

EXHIBIT 31

MAXUS

July 16, 1996

Dominic Mastracchio
Internal Revenue Service
Appeals Office
8701 S. Gessner
Suite 750 Stop 8000 - HAL
Houston, Texas 770747 - 2942

Dear Sir:

Re: Maxus Energy Corporation and Subsidiaries, EIN 75-1891531, Tax
years ended 1987, 1988, and 1989

Maxus Energy Corporation (Maxus) hereby submits its revised protest to the results of the audit of its 1987-1989 Consolidated Federal Income Tax Returns. Included herewith are the revised responses to Issues 1 - 3 below. Exhibits mentioned with respect to each issue are placed at the end of the issue to which they pertain. The specific items which Maxus protests are as follows:

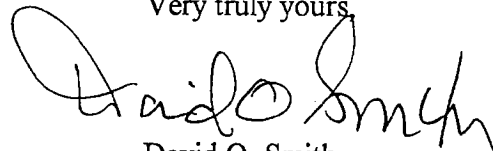
1. RAR issues M-0016 and M-0017. The increase in basis of the stock of Diamond Shamrock Coal Company (Coal).
2. RAR issues IE-0010 and M-0157. The increase in dividend income to Fint Corporation as an increase in investment in U.S. property by DS Investments, S.A. The disallowance under §165 of a on the worthlessness of the stock of Diamond Shamrock Europe Limited.
3. RAR issue M-0155. The increase in income on the recognition of a deferred intercompany gain realized on the formation of Diamond Shamrock R&M, Inc. (R&M) in 1983. The RAR imposes the recognition of the gain on the distribution of the stock of R&M in 1987.

4. RAR issue M-0014. The reduction in Investment Tax Credit (ITC) carryover on the distribution of R&M stock in 1987.
5. RAR issues M-0102, M-0156, and M-0162. The increase in income on the recognition of a deferred intercompany gain realized in 1984 on the sale of the stock of Natomas North America, Inc. The increase in income in 1989 on forgiveness of a debt of Natomas Energy Company (NEC) on the sale of NNA stock to Natomas Company.
6. RAR issues M-0139, M-0140, M-0141, M-0142 M-0143, M-0144, M-0145 and M-0146. The disallowance of product liability losses in 1987 and 1988 and the resulting carryback of such losses to tax years 1977 and 1978.
7. RAR issue M-0004. The disallowance of a correction of a mistake whereby net partnership income was reported twice.
8. RAR issue M-0039. The disallowance of the correction of a mistake in the 1987 return in the amount of \$9,644,522 and the imposition of an additional amount of income in the amount of \$9,644,522 doubling the mistaken entry. The RAR error results in an improper increase in 1987 taxable income in the amount of 2 times \$9,644,522 or 19,289,044.
9. RAR issues M-0092 and M-0093. The disallowance of the correction of a mistake in the 1987 return in the amount of \$18,911,981 and the imposition of an additional amount of income in the amount of \$17,565,234 almost doubling the mistaken entry. The RAR error results in an improper increase in 1987 taxable income in the amount of \$36,480,829.

Maxus requests an Appeals Conference with a representative of the Appellate staff in order to resolve the above issues.

Under penalties of perjury, I declare that I have examined this Protest and Brief, and to the best of my knowledge and belief the facts presented herein are true and correct.

Very truly yours,



David O. Smith
Assistant Secretary

BRIEF IN SUPPORT

OF

REVISED PROTEST OF MAXUS ENERGY CORPORATION

TAX YEARS 1987, 1988 & 1989

David O. Smith
Director of Tax &
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717 N. Harwood
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PROTEST ISSUE 3. RAR ISSUE M-0155
RECOGNITION OF DEFERRED GAIN ON DISTRIBUTION OF STOCK OF
DIAMOND SHAMROCK R&M, INC.

Maxus does not agree with the Auditor's issue regarding the recognition of deferred gain on the spin off of Diamond Shamrock R&M, Inc.

FACTS

Maxus does not disagree with the facts as stated by the Auditor. Some additional facts are necessary for determination of this issue.

On August 31, 1983, Diamond Shamrock Corporation acquired all of the stock of Natomas Company (Natomas). In the acquisition transaction a new Diamond Shamrock Corporation was formed (now named Maxus Energy Corporation). The old Diamond Shamrock Corporation changed its name to Diamond Shamrock Chemicals Company (Chemicals). Natomas was acquired as a 100% owned subsidiary of Maxus.

After the acquisition of Natomas Company, Maxus management decided to reorganize the corporate structure of Maxus. It was decided to form separate operating companies for each business unit. At the time Chemicals owned the assets of the chemicals business, the oil and gas producing assets of the exploration and production business, the refining and marketing assets, including the stock of Sigmor Corporation (Sigmor), and the stock of the operating coal companies, Falcon Coal Company and Amherst Coal Company.

The Maxus Legal Department was put in charge of designing the new corporate organization and implementing the reorganization transactions. A meeting was held during the week ending October 21, 1983, wherein the Legal Department outlined the anticipated transactions to the Maxus Tax Department personnel. (See Exhibit A, Weekly Report to the Vice President of Finance on Activities during the week ending October 21, 1983.) The Legal Department described the proposed transactions as follows:

- 1) Chemicals would form four subsidiaries:
 - a) Diamond Shamrock Exploration Company (Exploration)
 - b) Diamond Shamrock Refining and Marketing Company (R&M)
 - c) Diamond Shamrock Coal Company (Coal)
 - d) Diamond Shamrock Corporate Company (Corporate)
- 2) Chemicals would contribute to Exploration all the assets and liabilities of the exploration and production business, including the oil and gas producing properties and the stock of corporations owning exploration and production assets.

- 3) Chemicals would contribute to R&M all the assets and liabilities of the refining and marketing business including the McKee refinery, the stock of Sigmor and the stock of all other corporations owning refining and marketing assets.
- 4) Chemicals would contribute the office furniture and fixtures of the Lexington, Kentucky, coal headquarters and all the stock of the coal operating companies such as Falcon Coal Company and Amherst Coal Company.
- 5) Chemicals would contribute all of the assets and liabilities of the Dallas office to Diamond Shamrock Corporate Company (Corporate).
- 6) Chemicals would distribute the stock of Exploration, R&M, Coal and Corporate to Maxus.
- 7) Maxus would contribute the stock of Exploration, R&M and Natomas to an oil and gas holding company Diamond Shamrock International Energy Company.
- 8) Diamond Shamrock International Energy Company would contribute the stock of Natomas to Diamond Shamrock International Petroleum Company (DISPC).
- 9) At a later time the refining and marketing assets of Natomas would be transferred to R&M, the domestic exploration and production assets of Natomas would be transferred to Exploration, the coal assets of Natomas would be transferred to Coal and the international exploration and production assets of Exploration would be transferred to DSIPC.

In the contemplated transactions, the Legal Department did not propose that there be any intercompany notes between Exploration and its parent, between R&M and its parent, between Coal and its parent, or between DSIPC and its parent.

After researching the issues Maxus's Manager of State and Local Taxes, Fred Critchfield, recommended to management that since the vast majority of Exploration's assets would be located in Texas, in order to reduce Texas Franchise Tax liability, at the time of the formation of Exploration a note should be made between Exploration and its parent in a 3:1 debt:equity ratio. Mr. Critchfield also recommended that since the vast majority of the refining and marketing assets of R&M would be located in Texas, in order to reduce Texas Franchise Tax liability, at the time of the formation of R&M a note should be made between R&M and its parent in a 3:1 debt:equity ratio.

No debt was recommended for Coal because interest on an intercompany note would reduce the Net Income Limitation on Coal's statutory depletion under §611 of the Code. No debt was recommended for DSIPC because its home office was in California and California did not have a net worth based franchise tax. (See Exhibit B, Affidavit of Fred J. Critchfield. See also Exhibit C, a memo from Mr. Critchfield to T.J. Fretthold attorney in the Maxus Legal Department, recommending that in the redeployment transactions described in 9) above the balance on the intercompany notes be increased to maintain the 3:1 debt equity ratio.)

Based on Mr. Critchfield's recommendation the Maxus Legal Department included notes in a 3:1 debt equity ratio in the original capitalization of Exploration and R&M. Unfortunately, the Legal Department did not ask the Manager of Federal Taxes for his advice on the terms of the notes. If such advice had been requested, the Federal Tax Section of the Tax Department would have recommended that the notes have a 10 year maturity. Without such advice the Legal Department drafted the notes as demand notes.

In pursuance of the above plan the stock and notes of Exploration and R&M were distributed by Chemicals to Maxus. In further pursuance of said plan the stock and notes of Exploration were contributed by Maxus to Diamond Shamrock International Energy. When R&M was formed, Chemicals transferred its refining and marketing assets and liabilities to R&M in exchange for 100% of the stock of R&M and a note from R&M to Chemicals in the amount of \$361,983,771.

During the period November 1, 1983, to May 1, 1987, R&M made no interest or principal payments on said note. Each month the interest would be accrued and recorded in an intercompany liability account. In Exhibit H, attached hereto, is a consolidated balance sheet of the R&M unit which shows the original note labeled "Long Term Debt Intercompany" at \$361,984,000 as of December 31, 1983. It was increased to \$373,154,000 in 1984 pursuant to Mr. Critchfield's recommendation and remained at that balance until after December 31, 1986. There was never any intention of Maxus or the holder of the note, Diamond Shamrock International Company, to require R&M make any principal or interest payment on the note.

In late 1986 a take over of Maxus was launched by Mesa Petroleum. As a defensive measure Maxus decided to spin off the stock of R&M to its shareholders. Maxus and R&M entered into a distribution agreement prior to the spin off. As part of the Distribution Agreement, R&M agreed to obtain outside financing and use the proceeds to repay the note to its parent. Maxus formed a new corporation, Diamond Shamrock R&M, Inc. (RMI). Maxus contributed 100% of the stock of R&M to RMI. Maxus forgave the intercompany balance of \$195,737,577 owing by R&M to Maxus. Immediately thereafter the stock of RMI was distributed to Maxus's shareholders.

In the public documents filed with the SEC in connection with the spin off of R&M, the intercompany debt of \$373,154,000 is referred to as "Long-term Debt, Intercompany." See Exhibit H, Page F-3 of the Form 10 filed by Diamond Shamrock in connection with the spin off of Diamond Shamrock R&M Inc.

ISSUE

The issue presented is whether the note issued by R&M to Chemicals in 1983 was a security or represents boot in a §351 transaction. If the note is a security, there was not a deferred intercompany transaction in 1983. If the note was boot, there was a deferred intercompany transaction in 1983 and the unamortized portion of the gain on that transaction must be recognized by Maxus in 1987 on the spin off of RMI.

LAW AND ARGUMENT

I. Note Is a Security

Maxus is of the opinion that the note issued to Diamond Shamrock Chemicals Company (Chemicals) in connection with the formation of Diamond Shamrock Refining & Marketing Company (R&M) in 1983 was a security under §351.

The Auditor has cited the case of *Peter Raich v. Commissioner*, 46 T.C. 604 (1966) for the proposition that an intercompany note which was paid off in three and one

half years is not a security. The determination of whether a note represents an equity interest (a security) or other property is not an easy one. The test is, taking into consideration all the surrounding facts and circumstances, was it the intention of the parties at the time of the creation of the note to create a security or other property. In other words, was it the intention of the parties to create a continuing interest in the company or to make a sale of assets.

In *Raich* the shareholder received a note for \$16,280.58 in early 1960. By January 3, 1961 the balance on the note was \$12,755. On May 31, 1961 the balance was \$4,150. On May 31, 1962, the balance was \$1780. The note was paid in full by May 31, 1963. Obviously the formation of the corporation in *Raich* was part sale and part equity interest represented by the stock the shareholder received. The note was short term and payments were begun immediately. The shareholder intended to get some cash out of his business and did so in the form of the note payments.

In *Camp Wolters Enterprises, Inc. v. Commissioner*, 22 T.C. 737 (1954) a corporation issued a series of 89 notes with maturity dates from 5 to 9 years. The Tax Court held that these notes were equity and represented a permanent investment in the corporation. This case is usually cited for the proposition that while the length of term of a note is a factor, the real inquiry is the nature of the investment.

The management of Maxus had no intention to make a sale of property from Chemicals to R&M. The intention was to reorganize the corporation into a business unit format. It was not until the Tax Department informed management of the Texas State Tax advantage of capitalizing Exploration and R&M with notes, that the intercompany note was put into effect.

The following factors show that the note executed by R&M to Chemicals at the time of the formation of R&M was intended to be an equity interest:

1. There were no notes executed with respect to Coal and DSIPC because they did not do business in Texas.
2. The note was distributed in conjunction with the stock to Maxus.
3. The note was contributed in conjunction with the stock to Diamond Shamrock International Energy Company.
4. No payment of principal or interest was made on the note.
5. The accumulated interest was forgiven at the time of the spin off.
6. At the time of the spin off of R&M, R&M recapitalized in borrowing funds from a third party using the funds to extinguish the debt to its parent.
7. In public documents the note was referred to as a "Long Term Liability".
8. The note between Exploration and its parent was not extinguished until 1995. The reason for extinguishing the note at that time was at the insistence of a third party lender to Exploration. No payment of interest or principal was made on the Exploration note from its inception in 1983 until it was extinguished in 1995.

CONCLUSION

Maxus believes that it is clear that the intention of the parties at the time of creation of the note between R&M and Chemicals was to create a continuing equity interest in the business of R&M. The note should be considered a security under §351 of the Code and no deferred intercompany transaction occurred.

II. If Note Is Other Property

Maxus is of the opinion that if in the opinion of the Appellate Conferee the note is not a security and is "other property" under §351, the agent has erroneously calculated the amount of the gain to be recognized under Regs. §1.1502-13 as of the spin off of R&M.

Maxus was very surprised at the statement by the Auditor in his Response to Protest Issue 3. RAR Issue M-0155, Law and Argument II A 2, that Maxus did not respond to his IDR concerning his reduction of the tax basis of R&M assets in the amount of note by R&M to Chemicals. Attached as Exhibit D is a copy of the response to that IDR. This response and others were tendered to the Auditor in the presence of his Case Manager. He refused to accept them. The next day he accepted them but refused to sign a receipt for them.

Maxus was further surprised by the Auditor's statement that he requested depreciation schedules three times so that he could determine the gain amortization and Maxus refused to give him schedules.

First, Maxus provided a schedule showing the categories of all assets of R&M (the Auditor used this as the basis for his spreadsheet).

Second, Maxus provided the Auditor a written explanation of the year of acquisition of each category of depreciable asset and the method of depreciation for each category.

Third, the actual tax return work papers showing the depreciation calculations were records of Diamond Shamrock Inc. and not records of Maxus. Maxus requested such records from Diamond Shamrock, Inc. and was told they could not find any such records.

Fourth, Maxus searched its off site storage in October 1995 for such records for its original response to the original RAR. (Maxus never received a form 5701 prior to the RAR that would give Maxus notice that the depreciation of R&M assets during 1983-1987 was an issue in this audit.)

Fifth, Maxus Tax Department was moving its offices and sent the off site storage boxes back to off site storage in connection with the move. Maxus had not heard that the Auditor was not satisfied with the schedules presented to him.

Sixth, the Auditor issued IDR 263, six months after the RAR was issued, at that time Maxus searched again its off site storage records and found additional documentation of the R&M 1984 depreciation schedules. Maxus presented the response to this IDR to the Auditor. The Auditor refused this response, attached as Exhibit E, as stated above. He later accepted it, but refused to sign a receipt for the response.

A. Realized Gain
1. Introduction

The Auditor has erroneously calculated the amount of the gain realized in 1983 by Chemicals on the formation of R&M under §§351 and 1001. His determination of the realized gain is not in accordance with established tax principles..

The Auditor has determined that Chemicals owned an oil and gas refining and marketing business valued at \$582,122,000, that it transferred that business to a newly formed corporation that had no other assets, received in exchange 100% of the outstanding stock and a note for \$361,983,771, and that the value of the stock and note was \$1,177,077,612. Maxus believes that the Auditor came to that result through an erroneous view of the transaction. The Auditor has also erroneously determined Chemical's tax basis in the assets and liabilities of the refining and marketing business transferred to R&M.

2. Value of Refining and Marketing Business owned by Chemicals

The value of the refining and marketing business owned by Chemicals in 1983 had a fair market value of \$499,543,000 not \$582,122,000. Apparently, the Auditor did not understand the methodology of *Oil Industry Comparative Appraisals* as reported in the May 1984 issue. This periodical is attached as Exhibit F. On page 699 the periodical appraised the operating assets of the refining and marketing business as having a fair market value on December 31, 1983, of \$532,400,000. That amount is only the starting point to determine the value of the refining and marketing business. It does not include working capital items, investments, and liabilities. Notice that three lines below "Refining and Marketing" is found the words "Working Capital". The value of Diamond Shamrock's working capital in all of its businesses at that time was \$321,400,000 million. Some portion of that working capital was part of the refining and marketing business. Therefore, to determine the value of the refining and marketing business, we must add to the assets the refining and marketing working capital, investments, and liabilities.

The working capital of Diamond Shamrock's refining and marketing business was not located in only one corporation. There was a refining and marketing consolidated group for which the financial records determined a consolidated balance sheet. This balance sheet was prepared in connection with the spin off of R&M in 1987. That balance sheet as of December 31, 1983, is attached as Exhibit G. It was supplied to the Auditor with the response to IDR 167. Refining and marketing consolidated working capital is determined by subtracting "Total current liabilities" from "Total current assets" or subtracting \$392,573,000 from \$314,478,000. Therefore, the refining and marketing working capital is a negative \$78,095,000 as reported in the response to IDR 167. In order to determine the fair market value of Chemicals refining and marketing business, the remainder of the 1983 consolidated balance sheet must be added to the appraised value of the operating assets and the working capital. However, the \$361,983,771 note which was not incurred until formation must be ignored. This is because the determination is being made of the value of the refining and marketing business in the hands of Chemicals.

Including the listed Investments, Deferred Charges, Long Term Debt and Deferred Credits as shown in this consolidated balance sheet, the fair market value of the refining and marketing business owned by Chemicals in 1983 was \$499,543,000.

The Auditor arrived at his value of \$582,122,000 by not including negative values from the consolidated balance sheet. The value of a business is the fair market value of its assets less the fair market value of its liabilities. Maxus has no idea under what theory the Auditor is operating when he includes some portion of a business' balance sheet and not others in determining the fair market value of that business.

In any case it is clear that the fair market value of the refining and marketing business in the hands of Chemicals was \$499,543,000 at the date of transfer to R&M.

3. Value of R&M Stock Issued to Chemicals

In any sale or exchange (except a bargain sale where there is an implied gift as defined in Regs. Section 1.1001-1(e)) the value of the property received always equals the value of the assets transferred. Maxus agrees with the Auditor that the note should be valued at its face, \$361,983,771. That means that in order to determine the value of the stock issued by R&M to Chemicals the face amount of the note issued must be subtracted from the fair market value of the business transferred.

In the transfer of the refining and marketing business by Chemicals to R&M it has been established that the value of the refining and marketing assets was \$499,543,000; therefore, the value of the note plus the stock must equal \$499,543,000. Since the stock and debt issued by R&M must equal \$499,543,000, the value of the stock issued by R&M to Chemicals in partial exchange for the refining and marketing assets is \$499,543,000 minus \$361,983,771 or \$137,559,229. This concept is demonstrated in Exhibit G in that the stock holder's equity as of December 31, 1983 of the R&M consolidated group was only \$103,501,000. This does not match the fair market value for the equity because only book value of assets was used, retained earnings during the period November 1, 1983 - December 31, 1983 were included and the subject balance sheet is the R&M group consolidated balance sheet rather than the separate balance sheet of R&M. In addition, the balance sheet included in the RAR attachment shows a total equity of Chemicals in R&M of \$117,466,167. This cannot be reconciled with the Auditor's \$582,122,000 value of the R&M stock that the Auditor has determined.

The Auditor has cited to Rev. Rul. 56-303 as the Service's method of calculating the realized gain in a §351 transaction. Maxus agrees with the Revenue Ruling. However, in Rev. Rul. 56-303 all that is said is that the fair market value of the assets and liabilities transferred must equal the value of the stock and notes issued in exchange therefor. If the total value of the stock and notes is known but the value of the assets and liabilities transferred is not known, one can determine the value of the assets and liabilities transferred by adding together the values of the stock and notes issued in exchange for the assets and liabilities. In case one knows the value of the business (the assets and liabilities) and the value of the note issued, the value of the stock can be determined by subtracting the value of the note from the value of the assets and liabilities transferred. Rev. Rul 56-303 is in accord with this principle.

4. Inclusion of Intercompany Liabilities in Calculation of Proceeds

At the time of the transfer of the assets of the refining and marketing business by Chemicals to R&M, the Refining and Marketing division of Chemicals had an intercompany liability in the amount of \$232,971,841. The Auditor included this amount as proceeds in the determination of the realized gain to Chemicals on the transaction whereby it transferred the refining and marketing business to R&M and R&M transferred to Chemicals stock and a note. First, it is clearly improper to include the liability as additional proceeds, and second, it is improper to consider this liability as boot under §357.

The following example demonstrates the proper ways to handle liabilities assumed in a transaction governed by §351:

Assume corporation X decides to incorporate division R which has a value of \$500x. The R division has a liability of \$200x to corporation Z. X has a tax basis of \$100x in the assets of the R division. X incorporates the R division, transferring all of the assets and liabilities of the R division to newly formed M corporation. M corporation issues 500 shares of stock in exchange for the transfer.

Section 351 of the Code applies to this transaction to make it non taxable. Section 357(a) provides that liabilities assumed in a §351 transaction shall not be considered as money or other property. However, §357(c) provides that if the sum of the liabilities assumed exceeds the total adjusted basis of the property transferred, then such excess shall be considered as gain. Therefore, in this example X has a gain of \$100x on the transaction.

Section 357(c) only applies to the transaction between Chemicals and R&M if Chemicals' tax basis in its assets is less than the liabilities assumed. The Auditor states that the assumed liabilities were \$232,971,841. On page 4 of his spreadsheet he shows the tax basis of Chemicals' assets as \$635,350,793. (Maxus disagrees with this amount.) Therefore, given the Auditor's assumptions concerning the facts, by the terms of §357 there is no gain with respect to the assumption of the liabilities.

5. Result of Auditor's View of the Transaction

It has been demonstrated that assuming the executed note is "other property" under §351, Chemicals' realized gain is determined by subtracting Chemicals' tax basis in its refining and marketing division from the value of the refining and marketing division - \$499,543,000. This is the proper view of the transaction since all the steps, the transfer of the refining and marketing assets, the assumption of the refining and marketing liabilities, the issuance of the stock of R&M and the issuance of the \$361,983,771 note by R&M were interconnected and dependent upon each other.

On the other hand, the Auditor appears to view the steps as completely independent. He appears to assume that at step one Chemicals transferred all of its assets to R&M in exchange for its stock. This is shown by the Auditor's calculation of the value of the stock received by Chemicals was \$582,122,000. If his theory is adjusted to comply with §357, the value of the stock he shows should be added to the liability assumed in the amount of \$232,971,841. He is in effect claiming a stock value of \$815,093,841. (See

the Auditor's alternative position.) He shows the fair market value of Chemicals' assets on page 4 of his spreadsheet as \$880,977,399. This is not exactly his stock value amount because he neglected to account for some of the other liabilities assumed.

At step two the Auditor is assuming that R&M assumed the intercompany liability of \$232,971,841. At step three R&M issued a note in the amount of \$361,983,771. If the Auditor is correct that the steps are independent of each other, the tax result of these steps is as follows:

- a. The transfer of stock in exchange for the assets of the refining and marketing division of Chemicals is a nontaxable transaction under §351.
- b. Chemicals adjusted basis in the assets (\$635,350,793 according to the Auditor) transferred becomes the basis in the stock of R&M issued in the transaction under Regs. S1.358-1(a).
- c. The assumption of the intercompany liability of \$232,971,841 is a distribution from R&M to Chemicals under Regs. §1.301-1(d)(1)(ii).
- d. The distribution is not taxable under Regs. §1.1502-14(a).
- e. Chemicals' basis in its R&M stock is reduced by \$232,971,841 under Regs. §1.1502-32(b)(2)(iii) to \$402,378,952.
- f. The issuance of the note by R&M to Chemicals in the amount of \$361,983,771 is a distribution under Regs. §1.301-1(d)(1)(ii).
- g. The distribution is not taxable under Regs. §1.1502-14(a).
- h. Chemicals' basis in its R&M stock is reduced by \$361,983,771 under Regs. §1.1502-32(b)(2)(iii) to \$40,395,181.

None of the above steps results in a taxable transaction, even using the Auditor's erroneous basis amount for the assets of Chemicals. Maxus is willing to agree that the tax results of the transaction should be determined under the Auditor's apparent view of the transaction. In fact, Maxus believes this view is wrong and if the note is "other property" the transaction does result in a deferred intercompany gain which should be recognized on the spin off of R&M.

6. Chemicals' Tax Basis in the Refining and Marketing Business
a. Realized Gain on Transaction

The Auditor has calculated a total realized gain on this transaction in the amount of \$918,176,038. Maxus has shown that this extraordinary amount results from the Auditor's ignoring several principles of federal income taxation.

In any case the gross realized gain on the transaction is irrelevant. Rev. Rul. 68-55 states that any gain calculation must be done on an asset by asset basis. It is interesting to note that the Auditor state that the net tax basis of Chemicals in its refining and marketing assets is \$258,901,574. However, from his spreadsheet in the revised RAR he shows the tax basis of all assets be \$635,350,793 and liabilities other than the note issued in this transaction plus deferred taxes, which is not a liability for tax purposes, to be \$351,999,422. That would calculate to a net tax basis of \$283,351,371.

b. Basis in Stock of Sigmor Corporation

In Maxus's response to IDR 167, Maxus showed the Auditor that Chemicals' adjusted basis in the stock of Sigmor Corporation (Sigmor) was \$297,964,847. In Maxus's original protest it erroneously reported the adjusted basis of the stock of Sigmor as \$269,693,047. This error has no tax effect in this tax period.

Maxus determined the tax basis of Chemicals in the stock of Sigmor by adding the amount Chemicals paid for 21% of Sigmor stock in 1978 for \$28,200,000, plus 79% of Sigmor's tax basis in its assets less its liabilities at January 14, 1983, plus 82.6% of Sigmor's earnings and profits for 1983, plus a capital contribution of \$221,157,000.

The Auditor determined that Chemicals' tax basis in the stock of Sigmor was \$69,693,047. Interestingly, this is exactly \$200,000,000 less than the basis Maxus reported in its original protest. Maxus assumes the Auditor disallowed the \$221,157,000 capital contribution to Sigmor. No reason is given in the original RAR or the final RAR for the Auditor's reduction in the basis of Sigmor. From conversations with the Auditor it appears that he was of the opinion that Maxus had double counted the contribution to capital. He suspected that the \$221,157,000 was shown on Sigmor's balance sheet as an intercompany liability and as an asset on Chemical's books as an intercompany receivable. The double counting would have occurred if Maxus showed Chemicals as having an asset of a receivable from Sigmor in the amount of \$221,157,000 and also including it in the tax basis of the Sigmor stock. This double counting would increase the tax basis of Chemicals in its R&M assets by \$221,157,000.

In fact, the balance sheet of R&M at December 31, 1983, does show an intercompany receivable in the amount of \$222,113,513. Maxus was unable to find the records to demonstrate conclusively the transactions which resulted in creating this intercompany item. In the absence of records to the contrary, Maxus will defer to the Auditor's judgment and accept his reduction in the basis of the stock of Sigmor. Maxus believes that in accepting the Auditor's reduction in the tax basis, that the tax basis of Chemicals in the stock of Sigmor should be \$76,707,847.

c. Bad Debt Reserve

The Auditor has determined that the value of the accounts receivable of the refining and marketing business should not include the book bad debt reserve, but that the tax basis should include the book bad debt reserve. The refining and marketing accounts receivable at December 31, 1983, were \$121,463,363. The bad debt reserve for these accounts was \$674,527.

The Auditor cites Rev. Rul. 78-280 for the proposition that a bad debt reserve is included in the tax basis of accounts receivable. That revenue ruling does not apply. The taxpayer in that ruling was on the reserve method for tax purposes. Chemicals and Maxus are not on the reserve method. Bad debt are deducted by Maxus for tax purposes when the debt is determined to be uncollectible. The tax basis of Maxus and all of its subsidiaries for its accounts receivable is the face amount of the accounts since Maxus has taken the face amount of the accounts into gross income.

d. LIFO Reserve

The refining and marketing division of Chemicals had several reserve subaccounts in its inventory accounts. The reserve subaccounts netted to \$36,038,312. The Auditor has increased the value of the inventory of the refining and marketing business by the amount of these reserve accounts. Maxus believes this is improper. Under Regs. §1.381-5 R&M is required to continue the same method of dollar value LIFO inventory as Chemicals. If a gain were recognized in this transaction R&M would increase the tax basis of its inventory by the amount of the gain (§358(a)(1)(B)). Such increase in the tax basis in the inventory would mean that the LIFO inventory value for financial purposes would be different than the value for tax purposes. That would violate the LIFO conditions of §472(c). Maxus is of the opinion that Regs. §1.381-5 and §472(c) of the Code require it to value the inventory at its LIFO value of \$76,407,738.

B. Tax Effects of Transaction

1. Tax Effects Under §351(b)

For purposes of this Section II it has been assumed that the note issued by R&M to Chemicals was "other property" under §351, and that therefore, the transaction is partially taxable. This part B sets out how the transaction is to be taxed. Rev. Rul. 68-55 sets forth the method for determining the tax effects of a transaction under §351(b). This revenue ruling specifies that in a §351(b) exchange the recognized gain is to be determined on an asset by asset approach. Therefore, the amount of stock and boot that the transferring corporation receives should be allocated to each asset transferred on a fair market value basis. Then for each asset the gain to be recognized is the lesser of the realized gain or the allocated boot. The realized gain is determined by subtracting the transferor's tax basis from the fair market value of the asset.

With the Auditor's unique view of the transaction whereby Chemicals received \$1,177,077,612 in exchange for a business valued at \$499,543,000 an erroneous tax effect of this transaction was calculated by the Auditor. The violation of basic tax principles by the Auditor's approach is demonstrated by the fact that the Auditor has calculated that Chemicals should recognize a \$575.41 gain on its cash of \$1,712! Maxus has never before encountered a taxable gain on the transfer of cash! It is difficult to conceive of how would such a concept work. The Auditor must be proposing that Chemicals take a tax basis of \$2,207.41 in its cash account of \$1712 and then recognize a tax loss when it spent the cash. Other items such as inventory and receivable show a similar inconsistency with tax principles.

The proper method of determining the tax effect under §351(b) is demonstrated by Exhibit I, a spreadsheet prepared by Maxus which sets forth all of the assets of Chemicals refining and marketing business, the fair market value of each asset, the tax basis of each assets and the portion of the \$361,983,771 note to be allocated to each asset. The amount of the note (boot) to be allocated to each asset was determined by the following formula: fair market value of each asset divided by the fair market value of all assets (not including liabilities) times \$361,983,771. The fair market value of all assets was \$867,447,383. The total recognizable gain shown in Exhibit I is \$71,164,978.

2. Recognition of Deferred Gain

Since Chemicals and R&M were members of the same consolidated group from 1983 - 1987, The recognition of the gain under §351(b) is determined under the consolidated return regulations.

Regulations §1.1502-13 governs the recognition of gain or loss in an intercompany transaction. Basically, when an intercompany transaction occurs any gain or loss on the transaction is deferred until the selling member leaves the group, the purchasing member leaves the group or the asset sold is disposed of out of the group. An intercompany gain or loss on an asset subject to depreciation, depletion, or amortization (D,D&A) deferred under Regs. §1.1502-13, must be amortized over the life of the assets transferred. (Regs. §1.1502-13(d)). However, in a transaction subject to §351(b), no loss is to be recognized; therefore, only the assets on which Chemicals had a recognizable gain are subject to the deferred intercompany transaction rules of Regs. §1.1502-13.

When a corporation in a consolidated group acquires assets in a deferred intercompany transaction in which a gain is recognized, the acquiring corporation increases its basis in the assets by the amount of deferred gain in the transaction. The purchasing corporation then has increased D,D&A on those assets. Under subsection (d) of the regulation, the selling corporation recognizes gain in an amount approximately equal to the increased D,D&A. This procedure results in no increase in income or deduction to the consolidated group as a whole over the life of the assets. However, if the purchasing member of the group (R&M) leaves the group before the entire deferred gain has been recognized in the selling member's return, the remaining gain is recognized to the selling member as stated in Regs. §1.1502-13(f)(1).

Exhibit J shows the calculation of the amount of unamortized deferred gain to be recognized by Chemicals on spin off of R&M. That amount is \$14,511,815. Since Reg. §1.1502-13 was not designed efficiently, there is a mismatch of gain recognition and increased depreciation in the Maxus consolidated returns for the years 1983-1987. Exhibit J calculates that mismatch by determining the amount of gain to be offset during the years 1983-1987 in the income tax return of Chemicals and the increase in D,D&A to R&M during the years 1983-1987. The net mismatch during years 1983-1987 is a reduction in income in the amount of \$4,215,229. Since Maxus had an NOL at the end of 1986 carryable to 1987, this mismatch would increase the NOL available for use in 1987.

The increase in basis of assets transferred to R&M in 1983 were eligible for ACRS depreciation. (Prop. Regs. §1.168-4(d)(5)) Exhibit J shows the gain amortization of refining and marketing assets equal to the depreciation deduction for 5 year property. Exhibit J uses the following depreciable lives: Furniture and fixtures are 5 year property; autos and trucks are 3 year property; leased equipment is 5 year property; and the buildings are 19.5 year property. The gain amortization is roughly equal to the depreciation of those assets.

3. Treatment of Gain on Stock under §304

Exhibit I shows a realized gain on the transfer of the Sigmor stock in the amount of \$121,360,734. The amount of boot to be allocated to the Sigmor stock is \$82,630,149. However, that gain is not recognized under §304 and Regs. §1.1502-80. For transfers of stock within a consolidated return prior to 1991, Regs. §1.1502-80 provides that §304 applied to the transfer. In other words it was not a sale of stock but treated under §304 as a dividend from the acquiring corporation to the transferring corporation.

For transactions occurring after August 31, 1982, §304(b)(3)(A) provides that §304 takes precedence over §351. That section states, "subsection (a) (and not section 351 and not so much of sections 357 and 358 as relates to section 351) shall apply to any property received in a distribution described in subsection (a)."

Section 304 is very complicated, but in essence it provides that when a parent corporation (Chemicals) transfers the stock of one subsidiary (Sigmor) to another subsidiary (R&M), the amount received will be treated as a distribution from R&M to Chemicals and a contribution of capital of the Sigmor stock to R&M. The quoted portion above states that §304 only applies to the boot received in a §351(b) exchange. It does not apply to the stock received.

4. Explanation of Exhibit I

a. Column 1 is the detailed balance sheet of R&M showing the balance in each account. Debit balances are shown as positive, credit balances are shown with parentheses.

b. Column 2 is the summary balance sheet of R&M in the 1983 Consolidated Federal Income Tax Return. The detail in column 1 ties to the summary data in column 2.

c. Column 3 is the fair market value of the assets only. This spreadsheet assumes that fair market value of the property, plant & equipment of R&M equals its book value. There is no known detailed appraisal of these values. The Herold, Inc. appraisal provided to the Auditor and accepted by him said that the facilities were appraised at \$532,400,000 which had a book value of \$531,400,000. The facilities spoken of include the assets of Sigmor Corporation, Sigmor Refining Company, all of the Sigmor subsidiaries (each gas station was a separate corporation), The Shamrock Pipeline Company, D-S Pipeline Company, etc. Since the Three Rivers Refinery owned by Sigmor Refining Company was just completed in 1983, the assumption was made that any value in excess of book value was in Sigmor Refining Company. It was also assumed that the value of the stock transferred by Chemicals to R&M was equal to book value.

d. Column 3 is the tax basis of each asset. The tax basis of cash, receivable, and inventory is equal to book value. The tax basis of the stock in subsidiaries was calculated in response to IDR 167. We have not been able to locate a copy of the R&M separate return for 1983 which would have a detailed depreciation schedule (form 4562). Therefore, in absence of a detailed tax basis, it was assumed that all tax basis per a memo dated January 25, 1985, should be allocated to the McKee Refinery. That leaves all other property plant and equipment with a tax basis of \$0, except for the land which would not be depreciable and whose tax basis should equal its book cost.

e. Column 5 is the realized gain on each asset transferred, which is fair market value less tax basis.

f. Column 6 is the proper allocation of boot. The allocation was done with the following formula: fair market value of each asset **divided by** the total fair market value of all assets (not including liabilities) **times** the boot amount of \$361,893,771.

g. Column 7 is the recognizable gain under §351(b) being the lesser of the realized gain or boot allocation for each asset. No gain is recognized on the stock of subsidiaries transferred from Chemicals to R&M under §304.

5. Explanation of Exhibit J.

Exhibit J shows the calculation of the amortization of the deferred gain to Chemicals and the resulting recognizable gain on the spin off of R&M in 1987. The assets shown are only the depreciable and amortizable assets.

a. Column 1 is the same as Column 1 in Exhibit I.

b. Column 2 is the same as Column 4 in Exhibit I.

c. Column 3 is the same as Column 7 in Exhibit I.

d. Columns 4, 5, 6, 7, and 8 show the amount of total depreciation for the transferred assets in R&M's hands. The total depreciation for each year is shown in the row labeled "TOTAL DEPRECIATION OF GAIN ASSETS". The next row labeled "RECOGNIZED GAIN" shows the deferred gain recognized by Chemicals in tax years 1984 - 1987 as calculated by the formula

shown at the bottom of Exhibit J. The next row labeled "DEPRECIATION OF BASIS INCREASE" shows the increase in depreciation to R&M as a result of the recognizable gain. The next row labeled "INCR (DECR) IN TAXABLE INCOME" shows the difference between the two previous rows and calculates the mismatch in depreciation and recognizable gain.

e. Column 9 shows the remaining amount of gain to be recognized by CHEMICALS in 1987 on the spin off of R&M. That remaining gain as of May 1, 1987 is \$14,511,815.

CONCLUSION

If the Agent is correct that the note issued by R&M in connection with its formation is "other property" as defined in §351, Maxus must recognize a deferred intercompany gain in 1987 in the amount of \$14,511,815. R&M must increase the basis in its assets as of the date of the spin off by \$14,511,815. In addition Maxus's taxable income for 1983 should be reduced by \$4,124,956. The taxable income for 1984 should be increased by \$1,810,685. The taxable income for 1985 should be increased by \$1,414,216. The taxable income for 1986 should be reduced by \$1,009,620. The taxable income for 1987 should be reduced by \$2,305,553. The net adjustment to 1987 income should be \$10,296,586.



Diamond Shamrock

EXHIBIT A

RECEIVED
NOV 14 1983

NATOMAS TAX DEPT.

Interoffice Correspondence

To: R. M. Ahlstrom
From: Corporate Tax Department
Date: November 11, 1983

Subject: Weekly Activity Report
Week Ending November 11, 1983

D 118-D

REFINING AND MARKETING UNIT -- J. L. Matthews

1. Completed several Final Form 940's and Form 941's on TETCO "Shell" Companies in order to receive over-payment refunds and zero all tax accounts on IRS transcript of accounts.
2. The IRS audit of Federal income taxes for RYE's 6/80, 6/81, 6/82 and 1/83 is continuing.
3. The IRS audit of Windfall Profits Tax including Net Income Limitation for 7/1/82 to 12/31/82 on Sigmor Corporation is progressing.
4. Wrote memo on requirements of microfilming (to include microfiche) in accordance with Rev. Proc. 81-46.

EXPLORATION AND PRODUCTION UNIT -- J. L. Carter

1. We are studying the integration of Natomas offshore into our tax system.
2. We are working on 1983 tax partnership information, final information for the IRS for 1979 - 1981, 1983 Federal tax data gathering, and 1982 net income limitation.
3. We are analyzing various 1983 tax reporting problems due to Refining and Marketing accounts, Natomas, and the November 1 reorganization.
4. Gary Gibson resigned effective November 15, 1983.

FEDERAL TAX

1. Responded to a question from SDS Biotuh in reference to the DISC election procedure.
2. Met with Chemical Unit personnel concerning divertitive program.
3. Finalized logic corrections in Visicalc Tax provision program.

FEDERAL TAX (continued)

4. Prepared backup withholding mailout to vendors.
5. Updated 1983 tax provisions calculation for October closing.
6. Deposited semi-monthly superfund payment.
7. Paid final tax and interest amount in settlement of Falcon Seaboard 1975-1978 IRS audits.
8. Continued final assembly of 1982 amended return and refund claims.

STATE AND LOCAL TAX

1. Preparing 1982 state and local income tax returns for Diamond Shamrock Chemicals.
2. Gathered information to prepare tax returns due November 15.
3. Discussed with Mark Miller the State of New Jersey interrogatories on the windfall profits tax litigation. Mark is to attend a meeting in Newark next week to discuss the industry's responses to the interrogatories.
4. Discussed with J. L. Carter how to structure Diamond Shamrock Exploration Company's inter-company debt to avoid paying future franchise and income taxes.
5. Sent additional information to our outside counsel to file a protest on the Kentucky sales and use tax assessment.
6. Advised sales offices on two (2) state sales and use tax rate increases.
7. A Texas franchise tax auditor is scheduled next week to audit Diamond Shamrock Chemical's 1979-1983 returns.

NATOMAS -- J. I. Mattox

1. Continued discussions of license acquisition allowance for U.K. Corporate tax.
2. Attended two meetings on tax provision and purchase price allocation.

STATE OF TEXAS

COUNTY OF DALLAS

BEFORE ME, the undersigned personally appeared Fred J. Critchfield, known to me to be a credible person, and after being duly sworn by me stated on his oath as follows:

That in 1983 he was employed by Diamond Shamrock Corporation. That Diamond Shamrock Corporation changed its name to Maxus Energy Corporation (Maxus). That his position in 1983 was Manager, State and Local Taxes. That he performed state tax planning services for Maxus.

That the Maxus Legal Department was put in charge of designing the new corporate organization and implementing the reorganization transactions. A meeting was held during the week ending October 21, 1983, wherein the Legal Department outlined the anticipated transactions to the Maxus Tax Department personnel. (See Exhibit A, Weekly Report to the Vice President of Finance on Activities during the week ending October 21, 1983.) The Legal Department described the proposed transactions as follows:

- 1) Chemicals would form four subsidiaries:
 - a) Diamond Shamrock Exploration Company (Exploration)
 - b) Diamond Shamrock Refining and Marketing Company (R&M)
 - c) Diamond Shamrock Coal Company (Coal)
 - d) Diamond Shamrock Corporate Company (Corporate)
- 2) Chemicals would contribute to Exploration all the assets and liabilities of the exploration and production business, including the oil and gas producing properties and the stock of corporations owning exploration and production assets.
- 3) Chemicals would contribute to R&M all the assets and liabilities of the refining and marketing business including the McKee refinery, the stock of Sigmor and the stock of all other corporations owing refining and marketing assets.
- 4) Chemicals would contribute the office furniture and fixtures of the Lexington, Ky. coal headquarters and all the stock of the coal operating companies such as Falcon Coal Company and Amherst Coal Company.
- 5) Chemicals would contribute all of the assets and liabilities of the Dallas office to Diamond Shamrock Corporate Company (Corporate).
- 6) Chemicals would distribute the stock of Exploration, R&M, Coal and Corporate to Maxus.
- 7) Maxus would contribute the stock of Exploration, R&M and Natomas to an oil and gas holding company Diamond Shamrock International Energy Company.
- 8) Diamond Shamrock International Energy Company would contribute the stock of Natomas to Diamond Shamrock International Petroleum Company (DISPC).
- 9) At a later time the refining and marketing assets of Natomas would be transferred to R&M, the domestic exploration and production assets of Natomas would be transferred to Exploration, the coal assets of Natomas would be transferred to Coal and the international exploration and production assets of Exploration would be transferred to DSIPC.

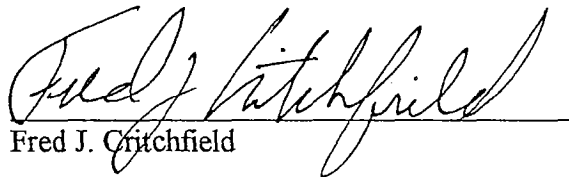
In the proposed transactions, the Legal Department did not propose that there be any intercompany notes between Exploration and its parent, between R&M and its parent, between Coal and its parent, or between DSIPC and its parent.

After researching the issues he recommended to management that since the vast majority of Exploration's assets would be located in Texas, in order to reduce Texas Franchise Tax liability, at the time of the formation of Exploration a note should be made between Exploration and its parent in a 3:1 debt:equity ratio. He also recommended that since the vast majority of the refining and marketing assets of R&M would be located in Texas, in order to reduce Texas Franchise Tax liability, at the time of the formation of R&M a note should be made between R&M and its parent in a 3:1 debt:equity ratio

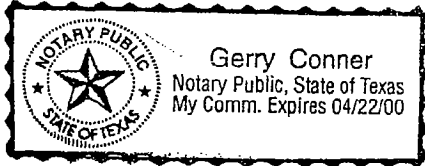
No debt was recommended for Coal because interest on an intercompany note would reduce the Net Income Limitation on Coal's statutory depletion under §611 of the Code. No debt was recommended for DSIPC because its home office was in California and California did not have a net worth based franchise tax.

Based on his recommendation the Maxus Legal Department included notes in a 3:1 debt equity ratio in the original capitalization of Exploration and R&M.

Further Affiant saith not.


Fred J. Critchfield

Sworn to and subscribed before me this the 16 day of July, 1996.




Notary Public for the State of Texas

Interoffice Correspondence

To: T. J. Fretthold
From: Fred J. Critchfield
Date: March 20, 1984

Subject: Redeployment of Natomas and Subsidiaries and Exploration Company's Foreign Subsidiaries

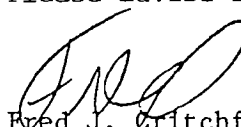
D 118

We have the following comments on the March 13, 1984 draft memo applicable to the redeployment of Natomas and Subsidiaries and Exploration Company's foreign subsidiaries:

1. Part III, A and B -
If Natomas North American, Inc. and Natomas of Canada, Inc. are contributed to Diamond Shamrock Exploration Co. (DSEC) and Diamond Shamrock Refining and Marketing Co., (DSRMC) it will increase the capital base for DSEC and DSRMC. The Texas franchise taxes would subsequently be higher for both companies.

To lower prospective Texas franchise taxes and other state income taxes, we recommend that the value of the subsidiaries be transferred at 25% contribution to capital and 75% intercompany debt. Two interest bearing debt instruments should be written to formalize the intent to pay back the debt.
2. Part III, C -
Since Diamond Shamrock Coal Company is a subsidiary of Diamond Shamrock Corporation, DSIEC can not contribute Natomas Coal directly to Diamond Shamrock Coal.
3. Parts II and III--
Assuming that DSIPC will be incorporated and qualified to do business in Delaware only, it will not matter for state tax purposes how you transfer Natomas Company and the Exploration Company's foreign subsidiaries.

Please advise if you have any questions.



Fred J. Critchfield

FJC:ls

RESPONSE TO IDR M-0256

In the last paragraph on the second page of Attachment A to your original form 5701 M-0155 you state "taxpayer included \$232,429,203 in inter company accounts owed to DSRMC; however, the taxpayer did not include in intercompany accounts owed to its parent, DSC, in the amount of the note given on the date of distribution, \$361,983,771."

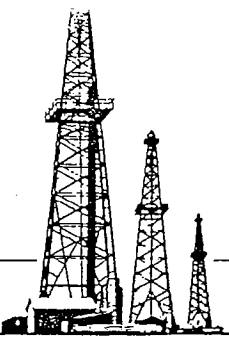
In the section of my response to which you refer and in this section of your 5701 the discussion concerns Diamond Shamrock Chemical Company's (DSCC) tax basis in its assets transferred to DSRMC. (We must look at DSCC's tax basis because it is the corporation for which you are proposing to recognize taxable gain.) In this last paragraph on the second page you reduce DSCC's tax basis for the amount of the note given. This is not proper. The note is given by DSRMC TO DSCC it is not an account payable that would reduce the tax basis of the assets of DSCC.

Therefore it was proper for me to increase the tax basis of DSCC's assets for the intercompany accounts owed to DSCC prior to the transfer, but it is not proper for you to reduce the tax basis of DSCC's assets for a note owed by DSRMC to DSCC after the transfer.

EXHIBIT E (without attachments)

RESPONSE TO IDR M-0263

I have previously given to you Maxus's response on the depreciation of DSRMC's assets for the years 1983-1987. In my second prior response the attached table shows the basis of each asset group and the depreciation classification (Guideline, ADR, ACRS + vintage year). In the written part of the response (page 4, 2. a.) is a written description of the assumptions used in my depreciation schedule. This is all I know to give you. You have sufficient data to recreate my schedule.



OIL INDUSTRY COMPARATIVE APPRAISALS

MAY 1984 EDITION

PAGES 691-778

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Annual Subscription - \$295

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FILING INSTRUCTIONS: This edition should be filed on top of the material already in your binder.

Company appraisals in this May 1984 edition include:

American Petrofina	Lear Petroleum	Pogo Producing	Std. Indiana
Diamond Shamrock	PanCanadian Petroleum	Quaker State Oil	Texas Eastern Corp.
ENSERCH Corp.	Phillips Petroleum	Shell Oil	United States Steel Corp.
Gulf Canada			Wainoco Oil

YOUR ATTENTION IS CALLED to Diamond Shamrock and United States Steel Corp., new OICA additions on pages 699 and 762, respectively, the OIL STOCK PANOGRAPH on page 693 and the Appraised Values and Price/Appraised Worth Ratios on page 774. A revised Occidental Petroleum appraisal will be found on page 722.

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(Continued on next page)

DIAMOND SHAMROCK CORPORATION

PROFITS SHOULD ADVANCE MODESTLY for several years from DIA's diverse 12-31-83 assets. During 1984, management expects cash earnings from operations and redeployment of assets "to reach an all-time high of over \$1 billion, more than adequate to fund record capital spending of \$700 million, support the dividend and pay down debt," which was 76% of shareholders' equity at 12-31-83.

PROFILE: Diamond Shamrock is engaged in oil and gas exploration and production, refining, marketing, chemicals, coal production and geothermal energy. During 1983, sizable acquisitions included Sigmor Corp., principally a refiner and marketer of gasoline in Texas, and Natomas Company, a major producer of Indonesian oil and California geothermal energy.

APPRAISED WORTH of Diamond Shamrock's tangible assets as of 12-31-83 is outlined as follows:

		Total Million \$	\$ Per Common Share*
Energy Reserves	(a)		
Crude Oil		1,004.5	7.95
Natural Gas		1,333.9	10.55
Geothermal		710.3	5.60
Coal		275.5	2.15
Prospective Acreage	(b)	600.0	4.75
Refining & Marketing	(c)	532.4	4.20
Chemical Facilities	(d)	580.4	4.60
Investments & Other Assets	(e)	471.5	3.70
Working Capital	(f)	321.4	2.55
		<u>5,829.9</u>	<u>46.05</u>
Less: Long-Term Liabilities	(g)	<u>2,070.4</u>	<u>16.35</u>
<u>APPRAISED NET WORTH</u>		3,759.5	29.70
Less: Preferred Stock @ Liquidating Value		<u>258.0</u>	<u>2.05</u>
<u>APPRAISED NET WORTH OF COMMON</u>		3,501.5	27.65**

*Based on 126,561,585 shares. **Conversion of the preferred into 7,252,287 common shares would increase the appraised worth to \$28.10 a share.

Net book value of Diamond Shamrock's common stock at 9-30-83 was \$2,736,600,000, or \$21.62 a share, and Company estimates that the replacement cost of its assets would be \$3,855,600,000, or \$28.81 a share.

EXPLANATORY NOTES TO APPRAISED WORTH

(a) Reserves:

	-----Estimated Quantities-----		
	United States	Indonesia	Other
Net Oil Reserves*	35,800,000 bbls.	73,900,000 bbls.	10,400,000 bbls.
Net Oil Production	5,300,000 bbls.	11,000,000 bbls.	1,300,000 bbls.
Reserves/Production Ratio	6.8	6.7	8.0
Current Sales Price	\$29.75/bbl.	\$29.00/bbl.	\$29.00/bbl.
Current Operating Cost	\$12.35/bbl.	\$10.00/bbl.	\$15.00/bbl.
Current Operating Profit	\$17.40/bbl.	\$19.00/bbl.	\$14.00/bbl.
Current Annual Oper. Profit	\$ 92,200,000	\$ 209,000,000	\$ 18,200,000
Future Operating Profit	\$571,400,000	\$1,322,600,000	\$113,600,000
Less: Development Costs	\$ 45,000,000	\$ 80,000,000	--
Net Future Oper. Profit	\$526,400,000	\$1,242,600,000	\$113,600,000
Present Worth - Total**	\$282,400,000	\$ 658,100,000	\$ 64,000,000
- Per Unit	\$ 7.89/bbl.	\$ 8.91/bbl.	\$ 6.16/bbl.
Net Gas Reserves*	821.9 bill. cu.ft.	4.4 bill. cu.ft.	88.8 bill. cu.ft.
Net Gas Production	100.0 bill. cu.ft.	.3 bill. cu.ft.	4.7 bill. cu.ft.
Reserves/Production Ratio	8.2	14.7	18.9

(Continued on next page)

(Continued from previous page)

	- - - - - Estimated Quantities - - - - -		
	United States	Indonesia	Other
Current Sales Price	\$3.00/MCF	\$2.50/MCF	\$4.50/MCF
Current Operating Cost	\$.85/MCF	\$.55/MCF	\$2.50/MCF
Current Operating Profit	\$2.15/MCF	\$1.95/MCF	\$2.00/MCF
Current Annual Oper. Profit	\$ 215,000,000	\$ 600,000	\$ 9,400,000
Future Operating Profit	\$3,082,400,000	\$10,700,000	\$288,600,000
Less: Development Costs	\$ 20,000,000	--	\$ 4,000,000
Net Future Oper. Profit	\$3,062,400,000	\$10,700,000	\$284,600,000
Present Worth - Total**	\$1,253,900,000	\$ 5,300,000	\$ 74,700,000
- Per Unit	\$1.53/MCF	\$1.20/MCF	\$.84/MCF

*Company estimates as of 12-31-83, excluding reserves to be sold to Apache Petroleum. Oil reserves are 82% developed in the U.S., 83% in Indonesia and 99% in other areas. Gas reserves are 96% developed in the U.S., 100% in Indonesia and 90% in other areas. **Our \$2,338,400,000 appraisal of Diamond Shamrock's oil and gas reserves is based on a 15% discount. If a 10% discount were used, the value would be \$2,914,500,000 and at 20% it would be \$1,939,500,000.

Based on SEC guidelines, Company says that future net revenues from its 12-31-83 proven reserves of oil and gas and their present worth at 10% discount will be as follows:

	U.S.	Indonesia	Other Foreign	Total
	- - - - - Million \$ - - - - -			
Future Net Revenue	2,541	1,220	431	4,192
Present Worth	1,626	939	259	2,824

Geothermal Reserves at 12-31-83 amounted to 171,000,000 equivalent barrels of oil. Company drills for and supplies naturally-generated steam to electrical power plants owned and operated by a California utility from the 50%-owned The Geysers in Northern California, "the world's largest geothermal energy project." Company's share of steam generated 2,500,000 megawatt-hours of electricity in 1983, which was equal on a BTU basis to about 4,400,000 barrels of oil. Management says, "new electric generating plants will increase our customer's capacity at The Geysers by 25% by 1988." Company is also evaluating plans for developing its Hawaiian geothermal prospect, where two exploratory tests have been drilled. Appraised at 12-31-83 net book value of \$710,300,000.

Coal Reserves at 12-31-83 were 1,148,500,000 tons. Production in 1983 was 7,100,000 tons. Net book value at 12-31-83 was \$119,600,000. Operating profits averaged \$55,100,000 per year during the 3 years ended 12-31-83. Appraised at 5 times this amount, or \$275,500,000, which is equivalent to 24¢ per ton of reserve.

(b) Prospective Acreage at 12-31-83 included 3,800,000 net acres in the U.S. and 6,800,000 net acres in Indonesia, North Sea, Colombia, Tunisia, Australia, New Zealand, etc. Company's "unproved properties" had a 12-31-83 cost of \$1,201,700,000. Appraised at \$600,000,000.

(c) Refining & Marketing Facilities include refineries in Texas with capacities of 72,000 b/d and 45,000 b/d and approximately 2,100 North American retail outlets. Company is No. 4 in petroleum product sales in Texas. Motor fuels and heating oil are also sold in Canada. We appraise Company's downstream facilities at \$532,400,000, or 4 times average annual operating profits of \$133,100,000 in the 3 years ended 12-31-83 compared to a net book value of \$531,400,000.

(d) Chemical Facilities: Company is engaged in the manufacture and sale of a variety of commodity and specialty chemicals. Management says, "we are the only major U.S. chlor-alkali chemicals producer that has not been forced to shut down capacity in the last seven years." Operating profits, which declined 45% in 1983 to \$72,600,000 due to a \$58,600,000 pre-tax write-off, averaged \$145,100,000 annually in the 3 years ended 12-31-83. Appraised at 4 times this amount, or \$580,400,000 compared to a 12-31-83 net book value of \$530,000,000.

(e) Investments & Other Assets at 12-31-83 included \$248,000,000 in investments, intangible assets amounting to \$132,600,000, deferred charges of \$27,600,000 and miscellaneous assets with a net book value of \$63,300,000. Total - \$471,500,000.

(f) Working Capital at 12-31-83 was \$321,400,000 (current assets of \$1,167,500,000, including \$160,000,000 for properties to be sold to Apache Petroleum, less current liabilities of \$846,100,000).

(g) Long-Term Liabilities at 12-31-83 included long-term debt of \$1,797,900,000, lease obligations of \$25,300,000 and other liabilities and deferred credits of \$247,200,000. Total - \$2,070,400,000.

	1979	1980	1981	1982	1983	% Change 1979-83a	
	Sources of Operating Profits					DIA	Industry
Oil & Gas Production	NA	NA	\$ 287.5	\$ 330.0	\$ 466.1	NA	+ 104
Refining & Marketing	NA	NA	165.9	134.0	99.5	NA	+ 13
Coal	NA	NA	43.4	66.5	55.5	NA	--
Geothermal	NA	NA	--	--	23.5	NA	--
Chemicals	NA	NA	231.6	131.2	72.6	NA	- 30
Corporate	NA	NA	(131.5)	(128.1)	(176.4)	NA	--
Total	NA	NA	596.9	533.6	540.8	NA	+ 79
-----Capital Expenditures-----							
Oil & Gas Production	NA	NA	\$ 317.5	\$ 439.2	\$ 276.9	NA	+ 172
Refining & Marketing	NA	NA	40.7	24.4	37.8	NA	+ 107
Coal	NA	NA	25.9	30.4	20.4	NA	--
Geothermal	NA	NA	--	--	14.8	NA	--
Chemicals	NA	NA	140.5	103.0	33.4	NA	+ 68
Other	NA	NA	25.1	15.7	29.5	NA	--
Total	\$ 310.4	\$ 449.9	549.7	612.7	412.8	+ 33	+ 130
Capital Expend./Cash Earnings*	.9	1.1	1.2	1.4	.9	--	--
----- Balance Sheet & Appraisal Data-----							
Working Capital	\$ 429.7	\$ 535.2	\$ 472.0	\$ 313.3	\$ 321.4	- 25	- 53
Long-Term Obligations	750.9	844.9	869.3	947.4	2,070.4	+ 176	+ 96
Total Assets	2,514.5	2,895.5	3,016.4	3,194.0	6,024.4	+ 140	+ 102
Net Book Value	1,101.4	1,329.2	1,349.7	1,407.2	2,736.6	+ 148	+ 66
Net Worth by JSH (1)	--	--	--	--	3,501.5	--	+ 69
Debt/Book Value Ratio*	.70	.63	.64	.67	.76	--	--
Debt/App. Worth Ratio*	--	--	--	--	.59	--	--

OPERATING DATA - Millions

Net Oil Reserves, bbls.	37.3	36.0	36.0	33.3	120.2	+ 222	- 7
Net Oil Production, bbls.	3.5	3.5	3.8	3.8	11.7	+ 234	- 11
Net Gas Reserves, MCF	865.9	893.5	931.3	879.5	915.2	+ 6	+ 2
Net Gas Production, MCF	110.1	110.5	112.7	102.3	96.0	- 13	- 12
Net Coal Reserves, tons	418.6	678.2	1,013.0	1,044.1	1,148.5	+ 174	--
Net Coal Production, tons	7.5	7.6	6.4	7.7	7.1	- 5	--
Refinery Runs, bbls.	18.6	25.9	25.9	25.9	42.7	+ 130	- 19
Ratio Runs/Production*	5.3	7.4	6.8	6.8	3.6	--	--
Refined Product Sales, bbls.	25.0	30.8	30.5	33.0	47.8	+ 91	- 16

FINANCIAL DATA PER UNIT

Operating Profit							
Per equiv. bbl. production	NA	NA	\$ 12.72	\$ 15.79	\$ 16.83	NA	--
Per bbl. refined product	NA	NA	5.44	4.06	2.08	NA	--

(1) 15% discount. (a) 1978-82 for the industry.

Oil Finding & Development Costs of Diamond Shamrock have been substantially greater than those of the industry.

	Diamond Shamrock's Cost						Weighted Avg. Cost 1978-83*	
	1978	1979	1980	1981	1982	1983	DIA	Industry
	\$/equivalent barrel**							
United States	18.86	19.28	9.60	12.69	41.63	17.93	17.46	10.75
Foreign	23.00	***	.46	2.37	***	14.56	14.39	6.25
Worldwide	18.93	24.98	8.58	11.72	48.23	15.05	15.81	8.89

*1978-82 for the industry. **Gas converted to oil at 6 MCF/bbl. ***Downward revisions of prior years' estimates exceeded reserves found..

continuing through 1988 as DIA "pursues an accelerated remodeling and reidentification program to enhance the image of our outlets and as we add new Company-owned retail outlets in our existing marketing area."

(d) Company says, "our long-term coal sales contracts combined with continued attention to cost control and mining efficiency are expected to maintain 1984 operating profits at or above 1983 levels." Because of its competitive advantages as a low-cost supplier of low-sulphur, high-BTU coal and its proximity to East Coast ports, DIA is aggressively pursuing medium and long-term contracts with foreign customers. Management says, "we began aggressively seeking long-term contract customers for a one-billion-ton Alaskan coal resource, in which we are operator and 50% interest owner. Several years of study has confirmed that we could become the lowest-cost supplier of energy to rapidly expanding Pacific Rim economies."

(e) The acquisition of Natomas made DIA a 50%-owner of the world's largest geothermal energy project, The Geysers, which is located in California. Management says, "geothermal operations should show increased earnings as prices and capacity utilization rise. We have contracted to supply steam for 50 years after the last Pacific Gas and Electric Company generating plant is built." DIA is also "evaluating plans for developing a Hawaiian geothermal prospect and a prospect in Northern California." Exploratory tests have been drilled in both of these areas.

(f) DIA says, "our chemical businesses will show substantial improvement as the industrial economy expands, and they will continue to provide attractive cash flow."

COMPANY ADDRESS: Diamond Shamrock Tower, 717 North Harwood Street, Dallas, Texas 75201. Chairman & CEO - William H. Bricker. Investor Contact - Robert S. Beadle. Telephone (204) 922-2000. Common stock is traded on the New York, Pacific and several foreign stock exchanges with the symbol DIA.

William D. Swanston
John S. Herold, Inc.
Greenwich, CT 06830
April 1984

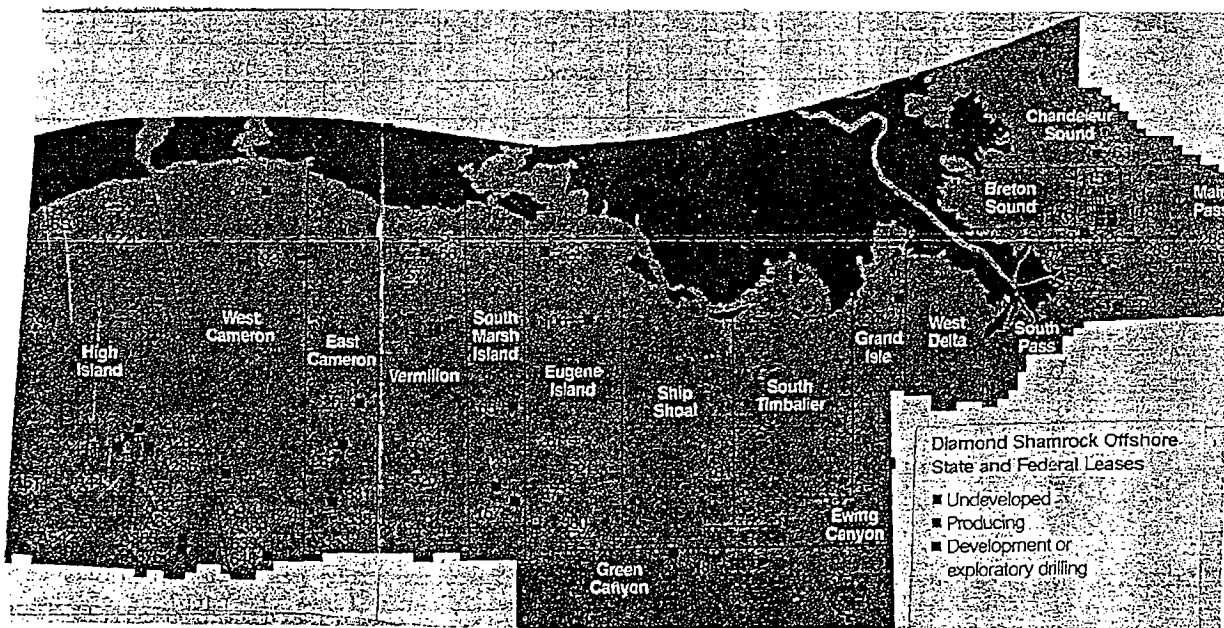


EXHIBIT G

k25 DIAMOND SHAWROCK REFINING & MARKETING COMPANY 21-Jan-87
 CONSOLIDATED BALANCE SHEET
 December 31, 1986
 (dollars in thousands)

	December 31, 1986	December 31 1985	December 31 1984	December 31 1983
ASSETS				
Current Assets				
Cash	20,185	9,071	13,247	8,028
Temporary investments	0	869	0	0
Receivables	76,129	126,961	129,855	137,372
Inventories	135,425	212,812	185,165	168,284
Prepaid expenses and other assets	17,273	3,413	1,403	794
Total current assets	249,012	353,127	329,671	314,478
Investments	27	45	62,398	49,722
Properties & Equipment, less depr.	522,125	518,829	531,051	528,700
Deferred Charges	(243)	16,089	12,011	4,615
TOTAL ASSETS	770,921	888,090	935,131	897,515
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current Liabilities				
Notes payable	0	0	5,295	12,741
Long-term debt and capl leases payable within one year	288	329	404	393
Accounts payable	90,250	123,300	108,732	148,004
Accounts payable, intercompany	251,276	254,928	153,445	204,729
Taxes payable	14,978	15,956	19,779	(8,856)
Accrued liabilities	45,751	84,230	85,205	35,562
Total current liabilities	402,543	478,743	372,859	392,573
Long-Term Debt	118	1,765	2,033	2,322
Long-Term Debt, intercompany	373,154	373,154	373,154	361,984
Long-Term Capital Lease Obligations	314	0	0	0
Deferred Income Taxes	74,116	71,102	50,292	30,358
Other Liabilities and Def Credits	0	882	478	6,777
Stockholders' Equity				
Common Stock -xx Shares Issued	0	0	0	1,000
Preferred Stock - XX Shares Issue	0	0	84,437	500
Paid-in Capital	160,693	160,693	129,286	120,662
Cumulative translation adjustment	0	0	(1,285)	(2,262)
Retained earnings	(240,017)	(198,250)	(76,123)	(16,399)
	(79,324)	(37,557)	136,315	103,501
TOTAL LIAB AND STOCKH. EQUITY	770,921	888,090	935,131	897,515

k25

EXHIBIT H

DIAMOND SHAMROCK R&M, INC.

CONSOLIDATED BALANCE SHEET (dollars in thousands)

ASSETS

	December 31.	
	1986	1985
Current Assets		
Cash and temporary investments	\$ 20,185	\$ 9,940
Receivables, less doubtful receivables	30,129	56,961
Inventories	135,425	212,812
Prepays and other current assets	17,273	3,413
Total Current Assets	203,012	283,126
Properties and Equipment, less accumulated depreciation	522,151	518,874
	\$725,163	\$802,000

LIABILITIES AND STOCKHOLDER'S EQUITY

Current Liabilities		
Long-term debt and capital lease obligations payable within one year	\$ 878	\$ 878
Accounts payable	90,251	123,300
Accounts payable, intercompany	116,137	122,951
Taxes payable	14,977	15,956
Accrued liabilities	45,994	116,123
Total Current Liabilities	268,237	379,208
Long-term Debt and Capital Lease Obligations	8,566	10,389
Long-term Debt, Intercompany	373,154	373,154
Deferred Income Taxes	21,135	40,502
Stockholder's Equity		
Preferred Stock, \$.01 par value		
Authorized shares — 25,000,000		
Issued shares — None		
Common Stock, \$.01 par value		
Authorized shares — 75,000,000		
Issued shares — 100		
Paid-in capital	147,213	27,092
Accumulated deficit	(93,142)	(28,345)
	54,071	(1,253)
	\$725,163	\$802,000

See "Commitments and Contingencies".

The Financial Summary is an integral part of this and
related Consolidated Financial Statements.

ALLOCATION OF BOOT TO
DIAMOND SHAMROCK REFINING AND MARKETING COMPANY
12/31/83 BALANCE SHEET

ASSETS AND LIABILITIES	1 DETAILED BALANCE SHEET 12/31/83	2 TAX RETURN BALANCE SHEET 12/31/83	3 FAIR MKRT VAL 12/31/83	4 TAX BASIS	5 GAIN	6 ALLOCATION OF BOOT	7 RECOGNIZED GAIN
Cash	\$1,712	\$1,712	\$121,463,363	\$1,712	\$0	\$714	\$0
Accounts Receivable	\$966,222	\$121,463,363	\$121,463,363	\$1,712	\$0	\$50,672,024	\$0
Notes & Trade Accep	\$79,203,848						
Trade Accts Reciev	\$41,282,957						
Accts Receivable Misc.	\$182						
Advances to Employees	\$10,154						
Accrued Interest & Dividends Reciev.	(\$674,527)	(\$674,527)					
Less Bad Debt Reserve							
Inventory		\$76,407,738	\$76,407,738	\$76,407,738	\$0	\$31,875,741	\$0
Raw Material	\$21,813,761						
Supplies	\$12,454,005						
Goods In Process	\$20,001,355						
Finished Goods	\$58,176,929						
Reserve for IPP in Inventory	(\$5,990,678)						
Reserve for LIFO in raw Materials	(\$1,035,747)						
Reserve for LIFO raw Materials	\$25,086,928						
Reserve for LIFO finished goods	(\$54,059,656)						
Reserve for Warehouse stock	(\$39,159)						
Other Assets							
Prepaid Insurance	\$2,703						
Other Prepays	(\$120,907)			\$2,703			
Other Investments		\$237,688,157					
Sigmor Corp	\$198,068,581			\$76,707,847	\$121,360,734	\$82,630,149	SUBJ. SEC 304
The Shamrock Pipeline Corp.	\$31,794,169			\$32,510,792	(\$716,623)	\$13,263,875	SUBJ. SEC 304
Emerald Corp	\$4,134,053			\$4,136,566	(\$2,513)	\$1,724,642	SUBJ. SEC 304
Diamond Reforming, Inc	\$477			\$477	\$0	\$199	SUBJ. SEC 304
D-S Pipeline Corp	\$3,041,680			\$3,042,361	(\$681)	\$1,268,927	SUBJ. SEC 304
Crude Oil Int	\$27,000			\$27,000	\$0	\$11,264	SUBJ. SEC 304
Diamond Shamrock Petroleum Corp	(\$500,167)			\$0	\$0	\$0	SUBJ. SEC 304
Seaway Pipeline	\$1,330,000			\$1,330,000	(\$283,517)	\$436,571	SUBJ. SEC 304
Other Long term Investments	\$75,881			\$75,881	\$0	\$31,656	SUBJ. SEC 304
Equity in Unconsolidated Subs	(\$283,517)			\$0	\$0	\$0	\$0
Land	\$1,738,464			\$1,738,464	\$0	\$725,252	\$0
Buildings and Other Depr. Assets		\$1,738,464					
Less Accumulated Depreciation	\$4,854,036	(\$137,827,676)					
Buildings		\$312,159,371					
Less Accumulated Depreciation	(\$1,816,317)						
Building Net Value			\$3,037,719	\$0	\$3,037,719	\$1,267,274	\$1,267,274

DIAMOND SHAMROCK REFINING & MARKETING, INC.
DEPRECIATION SCHEDULE FOR
TAX BASIS OF ASSETS AT 12/31/83

ASSETS AND LIABILITIES	1 DETAILED BALANCE SHEET 12/31/83	2 TAX BASIS	3 RECOGNIZED GAIN	4 1983 DEPRECIATION	5 1984 DEPRECIATION	6 1985 DEPRECIATION	7 1986 DEPRECIATION	8 1987 DEPRECIATION	9 TOTAL DEPRECIATION ON SPOFF
Land	\$1,738,464	\$1,738,464	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Buildings and Other Depr. Assets									
Less Accumulated Depreciation									
Buildings	\$4,854,036								
Less Depreciation	(\$1,816,317)								
Guideline Net Value									
McKee Refinery	\$288,805,744	\$0	\$1,267,274	\$13,940	\$115,322	\$105,184	\$95,046	\$28,725	\$28,725
Less Depreciation	(\$130,709,141)								
Refinery Net Value		\$89,044,428	\$65,954,660	\$9,893,199	\$14,510,025	\$13,850,479	\$13,850,479	\$4,616,826	\$608,400
Guideline McKee		\$608,400		\$33,800	\$202,800	\$202,800	\$202,800	\$0	\$0
Guideline Trans Texas & Colo. Prod		\$1,185,672		\$58,729	\$352,375	\$352,375	\$352,375	\$128,548	\$1,185,672
ADR - McKee		\$49,992,700		\$1,713,631	\$10,282,987	\$8,824,381	\$7,721,333	\$1,103,047	\$27,931,747
1981 ACRS 5 year property		\$9,215,716		\$767,976	\$4,607,858	\$4,607,858			
1981 ACRS 15 year property		\$20,886,790		\$1,215,633	\$6,962,263	\$6,962,263			
1982 ACRS 5 year property		\$46,668		\$948	\$5,118	\$4,549		\$1,327	\$14,975
1982 ACRS 15 year property		\$7,107,193		\$451,626	\$1,847,561	\$1,763,581		\$687,860	\$5,962,583
1983 ACRS 5 year property		\$1,289		\$24	\$145	\$131		\$34	\$425
TOTAL		\$89,044,428							
Leasehold Improvements	\$302								
Less Depreciation	(\$302)		\$0	\$0	\$0	\$0	\$0	\$0	\$0
Leasehold Improvements Net Value		\$0							
Furniture & Fixtures	\$51,522								
Less Depreciation	(\$23,555)								
Furniture & Fixtures Net Value		\$0	\$11,667	\$1,750	\$1,983	\$2,567	\$2,450	\$2,450	\$0
Auto & Trucks	\$548,443								
Less Depreciation	(\$317,949)								
Autos & Trucks Net Value		\$0	\$96,157	\$24,039	\$36,540	\$35,578	\$0	\$0	\$0
Construction Work in Progress	\$4,121,584								
Leased Machinery & Equipment	\$13,777,740								
Less Amortization	(\$4,584,528)								
Net Leased Machinery & Equipment		\$0	\$3,835,219	\$575,283	\$651,987	\$843,748	\$805,396	\$805,396	\$0
Depreciation of rights of Way	(\$375,884)								
TOTAL DEPREC OF GAIN ASSETS		\$0	\$71,164,978	\$14,750,779	\$39,576,964	\$37,555,494	\$31,759,820	\$7,274,212	\$35,732,528
RECOGNIZED GAIN				\$6,383,255	\$17,126,543	\$16,251,771	\$13,743,750	\$3,147,844	\$56,653,164
DEPRECIATION OF BASIS INCREASE				\$10,508,211	\$15,315,858	\$14,837,556	\$14,753,370	\$5,453,397	\$60,868,392
INCR (DECR) IN TAXABLE INCOME				(\$4,124,956)	\$1,810,685	\$1,414,216	(\$1,009,620)	(\$2,305,553)	(\$4,215,229)
LESS: MULTA IN REGS 1.1502-13(d)(ii): Depreciation of old basis & add'l basis Old tax basis + Recognized gain	Times Recognized Gain								
Annual Depreciation	X	\$71,164,978							