State of California

Board of Equalization
Legal Division - MIC: 82

565.1375

Memorandum

To: Mr. Lucian Khan
Appeals Section (MIC:85)

Date: December 13, 1995

From: John L. Waid
Senior Tax Counsel

Subject: REDACTED TEXT
U.S. Contracts to Repair Vessels

I am writing this to comment on our conversations and the letter to you dated September 27, 1995 from Mr. REDACTED TEXT arising out of the opinion of the Legal Division as expressed in my memorandum to you dated September 25, 1995, regarding this taxpayer, that title to overhead materials is not passed to the United States on an accelerated basis under the contract clauses at issue. Mr. REDACTED TEXT argues that overhead materials are included in the Progress Payments Clause applicable to the contract, DFARS 52.217.7106.

Mr. REDACTED TEXT makes other arguments as to the amount of materials covered under DFARS 52.217-7005 and 52.217-7006 and also materials covered under the taxpayer's cost-reimbursement contracts containing FAR 52.232-16. The issue originally presented involved the interpretation of the two DFARS clauses mentioned above only. The amount of materials included would be an audit issue best left to the review process to resolve. As we have no facts regarding the cost-reimbursement issue, we cannot respond to it. We do note, however, that the sample contract included with the memorandum to me dated February 7, 1995, by Staff Tax Auditor Jim Duckham, specifically incorporated only the DFARS clauses and not the cost-reimbursement clause contained in FAR 52.232-16. Therefore, any arguments based on that clause are not germane to this discussion.

First, Mr. REDACTED TEXT argues that, by analogy to FAR 52.232-16, which contains a title clause substantially similar to that at issue in Aerospace case and which the court determined passed title to items of indirect cost to the United States prior to use by the contractor, "all consumable supplies are exempt from sales tax. Accordingly, it would not be logical to interpret that DFARS clauses to limit the specific categories of consumable supplies that are exempt from the tax." As we pointed out in our previous memorandum, the DFARS specifically supplants the FAR in the places where they conflict. Also, as noted above, the sample contract provided for our review incorporates the DFARS clauses and not the FAR clauses. We thus must interpret the language of the DFARS clauses without a view to what the FAR might say on a similar contract.

We do agree, for the sake of discussion, however, that the title clause of FAR 52.232-16(d) appears to be broader than that of DFARS 52.217.7106. We can only assume, therefore, that the Navy did not wish to take title to everything it could have had it used the FAR clause.

Mr. REDACTED TEXT's analysis is wide of the mark for two reasons. First, DFARS 52.217-7006 provides that title to any Contractor-furnished materials passes to the government as to all property "to be incorporated into the vessel in the performance of a job order" when that property is delivered to the dock. Overhead materials are not intended "to be incorporated in, or placed on, any vessel." Therefore, the DFARS clause does not cover overhead materials at all. Second, at the completion of the job, title to "all contractor-furnished materials and equipment not incorporated in, or placed on any vessel" shall revert to the contractor unless the government has already reimbursed the contractor for its cost. Taxpayer's interpretation would have the government taking title to materials indirectly in subdivision (b) by the device of reimbursing the contractor for its "overhead expenses" under DFARS 252.217-7007. We note that the progress payment itself is to be measured by the "labor and materials incorporated in the work, materials suitably stored at the site of the work [i.e., 'to be incorporated in a vessel'], and preparatory work completed...." (DFARS 252.217-7007(b)(3).) No mention of overheard materials there either. The Aerospace case only sanctioned the accelerated passage of title in cases where the contract specifically called for it. (Aerospace Corp. v. S.B.E. (1990) 218 Cal.App.3d 1300, 1311-1312.) The United States could have used clauses substantially similar to the broader title clauses contained in FAR 52.232-16 or 52.245-5 had it wished to take title to all property purchased by the contractor for use in performance of the contract. It did not do so in the case of contracts to repair a vessel but chose instead to take title during the course of the job only to materials intended to be incorporated into the ship and, at the end of the job, retain title only to those materials actually incorporated into the ship or intended to be and for which the government had already reimbursed the taxpayer. The "materials and equipment," then, to which the last phrase of DFARS 252.217-7006(b) refers are the "materials and equipment to be incorporated in a vessel" title to which passed to the United States upon delivery to the dock and to which it wishes to retain title because it has already paid the taxpayer for the cost thereof.

We conclude that DFARS 52.217-7006 does not pass title to overhead items because (1) overhead items are not intended to be incorporated into a vessel, and (2) the government does not acquire title indirectly to property not covered by a specific title clause. That the government bears the financial burden of the purchase of the property does not mean that title to it passes to the United States. (See, United States v. New Mexico (1972) 450 U.S. 720.)

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cc: Mr. Michael Hilbert (MIC:40)