

STATE OF CALIFORNIA
BOARD OF EQUALIZATION
APPEALS REVIEW

In the Matter of the claim)	
for Refund Under the Sales)	DECISION AND RECOMMENDATION
and Use Tax Law of:)	
)	
)	
<u>Claimant</u>)	

The Appeals conference in the above-referenced matter was held by Staff Counsel Rachel M. Aragon on July 20, 1995, in REDACTED TEXT.

Appearing for Petitioner: REDACTED TEXT

Appearing for the
Sales and Use Tax Department: District Principal Auditor

Subject of Claim

Claimant seeks a refund of tax for the period January 1, 1985, through June 30, 1991, measured by:

<u>Item</u>	<u>State, Local and County</u>
Tax paid on overhead materials on U.S. Government contracts.	\$10,059,833

Claimant's Contentions

Title to the overhead materials passes to government prior to use by claimant; therefore, pursuant to Aerospace Corp. v. State Board of Equalization (1990) 218 Cal.App.3d 1300, claimant is entitled to a refund of the tax paid.

Summary

Claimant builds, converts, and repairs ships for the U.S. Navy. In recent years, the bulk of claimant's activity has related to new ship construction and conversion contracts. For 1995, approximately ninety-five percent of claimant's activities relate to the new construction and conversion contracts; approximately five percent relate to repair contracts. Claimant's overhead

materials consist of paper clips, pens, pencils, etc. Claimant is not reimbursed by the government for overhead materials as direct items of cost. Claimant has fixed-price repair contracts which contain progress payment clause 252.217-7106 which states, in relevant part:

"(e) All material, equipment, and other property or work in process covered by progress payments made by the Government shall upon the making of such progress payments become the sole property of the Government, and shall be subject to the provision of Clause 252.217-7105 entitled TITLE hereof."

Clause 252.217-7105 states, in relevant part:

"Unless title to materials and equipment acquired or produced for, or allocated to, the performance of this agreement shall have vested previously in the Government by virtue of other provisions of this agreement, title to all materials and equipment to be incorporated in any vessel or part thereof, or to be placed upon any vessel or part thereof in accordance with the requirements of the job order, shall vest in the Government upon delivery thereof...."

The clause further provides that "all such Contractor-furnished materials and equipment not incorporated in any vessel or part thereof, or not placed upon any vessel or part thereof,...shall become the property of the Contractor, except those materials and equipment the cost of which has been reimbursed by the Government to the Contractor."

Claimant stated that the intent of the clause is for the title to vest in the federal government at the earliest possible moment which is evidenced by 252.217-7104(c), which states that "[a]ll material and workmanship shall be subject to inspection and test at all times during the Contractor's performance of the work..."

Claimant submitted several documents to support its argument that title to the overhead supplies passes to the government prior to the claimant's use. The writings and documentation are included in the petition file. Claimant contends that its accounting methods and procedures are analogous to those in Aerospace: (1) claimant has detailed accounting records which track some of the overhead items which show the date, time, employee, and description pertaining to usage of some overhead items, evidence which claimant stated the Department has been unwilling to review; (2) claimant must stockpile overhead materials to facilitate various production needs because the cost of a work stoppage due to material shortage is very high; (3) claimant maintains a job-order costing system with a direct labor dollar base used for overhead allocation; and, (4) claimant bills the government on a monthly or bi-weekly basis and receives payment within 15-60 days.

The Sales and Use Tax Department (Department) stated that, pursuant to the progress payment provisions in claimant's contracts, government does not make payments until some portion of the work has been completed and the overhead materials have been consumed. Many departments may use the materials on an as-needed basis. The Department stated that when stockroom items are used as needed, claimant cannot prove that the old stock is taken first and the recently-purchased stock is put to the back of the shelf. Claimant has no accounting records to track this.

The Department stated that in order for claimant to prove that title to the overhead materials passes to the government prior to use by claimant, claimant must take each sample unit and show when it was purchased, when it was used, and when the applicable progress payment was received. It is the Department's position that this cannot be done because claimant does not capture this information.

Claimant stated that the Department is imposing a requirement that is directly opposed to the Aerospace case. Claimant could, for selected items, comply with the concept of documenting purchase dates, usage dates, and progress payment dates. In fact, some of the detail overhead is currently in existence. For other overhead items, alternative usage tracking mechanisms could conceivably be developed, however, it should not be necessary. Claimant also stated that it does have a first-in-first-out inventory system.

The Department solicited an opinion from the Board's legal staff in 1992. The Department specifically asked how claimant's progress payment clauses compared with the Aerospace decision. The conclusion of the legal staff was that the title provisions required the government to actually make a progress payment before title to the contractor-furnished property passed to the government (a copy of the memorandum is in the petition file).

The Department further contends that the title provisions of 252-217-7105 are limited to materials and equipment to be incorporated in or placed upon any vessel. The Department stated that in Aerospace, the court concluded that under its contracts with the federal government, the taxpayer's use of the materials occurred after title passed to the government under the title clauses of the contracts and that such use was exempt from the use tax; claimant has no such title provisions; claimant's title provisions do not apply to consumable supplies; claimant has no title provisions which apply to consumable supplies. Therefore, Aerospace does not apply.

Analysis and Conclusion

Sales tax is imposed on all retailers measured by their gross receipts from retail sales of tangible personal property in this state unless the sale is specifically exempted or excluded from tax by statute. (Rev. & Tax. Code § 6051.)

Revenue and Taxation Code section 6381 exempts the sale of tangible personal property to the United States Government. It is claimant's contention that the overhead supplies which it uses on government contracts are exempt sales to the government. Therefore, claimant stated it can properly purchase the property using a resale certificate. (Reg. 1668 (a)(1).)

The Department stated that title to the supplies does not pass to the government prior to use by claimant; therefore, claimant's use is subject to the use tax (Rev. & Tax. Code §§ 6201, 6401; Reg. 1668 (a)(2).)

Both parties rely on Aerospace, supra, to support their position. In Aerospace, at page 1304, the trial court found that under Aerospace's title provisions and governing federal regulations, "overhead materials allocated to specific cost reimbursement contracts on a reasonably acceptable basis, such as direct labor, were issued for use in the performance of those contracts, thereby vesting title in the Government as to all such allocated materials even before reimbursement of the cost thereof by the Government." It was not necessary for Aerospace to

trace every specific item of its overhead materials to use in the performance of a particular contract by specific documentation.

The Court concluded that Aerospace's resale of overhead materials to the government under its contracts was exempt pursuant to section 6381, since the use occurred after title passed to the government under the title clauses of the contract. Also see Lockheed Aircraft Corp. v. State Bd. of Equalization, (1978) 81 Cal.App.3d 257.

Claimant stated that its accounting methods prove that most of the overhead materials are paid for by the government prior to use. However, even if we were to conclude that claimant's accounting methods were similar to those of Aerospace, in order for title to the overhead materials to pass to the government prior to use by claimant, there must be an appropriate title provision between claimant and the government.

The only title provision included in claimant's contract is the progress payment clause. That clause provides that the payment is measured by the labor and materials incorporated in the vessel. In fact, the title clause provides that contractor-provided materials not incorporated in the vessel become the property of the contractor. Overhead materials do not include materials which are incorporated in the vessel (see footnote in Aerospace, page 1304).

It is our conclusion that absent the appropriate title provisions as set out in Aerospace, the government does not acquire title to the overhead materials at all, let alone prior to claimant's use. Therefore, claimant is liable for the tax.

Recommendation

Deny the claim for refund.

Rachel M Aragon, Staff Counsel

February 15, 1996

Date