565.1400

Memorandum

To: Mr. Glenn A. Bystrom
Principal Tax Auditor

Date: April 10, 1991

From: Gary J. Jugum
Assistant Chief Counsel

Subject: Sales to the United States
Impact of DCAA Audits on Federal Contractors

In your memorandum to me of March 14, 1991, you inquired as to what position the Board staff should take regarding disallowance of costs during audits of federal contractors performed by the Defense Contract Administration and Audit Agency (DCAA). In your memorandum you indicate that you did some factual investigation with the Torrance District after our conversation on this problem. You set forth the results of your investigation as follows:

> "…Currently,…(as far as I can tell) [no] district in this state reviews DCAA audits or proposes any adjustments in our audits as a result of DCAA audits. DCAA is currently running five to fifteen years behind the times. Generally, DCAA audits disallow charges made to the government via a contract that has been paid. In effect, DCAA is stating that the charges were inappropriate for the contract in question. Usually, the disallowance is in labor and the corresponding overhead burden. Under the Aerospace decision, presumably the government contractor will now consider some portion of overhead supplies as sold to the U.S. Government. If the charge was disallowed as being inappropriate, the question of course is "was there ever a sale to the government?" A secondary question, if we conclude there was not a sale, is "how do we treat the disallowance?" Has the statute run, or does the statute start when the government makes the disallowance?"

You further indicated that this issue has been highlighted in your mind by the recent allegations surrounding REDACTED TEXT charging the government on certain contracts for items apparently unrelated to the contracts. Pursuant to its normal procedure in these matters, the federal government paid REDACTED TEXT charges, later audited the contracts, and disallowed certain of the charges. The U.S. government now takes the position that it never meant to, nor did it, take title to the items the charges for were disallowed.

In view of the government's position in this case, you posed the two questions set forth above. In view of our conclusion on the first question, this memorandum will not address the second.

Opinion

Pursuant to authority granted by 41 U.S.C. Section 254(c), federal contractors are audited by various federal agencies. In the context of the Department of Defense (DOD), auditing authority is found in 10 U.S.C. Section 2313. Federal acquisition statutes are interpreted and implemented by the Federal Acquisition Regulations (FAR) (and, here, the DOD FAR Supplement) which set forth the purpose of the property acquisition and contract administration programs, and designate various clauses which must be included in U.S. government contracts. DOD FAR Supplement, Subpart 242.60, designates the DCAA as the agency to audit DOD contracts. (Ibid., § 242.7005.)

Regarding the issue you raise, an analysis of the appropriate sections in the FAR and the DOD Supplement reveals that the passage of title to property to the United States does not depend on the government reimbursing the contractor for the property. Typically, DOD contracts provide with respect to indirect cost items, as follows:

Title to all overhead material shall pass to and vest in the United States upon the first to happen of the following events: (1) issuance of the material for use in performing the contract; (2) commencement of processing the material for use; or (3) the government reimbursing the contractor for the material.

(See e.g., FAR §§ 52.245-2(c)(4) (fixed-price contracts), 52.245-5(c)(2) (cost-reimbursement, time-and-materials, or labor-hour contracts), and 52.245-7(d) (consolidated facilities). Such property is considered under the above authority to be government property. (FAR § 45.106.)

The upshot of the above provisions is that, in many instances, the U.S. acquires title to this "government-furnished" property prior to reimbursing the contractor for its cost. The regulations require that the clauses setting forth the above principles be inserted into the contract. (FAR §§ 45.106(b)(1) (fixed-price contracts), 45.106(f)(1) (cost reimbursement, time-and-material, or labor-hour contracts, and 45-310-6(a) (consolidated facilities.) Under the Aerospace decision (Aerospace Corp. v. State Board of Equalization (1990) 218 Cal.App.3d 1300, 1313 [267 Cal.Rptr. 685]), these clauses control the passage of title. Thus, we conclude that, when clauses such as those set forth above are included in a federal contract, title passes to the property described therein upon the happening of one of the critical events. Passage of title is thus not contingent upon the federales reimbursing the contractor for the purchase price of the property.

The being the case, the subsequent disallowance of the expense, especially pursuant to an audit which, as you noted, may occur some years after performance under the contract has been completed, cannot be held to wipe out the original transference of title. Indeed, DOD Far Supplement, Subpart 242.70 does not give the DCAA authority to rescind contracts. Interestingly enough, the only remedy which the DOD FAR Supplement outlines is that of voluntary refunds, either unsolicited or made pursuant to a request by the government. (Subpart 242.71.) Such refunds are to be requested when the government considers that it has been overcharges under a contract, among other events, and the contractor's retention of the money would be contrary to good conscience and equity. (DOD FAR Supp. § 242.7101.) Generally, the voluntary refund is to be used as a set-off against future debt which the contractor owes to the government. (FAR DOD Supp. § 242.7100.) The regulations, then, do not appear to contemplate the unwinding of property transfers as a matter of course.

In the case of a disallowance where a refund is sought from the contractor, what happens, at most, is a forced re-sale of the property by the government back to the contract. Such transactions would be exempt from tax under Revenue and Taxation Code Section 6402. Yet by the time the DCAA audit takes place the property in question – nondurable overhead items – does not in all likelihood even exist anymore. There can be no transfer of title to property not in existence. Statements to the press that the Government has not taken title to items inappropriately charged to the Government are not indicative as to the true relationship under the contract, particularly with respect to overhead supplies where the title provisions are self-executing.

JLW:es
3809I

cc: Mr. John Abbott
Mr. John Waid