BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)		
GASCO GASOLINE, INC., ET AL.	) No.	83R-950-MW
	)	84A-940
	)	

For Appellant: Lou M. Carpiac
Attorney at Law

For Respondent: Kathleen M. Morris
Counsel

O P I N I O N

These appeals are made pursuant to sections 25666 and 26075, subdivision (a)1/ of the Revenue and Taxation Code from the actions of the Franchise Tax Board on the protests of Gasco Gasoline., Inc., and Thompson Petroleum Tank Lines, Inc., against proposed assessments of additional franchise tax, and in denying the claim of Gasco Gasoline, Inc., for refund of franchise tax, in the amounts and for the years as follows:

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

Appeals of Gasco Gasoline, inc., et al.

	Income Years Ended	Proposed Assessments
Gasco Gasoline, Inc.	1-31-80	$68,671
Thompson Petroleum Tank Lines, Inc.	12-31-80	18,000

	Income Year Ended	Claim for Refund
Gasco Gasoline, Inc.	1-31-81	$32,763

Appeals of Gasco Gasoline, Inc., et al.

The question presented by these appeals is whether certain oil-drilling interests owned by appellants were part of their unitary business.

The appellants, Gasco Gasoline, Inc. **(Gasco),** and Thompson Petroleum Tank Lines, Inc. **(TPTL),** were both loo-percent owned by Mr. William E. Thompson (Thompson). Thompson also owned Desert Petroleum, Inc. (Desert), and Gasco owned Anchor Refining Co., Inc. (Anchor). Gasco was a wholesale distributor of petroleum products, TPTL transported only petroleum products, Desert owned and operated service stations, and Anchor refined petroleum. Apparently, both parties agree that these four companies formed a vertically integrated unitary oil business.

The unitary business which existed during the appeal years had developed over more than twenty years, beginning with Desert's predecessors in the early sixties and continuing with the formation of Gasco in 1967 and TPTL in 1974 and the purchase of Anchor in 1979.

Shortly after the Anchor purchase was concluded, Gasco purchased a limited partnership interest in the Maritime Southern Drilling Partners (Maritime) for **$1,020,000.** As a limited partner, Gasco was specifically prohibited from participating in the management of or transacting any business for the partnership. Gasco also had no right to demand or receive a distribution of property instead of cash. Maritime entered into a joint venture with others to explore and drill for oil and gas in certain areas of Texas. In a separate agreement, Thompson obtained a right of first refusal, signed by all the joint venturers, allowing him to buy any oil produced at the highest price and upon the same terms as those offered by any'third-party purchaser. Thompson assigned this right to Gasco. It is not clear whether any wells were completed and produced oil during the appeal years, but appellant did not exercise its right of first refusal during either 1980 or 1981. Ultimately, one well produced only water and the other produced approximately 60 **barrels** of high quality crude per day. Gasco deducted its distributive share of losses in the amount of $758,793 on its return for the 1980 income year and included its share of income, **$34,099,** on its return for the 1981 income year.

On December 29, 1980, TPTL purchased a **15-percent** interest in a Wyoming oil-drilling partnership called **Kirkwood** 1981-1 **(Kirkwood).** The partnership agreement was silent as to which partner *or* partners would be involved in the management and operation of the partnership's business. Appellants allege that TPTL had an oral agreement with William Kirkwood, the

majority partner and the contributor of the leasehold working interests to be explored, whereby TPTL or any of its affiliates would have a right to buy any oil produced at prevailing prices. Kirkwood drilled four wells, of which two were dry holes, one was the economic equivalent of a dry hole, and one produced some oil, but, according to appellants, not enough to be useful. Appellants apparently did not purchase any of the oil produced, nor was TPTL used to transport the oil or Anchor to refine it. A partnership loss in the amount of $187,500 was claimed for its income year which ended December 31, 1980.

On January 23, 1981, Gasco paid $165,000 for a limited partnership interest in Oxco Drilling Partners (Oxco). Gasco was obligated to contribute no more than an additional $55,000. Gasco's profit and loss allocation was approximately 91 percent, but it was allocated 100 percent of federal and state tax deductions for intangible drilling expenses, investment tax credits, and depreciation. Gasco was specifically prohibited from participating in the management of the business or transacting any business for the partnership. The Oxco well did not produce any oil. Gasco deducted $165,000 in intangible drilling costs on its return for its income year which ended January 31, 1981.

In November and December- 1980, Gasco acquired 87.5-percent working interests in each of two oil wells in Louisiana from Village Land & Exploration Company, Inc. (Village), at a total cost of $250,668.27. The agreement in regard to each well provided that Village would drill and test the well and then operate it at cost plus 15 percent. Both wells were apparently dry holes. On January 29, 1982,. Gasco abandoned the wells and transferred all of its interest in them back to Village. Gasco.deducted the amount of its investment, in the two wells on its return for its income year which ended January 31, 1981.

The FTB determined that none of the above-described interests were part of appellants' unitary business operations during the appeal years. Therefore, both the deductions claimed and the income reported'were excluded in determining appellants' income subject to tax by California.

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. 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 may be 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 [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. The FTB's determination regarding the existence or nonexistence of a unitary business is presumptively correct, and appellants bear the burden of showing that it is incorrect.

To demonstrate the existence of a unitary business, it is necessary to do more than simply list circumstances which are labeled "unitary factors". There must be evidence that the affiliated entities form a functionally integrated enterprise, rather than merely a group of investments whose operations are unrelated. (Appeals of Santa Anita Consolidated, Inc., et al., Cal. St. Bd. of Equal., Apr. 5, 1984.)

Appellants contend that the acquisition of direct and indirect interests in oil wells following the purchase of a refinery was the final step in creating a complete vertically integrated oil business. They state that the acquisition of these interests was necessary for continued existence of the refinery in the face of the elimination of government-mandated crude oil supply contracts in 1981. Appellants argue that the failure to achieve their intended result, when that failure was due to circumstances beyond their control, should not prevent these interests from being part of their unitary business. Appellants would have us focus our inquiry on the intended product flow and "on the plausibility and authenticity of that claimed intention." (App. Rep. Br. at 2.)

The FTB argues that appellants have not shown, by facts which existed during the appeal years, that their interests in the oil-drilling ventures were functionally integrated parts of their unitary business. Rather, the FTB asserts, these interests were purchased as investments.

We agree with the FTB's determination. Although the acquisition of a crude-oil source would appear to be a natural extension of appellants' unitary business, mere appearance is not enough. The integration of appellants' oil-drilling interests with the rest of their unitary business has been questioned and appellant must be able to prove that such integration really existed. Just as diversity in lines of business does not, per se, preclude a finding of unity, similarity in lines of business does not, per se, assure a finding of unity. Nor does intent, no matter how plausible, form a basis for a determination of unity. What is required is a showing that the oil-drilling interests were functionally integrated with the rest of appellants' unitary business operations and not merely passive investments.

The evidence presented simply does not demonstrate the existence of functional integration during the appeal years. Instead, it supports a conclusion that appellants purchased these interests as passive investments. Two of the four were limited partnership interests, which are classic examples of passive investments -- appellants contributed only money and were entitled to receive only a share of the profits and losses. Absent unusual circumstances, we believe that it would be extremely difficult to overcome the inherent passive investment nature of a limited partnership interest. In the present case, the evidence unequivocally reinforces the conclusion that these were acquired and maintained as passive investments.

It appears that appellants acquired interests only in wells that were not yet drilled< so there was absolutely no assurance that any of them would produce oil. In three out of the four situations, appellants 'had no right, as partners, to any of the oil which might be produced. The right of first refusal in connection with Martime's drilling venture was obtained by Thompson and assigned to Gasco. Nothing in the agreement indicates that it arose out of Gasco's investment in Maritime. Appellants have not provided any evidence to substantiate their allegation that TPTL had an oral agreement with regard to any oil produced 'by Kirkwood. In all cases, any right to oil which appellant may have had was rendered moot by the lack of oil discovered. While we may accord some value to the simple existence of a right to acquire oil, to base a determination of unity on such meager grounds would be entirely unjustified.

The timing and nature of appellants' acquisitions were such that their potential as sources of crude oil were speculative at best, but their potential as sources of income-sheltering tax deductions was undoubted. In some of the

agreements, it appears that appellants received special allocations increasing the percentage of deductible items, such as intangible drilling costs, over their allocable share based on their capital contributions. In all four cases, appellants' interests were purchased shortly (in two cases, merely days) before the end of appellants' fiscal years. (Maritime - purchased October 1, 1979, fiscal year end January 31, 1980; Oxco - purchased January 23, 1981, fiscal year end January. 31, 1981; Kirkwood - purchased December 29, 1980, fiscal year end December 31, 1980; Village - purchased November 13, 1980, and December 3, 1980, fiscal year end January 31, 1981) and large losses were deducted for the year of acquisition (Maritime - 758,793; Oxco - $415,668; Kirkwood - $187,500; Village - $250,668.27). While there is nothing wrong with a taxpayer taking advantage of allowable tax shelters, and incidental tax-shelter aspects of transactions will not necessarily preclude the existence of functional integration, these tax-shelter aspects, taken together with the other evidence discussed previously, help convince us that, in substance, appellants' purchases were merely passive investments. The remote possibility that these interests might someday be integrated with the operating activities of appellants' unitary oil business is simply too speculative to support a determination of unity.

Based on the record as a whole, we conclude that appellants have not proven that the oil-drilling interests which they acquired were functionally integrated parts of their unitary business. The action of the Franchise Tax Board, therefore, must be sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in these proceedings, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to sections 25667 and 26077 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board on the protests of Gasco Gasoline, Inc., and Thompson Petroleum Tank Lines, Inc., against proposed assessments of additional franchise tax, and in denying the claim of Gasco Gasoline, Inc., for refund of franchise tax in the amounts and for the years as follows:

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be and the same are hereby sustained.

Done at Sacramento, California, this 1st day of June, 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Bennett, Mr. Collis, and Mr. Davies present.

Ernest J. Dronenburg, Jr., Chairman

William M. Bennett, Member

Conway H. Collis, Member

John Davies* **, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

**Abstained