



STATE BOARD OF EQUALIZATION

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August 5, 2011

Dear Interested Party:

Enclosed is the Initial Discussion Paper on Regulation 1618, *United States Government Supply Contracts*. Discussion regarding proposed amendments to Regulation 1618 is scheduled for the Board's **December 15, 2011 Business Taxes Committee** meeting.

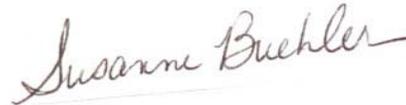
However, before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, a meeting is scheduled in **Room 122 at 10:00 a.m. on August 18, 2011**, at the Board of Equalization; 450 N Street; Sacramento, California.

If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please write to me at the above address or send a fax to (916) 322-4530 before the August 18, 2011 meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting. If you plan to attend the meeting on August 18, 2011, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Ms. Judi Pierce at (916) 327-2045 or by e-mail at [judith.pierce@boe.ca.gov](mailto:judith.pierce@boe.ca.gov) prior to August 16, 2011. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing. In addition, please let Ms. Pierce know if you wish to have future correspondence, including the second discussion paper and all attachments, sent to your e-mail address rather than to your mailing address.

Whether or not you are able to attend the above interested parties' meeting, please keep in mind that the due date for interested parties to provide written responses to staff's analysis is **September 2, 2011**. Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Leila Hellmuth, Supervisor, Business Taxes Committee Team, at (916) 322-5271.

Sincerely,



Susanne Buehler  
Chief, Tax Policy Division  
Sales and Use Tax Department

SB: jmp

Enclosures

cc: (all with enclosures)  
Honorable Jerome E. Horton, Chairman, Fourth District  
Honorable Michelle Steel, Vice Chair, Third District  
Honorable Betty T. Yee, Member, First District (MIC 71)  
Senator George Runner (Ret.), Member, Second District (MIC 78)  
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(Via E-mail)

Mr. Robert Thomas, Board Member's Office, Fourth District  
Mr. Neil Shah, Board Member's Office, Third District  
Mr. Tim Treichelt, Board Member's Office, Third District  
Mr. Alan LoFaso, Board Member's Office, First District  
Ms. Mengjun He, Board Member's Office, First District  
Mr. Lee Williams, Board Member's Office, Second District  
Mr. James Kuhl, Board Member's Office, Second District  
Ms. Natasha Ralston Ratcliff, State Controller's Office  
Ms. Kristine Cazadd  
Mr. Randy Ferris  
Mr. Jeffrey L. McGuire  
Mr. Jeff Vest  
Mr. David Levine  
Mr. Bradley Heller  
Mr. Cary Huxsoll  
Mr. Robert Tucker  
Mr. Todd Gilman  
Ms. Lauren Simpson  
Mr. Robert Ingenito Jr.  
Mr. Bill Benson  
Mr. Stephen Rudd  
Mr. Kevin Hanks  
Mr. Geoffrey E. Lyle  
Ms. Leila Hellmuth  
Ms. Judi Pierce

# INITIAL DISCUSSION PAPER

## Proposed Revisions to Regulation 1618, *United States Government Supply Contracts*

### Issue

Should Regulation 1618, *United States Government Supply Contracts*, be amended to conform the regulation to changes in the Federal Acquisition Regulation (FAR)?

### Background

Regulation 1618 provides guidelines for the application of tax to purchases and sales made by United States government supply contractors. The regulation was last amended in 1995 to incorporate the decision in *Aerospace Corporation v. State Board of Equalization* (1990) 218 Cal.App.3d 1300, which provided that title to overhead materials could pass to the government prior to use when the appropriate title clauses are in the contract. Procedures for auditing government supply contractors are included in Audit Manual sections 411.00 through 411.25 and Exhibits 10A through 10F. The audit manual sections discuss the application of tax to direct and indirect supplies based on the type of contract (fixed price or cost reimbursement) and the specific title clauses included in the contract.

In the late 1990s, the United States Government initiated a complete rewrite of FAR Part 45 (Government Property) and associated clauses. Another rewrite of Part 45 was proposed in September 2005 and was final in May 2007. A significant change to the FAR was the consolidation of various clauses into one, FAR 52.245-1, *Government Property*. In essence, the FAR clauses at 52.245-1, *Property Records*; 52.245-2, *Government Property (Fixed Price Contracts)*; 52.245-5, *Government Property (Cost-Reimbursement, Time and Material, or Labor Hour Contracts)*; and 52.245-19, *Government Property Furnished "As Is,"* were combined to form one new clause – 52.245-1, *Government Property*. Several other clauses were deleted in their entirety, including the clauses for “special tooling” (52.245-17) and “special test equipment” (52.245-18).

Regulation 1618 should be updated to reflect the new consolidated clause and the deletion of the separate title clauses for “special tooling” and “special test equipment.”

### Discussion

#### What is FAR?

FAR is the United States Government regulation governing the “acquisition process,” which is the process through which the government purchases goods and services. The regulation is divided into “parts” covering various subjects. “Parts” of particular concern to sales and use tax issues are:

- Part 2 – Definitions of Words and Terms
- Part 16 – Types of Contracts
- Part 32 – Contract Financing
- Part 45 – Government Property, and
- Part 52 – Solicitation Provisions and Contract Clauses

# INITIAL DISCUSSION PAPER

## **Proposed Revisions to Regulation 1618, *United States Government Supply Contracts***

In addition to the definitions provided in Part 2, each part may contain specific definitions applicable to that part. Part 52 provides the actual text of all FAR provisions and clauses which are inserted in the contracts.

### **Part 16 – Types of Contracts**

The contract types are grouped into two broad categories: fixed-price contracts (FAR 16.2) and cost-reimbursement contracts (FAR 16.3).

A fixed price contract, in general, provides for a firm price, or in appropriate cases, an adjustable price (an adjustable price may include a ceiling price, a target price, or both). A firm-fixed price contract provides for a price that is not subject to any adjustment on the basis of the contractor's cost experience in performing the contract. This contract type places maximum risk upon the contractor and full responsibility for all costs and resulting profit or loss.

A cost-reimbursement type of contract provides for payment of allowable incurred costs, to the extent prescribed in the contract. These contracts establish an estimate of total cost for the purpose of obligating funds and establishing a ceiling that the contractor may not exceed (except at its own risk) without the approval of the contracting officer.

The time of title transfer may vary depending on whether the contract is a fixed price contract or a cost reimbursement contract.

### **Part 32 – Contract Financing**

Part 32 prescribes policies and procedures for contract financing and other payment matters. Two types of financing used in government supply contracts are progress payments and performance-based payments. The related financing clauses inserted in the contract include a title clause.

### **Part 45 – Government Property**

Part 45 prescribes policies and procedures for providing Government property to contractors, and contractors' management and use of Government property. In general, it does not apply to property under any statutory leasing authority, to property to which the Government has acquired a lien or title solely because of partial, advance, progress, or performance-based payments; or to software and intellectual property. Subpart 45.4 discusses title to government furnished property and contractor acquired property.

### **Part 52 – Solicitation Provisions and Contract Clauses**

Part 52 includes instructions for using provisions and clauses in solicitations and/or contracts and sets forth the solicitation provisions and contract clauses prescribed by this regulation. Subpart 2 contains the actual text of the clauses inserted into contracts. The numbering of the clause includes a reference to the related part of FAR. For example, the government property clause is 52.245-1 and government property is covered in Part 45.

## INITIAL DISCUSSION PAPER

### Proposed Revisions to Regulation 1618, *United States Government Supply Contracts*

#### How FAR Changed

There were three significant changes to FAR that impact the California Sales and Use Tax Law:

- Several government property clauses for records, fixed price contracts, cost reimbursement contracts, and “As is” property were combined into one clause, 52.245-1. The FAR clauses referenced in the audit manual need to be updated to reflect the current numbering systems.
- The clauses for “special tooling” and “special test equipment” were deleted. Title to these items now transfers at the same time as title passes for other equipment and tooling. Both the regulation and the audit manual need to be updated to delete the references to the separate clauses and the different tax treatment of these items.
- A title transfer clause was added to the performance-based payment clause (52.232-32). Contracts that rely on this clause to pass title to the property will not pass title until the first performance-based payment. The use of property prior to the passage of title to the United States government will be subject to tax. After the first payment, title of tangible personal property passes prior to any use.

Staff recommends that Regulation 1618, *United States Government Supply Contracts*, be updated to reflect these changes.

#### Regulation 1618

Staff recommends the following amendments to Regulation 1618. The proposed amended regulation is attached as Exhibit 1.

- Subdivision (a)(2) – Delete last sentence to reflect that FAR no longer excludes “special tooling” from the definition of tools.
- Subdivision (b) –
  - Change wording and punctuation to clarify that direct consumable supplies are not charged to overhead accounts.
  - Add a reference to the performance-based payments clause in the discussion of types of fixed price contracts.
  - Delete the last paragraph titled “special tooling.”

FAR provides that specific clauses be inserted in the contracts. Previously, FAR 52.245-2 was the government property clause inserted in fixed price contracts. The clause provided that “special tooling” was excluded from the provisions of the clause and that FAR 52.245-17 applied to “special tooling.” As part of the revision of FAR, the “special tooling” clause was deleted and “special tooling” was combined with other clauses pertaining to Government property under 52.245-1. As a result, title transfers to “special tooling” and “special test equipment” are no different than title transfers of other tooling or equipment.

## **INITIAL DISCUSSION PAPER**

### **Proposed Revisions to Regulation 1618, *United States Government Supply Contracts***

#### **Audit Manual**

Staff is in the process of rewriting Audit Manual section 411.00, *United States Government Supply Contracts*, not only to update the FAR revisions but to also simplify and clarify the guidance provided. A draft of the revisions will be included in the second discussion paper for interested parties' comments.

#### **Summary**

Staff proposes revising Regulation 1618 to incorporate the FAR changes that consolidated several property clauses into one clause. In addition to the consolidation, the specific clauses for "special tooling" and "special test equipment" were deleted and a title clause was added to the Performance-Based Payment clause. Staff welcomes any comments, suggestions, and input from interested parties regarding this issue.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 8/4/2011

Regulation 1618. United States Government Supply Contracts.

Reference: Sections 6007 and 6381, Revenue and Taxation Code.

Aerospace Corp. v. St. Bd. of Equalization (1990) 218 Cal.App.3d 1300.

(a) Definitions.

(1) “United States Government supply contract” means a contract with the United States to furnish, or to fabricate and furnish, tangible personal property including ships, aircraft, ordnance, or equipment, whereby title to tangible personal property purchased for use in fulfilling the contract passes to the United States pursuant to the title provisions contained in the contract before the contractor uses the property to perform the function or act for which the property was designed or manufactured. The term “U.S. Government supply contract” does not include contracts to construct improvements on or to real property or to the purchase of tangible personal property for use in fulfilling such contracts.

(2) “Direct consumable supplies” means supplies, tools, or equipment consumed in the performance of a contract which are specifically identified to the contract and the actual cost of which is charged as a direct item of cost to the specific contract. ~~“Tools” as used in this definition does not include “special tooling” subject to the provisions of Federal Acquisition Regulation (FAR) 52.245-17 or any regulation(s) which succeeds FAR 52.245-17.~~

(3) “Overhead materials” means supplies consumed in the performance of a contract the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles.

(b) Application of Tax.

Sales to U.S. Government supply contractors of tools, equipment, direct consumable supplies and overhead materials are sales for resale if the United States takes title pursuant to a United States government supply contract prior to any use of the property by the contractor to perform the function or act for which the property was designed or manufactured. Accordingly, tax does not apply to such sales even though the property does not become a component part of the tangible personal property furnished, fabricated, or manufactured by the contractor. If the contractor makes any use of the property to perform the function or act for which the property was designed or manufactured prior to the passage of title to the United States, tax applies to the sales to or to the use by the contractor.

Whether title to direct consumable supplies and overhead materials passes to the United States under a United States government supply contract and the time at which title passes will be determined in accordance with the title provisions contained in the contract, if any. ~~In a case where the cost of~~For direct consumable supplies, or overhead materials which are charged to an expense account which is then allocated to various locations, cost centers or contracts, some of which are engaged in other than United States government cost reimbursement contracts and/or

fixed-price contracts with a progress payments or performance-based payments clause, it will be considered that title did not pass to the United States prior to use of the property, and tax will apply with respect to the purchase or use of the property charged to the expense account, unless the item is specifically accounted for as being charged to a specific United States government supply contract, pursuant to the terms of which title passes to the United States prior to the use of the item. Property will be considered charged to a specific United States government supply contract when it is allocated pursuant to:

- (1) accounting standards promulgated by the Cost Accounting Standards Board (Office of Federal Procurement Policy, Office of Management and Budget), if applicable; otherwise,
- (2) generally accepted accounting principles that are equitable, consistently-applied, and appropriate to the particular circumstances.

Direct consumable supplies and overhead materials which may be allocated in this manner include, but are not limited to, property used to repair items of capital equipment when a portion of the contractor's use is properly allocable to its government supply contracts, notwithstanding the fact that title to the property being repaired remains with the contractor.

~~Special Tooling. Effective December 29, 1989, title will generally not pass prior to use by the contractor for special tooling which is subject to the Special Tooling Clauses of Federal Acquisition Regulation (48 CFR) 52.245-17. Title to such special tooling will pass prior to use by the contractor only if the agreement between the contractor and the United States government contains a custom clause providing for title passage prior to use by the contractor. Therefore, sales of special tooling will generally be subject to tax.~~