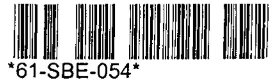
61-SBE-054

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

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

For Appellant: Dempsey, Thayer, Deibert & Kumler, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel; John S. Warren, Associate Tax Counsel; A. Ben Jacobson, Associate Tax Counsel.

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O P I N I O N

This appeal is made pursuant to Section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of North American Aviation, Inc., for refund of franchise tax and interest in the amount of $21,254.38 for the income year ended September 30, 1952.

Appellant is engaged in the business of manufacturing and selling aircraft and parts. It made sales to the United States under so-called "price revision" contracts. Each contract extended over a period of several years. Under these contracts the total sales price was indefinite prior to the completion of the contract or the time when prices were fixed by negotiation. Appellant's practice was to record sales under the contracts in accordance with estimating procedures it had developed. In the following years, on the basis of the final or the most recent prices determined by negotiation, adjustments were made to reallocate sales to the proper years covered by each contract. The reallocation of sales was done upon regular examinations of Appellant's returns by the United States Treasury Department after the sales prices were determined.

On April 16, 1953, the Treasury Department shifted taxable income on individual contracts among the fiscal years 1949, 1950, 1951 and 1952. On one contract, taxable income of $288.95 was shifted from 1952 to 1949. On another, the sum of $6,940.27 was shifted from 1949 to 1952. No other amounts were transferred between these two years. Taking all contracts into consideration, the results of the adjustment with respect to these two years were to increase taxable income for 1949 and 1952 by $450,000 and $525,000, respectively.

On June 10, 1953, in accordance with Section 25432 of the Revenue and Taxation Code, Appellant filed with Respondent a report of the federal change, stating that the increase for 1949

was final, and conceding the correctness thereof. Pursuant to Section 25674, Respondent could have mailed a notice of proposed assessment for the income year ended in 1949 within six months after the report was filed. Respondent did not at any time mail such a notice.

In November, 1954, the Treasury Department completed another examination of Appellant's returns and shifted income among the fiscal years 1950 to 1954, inclusive. This resulted in a decrease of taxable income for the year ended in 1952 in the amount of approximately $3,000,000. None of this decrease involved a shift of income to or from the year ended in 1949.

Appellant and Respondent have accepted the federal adjustments as correct. As a result of those adjustments and others that are not material here, they agree that Appellant has underpaid its franchise tax for the income year ended September 30, 1949, by the amount of $15,259.34 and that it has overpaid its tax for the income year ended September 30, 1952, by $77,941.63.

In 1956, Respondent notified Appellant that it was offsetting the barred deficiency for the year ended in 1949 against the refund due for the year ended in 1952. Including interest, the offset totaled $21,254.38. The propriety of making the offset is the disputed point in this appeal.

In reliance upon Bull v. United States, 295 U.S. 247, and Crossett Lumber Co. v. United States, 87 F. 2d 930, Respondent contends that the deficiency may be recouped from the overpayment even though the time in which the deficiency could be assessed has expired. Since its decision in Bull v. United States, the United States Supreme Court has manifested a desire to greatly restrict the doctrine of recoupment as applied to taxes. It is, in fact, doubtful whether the Court wishes the doctrine to, retain any real vitality whatever. In any event, a minimum prerequisite to its application, and one to be narrowly construed, is that the deficiency and the overpayment arise from a single transaction or taxable event. (Rothensies v. Electric Storage Battery Co., 329 U.S. 296.)

Assuming, but not deciding, that the doctrine of recoupment is applicable in an appropriate case to California franchise taxes, the facts presented to us do not indicate that this is such a case. The federal adjustments to Appellant's income resulted in a relatively insignificant amount of income being shifted between the years 1949 and 1952. The net effect of the shifting that did take place was a transfer of income from 1949, the year of the barred deficiency, to 1952, the year of the overpayment. Under these circumstances, we cannot find that the deficiency and the overpayment arose from the same transaction or taxable event.

Respondent also contends that under Section 440 of the Code of Civil Procedure, the deficiency for 1949 should be considered as offset against the refund due for 1952. Section 440 provides:

> When cross-demands have existed between persons under such circumstances that, if one had brought an action against the other, a counter-claim could have been set up, the two demands shall be deemed compensated, so far as they equal each other, and neither can be deprived of the benefit thereof by the assignment or death of the other,

The above section contemplates a demand that could have been set up as a counterclaim. Such a claim may not be set up unless it constitutes an existing cause of action, the test being whether the person asserting the demand is able to maintain an independent action upon it. (Baker v. Littman, 138 Cal. App. 2d 510.) A reasonably close parallel to the facts before us may be found in the case of Franck v. J. J. Suparman-Rudolph Co., 40 Cal. 2d 81, holding that a person could not obtain the benefit of Section 440 where he failed to give notice of a breach of contract within the time required by law to establish liability for the breach.

Section 25663 of the Revenue and Taxation Code specifically provides that no deficiency shall be collected unless a notice of additional tax proposed to be assessed is mailed within a specified time. Since no such notice was sent within the time permitted, no action could have been brought at any time to recover the 1949 deficiency and no offset occurred under Section 440 of the Code of Civil Procedure.

In arriving at our conclusion on this point we have thoroughly considered the cases cited by Respondent. Jones v. Mortimer, 28 Cal. 2d 627, held that an assessment levied by the Building and Loan Commissioner was offset under Section 440 against a coexisting cross-demand even though the period for commencing an action on the assessment had since expired. The court pointed out that the demands had coexisted at the time the assessment became due, a time when neither demand was barred by the statute of limitations. Unlike the case before us, the Commissioner there had properly levied the assessment and, when it became due, his right of action accrued. Sunrise Produce Co. v. Malovich, 101 Cal. App. 2d 520, holding that cross-demands need not be liquidated in amount in order to be offset, is not in conflict with the conclusion we have reached. Other cases cited by Respondent stand for the principles in the Jones and Sunrise Produce cases, and are equally distinguishable.

Appeal of North American Aviation, Inc.

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 Board in denying the claim of North American Aviation, Inc., for refund of franchise tax and interest in the amount of $21,254.38 for the income year ended September 30, 1952, be and the same is hereby reversed.

Done at Sacramento, California, this 9th day of August, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

ATTEST: Dixwell L. Pierce, Secretary