



BEFORE THE STATE BOARD OF EQUALIZATION.
OF THE STATE OF CALIFORNIA

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

Appearances:

For Appellant: James R. Ron
Tax Counsel

For Respondent: Kendall E. Kinyon
Counsel

OPINION ON PETITION FOR REHEARING

On March 3, 1982, we reversed the action of the Franchise Tax Board on the protest of **Occidental** Petroleum Corporation against proposed assessments of additional franchise tax in the amounts of **\$1,038,346**, \$20,997, and **\$396,156** for the income years 1967, 1969, and 1970, respectively. On March 29, 1982, respondent filed a timely petition for rehearing pursuant to section 25667 of the Revenue and Taxation Code.

This appeal involves two issues: (1) the deductibility of certain taxes paid to Libya; and (2) whether the income realized from various sales of stock was business or nonbusiness income. Respondent has requested a rehearing on the first issue only; however, on our own motion we asked the parties to submit supplemental briefs regarding the effects, if any, of the U.S.

Appeal of Occidental Petroleum Corporation

Supreme Court's decisions in ASARCO, Inc. v. Idaho State Tax Commission, -- U.S. -- [73 L.Ed.2d 787] (1982), and F.W. Woolworth Co. v. Taxation and Revenue Department, -- U.S. -- [73 L.Ed.2d 819] (1982), on our original decision that the income from the stock sales constituted business income.

Respondent's argument in support of its request for rehearing is that we should defer a decision on the Libyan tax issue pending a final judicial determination of appellant's refund suit for its 1978 income year. Appellant filed that action in the Los Angeles County Superior Court on September 2, 1981, but we were not advised of its existence until respondent filed this petition for rehearing on March 29, 1982. While respondent contends that the court action involves the 'very same issue as the one now before us, appellant states that its lawsuit involves the deductibility of a different Libyan tax, viz., the tax imposed by the Libyan Company Tax Law. The tax involved in the appeal before us is the one imposed by the Libyan Petroleum Law.

Although we will generally defer further proceedings in an appeal when a timely request is filed on the grounds that the same or a closely related issue is before the courts, respondent's request is neither timely nor based on pending litigation whose resolution would clearly be controlling or helpful in deciding this appeal. In light of appellant's objections to further delay, it seems entirely inappropriate to defer a decision at this point in the appellate process without a more compelling showing than respondent has been able to make.

Having declined to defer our decision in this matter, we now must consider respondent's alternative request for modification of our opinion. Respondent urges us to delete the paragraph relating to "realization" on page 6 of the original opinion (see page 8, infra, of this opinion), on the grounds that this material is unnecessary to the decision and will seriously prejudice respondent's position in other cases involving foreign taxes imposed on the extraction of minerals other than petroleum. In support of this request, respondent relies in part on The Anaconda Company v. Franchise Tax Board, 130 Cal.App.3d 15 [-- Cal.Rptr. --] (1982), where the court held that certain taxes imposed by the governments of Chile and Mexico on the taxpayer's copper mining operations in those countries were nondeductible income taxes.

Appeal of Occidental Petroleum Corporation

With respect to the impact of our opinion on respondent's potential litigating position in other cases, we think that respondent's fears are unwarranted. Our opinion does not purport to lay down an immutable rule in **favor** of the deductibility of all foreign taxes levied on **every** multinational corporation under all conceivable circumstances, and there is no justification for so reading it. In this appeal, we decided only that appellant was entitled to **deduct** a portion of the taxes imposed on it by the Libyan Petroleum Law during the years on appeal. Nothing in our opinion inhibits respondent from asserting the nondeductibility of some other tax (or part thereof) imposed by Libya or any other country on appellant or any other taxpayer. Each such case will, as always, be decided on its own facts in accordance with the applicable statutes as currently construed by the courts.

Insofar as the Anaconda case is concerned, it appears, from the **court's abbreviated** discussion of the **tax** issue, that the basis for its holding was that the taxes **in question** were labeled income taxes under the laws of Chile and Mexico, and that the taxpayer failed to carry its burden of showing that the taxes were not truly based on income. That is not the situation here, however, since appellant has adequately demonstrated that the Libyan tax on the posted price differential was not a tax on income under the applicable standards. Thus, the Anaconda case does not require modification of our **opinion** on this issue.

For the above reasons, we conclude that respondent has failed to demonstrate adequate cause for granting **its petition for rehearing or for modifying our original opinion on the foreign tax issue.**

With respect to the business income issue, we have concluded that our original opinion must be modified to reflect our own recent decision in the Appeal of Standard Oil Company of California, decided March 2, 1983, as well as the Supreme Court's decisions in the ASARCO and Woolworth cases, supra. **For ease of reference in the future,** the entire text of our opinion in this matter, incorporating the modifications on the business income issue, is set forth below.

Appeal of Occidental Petroleum Corporation

M O D I F I E D O P I N I O N

Two issues are presented by this appeal. The first concerns the deductibility of certain taxes paid to Libya in connection with appellant's petroleum operations in that country. The second is whether the gains and losses several members of appellant's unitary group realized from sales of stock in affiliated and unaffiliated corporations constituted business income apportionable by formula or nonbusiness income specifically allocable to the commercial domicile of the respective corporate shareholder.

Appellant was incorporated in California on May 21, 1920, and has always had its commercial domicile in this state. Prior to 1957, appellant's activities were relatively nominal, limited generally to the exploration and development of oil and gas properties in California; In 1957, Dr. Armand Hammer assumed control of appellant and led it into a period of spectacular growth through the acquisition of a group of natural resource-oriented companies. Also, as a result of extensive exploration activities in Libya, appellant's unitary subsidiary, Occidental of Libya, Inc., (hereinafter referred to as "Oxy Libya"), discovered major oil and gas reserves on its Libyan concessions in 1966. In 1968, Oxy Libya began exporting crude oil from these concessions, and also began making substantial payments to Libya, as required by Libyan law.

I. The Deductibility of Libyan Taxes

Revenue and Taxation Code. section 24345^{1/} provides, in pertinent part:

There shall be allowed as a deduction--

(a) Taxes or licenses paid or accrued during the income year except:

* * *

(2) Taxes on or according to or measured by income or profits paid or accrued within the income year imposed by the authority of

^{1/} All section references are to sections of the Revenue and Taxation Code, unless otherwise indicated.

Appeal of Occidental Petroleum Corporation

(A) The Government of the United States or any foreign country; ...

For the income year 1970, appellant's combined report claimed a deduction for a part of the taxes Oxy Libya paid to Libya in that year. As explained more fully below, the amount deducted was the portion of Libyan taxes based on the "posted price" of Libyan crude oil, to the extent that this artificial price exceeded the actual market price for which Libyan crude was sold. Appellant's theory is that a tax based on such an arbitrary, artificial figure, which bears no relationship to the actual gross receipts Oxy Libya realized from the sale of Libyan crude, is deductible under section 24345 because it is not a tax "on or according to or measured by income or profits," within the meaning of that section. Appellant has filed refund claims for its 1968 and 1969 income years, reflecting similar deductions for those years, and respondent has indicated that it will dispose of those claims on the basis of our decision in this appeal.

Under Article 14(1) of the Libyan Petroleum Law No. 25 of 1955, as amended through 1965, and Clause 8(1) of the Second Schedule (Standard Form Deed of Concession) to that Law, oil companies operating in Libya were required to pay "such income tax and other taxes and imposts as are payable under the laws of Libya." In addition, Article 14(1)(a) of the Petroleum Law and Clause 8(1)(a) of the Concession Form required that if the total annual amount of fees, rents, income tax, other direct taxes, and royalties (except 12 1/2 percent of the value of crude oil exported) paid by the company to Libya fell short of 50 percent of its profits from all of its petroleum concessions in Libya, then the company had to pay Libya a "surtax" sufficient to make its total payments equal 50 percent of its profits.

"Profits" were defined as the income resulting to the company from its operations in Libya after deducting (1) operating expenses and overhead, (2) depreciation of physical assets in Libya, (3) amortization of all other capital expenditures in Libya, (4) exploration and prospecting expenses, and (5) intangible drilling costs. No deduction was allowed for the fees, rents, royalties, income tax, and other direct taxes mentioned in Article 14(1)(a) of the Petroleum Law, or for interest paid to finance operations in Libya. Similarly, expenditures incurred to organize and initiate petroleum operations in Libya were nondeductible.

Appeal of Occidental Petroleum Corporation

Clause 8(5)(a) of the Concession Form defined the phrase "income resulting from the operations of the Company in Libya" as:

(a) in relation to crude oil exported by the Company from Libya: total gross receipts realized by -the Company from such export, and such receipts shall not be less than the amount which results from multiplying the number of barrels of such crude oil exported by the applicable posted price per barrel of such crude oil exported less [certain marketing allowances] (Emphasis added.)

Clause 8(5) of the Concession Form and Article 14(5) of the Petroleum Law further provided that the term "posted price" meant:

the price f.o.b. Seaboard Terminal for Libyan crude oil of the gravity and quality concerned arrived at by reference to free market prices for individual commercial sales of full cargoes and in accordance with the procedure to be **agreed** between the Company and the Ministry [of Petroleum] or if there is no free market for commercial sales of full cargoes of Libyan crude oil then posted **price** shall mean a fair price fixed by agreement between the Company and the Ministry

Despite the language above suggesting otherwise, by 1970 Libya was unilaterally fixing its posted prices without regard to the actual market prices for its oil. According to appellant's figures, Libya's posted price in 1970 averaged **about \$2.33** per barrel, while-the market price Oxy Libya realized per barrel averaged **about \$1.83**. Based on the approximate difference of **\$.50** a barrel, Oxy Libya was required by **Libyan** law to declare additional "income" of **\$121,664,040** and to pay additional Libyan taxes of **\$62,127,733** in 1970. The question to be resolved is whether those additional taxes are deductible in computing the business income of appellant's combined report group.

There is no doubt that the taxes in question are deductible under section 24345 unless they are "on-or according to or-measured by income or profits" within the meaning of subdivision (a)(2) of that section. Although the California Supreme Court has not construed this phrase. in a case arising under section 24345, it has interpreted

Appeal of Occidental Petroleum Corporation

the identical phrase contained in section 17204, which is section 24345's counterpart in the Personal Income Tax Law. (See Beamer v. Franchise Tax Board, 19 Cal.3d 467 [138 Cal.Rptr.199; 563 P.2d 238] (1977).) In MCA, Inc. v. Franchise Tax Board, 115 Cal.App.3d 185 [171 Cal.Rptr. 2421 (1981)], the court of appeal held that the Beamer decision's construction of this phrase in section 17204 controls the interpretation of the identical language appearing in section 24345.

Beamer involved a Texas "occupation tax" on the production of crude oil and natural gas. The taxpayers were California residents who owned an interest in a Texas oil and gas field and received royalty income from the oil and gas produced from the field. The Texas tax was a specified percentage of the "market value" of the oil and gas "as and when produced," and liability for the tax accrued when the minerals were produced, regardless of whether anything further, such as a sale, took place. In the case of a sale for cash, Texas law provided that the tax was to be computed on the producer's gross cash receipts, without deduction for the "lifting costs" incurred in producing the oil and gas. (Beamer v. Franchise Tax Board, supra, 19 Cal.3d at 475-477.)

The court held that the Texas tax was deductible under section 17204. In reaching that conclusion, it read the phrase "taxes on or according to or measured by income or profits" as using the term "income" in the sense of gross income under general tax law as currently operating. (Id. at 479.) After analyzing the pertinent income tax statutes, regulations, and administrative rulings applicable to the production of oil and gas, the court determined that the Texas tax was measured by gross receipts and not by gross income, since it did not allow a deduction for "lifting costs." Under general income tax law, the court found, the "gross income" of a mining business is its total sales less the cost of goods sold, and the "lifting costs" of a petroleum producer constitute a part of his production costs. (Id. at 476-477.) The court also noted that an economic gain must be "realized" before it is taxable as income, and it rejected the Franchise Tax Board's contention that the mere reduction of oil and gas to possession, which was the taxable event that triggered the Texas tax, constitutes "realization" of income. (Id. at 479-480.)

. Appellant argues that the Libyan tax based upon the difference between the "posted price" and the

Appeal of Occidental Petroleum Corporation

amount Oxy Libya actually received from its sales of Libyan crude cannot be a tax on income, since there was never a "realization" of that difference. There are, it seems to us, two distinct reasons why appellant's position is essentially correct. The most elementary one is that, in order to have gross income, a taxpayer must first receive economic gain in some form. (Commissioner v. Glenshaw Glass Co., 348 U.S. 426 [99 L.Ed. 483] (1955); Doyle v. Mitchell Bros. Co., 247 U.S. 179 [62 L.Ed. 1054] (1918).) Here, it can hardly be said that Oxy Libya obtained any economic benefit or gain from a purely fictitious amount of Libyan "income" which it never received, and never will receive. To the extent that it was imposed on the difference between the "posted price" and the actual sales price of Libyan crude oil, therefore, the Libyan tax was levied on an artificial tax base, and 'was not a tax on or measured by "income" as that term is used in general United States tax law. (See Rev. Rul. 78-63, 1978-1 Cum. Bull. 228, holding that the Libyan "surtax" imposed by Article 14(1)(a) of the Libyan Petroleum Law is not a creditable "income tax" under section 901 of the Internal Revenue Code.)

The second reason is that the Libyan tax was not imposed on "realized" income. Since the "income" subject to the tax could not be less than the number of barrels exported multiplied by the posted price less marketing allowances, the tax could be triggered by the export of crude oil regardless of whether a sale or other disposition of the oil had taken place. We believe, as did the Internal Revenue Service in Revenue Ruling 78-63, supra, that the act of exporting oil does not constitute a sufficient realization of income for general income tax purposes. Although the technical concept of realization does not require the receipt of money or property by the taxpayer, it does require some identifiable event whereby the taxpayer obtains the final enjoyment of whatever economic gain or benefit has accrued to him. (Helvering v. Horst, 311 U.S. 112 [85 L.Ed. 75] (1940).) The mere exporting of oil, without more, seems clearly insufficient to satisfy this requirement. In order for Oxy Libya to obtain "the fruition of the economic gain which has accrued to [it]" (Id. at 115 [85 L.Ed. at 78]), some additional event, such as a disposition of the oil, would have to take place.

Respondent contends that appellant's argument regarding the lack of "realization" fails to recognize

Appeal of Occidental Petroleum Corporation

that any increases in the posted price over the prevailing market price constitute, in substance, nothing more than Libya's method of increasing the rate of tax and royalties on oil concessionaires without violating the Concession Agreements. Support for this position allegedly comes from certain statements in appellant's 1970 annual report to its shareholders, where appellant noted that an increase in the posted price had raised "[o]ur overall rate of Libyan taxes on profits" from 50 percent to 58 percent. While we certainly would not quarrel with the general proposition that substance governs over form in matters of taxation, we think the principle is inapplicable to the present circumstances. Any artificial addition to the tax base has the effect of a rate increase. For example, if the Congress decreed that every individual must add \$50,000 to his reportable gross income before computing his federal income tax liability, the effect would be a rate increase on the individual's real income as determined in the usual fashion. But that \$50,000 itself clearly is not "income" in the ordinary sense, and a tax levied on it would not be a tax on realized income within the meaning of the Beamer case.

In any event, the record does not support respondent's assumption that Libya was either unable or unwilling to raise its tax rate in a straightforward manner. Libya apparently raised the tax rate from 50 percent to 53 percent effective September 1, 1970, and further increases were instituted in later years. By 1975, for example, the applicable rate was 65 percent of each oil concessionaire's profits. (Rev. Rul. 78-63, supra.)

For the above reasons, we conclude that the Libyan tax on the posted price differential was not a tax "on or according to or measured by income or profits," and that to this extent it was properly deductible under section 24345.

II. Business vs. Nonbusiness Income

The second issue is whether certain gains and losses appellant and its affiliates realized from sales of stock in various corporations constitute business income apportionable by formula or nonbusiness income specifically allocable to the particular state where each corporate stockholder maintained its commercial domicile. Resolution of this issue is governed by the

Appeal of Occidental Petroleum Corporation

provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is contained in sections 25120-25139 of the Revenue and Taxation Code.

The sales in question involved the stock of five different corporations: Tenneco, Inc., Island Creek Coal Company, Cofesa Comercio de Fertilizantes, Ltda. (Cofesa), Oxytrol Corporation, and Waiawa Realty Company; The record establishes that each of the stock sales was related in some fashion to appellant's concerted effort to expand and consolidate its basic unitary business involving natural resources and energy sources. Before examining the specific facts of each transaction, we should commend the appellant for producing a considerable volume of relevant corporate documents, including detailed minutes of its board of directors' meetings, in order to present us with an unusually clear picture of its activities and the reasons behind them.

In 1967 appellant realized a gain of **\$17,367,754** from the sale of Tenneco preference stock. Appellant had obtained this stock in connection with its unsuccessful effort to acquire Kern County Land Company (KCL). In keeping with its expansion program in the natural resources area, appellant was interested in combining KCL's business with its own primarily because of KCL's petroleum income and operations, its ownership of large landholdings which were thought to contain significant oil and gas reserves, and its experience in land development. After failing to induce KCL's management to discuss a merger, appellant initiated a tender offer for a portion of KCL's stock. Although appellant ultimately acquired over 20 percent of KCL's outstanding stock, KCL thwarted appellant's takeover bid by agreeing to be acquired by Tenneco. As a result of that agreement, appellant received Tenneco preference stock in exchange for its KCL common stock. Shortly thereafter, appellant sold the Tenneco stock so that it could redeploy its assets in other ventures.

Also in 1967, appellant undertook a friendly acquisition of Island Creek Coal Co. At a meeting of appellant's board of directors in August of that year, appellant's president, Dr. Armand Hammer, explained to his fellow directors that appellant was interested in Island Creek **because it was** an "entry into one more aspect of the company's basic business - that of natural resources and sources of energy." Prior to reaching a definitive merger agreement with Island Creek, appellant

Appeal of Occidental Petroleum Corporation

had acquired a relatively small amount of Island Creek's stock, apparently for the purpose of impressing Island Creek's management with the sincerity of appellant's interest in acquiring their company. In order for appellant to secure a favorable ruling from the Internal Revenue Service that the proposed merger would qualify as a tax-free reorganization, appellant's tax attorneys advised it that it would be necessary to dispose of its Island Creek stock prior to consummating the merger. Accordingly, appellant sold the stock at a gain in 1967, a favorable ruling was obtained on the basis of appellant's representation that it would not own any Island Creek stock at the time of the merger, and the acquisition of Island Creek was consummated on January 29, 1968.

Cofesa was a wholly-owned **Brazilian** subsidiary of International Ore and Fertilizer Corporation (Interore), a Delaware corporation domiciled in New York. Both corporations were a part of appellant's unitary business. Unlike Interore, which sold to wholesalers, Cofesa sold fertilizer directly to farmers. As a result of its inability to find competent and honest local management to run Cofesa in Brazil, and in order to **avoid** continuing operating losses, **Interore** got out of retail operations in 1967 by liquidating Cofesa at a loss of **\$1,058,422**.

During 1969, as part of a realignment of appellant's unitary real estate activities, Monarch Investment Co., appellant's wholly-owned subsidiary, sold all of the stock of Waiawa Realty Co. to an unrelated third party for a gain of \$548,835. Waiawa operated in Hawaii, where appellant had no other activities. The decision to sell the company was based primarily on appellant's inability to obtain competent local management in Hawaii and its belief that any income to be generated by Waiawa was purely speculative in nature.

Sometime during 1969, appellant organized a new subsidiary, Oxytrol Corporation, to market its patented nitrogen-controlled atmosphere system for fruits and produce during shipment. Prior to the incorporation of Oxytrol, these operations had been conducted by the Oxytrol division of appellant as part of the unitary business. At the time that Oxytrol was incorporated, appellant sold 200,000 Oxytrol shares to an unrelated third party in order to gain the latter's assistance in developing markets for the Oxytrol system.

Appeal of Occidental Petroleum Corporation

This transaction resulted in a gain to appellant of \$532,595. Approximately one year later, in July 1970, appellant sold its remaining 800,000 shares in Oxytrol at a net gain of \$2,334,590. This complete disposition of its interest in Oxytrol seems to have been based on the perception that Oxytrol's operations were at variance with appellant's natural resources orientation and on appellant's desire to redeploy its financial resources in other areas.

In its combined reports for the years in question, appellant treated the gains and loss described above as business income apportionable by formula under UDITPA. Respondent determined, however, that they should have been reported as nonbusiness income specifically allocable to the commercial domiciles of the respective corporate stockholders.

UDITPA defines business income as:

income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
(Rev. & Tax. Code, § 25120, subd. (a).)

Nonbusiness income, on the other hand, is "all income other than business income." (Rev. & Tax. Code, § 25120, subd. (d).)

Section 25128 provides that all business income must be apportioned by formula. Under section 25123, however, nonbusiness income must be allocated as provided in sections 25124 through 25127. Section 25125, subdivision (c), states that:

Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

For the years in question, respondent's regulation 25120 provides, in pertinent part:

(a) Business and Nonbusiness Income Defined. Section 25120(a) defines "business income" as income arising from transactions

Appeal of Occidental Petroleum Corporation

and activities in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, the business income of the taxpayer is that portion of the taxpayer's entire net income which arises from the conduct of the taxpayer's trade or business operations. For purposes of administration of Sections 25120 to 25139, inclusive, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income- sections 25120 to 25139, inclusive and the regulations thereunder.

Nonbusiness income means all income other than business income.

* * *

(c) Business and Nonbusiness Income: Application of Definitions. The classification of income by the labels customarily given them, such as interest, dividends, rents, royalties, capital gains) is of no aid in determining whether that income is business or nonbusiness income. The gain or loss recognized on the sale of property, for example, may be business or nonbusiness income depending upon the relation to the taxpayer's trade or business.

The following are rules and examples for determining whether the particular type of income is business or nonbusiness income:

* * *

(2) Gains or losses from sales of assets. As a general rule, gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used to produce business income. However, the gain or loss will constitute nonbusiness income if such property was subsequently utilized principally for the production of nonbusiness income or otherwise was

Appeal of Occidental Petroleum Corporation

removed from the property factor. (See Regs. 25129 to 25131, inclusive.)

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(4) Dividends. Dividend income is business income when dealing in securities is a principal business activity of the taxpayer. Most other dividends are nonbusiness income.

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Example (C): The taxpayer owns all the stock of a subsidiary corporation which is engaged in a business similar to that of the taxpayer. Any dividends received from the subsidiary would be nonbusiness income. (Emphasis added.) (Cal. Admin. Code, tit. 78, reg. 25120 (art. 2).)

Respondent's position may be summarized as follows: Since appellant and its affiliates were not dealers in securities, any dividends they might have received on their stockholdings would have constituted nonbusiness income under subdivision (c)(4) of regulation 25120. Consequently, since the stock, while owned by the taxpayers, **was used to produce nonbusiness income**, any gain or loss from the sale of that stock would be nonbusiness income by virtue of subdivision (c)(2) of regulation 25120.

Under this view of the case, it is apparent that the present situation is merely one step removed from that in the Appeal of Standard Oil Company of California, decided by this board on March 2, 1983, which involved the proper classification of dividend income under **UDITPA's** definitions of business and nonbusiness income. The correctness of respondent's determination regarding the gains and loss in this case clearly stands or falls according to the business or nonbusiness nature of any dividends that might have been received from the stockholdings described above.

In support of its position that dividends received by a nondealer in securities constitute non-business income under UDITPA, respondent relies here on the same reasoning which we analyzed and rejected in Standard Oil. Briefly stated, that reasoning is that **virtually all** dividends constituted nonunitary (or nonbusiness) income under pre-UDITPA law, and that the

Appeal of Occidental Petroleum Corporation

adoption of UDITPA did not change this aspect of pre-existing law. We found this reasoning unpersuasive, and held that the treatment of dividends under UDITPA is not controlled by pre-UDITPA law or administrative practice. We went on to hold that the classification of all **types** of income from intangibles, under the functional test,^{2/} must be made on the basis of the relationship between the intangibles and the taxpayer's unitary business operations. Thus, if the income-producing intangible is integrally related to the unitary business activities, the income is business income subject to formula apportionment. If the intangible is unrelated to those activities, however, the income is nonbusiness income subject to specific allocation.

Appellant's evidence shows clearly that each of the stock sales in question was made pursuant to a specific corporate plan to consolidate or expand the unitary business in accordance with an established natural resources' orientation. With respect to the sales of Cofesa, Waiawa Realty, and Oxytrol stock, we believe that the transactions involving these unitary subsidiaries gave rise to business income under the functional test. In each case, the stock had been acquired (or created) and managed in furtherance of the actual operation of appellant's unitary business. Furthermore, at the times the various decisions to sell were made, the assets and activities represented by the stock were fully integrated and functioning parts of appellant's **existing unitary** business. (See ASARCO, Inc. v. Idaho State Tax Commission, -- U.S. -- [73 L.Ed.2d 787] (1982); Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 [63 L.Ed.2d 510] (1980). Cf. Times Mirror Co. v. Franchise Tax Board, 102 Cal.App.3d 872 [162 Cal.Rptr. 630] (1980), where the court held that capital gains from the sale of stock in a unitary subsidiary constituted business income as a matter of law, based on stipulations of fact by the Franchise Tax Board

^{2/} As we reiterated in Standard Oil, section 25120's definition of business income **contains** two separate tests. Income from property is business income if the transaction or activity which gave rise to it occurred in the regular course of the taxpayer's trade or business (the "transactional test"), or if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's regular trade or business operations (the "functional test").

Appeal of Occidental Petroleum Corporation

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which the court interpreted as a concession by the Board of the very issue in dispute.^{3/})

The Tenneco and Island Creek stock sales present a different situation. Although appellant's purpose in acquiring KCL and Island Creek stock was to expand its unitary business, neither the stockholdings nor the assets and activities they represented constituted integral parts of appellant's existing unitary **operations** at the times appellant decided to sell them.^{4/} In fact, at no time did they possess more than the potential for actual integration into appellant's ongoing business, and we believe that mere potential is insufficient to support a finding that the gains on these sales were business income under the functional test. (Cf. F. W. Woolworth Co. v. Taxation and Revenue Department, supra.) In addition, we believe that the lack of integration between these stockholdings and the existing unitary operations also precludes a finding that the purchase and sale of these securities constituted "transactions and activity in the regular course" of appellant's unitary business. Insofar as

^{3/} Contrary to the dictum in Times Mirror, supra, 102 Cal.App.3d at 877-8, we do not attach any particular significance to the taxpayer's eventual use of the proceeds from stock sales such as the ones involved in this appeal. (See F. W. Woolworth Co. v. Taxation and Revenue Department, -- U.S. --, fn. 11 [73 L.Ed.2d 8191 (1982).]) The moment of judgment will generally be when the decision to sell is made. If the stock is an integral **part** of the taxpayer's unitary business at that moment, the gain or loss will be business income if the sale is made as expeditiously as practicable and the taxpayer has done nothing to convert the stock or the underlying assets into a nonbusiness investment prior to the actual sale. (See Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(2) (art. 2); cf. Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (art. 2).)

^{4/} Cf. Appeal of Pacific Telephone and Telegraph Co., Cal. St. Bd. of Equal., May 4, 1978, where we held that sales of **stock pursuant** to a reorganization of the **taxpayer's** existing unitary business gave rise to unitary (business) income under pre-UDITPA law.

Appeal of Occidental Petroleum Corporation

sales of property are concerned, the transactional test seems designed primarily to embrace sales of things like inventory items. Clearly, these securities were not inventory items. **Moreover**, they were not a type of property that appellant regularly and systematically disposed of in the ordinary course of mining, processing, and selling natural resources. For these reasons, we conclude that respondent properly **classified** the Tenneco and Island Creek gains as nonbusiness income.

