



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
TOSCO CORPORATION)

For Appellant: Arthur L. Gross
Assistant Corporate Tax Manager

For Respondent: Bruce W. Walker
Chief Counsel

James C. Stewart
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Tosco Corporation against proposed assessments of additional franchise tax in the amounts of \$337.00 and **\$12,587.00** for the income years 1972 and 1973. During the proceedings appellant paid **\$9,190.00** of the proposed assessment for the income year 1973, leaving only **\$3,397.00** in controversy.

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The sole issue for determination is whether respondent properly excluded appellant's interest in oil shale reserves from the property factor of the apportionment formula.

Appellant, formerly The Oil Shale Corporation, was organized in 1955 specifically to develop and license a unique retorting process for the recovery of hydrocarbons from oil shale rock. The successful development of the Tosco II process led appellant to acquire, over a period of time, a substantial reserve of oil shale properties in Colorado and Utah and to advance additional projects aimed at large scale commercialization of the process.

The process development began with bench scale studies which were followed by the construction of a 25-ton-per-day pilot plant in 1957. Successful operation of the pilot plant in 1964 led to the formation of a joint venture between appellant, Sohio Petroleum Company, and The Cleveland-Cliffs Iron Company, known as Colony Development Company (Colony). Colony was to build and operate a large scale facility for mining and processing oil shale. In 1965 the venture completed construction of a 1,000-ton-per-day retorting plant at Parachute Creek, Colorado. The plant was located on an 8,715 acre tract of land known as the Dow property.

In 1968 Colony sold an interest in certain technological rights and oil shale property to Atlantic Richfield (ARCO). The venture then continued under the direction of ARCO. The testing program was completed in 1971. Thereafter, appellant and ARCO continued the developmental program without the other venturers. The second phase of this testing program, which was completed in 1972, confirmed the scale-up procedures and tested environmental safeguards required by federal law. This program continued through the last appeal year, at which time appellant and its co-venturers had spent more than \$55 million in developing the technology, mining 1.2 million tons of oil shale, producing and selling 170,000 barrels of shale oil, and demonstrating advanced environmental control measures.

In 1973, the last of the appeal years, appellant contracted with an engineering company to design and oversee the construction of a 45,000-barrel-per-day oil shale complex at Parachute Creek. At this time the estimated cost of constructing the commercial plant was estimated at \$300 million. Appellant and its

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co-venturers actually spent \$12 million for the development of detailed plans and specifications. In 1974 the planned construction was suspended, because of the high rate of inflation. However, as a result of appellant's prior developmental efforts, licensing agreements were concluded with Standard Oil Company of Indiana and Gulf Oil Corporation, permitting them to use the Tosco technologies on a federal oil shale tract in Colorado for an initial fee of \$4.5 million. Since its inception Tosco also earned an additional \$4.6 million in licensing fees for the use of its patented oil shale mining and production technologies.

Concurrent with its development of the technology to extract petroleum products from oil shale, appellant gradually acquired interests in oil shale properties. By the appeal years appellant had acquired an interest in approximately 26,000 acres. Its annual principal payments for land purchases exceeded \$1 million. The largest tract was the Dow property where the Colony mine and retorting works were located. This property represented approximately 90 percent of the capitalized value of appellant's oil shale property. The mine and retorting works encompassed a geographic area of approximately 850 acres or roughly 10 percent of the Dow property.

Although owning no reserves of crude oil for feedstock, appellant acquired an oil refinery in California during 1970, and in 1972 acquired a second refinery in Arkansas with its affiliated retail outlets. Appellant bought the refining and marketing facilities for two reasons: (1) for additional working capital to help finance the commercial development of the oil shale project; and (2) to provide the company with the necessary expertise to market its petroleum products when commercial oil shale production commenced.

During the appeal years, Tosco was prepared to commence construction and operation of a commercial oil shale facility once the proper financing and governmental approvals were secured. In fact, as of 1973, the last of the appeal years, appellant anticipated that construction of a commercial complex would commence in 1974 and that commercial oil from a shale plant would be **onstream** by 1976. However, such a facility was not built and has not been built as of the date of this opinion due to economic and environmental problems.

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During the audit of **appellant's** franchise tax returns for the appeal years, it was agreed that appellant's oil shale activities and its petroleum refining **activities** comprised a single unitary business. As a result of the audit, respondent adjusted the property factor by excluding most of appellant's oil shale property from the denominator of the property **factor.**^{1/}

It is respondent's position that only oil shale reserves actually used in the development of mining and processing technology are includible in the property factor. Respondent argues that commercial oil shale reserves not directly used in the experimental activities which are not capable of being profitably used in the unitary business, or reserves which are not usable, **as a** practical matter, at any time in the foreseeable future, are not includible in the property factor. Respondent seeks support for its position from our decision in Appeal of Union Oil Company of California, decided November 17, 1954. Appellant contends that if this appeal **is controlled** by the Union Oil test, it is factually distinguishable and that, **any** event, it has satisfied the test. Appellant also contends that respondent's own regulations compel the inclusion of the oil shale reserves in the property factor.

During the appeal years, appellant **concededly** operated as a unitary business **subject** to the provisions of the Uniform Division of Income for Tax Purposes Act

^{1/} **Respondent** has included in the denominator of the property factor 9 percent of the capitalized value of appellant's oil shale property which, in respondent's opinion, represents the property actually used by appellant in the development of its oil shale technology. Respondent arrived at 9 percent since the physical operations at Parachute Creek occupy **10** percent of the Dow property, and the Dow property represents 90 percent of the capitalized value of all of appellant's oil shale interests; therefore, 10 percent of 90 percent equals 9 percent. For 1972, \$255,201 in oil shale property rents and **\$7,816,973** in oil shale property owned in fee were excluded, while for 1973, \$313,160 in rents and **\$8,155,963** in fee oil shale property were excluded from the property factor.

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(UDITPA). (Rev. & Tax. Code, §§ 25120-25139.) Section 25129 defines the property factor 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.

Respondent's interpretive regulation 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 for the production of business income. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. (Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Art. 2); Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Art. 2.5), effective for income years beginning after December 31, 1972, is substantially identical.)

Central to respondent's position is our decision in Appeal of Union Oil Company of California, supra, decided prior to the enactment of UDITPA. Accordingly, the current regulation quoted above must be compared with the applicable pre-UDITPA regulation, which provided, in part:

The property factor will normally include the average value of all real and tangible **personal** property owned by the taxpayer and used in the unitary business. Leased property is excluded from the factor. Also generally excluded is property owned, but not used in the unitary business. (Cal. Admin. Code, tit. 18, reg. 25101, subd. (a).)

Initially, respondent states the correct test as announced in the UDITPA regulations: Appellant's oil shale reserves are **includible** in the property factor if they were used, were available for use or were capable of being used during the income years in the regular course of appellant's trade or business.

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It is undisputed that part of **appellant's** single unitary business was the development and licensing of oil shale processes and technology. However, appellant's mine and retorting works encompassed only 10 percent of the Dow property--the portion respondent is willing to include in the property factor. There has been no extended use, other than for testing, of the remaining oil shale reserves which respondent seeks to exclude from the factor on the theory that they are usable only after a commercial oil shale plant is constructed.

Although we may agree that the oil shale reserves were not used, the question remains whether the reserves were available for use or capable of being used. (Cal. Admin. Code, tit. 18, reg. 25129, subd. **(b)** (Arts. 2 and **2.5**.) In this regard respondent asserts that the UDITPA regulations and the old regulation are the same except for the current inclusion of rental property in the factor. Based on this assertion, respondent then transitions from the correct test it originally asserted to the test interpreting the old regulation promulgated by Union Oil, supra. In addition to property used in the trade or business, the Union Oil test only calls for the **inclusion in** the factor of: property which is capable of being profitably used in the unitary business, **or** property for which there is a reasonable prospect that it will be usable at any time in the **foreseeable future**.

Respondent's reliance on the old Union Oil test is misplaced because, contrary to its assertion, the UDITPA regulations are not the same as the old regulation. A comparison shows a substantial difference. (Compare Cal. Admin. Code, tit. 18, reg. 25129, subd. **(b)** (Arts. 2 and 2.5) **with** Cal. Admin. Code, tit. 18, reg. 25101, subd. .(a).) The old regulation provided only for the inclusion in the factor of property used in the unitary business. Generally speaking, property owned but not used in the unitary business was excluded from the factor. Union Oil was an attempt to **engraft** upon the regulation a rational approach for handling property held in reserve. This regulatory deficiency was rectified by the adoption of the UDITPA regulations. These regulations adopted a solution bearing some resemblance to the Union Oil approach but which was not identical. For example, there is no restriction that the property be capable of profitable use in the trade or business. More important to this appeal, however, are the differences in the UDITPA regulations which

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include in the factor property available **for** use and property held as reserves. Therefore, the correct test is the one set forth in the UDITPA regulations: Property is includible in the property factor if it was used, was available for use or was capable of being used during the income year in the regular course of the taxpayer's trade or business.

Based on the record before us, after 20 years of development, appellant was prepared, during the appeal years, to construct and operate a commercial oil shale facility upon the acquisition of financing and governmental approval. Central to this 20-year development process was appellant's bona fide periodic acquisition of oil shale property. Since the Tosco II reduction process required slightly more than one ton of oil shale to produce one barrel of petroleum, it is obvious that enormous quantities of oil shale reserves would be required to operate the **45,000-barrel-per-day** commercial oil shale complex appellant intended to build. It is equally obvious that prudent business judgment required appellant to acquire oil shale reserves throughout the years it was developing the reduction process. It takes little imagination to speculate what the price increase of oil shale property would be after a commercial plant became operational.

The purpose of the property factor in the apportionment formula is to reflect the income producing effect of capital invested in the taxpayer's trade or business. (See, e.g., Wahrhaftig, Allocation Factors in Use in California, 12 Hastings L.L.J. 45, 733 (1960).) Here, appellant's capital was periodically invested in oil shale reserves throughout the 20-year development process on the good faith belief that ultimately a suitable return on its investment would be achieved. Since appellant's oil shale reserves clearly were available for use, their inclusion in the property factor was appropriate. Furthermore, it is also apparent that appellant's oil shale reserves qualify as "reserves . . . or property held as a reserve source of materials" which are includible in the property factor pursuant to the UDITPA regulations. (See Cal. Admin. Code, tit. 18, reg. 25129, subd. (b) (Arts. 2 & 2.5).) Therefore, respondent's action in this matter must be reversed.

