

**Memorandum****565.1700**

To: Mr. Wayne Hopkins  
Senior Tax Auditor  
Out-of-State District - OH

Date: August 28, 1995

From: John L. Waid  
Senior Tax Counsel

Subject: REDACTED TEXT  
Claim for Refund (Special Tooling)

I am responding to your memorandum to the Legal Division dated October 12, 1993. I apologize for the long delay in responding to it. At the time you wrote, the amendments to Regulation 1618 regarding sales of special tooling were not yet in final form. Amendments to Regulation 1618 were held pending the agreements regarding paying out the Aerospace refunds. The Aerospace refund program is now in progress, and, on August 1, 1995, the Board amended Regulation 1618 to incorporate the Aerospace rule and the federal changes in the sale of special tooling. (The amendments have not yet been approved by OAL.)

You attached to your memorandum a copy of a memorandum to your office from Senior Tax Auditor Dale T. Folkening, of the Chicago Office, which you reviewed on September 22, 1993. Attached to Mr. Folkening's memorandum was a copy of a letter to Mr. Folkening dated September 17, 1993, from REDACTED TEXT, Tax Counsel for the taxpayer, REDACTED TEXT. REDACTED TEXT attached to his letter a brief which set forth the factual background of, and legal analysis advanced to support, REDACTED TEXT Claim for Refund.

I. FACTUAL BACKGROUND.

According to REDACTED TEXT, REDACTED TEXT entered into a contract in 1984 with the Navy to develop and deliver two prototype REDACTED TEXT aircraft. The contract was modified in 1986 to provide that REDACTED TEXT would "fabricate and furnish" an additional number of airframes. As part of the contract, REDACTED TEXT would acquire or manufacture certain items of special tooling ("ST") and special test equipment ("STE"). The ST/STE are so highly specialized that their use is restricted to testing the REDACTED TEXT and related supplies and parts.

REDACTED TEXT attached to his letter a copy of Contract Clause H-83, "Contractor Investment in Special Tooling and Special Test Equipment." In pertinent part, this clause provides as follows:

"1. The contractor will acquire, own and retain title to all new production special tooling and special test equipment (ST/STE) to perform at a production rate of four

aircraft per month by FY1991 for FY1991-1995 procurements. All ST/STE tooling costs, except for sustenance tooling type costs such as the costs of maintenance and refurbishment due to normal wear and tear, methods improvements, quality assurance and calibration, are included in the contractor's planned investment under this clause...

"\* \* \* \*

"3. [T]he not-to-exceed recoverable tooling investment estimated at \$53,800,000 (Then Year dollars) will be paid to the Contractor [pursuant to the schedule set forth herein].

"4. All special tooling and special test equipment, regardless of ownership, will be made available for use on a no charge and priority basis except as otherwise provided in paragraph 1 of this clause, under any and all Government T45TS production contracts awarded to the contractor for U.S. Government requirements.

"5. In the event that the contractor elects at any time to dispose of the special tooling and test equipment, the government will have the right of first refusal to acquire the ST/STE at a mutually agreed price, which would include costs incurred commencing with the Contractor's written notification for dismantling, moving, handling and storage or disposing of the ST/STE remaining in the Contractor's possessions and which the Government has elected to acquire...

"\* \* \* \*

"7. In the event of termination for convenience, nonexercise of an option or program cancellation, the balance will be rephased to reflect the shortened life of the program. In such event, the contractor shall be entitled to recover his actual tooling investment to date (NOT \$53.8M), less all annual allocations recovered to date, but only to the extent that funds are available...."

He also included a copy of page 8-23 of the Contract, containing Section I--FAR Contract Clauses included in the agreement. Clauses 52.245-17, SPECIAL TOOLING (APR 1984), and 52.245-28, SPECIAL TEST EQUIPMENT (APR 1984), were checked off as being included. The designation for each clause also had under it, in handwriting, the following phrase: "Also see Section H, Special Contract Requirement entitled "Contractor Investment in Special Tooling and Special Test Equipment." We note that 52.245-2, GOVERNMENT PROPERTY (FIXED-PRICE CONTRACTS) (APR 1984), the title-passage clause of which was at issue in Aerospace Corp. v. S.B.E. (1990) 218 Cal.App.3d 1300 is omitted.

Regarding government acquisition of ST, FAR 52.245-17, as it read in 1984, provided, in pertinent part, as follows:

"[W]hen contracting by negotiation, insert the following clause in solicitations and contract when a fixed-price contract is contemplated, the contracting officer decides to acquire rights to the contractor's special tooling, and it is not practical to identify the special tooling required:

"\* \* \* \*

"(i) Disposition instructions.

"\* \* \* \*

“(l) The Contracting Officer shall give the Contractor a list specifying the products, parts, or services for which the Government may require special tooling and request the Contractor to transfer title (to the extent not previously transferred under any other clause of this contract) and deliver to the Government all usable items of special tooling that were designed for or used in the production or performance of such products, parts, or services and that were on hand when such production or performance ceased.”

Neither FAR 52.245-17 nor FAR 52.245-18 made provision for the government to take title to STE prior to use by the contractor.

### OPINION

REDACTED TEXT avers that, under Clause H-83, "the Navy becomes the equitable or defacto owner of the ST and STE, in that it effectively acquires complete control over the use and disposition of this property. REDACTED TEXT summarizes REDACTED TEXT argument as follows:

"At the time it was negotiated, Clause H-83 was a very unusual government contract provision. By requiring contractors like REDACTED TEXT to initially fund the ST and STE needed to perform a contract, and then reimbursing the contractors over time, without interest, the government's current purchasing power was increased. The government still, in effect, received the full and immediate benefit of the ST and STE. The contract provisions described above assured control of this property. It did not, however, have to pay for the ST and STE immediately. This arrangement also gave the government the ability to pay for the ST and STE with inflated dollars over time. In sum, although Clause H-83 purports to change the nature of the ownership of the ST and STE, its actual purpose was instead to change only the financing arrangement for this property.

"\* \* \* \*

"As demonstrated by the foregoing, under California law, the ST and STE acquired by REDACTED TEXT to construct the REDACTED TEXT aircraft were sold to the Navy. This means that REDACTED TEXT purchase of the ST and STE was for resale, and exempt from sales tax. Moreover, because title to the ST and STE passed to the Navy, REDACTED TEXT is not liable for use tax in connection with the use of this property to construct the REDACTED TEXT aircraft."

In actual fact, REDACTED TEXT purchased the ST/STE, or the materials to make them, as a consumer, and did not transfer title to the Navy prior to using the property. The fact that the Navy reimbursed REDACTED TEXT for its costs of manufacturing or acquiring the ST/STE and that its acquisition provided a benefit to the Navy does not in and of itself create a sale to the Navy. (See, United States v. New Mexico (1982) 455 U.S. 720, 735 [102 S.Ct. 1373, 71 L.Ed.2d 580].) A contract must contain clauses specifically providing for the transfer of title to the property in question to the government prior to any use by the contractor for the contractor to be regarded as

purchasing the property for resale (no tax) rather than for use (tax). (Lockheed Aircraft Corp. v. S.B.E. (1978) 81 Cal.App.3d 257; 265-266 [146 Cal.Rptr . 283].)

No such clause exists in this contract. Actually, Clause H-83 specifically provides that REDACTED TEXT retains title "to *all* new production special tooling and special test equipment" (emphasis added) and that the Navy would have a right of first refusal to acquire the ST/5TE "[i]n the event that the contractor elects at any time to dispose of the [ST/ STE.]" Clearly, the Navy obtained no more than an option to purchase, an option triggered by decision to dispose of the ST or STE. Thus, the Navy does not even get the opportunity to buy the ST/STE until after is done with it. As a result, did not sell the property to the Navy prior to use.

The provisions of FAR 52 .245-17 and 52.245-18 do not mandate a different result. We should first note that the reference to these clauses in the contract was modified in handwriting to incorporate the provisions of Clause H-83. In California, where a contract is partly written and partly printed, the intention of the parties disclosed by the written portions prevail over the printed parts where the two are in conflict. (Burns v. Peters (1936) 5 Cal.2d 619, 623 [55 P.2d 1182]; Civ. Code § 1651.) Therefore, even if these two FAR clauses provided for some sort of title transfer, those terms were modified by the terms of Clause H-83. Second, the fact is that these clauses do not provide for accelerated transfer of title. FAR 52.245-18 does not refer to title to STE at all. FAR 52.245-17, by its terms, is to be used when the contracting officer decides to acquire rights in the ST. It is evident that the "rights" contemplated were the rights to acquire title to the ST at the close of the contract. Title was to remain in the contractor, but the government could acquire title upon disposition at the end of the contract without further payment. The Summary Information published when FAR 52.245-17 was amended in 1989 makes it clear that the clause is, and always was intended to be, so used only when the government wanted to maintain rights to the ST "until such time that the Government decides it wants full title to the special tooling or has no further interest in the special tooling." (54 FR 48981(Nov. 28, 1989).) The clause as amended now makes that intent explicit. (54 FR 48995-48996 (Nov. 28, 1989); See, Reg. 1618(b).)

In support of REDACTED TEXT argument Mr. REDACTED TEXT cites Northrop Corp. v. S.B.E. (1980) 110 Cal.App.3d 132, 167 Cal.Rptr. 707, and Lockheed, supra. Neither case supports his argument, and indeed, as noted above, the Lockheed case is squarely against him. First of all, in the Northrop case the issue was whether or not Northrop had sold ST to Boeing where the contract transferred the indicia of ownership to Boeing but Northrop had retained title for security purposes. The court found that, despite the retention of bare legal title by Northrop, Boeing had the absolute right to, at any time, remove the tooling from Northrop's possession, require Northrop to deliver it to a third party, direct Northrop to use or not use the tooling, or even divest Northrop of title. The court further found that the evidence showed that Northrop retained title for sales tax purposes only.

(Northrop, supra., 110 Cal.App.3d at 142-143.) Here, while REDACTED TEXT use of the ST/STE was limited to performing the contract, the United States could not direct REDACTED TEXT to dispose of the property nor even disturb possession. The Lockheed case is not on point for two reasons: (1) there were clauses in that contract vesting title to the ST in the government prior to any use being made of it by

Lockheed (Supra., 81 Cal.App.3d. at 263); and (2) Lockheed was decided under the terms of the Armed Services Procurement Regulation (ASPR) which did provide for accelerated transfer of ST when the appropriate title-passage clauses were present. Those provisions were removed when FAR superseded ASPR in April of 1984. Thus, while the rule espoused in Lockheed is still good

law (See, Aerospace, supra.), the result as regards ST was reversed due to a change in the underlying procurement regulations.

Thus, we conclude that Clause H-83 means what it says. REDACTED TEXT retained full title to the ST/STE with the government getting a right of first refusal in the event REDACTED TEXT decided to dispose of the property. There was no sale to the Navy. Thus, REDACTED TEXT bought the ST/STE or the materials to make it as a consumer and thus owed tax measured by the cost to it of the ST/STE or materials.

JLW:sr