Graduate School of Business
STANFORD UNIVERSITY

S-A-154
April 1998

Gulf Canada Limited

In March 1984, Standard Oil Company of San Francisco purchased Pittsburgh-based Gulf Oil Corporation for $17 billion.[1] The combined entity was renamed Chevron. The acquisition attracted the attention of regulatory agencies worldwide. The United States Federal Trade Commission approved the purchase on condition that Chevron sell certain assets. One of Chevron's Canadian subsidiaries was Gulf Canada Limited (Gulf). In connection with the approval under Canada's Foreign Investment Review Act of Chevron's acquisition of control of Gulf, Chevron gave undertakings to the Government of Canada that it would offer its shareholding in Gulf for sale to Canadian-controlled purchasers.

Gulf's 1984 revenues of $5.42 billion (Exhibit 1) made it Canada's fourth-largest oil company. Gulf had two divisions. The upstream division was engaged in oil and gas exploration and production. The downstream division was engaged in refining and marketing. Net production in 1984 consisted of 277 million barrels of liquids and 75 billion cubic feet of gas. Gulf had proven oil reserves of 227 million barrels, proven natural gas holdings of 1.7 trillion cubic feet, and 23 million acres of net exploration land. The company was an active explorer in the very promising regions of the Beaufort Sea and the Hibernia oil fields off the coast of Newfoundland. The book value of Gulf's assets was $5.6 billion at the end of 1984 (Exhibit 2). Exhibits 3 and 4 contain additional financial information.

Few Canadian companies could afford an acquisition of this size.

Copyright © 1991 by the Board of Trustees of the Leland Stanford Junior University. All rights reserved. This case was prepared from published sources by V.G. Narayanan, Research Assistant, under the supervision of Steven Huddart, Assistant Professor of Accounting, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Funding for this case was provided by the Business Fund for Canadian Studies in the United States.

[1] Amounts are in Canadian dollars unless otherwise noted.

The Reichmanns

In 1956, Ralph Reichmann started an importing business in Toronto named Olympia Floor and Tile Company. Later, his brothers Paul and Albert got into real estate by building warehouses. The family incorporated its business as Olympia & York Developments Limited (O&Y). In 1974, O&Y began Canada's largest office construction project, the 5 million square foot First Canadian Place in Toronto. In 1980, the Reichmann organization began work on the largest office complex in the United States, the 8 million square foot World Financial Center in Manhattan.

The Reichmanns' corporate stock investments, capitalized at more than $2 billion, included big blocks in Trizec and Cadillac Fairview (Canada's biggest public real estate companies), and Abitibi-Price, the world's largest producer of newsprint. One observer estimated that in 1984 O&Y's real estate businesses had cash flows of roughly $500 million and accounted for about 65 percent of the Reichmanns' estimated $20 billion assets. Precise figures are difficult to obtain because O&Y remains a closely-held, private company.

In 1985, Paul Reichmann said that his family wanted to be as big in natural resources as it was in real estate. In May 1985, O&Y agreed to buy Chevron's 60.2 percent equity stake in Gulf for $3.0 billion. This would be the second-largest takeover in Canadian history.

Government Regulation

Instability marks the history of oil and gas industry taxation in Canada before 1985.

> There have been very large and rapid swings in the rates and structure of taxation, ranging from subsidies exceeding 100 percent of costs in the high-flying days of superdepletion, to marginal tax rates reaching 100 percent during some of the federal-provincial struggles for larger shares of revenues when oil prices were rising rapidly in the aftermath of the 1973–74 and 1979–80 world oil price shocks.[2]

Gulf outlined the extant and anticipated regulatory environment to its shareholders:

> The petroleum and natural gas industry in Canada operates under legislation and regulations governing exploration, development, production, refining, marketing, and other activities. A number of significant changes in the regulatory framework have occurred or have been proposed in 1985. Outlined below are some of the more significant aspects of government regulation which affect the petroleum industry in Canada generally as well as Gulf's operations.
>
> *Energy Policy*

---

[2] Helliwell, John F., et al., *Oil and Gas in Canada: The Effects of Domestic Policies and World Events* (Toronto: Canadian Tax Foundation, 1988) p. 102.

The energy policy of the Government of Canada was previously outlined in the National Energy Program ("NEP"), first introduced in 1980 and amended in 1982. This included a Petroleum Gas Revenue Tax ("PGRT"), which is a [wellhead] tax on petroleum and gas production revenue and certain incremental oil revenue, which was levied in recent years at a rate of 16% but was effectively 12% in most instances because of a resource allowance deduction. A Petroleum Incentives Program ("PIP") was also included, providing for incentive payments to encourage oil and gas exploration and development. The payments were graduated to offer higher levels of benefits for companies with a high Canadian Ownership Rate ("COR"). The NEP policy framework was impacted by energy agreements with each of the three producing provinces, Alberta, Saskatchewan and British Columbia, which provided for a two-tier pricing system. Under this system, [producers were required to sell] oil discovered prior to 1974... at approximately three quarters of the world price, while the NORP [or New Oil Reference Price], which approximated the world price, was provided for conventional oil discovered after 1973 and for oil from certain specific sources. Natural gas prices for gas exported from the provinces were also established under these agreements.

On March 28, 1985 the governments of Canada, Alberta, Saskatchewan and British Columbia announced an agreement (the "Western Accord") which replaces the previous arrangements covering the pricing and fiscal treatment of oil and gas. The Western Accord provides for the deregulation of crude oil prices and future changes to natural gas pricing, reduced control over crude oil exports and imports, and the removal of a number of charges previously levied by the Government of Canada. The governments agreed that the benefits resulting from the changes to the federal tax regime and pricing decontrol shall flow through to the oil and gas industry.

The Western Accord provided that the PGRT will not apply for new production of oil, natural gas and gas liquids on or after April 1, 1985 and would be phased out for prior production over a three year period beginning January 1, 1986.

Pursuant to the Western Accord, PIP payments will expire on March 31, 1986, with limited extension for eligible costs and expenses incurred in drilling grandfathered wells on Canada Lands.

The Western Accord provides that if the supply of crude oil and products to Canadian consumers becomes significantly jeopardized or sharp price changes occur with potentially negative impacts on Canada, the Canadian Government may, after consultation with the provinces, restrict exports or take appropriate measures to protect Canadian interests.

The Government of Canada has also reached an agreement, effective February 11, 1985, with the Government of Newfoundland (the "Atlantic Accord") with respect to similar issues that will affect future petroleum and natural gas operations offshore Newfoundland and Labrador (see "Land Tenure — Canada Lands").

Energy Pricing

Effective June 1, 1985, producers of oil may negotiate sales contracts directly with crude oil purchasers and the market will determine the price of oil. With such deregulation, buyers of crude oil have access to a choice of sources and producers similarly have access to different outlets for their crude oil.

Effective November 1, 1986, the prices of all natural gas in interprovincial trade will be determined by negotiation between buyers and sellers.

Prices for natural gas exported from Canada have been determined since November 1, 1984 by negotiation between exporters and customers, subject to certain constraints, including a specified minimum price. Under the Natural Gas Agreement, this arrangement is to be eliminated effective November 1, 1986.

Royalties

On Canada Lands there is currently a basic Government of Canada royalty of 10% on crude oil and natural gas production, and a progressive incremental royalty of 40% of the net annual profit derived from a property after an allowance of 25% return on eligible investment. There also exist provisions wherein such royalties may be reduced or suspended. On October 30, 1985 the Government of Canada announced its intention to replace the current royalty provisions affecting Canada Lands. The proposed new royalty regime would provide for reduced royalties in the early years of a project before it becomes profitable with increases in stages to a royalty of 30% of net cash flow after "payout" (to be defined by regulation) of the initial investment, subject to any negotiated changes. In addition, a 25% investment royalty credit applicable to frontier exploration well costs of $5 million or less was proposed for new exploration wells, with the credit to be applied against royalties otherwise payable within the region.

Canadian Taxes

Gulf is subject to Canadian federal and provincial income taxes of general application. The general federal rate is 46% which is abated to 36% for taxable income earned in a province and is further abated to 30% in respect of manufacturing and processing income earned in a province. Gulf is also subject to provincial income taxes ranging from 5.5% to 16%.

On October 30, 1985 the Government of Canada announced its intention to introduce a 25% exploration tax credit applicable to Canadian exploration expenses incurred anywhere in Canada in excess of $5 million per well, commencing December 1, 1985 and terminating December 31, 1990. The tax credit earned may be used to reduce federal income taxes otherwise payable. This credit will not apply to exploration expenditures that are eligible for PIP grants.

Land Tenure

Gulf has acquired crude oil and natural gas exploration and production rights from the Government of Canada, from various provincial governments, and from freehold mineral owners.

Canada Lands. Gulf's Canada Lands are currently held under Exploration Agreements which have been negotiated with the Government of Canada, but not yet executed, and the basic terms of such agreements are contained in ministerial letters. The terms of each agreement include a work program which includes the drilling of at least one well and the obligation to relinquish 50% of the lands during the initial term, a process which began for the Atlantic Offshore and the Northwest Territories in 1984.

COGA [Canada Oil and Gas Act], with few exceptions, vests in the Government of Canada a 25% interest (the "Crown Share") in every interest granted in Canada Lands. Up to the point where the exploration agreement is converted to a production license, the Crown Share is not liable for any exploration or development costs. Following conversion, the Crown Share, which may be disposed of to a qualifying Canadian corporation, must assume full responsibility for its share of costs incurred after conversion and is liable to pay a portion of certain pre-1981 exploration expenditures out of the net proceeds of production.

Federal legislation has established rules and an agency for determining the COR of industry participants. COGA requires that the interest holders in a project group have a combined COR of not less than 50% to qualify for a production license. Any shortfall may revert to the Crown.[3]

[3] Extracted from Gulf Canada Limited, "Notice of Special Meeting of Shareholders, Notice of Application, Management Proxy Circular and Proxy Statement" (January 6, 1986) pp. 73–77.

Gulf's President said the Western Accord would add about $30 million to Gulf's 1984 net earnings of $308 million. Chevron Corporation said the Accord would increase the value of Gulf by about $2 per share.[4]

Petro-Canada

Energy self-sufficiency and the "Canadianization" of the oil and gas industry were the main policies of the Liberal government in power in Canada from 1974 to 1979. In 1976, the Government of Canada established a crown corporation,[5] Petro-Canada, as a national oil company in response to the uncertainties of OPEC-controlled oil. Petro-Canada is a taxable entity under the Canadian income tax laws. In part, Petro-Canada was formed to reduce foreign control over the Canadian oil industry. When the Progressive Conservative Party returned to power in 1984, the corporation received a new mandate. Petro-Canada's 1984 annual report declared:

> In the first nine years, Petro-Canada was directed to work towards Canada's energy security effectively and efficiently, without overriding concern for profitability. The Corporation has now been given a new mandate by its shareholder—to operate in a commercial, private sector fashion, with emphasis on profitability and the need to maximize the return on the Government of Canada's investment. In this regard, Petro-Canada is not to be perceived in the future as an instrument in the pursuit of the Government's policy objectives. However, the Government maintains the right as a shareholder to formally direct Petro-Canada to carry out certain activities in the national interest.[6]

The Parleys

Although Chevron had tentatively agreed to sell its interest in Gulf to O&Y for about $3.0 billion in May of 1985, the closing of the sale was repeatedly delayed. O&Y needed more time to obtain certain tax rulings from Revenue Canada.[7] If the tax rulings were not forthcoming, observers doubted O&Y would purchase the Gulf shares. On June 21, Chevron gave O&Y until July 15 to decide on the deal. The closing was rescheduled from July 16 to August 15. In the meantime, Revenue Canada issued certain favorable tax rulings. However, other concessions sought by the Reichmanns were not granted by the Canadian Government.[8]

---

[4] *Oil & Gas Journal* (May 20, 1985) p. 33.

[5] Government-owned corporations in Canada are called "crown corporations."

[6] Quoted in Peter Foster, *The master builders* (Toronto: Key Porter Books, 1986) p. 127.

[7] Revenue Canada's function is similar to that of the Internal Revenue Service in the United States.

[8] Neither the nature of the additional concessions sought nor the reasons for rejection have been revealed.

The purchase of certain of Gulf's assets by Petro-Canada, and the price to be paid for them, caused more delay. On July 12, the Government of Canada gave Petro-Canada the go-ahead to negotiate with the Reichmanns. Petro-Canada was authorized to spend as much as $1.8 billion to buy assets of Gulf.

On August 1, 1985, O&Y purchased 113.5 million common shares, or 49.9 percent, of Gulf for $20.35 per share. In addition, O&Y agreed to purchase an option on the remaining 23.5 million Gulf common shares owned by Chevron. The price of the options was $3.50 per share and the exercise price was $19.50.

The purchase raised domestic ownership of the oil and gas industry to 46% from 41%. A spokesman for the Minister of Energy, Mines and Resources said "Canadianization is still very much a priority of the Government. Certainly the Government feels very happy with the Gulf deal. It brings us well within reach of our 50 percent ownership objective."[9]

The Ritual

Chevron's sale of Gulf shares to O&Y was the first step in a series of transactions (details of which are presented in Exhibit 5) orchestrated by O&Y to achieve several purposes:

(i) funding the purchase of Gulf shares from Chevron;
(ii) sale of some Gulf assets to third parties;
(iii) satisfaction of regulatory requirements; and
(iv) realization of certain tax advantages.

On this last point, Gulf's January 6, 1986 Proxy Circular (pp. 26–27) disclosed:

> Advance income tax rulings (the "Rulings") have been obtained by Gulf Canada Corporation from Revenue Canada, Taxation and the Alberta Treasury, Corporate Tax Administration confirming the manner in which the Income Tax Act (Canada) and the Income Tax Act (Alberta) (collectively the "Acts") will apply to certain transactions involving Gulf, Superior Propane, Gulf Calgary and Gulf Canada Corporation. The rulings confirm the manner by which Gulf Canada Corporation will determine the cost for income tax purposes of certain assets which will be owned by it if certain future events occur...
>
> Assuming that such future events do occur, Gulf Canada Corporation may determine, within certain limits, an increased cost of certain of its assets for income tax purposes. The beneficial tax consequences of so doing are dependent upon a number of factors and assumptions which have a material effect on their quantification which cannot be accurately determined at this time...
>
> Subject to the foregoing qualifications, the beneficial tax consequences to Gulf Canada Corporation arising from such cost determination could reduce the cash required to pay income taxes and income tax expense and thereby increase the cash

[9] Quoted in Dianne Maley, "Ottawa delays O&Y's deal for Gulf," *Globe and Mail* (June 20, 1985) p. B1.

available to, and the after-tax earnings of, Gulf Canada Corporation from that which would otherwise be the case in respect of:

(a) the distribution of certain resource properties and the sale of the business of Superior Propane to Norcen, in the event of the withdrawal of Norcen from the Gulf Resources Partnership, and the sale of the Edmonton refinery and related business to Petro-Canada; and
(b) the ongoing operations of Gulf Canada Corporation.

The following are the estimated amounts of such increases in future years commencing with the first year in which the last of the events referred to in the first paragraph under this subheading have occurred:

	Increase in Cash Available	**Increase in After-Tax Earnings**
	(*millions of dollars*)	
First year*	$261	$332
Second year	101	93
Third year	49	42
Fourth year	35	30
Fifth year	26	21

with progressively lesser amounts in succeeding years.

NOTE:

* Increase in cash flow and increase in after-tax earnings for the first year include $130 million and $211 million, respectively, relating to the distribution of certain resource properties and the sale of the business of Superior Propane to Norcen, and the sale of the Edmonton refinery and related business to Petro-Canada.

The Little Egypt Bump

The Income Tax Act of Canada (the Act) groups property into five categories:

depreciable capital property (e.g., machinery);
non-depreciable capital property (e.g., land);
eligible capital property (e.g., purchased goodwill);
Canadian resource property (e.g., oil well); and
non-capital property (e.g., inventory).

The Act permits a portion of the cost of depreciable capital property to be deducted in the calculation of an entity's taxable income for a year. These deductions reduce income for tax purposes just as depreciation reduces income under generally accepted accounting principles. Exhibit 6 summarizes the rates of tax amortization which apply to representative assets in each of the categories.

Within the category of depreciable capital property, the Act prescribes a set of asset classes and a schedule of tax amortization for each class. Roughly speaking, the tax basis of an asset class is equal to the original cost of the corresponding assets less the accumulated tax amortization. Additional adjustments occur when assets are sold, as described below.

When an asset is sold, the lesser of the proceeds of disposition and the original cost of the asset is deducted from the tax basis of the class. If the tax basis of the class becomes negative, it is reset to zero by adding an amount called recapture.[10] Recapture is taxed at ordinary rates. The excess (if any) of the proceeds of disposition over the original cost is a capital gain. One half of capital gains are taxed at ordinary rates.

Deductions may also be made against eligible capital property and Canadian resource property. The mechanics of calculating the allowable deduction on such expenditures resemble the system for depreciable capital properties. These deductions also constitute tax amortization of a capital property. No tax amortization is allowed on non-depreciable capital property. Any excess of the proceeds of disposition of these properties over their tax basis is a capital gain.

No tax amortization is allowed on non-capital property. The difference between the tax basis and proceeds of disposition of non-capital property is income taxed at ordinary rates.

When a wholly-owned subsidiary is wound-up into its parent, the law allows the tax basis of certain of the subsidiary's properties to be increased although no tax is paid by either the subsidiary or parent. The difference between the tax basis of the shares[11] and the tax basis of the properties is called the §88(1) corporate bump. The increase in the tax basis of property is limited by the amount of the bump. Also, the tax basis of a property cannot be increased beyond its fair market value.

Similarly, when a partnership is dissolved but one of the partners continues the business, the law allows the tax basis of certain of the partnership's properties to be increased although no tax is paid by the former partners. The difference between the basis of the partnership interest and the tax basis of the properties is called the §98(5) partnership bump. As for the corporate bump, the increase in the tax basis of property is limited by the amount of the bump. Also, the tax basis of a property cannot be increased beyond its fair market value.

The corporate bump may be allocated only to non-depreciable capital property. The partnership bump may be allocated to any asset in any of the five categories of property. The increase in the tax basis of properties realized on the dissolution

[10] This calculation often postpones the taxation of tax amortization in excess of economic depreciation until such time as most of the assets in the class have been sold. In the U.S., in contrast, the sale of an asset triggers immediate taxation of tax amortization in excess of economic depreciation for that asset.

[11] The basis of the shares is adjusted by the subsidiary's cash and liabilities, and certain distributions.

of a partnership may greatly exceed the increase available on the wind-up of a corporation owning identical properties.

If Gulf had been directly wound-up and its assets distributed to O&Y, the increase in tax basis would have been limited to non-depreciable properties. To avoid this limitation, the Gulf Resources Partnership (GRP) was formed. When Gulf was wound-up into Gulf Canada Corporation (GCC), Gulf's interest in GRP (a non-depreciable capital property) was bumped up to the extent of the purchase price paid by O&Y for Gulf's shares. This occurred pursuant to provisions of §88(1) of the Act.

The second bump occurred when the GRP dissolved, distributing its assets to GCC. The bump available to GCC in respect of these assets was set by the tax basis of GCC's partnership interest. GCC could selectively allocate this second bump among any of the properties that it received from the partnership. The tax basis of individual assets could be increased to their fair market value subject to a limit on the aggregate of the increases. This two-stage transaction was commonly known as the Little Egypt Bump.

On October 2, 1985, the leader of the opposition, John Turner, made headlines across the nation: "I want the people who participated in the Gulf Canada sale to appear before a parliamentary committee, produce the tax rulings and have the whole deal explained to the Canadian people so the taxpayer will know how much it cost them," he said.[12]

"Suggestions in the media and in the House that the tax saving amounts to a Government concession are simply not so, says Paul Reichmann. . . . As to the notorious Gulf tax ruling, it 'is simply an interpretation of the law,' Mr. Reichmann said. 'It is nothing given.'"[13]

Subsequently, the Department of Finance announced the demise of the Little Egypt Bump:

> In certain circumstances, a member of a partnership is currently permitted to allocate the cost of his partnership interest to the properties which he receives from the partnership when it ceases to exist. For depreciable property, the existing partnership step-up rule has the effect of increasing future capital cost allowance deductions [i.e., tax amortization] and, on the subsequent sale of the properties, of reducing or eliminating tax on recapture of depreciation. Similar increases in available tax deductions occur where inventory, resource properties and eligible capital properties are involved.
>
> To avoid these effects, the amendments will confine the step-up to non-depreciable capital properties. In doing so, the partnership provisions will be brought into line with

[12] Quoted in Christopher Waddell, "Gulf avoided $1 billion in taxes, Turner says," *Globe and Mail* (October 2, 1985) p. A1.

[13] Dianne Maley and Bruce Little, "Gulf Canada's reorganization to save $500 million in taxes," *Globe and Mail* (October 22, 1985) p. B17.

those presently in section 88 of the Income Tax Act that apply on the winding-up of corporations.[14]

[14] Canada Department of Finance, *Release* no. 85-216 (December 4, 1985) pp. 1–2, quoted in Ronald S. Wilson, "Cost Adjustments in Corporate Reorganization Transaction: Policy and Practice," Report of Proceedings of the Thirty-Eighth Tax Conference convened by the Canadian Tax Foundation (1986).

Exhibit 1

Consolidated Statements of Earnings and Retained Earnings*
Gulf Canada Limited—Three Years Ended December 31, 1985

EARNINGS (*millions of dollars*)	1985	1984	1983
Revenues			
Crude oil, natural gas and natural gas liquids	$ 1,619	$ 1,646	$ 1,508
Forest products	1,093		
Other operating revenues	350	324	215
Net sales and other operating revenues	3,062	1,970	1,723
Investment and other income	115	82	62
Net revenues	3,177	2,052	1,785
Expenses			
Purchased petroleum products	335	319	309
Cost of sales—forest products	879		
Operating expenses	394	372	314
Exploration expenses	139	197	213
Selling and administrative expenses	264	120	103
Wellhead taxes	176	197	169
Depreciation, depletion and amortization	306	172	125
Interest on long-term debt	142	120	114
Minority interest	9		
	2,644	1,497	1,347
Earnings from continuing operations before income taxes	533	555	438
Income taxes	300	322	221
Earnings from continuing operations	233	233	217
Earnings from discontinued operations (net of income taxes)	93	75	1
Other non-recurring items (net of income taxes)	13		
Earnings for the year	$ 339	$ 308	$ 218
Earnings per share from continuing operations (*dollars*)	$ 1.02	$ 1.02	$ .95
Earnings per share (*dollars*)	$ 1.49	$ 1.35	$ .96
RETAINED EARNINGS			
Balance, beginning of the year	$ 2,133	$ 1,939	$ 1,821
Add earnings for the year	339	308	218
	2,472	2,247	2,039
Deduct dividends	118	114	100
Balance, end of the year	$ 2,354	$ 2,133	$ 1,939
Dividends per share (*dollars*)	$ .52	$ .50	$ .44

* *Source*: 1985 Annual Report of Gulf Canada Limited.

Exhibit 2

Consolidated Statements of Financial Position*

Gulf Canada Limited—December 31, 1985 and 1984

ASSETS (*millions of dollars*)	1985	1984
Current		
Cash and short-term investments, at cost which approximates market	$ 775	$ 861
Accounts receivable	857	919
Inventories	341	717
Materials, supplies and prepaid expenses	137	112
Net current assets associated with assets held for sale	288	
Total current assets	2,398	2,609
Assets held for sale	249	
Investments, long-term receivables and other assets	256	140
Property, plant and equipment, at cost less accumulated depreciation, depletion and amortization	3,598	2,886
	$ 6,501	$ 5,635
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Short-term loans	$ 31	$
Accounts payable	503	604
Income and other taxes payable	231	443
Dividends payable	32	30
Other current liabilities	372	289
Total current liabilities	1,169	1,366
Deferred gas production revenue	132	159
Long-term debt	1,286	854
Deferred income taxes	913	718
Minority interest, including preferred shares of subsidiary of $124 million	237	
Shareholders' equity		
Share capital		
Common shares issued—227,487,030 without nominal or par value	405	405
Retained earnings	2,354	2,133
Deferred foreign currency translation gain	5	
Total shareholders' equity	2,764	2,538
	$ 6,501	$ 5,635

* *Source*: 1985 Annual Report of Gulf Canada Limited.

Exhibit 3

Property, plant and equipment*
(millions of dollars)

	Range of depreciation rates	Gross investment at cost	Accumulated depreciation, depletion and amortization	Net investment 1985	Net investment 1984
Oil and gas					
Exploration and production	(1)	$ 1,806	$ 719	$ 1,087	$ 1,096
Syncrude project	(1)	261	51	210	206
Oil sands and coal	(2)	67	49	18	52
Drilling system	$6^{2}/_{3}$%–20%	552	109	443	503
Pipelines	(3)	31	15	16	
		2,717	943	1,774	1,857
Forest products					
Property, plant and equipment	(4)	1,701	45	1,656	
Refined products and chemicals					869
Capital leases	(5)	38	16	22	20
Other	2.5%–10%	238	92	146	140
		$ 4,694	$ 1,096	$ 3,598	$ 2,886

(1) Unit-of-production or group basis.
(2) Mineable oil sands properties on the group basis. Charges against earnings for the capitalized cost of coal properties are dependent upon the results of evaluation and development. The cost of equipment used in research and testing activities on these properties is depreciated over the life of the related activities.
(3) Group basis at rates from five percent to 20 percent.
(4) The principal asset category is primary production equipment which is depreciated on a straight-line basis over 20 years.
(5) Straight-line from three to five years.

* *Source*: 1985 Annual Report of Gulf Canada Limited.

Exhibit 4

Gulf Canada—Projections*

The following projected financial information of Gulf is presented without giving effect to the Arrangement or any possible beneficial tax consequences deriving from the Arrangement and certain other transactions.

	Gulf			
	1984 Actual	1985	1986	1987
	(*millions of dollars*)			
Earnings before income tax	$ 671	$ 703	$ 695	$ 747
Income tax	363	386	391	371
Earnings before the following:	308	317	304	376
Asset gains (losses) net of income tax:				
Partnership transactions (1)	—	93	3	—
Sale of downstream business west of Quebec, business of Superior Propane and Edmonton refinery	—	(80)	55	—
Earnings	$ 308	$ 330	$ 362	$ 376
Earnings per share before asset gains (losses)(*dollars*)	$ 1.35	$ 1.39	$ 1.34	$ 1.65
Earnings per share (*dollars*)	$ 1.35	$ 1.45	$ 1.59	$ 1.65

NOTE:

(1) 1985 includes formation of the Gulf Resources Partnership and 1986 includes the distribution of certain resource properties to Norcen.

* *Source*: Gulf Canada Limited, "Notice of Special Meeting of Shareholders, Notice of Application, Management Proxy Circular and Proxy Statement" (January 6, 1986).

Exhibit 5

Sequence of Olympia & York Transactions to Acquire Gulf Canada Limited

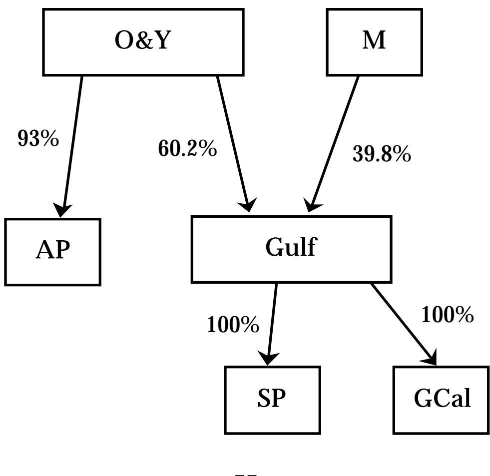
Legend

AP	:	Abitibi-Price Incorporated
GCal	:	Gulf Canada Calgary Limited
GCC	:	Gulf Canada Corporation
Gulf	:	Gulf Canada Limited
GRP	:	Gulf Resources Partnership
M	:	Minority Shareholders
N	:	Norcen Energy Resources Limited
O&Y	:	Olympia & York Developments Limited (and its subsidiaries or affiliates)
PC	:	Petro-Canada Incorporated
SP	:	Superior Propane Limited
UMC	:	Ultramar Canada Incorporated
➡	:	Asset Transfer
⟶	:	Ownership

Dashed lines and shaded boxes flag changes in structure.

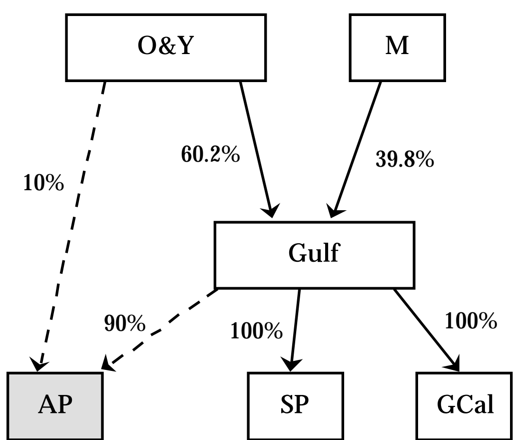
I.

On August 1, 1985, Chevron sold a 49.9% interest in Gulf to Olympia & York (O&Y). O&Y also purchased options to buy Chevron's remaining 10.3% stake in Gulf. (The options were exercised on November 22, 1985.) Under the terms of the Canada–U.S. Tax Treaty, Chevron paid no tax in Canada on the capital gain arising from the sale of Gulf shares.



II.

Prior to August 2, O&Y owned approximately 93 percent of Abitibi-Price, the world's largest producer of newsprint. Between August and November 1985, Gulf acquired a 90% stake in Abitibi-Price. Gulf purchased on August 2 and August 23, 1985, 84 percent of the outstanding common shares of Abitibi-Price for a purchase price of $1,132 million. Five percent of total shares outstanding were acquired for $63 million from the minority shareholders at the same price of $21 per share as was paid to O&Y. On November 7, Gulf raised its ownership to 90 percent by acquiring further shares from O&Y. This acquisition, which cost Gulf $1.2 billion, was financed as to $480 million from Gulf's existing cash resources and as to the balance from temporary borrowings that were subsequently repaid, principally from the proceeds of the sale of certain "downstream" assets described in steps IV and V. In essence, O&Y sold Abitibi-Price to Gulf to pay for Gulf shares it got from Chevron.

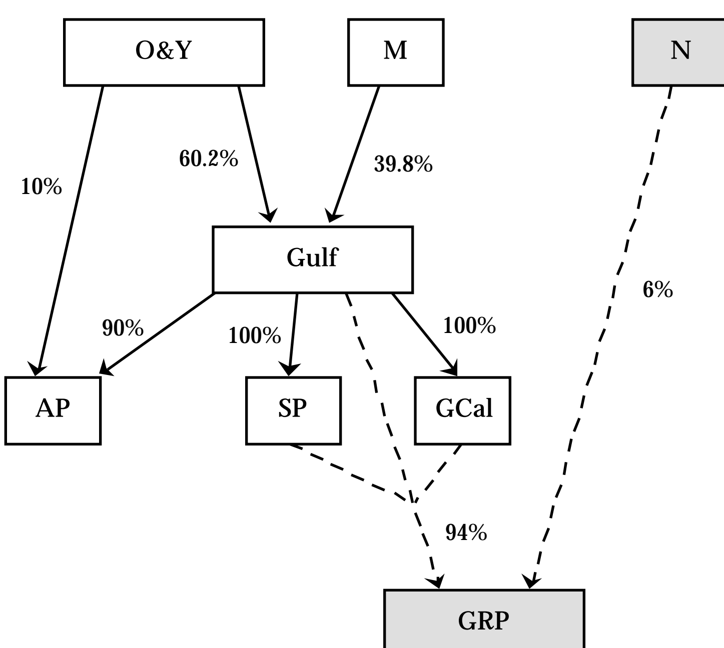


III.

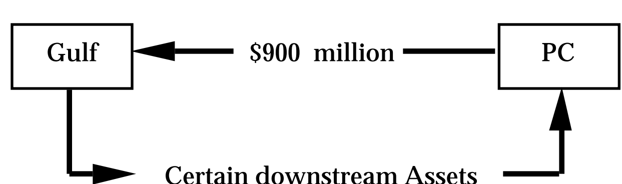
On August 31, 1985, Gulf, Norcen, Gulf Calgary, and Superior Propane formed the Gulf Resources Partnership (GRP). The partnership was to carry on the business previously carried on by Gulf. Gulf managed, and had 94 percent interest in, the GRP. Norcen (which was interested in acquiring Superior Propane and certain of Gulf's upstream properties together valued at $300 million) had the remaining 6 percent interest in the partnership. Appropriate elections were made under the Income Tax Act (Canada) so that all transfers of properties to the GRP would be effected on a "rollover" basis: the tax basis of properties did not change as a result of the transfer. Assets contributed to the partnership were:

	GRP Asset	*Contributed by*
1)	Edmonton Refinery*	Gulf
2)	All up-stream assets directly owned by Gulf	Gulf
3)	Superior Propane business	Superior Propane
4)	$10 million in cash	Gulf Calgary
5)	$300 million in cash	Norcen

* The Edmonton refinery cost Gulf $75 million in 1971. The capacity of the refinery was doubled in 1983 at a cost of $273 million.

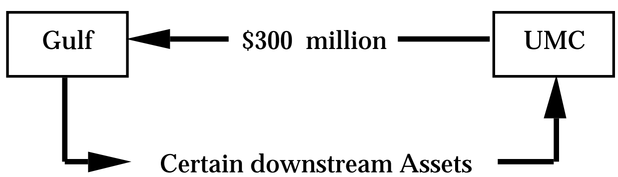


IV.



On September 30, 1985, Gulf sold to Petro-Canada its downstream business (including its refining, transportation, and marketing assets) located west of Quebec (but excluding the Edmonton refinery) for $900 million in cash.

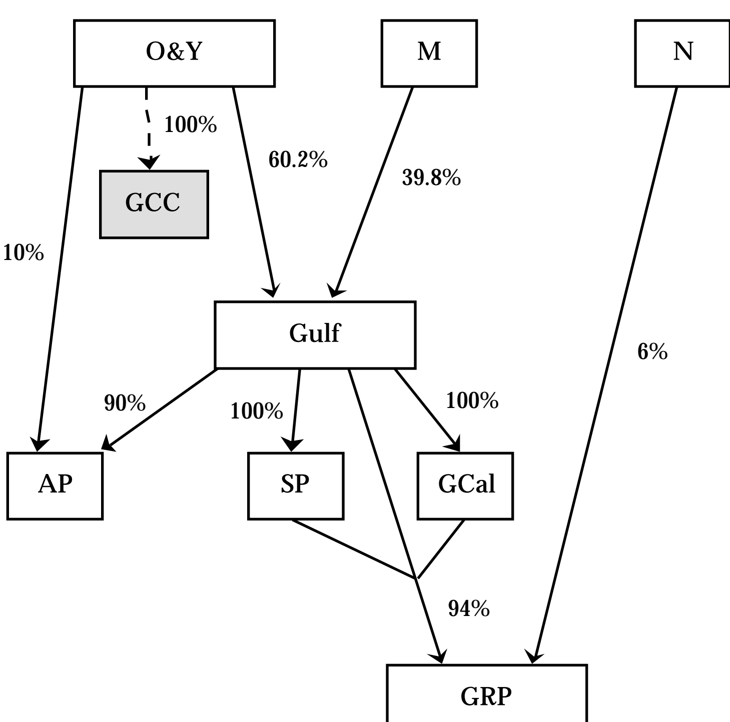
V.



On January 1, 1986, Gulf sold to Ultramar Canada its remaining downstream business located east of Ontario.

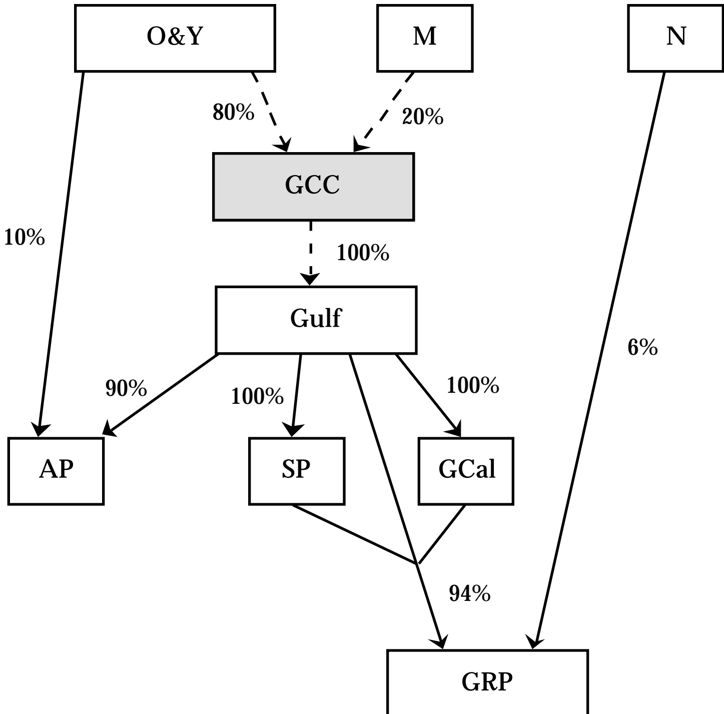
VI.

A new corporation, Gulf Canada Corporation (GCC) was formed as a wholly-owned subsidiary of O&Y. An arrangement (approved by the requisite two-thirds of common shares) provided that each issued and outstanding Gulf common share would be exchanged on February 10, 1986 for, at the option of each holder thereof, either (i) one GCC common share and one GCC series 1 preference share (a tax-free exchange); or (ii) $10.40 in cash and $10.40 principal amount of GCC subordinated debentures (triggering a capital gain or loss, part of which may be deferred). In the exchange, Gulf became a wholly-owned subsidiary of GCC. Thirty-eight percent of the minority shareholders took shares in GCC. Completion of this arrangement left the Reichmanns with 80 percent of the new, more heavily indebted GCC. Minority shareholders who elected the cash and debentures received in aggregate $580 million in cash and $580 million GCC subordinated debentures.



VII.

After the exchange of shares, the following ownership structure existed:

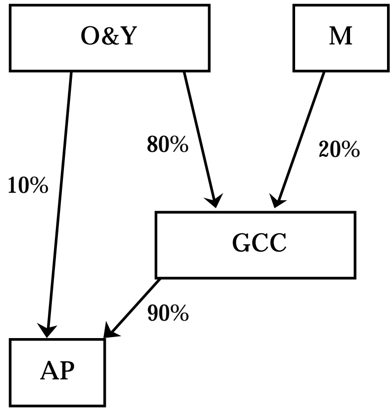


In the special meeting of Gulf shareholders held on January 31, 1986, the shareholders approved the dissolution of Gulf, Superior Propane (SP), and Gulf Calgary (GCal). On February 24, 1986, Gulf and Superior Propane were dissolved into GCC. All property, including its interest in the GRP, was distributed to GCC. It was during this dissolution of Gulf that the §88(1) corporate reorganization bump occurred. On March 1, 1986, Norcen withdrew from the partnership, taking $120 million in cash and certain oil and gas fields. On March 3, 1986, the GRP and Gulf Calgary were dissolved into GCC. All the property of the GRP and Gulf Calgary was distributed to GCC. It was at this stage that the §98(5) partnership bump occurred. Revenue Canada allowed the Edmonton refinery's tax basis to be revalued at $268.9 million.*

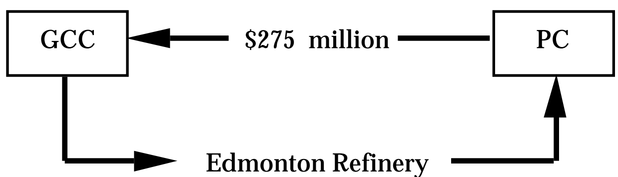
* Christopher Waddell, "Gulf avoided $1 billion in taxes, Turner says," *Globe and Mail* (October 2, 1985) p. A2.

VIII.

The final organizational structure is shown below.

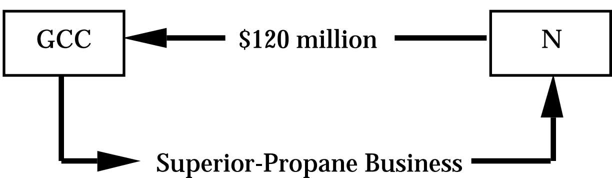


IX.



On April 2, 1986, GCC sold Petro-Canada the Edmonton Refinery for $275 million.

X.



On June 2, 1986, GCC sold Norcen the Superior Propane business for $120 million.

Exhibit 6

Classification of Assets for Purposes of Tax Amortization and the §88(1) and §98(5) Bumps

Asset	Type of Property	Eligibility for Bump *Corporate* §88(1)	*Partnership* §98(5)	Rate of Tax Amortization
Inventory	non-capital		✓	none
Partnership interest	non-depreciable capital	✓	✓	none
Land	non-depreciable capital	✓	✓	none
Manufacturing or Processing Equipment	depreciable capital		✓	25% in the first year 50% in the second year 25% in the third year
Pipeline	depreciable capital		✓	6% declining balance
Natural Gas and Petroleum Properties	Canadian resource		✓	10% declining balance (30% declining balance for property acquired before December 12, 1979)
Purchased Goodwill	eligible capital		✓	one-half the value of the property is amortized at 5% declining balance

Exhibit 7

Chronology of Federal Elections in Canada

Election Date	Elected Party	Prime Minister
October 1972	Liberal (minority government)	Trudeau
July 1974	Liberal	Trudeau
May 1979	Progressive Conservative (minority government)	Clark
February 1980	Liberal	Trudeau/Turner
September 1984	Progressive Conservative	Mulroney

Exhibit 8

Exchange Rate of the Canadian Dollar against the U.S. Dollar

	1985	1984	1983
Average for the year	0.734	0.771	0.811

Graduate School of Business | S-A-154Q
Stanford University | November 2000

Gulf Canada Limited

Questions

1. Suppose the Edmonton Refinery sold to Petro-Canada consists solely of manufacturing and processing equipment. What would be the potential tax avoided by revaluing the refinery?

2. Exhibit 5 of the case contains ten parts. Each part describes one transaction in a sequence of steps taken to reorganize and redistribute the assets of Gulf. Classify each transaction as either an exchange of shares or an exchange of assets. Further, classify each transaction as a taxable or tax-free exchange.

3. Gulf's Proxy Circular alleges that tax saving in the first five years following the transaction will be $261m, $101m, $49m, $35m, and $26m (see page 7 of the case). What is the benchmark against which such savings are calculated? Is this the appropriate benchmark?

4. What motivated the sale of Gulf Canada to Olympia and York?

5. What role did the federal government play in the deal?

6. In what ways did tax considerations affect the transaction?