STATE BOARD OF EQUALIZATION
(916) 445-5550

February 21, 1992

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This is in response to your letter dated February 4, 1992. There have been a number of communications between you and the audit staff regarding the audit of [ABC]. In a letter dated January 21, 1992, Senior Tax Auditor --- --- briefly set out the legal staff's conclusion with respect to the United States construction contracts under review. You have certain problems with the reasoning in that letter which you ask us to consider. We believe that the answers in this letter should resolve the remaining legal issues in this audit.

You believe that the Board has mistakenly focused only on the title vesting language in FAR 52.245-2(c)(4)(i), Government Property Clause. You note that two of the contracts at issue also include FAR 52-232-7005, Payments under Fixed-Price Construction Contracts. Subdivision (d) of the latter FAR provision includes a provision that states: "All material and work covered by progress payments shall, at the time of payment, become the sole property of the Government…." You therefore believe that, to the extent any property purchased by [ABC] was covered by a progress payment made by the government before the property was delivered to California, title necessarily vested in the government outside California at the time of payment.

Subdivision (c) of FAR 52.245-2 states that "all property acquired by the Contractor…, are subject to the provisions of this clause." (Emphasis added.) Thus, with respect to any property for which FAR 52-245-2 provides for passage of title to the government, that provision controls the timing of that vesting of title. Subdivision (c)(4) sets forth the timing of title passage with respect to any property for which the government reimburses the contractor as a direct item of cost under the contract. Thus, the timing of title passage for all direct items of cost is controlled by FAR 52.245-2. Assuming that all items in question are direct items of cost, [ABC] is the consumer of all such items for which it obtains physical possession in California, as explained in Mr. Woolston's January 21, 1992 letter.

You also argue that, even if the above analysis is correct, it does not follow that the items in question were taxable to [ABC] simply because title transferred to the United States inside California. You argue that, with respect to items purchased from out-of-state vendors, the sales tax is inapplicable under Regulation 1620 and [ABC] can be taxed by California only if the use tax is properly applicable. We agree that if sales tax does not apply as explained in Regulation 1620, the remaining question is whether use tax applies. You argue further that the use tax can be applied only if [ABC[] made some use of the property in California incident to the ownership of that property within the meaning of section 6009. You believe that, under the Lockheed and Aerospace cases, it is no beyond dispute that after title to property purchased by a contractor has vested in the government under an applicable clause, any use of the property by the contractor in performing the contract is deemed to be made on behalf of the government.

We understand that as an advocate you will make all arguments to support your client's interests. I am also sure that you are well aware that the Lockheed and Aerospace cases have no relevance to this discussion since both cases relate to United States supply contracts and not to construction contracts such as the ones involved here. You believe that subdivision (b)(1)(A) of Regulation 1521, which states that a United States construction contractor is the consumer of materials and fixtures and that either the sales or use tax applies, attempts to impose a tax beyond that which is authorized by statute. You cite the Aerospace case in support. Since you handled the Aerospace case, you are well aware that construction contracts were not considered by the Court of Appeal in that case. What the court did consider was the validity of Regulation 1618, United States supply contracts, by applying the rule that an agency cannot promulgate a regulation that is inconsistent with the governing statute. (See Aerospace, 218 Cal.App.3d 1311.) Here, there is no such infirmity since Regulation 1521 is clearly consistent with Revenue and Taxation Code sections 6007.5 and 6384.

Your argument that section 6384 applies only when sales tax would otherwise be applicable is not well taken. Section 6384 specifically states that "the tax imposed under this part shall apply…." "This part" refers to the entire Sales and Use Tax Law, which includes both the sales tax and the use tax. Revenue and Taxation Code section 6007.5 is even more explicit. It states that the "gross receipts from such a sale or the sales price of property so sold shall be included in the measure of the taxes imposed by this part." As you are also well aware, sales tax is measured by "gross receipts" and use tax is measured by "sales price." (Rev. & Tax. Code §§ 6051, 6201.) That is, section 6007.5 applies to both sales tax and use tax.

That sections 6007.5 and 6384 are valid and apply to both sales tax and use tax is beyond dispute. C.F. Frederick, Inc., v. State Board of Equalization (1974) 38 Cal.App.3d 385 considered this specific question. As the court explained, "It is manifest that …section 6384 is an exception which imposes sales and use taxes on certain type of personal property sold or resold to contractors under contract to the United States…." Id. At 396 (emphasis added). See also, Honeywell, Inc. v. State Board of Equalization (1975) 48 Cal.App.3d 907.) If, after these cases, there were any doubt remaining that these provisions are valid, these doubts were resolved in In re Howell, (oth Cir. 1984) 731 F.2d 624. In that case, the court held that Revenue and Taxation Code sections 6007.5 and 6384 were valid and that Regulation 1521 was similarly valid.

As noted above, we believe that this letter resolves the remaining legal issues in this audit. Therefore, by copy of this letter, we are advising the audit staff to complete the audit based on the conclusions in this letter.

Sincerely,

David H. Levine
Senior Tax Counsel

DHL:cl:0620E

cc: Out-of-State District Administrator

bc: Mr. Jack Warner (OH District Principal Auditor)

As you can see, I avoided [ABC]'s arguments pertaining to FAR 52.232-7005 by assuming that the property in question was reimbursed by the United States as a direct item of cost. If this assumption is not valid, the arguments in your February 10, 1992 memorandum to me are as good as any, and certainly more persuasive than [ABC]'s.