

**565.2500****Memorandum**

To: Lakewood Branch Office Supervisor

Date: February 13, 1986

From: Legal (JBA)

Subject: REDACTED TEXT

Your memorandum of January 24, 1986 has been directed to me for a response. Your memorandum states as follows:

“We are currently conducting an audit of REDACTED TEXT and have encountered some problems interpreting Regulation 1618 along with Operations Memo No. 680 as they relate to direct consumable supplies. The taxpayer is the only shipyard on the west coast constructing new Navy vessels. The contracts, in question, are fixed-price plus incentive U.S. Government contracts. In our audit, we are questioning direct consumable supplies.

“All contracts involved contain the government property title clause (ASPR 7-104.24) but do not contain the progress payment title clause (ASPR 7-104.35). Based on our interpretation of Operations Memo 680, this would make all direct consumable supplies taxable. However, the taxpayer does have a special clause, identified as J-28 Liens and Titles (copy attached), which the taxpayer believes transfers title of direct consumable supplies to the U.S. Government prior to use.

“We wish to know whether this special clause J-28 is sufficient to indicate that title for direct consumable supplies passes to the U.S. Government prior to use? If not, are we correct in recommending that tax is due on the items listed on the attached schedule?

“The measure of tax involved is over \$2.7 million. Your expedient attention in this matter is appreciated.”

The schedule attached to your memorandum is attached hereto and incorporated herein as “Exhibit A” as is the J-28 lien and title clause (“Exhibit B”). Government Property Clause 7-104.24 is quoted in Operations Memo 680, Aug. 27, 1980.

Operations Memo 680 provides that under a fixed price contract Government Property Clause 7-104.24 only passes title to the United States for facilities, special test equipment, and certain types of special tooling. Consequently, if this is the only title clause in the contract, the purchase or use of “direct consumable supplies” or “overhead materials” by the contractor will be

subject to tax. When progress payment clause 7-104.35 is present in a fixed price contract, however, title to direct consumable supplies vests in the United States upon acquisition or production by the contractor and his purchases of such property are exempt. The question, then, is whether the J-28 clause serves the same function as the 7-104.35 clause as relates to direct consumable supplies.

Subdivision (a) of the J-28 clause provides that the United States acquires a lien upon materials and equipment purchased by the contract on account of the vessel from the proceeds of partial payments paid by the Government. Subdivision (b) details the Government's rights under its lien. Subdivision (c) provides that the Government has title to the vessel under construction, as well as title "to all materials and equipment acquired for the vessel..." Title to such materials and equipment vests in the Government upon delivery thereof to the contractor, except in instances not relevant to your inquiry.

In the absence of any definition in the contract for the expression "materials and equipment acquired for the vessel," it is our conclusion that the J-28 title provision found in subdivision (c) of that clause does not pass title to direct consumable supplies to the United States prior to the contractor's taxable use thereof. Subdivision (c) appears to relate solely to materials and equipment which are to become component parts of the vessel or which enable the vessel to function. It does not appear to deal with direct consumable supplies. In this context, we note that subdivision 9c) specifically refers first to the Government's title to the vessel under construction itself and then proceeds to refer to the Government's vested title in materials and equipment "for the vessel." Subdivision (a), conversely, refers to materials and equipment "on account of the vessel" as to which the Government acquires a lien when such materials and equipment are paid for by the contractor from the proceeds of partial payments from the Government. Such materials and equipment may properly be chargeable to this contract, but may not be "for the vessel." Thus, the Government acquires a lien, but not title, as to all such materials and equipment (Subdivision (a)), but acquires a superior property right, i.e., title, to materials and equipment which are to become component parts, or are necessary to the functioning of, the vessel. (Subdivision (c); see also 7-104.35 set forth in Operations Memo 680 which provides that title to direct consumable supplies vests in the Government if the purchase thereof is properly chargeable to the contract.)

Our conclusion that the J-28 clause is not sufficient to pass title to direct consumable supplies to the Government prior to use thereof by the contractor is based upon the assumption that the expression "materials and equipment for the vessel" is either not defined elsewhere in the contract or that it is defined so as to exclude direct consumable supplies.

We now turn to your inquiry regarding your recommendation that the contract is liable for tax on its purchase of the items listed on your schedule "Account of Direct Expense Charged." Clearly, the items listed under the headings of "Launching," "Commissioning Ceremony," and "Staging Scaffolding" appear not to have been "for the vessel" as we have defined that expression above; the same would be true with respect to items under the headings of "Consumable Supplies" assuming that these items were not incorporated into the vessel. Given the description of some of these items, e.g., "7 Part Forms" we are unable to make any determination in this regard. The items listed under the heading "Systems Testing" may require a different finding. We offer no opinion as to the "Silkscreened Binders" since the description is insufficient to disclose whether or not there were "for the vessel" or if they constituted "special test equipment." (7-104.24.) The diesel fuel, on

the other hand, may properly be found to have been “for the vessel” if it was purchased for the functional use of the vessel. Among the factors to be reviewed prior to making a determination in this regard will be whether the “systems testing” was performed by the contractor or the Government and whether all or only a portion of the diesel fuel was consumed during the testing.

JBA;ba

cc: Downey – Auditing (EEB)  
Lakewood – J. Guzman  
Lakewood – D. Madlana