General Dynamics Corp. v. Commissioner, 118 T. C. 478 (2002)

All costs, including prior year period costs, must be accounted for when computing combined taxable income for export sales under the DISC and FSC provisions.

Summary

General Dynamics Corp. and its foreign sales corporation faced tax deficiencies for the years 1985 and 1986, with the main issue being the computation of combined taxable income (CTI) for export sales under the DISC and FSC provisions. The court held that all costs, including prior year period costs, must be included in calculating CTI, rejecting the petitioners' argument that only current year period costs should be considered. Additionally, the court upheld the one-year destination test for export property, ruling that two LNG tankers did not qualify as export property due to delays in their foreign use.

Facts

General Dynamics Corp. (GENDYN) and its foreign sales corporation (GENDYN/FSC) were involved in manufacturing and selling various products, including two liquefied natural gas (LNG) tankers, which were sold to an unrelated third party for foreign use. GENDYN used the completed contract method for federal income tax reporting and elected to expense certain period costs. The IRS determined tax deficiencies for GENDYN and GENDYN/FSC for 1985 and 1986, asserting that prior year period costs should be included in computing CTI under the DISC and FSC provisions. Additionally, the IRS questioned the status of the LNG tankers as export property due to delays in their foreign use.

Procedural History

The IRS issued notices of deficiency to GENDYN and GENDYN/FSC for the taxable years 1985 and 1986. The petitioners challenged these deficiencies in the U. S. Tax Court, which consolidated the cases. The court considered the foreign issues separately from the domestic issues, focusing on the computation of CTI and the classification of the LNG tankers as export property.

Issue(s)

1. Whether petitioners must include prior year period costs in computing combined taxable income attributable to qualified export receipts under sections 994 and 925?
2. Whether two liquefied natural gas tankers manufactured by petitioners and sold to an unrelated third party for foreign use constitute export property under section 993(c)(1), despite delays in foreign use?

Holding

1. Yes, because the regulations under sections 994 and 925 require taxpayers to

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account for all costs related to export sales, including prior year period costs, in determining combined taxable income.
2. No, because the tankers did not meet the one-year destination test for export property under the regulations, as they were not used for foreign purposes within one year of their sale.

Court’s Reasoning

The court analyzed the statutory and regulatory framework of the DISC and FSC provisions, focusing on the definition of combined taxable income (CTI). The court found that the regulations under sections 994 and 925 require taxpayers to account for all costs, including prior year period costs, related to export sales when calculating CTI. The court rejected the petitioners’ argument that their completed contract method of accounting should exclude prior year period costs, emphasizing that the regulations govern the allocation of costs for CTI purposes. The court also upheld the validity of the one-year destination test for export property, finding no basis for an exception due to unforeseen delays. The court’s decision was influenced by the need to limit tax deferral or exclusion to actual income from foreign sales, as intended by Congress.

Practical Implications

This decision clarifies that taxpayers must include all costs, including prior year period costs, when computing combined taxable income for export sales under the DISC and FSC provisions. This ruling affects how companies engaged in export activities should allocate their costs and calculate their tax benefits. The strict application of the one-year destination test for export property underscores the importance of timely foreign use for qualifying sales. Legal practitioners should advise clients on the need to account for all related costs in CTI computations and ensure compliance with the destination test for export property. This case may influence future disputes regarding cost allocation and the classification of property as export property under similar tax provisions.

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