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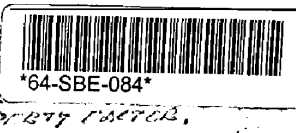

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
UNION OIL COMPANY OF CALIFORNIA)

Appearances:

For Appellant: Timothy P. Reames, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board denying the claim of Union Oil Company of California for refund of franchise tax in the amount of $16,120.65 for the Income year 1951.

Appellant, an integrated oil company, is engaged in oil exploration and production, and the refining and marketing of petroleum products. It carries on these activities both within and without the State of California.

In order to maintain its production of oil, appellant constantly engages in oil exploration activities, making continuous and substantial investments in prospective oil lands and leases, exploration surveys, and well drilling. Appellant's oil leases typically require the commencement of drilling within one year or the payment of rent in lieu thereof. The one-year period is regarded by appellant as the time required to acquire adjacent or nearby leases and to complete such geological and geophysical surveys as are deemed necessary to justify the drilling of an exploratory well.

There is no certain method for determining whether or where an oil deposit may be found except by drilling a well. In the United States, only one well out of every nine drilled on unproved structures finds oil. The ratio for economically

productive deposits is in the neighborhood of one to forty or fifty. However, taken as a whole, it is known that appellant's prospective oil properties do contain oil and gas.

The uses to which appellant's prospective oil properties are put are summarized as follows:

(a) Exploration and testing of the properties furnishes information useful in appraising the performance and extent of nearby producing deposits, in determining whether additional property in the vicinity should be acquired and in determining whether existing leases should be developed faster, retained or terminated.

(b) For financial purposes, the magnitude of appellant's Investment in such property is regarded by lenders as an Important factor in appraising the income producing potential and thus, the borrowing capacity of appellant.

(c) For competitive purposes, the investment in prospective land may be made in order to prevent other companies from acquiring acreage near a producing property and also for the purpose of facilitating the subsequent unitization of an oil field or deposit, Without such protective acreage, appellant's competitive position would be weakened and the pooling or unitization of oil interests made more costly or even blocked.

In addition to its prospective oil lands, appellant owns certain oil shale deposits in Colorado. This shale contains a substance similar to crude oil, known as kerogen, which is easily converted to crude oil, In 1957 appellant mined and processed the shale for a periodcf five months, producing up to 800 barrels of kesogen a day, Because of the relatively high cost of production, however, the operation has been conducted only on an experimental basis,

For franchise tax purposes, appellant apportioned its total net income to sources within this state by means of a three-factor formula, Only the property factor is in-question. Appellant included in its property factor for the year on appeal the average annual value of its unproved oil lands, rights and leases, and the value of its Colorado oil shale deposits. The value of such property was excluded by the Franchise Tax Board from appellant's property factor, and the net income allocable to California was recomputed accordingly,

Section 25101 (formerly 24301) of the Revenue and Taxation Code provides that income from sources within and without California shall be apportioned on the basis of sales, purchases, expenses of manufacture, payroll, property or any

of these or other factors or by such other method as is fairly calculated to determine the income derived from sources within this state, Respondent has adopted regulations implementing this section which provide, in part, that "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, " (Cal, Admin. Code, tit, 18, reg. 25101, subd. (a), formerly reg, 24301, subd. (a).)

The Franchise Tax Board contends that appellant's oil and gas properties do not contribute to unitary Income and, thus, cannot be considered to be used in the business until one or more producing wells are brought in.

The operations of appellant herein differ from those found in the Appeal of Richfield Oil Corporation, Cal, St. Bd. of Equal., decided this day, only in matters of degree too minor to permit a valid distinction. It therefore follows that what we held in that appeal is equally applicable here. We conclude that respondent must include in appellant's property factor the value of its unproved oil lands, rights and leases, We are in accord, however, with the Franchise Tax Board's treatment of appellant's Colorado oil shale deposits, a separate issue not present in Richfield,

Appellant argues that its oil shale deposits are known to contain producible quantities of oil and are, therefore, proved reserves. On the strength of our opinion in the Appeal of E. K. Wood Lumber Co., Cal, St. Bd, of Equal., July 15, 1943, wherein we held that certain timber lands, held in reserve, were used in the taxpayer's lumber business, appellant argues that its oil shale deposits must also be considered to be used in the business,

There are, however, important factual differences which we believe distinguish the instant case from Wood. Appellant has not shown that its oil shale deposits have ever been utilized except on a temporary, experimental basis. It has not shown that, in 1951, such property was capable of being profitably used in the unitary business or that there is any reasonable prospect that such property will be useable, as a practical matter, at any time in the foreseeable future. In Wood, on the other hand, the timber land reserves had been used in prior years, The mere fact that they were temporarily removed from service did not change their status, Appellant's oil shale deposits are not, in our opinion, comparable to the timber reserves in Wood,

We believe that the facts of the instant appeal are more closely akin to those of the Appeal of American President

Lines, Ltd., Cal, St. Bd. of Equal,, Dec.18, 1952. One of the issues therein involved the treatment of the value of certain real property which the taxpayer had purchased for the future development of a terminal, Upon finding that no terminal was ever constructed and that, in fact, the property had never been used in connection with the buslness and had never contributed in any way to the taxpayer's Income, we held that the realty was properly excluded from the property factor.

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,

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 claim of Union Oil Company of California for refund of franchise tax in the amount of $16,120.65 for the income year 1951, be modified in accordance-with the opinion of the board,

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