BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 82A-233
W. K. EQUIPMENT COMPANY )

Appearances:

For Appellant: Richard D. Andrews
Attorney at Law

For Respondent: Kendall Kinyon
Assistant Chief Counsel

## O P I N I O N

This appeal is made pursuant to section 25666[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of W. K. Equipment Company against a proposed assessment of additional franchise tax in the amount of $31,450 for the income year ended April 30, 1978.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

The sole issue to be decided is whether appellant's interest in a Texas oil-drilling joint venture constituted part of a unitary business. The Franchise Tax Board has conceded that it erred in partially denying a bad debt expense deduction which was previously in dispute.

Appellant is in the business of renting and selling equipment to the construction industry in California. Shortly before the end of the income year in question, appellant purchased a 50-percent interest in an oil-drilling joint venture in Texas. Appellant had no control over the drilling, but simply provided funds for the drilling which was conducted by an unrelated drilling company. One well was drilled before the end of the income year, but it was immediately abandoned as a "dry hole." Appellant's share of the drilling costs was $317,500.

Appellant deducted the drilling costs as expenses in arriving at taxable income on its franchise tax return for the 1978 income year. The Franchise Tax Board disallowed this deduction and allocated it entirely to Texas, contending that the oil-drilling venture and appellant's equipment business were separate businesses rather than a single unitary business. Appellant argues that the two activities constituted a single unitary business and that losses from one were properly deductible from the income of the other.

A taxpayer which derives income from sources both within and without California measures its franchise tax liability by its net income derived from or attributable to sources within this state. (Rev. & Tax. Code, § 25101.) The California-source income of such a taxpayer must be computed in accordance with the provisions of the Uniform Division of Income for Tax Purposes Act contained in sections 25120 through 25139. (Rev. & Tax. Code, § 25101.) If the business conducted within and without the state is unitary, the portion of the business income from the entire unitary business which is attributable to sources within this state must be determined by formula apportionment. (Cal. Admin. Code, tit. 18, reg. 25101, subds. (a) and (f).) Where the taxpayer holds an interest in a partnership or joint venture, and the partnership's activities and the taxpayer's activities constitute a single unitary business, the taxpayer's shares of partnership income and apportionment factors are included in the taxpayer's combined report. (Cal. Admin. Code, tit. 18, reg. 25137.1 (art. 2.5); Appeal

of Albertson's, Inc., Cal. St. Bd. of Equal., Sept. 21, 1982.)

The California Supreme Court has set forth two alternative tests for determining whether a business is unitary. In Butler Bros. v. McColgan, 17 Cal.2d 664 [111 P.2d 334] (1941), affd., 315 U.S. 501 [86 L.Ed. 991] (1942), the court held that the existence of a unitary business was definitely established by the presence of the three unities of ownership, operation, and use. Later, in Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472, 481 [183 P.2d 16] (1947), the court said that a business is unitary if the operation of the business done within this state depends upon or contributes to the operation of the business outside the state.

Respondent's determination is presumptively correct and the appellant bears the burden of proving that it is incorrect. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) Appellant must show that the relationships between its equipment business and the oil-drilling joint venture were of sufficient substance to demonstrate the existence of a single unitary business. (Appeal of the Amwalt Group, Inc., etc., Cal. St. Bd. of Equal., July 28, 1983.)

Appellant argues that the oil-drilling venture was clearly unitary with its equipment rental business because it needed to have gasoline to use in the equipment which it rented. Appellant believed that this venture would help solve its fuel shortage problems because "owning a supply of oil and gas might allow a 'trade off' of unrefined oil and gas for petroleum products in times of shortages or, in the alternative, create leverage to acquire fuel locally," and it "would be a good hedge against increasing prices for fuels . . . that is, increased prices for Texas oil and gas would help offset local price increases for fuels; . . ." (App. Br., Oct. 5, 1982, at 3.) Appellant also believed that diversification would help provide more income stability by offsetting reduced income during slow periods in the construction industry. Appellant contends that "[a]s soon as the taxpayer starts to 'trade-off' crude oil in Texas for petroleum products in California, a vertically structured enterprise results. . . ." (App. Br., Oct. 5, 1982, at 5.)

Respondent argues that the oil-drilling venture was not an integral part of appellant's business, but

merely an investment which was separate from appellant's equipment business. We agree with respondent.

Appellant has not pointed to a single substantial relationship between its business and the oil-drilling venture which would indicate that, during the 1978 income year, the two constituted a single integrated economic unit under either of the two tests for unity. Appellant simply alleges that the "oil venture . . . was clearly intended to be vertically integrated with its equipment rental business." (App. Reply Br. at 2.) While we do not doubt appellant's intention, we must base our decision on the actual interrelationships which existed between the two activities during the year at issue, not those which existed in later years or those which appellant intended should exist. (Appeal of Hollywood Film Enterprises, Inc., Cal. St. Bd. of Equal., Mar. 31, 1982.)

During the appeal year, the only relationship between appellant's equipment business and the oil-drilling venture was appellant's funding of the exploratory drilling. This single relationship, as well as several of the reasons given by appellant for participating in the joint venture, is completely in concert with respondent's characterization of the relationship as simply an investment. On the facts presented regarding the year on appeal, it is clear that no operational integration existed, and, therefore, we cannot say that appellant's business and the oil-drilling venture constituted a single unitary business. Respondent's action, therefore, must be sustained.

Appeal of W. K. Equipment Company

## 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 W. K. Equipment Company against a proposed assessment of additional franchise tax in the amount of $31,450 for the income year ended April 30, 1978, be and the same is hereby modified to reflect respondent's concession regarding the bad debt deduction. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 10th day of September, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Richard Nevins, Member

Walter Harvey*, Member

_____, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) 82A-233 MW
W. K. Equipment Company )

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed October 9, 1985, by W. K. Equipment Company for rehearing of its appeal from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of September 10, 1985, be and the same is hereby affirmed.

Done at Sacramento, California this 4th day of February, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9