN ACCELERATING PACE, CONGRESS HAS CARVED OUT MANY EXCEPTIONS TO

THE GENERAL RULE OF NONRECOGNITION. EXAMPLES INCLUDE COMPLETE RECAPTURE OF DEPRECIATION IN THE CASE OF PERSONAL PROPERTY, RECAPTURE OF ACCELERATED DEPRECIATION FOR REALITY, AND THE RECENTLY ENACTED TRIGGERING OF LIFO INVENTORY RESERVE.

LET ME RETURN FOR A MOMENT TO THOSE OIL COMPANIES. SINCE 1976, SECTION 1254 OF THE CODE HAS TREATED AS RECAPTURABLE -- REQUIRED RECOGNITION -- THE BULK OF INTANGIBLE DRILLING AND DEVELOPMENT COSTS PREVIOUSLY DEDUCTED WITH RESPECT TO OIL AND GAS PROPERTIES. IT IS LARGELY IN LIGHT OF THAT PROVISION I EARLIER SUGGESTED THERE IS NO IMPELLING REASON OF TAX LAW TO DENIGRATE OIL COMPANY ACQUISITIONS RELATIVE TO OTHER CORPORATE ACQUISITIONS.

THERE IS, HOWEVER, AMPLE REASON TO CHANGE THE LAW, TO CIRCUMSCRIBE FURTHER THE GENERAL UTILITIES DOCTRINE, FOR ALL CORPORATE ACQUISITIONS. UNDER CURRENT LAW, IN AN OTHERWISE TAXABLE "COST BASIS" ACQUISITION THE TARGET CORPORATION IS NOT TAXED, ORDINARILY, ON A SIGNIFICANT PART OF THE APPRECIATION IN THE VALUE OF ITS ASSETS. THE ASSETS AND APPRECIATION THUS BENEFITED MAY BE LOOSELY GROUPED THIS WAY.

-- APPRECIATION IN EXCESS OF ORIGINAL COST, OFTEN ATTRIBUTABLE LARGELY TO INFLATION, EXEMPLIFIED BY INVESTMENTS IN UNDEVELOPED LAND, PORTFOLIO SECURITIES, BUILDINGS HELD FOR INVESTMENT OR PRODUCTIVE USE, AND INTANGIBLE ASSETS SUCH AS GOODWILL.

-- APPRECIATION, ABOVE ADJUSTED BASIS BUT NOT IN EXCESS OF ORIGINAL COST, ATTRIBUTABLE TO DEPRECIATION OR AMORTIZATION OR COST DEPLETION OF OTHER PREVIOUSLY ENJOYED TAX DEDUCTION THAT DID NOT

MIRROR AN EQUIVALENT DECLINE IN ECONOMIC VALUE. I CONCENTRATE HERE ON APPRECIATION THAT IS NOT SUBJECT TO THE RECAPTURE RULES OF CURRENT TAX LAW, FOR EXAMPLE THE VALUE OF REAL ESTATE, ABOVE ADJUSTED BASIS BUT BELOW ORIGINAL COST, WHEN DEPRECIATION WAS TAKEN ON THE "STRAIGHT LINE."

-- THE APPRECIATION IN ORDINARY INCOME ASSETS, DOMINANTLY FIFO INVENTORY, THAT IS NOT SUBJECT TO CURRENT RECAPTURE OR OTHER RECOGNITION RULES.

AGAIN LOOSELY, THE FIRST CATEGORY OF TAX EXEMPT APPRECIATION MIGHT BE DENOMINATED CAPITAL APPRECIATION, THE SECOND TAX BENEFIT APPRECIATION, AND THE THIRD OPERATING PROFIT APPRECIATION.

IF THE CODE PROVISIONS THAT CURRENTLY SUBSUME THE GENERAL UTILITIES DOCTRINE, SECTIONS 336 AND 337 AND, TO A LESSER EXTENT, SECTION 311, WERE AMENDED MORE APPROPRIATELY TO BALANCE THE STEPPED-UP BASIS BENEFIT, THE IMPROVEMENT IN OUR TAXING SYSTEM, MOST PARTICULARLY IN ENHANCED NEUTRALITY, WOULD BE MARKED INDEED.

AT THE LEAST, OPERATING PROFIT APPRECIATION OUGHT NEVER ESCAPE TAX WHEN BASIS IS STEPPED-UP. THE PENDING TAX REFORM BILL EMBRACES THIS CONCLUSION, IN A PROPOSED AMENDMENT TO SECTION 311, FOR PROPERTY DISTRIBUTIONS UNRELATED TO A CORPORATE ACQUISITION. THAT WISDOM OUGHT TO BE GENERALIZED. SECTIONS 336 AND 337 DESERVE EQUIVALENT AMENDMENT.

WITH ONLY SLIGHTLY LESS FORCE, I BELIEVE TAX BENEFIT APPRECIATION ALSO MERITS RECOGNITION WHEN ASSET BASIS IS STEPPED-UP. I BELIEVE THAT IS SO WHETHER THE OPERATIVE EVENT IS A SIMPLE DIVIDEND

DISTRIBUTION, A STOCK REDEMPTION, A PARTIAL OR COMPLETE LIQUIDATION, OR A CORPORATE ACQUISITION SUBJECT TO A SECTION 338 ELECTION. THE PENDING TAX REFORM BILL, IN ITS HOUSE VERSION, IN EFFECT EMBRACES THIS CONCLUSION FOR ORDINARY DISTRIBUTIONS, ALTHOUGH WITH A COMPLICATING EXCEPTION FOR CERTAIN "QUALIFIED DIVIDENDS." AS RECENTLY CONFIRMED BY THE SUPREME COURT'S BLISS DAIRY DECISION, THE SENSIBLE DIRECTION OF OUR TAX LAW IS TOWARD THE RECAPTURE OF TAX BENEFITS WHEN SUBSEQUENT EVENTS CONFIRM AN EARLIER DEDUCTION TO HAVE BEEN CONVINCINGLY INCONSISTENT WITH LATER REALITY. I DO NOT SUGGEST A CHANGE IN THE QUALITY OF THE INCOME, WHICH UNDER CURRENT LAW IN MANY CASES WOULD BE CAPITAL GAIN, BUT I DO URGE THAT TAX BENEFIT INCOME OUGHT NOT BE EXEMPTED, AS IN MOST CASES IT NOW IS, FROM ALL CORPORATE TAX.

CAPITAL APPRECIATION, VALUE IN EXCESS OF THE ORIGINAL COST OF CAPITAL ASSETS AND TRADE OR BUSINESS PROPERTY, SEEMS TO ME DISTINGUISHABLE. IN CORPORATE ACQUISITIONS, CURRENT LAW'S NONRECOGNITION TREATMENT SHOULD BE CHANGED, IF AT ALL, ONLY AS PART OF A COMPLETE RESTRUCTURING OF SUBCHAPTER C, A RESTRUCTURING THAT WOULD AFFORD SHAREHOLDERS APPROPRIATE RELIEF FROM OVERLY BURDENSOME DOUBLE TAXATION.

I EARLIER REFERRED TO ENHANCING THE NEUTRALITY OF THE TAXING SYSTEM. THIS SEEMS TO ME THE MAIN POINT. WE OUGHT NOT FURTHER CONFOUND OUR AWESOMELY COMPLEX TAX LAW BY ASKING THE INTERNAL REVENUE CODE TO SHOULDER THE BURDEN OF ANTITRUST POLICY. BUT, IN AID OF NO PERCEPTIBLE TAX POLICY, WE OUGHT NOT MAINTAIN A TAX LAW

THAT RUNS COUNTER TO SENSIBLE MARKET NOTIONS. AS NEARLY AS CAN BE, THE TAX LAW SHOULD BE NEUTRAL IN BUSINESS COMBINATION DECISIONS.

IN FACT, I BELIEVE, THE TAX LAW CURRENTLY FUELS MANY BUSINESS COMBINATIONS. IT DOES SO IN A NUMBER OF WAYS. THE TAX EFFICIENCY OF DEBT FINANCING OVER NEW EQUITY FINANCING IS ONE, A COMPLEX PROBLEM THAT DEFIES A SIMPLISTIC, ONE-EYED SOLUTION. ANOTHER IS THE GENERAL UTILITIES RULE ALLOWING A TAX FREE STEP-UP IN ASSET BASIS. HERE NEITHER THE PROBLEM NOR ITS RATIONAL SOLUTION IS COMPLEX, AND HERE -- OPERATING PROFIT APPRECIATION CERTAINLY, TAX BENEFIT APPRECIATION IN MY VIEW AS WELL -- CONGRESS CAN AND SHOULD PROCEED WITH ECONOMY AND DISPATCH. CORPORATE MERGERS THAT MAKE GOOD BUSINESS SENSE WILL NOT BE DETERRED, BUT CORPORATE MERGERS THAT MAKE MAINLY OR EXCLUSIVELY TAX SENSE WILL BE SIGNIFICANTLY INHIBITED.

SINCE I ADDRESS A TAX WRITING COMMITTEE, LET ME CLOSE ON A PURELY TAX NOTE.

IN AND OUT OF GOVERNMENT, NEARLY EVERYONE DEPLORES THE AWFUL, PROLIFERATING COMPLEXITY OF THE TAX SYSTEM AND CRYS FOR SIMPLIFICATION. TAX SIMPLIFICATION IS A PROTEAN CONCEPT. IT MEANS ONE THING WHEN WE SPEAK OF INDIVIDUAL TAXPAYERS WHO DO NOT ITEMIZE DEDUCTIONS, AND SOMETHING VERY DIFFERENT WHEN WE CONCENTRATE ON THE ACQUISITION, DISPOSITION, OR DIVISION OF BUSINESS ENTITIES. SUBCHAPTER C, WHICH GOVERNS THE TAX RELATIONSHIP OF CORPORATIONS AND SHAREHOLDERS IN THESE MATTERS, IS MADDENINGLY DIFFICULT FOR A NUMBER OF REASONS -- INAPPROPRIATELY BURDENSOME TO THE ILL-ADVISED WHILE ADVANTAGEOUSLY

MANIPULABLE BY THE WELL-ADVISED -- BUT DOMINANT AMONG THOSE REASONS IS THE <u>GENERAL UTILITIES</u> DOCTRINE. IT SPAWNED SECTION 341, THE COLLAPSIBLE CORPORATION PROVISION, PERHAPS THE LONGEST AND SURELY THE MOST COMPLICATED SUBSTANTIVE SECTION IN THE CODE. AS TREASURY CANDIDLY TESTIFIED IN THE 1982 TEFRA HEARINGS, THE GROSSLY UNFORTUNATE CONSISTENCY REQUIREMENT THAT FORMS A PART OF OTHERWISE CONCEPTUALLY SENSIBLE AND SIMPLIFYING SECTION 338 FUNCTIONS AS AN INADEQUATE SURROGATE FOR THE REPEAL OR SUBSTANTIAL NARROWING OF <u>GENERAL UTILITIES</u>.

IN COMPLEX COMMERCIAL MATTERS, TAX SIMPLIFICATION IS LARGELY SYNONYMOUS WITH TAX NEUTRALITY. IF, IN THE CORPORATE ACQUISITION ARENA, CONGRESS WERE TO WITHDRAW THE TAX EXEMPTION SECTIONS 336 AND 337 NOW AWARD ORDINARY INCOME ASSETS AND TAX BENEFIT APPRECIATION, TAX MOTIVATED BUSINESS COMBINATIONS WOULD BE SIGNIFICANTLY INHIBITED AND THE STAGE SET FOR SIGNIFICANT SIMPLIFICATION OF THE CORPORATE TAX RULES. THAT, I THINK, WOULD QUALIFY AS A VERY GOOD DAY'S WORK.

Senator WALLOP. It strikes me, and correct me if my assessment of what you said is wrong, but if there are significant tax advantages that occur out of these things, they primarily flow to the seller not the buyer. And so, therefore, the Pearlman statement that there are no significant tax incentives to induce these mergers is probably correct. Is that right?

Mr. GINSBURG. If we are talking about the oil company merger situation, I think that is right. There are tax advantages, but there is nothing here special to this industry, more special than to any other, and indeed one can argue that there is less here in some respects than there is in some other industries.

In that regard, one could have a lot of fun with examples of cases in which the target company's assets include a great deal of just plain intangible good will. A company is never taxed on that in connection with a corporate acquisition.

Senator WALLOP. There are some around where it would have crossed their minds, if they could think that far ahead

Mr. GINSBURG. But on the buyer's side, you see, a buyer equipped with a clever tax lawyer may determine that what looked like good will on the target company's side really is about five or six different intangible assets, four of which ought to be subject to capitalizing purchase price and writing off that allocated purchase price over 5 or so years. There the advantage of the transaction to the buyer is very substantial because you are creating all kinds of deductions, but that tends to be more in some of the service businesses and so forth, sometimes with companies with certain customers lists and the like, but not in the oil company acquisitions.

Senator WALLOP. And so, in essence, there seems to be nothing that is especially attractive and an inducement to oil merger versus ordinary merger activity?

Mr. GINSBURG. Let me be precise. There is nothing, I think, going on here in the oil company situations that is qualitatively different from what is going on in a lot of other companies. If one were creating a spectrum of greater potential for tax abuse, it is over there and not with the oil companies. That doesn't mean that there is no tax advantage in oil company combinations. There is always a tax advantage. It is just that it is not the major thing here.

Senator WALLOP. It is probably not so significant in and of itself to trigger a merger.

Mr. GINSBURG. That is right.

Senator WALLOP. Just one last thing. The changes that we made in TEFRA dealing with the stepped-up basis in acquired assets have a significant impact on the effectiveness or ineffectiveness of mergers versus what happened prior to that time. Is that right?

Mr. GINSBURG. Oh, yes. I am so glad you raised that. The TEFRA changes were in the main very useful changes because they did close down—as Mr. Murdy said this morning—some really abusive transactions. I think none of us was sorry to see those go. But like everything else, you trade problem—you rarely solve problems in the tax field. Some of the problems you are approaching in the present legislation—the 1984 tax reform provisions—were largely created by the 1982 changes in TEFRA. That doesn't mean that you did wrong in 1982—it just means that you run the Red Queen's race. You run as fast as you can to stay about where you are. So, in 1984 we deal with the next set.

But there was something said this morning that I really would like to comment on, and that was that section 338 and its consistency requirement has put an end to selective step-up basis transactions. It is possible that is true in the oil business—I don't know enough about the technicality of the position to comment on it. But I would like to assure the chairman that it is not true out there as a general matter. One of the first things the tax bar figured out, probably 2 or 3 weeks before you passed the statute in 1982, was how to get around the consistency requirement when it is useful to do so. And, nowadays, everybody in the tax field, having nothing else to do, writes another article explaining how to get out of the consistency requirement. The nice thing, you see, about approaching the corporate acquisition issue as a General Utilities question—cutting back on the free lunch on the target company side—is that it is the one effective way to approach the problem, as the Treasury fairly candidly testified in 1982. If you reduce the scope of General Utilities—if you say that you are going to require to a greater extent recognition of gain as the price of basis step-up—then you are indifferent to whether taxpayer pick and choose among the assets because target is paying the full tax price. After all, if a company has two assets, sells one and recognizes the gain, and simply keeps the second one, it has done just that—it has picked and chosen. We don't care about the retained asset as long as tax is paid on the asset awarded the stepped-up basis.

Senator WALLOP. It is a curious thing. I would venture a guess it has nothing to do with oil company mergers. If we either put the Finance Committee out of business or drastically simplify the Tax Code, the unemployment rate would rise by 2 percent if those who find out before we act how they are going to get around on what we have—and go to the streets for an honest living.

Mr. GINSBURG. I think the concern with unemployment certainly—as one who has been in this end of the business almost 30 years—is appreciated, but frankly, Mr. Chairman, I think we are safe. I have looked at the new tax bill and I do think it is an unemployment relief act. [Laughter.]

Senator WALLOP. I wouldn't quarrel with that. I appreciate your coming here very much, Professor Ginsburg.

Mr. GINSBURG. Thank you, sir.

Senator WALLOP. It has been very helpful to the committee. The next panel is Mr. T. Boone Pickens, the president of Mesa Petroleum in Amarillo; Mr. Jon Rex Jones, president of the Independent Petroleum Association of America; and Mr. Henry M. Schuler, director of energy security studies at the Georgetown University Center for Strategic and International Studies.

We welcome you all here, and I would say for the last panel that it is my intention to continue straight on through because this chairman has another committee to chair this afternoon. So, we will go straight through. Good morning, Mr. Pickens, and welcome.

STATEMENT OF T. BOONE PICKENS, JR., PRESIDENT, MESA PETROLEUM CO., AMARILLO, TX.

Mr. PICKENS. Am I first?

Senator WALLOP. Yes, please.

Mr. PICKENS. I would like to submit my statement for the record, and I will briefly summarize the statement.

Senator WALLOP. By all means.

Mr. PICKENS. First, I would like to clarify for the record of this hearing what I said before the Senate Judiciary Committee hearing that Senator Specter referred to earlier in his testimony this morning. Specifically, on March 15, what I did say and if I might I will read from the record:

"Senator SPECTER. Mr. Pickens, what effect would there be on your ability to take over a company like Gulf if there were a change in the tax laws related to the dividends received credit or if there were a new definition that you could not deduct interest payments or if there were a new rule as to capital gains treatment after liquidation?"

My answer. "I think that would certainly be a factor in looking at any situation."

"Senator SPECTER. Would it put a pretty big crimp in your sales?"

My answer was. "Pardon me?" And Senator Specter said: "Would it put a pretty good crimp in your sales?"

My answer. "It would change the economics if you did not have a dividend carry and you were not able to deduct interest." I would like for that clarification to be in the record. I also would like to discuss for the record the comments by Mr. Murdy with Gulf Oil, who testified a few minutes earlier. Mr. Murdy confirmed by his remarks that he never really understood the royalty trust concept, and I am available to discuss the details of the concept if you have any questions for me as I finish my remarks here. Remember, we did invest $1 billion in Gulf Oil and we were their largest stockholder, and we are their largest stockholder today. Gulf Oil's management has had a bit of a problem understanding this fact—that we are their largest stockholder. Let me paraphrase Mr. Lee on December 2 before 3,000 people at a Gulf special stockholders meeting in Pittsburgh. "We do not consider Mr. Pickens a stockholder because he borrowed the money to buy the stock"—which I found to be interesting. [Laughter.]

This is a prime example of why Gulf was taken over by another management. [Laughter.]

Gulf's management doesn't even recognize who their stockholders are. They always believed that the management owned the company. Management owned less than one-tenth of 1 percent of Gulf Oil, and remember, this company had not replaced its domestic reserve base for 12 straight years. Is this not liquidation? I come from the free enterprise system, and this naturally brings me from the stockholder's position. In America today, there are 42 million stockholders—Americans that own stock in public-owned companies. That is one out of every six people. If you assume they have a spouse, that would be 80 million people in America today who own stock in public-owned companies, which is one out of every three people.

Senator WALLOP. Mr. Pickens, I think that is a very modest assessment of who owns stock. Those are the direct shareholders. I think when you put the indirect shareholders—those who are part of pension funds and other institutional investments—that that figure gets up close to 200 million.

Mr. PICKENS. My information is from a study that was done by the New York Stock Exchange in mid-1983.

Senator WALLOP. But those are merely direct owners. There are others whose interest through a variety of other investing mechanisms would raise that figure considerably, and it only serves to enhance the point you are making.

Mr. PICKENS. That is correct. I am a geologist by education, and I have been in the exploration for oil and gas for 33 years. That is my whole life. I worked for a major oil company for less than 4 years, and then started the predecessor company to Mesa in 1956. We started with $2,500 paid in capital, and we went public in 1964 with less than $2 million in assets at that time. At the end of 1983, we had assets of over $2 billion. We started out with three employees in 1956, and presently employ 707. We made acquisitions along the way. We acquired Hugston Production Co. in 1969 in a contested takeover, and in 1973, we acquired Pubco Petroleum, and believe it or not, we were the "white knight." I think that has been the one and only time for us. We did not release any people in these acquisitions. We did not liquidate any parts of these companies. In fact, the stockholders of both Hugston and Pubco acquired and received a premium over the market in exchange for their stock. If they had retained the securities received, they would have more than tripled their investment today. How can I be continually characterized as a liquidator with that kind of record? I said my wife and I would move to Pittsburgh if we took over the Gulf Company. We had no intention of eliminating any parts or disrupting Gulf Oil's business. We would have run it in a much more efficient manner, and we would have run it for the benefit of the stockholders. As to mergers and acquisitions, in our industry, I believe it is necessary for the industry to be restructured at this time and prevent entrenchments of management in situations that have developed where managements in some situations own practically no stock in the company. This restructuring causes assets to flow from weak hands to strong hands—that is exactly what we have had happening in the Gulf situation. SoCal is a much better managed company than Gulf is—the record will prove that.

Don't worry about exploration. If the prospects are there, the wells will be drilled. There is plenty of money to drill economically feasible prospects in our industry today. Just look at the rig count. We hit a high water mark in December of 1981 of 4,531 rigs. Today we have 2,047 rigs running. Why? The prospects are not feasible for our industry to drill at this point, largely because of taxes. If you want to drop the rig count another 500 rigs, then pass the gas bill that is being proposed by Congress—Congressman Sharp—in the House today. That concludes my formal statement. Thank you.

Senator WALLOP. Thank you, Mr. Pickens. Mr. Jones?

[Mr. Pickens' prepared statement follows:]

T. Boone Pickens, Jr., president

MESA
PETROLEUM CO.

STATEMENT OF T. BOONE PICKENS, JR.
PRESIDENT AND CHAIRMAN OF THE BOARD
MESA PETROLEUM CO.

UNITED STATES SENATE
ENERGY SUBCOMMITTEE
SENATE COMMITTEE ON FINANCE

APRIL 5, 1984

Mr. Chairman, I appreciate the opportunity to testify before your Subcommittee to address the important income tax issues described in the March 23, 1984 press release of the Senate Finance Committee announcing today's hearings.

The Committee press release requests comments on whether recent energy company mergers are "tax motivated." In addition, the press release asks for comments on the impact of such mergers on oil and gas exploration and development.

Let me briefly summarize the points I intend to make:

First, recent corporate acquisitions in the energy industry are motivated primarily by the need of companies to economically replace diminishing reserves and are essentially "basket" property acquisitions. That is, they are the acquisition of numerous assets wherein the buyer must bid for all of the assets in the basket and not just for those assets of most interest or value. Market realities are the motivating force for these acquisitions rather than income tax considerations.

Second, energy acquisitions, whether through corporate acquisitions or direct property acquisitions, receive no special or different tax treatment than acquisition transactions in other industries. As a tax matter, the transactions are essentially indistinguishable. Accordingly, there is no theoretical basis for changing the tax laws with respect to such transactions without having such changes apply to all industries.

Third, corporate acquisitions have not diverted capital from exploratory and developmental drilling. Recent cutbacks in drilling simply reflect the realities of exploration economics; that is, stable energy prices, high drilling costs and the shortage of good prospects. Drilling cannot currently satisfy the need of companies to economically replace diminishing reserves. Accordingly, punitive legislation with respect to corporate acquisitions simply will divert capital from corporate acquisitions into direct property acquisitions and/or diversification out of the energy business. The legislation will not result in additional exploratory and developmental drilling.

Fourth, restructuring in the energy industry, whether by corporate acquisitions, property acquisitions or diversification will not have an adverse impact on the availability of credit for business or consumers.

Fifth, inefficient management of assets, which results in a low value for a company's stock, is one of the primary causes of merger activity.

Sixth, proposals to deny interest deductions with respect to debt incurred to purchase energy companies are extremely discriminatory and will prevent the most efficient allocation of capital in our economy. The efficient allocation of capital in a free market economy requires mechanisms to match willing buyers and sellers and the freedom of sellers to sell to the highest bidder. Income tax rules should not attempt to dictate credit allocation in this free market, thereby causing the removal of the highest bidders in a targeted industry from the market. Enactment of these types of rules is bad tax policy and would create an extremely bad legislative precedent.

Seventh, the effect of tax legislation impeding corporate acquisitions on industries outside the energy industry could be severe. Corporate acquisitions are an important goal of entrepreneurial activity in our economy. Private entrepreneurs, financed by venture capitalists, are the primary creators of new jobs and new businesses in our economy. The miscellaneous manufacturing, retailing, health care, services, high tech and restaurant industries are particularly dependent on the private entrepreneur for growth and continued vitality. A substantial portion of the value of companies in such industries is represented by their people, organizational structure and other intangible assets. They are not easily sold on an asset-by-asset basis. The founders and other owners of these companies must be able to sell their companies intact to the highest bidders through the sale of stock, or venture capital and associated entrepreneurial activity will significantly contract. This contraction would have serious implications for the level of employment in our economy.

Eighth, several other tax proposals pending before Congress will have an adverse impact on the efficient allocation of capital in our economy. One proposal would impose a new tax on a distributing corporation if such corporation makes a distribution of appreciated property to certain shareholders. Another proposal would reduce, by the amount of certain extraordinary dividends, the basis in stock held by certain corporate investors. Other proposals would effectively limit the 85 percent dividend received deduction for leveraged stock investments by corporate investors. With respect to energy companies, these proposals will not raise federal tax revenues. They will result in economic stagnation and a reduction in professional management accountability to shareholders.

Ninth, the experiences of Mesa Petroleum Co. and other companies demonstrate that the creation of oil and gas royalty trusts can increase federal tax revenue substantially and be very beneficial to shareholders. Oil and gas royalty trusts have a strong record of enhancing shareholder value over both the long and short term. Such trusts provide shareholders, in addition to their shares of common stock, with a direct interest in the net profits from oil and gas properties enabling them to receive and reinvest cash flows therefrom directly. This right is at the heart of a free market economy such as ours and is essential to our country's economic health.

Mergers Are Not Tax-Motivated

Mr. Chairman, restructuring of the energy industry, which is currently underway, represents a response to existing market forces. Oil and gas reserves are simply being depleted faster than they can be replaced. Energy prices have been stable, drilling costs are high and there is a shortage of good oil and gas prospects. Thus, corporate acquisitions and other efforts to maximize energy company efficiency -- such as the creation of royalty trusts -- are motivated by market forces and not by federal income tax considerations.

Let's look at Texaco's acquisition of Getty and Standard of California's effort to acquire Gulf. Texaco's domestic reserves declined by over 50 percent from 1978 - 1982 while Socal's domestic reserves declined by 40 percent. Texaco paid no federal income tax in 1982 and had an effective federal income tax rate from 1978 - 1982 of only 26 percent. Socal's effective federal income tax rate during that period was 38 percent. Thus, the motivation for Texaco to acquire Getty and Socal to acquire Gulf was the need to replace depleting domestic reserves and not the desire to reduce federal income taxes.

Current Tax Law

Energy acquisitions, whether through stock acquisitions or direct property acquisitions, receive no special or different tax treatment than other acquisition transactions. All acquisitions face one fundamental issue -- is the acquisition taxable or non-taxable? If it is non-taxable, no taxes are paid and the basis of the acquired assets are not stepped up. In taxable property acquisitions, the sellers pay recapture taxes and taxes on gain for the amount received in excess of the tax basis of the property sold. In a stock acquisition, the seller of stock pays tax on the gain in his stock and the buyer of the stock cannot step up the basis of the assets acquired unless all of the recapture taxes are paid by the acquired company. Most corporate acquisitions involve the acquisition of 80 percent or more of one company by another. In such a case, all of the taxable income of the acquired company is included with the acquiring company's taxable income and intercompany dividends are not taxable transactions.

Impact of Energy Mergers on Exploration and Development

The Finance Committee press release announcing these hearings inquires as to the impact energy acquisitions "may have on the ability of oil and gas companies, including the merger companies, to continue the exploration and development activity we have assumed as a national priority."

The number of rigs working in the U.S. today is barely half the number that were working at the end of 1981. But, this decrease has not been caused by acquisition activity or a reduction in the financial capacity of the nation's energy companies. The major domestic energy companies have net asset value in excess of $300 billion according to J. S. Herold, an independent energy industry appraisal service. That translates into an enormous amount of financial strength and that is just the majors.

The problem is a scarcity of good drilling prospects, high finding costs and stable prices. There is a serious question whether or not current energy prices afford sufficient economic incentive to explore in frontier areas and the natural gas market is saturated. But there is no question that the energy industry can go through this period of restructuring and still explore for and develop every good prospect available. It is not currently a growth industry but it does possess enormous financial capacity and staying power. After restructuring, it will be better able to provide for the nation's energy needs in the future.

Additionally, to the extent that any of the majors reduce their drilling budget for any reason, whether it be a lack of good prospects, a corporate or property acquisition or a decision to diversify out of the energy industry, this simply provides a greater opportunity for independent oil and gas producers to negotiate for lease farm outs and other deals. The independents are the real risk takers in the energy business and drill 80 percent of the exploration wells in the domestic U.S.

But, it is not just we who are claiming that mergers will not affect exploration. The New York Times of March 21, 1984 noted as follows:

> "The multibillion-dollar mergers reshaping the American oil industry may also offer new economies of scale that make ... exploration efforts more fruitful . . ." "Thus, when these separate resources are thrown together in a merger, the reasoning goes, the company that emerges can select its drilling projects from a richer list using the combined and presumably enhanced expertise that also results."

Energy Acquisitions Have Not Had An Adverse Impact On Capital Markets

To say that these acquisitions drain the resources of this nation and result in a shortage of bank credit generally available to individuals and businesses just is not true. This is a fallacy that is discredited by the recently publicized report of the Securities and Exchange Commission Advisory Committee on Tender Offers. Based on its own experience and study, and supported by the Federal Reserve Board, the SEC Advisory Committee notes that transactions involving acquisitions of control do not distort the credit markets or divert investment from new plants, nor do they limit consumers' ability to obtain credit or deplete credit otherwise available to would-be borrowers. Moreover, the SEC Committee explained that takeover transactions fundamentally involve a transfer of existing assets, not the absorption of new savings, and because the shareholders who sell their stock to an acquiring firm typically reinvest the proceeds, the capital remains in the economy and is made available to others.

Dr. Leif H. Olsen, Chairman of the Economic Policy Committee at Citibank, N.A., recently testified before the Senate Judiciary Committee. Dr. Olsen stated that viewing the capital market from a true perspective, in 1983 the equity transactions were in excess of 30 trillion gross dollars. Gross bank lending and investing was more than $4 trillion. A transaction of several billion dollars, while large in absolute terms, is not significant in comparison to the total funds available. Additionally, the trend today is to involve overseas sources as a means of attracting credit and these funds do not impact domestic money supplies for many months.

A Primary Cause of Mergers Is Ineffective Management

Management inefficiency, and not the tax law, is one of the basic underlying causes of corporate mergers, including some recent, highly publicized ones. As Assistant Attorney General for Antitrust J. Paul McGrath noted in a recent speech before the National Association of Manufacturers:

> "An active merger market is a healthy threat to incompetent management. If a firm is poorly managed, the price of its stock will likely fall below the level that it could be expected to reach with competent management. This makes the firm an attractive takeover candidate. A takeover in these circumstances is good for the economy because it shifts corporate assets from poor managers to more efficient ones."

Further support for this view has come from economist Michael Jensen, quoted in USA Today on March 20, 1984.

> "The merger market is really part of the labor market for top corporate managers . . . There's no unemployment bureau for CEO's of billion-dollar firms . . . [Managers, directors, and consultants are] appealing for help outside the market -- legislative help to protect them from the market."

I think these views demonstrate that corporate mergers are not motivated by the tax laws or by some kind of quick-profit scheme. These mergers reflect the response of sensible shareholders to market changes and problems with management. The merger is one means by which shareholders exercise the right to run the corporations they rightfully own.

Proposed Restrictions on Interest Deductions With Respect To Indebtedness Incurred to Acquire Energy Companies

Proposals to restrict interest deductions with respect to indebtedness incurred to acquire energy companies are highly discriminatory and will prevent the most efficient allocation of capital in our economy.

The efficient allocation of capital in a free market economy requires mechanisms to match willing buyers and sellers and the freedom of sellers to sell to the highest bidder. Income tax rules should not attempt to dictate credit allocation in this free market, thereby causing the removal of the highest bidders in a targeted industry from the market. Enactment of these types of rules is bad tax policy and would create an extremely bad legislative precedent.

Current tax rules treat energy company shareholders the same as other shareholders and that should not be changed -- particularly not on the misbegotten notion that discriminating against energy industry shareholders will cause energy industry managements to drill more domestic wells. There is no relationship between the two.

Legislation of this type can only send a chilling message to the private sector. A message that government has lost its sense of cause and effect in the economy and has determined that it can better provide for the economic health of the nation than the private sector.

Stock Acquisitions Provide an Important Source of Funds For Growth

Mergers and acquisitions provide an extremely important source of finance for existing companies to grow and for new companies to get started. The enactment of arbitrary income tax rules which restrict mergers and acquisitions will simply retard economic growth.

Based on data in the 1983 "Mergerstat Review" published by W.T. Grimm & Co., the energy industry accounted for only 4 percent of the number of mergers and acquisitions over the last three years. So, tax legislation that is equitable in its treatment of corporate shareholders and not discriminatory against energy company shareholders will also effect the 96 percent of the mergers and acquisitions not in the energy industry.

The effect of tax legislation impeding corporate acquisitions on industries outside the energy industry could be severe. Corporate acquisitions are an important goal of entrepreneurial activity in our economy. Private entrepreneurs, financed by venture capitalists, are the primary creators of new jobs and new businesses in our economy. The miscellaneous manufacturing, retailing, health care, services, high tech and restaurant industries are particularly dependent on the private entrepreneur for growth and continued vitality. A substantial portion of the value of companies in such industries is represented by their people, organizational structure and other intangible assets. They are not easily sold on an asset-by-asset basis. The founders and other owners of these companies must be able to sell their companies intact to the highest bidders through the sale of stock, or venture capital and associated entrepreneurial activity will significantly contract. This contraction would have serious implications for the level of employment in our ecomomy.

Congress Should Reject Tax Reform Proposals Relating to the Taxation of the Distribution of Appreciated Property to Shareholders

Congress should reject the proposal to tax distributing corporations on ordinary distributions of appreciated property to certain shareholders. Since a distributing corporation realizes no gain on the transfer of appreciated property, no tax should be imposed on the distributing corporation. In many instances, the distribution will be taxed at the individual shareholder level on the receipt of these distributions. The imposition of this new appreciation tax would simply result in "multiple" taxation which has an adverse impact on capital formation. In particular, the proposal results in the imposition of an excessive capital gains tax burden in many instances and would have an extremely deleterious effect on the creation of royalty trusts.

The royalty trust is a method of enhancing shareholder value. We believed that in 1979 when the first trust was created by Mesa, and we continue to advocate the establishment of trusts today. In fact, we see the trust as being of even greater importance to shareholders in 1984 when so many companies are depleting reserves faster than they are replacing them. This means the primary asset base of the shareholder is rapidly eroding and, in time, the company will be valueless.

There is nothing complicated about creating a royalty trust. An oil and gas company selects some portion of its properties -- producing, non-producing, or a mixture -- and distributes these properties to its shareholders in the form of a royalty interest. The royalty trust interest is passive, and all decisions regarding operation of the properties and the disposition of the oil and gas produced therefrom are retained by the company. The recipient of the royalty trust unit normally pays income tax based upon the value of that trust unit, continues to pay annual taxes based upon the income received and may pay a tax if the trust unit is later sold. The trust usually is administered by a national bank trustee, who receives and distributes the income to holders of the trust units and files all reports required by the Securities and Exchange Commission, the stock exchange and other regulatory authorities. The trustee must have its records externally audited and its reports distributed quarterly to the trust unit holders.

As you know, the value of corporate securities is determined by the stock market. Historically, the market ascribes a higher multiple to a royalty trust unit than to a share of stock in most energy companies. The shareholder who elected to hold the stock through the effective date of the trust unit distribution, and thereby receive the trust certificate, would have two stock certificates -- the original corporate share and the new trust unit. Experience has proven that the combined value of the two certificates is considerably in excess of the value of the single corporate security -- but, since the shareholder has received something of value in the form of a trust certificate, there will be a tax liability. That is fair enough. Value received by the shareholder, tax paid by the shareholder.

Since the distributing corporation did not receive any value by virtue of the royalty distribution to the owners, it should not be taxed. To impose a tax at the corporate level would amount to imposing a penalty which would discourage the corporation from creating the trust. This tax would be a "deal killer."

We have observed that when a company announces the creation of a royalty trust, the market price of the corporate shares increases in anticipation of the distribution. The shareholder can elect to sell the corporate stock at the enhanced value before the effective date of the distribution and not be subject to a dividend tax on the trust unit. By selling before the effective date, the shareholder would not be entitled to receive the trust certificate. However, the transaction will be susceptible to a tax on any capital gain incurred by the shareholder. Again -- value received, tax due.

Last December, as the largest shareholder of Gulf Corporation, Mesa and its co-investors requested Gulf to create a royalty trust consisting of 50 percent of its domestic reserves. This trust would have provided the Gulf shareholders with income equaling approximately 25 percent of Gulf's cash flow and would have left Gulf with ample resources to continue a vigorous exploration and production program. The creation of this trust would have generated initial income taxes in excess of $1 billion. Were similar trusts to be created by the ten largest domestically owned integrated oil companies, the initial tax impact would be in excess of $16 billion.

We strongly argue that there are no losers when a royalty trust is created:

- The shareholders experience an enhanced value in their investment and an increase in their annual income.
- The corporation retains control over the disposition of the oil and gas produced from the properties and maintains the ability to look for oil and gas because cash flows are not unreasonably diminished, and the borrowing

base is not significantly reduced. Management, by analyzing their prospects and decisions to budget funds more carefully, will be more efficient.

- And, the U.S. Treasury receives increased revenues as a result of the taxes. These are significant taxes.

If a royalty trust does so much for the shareholders, contributes to the efficiency of an energy company and materially increases revenues for the U.S. Treasury, there just is no way it can be identified as a tax loophole. It is a tax producer!

Congress Should Reject Other Misguided Tax Reform Proposals

Congress should also reject the proposal to reduce, by the amount of certain extraordinary dividends, the basis of certain stock held by corporate shareholders. Enactment of this proposal would result in a new tax burden on corporate investors, reduce stock market liquidity and aggravate the existing bias in the tax law in favor of debt as compared to equity financing. (In general, under present tax law, interest payments made by a corporation are deductible to the corporation whereas dividend payments are not deductible.) The arbitrary one year holding period in this proposal would add yet more complexity to the Internal Revenue Code. In terms of the realities of today's capital markets, a one year holding period clearly cannot be considered a short period of time since the performance of portfolio investments is often measured on a monthly or quarterly basis. Corporate investors provide an important source of liquidity to our capital markets which provides discipline and ensures greater efficiency in pricing. Disincentives to corporate equity investment such as this proposal will discourage such investments and reduce liquidity. The tax code, in many instances, encourages the use of debt and this proposal would further encourage highly leveraged capital structures which impair the ability of corporations to withstand adverse economic developments.

Restrictive proposals relating to corporate indebtedness and the 85 percent dividend received deduction would also reduce stock market liquidity, discourage equity investment and raise the cost of capital for many companies. These proposals are inconsistent with recent action taken by Congress to encourage investors to take the types of risk needed to develop new products and processes in order to promote economic growth and to boost productivity.

Experience of Mesa Petroleum Co.

Petroleum Exploration Inc., the predecessor company of Mesa, was capitalized with $2,500 in 1956. The name was changed to Mesa Petroleum Co. in 1964 and we became a public corporation at that time, total assets were less than $2 million. Five years later, we tendered for and acquired another public corporation engaged in the production of hydrocarbons. This company was 20 times the size of Mesa. It had large gas reserves, considerable cash flow and no exploration staff. It was destined to deplete its reserves in a matter of years, which meant the stockholders would deplete their assets and income while the employees ended up with no jobs.

This company was quickly assimilated into Mesa where the cash flow was directed to expanding our exploration activities, employing highly competent personnel and building the reserve base for our shareholders. Three years later, we acquired another energy company and the procedure was repeated. In each instance, efficiencies of operation were greatly improved and return on shareholders' investments was enhanced. No people were laid-off. Some few employees elected to resign rather than move to new locations.

Also, in each instance, the shareholders of those companies merged into Mesa who elected to take Mesa stock in exchange for their original shares enjoyed significant appreciation in both market value and asset value.

We proved that through acquisitions, a larger, more profitable and vital company could emerge. We also demonstrated that through expanded exploration budgets made possible by the larger cash flows and borrowing base of the combined companies, more oil and gas could be found.

Each year since its inception, Mesa has replaced and enhanced its reserve base. Replacement has been achieved primarily through intensive exploration and development. We have invested over $1.5 billion in offshore exploration and development in the Outer Continental Shelf and have an average interest of 28 percent in 49 offshore platforms. During the last five years, total additions to Mesa's liquid reserves represented 139 percent of production and additions to natural gas reserves represented 187 percent of production. Our total assets today are in excess of $2.3 billion and our net income last year was $115 million on revenues of $422 million.

In 1981, our capital budget was $420 million; this sum was considerably in excess of our cash flow. In 1982, the budget was $320 million, in 1983 it was $223 million and our 1984 budget is $110 million. This current budget represents about 40 percent of our cash flow, which percentage is consistent with practice in the industry. Our decision to bring capital expenditures in line with cash flows was a calculated decision based upon our concern over the near term future of the oil and gas business. It had no relation to our having created royalty trusts or our having invested in other energy companies.

We are proud of our record. We are less proud of our cost in finding oil and gas in recent years. Industry-wide, the high cost of finding hydrocarbons is the most serious problem facing management. However, there was a time when managements refused to disclose reserves and the shareholders had no knowledge of the extent to which reserves were being depleted and replaced or the cost of finding oil and gas. We initiated the policy of publishing reserve data in our annual report in 1973. Six years later, the SEC passed a regulation requiring all companies to disclose this information. We led the way in providing stockholders with this extremely important data.

The most recent Fortune 500 comparison of companies shows that Mesa would be included in the top five energy companies in assets and net income per employee, and in net income as a percent of stockholders' equity. An investor who purchased 1,000 shares of Mesa for $10,000 when the company was founded in 1964, as a result of the stock splits and the creation of two royalty trusts, would now have an investment with a market value of approximately $240,000.

Our management has been recognized for its ingenuity, its expertise in finding oil and gas, and its dedication to the shareholders. We have been selected as the best managed among 89 companies in oil and gas production, and the Wall Street Transcript identified me as the best chief executive among oil producers in 1981 and 1982. Last year, Financial World selected our annual report as one of the three best among companies in the petroleum industry.

We believe our record testifies to the fact that we put the interest of the shareholder first and we intend to maintain that interest as our paramount concern in the future.

Should you have any questions which may arise as a result of my testimony or the testimony of other witnesses, I would be most happy to appear before you again.

Thank you.

STATEMENT OF JON REX JONES, PRESIDENT, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, WASHINGTON, DC

Mr. JONES. Mr. Chairman, my name is Jon Rex Jones. I am an independent petroleum gas producer from Houston, Tex., appearing here today as president of the Independent Petroleum Association of America. We represent some 15,000 independent oil and gas producers in the United States.

Obviously, there are those who fear that the recent wave of mergers and acquisitions in the oil industry will reduce drilling and exploration budgets and result in less reserve development in the United States. We can find no evidence historically that periods of intense merger activities cause any measurable change in exploration and development. At the outset, I would suggest to those who are so concerned that they will find some real exploration disincentives if they will examine discriminatory tax changes of recent years.

For example, in 1969 the arbitrary reduction in the statutory depletion rate for oil and gas alone among more than 100 industries was followed in 1970 and 1971 by the two largest annual declines in U.S. petroleum exploration history. Since then, our industry has incurred additional disincentives, with the most destructive being the infamous windfall profits tax in 1980. And so it follows that in 1982 the domestic oil industry was the largest U.S. taxpayer by any standard one wishes to apply. And I suggest that if Congress wishes to stimulate exploration, it could begin by reducing this enormous tax burden. Now, these mergers themselves have very little direct effect on the majority of independent producers. However, we oppose any antimerger legislation that interferes with the free play of market forces. Furthermore, it is dangerous for the Government to establish such a precedent that could be used in the future to justify other far-reaching economic interventions.

Actually, mergers are only a consequence of shifting economic tides affecting the petroleum industry as a whole. In point of fact, these mergers and acquisitions are not a new phenomenon but rather a historical outcome of downturns in the business cycle, as well as corporate growth in general. Independent companies have been particularly hard hit by the depressed oil business to such an extent that eventually mergers may be our only answer. A Government ban on oil mergers and acquisitions would prohibit normal industrial free structuring that could salvage many independent companies nearing Chapter 11 proceedings. Moreover, it would be a violation of a fundamental economic right which is the cornerstone of our private enterprise system. That is the right to own, sell, exchange, or purchase properties and to run a business accordingly. If a comprehensive antimerger law were enacted, America would witness a substantial flight of capital away from an already overregulated industry and instead toward investment opportunities where business can control their own transactions and stock values. Now, only the participants in these transactions are able to state with any certainty the extent to which the current law has created incentives for the acquisitions themselves. However, it is our opinion that the Internal Revenue Code has been designed to treat the acquisition of assets in corporate mergers essentially in the same manner as if the assets had been acquired directly. We therefore feel the present tax laws treat this whole matter from a position of neutrality. In conclusion, Mr. Chairman, I would say that many different schemes have been proposed from the 1-year merger by the top 50 oil companies to the top 20 to a 6-month moratorium with various retroactive provisions. So, where would the impact of the moratorium end? Even if it just applies to large companies, think of the loss of value and ultimate loss of capital, resulting from the probability that this is only the initial signal from Congress, that independents would someday be impacted by anti-merger or acquisition legislation. The independent segment of this industry, which drills 90 percent of the wildcat wells, 85 percent of all wells, and finds 56 percent of the new reserves in America would not be able to sustain this same high level of activity against one more round of punitive legislation, even though this time it comes as a byproduct of legislation aimed at the larger companies.

Finally, with foreign oil supplies becoming increasingly unreliable as political tension mounts, it is even more important to maintain the viability of all U.S. petroleum companies. Thank you very much.

Senator WALLOP. Thank you, Mr. Jones. Mr. Schuler.

[Mr. Jones' prepared statement follows:]

Statement of Jon Rex Jones, President
Independent Petroleum Association of America
Before the Senate Committee on Finance
Subcommittee on Energy and Agriculture Taxation
April 5, 1984

Mr. Chairman:

My name is Jon Rex Jones and I am an independent oil and natural gas producer from Houston, Texas appearing here as President of the Independent Petroleum Association of America. The recent wave of mergers and acquisitions in the oil industry which are the subject of these hearings has little direct effect on the majority of independent producers represented by IPAA. However, on general principle, we oppose any anti-merger legislation that interferes with the free play of market forces. Furthermore, it is dangerous for the government to establish such a precedent that could be used in the future to justify other far-reaching economic intervention.

Mr. Chairman, at the outset I would like to address the question of the impact of merger activity on domestic petroleum exploration and development. The media has reported this as a major concern of merger moratorium advocates. I would suggest to those so concerned that they will find real exploration and development disincentives if they will examine discriminatory tax changes of recent years and counter-productive regulatory policy which was a major contributing factor in the 18% drop in gas well drilling in 1983 alone.

In 1969, the arbitrary reduction in the statutory depletion rate for oil and gas alone among more than 100 affected extractive industries was followed in 1970 and 1971 by the two largest annual declines in U.S. petroleum exploration in history. Since then, additional disincentives have resulted from five more negative tax changes for domestic oil and gas, capped by the infamous "windfall profit" tax in 1980. The domestic oil industry was the largest U.S. taxpayer in 1982 by any standard, and I suggest that if Congress wishes to stimulate exploration it could begin by reducing this enormous tax load. By contrast, we can find no evidence during periods of intense merger activities that this historically has caused any measurable change in exploration/development.

Oil mergers have been designated a problematic issue by some in Congress and the media when; in actuality, they are only a consequence of shifting economic tides affecting the petroleum industry as a whole. In point of fact, these mergers and acquisitions are not a new phenomenon but rather an historical outcome of downturns in the macroeconomic cycle as well as corporate growth in general.

As such, there is no evidence that consolidation increases concentration levels or decreases exploration activity. Present antitrust laws are therefore sufficient and do not require a supplemental ban on mergers. Furthermore, it cannot be shown that the present tax code treats property acquisition in a merger any more favorably than other types of investments. Each of these points will be discussed in turn as they relate to the independent oil producer.

Any government policy imposing a discriminatory moratorium on corporate petroleum mergers would interfere significantly with our free market economy. The petroleum industry today is undergoing a natural restructuring process in response to changing market forces such as the worldwide surplus, declining demand and prices. Consolidation is one viable option still open to firms grappling with business pressures like declining reserves and the shifting balance of economic power away from U.S. firms. Another problem is that fewer investors are interested because crude oil discovery and production yield a lower rate of return today given the high finding costs and ever-present threat of new taxation.

A moratorium on oil mergers will do nothing to alleviate these pressures but rather will foreclose one important means of confronting them. In general, mergers reduce joint average costs of the consolidated operations relative to each company's cost level before the merger. Therefore, a ban on mergers will preclude the realization of these economic benefits which in turn will ultimately yield an adverse impact on the cost structures and competitive positions of regulated industries. Of course eventually, the misallocation of economic resources leads to an increase in costs to consumers.

In purely economic terms, capital markets act to allocate resources efficiently in response to price signals. In this way, profit maximization is ultimately achieved. Ideally, it is the capital market itself which dictates when and where structural changes should occur within an industry. For instance, corporate acquisitions are one of the primary methods by which a competitive market system reallocates resources in order to increase efficiency through the infusion of new capital and management.

Some independent companies have been particularly hard hit by the depressed oil market to such an extent that eventually mergers may be their only answer. During the industry expansion from 1978 to 1981, independents amassed considerable debt. Then when oil and gas prices fell, they were disproportionately affected because their heavy debt load exacerbated the problem. Many independents have become so highly leveraged in the past few years that their cash flow positions have been seriously threatened to the point of rampant bankruptcies. Left unrestrained, the invisible hand of the free market will lead to the consolidation of complementary firms, solving the problems of cash flow as well as declining oil and gas reserves.

A government ban on mergers and acquisitions would prohibit industrial restructuring that could salvage many independent companies nearing Chapter 11 proceedings. Moreover, it would be a violation of their economic right to own, sell, exchange or purchase property and to run a business accordingly. If a comprehensive anti-merger law were enacted, America would witness a substantial flight of capital away from the controlled industry and instead toward investment opportunites where businesses can control their own transactions and stock values.

I. EFFECT ON EXPLORATION AND DEVELOPMENT ACTIVITY

One of the principal points of debate regarding pending mergers has been their impact on domestic exploration. Some fear that exploration and production budgets will be cut as a result of the tremendous debt incurred in the financial takeovers. In actuality, the level of exploratory drilling is determined by drilling costs in relation to oil prices and available capital. Since most of the easily-found domestic oil reserves have already been tapped, additional reserves are costly to locate and produce. Given the current price of oil, today's level of exploration activity is all that is economically feasible in this surplus market.

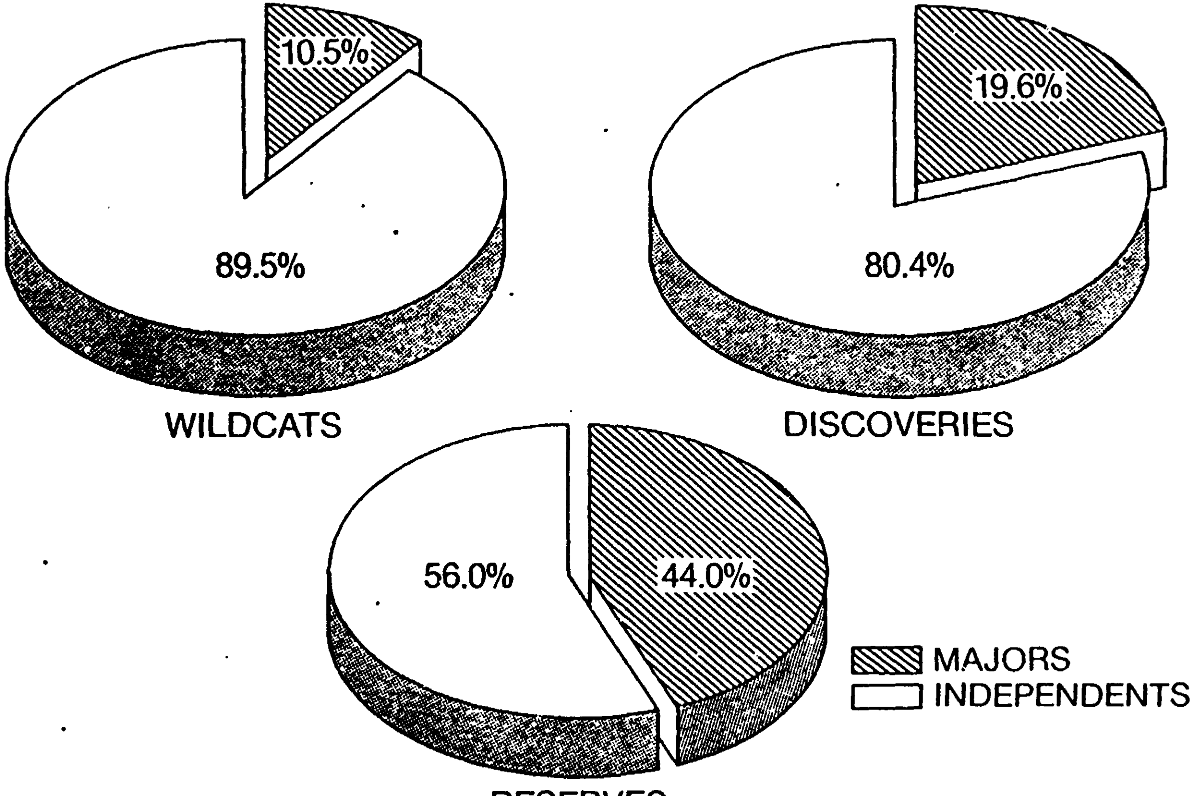
Taking into consideration the other side of the exploration equation, drilling costs in the U.S have declined by about one-fourth since 1981. Furthermore, a substantial part of the major oil companies budgets include large expenditures for offshore leases, bonuses and royalties. However with the cutback in federal offshore lease sales, plus extended delays caused by problems obtaining permits and litigation fostered by opponents of energy resource development, a part of these outlays will drop out of budgeted expenditures. These and many other such factors prove that projected expenditures are not a clear cut indicator of drilling activity.

No concrete evidence exists to substantiate that corporate acquisitions yield any sustained impact on exploration activity. The merged companies need new oil reserves over the long run just as they did operating separately. In fact, legislation that prevents the marketplace from reflecting the true value of oil reserves is far more likely to inhibit exploration activity. This can be seen by tracing how drilling programs have been impacted dramatically by political and economic factors such as the repeal of percentage depletion and the adoption of negative tax legislation.

Since World War II, the multiplicity of efforts by independent, non-intergrated companies has accounted for about 90 percent of U.S. exploratory drilling ventures. In addition, independents find 80 percent of significant new fields and over half of the total new reserves found. The share of exploration by independents has been affected only marginally by changing economic conditions in the petroleum industry. There has been no perceptible change in the independents' share of exploration activity during cyclical downturns of the 1950's and 1960's which were marked by restructuring through consolidation and acquisitions. Moreover, there has been no lasting effect on total exploration by the industry as a whole.

In terms of production activity, the average daily output of independent operators over the years has remained relatively constant. However, as a percentage of total domestic production, the independents' share has increased significantly since 1969. The major oil companies, on the other hand, have seen their average daily production decline continuously except for the addition of the Alaskan North Slope. Therefore, merger activity over

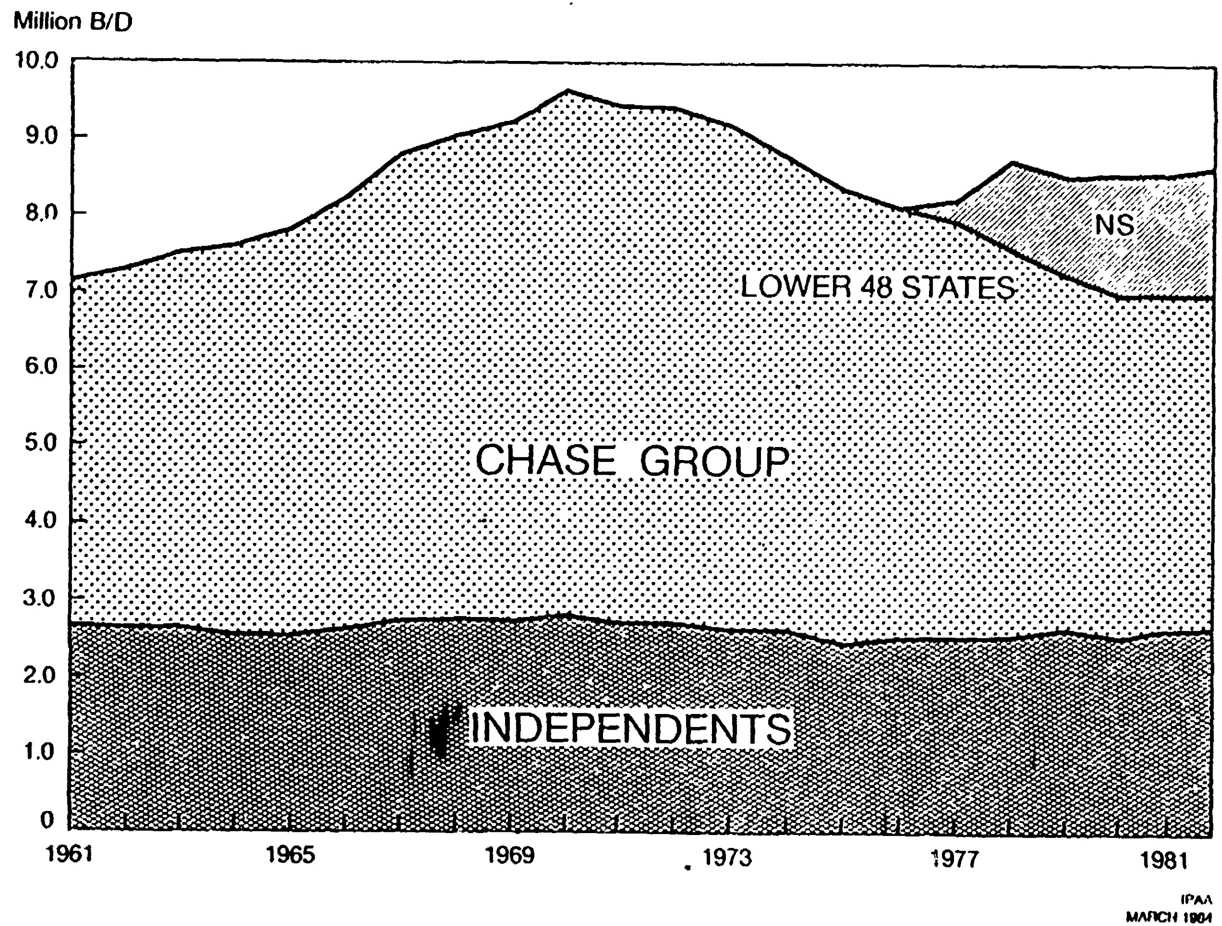
ROLE OF INDEPENDENTS 1969-1978



Source: U.S. Geologial Survey - Circ 860 - 1981
These USGS estimates do not include potentially large supplies from Heavy oil, tar sands, coal gas, geopressured reservoirs and Gas hydrates

IPAA
MARCH 1984

U.S. CRUDE OIL PRODUCTION



the period has not increased the concentration of crude oil production in the hands of a few large companies and, further, it is indefensible to assume that mergers will do so now.

The Federal Trade Commission has vigilantly tracked the competitive environment of the U.S. petroleum industry over the years. The most recent of their studies concluded that no evidence can be found supporting anti-competitive behavior in the oil industry. All things considered, existing antitrust review processes are fully adequate to deal with any aspects of a merger that might have possible monopolistic tendencies so that no changes in this system are warranted. In fact, the most significant regulation of business conduct imposed by the Clayton Act is that affecting mergers; its Section 7 is even more stringent than any implied by the Sherman Act.

Thus, a clear line of judicial interpretation has emerged that supports a maximum possible deterrent to anti-competitive merger activity. However, current merger moratorium proposals not only appear to be based on issues far removed from traditional antitrust concerns, but also preclude consideration of individual acquisitions on a case-by-case basis.

One of the results of America's antitrust laws has been the spinning off of assets by merging companies in market areas where concentration levels might possibly present a problem. This divestiture, either voluntarily or as a result of an FTC order, has yielded a serendipitous outcome for many independent companies who can acquire pipelines, refineries, terminals and service stations at reasonable terms with long-run supply contracts.

In addition, the major oil companies have a tendency to acquire more new acreage than needed for immediate drilling programs, thereby tying up leases that could be used for exploration. Once they have merged with another company, majors generally farm out more of their acreage to independents who are known for drilling more aggressively. Therefore, the net effect of merger activity often is the strengthening of competitive conditions in the petroleum industry, particularly in exploration activity.

II. NEUTRALITY OF TAX CODE

Only the participants in these transactions are able to state with certainty the extent to which current tax laws created incentives for the acquisitions. There is no indication however, that the Internal Revenue Code serves to encourage this activity. Conversely and perhaps just as importantly, the tax laws do not serve to discourage the acquisition of assets through a corporate merger as opposed to some other form of direct purchase. The tax laws have been designed to attempt to treat the acquisition of assets in a corporate merger in essentially the same manner as if the assets have had been acquired directly. If the transaction is taxable to the seller, the buyer is treated as having made a purchase. If the transfer is not taxable to the transferee, the transferor receives no tax benefit for the cost of the assets. This scheme has been designed to be both symmetrical and neutral. Proposed changes set forth by critics to the mergers, such as denying deductions for interest expense and prohibiting adjustments to the basis of the assets, violate the neutrality which has been so laboriously achieved. This would also establish a dangerous precedent which could later be extended to smaller companies or other business activity.

It is of course an understatement to describe the provisions of the Internal Revenue Code which deal with corporate acquisitions, reorganizations and other transactions between corporations and shareholders as among the most studied and most litigated areas of the tax law. However, these sections cannot address every possible factual pattern and, where atypical facts exist, it is possible that the resulting tax treatment is not what Congress intended. There is nothing in the recent series of transactions to indicate the presence of unique tax attributes sufficient to stimulate any business combination. There is, however, plenty of evidence to indicate that the transactions occurred because of a deep and fundamental difference of opinion as to the value of the companies' oil and gas reserves.

The reform and simplification of the income taxation of corporations has been the subject of ongoing study by this committee and its staff. This process of evaluation of the existing law has proceeded in an orderly manner, relying upon input from a large number of interested professional groups as well as the public. The final work product of this study will undoubtedly include legislative proposals to insure that the tax treatment of corporate acquisitions reflects the intent of Congress. Changes in the tax law which affect an area as pervasive as the taxation of corporations and shareholders should not be accelerated simply to respond to a series of highly visible oil company mergers.

III. CONCLUSION

Many different legislative schemes have been proposed from a one-year ban among the top 50 oil companies, or the top 20, to a six-month moratorium with various retroactive provisions. The entire issue of anti-merger legislation has evolved into a highly arbitrary concept. Where would the moratorium end? Even if it initially applied only to large companies, it would not be long before intermediate-size firms and then smaller independents were affected. Even more likely is the spread of anti-merger legislation to other industries such as steel. Once the precedent has been established, government has a natural tendency to keep expanding, layer by layer, one law on top of another, ad infinitum.

The domestic petroleum industry faces a multibillion dollar challenge, if not obligation, to find sufficient oil and gas supplies to provide for America's future energy security. With oil supplies in the Middle East becoming increasingly unreliable as political tension mounts, it is even more important to maintain the viability of U.S. petroleum companies.

In a competitive economy, the free market system undergoes its own self-correcting adjustments through capital flows, mergers and acquisitions resulting in a more efficient allocation of resources. These processes have occurred throughout industrial history with resulting gains in economic efficiency. They should be allowed to continue their normal course uninhibited by government policy. Within appropriate antitrust guidelines, any interference with the economic rights of business consolidation goes against America's entire free enterprise philosophy.

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STATEMENT OF G. HENRY M. SCHULER, DIRECTOR, ENERGY SECURITY STUDIES, GEORGETOWN UNIVERSITY CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, WASHINGTON, DC

Mr. SCHULER. My name is Henry Schuler. I hold the Dewey F. Bartlett Chair in energy security studies at Georgetown University Center for Strategic and International Studies.

Senator WALLOP. The opening for which several members of the Senate wish to attend in honor of our friend and colleague, Senator Bartlett, but we stayed in session and it kept us from coming down there, but it was not that our heart wasn't with him.

Mr. SCHULER. I appreciate that very much, and I am delighted to have the opportunity to discuss many of the same sorts of things that we discussed in the course of the sessions yesterday and the day before. I am concerned about these things not only because I hold the chair in energy security, but because I was resident manager of a middle-sized oil company in Libya 15 years ago this September when Qadhafi took over. It certainly became apparent to those of us who went through that experience that energy security would become increasingly important to the Nation. And so when I hear questions raised about the impact of these mergers upon the energy security of the United States I take a very great interest and have given it considerable thought. I would say and again emphasize that my own involvement in the petroleum industry has been with middle sized companies so I do not bring the perspective of major companies to my analyses. The thing that I think we need to do is to look at these mergers in the context of two sets of links with energy security. One is: Are these mergers taking place because of some underlying circumstances which do, in fact, pose a threat to the energy security of this country? And second: Are these mergers an appropriate or inappropriate response to those threats? Addressing the first of those questions, I would say that with respect to the underlying circumstances, they very definitely do reveal a threat to the energy security of this country and perhaps the hearings that Congress is having directed on the energy mergers might be more appropriately dedicated to some of these fundamental concerns. The reason that oil company stocks are depressed right now is because of the energy complacency that exists in this country. It is the same sort of complacency that motivates you and your colleagues to refuse to deregulate natural gas, to kill the Clinch River breeder reactor, to declare a moratorium on offshore leasing, and a variety of other things that are anathema to the development of domestic energy in this country. The threat is there. The underlying circumstances are very real.

Senator WALLOP. I think that at least as far as the Finance Committee is represented right at this moment, we are among the angels on that. I am sure that is correct. [Laughter.]

Mr. SCHULER. The threat we have here is very real. Although we get the bulk of our oil imports from Mexico and the North Sea, half of the oil moving in world trade comes from the Middle East and North Africa. That means that if those people who still need oil have to go there and get that oil, and as long as that situation pertains, we are vulnerable to events and policy decisions that can very much influence the world price of oil. It won't matter where we get our oil—it will be impacted by those events. And we don't have to postulate a closing of the Strait of Hormuz or a kamakazi attack on Rasenura, or more terror bombings in Kuwait. In fact, consider what would happen if the Iranians continue to appear to be gaining ascendency in the gulf region, and it once again becomes the Persian Gulf instead of the Arab persian Gulf as we have taken to calling it in recent years.

Ask yourselves whether the Saudis are not going to look for some way to strike a modus vivendi with the Iranians, and one of the things that may be the easiest for them to do that in is with respect to oil policy, and we all know what the Iranians contend on that. They have been demanding for the past 12 months that the OPEC decision to reduce oil prices by $5.00 a barrel be rescinded. So, I think the threat remains there.

If the acquired companies were available to be taken over because of this underlying complacency, the motivation for the acquiring companies also has a national security link. The reason that SoCal and Mobil and Texaco want to take over these companies, as we all know, is to secure their oil reserves because these are defining marketing companies that needed those reserves for the future. But their own depleting reserves are only a reflection of the depleting reserves of the United States as a whole. The estimate at the start of this year was that we had 27.3 billion barrels of proven reserves. At a production rate of around 3.2 billion barrels a year, we are talking about 8½ years of reserve life. So, clearly these companies, if they want to stay in their marketing and refining business, need to obtain access to additional oil, either through acquisition of reserves, exploration or importation. Now, these companies have certainly been very active in exploration and will continue to be so, but they have to realize that there is a lot of pending legislation and a congressional track record, notwithstanding the four of you, that doesn't auger well necessarily for finding those required reserves through exploration. I would point out the offshore moratorium that you referred to, proposals to raise the windfall profits tax, proposals to reregulate natural gas—all of these things may make it difficult to find those reserves through exploration. So, they then have a remaining choice of acquisition or importation, and I think it is noteworthy—with respect to importation—that these three companies—SoCal, Texaco, and Mobil—are members of the four company Aramco Consortium and have as good links and as good access to Middle East reserves as anybody.

Yet they chose not to go the import route, but rather to acquire reserves. I think it may tell us something—although I can't put words into their mouths and motivations into their minds—but they may be far more concerned about what is going on in the Middle East today and the security of that oil supply than Members of Congress and investors of Wall Street. And I think that might be instructive to us.

Now, just quickly, with respect to the appropriateness of the response—what we have are larger, stronger companies but fewer companies than we had before, by a margin of half of them—the taken-over companies.

I don't consider this to be deleterious to our energy security and, in fact, I think on balance it is advantageous. And the reason I say that is that the bulk of the large accumulations of oil that remain to be found are going to be found in the deep offshore waters and in the remote areas of Alaska. And that is necessarily a major oil company game. I would not say the same thing with respect to the finding of the smaller accumulations which cumulatively amount to a very significant input, and I would rather trust that frankly to Jon Rex Jones' 15,000 independents because we are talking there about innovative plays that they can develop and risk taking. But when you are talking about the offshore, you are talking about huge structures which virtually everybody knows are there because they have to be huge or you wouldn't go after them in 1,000, 2,000, or 3,000 feet of water. So, what you are talking about is the ability to mobilize technology and R&D, and I think the big companies can clearly do that—the big strong companies better than other companies—smaller companies.

In addition, you need to mobilize the capital. Some fear that a significant portion of the earnings that will be generated will be required to pay off the loans. But we must think of the alternative of what was going to happen to those earnings. If it had been possible to set up royalty trusts with respect to Superior at one stage or in Gulf more recently, those earnings certainly would not have been available for the integrated operations of the company. They would have gone directly to the shareholders, and perhaps benefited the shareholders although Gulf contends to the contrary. But they would not have been available to the integrated operations. We can't overlook that we are talking about vertically and horizontally integrated companies, because the energy security of this Nation requires not just the drilling of wells, as important as that is, but we need to be developing new energy alternatives—synthetic fuels, whatever—through the kinds of work that the major horizontally integrated companies do. Vertically integrated companies are also important because refineries need to be upgraded to process the heavy crude oils that will become available. So, all of these things I think are factors that say that these mergers can be desirable from an energy security point of view.

The last point I would like to make in that regard is that having been out there as a member of the oil industry negotiating team, negotiating with OPEC in the early 1970's and negotiating with Qadhafi on behalf of Bunker Hunt, believe me if you have got some secure company-owned reserves behind you, you are in a heck of a lot better position to negotiate for the remaining oil that you require. So, when these big vertically integrated companies acquire company-owned reserves, they are going to be in a lot better position to negotiate. In closing, I would say that we must consider the alternatives to these mergers. Is the Nation well served if the companies—Superior and Getty—continue to be torn up by family feuds? If Gulf is under constant attack by major shareholders? Are they going to function in an optimum fashion for our energy security then? Additionally, what do we want these big companies to do? If we are not going to let them seek to find future growth through the energy business, then they are going to go out and buy more drug stores and so forth. And I have to say that I would rather have Mobil buy Superior than more mail order stores and packaging companies. Thank you.

Senator WALLOP. Thank you very much, Mr. Schuler.

[Mr. Schuler's prepared statement follows:]

ENERGY COMPANY MERGERS
BALANCING THE COMPETITION RISKS AGAINST THE SECURITY BENEFITS

Testimony
submitted to
The Energy Taxation Subcommittee
Senate Finance Committee

Hearings
on Oil Company Mergers
April 5, 1984

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My name is G. Henry M. Schuler, and I have held the Dewey F. Bartlett Chair in Energy Security Studies at Georgetown University's Center for Stretegic and International Studies (CSIS) since the Bartlett Program was established 18 months ago. While I do not speak for CSIS (which does not adopt institutional positions), I do speak as someone who has been concerned about our nation's energy security ever since Colonel Qaddafi seized power in Libya 15 years ago while I was Resident Manager of an independent oil company in Tripoli. The demands of Qaddafi and his colleagues on the Revolutionary Command Council made it readily apparent to those of us who went through the experience that American company control over foreign oil reserves, commercially directed decision making and a highly competitive international market would soon be replaced by hostile government control, politicized decision making and cartelization which would threaten U.S. energy security.

I have over the years then and since, been privileged to serve as an executive of several oil producing companies: Grace Petroleum (a subsidiary of W. R. Grace), Hunt International (controlled by Nelson Bunker Hunt) and Champlin (a subsidiary of Union Pacific Corp.). All three were very substantial producing companies and Champlin was fully integrated as well; however, none were major companies like whose those taken-over of other companies have prompted the hearings. In short, I am neither a spokesman for "Big Oil" nor have I been indoctrinated with major company attitudes by past experience. Far from it, for an examination of my publications over the years and of my testimony to various Senate Committees, starting with Senator Church's

Multinational Corporation Subcommittee hearings 10 years ago, will reveal that I have never been detered from criticizing corporate activity which I believe to be contrary to the nation's overall energy security interests.

Having attempted to identify my experience and to set aside any concerns about my impartiality, let me address the relationship between these corporate mergers and national energy security under two headings:

Firstly, do the mergers arise out of a set of underlying circumstances which also constitute a threat to U.S. energy security? And, if so, are the mergers an appropriate or inappropriate response to that energy security threat?

<u>The Underlying Circumstances</u>

In answer to our first question it seems abundantly clear that the recent spate of mergers reflects a number of underlying conditions which threaten energy security far more than they threaten competition:

- <u>Energy complacency</u>: It is widely recognized that the acquisitions are only possible because most energy company stocks are vastly undervalued in relation to the value of their underlying resources, whether those resources are oil, natural gas, coal, uranium, nuclear technology, solar collectors or insulation. The reason for this undervaluation is a pervasive complacency which has gripped the entire country ever since the TV commentators and newspaper pundits decided that OPEC's highly publicized difficulty in maintaining control over international oil markets signalled the end -- or at least the beginning of the end -- of the "energy crisis". Politicians and public alike were delighted to embrace the happy projections that a perpetual "oil glut" would soon make oil prices subject to competitive market forces rather than to cartelized government fiat. Many were only too glad to return to the "good old days": the public would no longer have to accept cramped underpowered cars, and the politicians would no longer have to strike those excruciatingly difficult energy development balances with higher costs, air pollution, wilderness usage, environmental risks, radiation fears, price supports, etc. Instead, Congress could refuse to deregulate natural gas, refuse to fund the Clinch River Breeder Reactor, refuse to accept the Administration's offshore leasing schedule, refuse to accept responsibility for the completion of for the only surviving large scale synthetic fuel project and refuse to adopt a "least cost approach" to the acid rain problem. . In short, it could, with impunity, refuse to accept the risks or costs of almost every domestic development program which could promise realistic reflief from rising oil imports because the pundits had decided that foreign oil would continue to become cheaper and more plentiful. Like the rest of the country, Wall Street did its bit to promote energy complacency by driving down the stock prices. There can be no basis in reality for the pervasive complacency so long as half of the oil moving in world trade continues to come from the Middle East and North Africa. If that supply is disrupted, curtailed or priced at a higher level, the world price of oil will be bid higher, and our imports will cost more regardless of where they are produced. We need not postulate closure of the Straits of Hormuz, or a kamikaze attack on Ras Tanura or additional terrorist attacks on oil installations in Kuwait in order to raise the prospect of higher prices. Beyond those traumatic events, price increases could be achieved through Arab acceptance of repeated Iranian demands for recission of the $5.00 per barrel reduction engineered by Saudi Arabia a year ago. Consider the possibility of Iran gaining the ascendancy in the Gulf or even being able to maintain the current level of pressure on Iraq and its Arab allies. In either event, a modus vivendi will eventually have to be reached if the conflict is ever to end and oil policy is certain to be one element of the negotiations.

- Declining reserve base: If recent take-overs have been facilitated by complacency-depressed stock prices of the acquired companies, they have been prompted by the depleting oil reserves of the acquiring companies. It has been widely reported that Standard Oil of California (SOCAL), Texaco and Mobil were willing to risk their credit ratings and stock prices because they foresaw a need to secure future oil supplies for their refining and marketing operations. Instead of being criticized for looking beyond the next quarter's earnings report, board room concern about the future viability of their companies ought to become Congress's concern about the future security of the nation. The nation's proven oil reserves are, after all, no more than the sum total of the reserves held by the individual companies so it is hardly surprising that proven American crude oil reserves were estimated by the *Oil & Gas Journal* to be only 27.3 billion barrels on January 1, 1984. That sounds like an enormous volume of oil until we recognize that the United States produced 3.2 billion in 1983. At that rate, current proven reserves will be consumed in just eight and one half years! Any integrated company that wants to beat the national "mortality rate" will have to acquire future oil for its downstream operations through exploration, import or acquisition.

- **Exploration Barriers**: Of course, additional oil can be found through exploration, and the acquiring companies have a proven track record of risking vast sums in the successful search for it. Still, they know that the pace of exploration is controlled by government policy, for the search requires the availability of new acreage, the generation of retained earnings and the acceptance of environmental risk. The newly strengthened companies will be well placed to generate sufficient earnings and to mobilize acceptable technology for the search in the most promising deep offshore waters. Nonetheless, the Congressional track record over recent years and pending legislation to declare a moratorium on offshore leasing, to raise the so-called Windfall Profits Tax, to reimpose price controls on natural gas and to create new environmental barriers, would certainly prompt prudent managements to consider hedging their bets by also trying to purchase oil reserves to feed their refineries and fuel their customers.

- **Import concerns**: While I have no first hand information on motivations, I find it striking that Socal, Texaco, and Mobil were all members of the old 4 company ARAMCO consortium, with SOCAL the original concession holder in Saudi Arabia. As such, they know the Middle East well and have better access to its oil than most companies. Therefore, their willingness to risk high debt burdens in order to acquire American reserves instead of relying upon imports may point to a greater appreciation of the true cost of oil imports than that held by Congress. Imports are approaching the levels of 1973 when the ARAMCO companies were required by King Feisal to take a public stand on Middle East policy as the price of continued access to oil. That stand incurred a domestic political cost which most of the companies would not choose to pay again. More recently, they know -- and successfully resisted -- the cost of having to purchase unwanted quantities of overpriced oil under penalty of future denial. With the Gulf War escalating, American prestige suffering from the Lebanese withdrawal and Iranian influence rising, the anxiety of these 3 particular companies to reduce their dependence upon Middle Eastern oil may serve as a special warning to the United States to do the same thing.

The Appropriateness of the Response

Turning to our second question, the creation of larger and stronger energy companies strikes me as an entirely appropriate response to the energy security threat which faces the Nation. In stating that position, I start from the generally accepted understanding that immediate concerns about excessive concentration in individual markets can be avoided through FTC-ordered divestiture of offending segments, while longer term concerns about abuse of power will remain under the scrutiny of the antitrust laws. In sum, I believe that the risks to competition are outweighed by the benefits to security, including the following:

- <u>Mobilization of engineering and R&D capabilities</u>: Although some may disagree, experience has demonstrated to my own satisfaction that the giant oil companies are singularly well-suited to the exploration and development of those prospects in the deep offshore waters and remote Alaskan areas which hold the greatest hope for huge American oil accumulations. To be enetirely candid, I would not make that same observation about the quest for the cumulatively important but smaller discoveries in the lower 48 states where I believe the diversity and gambling instincts of 10,000 independent wildcatters improve the prospects for success. But I have observed the OCS to be the "major's game," for there the quest seems less dependent upon innovative development of new "plays" than upon the costly testing and development of huge structures. No one can afford to look for small strategraphic traps in 1000 feet of water, and the big structural traps should be visible on every company's seismic records. Therefore, success is more dependent upon the development of cost-cutting technology and the mobilization of massive engineering capability. Only the biggest companies can support the necessary R&D and engineering staffs which are required to develop deep water reservoirs. In fact, in many instances, the major companies have pooled their resources in ad hoc consortia to develop offshore prospects, thereby forming informal combinations which have raised concerns among many of the same legislators who now criticize these more formal mergers.

o **Mobilization of capital**: Some have expressed concern that a significant portion of future earnings of the acquired companies will be committed to debt service.

This may be true for a period of time, but critics should ask themselves what would have happened to the earnings of Gulf and Superior if their petroleum reserves had been placed in separate royalty trusts as was attempted. Although I owned no Gulf or Superior stock, it iis my understanding that the principal purpose of such trusts was to channel the earnings directly to royalty unit holders rather than to retain them within the corporation for its vertically and horizontally integrated operations. While such arrangements are said to benefit the income of sharheolders in some instances, they do not benefit the efforts of energy corporations to develop the alternative energy supplies which the Nation requires. Moreover, the truly capital intensive phase of frontier petroleum operations is during development, not exploration. The development of North Sea oil fields taught me that project financing is available only to those companies which are viewed as having the very best research and engineering qualifications. Rightly or wrongly, those capabilities were presumed by international bankers to accompany size.

- **Negotiating strength vis-a-vis OPEC**: It seems almost tantological to observe that the companies which are perceived as having a significant supply alternative are best able to negotiate for incremental suppliers from OPEC. Therefore, it seems to me that providing major marketers and refiners with company-controlled American reserves puts them in a better position when they face foreign producers across the table.

Conclusion: Consider the Alternatives

In closing, I would suggest that Congress consider the alternatives to permitting the consolidation of oil company assets. Firstly, would the nation's energy security be better served by breaking-up the acquired companies whose assets have been undervalued and board rooms sundered by Wall Street's complacency? After all, those underpriced assets not only provide an attractive investment opportunity for integrated energy companies interested in long term growth and survival, but also present easy prey for so-called raiders interested only in dis-integration and quick profits. It is important to remember that Gulf, the largest and most contentious of the recent acquisitions, was not offered the opportunity to maintain its independent existence but rather to choose between those take-over alternatives. Secondly, would the nation's energy security interests be better served if the acquiring companies were forced to look outside the energy industry to assure their future growth and prosperity? For my part, I would vastly prefer to see Mobil acquire Superior than more mail order stores and packaging companies.

Senator WALLOP. That is a very interesting commentary. Senator Long.

Senator LONG. No questions.

Senator WALLOP. Senator Bentsen.

Senator BENTSEN. Mr. Pickens, what do you think is causing the restructuring of the oil industry?

Mr. PICKENS. Finding costs are too high. The economics are not there for the industry. You are not going to have a great deal of exploration with $29 oil. You can check me on that by looking at the rig count. There is a lot of oil and gas to be found in the United States, but it is not economically sound to be aggressively drilling with the price that you have to sell that gas and oil for today.

Senator WALLOP. Just an amplifying question on that. If there was some easing of the windfall profits tax, would that be the same to you as an increase in the price of oil?

Mr. PICKENS. Sure it would. The taxes are so heavy on the industry that it just won't promote exploration. But I didn't completely answer that question as to why the mergers of oil and gas companies and acquisitions are taking place. I mean, you have a situation the same as Mesa's. We were probably the most aggressive large independent in the United States. We ran a budget of over $400 million in 1981. Our finding costs were unacceptable; 1982 was tough, and 1983 was tough, and we cut our budget, not because we were involved in acquisitions and mergers—it was because we couldn't stand it any more. We have 49 producing platforms in the Outer Continental Shelf, and we are one of the few independents that has any kind of ownership or representation like that in the Gulf of Mexico. We spent over $1.5 billion since 1970 in the Gulf of Mexico. So, we have tried it, and we have tried it hard, and we have been successful, but nonetheless we saw a better use of our capital. It wasn't economically sound to continue as we were. I think that is the same thing you are seeing here.

I think the majors are having problems, and I have sympathy for them because they have reserves that were found years and years ago. If you go back and analyze these major oil companies, you will find that most of the reserves that they have are not recently found reserves. So consequently, they have a problem, too, to take care of their stockholders, and they are trying to figure a way out of the dilemma, but they are finding costs are just as high as ours are. So, it is a problem for all of us in the industry.

Senator BENTSEN. Let me see if I understand what you said. You think the obligation is to the investor, or the shareholder? What role do you think the investor should play in the restructuring? Do you think it is incumbent on Congress to put some limitations on the maximizing of the return to the investor in his stock?

Mr. PICKENS. From my comments, you all know where I come from. I am a stockholder's advocate, and I believe that is the cornerstone of the free enterprise system and that is where the money comes from to make the system work. If we start putting any doubt in that investor's mind as to what Congress might do to limit what they may be able to make after they have made a good analysis of the situation, I think it will be disastrous for the industry. The capital markets, I think, will suffer tremendously by any kind of legislation that may develop that way. Let's look at the Gulf Oil situation. Gulf Oil, was appraised at about $114 a share. This company had never sold anywhere close to appraised value. The highest it had ever been was $53, and the day we started buying the stock in August, it was $36. I don't think it would ever have gone back to its all-time high of $53. This company also for 12 straight years had not replaced their domestic reserve base. So, the company was in liquidation. Now, they characterize me as a liquidator. Liquidation had been going on at Gulf Oil for 12 straight years. If you just lined up their points in their annual report as to what the reserve base was over that 12-year period and just connected them, you would have projected that into a total depletion of their reserves by 1995. So, this company wasn't going to be around for very long, and it was a shame to see it go out on this basis. So, the stockholder has to be protected by somebody in these situations. And what happened?

Why did Getty go? It went because Getty had a very large stockholder—Gordon Getty represented about 40 percent of the stock that Getty had outstanding—and Gordon had gotten to the point where he couldn't go any further with the Getty management because they weren't protecting the primary asset of the stockholders, which was the domestic reserves of oil and gas. So, Gordon forced that. That same situation came at Gulf, too. We were their largest stockholder and we forced them to do something.

Senator BENTSEN. Mr. Pickens, I used to chair an investment committee for a mutual fund, and our job was trying to maximize profits for those people in the mutual funds. And for the most part those were small investors. It is very difficult for me to understand that the obligation is otherwise—other than trying to maximize profits for the investor. Mr. Jones, let me ask you what you think happens to the independent if mergers occur and some properties are consolidated. The independents get farm outs, they get access to some of these properties to drill. Do you think there is going to be a reduction, an increase, or do you think there will be about the same amount of property for the independents to drill upon?

Mr. JONES. I think there will be some opportunities probably because the company when it merges will make reevaluations of some of their known prospects and perhaps some minds will be changed, and some acreage will therefore be available to independents, but Senator Bentsen, on the whole, I don't see large changes as far as that particular thing is concerned, affecting the independent segment of the industry.

Senator BENTSEN. One of the arguments made in debate was that you would have the further denial of farmouts or acreage to independents, but I really didn't see the logic behind the argument. Do really think there will be very little change?

Mr. JONES. Yes, sir. I think mainly the moratorium for acreage comes from Federal lands offshore and the like.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Senator WALLOP. Senator Boren.

Senator BOREN. Thank you, Mr. Chairman. Mr. Schuler. in terms of acquisitions what is the situation in regard to foreign takeovers of domestic American petroleum companies? As I understand it, the margin requirements do not fully apply. Is there any concern on your part or do you perceive that we may see an increase in the number of leverage buyouts of domestic American companies by foreign-controlled companies or by foreign companies?

Mr. SCHULER. Senator Boren, that is not a problem that I have looked at in any great detail, but I don't see a major threat in the situation you postulate of taking over American companies with American reserves. The reserves will remain in the United States. The logical market for those reserves will be in the United States, so I don't think the question of who owns it will necessarily have a deleterious effect on energy security. On the other hand, I suppose a foreign owner could decide deliberately to delay the development of those U.S. reserves in order to continue to have a market for its oil exports. If that were to happen it would pose an aditional threat to energy security.

Senator BOREN. Something that might be interesting for the Center to focus upon—at least to consider that question—and also consider if the economics under which we are now operating and the margin requirements that are asked might lead to increases in that area and what effect it potentially could have, and I certainly would welcome—as you look at this as we go along—any comments that you might have back on that. In regard to the independents, your testimony reflects something that I certainly understand in Oklahoma right now. You said that all mergers are not bad—that, in fact, some independent companies are having to merge in order to stay afloat. We would have seen probably more bankruptcies in the independent sector if we had not been able to have some of these mergers. Is that correct?

Mr. JONES. That is right, Senator. It concerns us a great deal if one of the opportunities for recovery were taken away from our segment of the industry. We feel that the marketplace, which is fairly good now for reserves, the purchasing of reserves, would be hurt tremendously if there were a moratorium on certain companies such that they couldn't buy us out. It is sort of like a rising tide that lifts all boats while a lowering tide would have the reverse effect, and we think our boat is low enough in the water now sir, and we would like not to see any of our markets removed, and opportunities for us to recover from the bad cycle that we are in right now.

Senator BOREN. Do you have any idea how many of these mergers have taken place of smaller independent companies in order to maintain them as a viable economic unit?

Mr. JONES. I don't know the numbers, Senator, but there have been a number of companies in the gulf coast area with which I am familiar that have sold out recently to avoid just being bankrupt.

Senator BOREN. Mr. Pickens, in terms of the comments—and I certainly agree—you made about shareholders 'interests, and Senator Bentsen eloquently stated that same philosophy on the floor of the Senate when we were discussing the antimerger legislation—the idea that there are stockholders that are locked in the situations where their investments are clearly undervalued, situations in which management is not fully responding to the situation, and building a moat around this situation—preventing it from changing—it certainly prevents the stockholders 'interests from being completely protected. I wonder, from the point of view of setting aside just the shareholders' view, what do you think will happen ultimately as long as we stay in the situation where we are now in terms of finding costs, the price of oil in the general range where we have it now—and there are some who feel it is going to be some time before we see a recovery of that. We don't see a change in, say, the windfall profits tax to provide additional incentives, and we don't see a change in price. Is it inevitable that we are going to see a reduction in the number of companies, particularly larger and middle-sized units of the industry? And what kind of restructuring do you think would be in the best interests of the United States if we consider energy independence and trying to develop our own domestic energy sources as much as we could—what kind of restructuring do you see as the most efficient use from the national interest point of view in the industry, given the kind of economics that we now have?

Mr. PICKENS. I think what we have going on is not bad. I think when you see weaker companies—whether they are large or small—going in the hands of stronger managements, that is a good result. I don't like the image of the oil industry in the United States. I think it has an image of being fat and inefficient, and I think that is being changed. I also know that, being a geologist, the reserves that aren't found in 1984, 1985 are not going to go anywhere. They have been there hundreds of millions of years, and so they will be there when the economics justify their discovery. I also find that when I think through this I see that if we are going to force people to drill wells with finding costs that are unacceptable, the consumer will have to pay for that at some point. So, I see the industry going through this phase of restructuring for the next probably 2 or 3 years. Hopefully, we will become more efficient as it takes place, and I believe that we will. I believe that there will be prospects that will come into economic range and will be drilled that may not be unless we did have a more efficient structure. I can't see runaway exploration as we had in 1981 where we had 4,500 rigs running. Something has to be done at some point. If you are going to drill and look for gas in the deeper reservoirs as you and I are both familiar with in western Oklahoma and Anadarko Basin that, before that exploration starts again, it has got to be economically sound because we have independents that are stretched too thin because they felt, as we did, that that exploration was sound and logical at the time. Yet we see legislation coming up on a new gas bill that is going to be severe on those people. I don't mind seeing the industry—the majors—load up with debt. I think that is healthy. I think it is good for the industry. I think it causes the industry to become more efficient. It will cause the majors to be more efficient. They have had a great deal of cash to work with, and so, if they want to owe $13 billion, I think that is fine. If they decide they don't want to drill a well, I think the independents are there to drill those wells, and looking forward to the opportunity to have more acreage available to them than they have had in the past.

Senator BOREN. But do you think that the major reason why we have had a decline is certainly not the restructuring but just the fact that the economic incentives in terms of price, tax, and other factors for the prospects that are out there to drill right now are just making those not attractive?

Mr. PICKENS. I think that is exactly right. And let me give you an example—I don't think it is an isolated case. The Sunday after I appeared on David Brinkley's show with Senator Johnson and Michael Pertchuk over at the FTC, I got a call—I got two calls within 48 hours—and both of both of them were independents, and both of them were from west Texas—and one of them said keep saying what you are saying about the prospects. We do not have the prospects available to us at this time under our present prospect structure even though we have the money available, and we will drill when we can make enough off of these deals to prospect. He said let me give you an example. He said we spent $30 million in 1983, and he said we would have gladly spent $100 million on our drilling—our exploration—had we had the opportunity to do so. And I believe that to be the norm for our group.

Senator BOREN. All right. Thank you.

Senator WALLOP. The reverse side of the question that was posed by Senator Specter this morning on public policy. The dangers of permitting mergers to go ahead—is the other question of public policy as to what the consequences of not permitting (a) free market circumstances to exist and (b) taking on some of the identifiable inhibitions to exploration and production that have been mentioned by Mr. Pickens, Mr. Schuler, Mr. Jones, and others as well as Senator Boren and myself. Just taking a long-term view for the moment of what is in the national interest—whether from a strategic or a consuming standpoint—what happens to us if we keep an industry which is already inefficient, has an oil refining over capacity, is burdened by taxes and regulations and segmentation in that State, as we approach the 1990's or even the mid-1980's with some of the Middle Eastern concerns that Mr. Schuler expressed. Would you just each briefly comment on that?

Mr. SCHULER. As our own domestic alternatives are denied an opportunity for development, we have to import or we have to do without energy. And under either event, the economy suffers and becomes hostage to foreign suppliers.

Senator WALLOP. And if our companies are not permitted a restructuring that strengthens them, then are they less competitive in the world markets with other oil companies or entities that may exist?

Mr. SCHULER. I believe that they will be. I believe that the stronger companies that have been created will be in a better position to go about the business of securing energy for this country.

Senator WALLOP. Mr. Pickens?

Mr. PICKENS. I am convinced that the OPEC cartel setting prices at $29.00 a barrel are very well tuned in on what our finding costs are in the United States. That is not hard to come by, but consequently, I think they follow the rig count very closely, too. So, we are going to import the oil, and we are going to have to do that until something becomes more efficient. I think that as a practical matter and being realistic about it, prices have to go up to put 4,500 rigs back to work. A point I would like to make, and I find this to be interesting, is that here you have a situation, specifically the Gulf-SoCal deal, which is obviously the transaction I am closely associated with—but here you have assets again flowing from a weak management group to a strong management group. I think that is good for America to have that happen. You also have $13 billion infused directly into the U.S. economy, and out of that $13 billion, half of it is profit, and Federal tax revenues, from what Keller said of SoCal—and it is a figure that we came up with also—should be over $2 billion. Here, I see in this situation that there are absolutely no losers—all winners. I even see, when somebody says you have got jobs involved here—there are jobs involved, but you look at the management of Gulf Oil, for instance, and you take Jim Lee, their chairman. Jim Lee is walking off from this transaction with $22 million out of the deal. All the stockholders of Gulf Oil doing well. You see a more efficient operation, and you see it flowing into the hands of stronger management. I think this is healthy.

Senator WALLOP. Aren't those jobs threatened anyway by the general status of the industry as it exists?

Mr. PICKENS. Exactly. We know we have an overcapacity of refining in the Unites States at the present time. We know that something is going to happen to some of those refineries, we have had 102 refineries closed in 3 years in the United States, and that is going to continue until it gets in balance. I think that the thing to do is to step back away from the industry and let it go ahead and take place, and I can see only a healthy result coming from whatever is going on here. Now, if Exxon steps out and tries to take over the next five largest oil companies, I would say that is something for us to be concerned about, but not what I see going on here because I think it is going to help the economy. I think you are going to help the consumer, and I think the stockholder will be rewarded.

Senator WALLOP. Even though they are that big, that would still be a hell of a pill to swallow.

Mr. PICKENS. It certainly would be.

Senator WALLOP. Mr. Jones?

Mr. JONES. Mr. Chairman, I am pleased to talk to that particular subject because, for the last 10 years, we have seen a developing scenario and you know, when we had the Arab embargo in 1973, then all of a sudden it became vogue and faddish to start talking about the alternate energy sources that we had available—the exotics, if you will. But in the last 2 or 3 years, as you know, it is not in vogue any longer to be talking about these alternate energy sources. Now, we in the petroleum industry have said that we felt that we could do our part in bridging the gap between now and when these exotic sources come offstream. But now that we are not seeing work done in the exotic areas, I become very concerned with anything that is detrimental to the oil and gas industry per se, because I think bridging this gap is going to be very difficult, and I am afraid that there will be those that point their finger at us one of these days and say, you are not doing your job. And we are doing our best at this time to move forward and saying it is going to take all sources of energy to keep America secure.

Senator WALLOP. One last point, and I appreciate what you said, but it has another side. And that is the opposite side of what Senator Bentsen and Senator Boren asked you. If there is some prohibition on mergers generally that might stop some beneficial mergers among the smaller independents which are necessary for them to retain or regain strength. By the same token, if a merger moratorium were imposed on the largest 50 companies within themselves, might that also not put them under an inordinate or a different kind of pressure to look for reserves in the companies smaller than the top 50? This would mean essentially your group. You might see them out trying to accomplish things to strengthen their reserve base by prospecting among independents because they couldn't sustain viability within each other.

Mr. JONES. Our experience so far, Mr. Chairman, has been that these mergers have not had a big effect on what the companies have done and in what quantities they have done it.

Senator WALLOP. No, but my question is this. If the top 50 are prohibited from merging in a free market situation—and I agree with Mr. Pickens that if Exxon were to start raiding the next three or four down, or some figure lower than that, you might have another consideration within and amongst each other, then do you not run the risk of placing an inordinate amount of pressure on those below the top 50, as these companies seek to do the same thing to strengthen their positions in the marketplace?

Mr. JONES. Yes Senator, and this goes to the point I was making earlier—it is not probable that antimerger legislation could be limited just to the large companies; eventually, something would trigger the "political necessity" to extend the controls to everybody. The possibility you suggest, an intensified acquisition of small producer reserves, would be just such a trigger and a very probable one. We have had demonstrated to us time and again that a bad idea implemented by Government cannot be easily contained. The best way to prevent its spread is to not start it to begin with.

Mr. SCHULER. Senator Wallop, I wonder if I might just say something in that regard. Isn't there a significant difference in that most of those independents are not publicly held companies, and therefore you don't have depressed stock that you can go out and acquire. You would have to pay the whole value.

Senator WALLOP. That is true, but there are some publicly traded independents. Mr. Pickens is one, and there are smaller companies. There is a threat there. If you stop it at one level, you have created a shortage and it starts at another. That is one of the problems that I have—absence of some clear demonstration that there is a clear public policy threat by permitting what is taking place at the level that it is going on at the moment. And I have yet to have anybody convince me that there is a threat to the American consumer, or the American public, or the American jobholders from these things. If I come across it, I will try to pass that on to you for comment.

Mr. PICKENS. I think the threat is the kind of legislation that Senator Johnson came up with. That is the threat I see to the industry and to the consumer and to the American people.

Senator WALLOP. Thank you, gentlemen. This room has a nomination hearing at 1:30, and I have an intelligence budget markup at 2:00 which I have to chair. So, I appreciate it very much. One last comment. Mr. Pickens, you still are a stockholder of Gulf, as I understand it. Gulf, however, did not consider you a stockholder because you borrowed money to buy the stock.

Mr. PICKENS. That is right.

Senator WALLOP. Is the new entity, SOCAL, with borrowed money, going to qualify it as a stockholder, or will you all be in the same boat?

Mr. PICKENS. Is what?

Senator WALLOP. Is the $13 million going to qualify SOCAL as a stockholder or will you all be in the same boat? [Laughter.]

Mr. PICKENS. I think that is going to clean up all of the stockholders.

Senator WALLOP. Thank you. The last panel—and I am sorry to have kept you waiting so long; but this has been of interest to all of us—is Dr Michael Gort, professor of economics, State University of New York at Buffalo, and Mr. William Harmon, general counsel and principal and secretary with Morgan Stanley & Co. in New York, accompanied by Mr. James Fralick, senior economist. I appreciate your being here and Dr. Gort especially, what you have provided to my office has been most useful in the hearings.

STATEMENT OF MICHAEL GORT, PH.D., PROFESSOR OF ECONOMICS, STATE UNIVERSITY OF NEW YORK AT BUFFALO, BUFFALO, NY

Dr. GORT. Thank you, Mr. Chairman. I assume that my full statement will be in the record and so I will only present a brief summary. I would first like to turn attention to the consequences of mergers generally. We know that there are some that have been very successful in terms of the efficiencies that they have generated, but with the evidence at hand, we cannot be sure that mergers in general lead to greater efficiency or improvements in managerial policy.

In the absence, however, of hard evidence and clear standards for judging the effects of mergers on efficiency, the prudent policy seems to be to allow those in the industry to make their own decisions. Public policy should not encourage mergers, but neither should it, in the absence of compelling considerations, impose obstructions in the way of the possible gains that might result from them, and have noted that some do indeed generate very large gains.

Regardless of whether mergers do or do not generate benefits restricting them imposes a limitation on the use of property that in itself reduces the value of such property. Now, turning to oil mergers in particular, one of the obvious questions is why, in recent years, have the acquisition prices for oil companies been so much above the preacquisition market prices of the stock? I believe that in large measure this premium results from a hedge against the risk of sharply higher prices of crude oil in the long run, resulting from some of the factors that Mr. Schuler noted today. It is important to provide opportunities for integrated oil companies to hedge against such risks. For the shareholders of acquired companies, the merger involves an immediate increase in their income and wealth.

A prohibition of oil company mergers would, therefore, depress the price of oil stocks to the extent that it excluded the possibility of being bought out, and this, in turn, would raise earnings-price ratios on oil stocks and, hence, the cost of capital. On balance this must have an adverse effect on exploration and development.

Why, then, should anyone wish to prevent such mergers? Three objectives have being raised, and all three are incorrect. The first is that oil company mergers are likely to reduce drilling for oil in the United States. This question has already been dealt with briefly, and I would only add the following. Drilling depends, as indicated by Mr. Keller, upon current and anticipated prices of crude oil and on the cost of exploration and development. The 20 largest oil companies account for only about half of domestic expenditures on drilling, the rest being accounted for by some 10,000 producers of crude oil. A reduction in outlays by any one company isn't likely to reduce aggregate expenditures. It will simply be offset by an increase in outlays by someone else. Moreover, though acquiring firms sometimes incur large amounts of debt to finance acquisitions, this in itself does not mean that they must reduce their outlays on exploration and drilling for oil. More than 80 percent of such expenditures are, in any case, financed through the reinvestment of gross earnings and not through debt capital. Therefore, to the extent that earnings generated by the acquisition cover the interest payments, there is no reason for a reduction in future expenditures.

The second argument that is given is that the debt used to finance a merger reduces the available credit on the economy. Mr. Keller has dealt at some length with this question, and I won't repeat his comments. One might, perhaps, add that the only conditions under which such debt could reduce the availability of credit for business investment is if the shareholders who receive cash in exchange for their shares either go abroad for their investment or else spend their money on consumer goods instead of investing the money. Both eventualities are unlikely.

Finally, the third argument relates to monopoly. Insofar as crude oil production is concerned, there simply is no monopoly problem to speak of. The question has been raised as to what would happen if Exxon and Mobil, or Exxon and SoCal, were to merge. Insofar as crude oil is concerned, there would be no consequences. That is, in the unlikely event that all of the six largest companies were to combine into one, they would still account for only about 6 or 7 percent of the non-Communist world's supply of crude oil. Monopoly considerations, insofar as they relate to oil company mergers, are limited to pipelines and to certain refining and marketing facilities, and these are I believe adequately dealt with under existing antitrust law. Thank you.

Senator WALLOP. Thank you, Dr. Gort. Mr. Harmon.

[Dr. Gort's prepared statement follows:]

Testimony of Michael Gort for presentation

before Committee on Finance, United States Senate,

Subcommittee on Energy and Agricultural Taxation, April 5, 1984

My name is Michael Gort. I am currently Professor of Economics at the State University of New York at Buffalo, a position I have held since 1963, and I hold a Ph.D. degree in economics from Columbia University. I have also served as a faculty member of the University of California, Berkeley, the University of Chicago, and Northwestern University, and have been a member of the senior research staff of the National Bureau of Economic Research.

I have served as a consultant to a number of agencies of the federal government, including the Federal Trade Commission, the Department of Commerce, and the Department of Health and Human Services. In addition, I have served as a consultant to agencies of state governments, and to numerous private corporations.

My publications include a number of widely cited studies that deal directly, or indirectly, with corporate mergers and their consequences.[1] In addition, I have been responsible for numerous publications that focus on studies concerning the organization of markets in the United States.

Recent mergers in the oil industry have been dramatic both in the magnitude of the assets transferred from one group of owners to another, and

[1]Among these publications are: Diversification and Integration in American Industry, Princeton University Press, 1962; "Diversification, Mergers, and Profits," in W. Alberts and J. Segall, The Corporate Merger, University of Chicago Press, 1962; "An Economic Disturbance Theory of Mergers," Quarterly Journal of Economics, November 1969; "New Evidence on Mergers," Journal of Law and Economics, April 1970.

in the capital gains realized by many shareholders. It is understandable, therefore, that they have attracted wide interest. And with interest has come puzzlement about the reasons for the phenomena and a natural reaction of suspicion towards the unknown. But before we embark on the manufacture of remedies for oil mergers, we should first ascertain if there is anything to be remedied. This, in turn, requires a better understanding of what has been happening. With this objective in mind, I shall raise a number of questions and then proceed to answer them.

1. What function, if any, do oil mergers perform?

The answer to this question may be found largely in the price offered by acquiring companies for the shares of the acquired firms. Why have acquiring companies paid so much more than the pre-acquisition market price of the shares subsequently acquired? If we consider the recent earnings of the acquired firms, their shares do not appear to have been greatly undervalued prior to merger. It is obvious, therefore, that the managements of acquiring companies expect that future earnings may be very different from those of the recent past. Is there some factual basis for such expectations?

There are two reasons that might cause the future of an oil company to be different from its past. The first of these is superior managerial policies. If managerial decisions after acquisition show improvement, the property increases in value and there is a consequent gain to shareholders, as well as as in the overall efficiency of the economy. The premium over market price that is paid for the stock simply reflects a sharing of the anticipated gains from merger between the shareholders of the acquiring and the acquired company. There are many observers of the industry who ascribe mergers to such anticipated gains. While the evidence in support of this view may as yet be more anecdotal than definitive, it is unreasonable to foreclose, by prohibiting mergers, the possibility of such improvements in management unless there are compelling offsetting considerations.

The second reason for paying a large premium above current market price rests in expectations about future prices of crude oil. Current market prices of shares reflect anticipated earnings in the relatively proximate future and are, in turn, based on earnings experience of the recent past. If, however, the price of crude oil were to rise much faster in the long-run than the general price level, the earnings experience of the recent past would be a misleading indicator of the value of the property.

There are considerable differences in long-run projections of crude oil prices--that is, projections over the next ten or fifteen years. The uncertainties arise from many sources: (a) the probable growth in energy demand (b) the rate of discovery of new reserves and the future costs of exploration and development (c) the ability of the oil cartel to function effectively (d) the consequences of political instability abroad on supplies of imported oil (e) the political obstacles at home to developing oil resources on federal land, and still other variables. It may, therefore, be reasonable for integrated oil companies to hedge against these uncertainties that could lead to vastly higher prices of the raw material that is essential to them. Such hedging could make sense even if everyone believed there was at least some possibility that future oil prices, in real terms, would be lower rather than higher than today's prices.

The discussion above leads to the conclusion that oil mergers perform a very important economic function somewhat similar to the role of futures markets in our economy. The acquisition price of oil company shares is the price paid today for crude oil that will be coming on stream many years into the future. As such, it performs the vital function of (a) allowing integrated oil companies to hedge against some of the risks of the future and (b) allowing shareholders who have a shorter planning horizon, or who believe that crude oil prices will not rise greatly, to realize a substantial increase in their near-term income and wealth.

To prohibit oil mergers, therefore, is to increase the perceived risks to some integrated oil companies, and to deny to shareholders of companies that might be acquired an opportunity to increase the value of their assets in the near future. For both reasons, the effect of such a prohibition on the market price of shares in oil companies is bound to be negative. This would, in turn, raise the ratio of earnings to the market price of oil company stocks and, hence, the cost of equity capital. Though we do not know the magnitude of the effect of such increases in the cost of capital on investment in exploration and development, the effect has to be negative. Thus future supplies of crude oil are likely to be adversely affected by such prohibitions on mergers.

2. Are there any reasons to suspect the effect of oil mergers on exploration and development may be negative?

There are two reasons frequently offered for the conclusion that the effect of oil mergers on drilling for oil will be negative--and both are incorrect. The first is that if an integrated oil company acquires crude oil reserves through merger, it has no incentive to search for new supplies. This view is based on the naive conclusion that integrated oil companies drill for oil merely to provide the raw material for their refinery runs. In fact, as we know, there is a world market for oil. Indeed, some integrated oil companies sell a large fraction of their crude oil production while buying crude oil supplies that are closer to their refineries from other companies.

The principal variables that determine the level of expenditures on exploration and development are the costs of drilling, the likelihood that oil will be found (that is, the opportunities for discovering oil), and the current and expected future price of crude oil. The effect of crude oil prices is dramatically illustrated in the changes that have occurred both in prices and drilling expenditures between 1970 and 1980. In 1970, the average price of domestically produced crude oil was $3.18 per barrel. By 1980 it had risen to $20.89. But concurrently, drilling for oil and gas in the United States (including expenditures on dry holes) rose from $2.58 billion to $22.8 billion.

But, one might ask (and this is the second argument referred to above), will not the large amount of debt that acquiring firms sometimes incur in financing a merger reduce their ability to raise capital funds for drilling? In response, one must first note that oil companies typically finance exploration and development outlays through reinvested gross earnings and not through debt capital. For a large sample of medium-sized and large oil companies, data compiled by the Chase Manhattan Bank showed that, in 1980, 86 percent of investment expenditures were financed through the reinvestment of gross earnings. Hence, a large outstanding debt need not significantly reduce capital outlays by acquiring companies.

Even more important, however, aggregate drilling expenditures in the United States do not depend upon how much any one or two companies decide to spend. There are roughly 10,000 producers of crude oil in the United

States. And the expenditures of even the 20 largest companies were only one-half of aggregate spending on exploration and development in the United States in 1980 (the last year for which data are available). In the same year, the spending of the six largest companies accounted for less than one-fourth of the total. In short, a reduction in outlays by any one company can reasonably be expected to produce an offsetting increase in spending by other producers.

3. But does not the large volume of debt used to finance oil mergers reduce the financial resources available for exploration and development?

First, to put the problem in perspective, even in the unlikely event that the entire acquisition cost of a company such as Gulf were financed by debt, it would represent a very small fraction of aggregate new borrowing in a single year. Net new borrowing in the first half of 1983 (the last data available) was at an annual rate of $585 billion (as compared with the proposed price of roughly $13 billion for Gulf). As a fraction of total outstanding debt (rather than net increases in debt), credit issued to acquiring firms would, of course, be vastly smaller. Our economy is so large that even $13 billion is a mere ripple in the financial markets.

But more important, it is incorrect to conclude that debt used to finance a merger reduces the available credit in the economy. If an acquiring firm issues debt instruments in exchange for cash, the investors who previously held cash now hold securities. However, the shareholders who previously held stock in the acquired firm now receive cash. Their propensity to invest this cash is roughly the same as that of investors who bought the acquiring firm's bonds or notes. Accordingly, nothing of significance has changed. It is simply bad economics to conclude that debt-financed mergers affect interest rates or the availability of credit for any use such as drilling for oil.

To make the point clearer, let us consider the three principal ways in which credit is used in the financing of mergers. First, the acquiring company may issue debt obligations (bonds and notes) to shareholders of the firm to be acquired. Second, the acquiring company may sell its debt obligations to other non-bank investors and use the cash proceeds to buy the shares of the firm to be acquired. Third, the acquiring company may obtain bank loans and use the proceeds of these loans to purchase the shares of the targeted company.

The first alternative is the simplest. Shareholders of the acquired firm find themselves holding one type of security, the bonds or notes of the acquiring firm, for another type of security, namely, the shares they previously held. The effect, therefore, on the availability of credit should be nil.

The second alternative, namely, the sale of the acquiring firm's debt obligations to other investors, is very similar in its effects to the first alternative, though the route through which funds travel is more circuitous. Some investors now hold the debt obligations of the acquiring firm in place of cash that they previously held. The propensity to reinvest cash in securities should be roughly the same for the previous shareholders of the acquired firm as it is for investors who purchased the acquiring firm's bonds or notes. Accordingly, once again there is no change in the availability of credit.

Now consider the third alternative. The acquiring firm secures bank loans and the proceeds are used to purchase shares. Initially, the business loans of banks have increased. The ratio of demand deposits to required bank reserves has risen and, it would seem, the availability of bank credit has been reduced. But what do the previous shareholders who now hold cash do with their cash? They can buy other securities in the market. But since the total volume of such securities has not increased as a result of the merger, their purchases will merely leave someone else holding cash. Ultimately, the cash must be used either to reduce the indebtedness of investors to banks, or to finance new capital requirements which would otherwise have been financed by banks. The first of these two alternatives would restore the previous ratio of deposits to reserves (the level that existed prior to the loan to finance the merger). The second alternative entails a substitution of funds provided by non-bank investors for loans that would have been made by banks, thus offsetting the effect of the original loan and leaving the supply of available loanable funds unchanged.

4. Sometimes a part of an acquired company (for example refining and marketing facilities) is sold to foreign investors. What effect does this have on competition and on financial markets?

It does not affect competition since the number of competing sellers remains the same. Foreign investment in the United States increases the availability of credit in the U.S. and reduces interest rates. Indeed, it has served the important function of offsetting the negative balance of trade that we have had.

5. Will the mergers lead to a level of concentration in the ownership of crude oil and natural gas production facilities sufficient to result in monopoly power?

No, even the largest oil companies control a very small fraction of the non-communist world's crude oil and gas capacity. The world-wide crude oil production of the six largest companies in the United States was 3.3 million barrels per day in 1982. This is roughly 5 percent of aggregate world-wide production, or between 6 and 7 percent if one excludes the USSR and China. Thus, even in the most unlikely event that all six companies combined into one, there would be no perceptible increase in monopoly power in the market for crude oil.

Monopoly considerations, insofar as they relate to oil company mergers, are limited to pipelines and to certain refining and marketing facilities. These, however, can be adequately dealt with under existing antitrust law.

6. What is the effect of debt issued by acquiring companies to finance mergers on federal tax revenues?

This subject has, I understand, been discussed at length in other congressional hearings. It has been pointed out that though interest on the newly issued debt is deductible for tax purposes, the recipients of such interest are subject to tax. Hence, one offsets the other except insofar as the tax brackets of interest payers and interest recipients differ. To the extent, however, that a merger results in an increase in the aggregate value of assets, for example because of managerial efficiencies, the resulting capital gains will produce a higher level of future income. This, in turn, will produce tax revenue not only from the capital gains tax but from taxes on the higher level of future income.

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STATEMENT OF WILLIAM HARMON, GENERAL COUNSEL, PRINCIPAL AND SECRETARY, MORGAN STANLEY & CO., INC., NEW YORK, NY

Mr. HARMON. Thank you very much. My name is Bill Harmon and I am general counsel of Morgan Stanley. This is a New York investment banking firm. With me today is Jim Fralick, who is a senior economist with our firm, who is knowledgeable about the credit market. We appreciate the opportunity to appear before your subcommittee to express our firm's views on the role tax considerations play in oil company mergers. I would like to make a few remarks initially, and then Jim and I would be happy to answer any questions which you may have. Our firm is a full-service investment company. We are a leading firm in investment activities and serve as financial advisors to both acquirers and acquirees in merger transactions, including both oil and gas mergers.

I should note that we are serving as the financial advisor to Standard of California in its acquisition of Gulf Oil Corp. On the basis of our experience, I would like to offer several observations on the impact of tax considerations on merger activity. Fundamentally, we believe that mergers including oil company mergers are motivated by fundamental business needs and economic considerations, such as the desire to acquire undervalued assets, to achieve economies of scale, or to enter new product areas as a for instance. As a general observation, mergers are essentially capital transactions involving the change of ownership or the redeployment of assets in a manner dictated by market forces. Because mergers are capital transactions, they are an integral part of our free market economy, and any tax regime should not be designed to impede these transactions as a policy matter over and beyond accepted notions of taxation of income and gains. In other words, the tax laws ought to be neutral. We do not believe that the current tax law creates any special incentives for mergers on the part of the acquiror, the acquiree, or the acquiree's shareholders.

In our experience as a financial advisor for over 150 mergers over the last decade, we are not aware of any merger or acquisition where the merger was motivated primarily or even in significant part to achieve tax benefits. Nevertheless, part of the structure of the transaction clearly takes into account the tax considerations, and there are economic significances to those tax considerations, but we are not aware of mergers that are primarily tax driven. I would like to address a few specific issues which have been raised earlier today. Certainly, I think the primary question that comes up in the tax policy area is the so-called tax subsidy of interest deductions on debt incurred to acquire another company.

We believe that this simply isn't a correct characterization of the facts. Our tax laws have always permitted corporations to deduct interest for funds borrowed, whether to purchase stock or real assets, to build a plant or equipment, to develop new products, or for general operating purposes. There is no reason to view the acquisition of another company through a merger as any differently than we would the acquisition of these other properties. We might note that the borrowing of funds does not create interest deductions for the borrower without creating corresponding interest income for the lenders, which is subject to tax. And we do note that in the floor debate there was some allusion to the fact that banks were the lenders which have a lower effective tax rate and therefore there was a tax differential between the interest deduction and the interest income.

In fact, it doesn't take into account that banks are intermediaries. The real source of funds are depositors, the purchasers of the certificates of deposits, the holders of savings account and NOW accouts whose tax rate really is the applicable one. With respect to the tax consequences of reorganizations, which were also discussed earlier, we understand that the Senate Finance Committee has under its consideration a number of issues under subchapter C and the taxation of gains on the sale or liquidation of corporate entities.

We believe that any reorganization issues raised by oil company mergers really should be addressed in the context of that subchapter C study. We would like to point out that the changes to section 338 of the Internal Revenue Code in 1982 have eliminated the ability of an acquiring company to selectively step up the tax basis of some assets without incurring recapture on other assets.

Finally, mergers do not provide any special tax treatment to shareholders that do not otherwise exist for shareholders of any other publicly held company. In other words, there is nothing in the transaction that itself gives rise to tax incentives for shareholders per se. Senator Specter has introduced legislation which parallels H.R. 3170, in addressing the 85-percent dividends received deduction. This issue is one that affects the efficient functioning of the capital markets as a whole, and has been addressed by others in hearings on that subject. This issue is not essentially a merger issue except for persons buying less than 50 percent of the stock of an acquiree.

I know there was much discussion again on the floor during the debate that somehow there was something going on that was not quite appropriate to have a corporation own a significant amount of the stock of another corporation and be entitled to a dividends-received deduction. That has been the entire history of consolidated tax returns and intercorporate dividends. When there is ownership in excess of 50 percent, even Senator Specter's bill would not operate to disallow the interest deduction. Clearly, in the mergers that have been discussed recently, those are mergers for corporate control and eventually complete buy-out, and the dividends received deduction is essentially an irrelevant issue. I think in summary our free market economy is based upon the efficient allocation of resources and as a matter of tax policy we see that there is little basis to discriminate against mergers in general and oil company mergers in particular, as opposed to other types of capital transactions. To the extent to which there is a discrimination in the tax regime, that gets translated into cost capital and to the allocation of resources by investors among investment opportunities. That concludes our remarks, but we would be happy to take any questions.

Senator WALLOP. Thank you, Mr. Harmon.

[Mr. Harmon and Mr. Fralick's statement follows:]

Statement of William R. Harman
Principal and General Counsel
Morgan Stanley & Co. Incorporated
before the Senate Finance Committee
Subcommittee on Energy and Agricultural Taxation

April 5, 1984

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1. Mergers are Not Tax Driven

Most mergers are driven by the desire to acquire undervalued assets, to achieve economies of scale or to enter new product areas. These are economic considerations.

Mergers are essentially capital transactions involving the change of ownership or the redeployment of assets in a manner dictated by market forces in which the acquiring corporation believes it can realize greater value for the shareholders than presently exists.

2. Mergers are Capital Transactions

Because mergers are capital transactions, they are an integral part of our free market economy and any tax regime should not be designed to impede these transactions as a policy matter, over and beyond accepted notions of taxation of income and gains. (In other words, the tax burdens on mergers should not be greater than on other capital transactions, such as purchases and sales of assets, issuance of securities or secondary market activities). The alteration of a uniform approach would disturb the abililty of the market to shift assets into more productive hands.

3. Few Tax Incentives

We do not believe the current tax law creates incentives for mergers on the part of the acquiror, the acquiree or the acquiree's shareholders. In our experience as a financial advisor for over 150 mergers over a ten year period, we are not aware of any merger or acquisition where the principal motivation was tax benefits.

4. Deductibility of Interest

Some have questioned the so-called "tax subsidy" of interest on debt incurred to acquire another company. We believe this is a misrepresentation of the facts. Our tax laws have always permitted corporations to deduct interest for funds borrowed, whether to purchase stock or real assets, to build plant and equipment, to develop new products, or for general operating purposes. There is no reason to view the acquisition of assets through a merger any differently.

- Furthermore, the borrowing of funds does not create interest deductions for the borrower without creating interest income for the lender which is subject to tax. Depending on the tax rates of the borrowers and lenders, the tax revenues and expenses should be a wash.

- Some have observed that banks as lenders have a lower effective tax rate resulting in a cost to the Treasury. This is specious logic. Banks are intermediaries for the ultimate lenders, depositors, in the form of certificates of deposit, savings accounts or NOW accounts. Interest income is taxable to them at their rates.

- We should also note that a disallowance of an interest deduction for acquisition debt would favor foreign corporations seeking to acquire U.S. companies because they can borrow and deduct interest in their own countries.

5. Tax Incentives in Reorganizations

We understand the Senate Finance Committee has under consideration a number of issues relating to corporate reorganizations under subchapter C and taxation of gains on the sale or liquidation of corporate entities. We believe that any tax issues raised by reorganizations occasioned by mergers should be considered in that forum.

- The changes to Section 338 of the Internal Revenue Code in 1982 have eliminated the ability of an acquiring company to selectively step up the tax basis of some assets without incurring all of the recapture taxes associated with the acquiree.

6. Tax on Shareholders

Mergers do not provide any special tax treatment of shareholders that do not otherwise exist for stockholders of any publicly held company. Senator Specter has introduced legislation which parallels H.R. 4170 in addressing the 85% dividends received deduction. This issue is one that affects the efficient functioning of the capital markets as a whole and has been addressed by others in hearings on that subject. This issue is not essentially a merger issue, except for persons buying less than 50% of the stock of an acquiree.

- In fact, premiums paid in merger transactions have been a major generation of capital gains tax revenue and any specific tax restraint on mergers would result in a decline in portfolio values for shareholders resulting in smaller gains or perhaps capital losses when sold and lower Treasury revenues.

- For example, it has been estimated that the SOCAL/Gulf merger will give rise to $2 billion in tax revenues from capital gains realized by Gulf shareholders.

WRITTEN STATEMENT OF WILLIAM R. HARMAN
PRINCIPAL AND GENERAL COUNSEL
MORGAN STANLEY & CO. INC.

Submitted to the

SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE
SENATE FINANCE COMMITTEE

In Connection with Its
Hearing Held April 5, 1984
Regarding

FEDERAL INCOME
TAX CONSIDERATIONS IN
OIL AND GAS COMPANY ACQUISITIONS

This statement is submitted as a supplement to my oral comments and summary of principal points presented to the Subcommittee at its hearing on April 5, 1984. Morgan Stanley & Co. Inc. is an investment banking firm located in New York City. It has been intimately involved in all phases of corporate acquisitions and mergers. This has included considerable efforts with respect to oil and gas mergers and acquisitions. In fact, over the past ten years we have been involved in over 150 corporate mergers and acquisitions, including Dupont-Conoco, Texas Gulf-Societe Nationale, ELF-Aquatine, Shell-Belridge, Socal-Gulf and the current Shell Oil buyout.

The Joint Committee Print concerning tax considerations in oil and gas acquisitions had just become available at the time of the Subcommittee's hearings on this matter.

This precluded in-depth comment at that time on the analysis and possible changes in the tax laws contained in the Committee Print. Therefore, we would take the opportunity presented by this written submission to comment on those matters.

Before turning to the Committee Print, however, one point bears reiteration. In our experience over the past ten years, we have not encountered a single merger or acquisition in which the principal motivation was tax benefits. Obviously tax considerations play an important role once an acquisition decision is made, but these considerations are subsidiary to the business factors underlying the decision.

THE JOINT COMMITTEE PRINT

Introduction

The pamphlet Federal Income Tax Considerations in Oil and Gas Company Acquisitions labors to present abuses in the tax treatment of oil and gas mergers that might be responsible for the recent merger activity in that industry. Unable to do so, it catalogues the current treatment of tax-free reorganizations and taxable acquisitions. Using a tone that connotes unwarranted and pervasive abuses, it raises questions about the tax treatment of specific items, with the note that any solution could be selectively targeted at the oil industry. A closer examination of the provisions involved, however, demonstrates that this punitive approach is unwarranted.

Overall, the pamphlet has been virtually unable to identify any unique treatment in the current tax laws favoring mergers in the oil and gas industry. Instead, the pamphlet's comments generally fall within three categories. First, many of the comments describe the general treatment of corporate mergers, acquisitions, and reorganizations, suggesting that any advantageous tax treatment is a patent abuse of the tax system. A minimal examination of the rationale behind particular provisions, however, quickly brings to light their economic and common sense basis. Second, some of the comments focus on past transactions that have led to amendments of the tax code, obviating the concerns expressed. And finally, where such amendments were not enacted retroactively, the pamphlet points out the failure to recapture past benefits. It does not discuss, however, whether the past Congressional compromises embodied in these transitional rules were equitable or just.

Since the tax treatment identified in the pamphlet is not unique to the oil industry, it is clearly inappropriate to modify corporate tax law in respect of that industry alone, unless it is specifically determined that these laws should be designed to inhibit mergers in that industry alone. This is not to say that amendment of the tax code in the interest of simplification and equity is not warranted. But this effort should be undertaken in the context of general corporate and business transactions.

<u>The Pamphlet's Description of the Present Law</u>

The Joint Committee Print provides an accurate and useful description of the present law concerning corporate acquisitions and mergers. On the other hand, it suggests tax abuses and loopholes where neither truly exists. For example, the pamphlet acknowledges that in the case of a taxable acquisition of assets from a non-liquidating acquired corporation, the acquiring corporation cannot realize the tax benefits of a step-up in basis unless the acquired corporation recognizes income on the sale or exchange of the assets. The pamphlet proceeds to state, however, that the acquired corporation can use its operating losses to offset income from the sale.

This is a misleading statement if it is intended to indicate that, for most asset distributions, the recognition of gain is of no import because a net operating loss will probably be available to offset part or all of the income. First, whether an acquired corporation has a net operating loss will vary from case to case. Second, this assumes that no cost is incurred when a net operating loss, rather than cash, is used to satisfy the tax liability. This is incorrect because the use of the loss against the asset-sale income eliminates a loss that could have been used to shelter future income. In any case, it is rational and equitable that the taxable gain resulting from past appreciation and the carryover of past losses should offset one another. The gain on the sale most likely reflects asset appreciation that occurred during the same period that the net operating loss was generated. This is one application of the tax policy underlying the generally applicable loss carryover provisions of section 170.

The pamphlet also spends an inordinate amount of space discussing obsolete law. It describes in detail the tax treatment accorded the U.S. Steel-Marathon Oil transaction, but notes that the preferential tax treatment accorded that transaction is no longer available after the enactment by TEFRA of section 338. This point bears re-emphasis: The only bona fide example of questionable tax treatment of an oil merger that is identified in the pamphlet has been eliminated by TEFRA.

The pamphlet notes that a number of tax benefits (such as accelerated depreciation) permit early tax write-off of the cost of an asset, resulting at times in a mis-matching for tax purposes of expense and the income attrib-utable to that expense. Although this is true, it is half the story. These deliberately enacted tax benefits are designed to create an incentive for certain capital allo-cation decisions, such as investment in fixed assets and the exploration for oil. The implication that this is a tax abuse, much less a tax abuse unique to the oil and gas industry, is unwarranted.

In its summary of present law, the pamphlet also discusses certain international aspects of borrowing. It implies that it is inappropriate to provide a deduction for interest expense when the interest is paid to a person not subject to U.S. taxation. This argument confuses the revenue impact of a particular transaction with the integrity of the deduction permitted. It is no more reasonable to deny a deduction for interest because the money was borrowed from a foreign lender than it is to deny a cost-of-goods deduction to a U.S. company because the goods were purchased overseas. In either case the U.S. taxpayer has experienced a very real cost of doing business that should be taken into account in a calculation of its taxable income. And, of course, this is not a situation unique to the oil and gas industry.

Another example of the strained analysis that is necessary to the assertion that tax benefits fuel corporate mergers is found in the discussion of the dividends received deduction. The pamphlet states that a corporation unable to use an interest deduction will have a tax incentive to issue stock instead of debt to finance an acquisition. Viewed in isolation, there is some truth to this statement. To the extent, however, that it is intended to indicate that this consideration will determine the financing of an acquisition, the statement is completely inaccurate. Acquisition financing is primarily determined by financial statement considerations of the acquiring corporation, such as debt capacity. Other considerations include potential dilution of outstanding shares and the sale of stock at less than book value. Further, in order for a corporation to have an incentive to issue stock because it is "unable to use an interest deduction," the hypothetical inability must extend to a number of years in the future, since any interest deduction could generate a net operating loss usable in future years. Similarly, the pamphlet's assertion that a corporation is able to "pass the tax benefit of interest deduction on to its shareholders" through the dividends received deduction is true only to the extent that it has taxable corporate shareholders.

THE CHANGES MENTIONED BY THE PAMPHLET

The pamphlet lists a number of changes in the tax laws that could be enacted in response to the concern that tax considerations were leading to oil and gas industry mergers. Since no provisions favoring oil and gas mergers were unearthed, the suggestions are generally applicable to all corporate acquisitions and mergers. Nonetheless, it is pointed out that they could be limited in application in oil and gas company acquisitions and mergers.

An examination of these possible changes indicates they are generally aimed at nonexistent problems. Further, in the absence of other reasons for inhibiting oil industry mergers, acquisitions, and other capital realignments, there is no justification for unique application to the oil industry.

Mandatory Asset Acquisition Treatment

The first possible change noted by the pamphlet is to require that an acquisition of stock in a transaction not qualifying as a tax-free reorganization be treated as a direct acquisition of the assets of the acquired corporation rather than as a stock acquisition. This would mean the acquired company would have taxable income with respect to its assets, even though consideration was received by the shareholders and not the company. The taxable income could be limited to items now recaptured on liquidation, or it could be expanded to include all of the appreciation of the assets. This suggestion follows from the untenable assertion that controlling the stock of an acquired oil and gas corporation is actually the acquisition of the assets of that corporation. So long as the acquired corporation continues to operate as a unit and its corporate integrity is maintained, the similarity to an asset acquisition is minimal. In any case, there is no tax justification for singling out oil companies in this regard.

Effect of a Section 338 Election to Treat as an Asset Acquisition

The pamphlet also states that the law could alternatively be changed to require recognition of all of an asset's appreciation when it is the subject of a section 338 election. The point is made that the current treatment is "inconsistent" with a pure two-tier tax system. Although this is true, no rational argument is or can be made that this should be limited to the oil and gas industry if enacted. In addition, the current tax treatment of liquidating distributions has been a part of our tax system for decades and should be altered only with an awareness of the full complexity and impact of the issue. In any case, the tax advantages of a non-liquidating dividend distribution of appreciated property (such as to a royalty trust) are eliminated in the tax bills now before Congress.

The pamphlet also suggests that the recapture rules could be "tightened" by requiring inclusion of intangible drilling costs deducted before January 1, 1976 and the inclusion of certain percentage depletion deductions. As noted before, the current exclusion of old IDC and depletion from recapture represents a compromise developed years ago by Congress. And, percentage depletion deductions are no longer available to oil companies of any significant size.

The pamphlet mentions that cost depletion could also be recaptured. As pointed out by Mr. Pearlman of the Treasury, however, <u>cost</u> depletion deductions are an appropriate recognition that oil reserves are wasting assets that physically diminish over time. Any capital gain on sale of such an asset will generally represent appreciation of the remaining portion of the asset. Although the depletion deduction is unique to mineral extraction, it is a reasonable response to these economic realities. The major potential for tax abuse, percentage depletion, has long been eliminated in the case of significant oil companies.

Interest Expense

The pamphlet mentions two possible tax law changes concerning interest expense. First, no deduction could be allowed with respect to interest paid on indebtedness to finance oil company acquisitions. The pamphlet notes that "many" have argued that the income tax laws motivate the acquisition of oil companies by permitting acquirers to deduct currently interest paid or accrued on debt incurred in connection with the acquisition. This is not the case. Acquisitions in the oil industry as well as other industries are motivated primarily by the business needs of the corporations involved. And, in fact, the deductibility of interest payments is not a primary consideration as to how an acquisition is financed. Of primary importance is the impact on the financial statements of the combined company and the desire of the resulting company to maintain a targeted capitalization that is appropriate for its industry. Corporations determine their financing with an eye to their pro forma earnings per share prior to the transaction. Although the deduction for interest is a factor in this calculation, it is only one of many financial considerations that will eventually determine whether the corporation uses debt or equity in the acquisition.

The pamphlet again makes the point that the lender from whom the acquisition debt was borrowed may not be a U.S. taxpayer. This is irrelevant to the integrity of the acquiring corporation's deduction. Unless the law is actually designed as a subsidy for U.S. lenders, the identity of the lender should be of no import.

The pamphlet also suggests that debt incurred by a member of a consolidated return group in connection with the acquisition of an oil and gas company could be allocated between domestic and foreign sources on a group basis. This suggestion is inappropriate. First, there is no reason to treat debt incurred in connection with oil and gas acquisitions any differently in this regard from other corporate debt. Further, the allocation of interest expense to income from U.S. and foreign sources is the subject of a complex regulation by the Treasury Department. To the extent Congressional amendment of these regulations might be considered, any changes should be taken only after a thorough review of the particular issue and not merely to create a special tax regime for the oil industry.

Installment Sales

The pamphlet in a number of places discusses the treatment of installment sales. The pamphlet indicates that it is anomalous and abusive to allow a taxpayer a cost basis in property that is purchased on the installment method. The argument is that basis-related tax benefits, such as cost recovery, should be limited to the amount of the installment price that has been paid to that time. This has little relevance to major oil and gas company acquisitions: we are not aware of a major oil and gas acquisition that was financed using installment notes. In any case, this approach reflects a misunderstanding of the fundamental nature of installment sales.

An installment sale amounts to seller financing of the transaction. If the purchaser of an asset (such as corporate stock) incurs debt to pay cash for the asset, there is no doubt that he should get the immediate benefit of the property's new basis. Yet, this does not materially differ from the use of an installment note, except the buyer's debt is to the seller. Limiting the cost recovery deduction available in the context of an installment purchase would merely force the same transaction to be performed through a financing intermediary.

It is also an analytical nonsequitor to condition the buyer's basis on the seller's recognition of income. The installment sale rules merely postpone recognition until the seller receives consideration in a liquid form; this is completely independent from an unrelated buyer's tax circumstances. And, in any case, this situation is not unique to the oil and gas industry, and a provision targeted towards that industry is punitive and inappropriate.

Dividends Received Deduction

The pamphlet's suggestions relating to the dividends received deduction also address concerns that are not unique to the oil industry. The discussion indicates that the deduction can lead to minimal taxation on corporate income if the company that pays the dividend does not have taxable income. This occurs, apparently, when the payor has a "dividend-paying" capacity, meaning earnings and profits. This argument incorrectly suggests that income has improperly escaped taxation. Underlying this concern is a confusion of taxable income, which measures the extent to which the corporation should be taxed, and earnings and profits, which is used to characterize distributions by the corporation for purposes of taxing its shareholders. These two attributes are calculated differently, and accumulated earnings and profits can exist when a corporation has no taxable income for the year. This is not a basis, however, for objecting to the distribution of the earnings and profits, and a response that forces a tax to be paid by the shareholders on an otherwise nontaxable distribution is clearly out of place. To the extent that the concern is that the monies available for the dividend should be taxed at some point, it should be remembered that there will be no dividends received deduction available when the money is eventually passed to an individual shareholder.

Use of these concerns to justify an elimination of the dividends received deduction in the case of stock of an acquiring corporation issued in connection with an oil company acquisition is a nonsequitor. To substitute, as the pamphlet suggests, a dividends paid deduction would create an anomalous treatment of corporate dividends within one industry without a scintilla of rationale that is connected to that particular industry.

Consolidated Returns

Generally, the consolidated return regulations permit an affiliated group of companies to be taxed as a single entity. Complex rules control the use of past losses and other tax benefits of a newly acquired company. In discussing consolidated returns, the pamphlet indicates that it is inappropriate for an acquiring oil company to be permitted to deduct interest on acquisition debt against income of the acquired company. We oppose this suggestion since no doubt has been cast on the integrity of the underlying deductions or on the integrated nature of the corporations involved. And no particular aspect of the oil industry is noted that makes this special disability appropriate.[1/]

CONCLUSION

We oppose the possible changes contained in the Joint Committee Print for two general reasons. First, none address a significant problem that is unique to the oil industry or causing the recent merger activity. If tax neutrality is desirable, no changes to the tax laws are necessary. And second, each of the changes suggested is inappropriate as a matter of general tax policy. In the absence of other non-tax reasons for impeding oil mergers, these changes would be pointlessly punitive. And, to the extent the prohibition of oil mergers is chosen as a Congressional goal, the Revenue Code provides a particularly unwieldy lever to accomplish this end.

1/ A special exception for newly acquired domestic life insurance companies is included in the present law because those companies are subject to special treatment in the taxation of their income. The current 5-year waiting period for consolidation is a loosening of prior law that denied consolidation altogether. No such unique characteristics are present in the oil industry.

Senator WALLOP. Mr. Harmon, let me just inquire of Dr. Gort and perhaps Mr. Fralick. If you would discuss—what I heard was—I did not see this reported—but I heard was reported in the Wall Street Journal that this would have an effect on interest rates. I may be unfairly attempting to give them that conclusion, but I heard that that was the case. At any rate, it was a reported opinion, and so it is important for us to address from an economic standpoint whether or not interest rates may rise.

Dr. GORT. I don't believe there would be any effect at all on interest rates. In the first place, these transaction; are too small for the size of the capital markets in the American economy, and second for reasons that I have outlined, there is no direct effect on interest rates anyway since there is no effect on overall availability of credit. There would, however, be effects on the market price of oil shares, and that has similar consequences to rises on interest rates. If earnings-price ratios rise, that increases the cost of equity capital.

Senator WALLOP. Mr. Fralick?

Mr. FRALICK. I would agree. The mergers that we have seen to date would have little effect on interest rates. Basically, you are dealing with financial transactions where one asset—financial asset—cash is swapped for another financial asset or equity. At the time of the purchase the moneys that are raised to finance the merger simply flow to the owners of the corporation, in this particular case it would be Gulf, who in turn have the opportunity to either reinvest that money or to pay down debt. I think if you looked at a snapshot of the American economy at the end of 1983 and at the end of 1984. you looked at debt outstanding on both of those dates, you would see that there was absolutely no changes. Bank loans would increase and corporate equities would decrease. No change.

Senator WALLOP. There is a curious thing that comes to my mind that if the effect on interest rates comes as Dr. Gort said—if any—from the narrowing of the ratio between price/earnings, then the way to take care of interest rates in the country would be to legislate that they had to remain a certain distance apart. There are some who might suggest that, too, clearly, that is not an area that would be beneficial in terms of market efficiency, I would think.

Dr. GORT. That is the rise in stock prices that we do see is desirable—and the prohibition that would do the opposite would, of course, be undesirable from the standpoint of decreasing investment.

Senator WALLOP. Let me ask two quick questions and the we had better call this committee adjourned. Mr. Keller—I believe—made a statement and it seems to make sense, and that was if they didn't borrow money in their company for exploration—they would for acquisition. Is that a consistent thing?

Mr. HARMON. Yes. I think our experience is that among the major oil companies I think that there is a tendency not to borrow to explore, and I think among many of the independents it is a high risk activity. If you borrow the funds and spend the funds on exploration and find nothing, why you would have some serious problems. So I think that there is a tendency to finance any exploration activity out of normal cash flow as a matter of prudence.

Senator WALLOP. Let me just ask this one last thing then. You may have seen in the Sunday New York Times a comment by the head of the department of economics at Harvard that he was intuitively uncomfortable with these mergers and thought that maybe there was something there that was worth watching, but his second question was one which I plagiarized in my statement: How do you devise a standard which can determine between good mergers and bad mergers? Whether in the oil industry or generally?

Mr. HARMON. I think the basis thesis ought to be, Senator Wallop, a sense of fairness and a sense of permitting market forces to operate in ways that are not aberrant and to the extent to which you can ensure that, either through the trust laws or the securities laws, or eliminate distortions that might be caused if there were unusual incentives in merger activity on the tax side, that those are the checks and balances and the safeguards that for anyone as a matter of industrial policy or national policy to attempt to intervene in the marketplace to make qualitative determinations about whether this merger is good or this merger is bad is hopelessly subjective, and that would depend entirely on the persons making the judgment at any particular time. There would have to be objective standards that are well understood and rational and uniformly applied.

Senator WALLOP. Is it your feeling that the current statutes, but for perhaps a minor adjustment or two, as may have been mentioned this morning by tax people, and I would assume antitrust people would have similar kinds of minor adjustments—generally speaking, would you say that they provide the protection that the public policy demands of them?

Mr. HARMON. Absolutely.

Senator WALLOP. Dr. Gort?

Dr. GORT. I would like just to add one comment on the question of how do you tell whether a merger is successful in bringing about efficiency. Some years ago——

Senator WALLOP. Would you answer one thing in addition to that? Is that a matter of concern? Must we demand efficiency before we permit them because, if that is the case, I don't know how you can demonstrate the value of a future act.

Dr. GORT. That is precisely my point. Not only isn't it a matter of public policy, but there is no really effective way that it can be made a matter of public policy. I was about to say that some years ago we had a study of the success and failure of mergers and examined the consequences of mergers 5 years later. The comments that were made in response by those who disagreed with our conclusions is that we didn't look far enough into the future. You had to consider the outcome 10 years later. Obviously, we can't wait 10 years before we decide whether we are going to permit a merger or not. To require that kind of standard for approval in effect would mean prohibiting all mergers.

Senator WALLOP. Generally, in the case of mergers, there is a historical standard, and I would assume that that is fuzzy—that in some cases you had an increase in efficiency and in other cases you had a failure. But what happens with the failures? Maybe first, Mr. Harmon, and then Dr. Gort?

Mr. HARMON. I think, Senator Wallop, that there is one way to determine what is a good merger and what is a bad merger, and that is the marketplace will speak. A number of conglomerate mergers that took place a number of years ago where there was no sense—not that there was anything wrong with conglomerate mergers, but where there is no sort of business sense or logic for putting products together, those turned out not to be an efficient way to operate those businesses. They became subject to divestitures—voluntary divestitures some years later. They just didn't make sense to have unrelated activities operating out of the same organization although they might be successful with another group of management and in another geographic environment. So, I think the marketplace will determine whether a business combination is a successful combination or is unsuccessful through time.

Senator WALLOP. Do you agree with that?

Dr. GORT. Quite apart from the question of whether there are gains in efficiency, it would not be desirable to interfere with the market even if there weren't any. For example, we heard reference to undervaluation of oil stocks. Obviously Gulf wasn't undervalued in everyone's eyes or it wouldn't have been selling at less than $40 before the rumors of acquisition. But is it desirable to prevent someone who places a higher value on the shares from buying them from someone who has a lower estimate of their value? These are normal market transactions and restricting these normal market transactions in itself does a great deal of harm.

Senator WALLOP. I would assume that the ultimate consequence of that would be a black market someday. I mean, if Government were to make the determination as to what the market value of a given thing would be it would either mean no investment or a black market.

Mr. HARMON. Well, essentially to put a cap on it would eliminate one of the investor's legitimate expectations of the rate of return on his investment. It is a combination of dividends of all future prospects and those of the company and some putting them for merger value that is an intended number that he carries in his head, and to the extent to which you put a cap on that activity, that represents a real diminution of value for total values. For example, we did a study on from the period of the date of the announcement of the moratorium proposed legislation right on down to the day in which it was not acted upon on the floor—there was a decline in the aggregate of approximately $12 billion worth of value in the equity markets for aggregate numbers of energy stocks. In other words, that lack of industrial expectation for return of premium on merger activity got translated immediately into a diminished realm to the extent of $12 billion.

Senator WALLOP. That is a consequence of the Government revenue figures from another perspective, too. I want to thank you all, and I apologize for keeping you waiting, but we did have information to develop. I think it was a most useful hearing. Your testimony was welcome. Thank you.

Mr. HARMON. Thank you very much.
Senator WALLOP. The hearing is adjourned.
[Whereupon, at 1:30 p.m., the hearing was concluded.]
[By direction of the chairman the following communications were made a part of the hearing record:]

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ACQUISITIONS
DIVESTITURES

MERGERS
REORGANIZATIONS

AMENDED STATEMENT OF ARTHUR BURCK FOR SENATE FINANCE COMMITTEE HEARINGS ON THE CURRENT OIL MEGAMERGERS AND THE TAX BREAKS THAT UNDERLIE THESE TRANSACTIONS

Giant mergers constitute a clear and present danger. As a leading expert in the field of mergers, I have been speaking out for almost two decades.

The wave of megamergers in recent years has reached the point where legislative action is clearly required. Since most of these huge transactions are based on tax breaks that usually are not available to smaller businesses as a practical matter, the problem can be quickly solved by withdrawing these tax breaks from use by large companies.

Rather than belaboring the text of this statement, I shall rely entirely on my attached published materials. The following are incorporated herein by reference with the same force and effect as if set forth herein:

1. Time Has Come To Put An End to Huge Mergers, article by Arthur Burck published in THE POST April 15, 1984,

2. A Merger Specialist Who Hates Mergers, interview with Arthur Burck published in FORTUNE October 19, 1981.

3. The Hidden Trauma Of Merger Mania, article by Arthur Burck published in BUSINESS WEEK dated December 6, 1982.

4. Ill-Conceived Tax Incentives Distort and Hurt Our Economy, speech by Arthur Burck published in VITAL SPEECHES OF THE DAY dated June 15, 1983.

5. Merger Specialist Arthur Burck Criticizes Tax Breaks For Dodo Birds, Sitting Ducks, and Dinosaurs, interview with Arthur Burck published in PEOPLE & TAXES dated April 1983.

Arthur Burck

Business

Business Briefs, C11
Money Talk, C4
Seminars, C13
Small Business, C4

SUNDAY, APRIL 15, 1984 The Post SECTION C

Time Has Come To Put an End to Huge Mergers

Commentary

Arthur Burck is a Palm Beach attorney specializing in mergers. This is an excerpt from a statement delivered to the U.S. Senate Finance Committee April 5.

By Arthur Burck
Special to The Post

The current spate of giant takeovers in the oil industry will open a Pandora's box of problems.

First, in weighing whether competition will be hurt, we must look ahead. If the current big mergers are completed, history shows that it will set in motion frenetic activity by competitors in the industry to shore up their positions with mergers of their own.

The inevitable result is that America will end up with a mere handful of gargantuan oil companies. The government antitrust authorities are whistling in the dark when they say that competition will not be impaired by the forces thus set in motion.

We also can wonder about the future of American exploration efforts if companies continue to go on spending sprees to buy existing assets instead of spending to discover new oil. Long range, doesn't our national welfare depend on discovering more oil, not only because of OPEC, but also because the Soviet Union is relatively self-sufficient? Also, what if the Soviet Union gains access to the Iranian oil fields while our reserves diminish?

Nor can we ignore the stagnant bureaucracies that will result when oil companies, already huge and cumbersome, double their size. We castigate the huge government bureaucracies; even more dangerous are the monster private bureaucracies. In today's fast-moving world, our businesses must be responsive to innovative change. Huge bureaucracies resist change. The concentrated auto and steel industries are excellent examples of the problems that come when huge bureaucracies get too many eggs in an outmoded basket.

The need that our oil giants be vibrant, creative and innovative becomes apparent when we reflect on the future of the industry. Oil is finite, and as supplies dwindle, it is imperative that the industry develop other sources. We already have seen enough of the problems in developing alternative energy to know that this is not the task for unimaginative bureaucrats.

America will be behind the eight-ball if our energy future is in the hands of a few massive oil companies.

Exxon, the world's largest industrial corporation, is a good example of how the oil giants stub their toes when they try to expand into other industries. Exxon's move into minerals already has lost over half its billion dollar investment, its huge investment in oil-shale projects has been put in mothballs, its several hundred million dollar project to develop high-technology products for business has been a flop and its $1.2 billion 1979 acquisition of Reliance Electric quickly turned into disaster. Recent billion-dollar boondoggles include such mammoth oil deals as Marcor by Mobil, Marathon Oil by U.S. Steel, Conoco by DuPont, Texasgulf by Elf Acguitaine and Kennecott by Standard Oil (Ohio).

On March 5, 1977, I testified before the Senate Subcommittee on Antitrust and Monopoly.

What I recommended then continues to be my solution for the excessive takeover activity of corporate giants. Seven years of scrutiny and attack by opponents have not undermined the soundness of the following recommendations:

✓ Large companies should be denied the privilege of a tax-free exchange unless they can demonstrate in specific situations benefit to the overall economy.

✓ Similarly, large companies should be denied income tax deductibility of interest on borrowings to finance acquisitions. There already is ample precedent for using tax laws to discourage takeover bids: the Tax Reform Act of 1969, section 279, disallows the interest deduction on certain types of indebtedness that finance acquisitions made by smaller companies. Flexibility would remain for the giants to make small acquisitions out of cash flow or the proceeds of divestitures.

✓ Hostile tender offers should be put on ice for a waiting period of at least 60 days. In the past, public stockholders often have been stampeded into improvident takeovers by short deadlines. Time gives an opportunity for the pros and cons to be resolved. At present, many takeover offers are stymied by state laws providing for waiting periods. However, there is legal doubt concerning the constitutionality of these state laws that perhaps should be resolved by supervening federal legislation. .

✓ The antitrust laws should be amended so that it becomes clear that conglomerate mergers can be challenged when large companies acquire industry leaders, product-line extension opportunities and similar situations where past FTC studies have shown there are potentials for anti-competitive activity.

It should be noted that the above recommendations involve minimum extension of bureaucratic activity. By and large, the reforms are designed to be self-operating in curtailing undesirable mergers

A Difference of Opinion

A Merger Specialist Who Hates Mergers

A great merger wave has been running, with the blessings of both FORTUNE *and the Reagan Administration (see "Don't Stop the Mating Game," August 24, and "Bold Departures in Antitrust," October 5) The new leniency at the Justice Department has sparked predictable opposition in Congress and academe, but one of the most vociferous critics is among the men who make the merger deals Arthur Burck, 68, is a securities lawyer who works from his estate in Palm Beach Over the past quarter-century he has put together hundreds of acquisitions and reorganizations, serving such large clients as ITT, Dow Chemical, and Litton Industries He recently discussed his unorthodox views with* FORTUNE*'s Edward Meadows. Excerpts.*

If you're opposed to mergers, why are you in the merger business in the first place?

I'm not against all mergers. In fact they are indispensable to the functioning of capitalism. Companies need to merge for various good reasons—to gain economies of scale, or to get capital that they otherwise couldn't obtain. Changing markets or just management attrition can force a company to seek a merger partner. We must accept the reality that many companies have to be sold. The question is to whom. I think the nation would be better served if the buyer were a group of private investors or a medium-sized company, but not a giant.

Why not a giant?

Takeovers by the corporate giants have damaged a great many companies. The acquisitions have weakened or destroyed countless thousands of small and medium-sized businesses that were star performers when they were independent.

Do you have evidence to support this charge?

Look at the wave of divestitures. In the past 15 years there have been thousands of divestitures of acquired companies. The buyer realizes after a while that he simply got stuck. From my own experience I would say that perhaps 95% of the merger proposals that are explored never materialize, and among the 5% that do go through, a high percentage, perhaps seven out of ten, are so-so or bad deals.

Why are so many bad merger deals consummated?

Many large companies are apprehensive that the future may be bleak in their present lines of business, so that makes them impatient to find new opportunities—the grass-is-greener syndrome. But few large companies are equipped to evaluate a merger deal Buying a company is an art, not a science. Big companies normally process a possible acquisition through a bureaucracy of people who are essentially pencil pushers.

When the giants seek outside advice, they often get it from Wall Street, where the adviser may only be interested in the huge fees flowing from the conclusion of a deal Wall Street has an additional incentive to promote takeovers: the desire to serve customers who can make a large profit by selling their stockholdings.

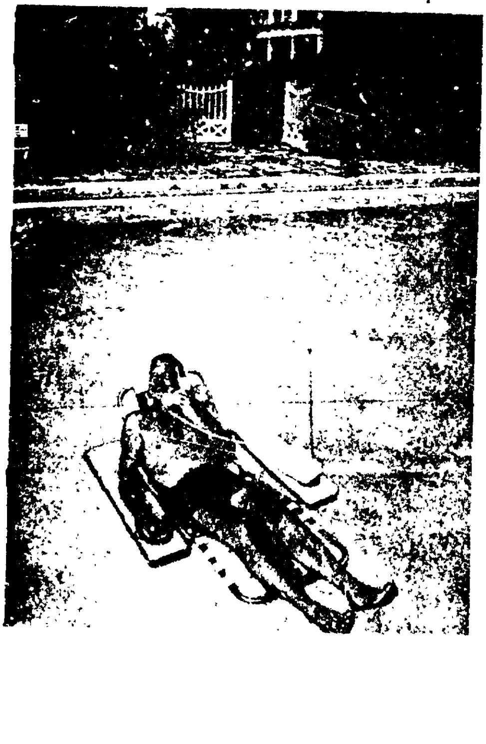
If a merger goes bad, so what? Can't the division be sold off and restored?

It's a long road. A company loses its momentum. Key people have left. Employee morale and efficiency have eroded. When workers become part of a sprawling, faceless bureaucracy, the identity with "their" company is lost. Productivity suffers. Ill-advised mergers have damaged an entire generation of incipient growth companies.

Not only have the companies been blighted, so have their host communities. The founders and executives of thriving companies—people with roots in the town—are eventually replaced by hirees of the acquirer. Local lawyers, bankers, and professionals are replaced by others in some distant headquarters. As the acquired company decays, workers are laid off, doing still more damage to the economy of the community.

Why would a merger lead to decay?

Deal maker Arthur Burck at work in his Palm Beach pool



When companies get too big, through merger or otherwise, they often lose the capacity to create new products. The failure to innovate then opens the door to destructive foreign competition

But that's the marketplace at work. If a company gets too big and suffers for it, then it can slim down.

I think that ignores the damage that occurs, the damage that unrestrained merger activity causes simply because some companies have billions of dollars of credit that they can use to go out and ruin something

Do you try to avoid doing deals with large companies?

Not at all. I usually represent companies having some need to sell, and they most often end up merged with large companies. I get my clients a better price from a giant, so like water finding its own level the good deals tend to flow to the majors, increasing concentration. The rules are stacked in favor of the giants. They have the blue-chip stocks, sometimes with high multiples, that can be used for tax-free barter. They can borrow at very advantageous terms

So what is your remedy?

Taxpayers in effect subsidize the mammoth mergers, invariably these deals depend on either tax-free exchanges of stock or the tax deductibility of interest on the huge borrowings needed to float the deal. So half the carrying charges are borne by the U.S. Treasury.

Large companies should be denied the privilege of a tax-free exchange of stock unless they can demonstrate in specific situations some benefit to the overall economy. Similarly, large companies should be denied the right to deduct the interest on their borrowings to finance acquisitions. Flexibility would remain for the giants to make small acquisitions out of cash flow or from the proceeds of divestiture

We could also use tax deferrals to revitalize small business. Huge pools of sterile capital lie dormant in stocks and properties where there are large unrealized gains. If owners could sell and reinvest the proceeds in small businesses and defer capital-gains taxes until a subsequent sale of the follow-on investment, abundant capital would become available. In other words, give prospective small-business investors the same sort of deferral advantage enjoyed by homeowners or investors who sell to the giants through a tax-free exchange of stock.

Mergers seem to come in waves. Do you think this wave has already peaked?

It's just beginning. Whether or not cash becomes available at reasonable interest rates, stocks are so undervalued that it is inevitable they will in time reflect price levels where it again becomes feasible for acquirers to use their stock as barter. At the same time, the future of many huge companies—in autos, oil, and so on—will be so bleak that they will try to diversify by taking over tempting targets.

So the stage is set for a big merger wave. When it runs its course our economy will be concentrated in a relative handful of huge companies that would have a power, little short of life and death, over the destinies of more human beings than most nations.

The next logical step will be takeover by the government, first of selected industrial targets and eventually of entire industries

Isn't that a bit farfetched?

It is easy, ostrich like, to say it can't happen here, but look what has happened elsewhere, not only in Communist Eastern Europe but also in Western Europe. Four of the top ten companies in Italy are government controlled. So are the majority of the top 20 in France, and the new Socialist government there is nationalizing dozens more

Ideas & trends

By Arthur Burck

The hidden trauma of merger mania

Most acquisitions by corporate giants lay the groundwork for future job losses because of the eventual erosion of the acquired business

Unfriendly acquisition attempts, such as the recent Bendix-Martin Marietta-United Technologies-Allied takeover battle, have ignited a firestorm of criticism. But few comments took note of one of the most harmful consequences of merger mania: the negative long-range impact on jobs. The reality is that most acquisitions by corporate giants lay the groundwork for future loss of jobs because of the eventual erosion of the acquired business.

Four years ago, William C. Norris, founder and chief executive officer of Control Data Corp., himself a veteran acquirer, described the job-destroying process of mergers in testimony before the Senate subcommittee on antitrust and monopoly: "If public concern for the social trauma of takeovers doesn't bring constraints, the increasing economic damage from unemployment certainly should. The most serious economic damage results from the destruction of job-creating resources. Technological innovation is the wellspring of new jobs. Immediately after a takeover, an innovation-stifling process sets in. The aggressor blankets the other with bureaucracy, layer upon layer. Proposals for new products languish. The result is the dispersal of the entrepreneurial team, the major job-creating resource."

One of the best-kept secrets around, although the underlying evidence is everywhere, is that most acquisitions of huge companies do not work out. Although there are no precise statistics—in part because acquirers understandably do not go out of their way to publicize their mistakes—some experts say that 7 out of 10 have been failures. Since 1953, I estimate there have been at least 50,000 corporate acquisitions and mergers in the U.S. Most were cases of huge companies' taking over small ones. My guess is that more than half of the companies acquired by the giants were weakened, damaged, or destroyed.

When dinosaurs mate. Most huge companies are run by bureaucracies not unlike those of big government. Like oil and water, it is difficult to mix staid bureaucracies—which by their very nature resist change—and creative, often fragile, entrepreneurial companies. When the merger involves two giants, especially when two dinosaurs mate, it is almost as hard to blend two big bureaucracies. If, as often happens, both are left untouched, the extra layer of bureaucracy hastens the enlarged company's stagnation and decay.

On the other hand, if there are wholesale firings or, as usually happens following a hostile takeover, many executives leave, the acquired business often loses momentum. The people who leave are usually key employees, and many of those who remain vegetate rather than make waves. Employee morale and efficiency decline. Productivity suffers, creativity fades. In time the damaged company is quietly "phased out" or, if it is salvageable, sold off.

It should be remembered, too, that for several decades the giants have been beating the bushes in search of the most tempting takeover targets, the cream of the crop of emerging growth companies and leading independent companies. The buy-ruin-and-sell process has already undermined a generation of the country's most promising enterprises.

Recent merger waves have been followed by less publicized divestiture waves, during which the giants have dumped thousands of acquisitions. Most of them were good performers when bought but have become ugly ducklings. In recent years, 35% of acquisition announcements reflected divestitures, almost all companies that had once been acquired. Some companies have been revolving doors for their acquisitions. The leader in discarding businesses is probably Whittaker Corp., which has gotten rid of 90 companies since 1967. W. R. Grace & Co. has divested more than 60 businesses in several decades.

Strength in numbers. The clear lesson is that in today's business climate, where change and innovation are essential for survival, the nation is served only when there is the largest possible number of viable, independent companies engaged in vigorous competition. Yet our business landscape is littered with stagnating giants that still have the means to raise huge war chests. The future of their present operations is bleak, and they lack the creativity to launch new businesses. They know that the only possible avenue for growth, or even survival, is to take over existing businesses. In recent years we have seen many giants struggle to shore up their position by the almost promiscuous acquisitions of whatever targets of opportunity happen to appear on the scene. And this trend is likely to continue.

Mergers are indispensable, of course, in a flexible, capitalistic economy, especially for smaller companies where sale of the business is often the only avenue for shareholders to achieve liquidity. The problem is that although mergers of small and medium-size companies help keep the economy dynamic and growing, giant corporations have a strong bidding advantage. They have, or can borrow, more cash. And they can use their stock for acquisitions with tax-free swaps.

One solution is simple: Deprive large companies of the tax incentives—interest deductibility and tax-free stock swaps—that fuel giant mergers. This change would not prevent the giants from making acquisitions. But it would eliminate most of the advantage they have over small and medium-size companies in acquisitions. It is likely that far more mergers would then take place among these small and medium-size outfits.

America's industrial future lies less with decaying giants than with the nimbler businesses that can open up new growth horizons. Mergers can hasten the growth of these creative companies. ■

Arthur Burck, a specialist in corporate mergers, acquisitions and reorganizations, heads his own Palm Beach (Fla.) company

Drawing by Arthur K. Miller/Miller-Lubin Design

VITAL SPEECHES OF THE DAY

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IMPARTIAL • CONSTRUCTIVE • AUTHENTIC

THE BEST THOUGHT OF THE BEST MINDS ON CURRENT NATIONAL QUESTIONS the move to computerize and automate — requiring more knowledge workers and reducing useful jobs for the unqualified.

5. Coping with that will increase the need to reach, teach, motivate and supervise employees — without being able to exert much discipline or serious fear of dismissal. That will be one of the most challenging tasks in communication and motivation that business has ever faced.

6. In the upper-tier part of the market, the appeal will increase for distinctiveness and decor, because the buyers will continue to seek individuality and self-expression as a way to show they are above the crowd

7. Whatever form sexual relationships take, it's likely that pairs will tend to have similar rungs in the system. There won't be many cases of an upper-tier worker living with someone in the lower tier.

Being able to hold a job will represent so much of the psychic meaning in life that almost everyone able to hold a good job will want one.

8. People in the top tier will be increasingly convenience-minded. They will want as little trouble as possible, feeling that worrying about machinery is beneath them. Dependability and long-life will be demanded.

9. Some workers will carry out their jobs at home, but not nearly as many as Alvin Toffler projected in *The Third Wave*. The social aspects of work will continue to be important for many — and take them out of the home. That means there probably will be little increase in food preparation in the home.

10. The tendency to want appliances to just plug in and work for many years will tend to eliminate the need for dealers. More ordering will be done directly from the factory or catalogue house.

All this, I think, will present new challenges to manufacturers. They will have to convey a feeling of quality, dependability, stability — *unchangingness, non-obsoleting* — at the same time they will have to convey an impression of being more advanced than their competitors.

Those of us who help companies develop and project their images will have a lot of fun with that!

Manufacturers will have to make money on the product and not on the service contract.

Underlying all this, of course, will be great danger to the survival of a system in which business can operate at all.

Our system has given millions of people the time, energy, motivation and resources to oppose the system. The growing split into two tiers will give millions more the time and motivation to attack.

Those with a stake in the system have been too busy at business — and too close to hard facts and the bottom line — to understand what has been happening and what must be done to avert disaster.

Years ago H. L. Hunt, Sid Richardson, the Murchisons and others put money into efforts to stem the tide — but those efforts were misguided and the timing was wrong. You can't buck a strong trend in public attitudes head-on. But when the trend turns in your direction — as it now has — you can accelerate it.

Now is the time for business and high-paid executives to put support behind *effective* movements to change the climate of attitudes — to reinstate regard for working, learning, obeying the laws and earning what you want in life.

My observations about the changes that have occurred and the domination of the human climate, I believe, are based on established fact. My speculations on where they lead — for your industry and for society — are, of course, speculations. But I think the record of projecting such changes has been good enough to justify taking them seriously and incorporating them into your planning.

This is an exciting time for us. We can be pretty sure that the next few years will be a lot different from the years in which we worked our way up to where we are. How we sense, adjust to and direct the new human climate will determine where we will be at the end of our careers.

Ill-Conceived Tax Incentives Distort and Hurt Our Economy

HELPING THE GOLIATHS

By ARTHUR BURCK, *President of Arthur Burck and Company*

Delivered to Rotary International, West Palm Beach, Florida, May 10, 1983

AMERICA's sputtering economy is on the brink of crisis. Countless businesses are obsolete or crippled. That is why we have double-digit unemployment, and the end is nowhere in sight since we continue to lose manufacturing jobs faster than our ability to create new employers.

The causes are many, but one is pervasive: obsolescence has overtaken the giant corporation as the mainstay of our industrial structure

Through most of this century our giants prospered, especially in concentrated industries, because of relative insulation from foreign competition, an edge over disadvantaged competitors that was prolonged a half-century by two world wars and their recovery aftermaths. Thus, our economy became structured primarily around gigantic corporations burdened by burgeoning bureaucracies, but most immobile giants — in autos and steel, for example — proved to be no more defendable against nimble foreigners than France's supposedly impregnable Maginot line. In other words, our big companies were sitting ducks.

Why are big firms poor innovators? When companies get too big, they often lose the capacity to take risks and develop new products. As companies increase in size, there is a commensurate increase in bureaucracy, which becomes more and more inflexible. In the business world, change is the name of the game. Yet it is the very nature of bureaucracy to resist change.

Another factor that leads to corporate stagnation is that the larger the company, the greater its stock in the status quo. When investments in established products and methods run into billions of dollars, manufacturers are reluctant to retool. The auto industry was slow to jettison the colossal investments in large cars until foreign competitors took the lead.

To be sure, big companies are necessary in some industries. However, it is noteworthy that most industrial giants that today maintain their success are those that act like small companies; i.e., 3M, IBM, Control Data

Things are likely to get worse. The reason is that most of the goodies of government aid go to the obsolete Goliaths — the Davids don't even get cut-rate slingshots, and indeed the entrepreneurial companies that are the future of America are in the "third world" in terms of government neglect and comparative wealth.

Mesmerized by the former success of the corporate giants and the great wealth that they have accumulated, the federal government for several decades has fostered a vast array of subsidies and tax breaks that now are wasted more often than not on the stagnating giants. These subsidies take a wide variety of forms: fast depreciation, depletion, import quotas, tax credits, loan guarantees, increased tariffs, subsidized loans, "voluntary" export limitations, tax credits on foreign earnings, taxpayer bailouts of huge companies (Lockheed, Chrysler), prolongation of tax carry-back periods, and last but not least the "sale" of tax credits whereby prospering corporations reduce their taxes by acquiring credits, usually from the huge dinosaur companies that are unable to use these tax credits themselves.

As the result, today's somewhat shocking statistic is that corporate taxes are now only 5.9 percent of federal revenues, in contrast to the 25 percent that prevailed during the 1950s and 1960s, the "Golden Age" of American prosperity. The Administration estimates that corporations will pay only $35 billion during fiscal 1983 — the smallest dollar amount, adjusted for inflation, since fiscal 1942 when corporate profits were a comparative pittance.

This means that most large companies today pay negligible taxes — because of the array of tax breaks they enjoy.

On the other hand, it has been my experience that most small and medium-sized corporations pay close to the maximum rates — usually about 50 percent including state income taxes. Smaller companies have nowhere to hide.

For example, let's take the 1981 tax act that drastically cut the period for depreciating business assets. This legislation was proclaimed as a bonanza for small business when in fact the large companies were the major beneficiaries; 80 percent went to the Fortune 1700, which are 0.1 percent of all companies. The big, dead, dodo birds are loaded with fixed assets, especially huge plants. In contrast, smaller companies have few fixed assets so that they usually have relatively little to depreciate

In view of the stagnancy of our old industries, it is clear that the future of America depends upon our innovative small business sector and its ability to spawn many new high-growth companies — the job creators for tomorrow Yet these are the businesses that must bear the brunt of full corporate tax rates.

Several bothersome questions emerge:

—Is it mere coincidence that the big companies languished and stagnated in almost exact relation to the amount of taxpayer largesse bestowed upon them?

—The purpose of this largesse was to help the big companies, but is that the way it worked out?

—If we taxed corporations closer to the ranges prevailing in the 1950s and '60s, wouldn't we cure the federal deficit that now underlies the high interest rates that imperil the future of business?

"Pro-bigness" tax policies are more pernicious than appears on the surface. The face of business America has been irrevocably altered — for the worse — by the tax-induced merger mania that during the past three decades has meant the loss of independence to over 50,000 once-prospering American businesses. Most of these acquisitions were made by big companies. Following are some of the disastrous effects upon our economy:

—The big became bigger. This has means concentration of our business assets in fewer and fewer hands.

—We now know that most of these acquisitions did not work out. Perhaps the majority of companies acquired by giants were ruined, damaged or weakened. Since the giants for decades have been beating the bushes to find and acquire the most promising growth companies, we have lost a generation of our best companies. Here is one of the reasons for our huge unemployment — many of our high-growth employers were ruined by the heavy hand of giant acquirers.

—The main reason for the failure of most acquisitions is the inability of the bureaucracy of the giants to mesh with fragile entrepreneurial smaller companies. Even when deals do work out, one may question whether the nation is served when control of vibrant companies is transferred to stagnent big companies that have made a mess of their own businesses.

In the years to come, the signs point to proliferation of giant takeovers. Our business landscape is littered with stagnating giants that still have the means to raise huge war chests for takeovers. The future of their present operations is bleak, and they lack the creativity to launch new businesses. They know that the only possible avenue for growth, or even survival, is to take over existing businesses. That is why in recent years we have seen many giants struggle to shore up their position by the almost promiscuous acquisition of whatever targets of opportunity happen to appear on the scene.

Now it is ironic that taxpayers have been subsidizing the merger activity that has been so deleterious to our economy. I estimate that four out of five of the huge takeovers depend on tax breaks: (1) the tax-free exchange of stock, and (2) the deductibility of interest on the huge loans that float these deals.

Another tax break that has promoted needless bigness is the opportunity for big corporations to retain just about whatever earnings they want. They get away with this approach because they can tell their stockholders, "Well, look, if we give you only 20 percent of the earnings as dividends that are taxable as ordinary income and keep the other 80 percent, we'll invest it and in time that will come back to you as a capital gain."

More often than not, companies retain earnings that they don't need in their own business. They then spend money on acquisitions whether doing so makes sense or not. Very often the acquisition is the last thing they need because they have no competence to manage the new area of business. It was rediculous for U.S. Steel and DuPont to spend billions to get in the oil business after only a couple of weeks considering whether to do this

Retained earnings often are put into offices, buildings and facilities that aren't needed or that are overly elaborate. Many companies have squirreled away an unbelievable array of infertile assets or peripheral businesses not germane to the main corporate thrusts. When one stops and thinks about this pattern being repeated countless times over the last 30 to 40 years, each year a company retaining more than it needs and then wondering what to do with it, it's not surprising that they end up collecting vast infertile assets.

The national tragedy is that such huge caches of capital have become locked up in regressive receptacles, often among the corporate has-beens, instead of being redeployed among the vigorous and vibrant doers. What oil is to the Arabs capital is to America: our most valuable asset. But like oil it is finite and so we must carefully husband capital and make sure that it is not wasted through ill-conceived tax breaks.

Even though our economy burns, legislators have been ignoring what is happening, not unlike Nero. That is hardly surprising since when issues collide with the power and the "deep pockets" of the corporate giants, can one blame any legislator for tempering valor with discretion? After all, survival in office can depend on not offending the well-funded PAC's that have become such telling weapons for use against "uncooperative" legislators. In the area of mergers, the big companies always resist even the most common-sense restraint; for example, it took Congress 20 years to pass a much-needed law requiring acquirers merely to inform the government of larger acquisitions. Indeed, it was a chilling experience for me to appear twice before the old Senate subcommittee on antitrust and monopoly, and observe all of the empty seats reserved for subcommittee members who didn't bother to show up — "friends" of big business was the staff's explanation. What else can we expect so long as most legislators must cater to big business in order to raise the massive sums needed for reelection?

And so it is highly unlikely that government will rearrange the incentives and disincentives that have contributed to the sorry current state of the nation's industry. To be sure, there is understandable nostalgia for big business. We all grew up with the idea that bigness is as much a part of America as is apple pie. Trying to question bigness in America is almost like questioning motherhood. But we've got to change our thinking away from helping the Goliaths. Their day is gone.

Life and Peace

ANOTHER WORD FOR UTOPIANISM IS HOPE

By TIMOTHY HEALY, *President, Georgetown University*

Delivered at Uppsala University, Uppsala, Sweden, April 21, 1983

ARCHBISHOP SUNDBY, Cardinal Arns, Reverend Metropolitans, Reverend Bishops, Fellow Christians, Ladies and Gentlemen: It is an honor for me to be here to represent the Catholic Church in the United States at this Christian World Conference on life and Peace. I bring you greetings from your fellow Christians in the United States who are as troubled as you are by the worldwide nuclear threat to life and peace. This morning I will try to speak from two perspectives. The first is that of the pastoral letter, which the American Roman Catholic Bishops have been preparing, and upon which they will meet to vote early next month. The second is more personal, that of a teacher who has spent most of his adult life in universities, public and private, secular and religious. The urgency of the Bishops' pastoral letter is doubled for those of us who have given of our lives for the learning and growth of the young. As Christians and as citizens, we, their elders, cannot leave them the nuclear tensions we have made.

The second Vatican Council opened its discussion of modern warfare with the words, "The whole human race faces a moment of supreme crisis in its advance toward maturity." I would like to take those words as the text of my remarks this morning. President John F. Kennedy began the decade of the sixties by remarking that "men must put an end to war, or war will put an end to mankind." Despite the violence of his presidency, for some years after his death it seemed that men and governments everywhere had begun to heed that warning. The beginning was impressive. There were treaties to ban nuclear weapons from space and from the sea floor. There were treaties to ban testing in the atmosphere and to restrict underground testing. There was the non-proliferation treaty under which many non-nuclear nations agreed not to work toward the acquisition of nuclear weapons in return for an undertaking by the nuclear powers to limit and reduce their own stockpiles of such arms. That undertaking has yet to be fulfilled. Finally, there was the SALT I Treaty and the Anti-Ballistic Missile Treaty. Preliminary work was done on a SALT II Treaty and there was indeed progress on a comprehensive test ban.

Despite the wars and the rumors of wars that filled the sixties and early seventies, these visible signs of progress, coupled with the development of detente in East-West relations, led to a general public acceptance that nuclear war could and would be avoided. In America our public guard was lowered and while all of us winced at the odd acronym, MAD (mutual assured destruction), we felt that some stability had been achieved and that if no arms had been scrapped at least equilibrium was an attainable goal. All of us felt that the arms race had slowed so notably that we could begin to hope for arms reduction.

It is true that during these years few strong voices in the American churches were raised to question either the fundamental assumptions of the nation state, or any of the immemorial Christian teachings about nuclear war. We in America all too easily forget the deep imperative that moves Russians, communist or not, in their three hundred year race to catch up with Western technology. Historical perspectives are not popular in democracies, in America or elsewhere, and the perennial optimism of a free and busy people approaches all governments and all theories of government with the practical axiom, "if it ain't broke, don't fix it."

In the last four years all this has changed. Our euphoria at a nuclear slow-down has been replaced by a collective anxiety in the United States and in many parts of Europe. Our worries are provoked by American preference for nuclear superiority and our stated ambition to develop new weapon systems: also by the continuing build-up in the Soviet Union of intermediate range ballistic missiles aimed at European cities.

There is little to gain by assigning blame, since the blame

Merger Specialist Arthur Burck Criticizes Tax Breaks for Dodo Birds, Sitting Ducks, and Dinosaurs

P&T: *Critics of the tax laws say that they encourage mergers. Can you explain how this works?*

Burck: The merger activity of the corporate giants has depended on two tax breaks. The first is the deductibility of interest on the huge borrowings needed to finance the operation. For example, U.S. Steel borrowed about $4 billion of the $6 billion it spent to buy Marathon. It was able to write off the interest against taxes.

Smaller companies can't borrow with that facility. If they can borrow at all, they get quite a different array of interest rates. They can't compete with the big companies, even for the small acquisitions. So as a practical matter, deductibility of the interest is something that only the big can take advantage of.

The second device is the tax-free exchange of stocks. Here again, when a company decides to take stocks instead of cash, the stock of the huge company is usually more liquid, more blue chip. And it is available as barter. The stock of the small company or medium-sized company usually isn't available.

P&T: *A lot of mergers wouldn't occur if these two tax breaks were not available to big companies?*

Burck: My guess in looking back over the past five years at the hundreds and hundreds of huge mergers that have taken place, without these tax breaks, four out of five, maybe nine out of 10 would not have occurred.

Without these tax breaks, companies still can go ahead and merge, as many small companies do. They just can't take advantage of the tax breaks now available. These tax advantages available to the big companies for mergers should be wiped out.

P&T: *You seem to be implying that mergers are bad, that they hurt the economy.*

Burck: Most of these deals don't work out. Most of the acquired companies are ruined. They are weakened since another layer of bureaucracy is added. And the good people are chased away. Those who stay there vegetate.

P&T: *If these mergers fail so often, then why have there been so many mergers in the past few years?*

Burck: These dinosaurs see only a bleak future in what they are doing. They know that they have been licked by foreign competition in some of the basic businesses. They know that they are not competent enough to get into new areas. Yet, they are sitting on billions of dollars in assets.

They have only one way to grow, only one way to survive. That is by taking over other companies, the bigger the better. In other words, when your own pasture is dried out, any other pasture looks green. So they are moving on to greener pastures.

P&T: *You seem to be saying that big is bad. Is that a general philosophy you have about business?*

Burck: Not necessarily. Big has its place. To give an analogy, a huge truck trailer has its purpose on the New Jersey Turnpike. But to try to take the trailer through downtown traffic during the rush hour illustrates places where big is not suitable. A big problem in America is that we have permitted the big to creep in to too many areas.

P&T: *Why don't you like big companies?*

Burck: Big companies have too many eggs in one basket. They can hardly afford to plan to change, to innovate. They have billions and billions of dollars tied up in the status quo that stands as a brake against making everything obsolete.

Take the auto industry, for example. Even if Ralph Nader had been president of General Motors 10 years ago, he would have thought twice before deciding that the day of the small car was coming. Even Ralph would have thought twice about making obsolete countless billions of dollars of plant, equipment, models, all of which were producing big cars that made the company prosperous.

And you see that in so many industries, not only in Detroit. You can run down the list of the industries that have been hurt by foreign competition. Foreign competition has found the industrial companies of America sitting ducks.

P&T: *If bigness hinders innovation and stifles these companies' growth, then why have big companies been so successful through most of America's history?*

Burck: The reason why they were viable then was because American companies did not have any real foreign competition in the past. We emerged entirely unscathed after World War II, so it was a one-way street. It was all made to order for big companies. When they needed raw materials, they really weren't bothered by foreign competition.

With minimal outside disturbance in terms of innovation, it was a period when huge assembly lines and huge plants worked. But with the intrusion of aggressive foreign competition, which has been nimble and agile, our huge industrial structure has no longer been able to cope.

P&T: *Getting back to taxes, what other kind of tax breaks have encouraged bigness?*

Burck: Another tax device that has promoted needless bigness is the opportunity for corporations to retain just about whatever earnings they want and declare dividends as low as they can get away with. They get away with this approach because they can tell their stockholders, "Well, look, if we give you only 20 percent of the earnings and keep the other 80 percent, we'll invest it and in time that will come back to you as a capital gain."

More often than not, they don't need these resources in their own business. Very often companies retain earnings that they don't need.

P&T: *If they don't need these retained earnings, then what are they doing with the money?*

Burck: One thing they do is spend money on acquisitions whether doing that makes sense or not. Very often the acquisition is the last thing they need because they have no competence to manage the new area of business. It is ridiculous for U.S. Steel and DuPont to get in the oil business after only a couple of weeks considering whether to do this.

Arthur Burck has worked with over 1,000 businesses, big and small. He has arranged acquisitions with over a dozen of the biggest 100 corporations and has worked over the years from time-to-time with at least one-third of the Fortune 500.

Burck was originally a Wall Street lawyer, where he became an expert on corporate reorganizations, securities and tax law with the law firm of Carter, Ledyard & Milburn. He then worked with the Securities Exchange Commission where he served as the impartial adviser to federal judges on big reorganizations.

Since 1953, Burck has worked as a merger and acquisition specialist. He has written widely about mergers and their impact on the economy, having been published in The Wall Street Journal, Fortune, *and* Business Week

Another thing these big companies do with retained earnings is put it into office buildings they don't need. In addition, they build plants that are overly elaborate.

It's just incredible to look behind the scenes of some of these huge companies. They have squirreled away just an incredible [illegible] of [illegible] assets. It's wasted money in a sense. So when you stop and think about this pattern being repeated thousands of times for the last 30 to 40 years, each year a company retaining more than it needs and then wondering what to do with it apart from acquisitions, it's not surprising that they end up squirreling away these assets.

P&T: *Should we tax retained earnings to prevent this waste that you have described?*

Burck: Yes, except when the company can show that it needs to retain earnings for appropriate purposes in connection with its own business. Taking the money out of the stagnant old property and reinvesting it in a vibrant new company would undoubtedly result in much larger revenue.

P&T: *What are some of the other tax breaks that only big corporations can take advantage of?*

Burck: Companies like Chrysler have been selling off their tax credits to General Electric and other companies that have finance subsidiaries. GE this past year had net earnings in the neighborhood of $600 million, and its tax rate last year was negligible.

And companies that have foreign operations — usually the big companies — are able to deduct foreign tax credits on foreign earnings from their U.S. taxes.

P&T: *In hearing you describe the tax breaks that only big corporations can take advantage of, I am reminded that one of the arguments for passing tax breaks for business is that they will help small business. I remember that the business lobbyists and the supporters of the 1981 tax act argued that it would benefit small business. But you are saying that these tax breaks, which are passed in the name of benefiting small businesses, don't actually benefit them?*

Burck: Only marginally. Small businesses are always delighted to pick up anything they can get.

But it's pure horsemanure to say that the main thrust of the 1981 tax act was to help small business. It was so needless and crazy. I think 80 percent of the benefits went to the Fortune 1700, which are 0.1 percent of all companies.

This is because the 1981 tax act allowed companies to depreciate their assets more quickly. The big, dead, dodo birds are loaded with these assets and can write-off their big plants and heavy depreciation.

In contrast, the small companies do not have a lot of physical assets. They don't have huge plants. They have small plants, and they can depreciate their equipment quite fast anyway.

Tax provisions that were meant for the small are invariably appropriated by the huge. Take for example the tax-free stock exchange. It goes back to the concept that as businesses grow, they should be permitted to merge with other small businesses in order to strengthen their position and help the economy.

That is the reason why Congress conferred the tax-free stock exchange. And yet today it is 99 percent misappropriated by the big. The original purpose was great, but it is now ignored.

P&T: *In trying to use the tax system to benefit small businesses, Congress almost always ends up helping the big corporations. Wouldn't it be better to declare some sort of moratorium on trying to do this? Should we instead try eliminate some of the different tax breaks that only the big can take advantage of and concentrate on other things that are important to small business, such as low interest rates and available venture capital?*

Burck: When I gave a talk in February before the Small Business Council and the National Democratic Party in Washington, I sat through the day and listened to the other speakers. Most of them proposed goodies — free benefits — that would help small business without having anything to do with incentives.

They were proposing lowering tax rates for all small businesses. But that's not the point. Most small businesses don't need lower taxes. The problem is getting capital and incentives into the hands of the doers.

Small businesses in the 1970s became the primary victims of too much inflation and too many recessions. That had an impact on them in a number of ways. Most importantly, there was the credit crunch throughout that period. That made it difficult for small companies to borrow.

P&T: *Instead of having a tax system that benefits big companies over small ones (or small companies over big ones), would it be better to have a neutral tax system, a system that did not give tax advantages to any particular size of company? Would this system then be better because the free enterprise system would then reward the small companies, which most people seem to agree are a better investment?*

Burck: Yes, I think so. I think that in time the big companies are going to fall under their own weight.

As a matter of fact, my prediction is that the future of Wall Street is going to be great because one of these days the huge staffs working on mergers are going to realize that the big companies have had it. They are going to then start turning to a program of de-merging. And then we'll have an atmosphere where it's much easier to get tax laws that don't favor the big, since there will be a lot more small and medium size companies.

P&T: *So you think continuing to pass these tax breaks for big business will encourage companies to stay big or get even bigger? And you think this will stop or slow down the transition to an era of smaller and more innovative companies?*

"One of these days the huge staffs working on mergers are going to realize that the big companies have had it. They are then going to turn to a program of de-merging. And then we'll have an atmosphere where it's much easier to get tax laws that don't favor the big."

Burck: That's right. The new era will come eventually, but the tax breaks will slow down the transition. In the meantime, we're going to have a situation where assets will be concentrated in the hands of the sluggish and non-doers.

Today, nobody gives a darn about what happens in the merger. The philosophy is if you get the dough, you can do anything, even if it ruins a job-producing company. That has been our national philosophy.

P&T: *And the tax laws have contributed to that.*

Burck: Yes. The tax laws have contributed to this by making it so much easier for the big to take over. A lot of the unemployment today results from the fact that a lot of companies in the past were taken over and were ruined or destroyed.

We all grew up with the idea that bigness is as much a part of America as is apple pie. Trying to question bigness in America is almost like questioning motherhood. But we've got to change our thinking entirely away from helping the goliaths. Their day is gone.

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

ON APRIL 5, 1984

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 expense 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.

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[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 reoganizations. 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 frequently 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.

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