INCOME FROM A RES[...] ESTATE
(1) IN OIL PROPERTIES

(2) COSTS OF MANAGEMENT OF CORP., EXCESSIVE?

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
COALINGA OIL CORPORATION, UNION OIL)
COMPANY OF CALIFORNIA, ASSUMER, AND)
MCALESTER CALIFORNIA OIL COMPANY)

Appearances:

For Appellants: John Ohl, Ralph Winger, L. D. Lawrence and Don C. Phelps, Attorneys at Law

For Respondent: Crawford H. Thomas, Associate Tax Counsel

OPINION

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Coalinga Oil Corporation, Union Oil Company of California, assumer, against proposed assessments of additional franchise tax in the amounts of \$59,331.50, \$59,331.50, \$58,728.25, \$65,327.71, \$99,003.67 and \$110,779.86 for the taxable years 1950, 1951, 1952, 1953, 1954, and 1955, respectively, and on the protests of McAlester California Oil Company against proposed assessments of additional franchise tax in the amounts of \$3,234.19 and \$2,576.22 for the taxable years ended August 31, 1954, and 1955, respectively. At the hearing of this matter reference was made to the franchise tax liability of appellant McAlester California Oil Company for the taxable year ended August 31, 1953. No appeal from the action of the Franchise Tax Board in regard to that year has been filed, however, and we are without jurisdiction to consider that action.

Two questions are presented: (1) whether income from a "reserved estate" in certain oil property was includible in the measure of Coalinga Oil Corporation's franchise tax, and (2) whether amounts deducted by McAlester California Oil Company as costs of managing that "reserved estate" and another similar interest, were excessive.

In early 1949 Union Oil Company of California became interested in acquiring the production from certain oil lands in which Mrs. Carrie Estelle Doheny owned a one-quarter interest. The property had a large number of producing wells. Mrs. Doheny's interest, hereafter referred to as "A property," was reliably estimated to have proved net reserves of over 32 million barrels of oil.

That summer Union enlisted the aid of Dillon, Read & Co., Inc., a New York investment banking firm, in its program for the acquisition of the A property. Nassau Associates, Inc., a wholly owned subsidiary of Dillon, Read & Co., began negotiating with Mrs. Doheny for the purchase of her oil interest.

Before consummating the purchase, Nassau entered into an oil sales contract with Union. Under this contract, Nassau agreed to sell and Union agreed to buy, at the posted field price, all the oil produced by the A property. The agreement acknowledged that Nassau intended to finance the purchase of the A property by borrowing $34,500,000. For the benefit of the lenders, Union agreed to pay any deficit if the proceeds from the sale of the oil were insufficient to permit Nassau to pay the loan installments and interest when due. These deficit payments were to constitute interest-bearing advances to Nassau. They were to be repaid out of the oil sales or, in any event, within five years after Union's obligation to make deficit payments ceased. The contract was binding upon all successors or assigns of Union and Nassau.

In September 1949 Nassau purchased the A property from Mrs. Doheny for a cash payment of $35,500,000. Nassau, whose previous assets were $50,000 in cash, borrowed $1,000,000 of the purchase price from a New York bank on a promissory note secured by Dillon, Read & Co. Nassau borrowed the remaining $34,500,000 from two insurance companies on promissory notes secured by an assignment of all proceeds from the sale of oil, a trust deed on the property, and Union's guarantee.

The assignment of oil proceeds was made pursuant to a trust. All funds were to be remitted by the oil purchaser, Union, directly to a trustee who would then disburse them in a detailed manner. In essence, the trustee was to pay the loan installments after reimbursing Nassau for direct operating costs. From the balance, Nassau was to receive the proceeds from 240,000 barrels of oil and $1,800 per month for overhead expenses. Surplus amounts were to be used to reduce the principal of the loans or to reimburse Union for deficit payments.

Coalinga Oil Corporation was formed in July 1949. Its authorized capital consisted of 10,000 shares of $5 par common stock. Initially, 5,250 shares were issued for cash at par; 2,500 shares to Union and 2,750 to individuals, principally persons connected with Dillon, Read & Co. Union also received a warrant entitling it to purchase, at a later date, the remaining 4,750 shares.

Immediately after its purchase from Mrs. Doheny, Nassau conveyed the A property to Coalinga. The conveyance expressly reserved all of Nassau's interest in the property until such time as the oil revenue would equal the amount owed to the insurance companies plus any unreimbursed deficit payments, the costs of operating the property and the proceeds from 240,000 barrels of oil. In any event, the reserved estate was to terminate within twenty-one years. Coalinga paid Nassau $1,000,000 with funds borrowed from Union.

McAlester California Oil Company ("McAlester") was organized on September 21, 1949, with $225,000 capital. About 84 percent of the stock was owned by McAlester Fuel Company of Dallas, Texas. The balance was owned by individuals connected with McAlester Fuel Company. McAlester was completely independent of Coalinga, Union, Nassau, or Dillon, Read & Co.

In October 1949 Nassau conveyed the reserved estate in the A property to McAlester. McAlester paid $200,000 cash and assumed the unpaid balance of the original $34,500,000 indebtedness. It also agreed to perform all of Nassau's duties under the promissory notes, assignment, deed of trust, and oil sales contract.

During the period of McAlester's interest, all of the various agreements were carried out in accordance with their terms. The oil was sold to Union and the proceeds were distributed by the trustee. As expected, oil revenues were ample to meet the loan commitments and Union made no deficit payments. As also expected, approximately half of the proved net reserves of the A property were devoted to paying out the reserved estate.

With the exception of the $1,800 per month for its overhead expense, the amounts McAlester received for development, operation, etc., of the A property were paid over to Los Nietos Company. Los Nietos, which had been acquired by Union in October 1949, was the operator of the A property.

McAlester reported gross receipts from the oil sold on its federal and California income tax returns. It claimed cost depletion and depreciation deductions which amortized its cash investment of $200,000 plus the debt it assumed, over the life of the reserved estate. As a result, McAlester paid tax only on the net income derived from its 240,000 barrel interest.

In March 1957 Union purchased at par the remaining 4,750 shares of Coalinga stock under the stock warrant previously mentioned. The following July, Union made an offer to buy the Coalinga stock held by individuals for $3,200 a share, resulting in the acquisition of an additional 1,559 shares.

McAlester's interest in the A property terminated in October 1957 when the notes were fully paid and cancelled. The trustee released the encumbrances and Coalinga became sole legal owner of the oil property.

Coalinga adopted a plan of complete liquidation in March of the following year and distributed all of its properties pro rata to its stockholders. As the largest transferee of Coalinga's property, 88.09 percent, Union assumed Coalinga's liability for unpaid franchise taxes.

Coalinga filed California franchise tax returns for the income years 1949 through 1955, reporting no gross income. On September 8, 1958, the Franchise Tax Board mailed notices proposing to assess additional franchise tax against Coalinga for the taxable years 1950 to 1955, inclusive, on the ground that Coalinga was the beneficial owner of all of the income derived from the A property during the period of the reserved estate, with the exception of McAlester's interest in some 240,000 barrels of oil.

In summary, Union secured the production from the A property through the following steps:

1. Union agreed with Nassau to purchase the entire output of the property. It also guaranteed repayment of the loans which were to be made to Nassau.

2. Nassau purchased the A property for $35,500,000. It borrowed $34,500,000 from insurance companies on promissory notes which were secured by trust deeds and an assignment of the oil revenues as well as Union's guarantee. Nassau borrowed the remainder of the purchase price from a bank.

3. Nassau conveyed its entire interest in the A property to Coalinga for $1,000,000, expressly reserving an estate. The reserved estate, according to the terms of the conveyance, was to terminate when sufficient oil was produced to pay off the debt, interest, and operating costs plus 240,000 barrels of oil. This estate would consume an estimated one half of the property's total proved reserves.

4. The reserved estate was conveyed to McAlester. McAlester paid $200,000 cash, assumed the unpaid portion of the debt and agreed to carry out all of Nassau's obligations under the promissory notes, assignment, trust deed and the oil sales contract with Union. Thereafter, the oil was sold to Union and the revenues applied to the payment of operating costs, debt, interest, etc., in accordance with the various agreements.

5. In October 1957, the reserved estate terminated and Coalinga took over as the sole owner of the A property.

Appellants' position is based upon Thomas v. Perkins, 301 U.S. 655 [81 L. Ed. 1324], where the owner of undeveloped oil and gas leases assigned them for a cash payment plus the purchaser's agreement to pay an additional $395,000 out of one quarter of all oil produced. Construing the assignment, the court found that the assignor withheld sufficient oil to pay the agreed amount. The court concluded that the assignor had a depletable economic interest in such oil, and that the income arising therefrom was taxable to the assignor rather than the assignee. Similar reserved interests, commonly known as "oil payments" have been sanctioned by other courts. (Commissioner v. Fleming, 82 F.2d 324; Commissioner v. Williams, 82 F.2d 328; Commissioner v. Elliott Petroleum Corp., 82 F.2d 193.) Appellants contend that Nassau reserved such an oil payment from the conveyance to Coalinga and transferred it to McAlester. They argue that the income from that interest was McAlester's.

Respondent's position rests on the principle that taxation is a practical matter, controlled by substance rather than form. (Commissioner v. Court Holding Co., 324 U.S. 331 [89 L. Ed. 981].) Respondent contends that, with the exception of the proceeds from 240,000 barrels of oil, all of the income derived from the A property during the period of McAlester's stewardship should be taxed to Coalinga because Coalinga, not McAlester, received the real benefit from that income.

The general rule that substance rather than form governs is as applicable to the matter of oil payments as it is to any other tax matter. The court gave recognition to the oil payment in the Perkins case because it concluded that even though the assignor no longer held legal title to the property, he retained a definite economic interest in the oil in place. The decision rested upon the practical consequences of the payment provision and not upon the formalities of the conveyancer's art. (Anderson v. Helvering, 310 U.S. 404 [84 L. Ed. 1277].)

After examining the practical consequences of the transaction presented here we agree with respondent's conclusion that the income in question should be included in the measure of Coalinga's tax.

In determining who is to be taxed on the income from property, the courts look not to the refinements of title but to the actual command over the property taxed--the actual benefit for which the tax is paid. (Reinecke v. Smith, 289 U.S. 172 [77 L. Ed. 1109].) Thus, the recipient of income who is a mere conduit, who lacks unfettered control over the income or is bound to pay it over to others and who receives no benefit or possibility of gain therefrom, may not be taxed on that income. (Keokuk & Hamilton Bridge v. Commissioner, 180 F.2d 58; Uniform Printing & S. Co. v. Commissioner, 88 F.2d 75; Central Life Assur. Soc., Mut. v. Commissioner, 51 F.2d 939; Silver Bluff Estates, Inc., T.C. Memo., Dkt. No. 12303, June 24, 1947.)

Except for the proceeds from 240,000 barrels of oil, McAlester could not gain from the oil revenue produced by the so-called reserved estate and it had no control over the bulk of the revenue. All revenue in excess of the proceeds from 240,000 barrels of oil was committed to payment of operating costs and to payment of the indebtedness incurred to purchase the entire A property from Mrs. Doheny. The funds applied against the debt did not even pass through McAlester's hands but were paid by Union directly to the trustee who disbursed them to the lenders.

Appellants argue that McAlester benefited because the income was used to pay the debt which McAlester had assumed. But McAlester's assumption of the multimillion dollar debt had no significance under the circumstances of this case. The loans were protected by Union's guarantee, a lien on all of the A property, and an assignment of the oil revenues. McAlester had no significant independent resources with which to pay the debt. Its assumption of the already fully secured debt, therefore, had no practical effect.

The net effect of the reserved estate mechanism and all of the related agreements was to benefit Coalinga by discharging the debt representing the purchase price of the A property, leaving Coalinga as the owner free of encumbrances.

While we are aware of no case so directly in point as to be controlling, our conclusion is supported by Keokuk & Hamilton Bridge v. Commissioner, 180 F.2d 58, and Decatur Water Supply Co. v. Commissioner, 88 F.2d 341. In each of those cases a municipality wished to acquire certain income-producing property. An intermediary corporation was set up for the purpose of acquiring and holding the property until the revenues it produced paid the acquisition cost. In order to finance the purchase, the corporation in Keokuk sold 4 percent first mortgage bonds, while in Decatur, 7 percent preferred stock was sold. The corporation's revenues were dedicated to retirement of the bonds or stock. When retirement was completed, the property was given free and clear to the city. In each case, the court held that the amounts devoted to the retirement of the securities were income to the city and not income to the corporation which actually received the funds. Each decision was based upon the conclusion that the corporation had no real beneficial interest in the income and that, as was noted in Decatur, the funds were actually placed at the "predetermined disposal" of the city. In the present case, the reserved estate mechanism produced a very similar result for the benefit of Coalinga.

Although done in a complicated fashion, the transaction presented here is basically simple. Union wanted to acquire the oil produced by the A property. Union supplied the credit necessary to buy the A property and bore the risk of loss. Nassau and McAlester were intermediaries who performed assigned tasks and received payment for their services. Union diverted the benefits of ownership to its subsidiary, Coalinga, and it is appropriate that Coalinga be taxed accordingly.

As previously indicated, the assignment of oil proceeds provided that McAlester, as the successor to Nassau, was entitled to receive $1,800 per month for overhead costs. The overhead costs were to include all compensation and salaries paid to managing officers and employees; the cost of providing office space, vaults, office equipment and supplies; and the costs of telephone, heat, light, and other utility services.

In 1950 and 1951 McAlester engaged in similar transactions with Union and Nassau involving oil properties located in Los Angeles and Ventura Counties, hereafter referred to as the "B property." McAlester, according to the terms of a conveyance, received a reserved estate in the B property which was to terminate when the production from the properties equaled a debt of $8,937,000 plus any deficit payments, operating costs, and the proceeds from 59,000 barrels of oil. McAlester was allowed $500 per month for overhead costs in the management of the B property.

McAlester was a subsidiary of McAlester Fuel Company. It had no employees. By separate agreement with The McAlester Fuel Company, a sister subsidiary engaged in providing managerial and related services to the McAlester group, McAlester agreed to pay The McAlester Fuel Company $2,300 per month ($1,800 in respect to the A property plus $500 in respect to the B property) for managing both properties. The McAlester Fuel Company handled all of McAlester's financial, corporate and tax affairs, including the keeping of general books and records, the receipt and disbursement of funds, the preparation and filing of all necessary corporate reports and income tax returns, and all matters arising under the assignment, trust deed, etc. These services involved not only clerical and stenographic employees, but also legal, accounting and executive personnel.

On its franchise tax returns for the years involved McAlester claimed deductions for the management fees paid to The McAlester Fuel Company in the amount of $27,600 per year. The Franchise Tax Board disallowed $22,600 of each annual deduction.

Under Revenue and Taxation Code section 24343 appellant McAlester may deduct all ordinary and necessary expenses incurred in carrying on its trade or business. Respondent's only contention is that McAlester has not produced evidence that its payments for managerial services were reasonable in amount. (Commissioner v. Lincoln Electric Co., 176 F.2d 815, cert. denied, 338 U.S. 949 [94 L. Ed. 586], held that the element of reasonableness is inherent in the term "ordinary and necessary" as used in the federal business expense provision.)

There was considerable testimony at the hearing of this matter as to the nature of the services rendered by The McAlester Fuel Company, including a statement that the management fee was not more than would have been charged by an independent firm. While these self-serving statements, which were made by McAlester's representative, should not be accepted uncritically, we find they are corroborated by a fact of independent significance.

McAlester was simply paying over the amount of the overhead allowance provided in the assignment of proceeds, an amount originally agreed upon by Nassau and the lenders for whose benefit the assignment was created. These parties had sufficiently adverse interests to assure that the amount agreed upon was reasonable. We conclude, therefore, that appellant McAlester has produced sufficient evidence to sustain its deductions in full.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Coalinga Oil Corporation, Union Oil Company of California, assumer, against proposed assessments of additional franchise tax in the amounts of \$59,331.50, \$59,331.50, \$58,728.25, \$65,327.71, \$99,003.67 and \$110,779.86 for the taxable years 1950, 1951, 1952, 1953, 1954, and 1955, respectively, be and the same is hereby sustained.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the action of the Franchise Tax Board on the protests of McAlester California Oil Company against proposed assessments of additional franchise tax in the amounts of \$3,234.19 and \$2,576.22 for the taxable years ended August 31, 1954, and 1955, respectively, be and the same is hereby reversed.

Done at Pasadena, California, this 28th day of June, 1966, by the State Board of Equalization.

[signature], Chairman

John W. Lynch, Member

[signature], Member

________________, Member

________________, Member

ATTEST: [signature], Acting Secretary