



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
DOUGLAS AIRCRAFT COMPANY, INC.)

Appearances:

For Appellant: Robert Hunter, Attorney at Law
For Respondent: Burl D. Lack, Chief Counsel;
Mark Scholtz, 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 claims of Douglas Aircraft Company, Inc., for refunds of tax in the amounts of \$190,994.48, \$394,533.09, \$305,687.25 and \$202,728.35 for the income years ended November 30, 1942, 1943, 1944, and 1945, respectively.

Appellant is a Delaware corporation with its principal place of business in Santa Monica, California, During the years in question it was primarily engaged in the production of military aircraft for the United States Government under cost-plus-a-fixed-fee contracts. It operated three manufacturing plants without this State which were constructed and owned by the United States Government and three manufacturing plants and a "modification center" within California. Of the California property, the Government owned the modification center, one of the plants and portions of the other two. Those portions of the California plants not owned by the Government were owned by Appellant. Its central management and engineering divisions were located in California. No rent was paid for the use of the Government-owned facilities and all expenses incur-

red by Appellant in maintenance, **alteration**, or repair of the plants were reimbursed to it by the Government,

Under the cost-plus-a-fixed-fee contracts Appellant purchased materials, hired labor and generally incurred costs which were necessary for performance, such expenses being reimbursed to Appellant on a direct cost basis. As consideration for such performance the Government paid to Appellant a fee which was negotiated and fixed for each contract. Although the contract did not recite the location at which it was to be performed, the place of performance of each contract was limited by the Government's previous direction as to which models of airplane were to be manufactured in each plant and by specification in each contract of the plant of delivery.

During the years in controversy each plant kept its own books of account for contracts being performed at that location and fees earned were credited to the plant which produced the item upon which the fee was paid,

Appellant, acting under Section 10 of the Bank and Corporation Franchise Tax Act, allocated a portion of its income to California by use of a three-factor formula consisting of sales, payroll and property; It included in the property factor all property used, thereby including the Government-owned property. Respondent re-allocated the income, using the same formula but limiting the property factor to property owned by Appellant.

Appellant contends that the use of property rather than its ownership is the important element in the **production** of income and that the exclusion of the government-owned property from the formula, accordingly, resulted in a distortion of the income attributable to California. As an alternative to inclusion of the Government-owned property, it suggests that property be omitted as a factor **in the** allocation formula.

In attacking the **Commissioner's** formula Appellant relies in part on separate accounting and in part on several alternative formulae. Inasmuch as the alternative formulae either include all of the property used or omit property entirely as a factor, such formulae give no consideration to invested capital as a source of income.

Separate accounting was rejected as a means of impeaching a formula used for allocating income of a unitary business in Edison California Stores v.

McColgan, 30 Cal. 2d 472. Similarly, computations which exclude invested capital as a source of income do not, in our opinion, meet the burden imposed upon the taxpayer under Butler Bros. v. McColgan, 315 U. S. 501; Edison California Stores v. McColgan, supra; ~~and~~ John Deere Plow Co. v. Franchise Tax Board, 38 Cal. 2d 214, of establishing by clear and cogent evidence that extra-territorial values have been taxed. As we said in our Opinion in Appeal of Art Rattan Works, dated August 24, 1944, in which we sustained the action of the Franchise Tax Commissioner in excluding rented property from the property factor of the allocation formula there involved:

"While Section 10 is silent as to the necessity of ownership of the property to be included, we believe that the theory involved in the use of the property factor, together with other factors, requires, at least in the absence of some extraordinary factual situation, that only property owned by the taxpayer is considered. Property is employed in the allocation computation because it is considered to be a factor in the production of income, the income of a business being attributable in part to the ownership of property.

"Capital is invested in property in the expectation of a return thereon, that is in the expectation that income will have its source in or will be derived from the ownership and use of the property.

"In the case of rented property, however, there has been no investment of capital in property from which income may be derived."

The rule thus applied is in accord with the general practice of the various states employing allocation formulae and, in particular, with that followed in California. See Altman and Keesling's "Allocation of Income-in State Taxation," 1950 edition, pp. 111, 134, 138. We are of the opinion that it is equally applicable in this case, even though we are not here concerned with rented property, since non-ownership of property or lack of

capital invested is the pivot on which the rule turns. We believe, accordingly, that the Commissioner did not act improperly in excluding the Government-owned property from his formula.

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 claims of Douglas Aircraft Company, Inc., for refunds of tax in the amounts of \$190,994.48, \$394,533.09, \$305,687.25 and \$202,728.35 for the income years ended November 30, 1942, 1943, 1944, and 1945, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 18 day of December, 1952, by the State Board of Equalization.

Wm. G. Bonelli, Chairman

J. H. Quinn, Member

Geo. R. Reilly, Member

_____, Member

_____, Member

ATTEST: F. S. Wahrhaftig, Acting Secretary