

(1) UNITARY B.

(2) SALES FACTOR

GOV'T CONTRACTS FOR REPAIRS



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of
AIRCRAFT ENGINEERING & MAINTENANCE
CO, and INTERNATIONAL AIRCRAFT
SERVICES, INC., ASSUMER AND/OR
TRANSFEREE.

Appearances:

For Appellants: Merritt G. Smalley,
Attorney at Law

For Respondent: Wilbur F. Lavelle,
Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Aircraft Engineering & Maintenance Co. and International Aircraft Services, Inc., Assumer and/or Transferee, against proposed assessments of additional franchise tax in the amounts of \$6,233.93, \$11,679.46, \$17,679.46, \$6,190.74 and \$3,013.54 for the income years ended May 31, 1955, 1957, 1958, 1958 and 1959, respectively.

Aircraft Engineering & Maintenance Co. (hereafter referred to as appellant) is a California corporation, formed on May 27, 1948. Before June 1, 1956, all of its stock was owned by Transocean Air Lines. On that date, Transocean Air Lines changed its name to Transocean Corporation of California and transferred its operating assets to a subsidiary which took over the former name and business of its parent. The method of operating the business remained unchanged, and the parent company continued to hold the stock of the operating subsidiary and several other corporations, including appellant. For convenience, the parent company will be referred to hereafter as "Transocean" or "parent" and as if it continued to conduct the airline operation.

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Transocean was an authorized air carrier formed in 1946, and engaged in international passenger and cargo flights. It operated its own fleet of airplanes out of its headquarters in Oakland, California.

Appellant was primarily engaged in the repair, modification and conversion of military aircraft under United States Government contracts. It also repaired and overhauled engine accessories, such as fuel pumps and instruments, on airplanes belonging to Transocean. All work was done at appellant's plant and offices in Oakland.

Oakland Aircraft Engine Service, Inc., (hereafter "Oakland Aircraft") is a California corporation wholly owned by Transocean. It did substantially all of the major overhaul of **engines** of **Transocean's** airplanes, and also did some similar work under military contracts. All work was done at its plant in Oakland.

The founder of Transocean, Mr. Orvis M. Nelson, was a principal promoter of appellant and Oakland Aircraft. He was the chairman of the board of directors of each of those corporations, and was also president of Transocean. Most of the other directors and officers of Transocean also served as directors and officers of the subsidiaries. In addition, there was some shifting of top management personnel between the various corporations.

Transocean, Oakland Aircraft, and appellant shared office space in the same building at the Oakland Airport and the maintenance facilities of Transocean and appellant were located in adjoining hangars within a single fenced area. Costs of operating these common facilities were shared by the affiliated corporations.

Transocean maintained a central insurance department which placed policies and handled insurance matters for its subsidiaries, charging the premiums to the particular subsidiary. In addition it maintained centralized public relations and legal departments for its affiliates. **Transocean's** personnel and industrial relations departments were also utilized by appellant and Oakland Aircraft. Though each subsidiary had its own accounting division, for a fee appellant did some work in its machine tabulating department for its affiliated corporations. The corporations utilizing these various unified departments shared the costs of operating them.

Appellant and Oakland Aircraft purchased aviation gasoline from Transocean under the **parent's** master contract with a major petroleum company. Appellant realized savings of approximately \$10,000 per year as a result of those intercompany

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purchases of fuel. Appellant also saved some \$25,000 per year in port royalties which were waived as a result of Transocean's long association with the Port of Oakland.

Appellant's billings to Transocean averaged \$191,000 per year during the years in question, A substantial portion of those billings each year were charges for maintenance of Transocean's airplanes.

Appellant argues that during the years on appeal it was engaged in a unitary business operation with Transocean and Oakland Aircraft, and that, therefore, the income of appellant attributable to California should be determined by combining and allocating the income of all of the corporations involved in the unitary business. It is respondent's position that only Transocean and Oakland Aircraft were conducting a unitary business during that period.

If a group of corporations is engaged in a unitary business, their income should be combined and allocated within and without the state by an appropriate formula. (Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16].) The California Supreme Court has recently reaffirmed and given broad application to the tests to be used in determining the existence of a unitary business. (Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33]; Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P.2d 40].) A unitary business exists when there is unity of ownership, unity of operation as evidenced by central purchasing, advertising, accounting and management, and unity of use in the centralized executive force and general system of operation (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334], aff'd, 315 U.S. 501 [86 L. Ed. 991]), or when the operation of the portion of business done within the state is dependent upon or contributes to the operation of the business without the state. (Edison California Stores, Inc. v. McColgan, supra.)

Respondent states that the formula method is to be used where there is an interdependence of in-state and out-of-state activities such that each is essential to the functioning of the other, and the discontinuance or impairment of one would seriously affect the other. Respondent argues that such interdependence does not exist here, and that in its absence separate accounting is proper. We cannot agree that such a high degree of interdependence is necessary for a finding of a unitary operation, in view of the California Supreme Court's recent declaration that the test of a unitary business is "not one based on essential activities, but rather one based on contributing activities'." (Superior Oil Co. v. Franchise Tax Board, supra.)

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Respondent contends that any savings realized by appellant as a result of its affiliation with Transocean were minimal in amount and would not be reflected in materially increased profits for the Transocean group. Viewing the entire factual situation, we believe respondent underestimates the value to the corporations of their association with one another.

Due to its association with Transocean, appellant realized savings on its purchases of fuel at cost and as a result of the waiver of port royalties. The sharing of office space and other facilities, the existence of common management, **Transocean's** maintenance of centralized departments which were utilized by appellant, Transocean's central purchasing of insurance for its subsidiaries, appellant's machine tabulating work for its affiliated corporations and the performance by appellant of repair and overhaul work for Transocean all inevitably resulted **in** savings and mutual benefits to the group. It appears, too, that Transocean's president, Mr. Nelson, was experienced in negotiating government contracts, and had developed contacts and associations which were of assistance to appellant **in** procuring such contracts.

Viewed in the aggregate, we believe the unitary features described above demonstrate a **degree of mutual dependency and contribution sufficient to establish the** existence of a **unitary** business operation by Transocean, Oakland Aircraft and appellant.

Though appellant initially contended that a subsidiary owned by it, Flight Enterprises, Inc., was also a part of the unitary business, appellant has not subsequently pressed that contention and has failed to establish facts sufficient to enable us to conclude that such a unitary relationship existed.

A second issue raised by these appeals is: Did respondent properly treat 100 percent of appellant's receipts from military contracts as California sales for purposes of the sales factor of the allocation formula?

Appellant's operations with regard to its military contracts generally proceeded as follows: Appellant had several employees stationed at various Air Force installations around the nation who advised appellant of government contracts about to be offered for bid. Appellant's bid was then prepared at its main office in Oakland. After the submission of the bid, the Air Force sent a survey team to determine **appellant's** qualifications to perform the proposed contract. Final **negotiation** of the contract generally took place in Ohio.

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The aircraft to be modified or converted were delivered to appellant's plant in Oakland by Air Force representatives. The Air Force furnished most of the equipment and parts necessary for the job, and reimbursed appellant for any material that appellant supplied. Upon completion of the job, Air Force pilots flew the planes away from appellant's plant in Oakland.

Respondent states that in computing the sales factor of the allocation formula, its long established practice is to assign receipts from contracts for services to the location where the services are performed. Since the services under appellant's military contracts were performed entirely in California, respondent's position is that all of the receipts are assignable to this state. Appellant contends, on the other hand, that at least one-third of such receipts should be assigned outside California on the basis of sales activities outside the state.

In support of its position, appellant cites a letter ruling issued by respondent on January 24, 1961. (CCH Cal. Tax. Rep. Par. 12-402.94; P-H State & Local Tax Serv. Cal. Par. 10,535.42.) The ruling states that for purposes of the sales factor, sales to the United States are to be apportioned according to the locations where the activities which result in the sales are conducted. Reflecting respondent's practice with respect to service contracts, however, the ruling also states that receipts from research and development contracts are to be allocated on the basis of where the services are performed.

It is well established that respondent has authority, within reasonable limits, to prescribe the allocation formula to be used in determining unitary business income properly allocable to California. (El Dorado Oil Works v. McColgan, 34 Cal. 2d 731 [215 P.2d 4], appeal dismissed, 340 U.S. 801 [95 L. Ed. 589]; Pacific Fruit Express Co. v. McColgan, 67 Cal. App. 2d 93 [153 P.2d 607].) One who attacks that formula must prove by "clear and cogent evidence" that its application results in the taxation of extraterritorial values. (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334], aff'd, 315 U.S. 501 [86 L. Ed. 991].)

Respondent's practice of apportioning receipts from services according to the situs of the services is in accord with the recommendation of the National Tax Association's Committee on Tax Situs and Allocation. The committee has characterized that method as the simplest and most accurate means of giving recognition in the sales factor to income producing activities of a service nature. (National Tax Ass'n., Proceedings of the Forty-Fourth Annual Conference on Taxation (1951), p. 465.)

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Appellant argues, nevertheless, that there is no justification for respondent's distinction between companies selling products and those providing **services**. But in the case of a company whose income is derived solely or primarily from services, it is unquestionably reasonable to place particular emphasis on the location of the services in allocating the income. Whether respondent's application of the sales factor has resulted in precisely the right emphasis, we need not decide. Rough approximation rather than precision is sufficient. (El Dorado Oil Works v. McColgan, supra, 34 Cal. 2d 731 [215 P.2d 4], appeal dismissed, 340 U.S. 801 [95 L. Ed. 589].)

It has not been established that respondent's method has resulted in the taxation of extraterritorial values nor can we find that respondent's established practice of distinguishing service companies from others is so arbitrary and unfounded as to amount to an abuse of its discretion.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Aircraft Engineering & Maintenance Co. and International Aircraft Services, Inc., Assumer and/or Transferee, against proposed assessments of additional franchise tax in the amounts of \$6,233.93, \$11,679.46, \$17,679.46, \$6,190.74 and \$3,013.54 for the income years ended May 31, 1955, 1957, 1958, 1958 and 1959, respectively, be and the same is hereby reversed with respect to the question of whether or not Aircraft Engineering & Maintenance Co. was a part of a unitary business operation. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 5th day of October, 1965, by the State Board of Equalization.

John W. Lynch, Chairman
Robert H. ..., Member
Paul R. Leake, Member
..., Member
..., Member

Attest: ..., Secretary