



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
NORTH AMERICAN AVIATION, INC. }

Appearances:

For Appellant: T.R. Dempsey, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Hebard P. Smith, Associate
Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 26077 of the Revenue and Taxation Code (formerly Section 27 of the Bank and Corporation Franchise Tax Act) from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) in denying the claim of North American Aviation, Inc., for a refund of tax in the amount of \$16,141.27 for the income year ended September 30, 1944.

The Appellant, an aircraft manufacturer, owns and operates plants in California and other states. Its records are maintained on the accrual basis. In 1941 it entered into a contract with the United States Government for the production of aircraft on a cost-plus-a-fixed-fee basis at its plant at Dallas, Texas. In accounting for its operations under the contract Appellant charged to accounts receivable from the Government the cost of materials, expenses of processing the materials and a prorated portion of its fee, and made corresponding credits to sales in the amount of these charges.

By supplemental agreement on December 15, 1943, the cost-plus-a-fixed-fee contract was converted into a fixed price contract. The rights and liabilities of the parties, from and after the effective date of the agreement, were to be determined as though the contract had been on a fixed price basis since its inception, the legality and propriety of all things done up to that time, however, being expressly recognized and preserved. The amounts theretofore paid by the Government to Appellant were to be considered attributable to payments at the fixed price rate on finished goods delivered by Appellant to the Gov-

ernment prior to the date of conversion. After offsetting the fixed price cost of those goods against the amount paid by the Government, Appellant had an excess of Government payments in the sum of approximately \$33,000,000, which it was agreed ~~should be~~ held by Appellant and applied to **fixed** price payments becoming due ~~thereafter~~. It was further agreed that accounts ~~receivable from~~ the Government in the amount of approximately \$27,500,000 at the time of conversion would be cancelled by Appellant.

The sum of these two items, approximate: \$60,500,000 (hereafter the terms **approximately** and **approximate** will be omitted), was attributed to the Appellant's cost of materials; expenses of processing materials and a **prorata** portion of its fee under the original contract, **accrued** up to the date of the supplemental agreement in connection with work then in progress. This amount had also been credited to sales. To reflect the conversion of the **cost-plus-a-fixed-fee** contract to a **fixed price** contract Appellant made **journal** entries (1) debiting inventories purchased from the U. S. Army in the amount of \$60,500,000; (2) crediting accounts receivable and accrued U. S. Government fixed fees in the **amount of** \$27,500,000; and (3) crediting progress billings on sales contracts in the amount of \$33,000,000.

The Commissioner did not **question** these entries in so far as they related to the determination of Appellant's total net income for the fiscal year ended September 30, 1944. His action, here being questioned, related only to the portion of that income to be allocated to California as income derived from or attributable to sources within this State under Section 10 of the Act. He **concluded** that the effect of the credits to sales under the original contract and those that would be made to sales following the conversion of that contract to one on a fixed price basis was **the inclusion** twice in out-of-state sales of the amount of \$60,500,000 and he, accordingly, reduced those sales for the **period** here in question by that amount.' The Appellant contends, on the other hand, that it actually purchased back from the United States Government inventory in the form of **raw** materials and work in progress of the value of \$60,500,000 and that the action of the Commissioner in reducing its out-of-state sales for the **period** ended September 30, 1944, in that amount was unwarranted.

We are in accord with the position of the Commissioner that the original contract, as modified by the supplemental agreement, did not contemplate sales in an amount in excess of the sales price of the finished goods at the fixed prices specified in the supplemental agreement. The conclusion is inescapable, **however**, that if the Appellant's **position** be sustained it will receive the benefit for

allocation purposes of out-of-state sales in excess of that amount, This fact is recognized by Appellant in its Annual Report for 1943 wherein a description of the conversion of the original contract and of Appellant's treatment thereof in its records is followed by the statement:

"In considering the effect of conversion of the contract it is to be noted that the amounts reported as sales on the ~~cost-plus-a-fixed-fee~~ basis prior to December 15, 1943, will be duplicated in the amounts to be reported as sales on the fixed-price basis subsequent to that date, as billings are made to the Government for completed airplanes and spare parts delivered, to the extent of approximately \$60,500,000, the amount of inventories acquired from the Government upon conversion of the contract."

The question then arises as to the adjustment to be made for allocation purposes as a result of the conversion of the contract. The adjustments made by the Appellant and accepted by the Commissioner as respects the determination of Appellant's net income for the fiscal year ended September 30, 1944, were undoubtedly prompted by the annual accounting concept, as set forth in such authorities as Burnet v. Sanford & Brooks Co., 282 U. S. 359; Security Flour Mills Co. v. Commissioner, 321 U. S. 281, and United States v. Lewis, 340 U. S. 590. y not necessarily follow that adjustments made in the light of that concept must be recognized as a matter of allocation. On the other hand, the same considerations that led to the adoption of that concept in the determination of net income are rather persuasive for its adoption as a general rule for allocation purposes.

The Appellant has stated its agreement with the view of the Commissioner that bookkeeping entries are only evidentiary of what has been done and that the real facts control. The facts relied upon by the Appellant relate for the most part to transfers of title to property between Appellant and the Government. It is alleged that title to the raw materials and work in progress originally passed to the Government under the cost-plus-a-fixed-fee contract, that title to that property passed back to Appellant as a result of the conversion of that contract to a fixed-price contract under the supplemental agreement, and that title to the same property again passed to the Government in the form of finished goods under the revised contract. Each of these passages of title is asserted by Appellant to be a sale with the consequence that its out-of-state sales include both the original sale to the Government of the raw materials and work in progress and the subsequent sale to the Government of the finished goods embodying those raw materials and work in progress.

Appellant's position as to the two or duplicate sales of the same items may be entirely correct as respects the law of sales. That position loses sight of the fact, however, that the amount of its sales is material in the present controversy, not from the standpoint of that law or from the standpoint of proper accounting, but solely as a measure of Appellant's activity within and without California. Appellant's manufacturing activity at its Dallas plant, as compared with its California activity, was not affected in the slightest degree by the fact that its contract with the United States was modified as respects the method of computation of the amount to be paid to it thereunder. Evidence and argument directed merely at justifying the inclusion twice in out-of-state sales of the sales in question under these circumstances do not, in our opinion, meet the burden imposed upon the taxpayer under Butler Brothers v. McColgan, 315 U.S. 501; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472; and John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214, appeal dismissed by United States Supreme Court May 5, 1952, of establishing by clear and cogent evidence that extra-territorial values have been taxed. We do not believe, accordingly, that we would be warranted in concluding, on the basis of the record before us, that the action of the Commissioner was erroneous.

O R D E R

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 26077 of the Revenue and Taxation Code that the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) in denying the claim of North American Aviation, Inc., for a refund of tax in the amount, of \$16,141.27 for the income year ended September 30, 1944, be and the same is hereby sustained.

Done at Los Angeles, California, this 7th day of October, 1952, by the State Board of Equalization.

_____, Chairman
Wm. G. Bonelli, Member
J. H. Quinn, Member
Geo. R. Reilly, Member
Thomas H. Kuchel, Member

ATTEST: Dixwell L. Pierce., Secretary