

No. 82A-0398-CD

Appearances:

For Appellant: David S. Mann  
Attorney at Law

For Respondent: Paul J. Petrozzi  
Counsel

O P I N I O N

This appeal is made pursuant to section 25666<sup>1/</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Proctor & Gamble Manufacturing Company, et al., against proposed assessments of additional franchise tax in the amounts and for the income years as follows:

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

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	<u>Income Years Ended</u>	<u>Proposed Assessments</u>
The Proctor & Gamble Manufacturing Company	6/30/74	\$ 75,228
	6/30/75	53,482
	6/30/76	59,654
	6/30/77	84,260
	6/30/78	97,412
	6/30/76	12,310
	6/30/77	16,438
	6/30/78	3,404
The Proctor & Gamble Distributing Company	6/30/74	\$ 6,861
	6/30/76	2,674
	6/30/77	32,434
	6/30/78	30,689
	6/30/77	3,100
The Proctor & Gamble Paper Products Company	6/30/74	\$ 14,053
	6/30/75	16,720
	6/30/76	28,562
	6/30/77	54,846
	6/30/78	61,628
	6/30/76	6,610
	6/30/77	10,702
	6/30/78	3,097
The Folger Coffee Company	6/30/74	\$ 17,835
	6/30/75	7,325
	6/30/76	11,361
	6/30/77	19,124
	6/30/78	23,010
	6/30/76	1,289
	6/30/77	2,030

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The issues presented by this appeal are whether respondent properly excluded from the property factor government-owned property which was used by appellants in their unitary business, and, if not, what amount should be included in the property factor.

Appellants were members of a group of wholly owned subsidiaries of The Proctor & Gamble Corporation which were engaged in a unitary business during the appeal years. One of these subsidiaries, Proctor & Gamble Company of Canada, Ltd., (P&G Canada) had executed a Forest Management Agreement (Agreement) with the Province of Alberta, Canada, under which P&G Canada was granted rights to harvest timber from, and to have other extensive rights to use, 3.5 million acres of timberland to which Alberta retained title.

In exchange for the rights granted by Alberta, P&G Canada was obligated to cut coniferous trees that grew on the timberland, in approximately equal numbers each year, for processing in an adjacent wood pulp manufacturing facility owned by P&G Canada. The trees that were harvested each year apparently represented, on average, production from 47,200 acres. The agreed rate of harvesting provided an adequate supply of timber to operate the wood pulp manufacturing facility and allowed P&G Canada to rotate its use of the timberland in such a manner that it would satisfy another obligation under the Agreement: to reforest completely the timberland over a period of approximately 80 years. P&G Canada agreed to pay Alberta \$1.15 a cord for the harvested trees, a price that was fixed for ten years. The timber that was actually processed in the wood manufacturing facility was included in appellants' property factor as inventory.

P&G Canada also had additional obligations under the Agreement, such as constructing all primary roads and bridges on the timberland, paying annually a "holding charge" of \$3.00 per square mile and a "forest protection charge" of \$12.80 per square mile, and maintaining public access to several recreation areas. For income tax purposes, P&G Canada generally treated the costs and fees associated with operating the timberland as expenses, but capitalized the cost of building permanent roads and amortized them over 20 years.

Appellants, since they were engaged in a single unitary business, were subject to the apportionment and allocation provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA), found in sections 25120 through 25139 of the Revenue and Taxation Code, in determining their income

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attributable **to** and taxable by California. (Rev. & Tax. Code, § 25101; Cal. Code Regs., tit. 18, reg. 25101.) Under UDITPA, a taxpayer's income attributable to this state is determined by multiplying its business income by a fraction (commonly called the apportionment formula), the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. (Rev. & Tax. Code, § 25128.) The property, payroll, and sales factors are fractions, the denominators of which are composed of the taxpayer's worldwide property values, payroll, and sales, respectively, and the numerators of which are composed of the taxpayer's California property values, payroll, and sales, respectively. (Rev. & Tax. Code, §§ 25129, 25132, 25134.)

Appellants filed combined reports for the appeal years and included in the denominator of the property factor an amount of \$399 million, which purported to represent the fair market value of the entire timberland in 1974, the year that appellants state that it was placed in productive use. The Franchise Tax Board (FTB) disallowed this treatment and issued **proposed** assessments. After the FTB's rejection of appellants' protest regarding its action, this timely appeal followed.

Before discussing the arguments of the parties, a review of the pertinent statutes and regulations under UDITPA is required. Section 25129 provides as follows:

The property factor is a fraction, the numerator of which 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 and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year. (Emphasis added.)

The regulation under section 25129 provides in pertinent part:

Property shall be included in the property factor if it is actually used or is available for or capable of being used during the income year in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. (Emphasis added.)

(Cal. Code Regs., tit. 18, reg. 25129, subd.(b).)

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Section 25130 describes how property included in the property factor is to be valued. It states that property owned by a taxpayer must be valued at its original cost and that property rented by a taxpayer must be valued at eight times its net annual rental rate.

Section 25137 provides potential relief from unfairness resulting from the application of the usual apportionment formula as follows:

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require., in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of any one or more of the factors:
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Pursuant to section 25137, the FTB has promulgated special rules for the property factor, one of which states:

If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a reasonable market rental rate for such property. (Emphasis added.)

(Cal. Code Regs., tit. 18, reg. 25137, subd. (b)(1)(3).)

The FTB contends that because the timberland was not "owned or rented and used" (see Rev. & Tax. Code, § 25129, supra) by appellants, no value associated with it may be included in the property factor. It further maintains that appellants may not make use of regulation 25137, subdivision (b)(1)(B), because appellants have not first demonstrated under

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section 25137 that the standard apportionment formula would unfairly reflect their business activity in California. The FTB also argues that if this regulation is ultimately found to apply, appellants may include in the property factor eight times the reasonable market rental value of, at most, 47,200 acres of the timberland.

Appellants rely on this board's application of regulation 25137, subdivision (b)(1)(B), in the Appeal of Union Carbide Corporation, decided April 5, 1984, to permit them to include the timberland in the denominator of the property factor. However, appellants also contend that the instant circumstances require them to disregard that portion of the regulation which mandates the determination of a reasonable market rental value to be reflected in the property factor and to include, instead, the fair market value of the entire timberland in the year that the property was placed in productive use.

In Union Carbide, supra, as here, a private business extensively used property that the government did not permit it to own or to rent and was successful in seeking the protection of the regulation. In that decision, this board stated that by issuing the regulation, "respondent has effectively conceded that where property owned by others is used by the taxpayer at no charge, a value for that property must be included in the property factor in order to fairly reflect the extent of the taxpayer's business activity in this state." We also said that **because** the FTB had implicitly agreed, by issuing the regulation, that the above described circumstances required a special formula, further proof by the taxpayer under section 25137 would be an empty exercise.

Although the FTB contends that significant factual differences between the two appeals compel a less favorable result for appellants here, we believe that the pertinent facts in the instant matter are not distinguishable from those in Union Carbide, supra. Therefore, we follow its rationale in finding that the regulation applies and that an appropriate amount associated with the timberland must be included in the denominator of the property factor.

With respect to identifying such an appropriate amount, the language of the regulation is clear that appellants must use the reasonable market rental value of the pertinent property rather than fair market value. Appellants maintain that because property similar to the timberland is unavailable to rent, they are unable to make appropriate comparisons that would, in their view, be necessary to construct a reasonable

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market rental value. Although we recognize that determining a reasonable market rental value under the circumstances described by appellants is difficult, we do not consider it impossible. We note that, despite their own concession that they cannot sell the timberland because they lack title to it, appellants maintain that they are able to determine its fair market value in the year that it was placed in productive use by comparing it with similar tracts of timber property that was sold in the southern U.S. in the same year. Surely the ingenuity shown by appellants in constructing what they consider to be fair market value can be matched in determining a reasonable market rental value.<sup>21</sup>

Finally, our review of the Agreement convinces us that it contains no restriction that precludes any part of the timberland from being "available for or capable of being used during the income year" (see Cal. Code Regs., tit. 19, req. 25129, subd. (b), *supra*). Accordingly, the entire area of the timberland, and not merely the 47,200-acre segment proposed by the FTB, should be included in determining reasonable market rental value.

Therefore, the action of the FTB must be modified in the manner discussed above.

<sup>21</sup> Although we prescribe no particular approach in constructing the reasonable market rental value of the timberland, the FTB's proposed "reasonable market rental value" of \$15.80 per square mile, computed by adding the annual "holding charge" and "forest protection charge," appears to be no more than a "nominal rate" of rent, and, thus, is unacceptable under regulation 25137, subdivision (b)(1)(B).

