**State of California**

**Board of Equalization**
**Legal Division (MIC:82)**

# M e m o r a n d u m

**565.1140**

To: Mr. Mike Hilbert
Aerospace Claims Coordinator
Audit Review and Refund Section

Date: October 15, 1991

From: John L. Waid
Tax Counsel

Subject: Aerospace Claim for Refund
SN -- XX-XXXXXX

The Legal Division has requested that I respond to your memorandum of September 4, 1991. You have requested advice as to whether a taxpayer is entitled to a tax refund under the case of Aerospace Corp. v. St. Bd. of Equalization (1990) 218 Cal.App.3d 1300, 267 Cal.Rptr. 685.

Mr. M--- J. M--- of D---, M--- & Associates, Inc., wrote you on August 27, 1991, and posed two hypothetical questions regarding situations as to when refunds would be due under Aerospace. For the sake of convenience, I shall organize my opinion around these hypotheticals.

OPINION

A. Situation #1.

Mr. M--- sets forth his first situation as follows:

A manufacturer is a supplier of parts and subcontractor to U.S. Government prime contractors. All subcontracts are of a fixed price type. None of the contracts have the progress payments clause, either by direct inclusion or by FAR clause reference number. However, all parts are sold to prime contractors whose contracts do contain the progress payments clause.

"Question: Are the overhead purchases of the manufacturer, the costs of which are allocated to the prime contractors whose contracts do contain the progress payments clause, exempt from sales/use tax, even though the subcontracts do not contain the clause?"

FAR 52.232-16 requires that a progress payments clause be inserted into all fixed-price contracts. That clause, in sub-paragraph (d), sets forth when title to the property for which the progress payment is made passes to the government. Sub-paragraphs (d)(1) & (2) provide that title to the property for which the progress payments are made passes immediately upon execution of the contract for property acquired

or produced before that date, otherwise upon the date the property is or should have been properly allocable or chargeable to the contract under sound and generally accepted accounting principles and practices.

FAR Part 52, among other things, gives instructions for using provisions and clauses in government contracts and also sets forth those clauses. (FAR §52.000.) Under Aerospace, those clauses must be inserted into the contract for title to pass to the United States prior to use by the contractor and so to qualify for the Section 6381 exemption.

This first hypothetical of Mr. M---'s concerns overhead materials which the manufacturer who supplies the government contractor purchases for its own use. The facts state that there are no clauses such as the progress payments clause discussed above, and we may assume that there are no other clauses which operate to pass title to the overhead materials to the govenrment contractor prior to ist use by the manufacturer. The fact that the manufacturer allocates all or a portion of those purchases to a contract with a government supplier does not, in itself, operate a a title-passage method. Tax applies to sales of tangible personal property, including overhead materials, to persons who purchase it for the purpose of use in manufacturing tangible personal property and not incorporating it into the property to be manufactured. (Reg. 1525(a).) Therefore, sales to the manufacturer of overhead materials which it will consume in pursuance of its contract with a government contractor are subject to tax when the requisite titl-passage clauses are absent.

B. Situation #2.

Mr. M--- sets forth his second situation as follows:

An aerospace company makes rockets for the U.S. Government and performs other function under various U.S. Government supply contracts. 100% of the company's workd is for the U.S. Government. Nothing is done for commercial enterprises.

This company has ten contracts. All ten contracts are prime government contracts. Eight contracts are fixed price contracts. Two are cost plus contracts. The two cost plus and six of the eight fixed price contracts are qualified government contracts. The two remaining fixed price contracts do not have the "Progress Payments" title clause, FAR paragraph number 52.232-16. HOWEVER, both of these contracts are handled in the exact same manner as the fixed price contracts that specifically contain the "Progress Payment" clause. That is, all 10 contracts are managed by the same cost accounting systems and contract costs are charged to the government monthly. Progress payments are made.

"Questions: Because all work performed by the company is 100% U.S. Government contracted for and, furthermore, the tow contracts in question are de facto treated as contracts containing the progress payments clause, are the overhead materials purchased, the costs of which are allocated to an overhead expense account and then allocated to the two contracts, exempt from sales/use tax?"

Here we are discussing the party directly contracting with the federal government. This is the situation covered by Regulation 1618. Although that regulation was declared invalid by the Aerospace court (Ibid., at 1315) and is currently being revised, the court's decision therein concerned only the second sentence

of sub-division (b)(2) regarding allocation of purchases of overhead materials to cost centers not exclusively involved in government contracts. The court held that that section violated Revenue and Taxation Code Section 6381 because it conflicted with the terms of the government contract. (Ibid., at 1315.) It is our position that the court left the remaining principles embodied in the regulation intact. They are therefore still applicable to federal government contracts.

Sub-division (b)(2) provides that "where the entire overhead material allocated is allocated exclusively to cost centers … involved only in federal government cost reimbursement and/or fixed-price contracts with a progress payments clause during the period of such allocation, for a complete reporting quarter, title to the property will pass to the united States prior to use by the contractor and the puchase an duse of the property by the contractor is nontaxable." The facts state that 100% of the manufacturer's contracts are with the federal government and all but two have a progress payments clause as required by FAR 52.232-16. Therefore, the manufacturer's purchases of overhead materials are considered to be sales to the United States except for those materials allocated to the two contracts which do not have in appropriate progress payment clauses. Purchases of those materials remain subject to tax.

JLW:es