BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
RICHFIELD OIL CORPORATION)

Appearances:

For Appellant: A. William Gallagher, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel

OPINION

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board denying the claims of Richfield Oil Corporation for refund of franchise tax in the amounts of $353.98 and $1,526.37 for the income years 1953 and 1954, respectively..

Appellant, a Delaware corporation, is engaged in oil exploration and production, and the refining and marketing of petroleum products. During the years 1953 and 1954, appellant carried on its activities in twelve states (including California) and three foreign countries.

As an Integrated oil company, appellant is constantly developing new oil reserves to supply its future needs. The search for oil producing properties is a continuous and substantial part of appellant's overall operation. During the years under review, some 2,000 persons, or about 40 percent of appellant's total work force, were directly or indirectly engaged in oil exploration, reconnaissance, and land and lease acquisition activities. Appellant invested approximately $15,000,000 a year furthering these functions.

Typically, appellant's exploration people outline the areas they are interested in and its Land and Leas8 Department is then assigned to secure as much of the prospective area as

possible. The lands acquired are surveyed by field geologists using various methods ranging from aerial photographs to traversing the area on foot. Seismic studies are commonly used to aid In charting the underground strata. In some cases, drilling test wells is the only feasible means of exploration, Other sources of Information are the records of abandoned wells, or,exploratory efforts on surrounding property.

The resulting data may suggest particular areas of Interest for more Intensive study which may, In turn, Indicate particular sites for test well drilling. There is no method known for determining with certainty the location of oil deposits short of drilling wells, In most cases, a productive well cannot be developed until geological and geophysical work is completed or dry or noncommerclal wells are drilled and the results evaluated, or until all of those steps are taken.

An average- of only one out of nine wells drilled on unproved structures in the United States results in the discovery of oil; only one well in every forty or fifty yields oil'in commercial quantities. While success is not predictable as to any given parcel, taking appellant's unproved properties collectively, it is possible to estimate on a historical or statistical basis that a certain amount of oil or gas will be produced.

Appellant's leases typically require the commencement of drilling within one year or the payment of rent in lieu thereof. Exploratory work is commenced as soon as practicable on new acreage In order to avoid the payment of rentals. Appellant conducts continuous geological, geophysical, paleontological, logging, core hole analysis, and various other activities on its undeveloped properties, constantly scrutinizing such acreage in light of known data and eliminating those parcels deemed undesirable.

The information gained from appellant's unproductive as well as productive properties is used to determine whether to continue its exploration activities in the area and seek additional leases on nearby lands or, conversely, whether to discontinue exploration and leasing activities or even drop existing leases. Such information is also used in evaluating the producing capacities and performance of nearby partially or fully proved acreage. The information gained from a dry test well often leads to later discoveries. Water may be injected through existing dry wells around the edge of a producing field as a means for increasing the production that would otherwise be possible in that field.

Appellant apportioned its total net lncome'to California, for franchise tax purposes, by means of an allocation formula consisting of three factors. Only the property

factor is in question here. For the years on appeal, appellant included in its property factor the average annual value of its undeveloped oil lands, rights and leases. The Franchise Tax Board issued the instant assessments on the ground that until appellant's unproved properties actually produce oil, they may not be included in the property factor.

Section 25101 (formerly 24301) of the Revenue and Taxation Code provides, generally for the basis on which income from sources both within and without California shall be apportioned to this state:

> Such income shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, pay roll, value and situs of tangible property or by reference to any of these or other factors or by such other method of allocation as is fairly calculated to determine the net income derived from or attributable to sources within this State;. ...

The Franchise Tax Board's regulations dealing with the property factor state in part:

> The property factor will *normally* include the average value of all real and tangible personal property owned by the taxpayer and used in the unitary business. Leased property is excluded from the factor. Also generally excluded is property owned, but not used in the unitary business. Thus, a building is not included in the factor until it is actually used in the unitary business. However, once property has been used in the unitary business, it shall be included in the factor, although temporarily unused for short periods. If the property is permanently withdrawn from unitary use, it should be excluded from the property factor.... (Cal. Admin. Code, tit. 18, reg. 25101 subd. (a), formerly reg. 24301, subd, [a).)

Respondent points out that the allocation formula is made up of factorsdesigned to properly reflect the relative

contribution of the various activities of the business to the production of total unitary income. (See Butler Bros. v. McColgan, 17 Cal. 2d 664, 678 [111 P.2d 334, aff'd, 315 U.S. 501 [86 L. Ed. 991].) It is unquestioned that the value of producing oil properties, whether or not they are in the form of oil leases, should be included In the property factor. Respondent contends, however, that although undeveloped oil and gas properties are potentially income producing, they cannot contribute to appellant's unitary income so long as they remain undeveloped. It is argued that such properties cannot be considered as "used" in the business, that Is, do not contribute to unitary income, until a producing well is brought in.

The Franchise Tax Board has too narrowly restricted its view as to what constitutes a contribution to appellant% unitary income. The most obvious contribution is made, of course, by 011, the life blood of appellant's entire operation. It should be equally obvious, however, that every factor necessary to the discovery of that oil also contributes to unitary income. As respondent has frequently emphasized, there is no means known for definitely determining the location of oil deposits short of bringing In a productive well and for that reason, only one out of every nine wells drilled strikes oil. But this fact simply illustrates the contribution made by unproductive land, for until science develops an exploratory method free of guesswork, a certain number of failures will remain an integral factor in producing oil.

Aside from the fact that the acquisition of new lands, much of which will prove to be unproductive, is an essential element in the process of discovering new oil sources, appellant has vividly demonstrated the many other contributions that such acreage makes to the ultimate realization of income. Appellant is not simply acquiring land and blindly drilling holes. Every investment that it makes is a reasoned decision, a decision made on the best available information, Without the information derived from unproductive as well as productive areas, It is reasonable to believe that the effectiveness and efficiency of appellant's exploration program would be diminished with a resulting increase in the cost of producing crude oil.

Pertinent to this case is an observation-recently made by the California Supreme Court in the course of holding that an oil company constituted a unitary business:

> While the actual recovery 'and sale of the crude oil are, perhaps, local activities, nevertheless very extensive interstate

> transactions are theretofore involved in the other individual operations which make such production possible. The evidence here reveals that such essential factors as land acquisition, exploration, technology, testing, availability of equipment and personnel, financing and many others are definitely interstate in character. It must also be considered that each producing well in a particular state is the end product of interstate activities which may involve many other unproductive wells in many other states. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33].)

Respondent's reliance upon the Appeal of American President Lines, Ltd., Cal. St. Bd. of Equal., Dec. 18, 1952, and the appeal of Ford Motor Co., Cal. St. Bd. of Equal., April 22, 1948, is misplaced. In each case we sustained the exclusion from the property factor of assets which had never been used in connection with the taxpayer's business. Those assets were in no way comparable to the instant unproved oil lands which have been shown to be an integral, essential, actively employed component of appellant's unitary operations.

Recognizing that respondent has discretion in adopting a formula for the allocation of income, we are of the opinion that its determination that the oil properties in question made no contribution to income was in error.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Richfield Oil Corporation

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board denying the claims of Richfield Oil Corporation for refund of franchise tax in the amounts of $353.98 and $1,526.37 for the income years 1953 and 1954, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 17th day of November, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

Member

Member

Member

Member

Attest: , Secretary