

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
TEXACO, INC.)

Appearances:

For Appellant: Norman B. Barker
Attorney at Law .

For Respondent: Paul J. Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Texaco, Inc., against proposed assessments of additional franchise tax in the amounts of **\$567,643.58**, **\$642,994.59** and **\$355,449.08** for the income years 1967, 1968 and 1969, respectively.

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During the audit and protest phases of this matter, certain peripheral issues were resolved. The amounts of proposed additional tax associated with the matters now in controversy are **\$150,653.58**, **\$153,033.72** and **\$161,335.44** for the income years 1967, 1968 and 1969, respectively.

The primary issue for determination is whether appellant's wholly owned subsidiary, Texaco Iran, Ltd., was engaged in a single unitary business with appellant and appellant's other affiliates and, therefore, properly included in the California combined report. If it is determined that Texaco Iran, Ltd., was part of appellant's unitary business, a second issue must be resolved; whether the standard three-factor apportionment formula, as applied by respondent, properly reflects appellant's income derived from or attributable to California sources.

Appellant is a Delaware corporation engaged in the worldwide exploration, production and distribution of petroleum and petroleum products.

In 1951, the government of Iran nationalized all **oil** properties in that country, including the main operating company, the Anglo-Iranian Oil Company. Three years **later**, after experiencing difficulties in exploiting its oil resources, the Iranian government approached **several** private corporations for assistance. As a result of these negotiations, a consortium of eight oil **companies, including** appellant who had a 7 percent interest in the consortium, entered into a complex series of agreements with the government of Iran, the National Iranian Oil Company, a wholly owned government corporation, and the Anglo-Iranian Oil Company. Under the agreement, the former Anglo-Iranian Oil Company released all of its property interests in Iran which had been previously nationalized by the Iranian government in consideration for which the consortium paid approximately \$1 billion. The cost of appellant's 7 percent interest in the consortium was approximately \$70 million.

Under the terms of the consortium agreement, neither the consortium nor its members acquired any oil reserves, exploration or producing equipment, refining facilities, pipelines or any other tangible property in **Iran** from either the Anglo-Iranian Oil Company or the Iranian government. **The** government of Iran, through its wholly owned company, the National Iranian Oil Company, retained legal title to all oil reserves and all **producing**, refining and pipeline properties. Pursuant to

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the agreement, however, the consortium was granted the full right to the exclusive use and complete management of all the properties.

Under the terms of the agreement, Iran's oil industry was to be operated by two operating companies, Iranian Oil Exploration and Producing Company and Iranian Oil Refining Company. The two producing companies were Netherlands' corporations which were owned by a British holding company, Iranian Oil Participants, Ltd. The holding company was, in turn, controlled by the consortium. The consortium was also obligated to advance all costs for the continuing operation of the Iranian oil industry. Thus, the producing companies operated, basically, as cost corporations selling their product to the National Iranian Oil Company at cost plus one shilling per cubic meter.

In exchange for its commitments under the agreement, the consortium was entitled to "purchase" oil from the National Iranian Oil Company for a stated payment equal to **12-1/2** percent, or one-eighth, of the "posted price" as arbitrarily established from time to time by the Iranian government. However, any oil so taken was required to be sold in Iran at the "posted price." The percentage interest held by any consortium member in the holding company, Iranian Oil Participants, Ltd., determined the amount of oil which that member could purchase through the special consortium arrangement. As indicated, appellant's interest in the holding company was 7 percent of the total.

As contemplated by the consortium agreement, appellant formed a wholly owned corporation, Texaco Iran Ltd. (hereinafter Texiran), to function as a "trading company." Appellant then assigned to Texiran all its rights, obligations and property interests under the consortium agreement, including its 7 percent stock interest in Iranian Oil Participants, Ltd., the holding company. Texiran had no employees. It was, in effect, a "paper corporation" completely controlled by appellant.

Texiran purchased oil from the National Iranian Oil Company at **12-1/2** percent, or one-eighth, of the posted price. Simultaneously, or immediately thereafter, Texiran sold the same oil to another wholly owned subsidiary of appellant, Texaco Overseas Petroleum Company (hereinafter TOPCO), at the full posted price. TOPCO then resold the oil in the world market at the world price.

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During the years in **issue**, the Iranian "posted price" for oil was considerably higher than the world price. **Under this arrangement, TOPCO sold oil in the world market** at a substantial loss. On the other hand, Texiran made a sizable profit. Iran was able to levy a heavy tax on Texiran's profit in order to raise revenue. The result was that Texiran's **profit**, reduced by the Iranian tax levy, was still substantially greater than **the loss** incurred by TOPCO in the world market, thus assuring appellant a substantial profit from the completed transaction.

Respondent determined that the entire Iranian operation constituted an integral part of appellant's unitary business, and included **Texiran's** income in appellant's total unitary income. For purposes of this appeal, **appellant** accepts respondent's treatment of its worldwide operation as unitary and subject to formula apportionment. However, appellant disputes respondent's inclusion of Texiran in the unitary business.

A taxpayer which earns income from sources both within and without this state is required to measure its California **franchise** tax liability by its net income derived from or attributable to California sources. (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 (UDITPA)**, Revenue and Taxation Code sections 25120 through 25139. (Rev. & Tax. Code, § 25101.) If the business is unitary, the portion of the business income which is attributable to California sources must be determined by formula apportionment. (Cal. Admin. Code, tit. 18, reg. 25101, subd. (f).)

The California Supreme Court has determined that a unitary business is definitely established by the existence of: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in a centralized executive force and general system of operation. (Butler Bros. v. McColligan, 17 Cal. 2d 664, 678 [111 P.2d 3343 (1941)], affd., 315 U.S. 501 [86 L. Ed. 9911 (1942)].) The court has also held that a business is unitary when the operation of the business within California contributes to or is dependent upon the operation of the business outside the state. (Edison California Stores v. McColligan, 30 Cal. 2d 472, 481 [183 P.2d 161 (1947)].) These general principles have been reaffirmed in several more recent cases. (Superior Oil Co. v.

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Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33] (1963); Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40] (1963); RKO Teleradio Pictures, Inc. v. Franchise Tax Board, 246 Cal. App. 2d 812 [55 Cal. Rptr. 299] ((1966))

It is appellant's position that the substantive inquiry in this appeal should relate not to its relationship with Texiran, but to the relationship between its income producing activities in California and the consortium's income producing activities in Iran. Appellant argues that the consortium carries on all of the management and income producing operations in Iran: Texaco and Texiran conduct none. Therefore, since it has only a 7 percent interest in the consortium, appellant concludes that the required unity of ownership is absent, and the income producing activities carried on by the consortium in Iran are not an integral and inseparable part of its income producing activities in California.

We believe that appellant's contentions must be rejected for several reasons. First, respondent is not attempting to combine either the consortium or the oil producing and refining companies. Therefore, the critical relationship is the one between appellant and Texiran, not between appellant and the consortium. Second, notwithstanding the fact that appellant's participation in the consortium is essential to its activities in Iran, it is not the consortium that is conducting the income producing activities in Iran as far as appellant is concerned. The consortium, through its control of the producing companies, produces and sells oil to the National Iranian Oil Company at approximately its cost. It is Texiran, by purchasing oil from the National Iranian Oil Company and selling it to TOPCO, which makes a profit in Iran. Finally, appellant is incorrect in asserting that either the consortium or **Texiran** must have direct contacts with its California operations. We have specifically rejected this argument in prior opinions. (See, e.g., Appeal of Arkla Industries, Inc., Cal. St. Bd. of Equal., Aug. 15, 1977; Appeal of Monsanto Co., Cal. St. Bd. of Equal., Nov. 6, 1970.)

For the reasons expressed below, regardless of which test is applied, we are satisfied that sufficient evidence is present to sustain respondent's determination that Texfran is part of appellant's unitary business.

In applying the three unities test, we first note that Texiran is wholly owned by appellant. Since

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we are only concerned with appellant's ownership interest in Texiran and not in the consortium, we conclude that unity of ownership is clearly satisfied. Unity of operation is also present in view of the complete centralization of service functions. Since Texiran has no payroll, it is evident that it must depend upon appellant entirely for these functions,, We believe that unity of **use** is also **established** by the complete integration of product flow and executive forces. This may be illustrated by the fact that Texiran purchases petroleum and sells all of it to TOPCO, another of **appellant's** wholly owned subsidiaries. Furthermore, it appears that all management is provided by appellant.

The contribution or dependency test is also satisfied. The absence of Texiran payroll coupled with appellant's 100 percent ownership indicates that all of **Texiran's** operations are dominated and controlled by its parent. Additionally, all of Texiran's sales are intercompany sales to TOPCO, another wholly owned subsidiary. The existence of centralized management and intercompany sales have been given great weight in determining unity under **the** contribution or dependency test. (Chase Brass & Copper Co. v. Franchise Tax Board, 10 Cal. App. 3d 496 [87 Cal. Rptr. 239] app. dism. and cert. den 400 U S 961 [27 L. Ed. 2d 381] (1970); Appeal of Ha&son-Wilier Refractories Co., Cal. St. Bd. of Equal., Feb. 15, 1972.)

We conclude that Texiran was engaged in a single unitary business with appellant and appellant's other affiliates and properly **includible** in the combined report.

Next, we must determine whether the standard three-factor apportionment formula, as applied by respondent, properly reflects appellant's income derived from or attributable to California sources.

Apparently, appellant seeks relief ^{1/2} under section 25137 of the Revenue and Taxation Code ^{1/2} on the

1/ Section 25137 of the Revenue and Taxation Code **pro-**
vides:

if the allocation and apportionment **pro-**
visions. of this act do not fairly represent
(Continued on next page.)

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basis that the statutory apportionment formula, as applied, results in a distortion of its California source income. In such a case section 25137 authorizes the use of a reasonable apportionment method different from the one prescribed by UDITPA. However, in order to insure that UDITPA is **applied** as uniformly as possible, we have held that the party seeking relief under section 25137 bears the burden of proving that exceptional circumstances are present. (Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Donald M. Drake Co., Cal. St. Bd. of Equal., Feb. 3, 1977, **mod.** March 2, 1977.)

The thrust of appellant's claim is that, although all of the income generated from its Iranian operations has been included in the combined report, nothing has been included in the denominator of the three apportionment factors to reflect the various **elements which are** responsible for earning that income. ^{2/} ~~The~~ resulting effect,

1/ (Continued from page 6.)

the extent of the taxpayer's business activity in this **state**, the taxpayer may petition fbr 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.

2/ It is not entirely **clear** whether appellant is challenging respondent's elimination of intercompany sales. In any event, we believe that this procedure was appropriate. This practice is followed since the inclusion of consecutive intercompany sales of vertically integrated operations would result in a serious distortion of the sales 'factor and produce an unreasonable apportionment of income. (See generally Keesling and Warren, The Unitary Concept in the Allocation of Income, 12 Hastings L.J. 42, 60 (1960); Keesling, A Current Look at the Combined Report and Uniformity in Allocation Practice, 42 Tax. 106 (1975).)

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appellant contends, is that its income derived from or attributable to California sources is substantially overstated. However, appellant has not offered even a suggestion of what it thinks should be included in the factor denominators; it has merely stated that separate accounting **should** be utilized.

Respondent counters with the assertion that nothing was included in the denominators of the property and **payroll** factors on **behalf** of Texiran because Texiran has no property or payroll. 3/

From the record it appears that respondent is correct in asserting that Texiran has no payroll. However, appellant does possess a valuable property interest, the 7 percent interest in the consortium. The precise nature of this **property** interest cannot be ascertained from the record. 4/ We can only conclude that the **property** interest is neither real nor tangible personal property. Intangible property, of course, is **not specifically** included in the property factor. (Rev. & Tax. Code, § 25129.) However, in cases not involving the finance industry where intangibles are regularly included in the factors, respondent has included intangibles in the property factor when appropriate. (Appeal of R. L. Polk & Co., Cal. St. Bd. of Equal., Oct. 26, 1944.) In any event, appellant has made no meaningful argument that any adjustment **should be** made to the property factor **because of this property** interest.

3/ It **should** be emphasized, however, that all of Texaco's and **TOPCO's** property and payroll which produced business income, wherever situated, was reflected in the respective factor denominators.

4/ **Appellant's** representative insisted that the property interest could not be construed as a leasehold. Additionally, it has not been suggested that appellant's interest in the consortium constituted an interest in a joint venture. In either of these situations a different result might be called for. (See McDonnell Douglas Corp. v. Franchise Tax Board, 69 Cal. 2d 506 [72 Cal. Rptr. 465, 446 P.2d 313 (1968)] [leased property]; Cal. Admin. Code, tit. 18, reg. 25137 subd. (e) [joint venture].)

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In view of the fact that Texiran has no real or tangible personal property or payroll, appellant has failed to establish that respondent's application of the standard three-factor apportionment formula did not fairly represent the extent of appellant's business activity in California. Since appellant has failed to prove that extraordinary apportionment methods should have been used, we must sustain respondent's action on this issue.

ORDER

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 Texaco, Inc., against proposed assessments of additional franchise tax in the amounts of \$150,653.58, \$153,033.72 and \$161,335.44 for the income years 1967, 1968 and 1969, respectively, be and the same is hereby sustained.

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765,022.74

Done at Sacramento, California, this 11th day of January, 197 , by the State Board of Equalization.

Leo Perry, Chairman
Paul H. Lee, Member
Mrs. Sankey, Member
William R. ..., Member
_____, Member