BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GENERAL DYNAMICS CORPORATION)

Appearances:

For Appellant: J. P. Ross
Assistant Comptroller and
Director of Corporate Taxes

Louis V. Nigro
Attorney at Law

For Respondent: James C. Stewart
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of General Dynamics Corporation against a proposed assessment of additional corporate franchise tax in the amount of **$437,629.76** for the taxable year 1968. Appellant has agreed to most of the additional assessment. The actual amount now in controversy is **$175,593.32.**

Appeal of General Dynamics Corporation

The sole issue for determination is whether a gain realized by appellant from the sale of stock in 1967 constituted unitary business income apportionable to California by formula, or nonbusiness income specifically allocable to its New York situs.

Appellant General Dynamics is a large diversified corporation engaged in unitary business operations. During 1967 its commercial domicile was in New York. General Dynamics has operating divisions in many industries: aerospace; marine; electronics; and resources. The aerospace division has operating units in Quebec, Canada; Fort Worth, Texas; San Diego and Pomona, California; and Washington, D. C. Appellant's aerospace business includes the manufacture and sale of commercial jet airliners. During the period pertinent to this inquiry, part of this activity involved an operating unit located in Washington, D. C., known as General Aircraft Leasing Corporation (GALCO). GALCO, a Delaware corporation, was incorporated in 1958 for the stated corporate purpose of buying, selling and leasing aircraft. GALCO's function was to take used piston engine aircraft in trade from commercial airlines that purchased new jet aircraft from appellant.

In 1959, appellant sold new jet aircraft to Swiss Air Transport Co., Ltd. (SWISSAIR) and Scandinavian Airlines Systems (SAS). In a separate but related contract, GALCO agreed to purchase seven DC-7C piston engine aircraft from the same companies. The price to be paid to SWISSAIR and SAS by appellant for the DC-7C's was contingent upon the resale price received by appellant. The agreement, as modified on November 1, 1959, provided that appellant would pay for the aircraft, as follows:

> (a) The total price of the aircraft sold hereunder shall be the aggregate of the unit final prices determined as follows:
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> (1) There is hereby established an initial unit price of $800, 000 per aircraft, which price shall be subject to adjustment as provided in subparagraphs (2) and (3) below.

(2) With respect to each aircraft, if the proceeds actually received by Purchaser upon resale thereof is more than $400,000, but not more than $1,000,000, then the unit final price of said aircraft hereunder shall be adjusted to $800,000, plus thirty-three and one-third percent (33 1/3%) of the amount in excess of $400,000.

(3) With respect to each aircraft, if the proceeds actually received by Purchaser upon resale thereof are in excess of $1,000,000 after deduction of selling costs, then the unit final price of said aircraft hereunder shall be adjusted to $1,000,000 plus fifty percent (50%) of such excess.

(b) . . . In the event goods or securities are received as full or partial payment for any aircraft, Purchaser agrees to convert such goods or securities to cash by sale or lease as soon as practical and any cash received from such conversion after deduction of purchaser's costs therefor shall be considered as the cash payments referred to herein.

In 1960, the seven DC-7C's were resold and delivered to Airlift International, Inc. (Airlift)1/. Roth the acceptance of the aircraft by GALCO, and the delivery to Airlift took place at Newark, New Jersey. The purchase price consisted of a down payment of $175,000 and four notes in the total amount of $5,790,000, payable in monthly installments over a five-year period starting January 1, 1961.

1/ Actually, the sale was to Riddle Airlines, Inc. However, Riddle subsequently became known as Airlift International, Inc.

Airlift defaulted on its payments, and a refunding agreement was entered into by appellant with Airlift in July 1961. The time for final payment was extended several times during the remainder of 1961 and during 1962.

In September 1962, Airlift, under new management, advised appellant that it hoped to refinance the company but needed to reduce its debt obligation by at least $1,000,000 in order to do so. With the object of protecting its position, appellant entered into another refinancing arrangement with Airlift. In January 1963, appellant accepted $1,000,000 in cash, a note for $1,700,000 and 1,000,000 shares of Airlift stock in full settlement of Airlift's obligation. Although appellant believed the stock to be worthless when received, the Internal Revenue Service valued the stock at 15 cents a share at the time of receipt for federal income tax purposes. The agreement provided that the shares would be issued in the name of a voting trustee and placed in a voting trust until December 31, 1972. The agreement also provided that appellant could only sell the shares with the approval of Airlift's management, and then only in conjunction with a bona fide public offering.

Airlift's operations resulted in a profit of almost $3,000,000 for the year ended June 30, 1966. Although the company was still in default on large obligations to Douglas Aircraft Company, Airlift's profit was encouraging and the market price of its stock increased substantially during that year. Nevertheless, Airlift still needed additional financial support, and proposed a public offering of $20,000,000 in convertible debentures in June 1967. Airlift agreed to permit appellant to sell its Airlift stock as part of the offering. Appellant sold the stock for a net gain of $8,170,000.

On October 2, 1967, a final settlement agreement was entered into by appellant with SWISSAIR and SAS. The gain from the sale of the stock, which was required to be treated as cash from the resale of the aircraft by agreement, and all payments received from Airlift for the aircraft were included in the determination of the price to be paid to SWISSAIR and SAS. Appellant received approximately $11,000,000 from Airlift for the seven DC-7C's including the gain on the sale of the stock. The final purchase price paid to SWISSAIR

and SAS was approximately $9,000,000. At the time of the settlement agreement, there was still a balance due SWISSAIR and SAS of approximately $100,000 which was contingent on Airlift's payment of its remaining note for approximately $400,000 which was due and payable by December 1968. Appellant made periodic payments to SWISSAIR and SAS, in accordance with the terms of the purchase agreement, as funds were received from Airlift. The entire amount of the purchase price paid to SWISSAIR and SA S was deducted from unitary business income as cost of aircraft sold.

On its California franchise tax return for the year in issue, appellant treated the gain realized from the sale of the Airlift stock as gain from the sale of intangible property, and specifically allocated it to its situs in New York as nonbusiness income. 2/

Respondent maintains that the stock was acquired and sold in the regular course of appellant's business of selling aircraft, not for investment purposes, and the gain from the sale thereof is business income. Therefore, respondent concludes, the gain should be included in unitary income and apportioned to California by formula.

The Uniform Division of Income for Tax Purpose Act (UDITPA) was adopted by California effective for years beginning after December 31, 1966. (Rev. & Tax. Code, §§ 25120-25139.) Section 25120 defines "business income" and "nonbusiness income", as follows:

> (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property

2/ It is true that appellant apportioned no part of the gain to California for 1967. However, as a result of the Internal Revenue Service's valuation of the 1,000,000 shares of Airlift stock at 15 cents a share, appellant did file an amended return including $150,000 in unitary income, part of which was apportioned to California by formula, for the income year 1963.

> if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.
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> (d) "Nonbusiness income" means all income other than business income.

The regulations explain that "business income" includes:

> income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, the business income of the taxpayer is that portion of the taxpayer's entire net income which arises from the conduct of the taxpayer's trade or business operations. (See Cal. Admin. Code, tit. 18, reg. **25120, subd. (a).)**

The origin of the definition of "business income" contained in section **25120 of the Revenue and Taxation Code can be traced to the** decisions **of this board in Appeal of Houghton Mifflin Co. , Cal. St. Bd. of** Equal., March **28, 1946; Appeal of International Business Machines Corp. , Cal. St. Bd. of Equal., Oct. 7, 1954; and Appeal of National Cylinder Gas Co, Cal. St. Bd. of Equal., Feb 5, 1957. (See J. H. Peters, The Distinction Between Business Income and Nonbusiness Income (1973) 25 So. Calif. Tax Inst. 251, 276-279.) In those three cases it was held that income from intangibles is business income subject to apportionment by formula where the acquisition, management, and disposition of the intangibles constitute an integral part** of the owner's regular business operations. (Accord,. Appeal of American Snuff Co., **Cal. St. Bd. of** Equal., April **20, 1960; Appeal of The United States Shoe Corp.,** Cal. St. **Bd.** of Equal. , **Dec. 16, 195%** Appeal of Union Carbide & Carbon Corp., **Cal. St. Bd. of Equal., Aug. 19 1957; Appeal of Marcus - Lesoine, Inc., Cal. St. Bd. of Equal.', July 7, 1942.)**

In determining whether the income from intangibles constitutes business or nonbusiness income, the classifications normally given income, such as interest, dividends, or capital gains are of no assistance. The relevant inquiry is whether the income arises in the main course of the taxpayer's business operations. (See Cal. Admin. Code, tit. 18, reg. 25120, subd. (c); Keesling and Warren, California's Uniform Division of Income For Tax Purposes Act (1967) 15 U.C.L.A. L. Rev. 156, 164.)

In the instant matter, appellant was engaged in a unitary business, part of which included the purchase and sale of aircraft. In 1962, appellant purchased seven aircraft from SWISSAIR and SAS.. The purchase price for each aircraft was contingent upon the amount appellant would ultimately realize on the resale of those same aircraft. The contract contemplated that appellant might receive something other than cash upon the resale: specifically mentioned were securities; Recognizing this possibility, the parties to the contract specifically provided that such securities should be reduced to cash as soon as practicable, and that the amount realized would be used to compute the final contract price per aircraft. Appellant did acquire 1,000,000 shares of Airlift stock in partial satisfaction of the purchase price on the resale of the aircraft. Appellant was unable to convert the stock to cash immediately because its agreement with Airlift required the shares to be placed in a voting trust and restricted the sale of the stock until some unascertained future date. As part of the purchase price for the aircraft, appellant also received cash and interest bearing notes. The interest from the notes was treated as business income from unitary operations and apportioned to California by formula.

In accordance with the terms of the contract with SWISSAIR and SAS, appellant sold the shares as soon as practicable and realized a substantial gain. It was this gain, along with the other consideration received from Airlift, which was used to fix the ultimate price to be paid to SWISSAIR and SAS by appellant for the seven aircraft. Appellant charged the entire amount paid to SWISSAIR and SAS for the aircraft against its unitary income as cost of aircraft sold.

It is no doubt true, as appellant asserts, that, although it had received promissory notes in the past, it had never received stock in payment for aircraft before this transaction. Nevertheless, it is readily apparent that the purchase and sale of the seven aircraft

were integral parts of appellant's unitary business, and that all of the income from that sale, including the gain ultimately realized on the sale of the Airlift stock, arose in the ordinary course of that sale. Therefore, the entire amount of income received from this transaction should be included in unitary income. This conclusion is emphasized by the fact that the entire cost of the aircraft sold, including that portion of the gain on the sale of the stock which was paid to SWISSAIR and SAS pursuant to the agreement, was charged against unitary income. (See Appeal of Ford Motor Co., Cal. St. Bd. of Equal., April 22, 1948.) The fact that part of the consideration received from the resale of the aircraft consisted of stock, the ultimate disposition of which resulted in a gain, does not alter this determination. As we have noted above, the labels normally attributed to such income is of no assistance in determining whether the income is business or nonbusiness income. The critical inquiry is whether the income arose in the main course of appellant's unitary business. The acquisition, retention, and disposition of the Airlift stock was so inextricably entwined with appellant's unitary business operations involving the purchase and sale of the seven aircraft that it compels the- conclusion that the gain accruing to appellant from the conversion of the stock to cash was business income.

In support of its position, appellant argues, in substance, that any unitary aspects of the transaction in question ended when appellant received the stock in full satisfaction of Airlift's obligation; thereafter, the stock was held as an investment. Since holding stock for investment purposes was not part of its unitary business operations; appellant concludes, the gain realized from the sale of the stock was investment income - nonbusiness income - which must be specifically allocated to its New York source, appellant's corporate' domicile. We are not persuaded by appellant's argument.

We are not convinced that appellant held the Airlift stock for investment purposes. The facts indicate that the receipt of the stock, which was accepted in substitution for a $1,000,000 note, was merely a continuation of the financial dealings connected with the payment for the aircraft by Airlift. According to the terms of' the contract with SWISSAIR and SAS, appellant was required to convert the stock into cash as soon as was practicable in order to firm up the price to be paid to SWISSAIR and SAS for the aircraft.

This appellant did. Although there was a substantial time delay from the receipt of the stock until it was finally sold, such delay did not occur because appellant was holding the stock as an investment, but because the terms of the agreement with Airlift mandated that the stock be held in a voting trust until its sale was authorized by Airlift's management.

Appellant relies, primarily, on two decisions of the California District Courts of Appeal and one decision of this board to support its position, i. e. , Fibreboard Paper Products Corp. v. Franchise Tax Board, 268 Cal. App. 2d 363 [74 Cal. Rptr. 46]; American President Lines; Ltd. v. Franchise Tax Board, 3 Cal. App. 3d 587 [83 Cal. Rptr. 702]; Appeal of American Airlines, Inc., Cal. St. Bd. of Equal. , Dec. 18, 1952. We believe these decisions are distinguishable.

In both Fibreboard and American President Lines, the corporate taxpayers had their commercial domiciles in California. Therefore, the question was whether the income from intangibles should be specifically allocated by situs pursuant to section 23040 of the Revenue and Taxation Code, which could not occur in the absence of local domicile, not whether California could reach the income by the apportionment formula or not at all. In the latter case section 23040 would not apply. (Fibreboard Paper Products Corp. v. Franchise Tax Board, supra at 370; American President Lines, Ltd. v. Franchise Tax Board, supra at 597-598.) In the instant matter, the question is whether the gain was business income and, therefore, subject to formula apportionment.

In Appeal of American Airlines, Inc. , supra, it was not contested that the taxpayer, a nondomiciliary corporation, invested idle funds in United States Treasury notes. Based upon that fact, this board concluded that the interest received from the investment was nonbusiness income and not subject to apportionment by formula. In the instant matter, the facts do not permit a determination that the Airlift stock was either acquired or held as an investment.

We also note that all three matters were decided before the effective date of the Uniform Division of Income for Tax Purposes Act (Rev. & Tax. Code, §§ 25120-25139.) Pursuant to the regulations issued thereto, the income from intangibles involved in those decisions would now be business income subject to apportionment by formula. (Cal. Admin. Code, tit. 18, regs. 25120 subds. (c)(3) and (4).)

In accordance with the views expressed above, we conclude that respondent's action in this matter must be sustained.

ORDER

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 protest of General Dynamics Corporation against a proposed assessment of additional corporate franchise tax in the amount of $437,629.76 for the taxable year 1968, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of June, 1975, by the State Board of Equalization.

John W. Lynch, Chairman

Member

Member

Member

Member

ATTEST: [signature], Executive Secretary