82-SBE-254

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ARGO PETROLEUM CORPORATION)

Appearances:

For Appellant: Richard P. Ebbert
Attorney at Law

For Respondent: John R. Akin
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 Argo Petroleum Corporation against a proposed assessment of additional franchise tax in the amount of $74,766 for the income year 1976.

Appeal of Argo Petroleum Corporation

The issue for determination is whether Argo Petroleum Corporation (hereinafter referred to as "appellant") may properly take advantage of section 24310 of the Revenue and Taxation Code so as to recover tax-free part of the gain realized on the sale of one of its leasehold interests.

Appellant is in the business of locating, acquiring, developing, extracting, and selling crude oil and natural gas. In the course of its business activities, appellant acquires leasehold interests which have the potential for the production of those energy resources. Substantial expenditures are incurred in the development and operation of those leasehold interests. While it normally operates its developed leasehold interests itself, appellant occasionally sells such interests to others.

In 1976, appellant sold all of its interest in one such leasehold (hereinafter referred to as "the Hamp Lease") for $18,300,000; appellant elected to report the gain from that sale under the installment method. Appellant's interest in the Hamp Lease was developed from 1971 through 1975. During those years, it drilled wells and installed equipment for the purpose of extracting crude oil and natural gas: the resources thereby produced were sold on a daily basis until the 19'76 sale. The expenses appellant incurred during the development of the Hamp Lease were claimed as current deductions. However, because it suffered net operating losses in each of those years, appellant allegedly derived no tax benefit from the expenditures it incurred in connection with the Hamp Lease.

Prior to its sale of the Hamp Lease, appellant incurred $3,132,613 in expenses in connection with the development and operation of that leasehold interest. Included in these expenses were intangible drilling costs, general and administration expenses, delay rentals, depreciation and other operating costs. In 1976, the year of the sale, appellant received approximately 28.42 percent, or $5,200,000, of the total sales price of $18,300,000. On its California franchise tax return for the year in issue, appellant excluded a proportionate amount, $890,240, of the adjusted development and operation costs which had previously been deducted with allegedly no tax benefit from the gain reported in that year.

Appellant claims that the $890,240 exclusion was appropriate under the "tax benefit" rule, as codified in Revenue and Taxation Code section 24310, and protested respondent's disallowance thereof. After considering appellant's contentions, respondent affirmed its decision on the grounds that appellant's development and operation of the Hamp Lease and its subsequent sale of its interest in that leasehold, was not a single integrated transaction. Consequently, respondent concluded, appellant could not utilize the "tax benefit" rule to offset past losses against the gain realized from the sale of the Hamp Lease.

The tax benefit rule is a limited exception to the annual accounting period principle. In the Appeal of H. V. Management Corporation, decided July 29, 1981, we summarized the rationale behind the "tax benefit" rule as follows:

> . . . Taxpayers who recover or collect items that have previously been deducted are ordinarily taxed on the amount received unless the prior deduction was of no "tax benefit" because it did not reduce the taxpayer's tax liability. [Citation.] Given the annual accounting concept, the deduction of amounts that are recovered in later years is a frequent occurrence. Creditors, for example, often deduct seemingly worthless claims but subsequently collect part or all of the debt when the debtor's financial status unexpectedly improves. While the courts have developed differing theories to explain the inclusion in income of a recovery that does not constitute an economic gain in the ordinary sense, these divergent views have in common the rationale that such a recovery is taxable because it is linked to a prior tax deduction which reduced the taxpayer's tax liability. [Citation.] Conversely, where a recovery, or portion thereof, has not resulted in a prior tax benefit, it is excluded from income. [Citation.]

Application of the tax benefit rule is precluded where the taxpayer merely seeks to take a second deduction rather than to prevent taxation of a recovery. Furthermore, if the events which give rise to the loss in the prior year and the recovery in the current year do not constitute a single integrated transaction, the tax benefit rule has no application. (Sloane v. Commissioner, 188 F.2d 254 (6th Cir. 1951); Allen v. Trust Co. of Georgia, 180 F.2d 527 (5th Cir.), cert. den., 340 U.S. 814 [95 L.Ed. 598] (1950); Capitol Coal Corp., 26 T.C. 1183 (1956), affd., 250 F.2d 361 (2d Cir. 1957).) However, when there is such an interrelationship between the event giving rise to the loss and the event which constitutes recovery that they can be considered as parts of one and the same transaction, the tax benefit rule is applicable. (Continental, Ill. Nat. Bank, 69 T.C. 357 (1977); Sloane v. Commissioner, supra.)

The tax benefit rule is both a rule of inclusion and exclusion: recovery of an item previously deducted must be included in income; but that portion of the recovery not resulting in a prior tax benefit is excluded. As we observed in the Appeal of H. V. Management Corporation, supra, the rule evolved judicially and administratively and has now been codified, as to certain items, in section 111 of the Internal Revenue Code. Section 24310 of the Revenue and Taxation Code, which codifies the tax benefit rule for California franchise tax purposes, is virtually identical to section 111 insofar as relevant to this appeal. Although the rule has been partly absorbed in the statute, it has been expressly stated that the unabsorbed portion of the rule continues to apply. (Dobson v. Commissioner, 320 U.S. 489 [88 L.Ed. 248] (1943); Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967); Mayfair Minerals, Inc., 56 T.C. 82 (1971), affd. per curiam, 456 F.2d 622 (5th Cir. 1972).)

Fundamental to the tax benefit rule is the requirement that the expense deducted and the subsequent recovery be part of a single integrated transaction. (Sloane v. Commissioner, supra; Allen v. Trust Co. of Georgia, supra.) In order to meet this requirement, the amount recovered must be directly attributable to the expense previously deducted. (Waynesboro Knitting Co. v. Commissioner, 225 F.2d 477 (3d Cir. 1955).) In the majority of cases, a sufficiently direct-relationship between the deducted expense and the alleged recovery has been found only when the recovery was specifically intended to be reimbursement for the expense, and the property or amount of money received by the taxpayer was determined by reference to the deducted expense. (American Financial Corp., 72 T.C. 506 (1979); Sidney W. Rosen, 71 T.C. 226 (1978), affd., 611 F.2d 942 (1st Cir. 1980); Birmingham Terminal Co., 17 T.C. 1011 (1951); see also,Bittker, The Tax Benefit Rule, 26 UCLA L. Rev. 265 (1978); Plumb, The Tax Benefit Rule Today, 57 Harv.L. Rev. 129 (1943).)

Thus, the tax benefit rule has been held to be inapplicable where the alleged recovery was intended as compensation for services rather than as reimbursement for deducted losses. (Merton E. Farr, 11 T.C. 552, affd., sub nom. Sloane v. Commissioner, supra .) The rule is also inapplicable where the alleged recovery was characterized by the court as constituting proceeds from the sale of property rather than a reimbursement. (Buffalo Wire Works Co., 74 T.C. 925 (1980); but see Quincy Mining Co. v. United States, 156 F.Supp. 913 (Ct. Cl. 1957) a singular case where the tax benefit rule was applied to permit the tax-free receipt of a portion of the proceeds from the sale of property.) Furthermore, the tax benefit rule does not apply to a venture which requires expenditures for operational expenses such as wages, supplies, and other deductible items that exceed income in one year followed by substantial receipts in a later year. Although the receipts flow from, and in a sense serve to recoup, the expenditures, it has been held that the recovery cannot be excluded under the tax benefit rule even if the prior deductions were of no tax benefit since the previous expenditures and the subsequent recovery were not part of an integrated transaction. (United States v. Rexach, 482 F.2d 10 (1st Cir.), cert. den., 414 U.S. 1039 [38 L.Ed.2d 330] (1973); Union Trust Co. of Indianapolis v. United States, 173 F.2d 54 (7th Cir.), cert. den., 337 U.S. 940 (93 L.Ed. 1745] (1949); Capitol Coal Corp., supra; see also Bittker, The Tax Benefit Rule, supra, 26 UCLA L. Rev. at 279; Plumb, The Tax Benefit Rule Today, supra, 57 Harv. L. Rev. at 140.)

After careful review of both the relevant authority and the record on appeal, we are satisfied that respondent properly concluded that this appeal does not present a situation in which the tax benefit rule may be applied. The gain from the sale of the Hamp Lease neither constitutes specific reimbursement for the previously deducted operational and developmental costs nor is it directly attributable to the previously deducted expenses. Therefore, the alleged recovery and the deduction cannot be considered parts of a single integrated transaction and the tax benefit rule is not applicable.

Appellant seeks support for its contention that the tax benefit rule is applicable by attempting to distinguish this appeal from the Appeal of H. V. Management Corporation, supra. In that appeal, we determined that the taxpayer could not utilize the tax benefit rule to offset the gain realized from the sale of a partnership interest with past losses incurred in connection with that interest. This decision was based on our conclusion that the holding of the partnership interest and its subsequent sale did not constitute a single integrated transaction.

Furthermore,,. appellant can find no support in the Appeal of Percival M. and Katharine Scales, decided Play 7, 1963. The Scales appeal held only that the payment of carrying charges on real property in prior years by real estate investors and the subsequent sale of that property did not constitute a single integrated transaction. (But cf. Smyth v. Sullivan, 227 F.2d 12 (9th Cir. 1955) which, in the context of an executor endeavoring to take his estate out of bankruptcy, held that where the executor holds estate realty over a period of years before he sells the property, the administration and ultimate sale of the realty is a single integrated transaction for purposes of the tax benefit rule.)

While appellant contends that there exists a relationship between the expenses it incurred and its subsequent sale of the Hamp Lease, its argument is based on the grounds that those expenses, which allegedly resulted in no tax benefit in the years in which incurred, should now be recovered tax-free because it alone was involved in all aspects of the Hamp Lease's acquisition, development, operation, and sale. This does not establish the type of relationship between the expenses and the subsequent sale so that the two events can be considered as parts of one and the same transaction. Accordingly, we must conclude that appellant has failed to establish that it may take advantage of the tax benefit rule under the circumstances presented by this appeal and that respondent's action in this matter was correct.

Appeal of Argo Petroleum Corporation

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 Argo Petroleum Corporation against a proposed assessment of additional franchise tax in the amount of $74,766~ for the income year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of November , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present,,

William M. Bennett , Chairman

Conway H. Collis , Member

Ernest J. Dronenburg, Jr. , Member

Richard Nevins , Member

____________________ , Member