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Memorandum

To: Mr. J. W. Cornelius
Supv., Aud. Eval. & Plan. Sect.
(MIC:40)

Date: November 20, 1996

From: John L. Waid
Senior Tax Counsel

Subject: Sales by Related Entities under Aerospace

I am responding to your memorandum dated September 13, 1996 to Assistant Chief Counsel Gary J. Jugum. You attached to your memorandum a memorandum dated August 26, 1996, from District Principal Auditor Philip K. Klepin to Program Planning Manager Dennis Fox, requesting advice on the application of the case of Aerospace Corp. v. S.B.E (1990) 218 Cal.App.3d 1300 to the operations of this taxpayer. Mr. REDACTED TEXT also supplied some additional facts in a telephone conversation I had with him on October 30, 1996. For the sake of brevity, I have attached a copy of Mr. Klepin's memorandum hereto rather than quote it at length.

In a nutshell, REDACTED TEXT the taxpayer, is one of several subsidiaries of REDACTED TEXT with which it shares facilities in REDACTED TEXT. REDACTED TEXT acts as a holding company and provides some services to and the other subsidiaries. The Purchasing Department buys all overhead materials. Some items are purchased directly by REDACTED TEXT for itself or one of the other entities, but most overhead items--generally those purchased on a recurring basis, like pencils, paper, printer supplies, etc.--are placed into any one of several overhead accounts that may be shared among the companies occupying the facility. Allocations from these accounts are based on the square footage occupied by all those companies or on a head count. REDACTED TEXT then assigns to its contracts the costs allocated to it.

According to REDACTED TEXT, REDACTED TEXT and REDACTED TEXT were one entity at the beginning of the audit period covered by Aerospace. They split up during the period and began using the above allocation method to assign costs. The auditor questioned this procedure, but approved a refund based on it. For reasons that are now unclear, REDACTED TEXT and REDACTED TEXT stopped allocating overhead costs by this method and reported only their direct purchases. REDACTED TEXT indicated that is under audit for the period 7/1/92-9/30/95, and about 70 percent of overhead purchases allocable under this indirect method during the audit period would qualify for exemption under Aerospace. Two issues are involved:

(1) can REDACTED TEXT now go back in the current audit period and identify additional overhead materials for Aerospace purposes using the above allocation method based on approval in the previous audit; and (2) can REDACTED TEXT continue to use the allocation method in the

future? If REDACTED TEXT is permitted to file a claim for refund, REDACTED TEXT estimated the maximum refund amount to be about \$232,500.00.

OPINION

As you know, the Aerospace court declared that persons contracting with the United States to render services may buy overhead materials tax free for resale to the federal government if their contracts contain clauses passing title to the property purchased to the United States prior to use by the contractor; the follow-on resale to the United States is exempt from tax under section 6381. Else, tax applies to sales to such persons.

The court held that a government contractor may allocate overhead purchases to specific contracts "on a reasonably acceptable basis." (Ibid. at. 1312; FAR 31.201-"any generally acceptable method of determining or estimating costs that is equitable and is consistently applied may be used...") During our telephone conversation, Mr. REDACTED TEXT stated that the United States audited REDACTED TEXT during the terms of its contracts, and found the above method of allocating overhead costs to be allowable and reasonable under FAR 31.201-2 and 31.201-3. As noted above, a refund was given to REDACTED TEXT on this basis at the time of the original Aerospace refunds. We thus conclude that REDACTED TEXT may continue to allocate to its government contracts the overhead costs assigned to it by REDACTED TEXT but that the small potential refund amount would mitigate against REDACTED TEXT filing a claim for refund.

JLW:sr

cc: Mr. Mike Hilbert (MIC:40)