82-SBE-019

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PAULEY PETROLEUM, INC.)

Appearances:

For Appellant: E. J. Babineau, Jr.
Treasurer

For Respondent: Brian W. Toman
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Pauley Petroleum, Inc., against proposed assessments of additional franchise tax in the amounts of $6,452.00 and $5,520.00 for the income years ended August 31, 1973, and August 31, 1974, respectively.

Appeal of Pauley Petroleum, Inc.

The sole issue presented for decision is whether respondent properly determined that certain of appellant's intangible drilling and development costs, incurred during the income years in issue, were not includible in the property factor of appellant's apportionment formula.

Appellant, a multistate business deriving income from sources both within and without this state, is the parent of a group of corporations whose business activities include oil and gas exploration and other oil related activities. During the income years in issue, appellant incurred certain intangible drilling and development costs incidental to, and necessary for, the drilling and preparation of wells for the production of oil and gas. Pursuant to section 263(c) of the Internal Revenue Code, appellant elected to currently deduct these costs for federal income tax purposes instead of treating them as capital expenditures. Appellant also included these costs in the property factor of its apportionment formula for state franchise tax purposes.

Upon examination of appellant's returns, respondent concluded that the costs in issue were not includible in appellant's property factor. Respondent subsequently issued the subject proposed assessments. Appellant protested respondent's determination that the intangible drilling and development costs were not includible in its property factor. The amounts of franchise tax pertaining to this issue are $1,435.00 and $2,261.00 for the 1973 and 1974 income years, respectively; appellant has not protested the balance of the proposed assessments. After consideration of appellant's arguments, respondent affirmed its proposed assessments, resulting in this appeal.

Revenue and Taxation Code section 25101 provides that when a multistate business, such as appellant, derives income from sources both within and without this state, the income derived from or attributable to California sources shall be determined in accordance with sections 25120-25140, inclusive, of the Revenue and Taxation Code, the Uniform Division of Income for Tax Purposes Act. Section 25128 of the Revenue and Taxation Code provides that a taxpayer's business income derived from sources both within and without California shall be apportioned to this state on the basis of a three-factor formula composed of sales, payroll, and property.

The property factor, as are the payroll and sales factors, is a fraction. Its numerator is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year; its denominator consists of the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year. (Rev. & Tax. Code, § 25129.) Property owned by the taxpayer is valued at its original cost. (Rev. & Tax. Code, § 25130.)

The term "original cost" is defined in California Administrative Code, title 18, regulation 25130, subdivision (a)(1) (art. 2.5), as follows:

> As a general rule "original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc.

For federal income tax purposes, intangible drilling and development costs incurred by an operator, such as appellant, in the development of oil and gas properties may, at its option, be chargeable to capital or to expense. (Treas. Reg. § 1.263(c)-1; Treas. Reg. § 1.612-4(a) (1965).) The taxpayer's election of one of these two options establishes the nature of its intangible drilling and development costs as either a capital or expense item. Accordingly, if a taxpayer elects to expense such costs, the basis of its property remains unaffected. (See Treas. Reg. § 1.1016-2(a) (1957), which provides that, in the case of oil and gas wells, no adjustment to basis shall be made in respect of any intangible drilling and development costs allowable as a deduction in computing net or taxable income for the taxable year.) Conversely, if a taxpayer elects to capitalize such costs, whether incurred in the same year the property is acquired or as a subsequent capital addition or improvement if incurred in a year subsequent to the acquisition of the property, the basis of its property is affected since those costs are incorporated within the original cost of the property. (Int. Rev. Code, § 1016(a)(1); Treas. Reg. § 1.1016-2(a) (1957).)

In view of the above, appellant's intangible drilling and development costs may not properly be

classified as capital expenditures and be added to the basis of its property for federal income tax purposes. Accordingly, as those costs are not properly includible as part of the "original cost" of appellant's property for property factor valuation purposes (Cal. Admin. Code, reg. 25130, subd. (a)(1) (art. 2.5)), we must conclude that respondent's action in this matter was correct.

Appellant has argued that intangible drilling and development costs are capital costs of developing oil and gas properties which must be capitalized under generally accepted accounting principles. While appellant has quoted recognized accounting authority to support this proposition, such authority is irrelevant to the issue presented by this appeal. Regardless of the manner in which the subject costs are treated for accounting purposes, section 263(c) of the Internal Revenue Code clearly provides that, for federal income tax purposes, they are not classifiable as capital expenditures whenever a taxpayer elects to treat them as expense items. Appellant's election to treat these costs as expenses in the year in which they were incurred established their nature as expense items for tax purposes.

Appellant also argues that its intangible drilling and development costs are a cost incurred in the production of income and, as such, are required to be apportioned. Therefore, appellant asserts, they should be included in the property factor of the apportionment formula. Appellant has provided no authority to support this proposition, nor are we aware of any. There exists no mandate requiring that every item of expense necessary to the production of income be included in one of the three factors comprising the apportionment formula.

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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 protest of Pauley Petroleum, Inc., against proposed assessments of additional franchise tax in the amounts of $6,452.00 and $5,520.00 for the income years ended August 31, 1973, and August 31, 1974, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of February, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Reilly, Mr. Dronenburg, and Mr. Nevins present.

William M. Bennett, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member