

565.0000 UNITED STATES CONTRACTORS

See also Construction Contractors.

(a) IN GENERAL

565.0025 Construction Contracts. The Lockheed and Aerospace court cases only pertain to United States supply contracts and not to construction contracts. Accordingly, Revenue and Taxation Code section 6007.5 and 6384 are valid and controlling with respect to the application of tax to United States Construction contracts. 2/21/92.

565.0030 Contract Provision. If a provision is required by law to be included in a United States construction contract, that provision must be regarded as part of that contract regardless of whether it is incorporated by written reference. 12/30/91.

565.0038 “Delivery” Defined in United States Construction Contracts. In our opinion, the term “delivery,” as used in United States construction contracts, refers to receipt by the person to whom the property is shipped. We believe that the usual meaning of this term in the context of the vendor’s delivery is that delivery occurs upon receipt by the contractor of physical possession of the delivered product.

Accordingly, a construction contractor would owe use tax on purchases delivered to it in California from out-of-state firms notwithstanding that the contract provides for “title to material purchased from a vendor shall pass to and vest in the government upon the vendor’s delivery of such material . . .” While under Uniform Commercial Code title passes from the vendor to the contractor upon delivery to the carrier, the “delivery” contemplated by the contract with the United States is the physical possession by the contractor. Thus title did not pass to the United States outside of California. Under Regulation 1521(b)(1)(A) the contractor is the consumer of materials and fixtures which it furnishes under a construction contract. 12/30/91.

565.0040 Distinction Between Federal Government Construction Contracts and Non-Government Construction Contracts, in Applicability of Tax. In the case of contracts with the Federal Government, the application of the tax differs from that in the case of a contractor with a private person or corporation in that, pursuant to express provisions of law, the sale to the contractor of any tangible personal property, whether “materials” or “fixtures,” is the taxable sale measured by the gross receipts from that sale. Even if the contractor fabricates “fixtures” from raw materials purchased by him, the tax applies not to the fair retail value of the fabricated fixtures, as in the case of non-Government contracts, but applies to the sale price of the raw material to the contractor. 2/2/51.

565.0060 Job Corps Centers. Effective October 16, 1986, pursuant to 29 USCA 1707, a sale of tangible personal property to or by, or purchase of tangible personal property by, the operator of a Job Corps Center, program, or activity under contract with the U.S. Department of Labor is exempt from sales or use tax. Such exemption applies even though the tangible personal property will be used to improve real property within sections 6007.5 and 6384. Such exemption is not retroactive. For periods prior to October 16, 1986, sales by a Job Corps Center, program, or activity were taxable, and sales to or purchases by a Job Corps Center, program or activity were taxable unless title to the tangible personal property passed from the Job Corps Center, program, or activity to the United States prior to use, and the tangible personal property was not used in improving real property. 6/12/87.

565.0075 Materials Paid for by Federal Funds. A United States “captive” contractor is the consumer of materials that it purchases to carry out improvements to realty in its contracts with the United States, notwithstanding the fact that the contractor uses federal funds to pay its vendors and it cannot perform other work without federal approval. 8/4/92.

565.0120 Overhead Expense of Related Entity. A related entity (A) which has no government contracts is related to entity (B) which does. Both share overhead expenses. Since entity (A) is a separate legal entity and not a party to entity (B)’s contracts, none of entity (A)’s overhead expenses may be allocated to entity (B)’s contracts. 8/4/92.

565.0160 **Resale Certificates**, properly given by vendee where latter resells to United States, except as to property used in performing contracts to construct improvements. 12/1/50.

565.0165 **Resale Certificates vs. Exemption Certificates**. Federal contractors may not purchase property extax under *Aerospace v. State Board of Equalization* (1990), 218 Cal.App.3d 1300 by issuing the vendor an exemption certificate. The relevant exemption is for sales of tangible personal property to the United States, not for sales of tangible personal property to United States supply contractors. The Aerospace decision related only to whether certain property was regarded as resold to the United States prior to the contractor's use or instead was used by the contractor. If the former, the contractor is entitled to purchase the property extax for resale, and the sale to the United States is exempt. If the latter, the sale to the contractor is taxable. When a contractor's supply contract with the United States comes within the Aerospace rule (i.e., the contractor is regarded as selling property in the form of tangible personal property to the United States prior to any use) it may purchase such property extax for resale by issuing the vendor a resale certificate. If however, title to the property does not pass to the United States prior to the contractor's use, the contractor may not purchase the property extax for resale. 3/31/94.

565.0175 **Safety Shoes**. A vendor sells safety shoes for use by employees of a U.S. supply contractor. The contractor provides the employees an allowance for the shoes. Any amount in excess of the allowance is withheld from employee's pay. Some of the contractor's contracts with the United States have provisions that title to property used by the contractor to fulfill the contract, passes to the United States prior to any use by the contractor.

The fact that employees reimburse the contractor for a portion of the cost of the shoes does not establish that the contractor purchased the shoes for resale. But for its contracts with the United States, the contractor would be the consumer of the shoes and the shoe vendor would owe sales tax on its sales to the contractor or use tax would apply to the contractor's use. However, the contractor is regarded as having purchased for resale those shoes which are allocated to government contracts containing the title passage provisions. With respect to all other shoes, tax applies to the sale to, or use by, the contractor. 8/20/93.

565.0177 **Sales to the Canadian Government**. A supplier, who is a United States contractor, is selling spare parts in California to Canada's Department of National Defense. The parts are stored in California for possible use in equipment either in California or in Canada.

Since the supplier transfers possession of the property to the purchaser in California, the sale takes place in the state. A person is a "United States contractor" only with respect to its performance of contracts with the United States. Since the United States is not a party to this contract, it is irrelevant whether the supplier is a United States contractor. Also, there is no specific exemption for sales to the Canadian government. Thus, the sale in California of spare parts to Canada is subject to tax. 12/2/92.

565.0178 **Sales and Construction Contracts**. Part of the Federal Acquisition Regulation (FAR) title clause 52.245.5 pertains to the time of passage of title to the government and is interpreted to apply to items sold to the government. In accordance with its provisions, with respect to the purchases of items other than fixtures and materials, title passes to the government upon the vendor's delivery to the contractor if the item is a direct item of cost for which the contractor is entitled to be reimbursed. Title to all other property passes at the time the property is committed to contract performance or reimbursement by government, whichever occurs first. Therefore, if the contractor makes any functional use of the property prior to passage of title to the government, the contractor must pay use tax measured by its purchase price of the property. Its subsequent sale of such property to the government will be exempt. 4/19/91; 4/13/93.

565.0180 **Severability of Contract**. Tax cannot be legitimately avoided by the device of splitting up what is essentially a contract to improve real property into a contract for the sale of the materials and into a contract for the installation or application of those materials. If at the time of ordering the material it is the intention of the parties that the supplier shall also put it in place, a contract for the improvement of real property is involved and the provisions of section 6384 govern. 10/15/51.

565.0183 **Supply Contract.** A contract with the U.S. Government at a military facility has three basic portions. The first portion includes providing architectural and engineering services. The second portion includes construction work consisting of site excavation, utilities, and foundation work. The third portion involves the leasing of a modular, prefabricated building that comes under the authority of the Department of Housing.

The tax application to the three portions of the contract is as follows:

- (1) Neither sales tax nor use tax applies to the architectural and engineering fees.
- (2) With respect to site improvements, contractors are the consumers of all fixtures and materials incorporated into site improvements. Thus sales tax or use tax applies to purchases made by the contractor or to subcontractors which are incorporated into site improvements. (Regulation 1521.)
- (3) Prefabricated units such as commercial coaches, house trailers, etc., registered with the Department of Motor Vehicles or the Department of House and Community Development, are tangible personal property even though they may be connected to plumbing and utilities. Neither sales tax nor use tax applies to the sale or lease of such property to the federal government. (Regulation 1521(c)(3) and Regulation 1614). Also, the contractor's or subcontractor's charge for performing work on the modular building, such as providing and installing the lights in the building, would not be subject to the tax because the materials become a part of the tangible personal property (building) sold or leased to the federal government. 12/7/90.

[565.0184](#) **Title Passage Clauses.** Tangible personal property purchased pursuant to a U.S. government nonconstruction contract, may or may not be exempt from sales tax as a sale for resale. The determinative factors are the title passage clauses in the individual contracts. Generally, if the contract provides that title passes to the government before the contractor makes any use of the property, the property may be purchased under a resale certificate. However, some contracts may also include provisions that the government will not take title to specified property such as computer software, or to certain items costing less than a specified amount. Such items should not be purchased under resale certificate. 5/12/89.

565.0185 **U.S. Construction Contracts.** Pursuant to Regulation 1521(b)(1), construction contractors are the consumers of materials and fixtures which they furnish and install and the retailers of machinery and equipment which they furnish in performing contracts with the United States. The contractor's liability for tax on materials and fixtures cannot be avoided by contract wording alleging that these items are for resale to the United States. 3/5/90.

565.0190 **U.S. Government Contractor.** A Department of Defense contractor is not exempt from tax because it is a United States contractor. Tax applies to the sale of property to the contractor that the contractor uses in the performance of contracts with the United States. If, however, the contract with the United States has an explicit provision that passes title to certain property to the United States prior to any use of the property by the contractor, then the contractor may purchase that property ex-tax for resale by issuing a timely and valid resale certificate to its vendors. 12/2/92.

[565.0195](#) **Uninterruptible Power Supply System (U.P.S.).** A U.P.S. system installed at an Air Force Base with backup generators that provide electric power for the military base operation is equivalent to a generator. Since the U.P.S. is essential to the real property as opposed to being used, for example, in a manufacturing process, it is classified as a fixture rather than machinery and equipment under Regulation 1521. Also, if the conduit and wiring are incorporated as part of the U.P.S. in such a way that they become an integral part of the U.P.S., they take on the same characteristics, i.e., fixtures. Otherwise, they are considered materials. In either case, the contractor is considered the consumer of the conduit and wiring as well as the fixtures (the U.P.S.) and, as such, the sale to the contractor is subject to tax. 1/18/94.

(b) "IMPROVEMENTS ON OR TO REAL PROPERTY"

565.0200 **Cement.** Cement purchased by a contractor with the United States to be used in laying foundation for machinery to be bolted thereon (under contract with clause passing title immediately to the U.S.), sale of, is taxable, as it is used in improving realty in United States Contract. 5/9/52.

565.0240 **Cooler Units.** Cooler units are integral parts of systems composed of ducts and other materials that comprise air-conditioning systems for the buildings to which they are attached. As such, the units are “fixtures.” (Regulation 1521(a)(5).) 3/12/57. (Am. 2003–2).

565.0248 **Device To Raise and Lower Causeway.** A device used to raise and lower a portion of a causeway to allow ships to pass underneath is classified as a fixture and not machinery and equipment. 3/19/84.

565.0255 **Dry Dock.** Work done for the United States to repair a dry dock which is attached to a pier and connected to electrical, water and compressed air lines is a contract to repair real property. Under Regulation 1521 the contractor is the consumer of materials and fixtures supplied in the course of the repair. 1/19/90.

565.0256 **Dry Dock.** Work done for the United States to repair a dry dock which is attached to a pier and connected to electrical, water and compressed air lines is a contract to repair real property. Under Regulation 1521 the contractor is the consumer of materials and fixtures supplied in the course of the repair. 12/5/89.

565.0260 **Drydock Floodgate.** Drydock floodgate is an integral part of a drydock which constitutes an improvement to real property. Tax applies to the sales price of the fabricated floodgate to the contractor performing the construction of a naval drydock to a United States Government contract. 1/29/69.

565.0265 **Dust Control Systems.** A dust control system designed to protect the environment in a building by removing dust particles from the air is an improvement to realty, and not machinery or equipment, where the dust collector sits on a platform attached to the ground by lag bolts, and ducts extend from the collector through openings in the walls of the building to the locations from which dust is collected. 1/9/79.

565.0270 **Electrical Transmission and Distribution Lines.** Electrical transmission and distribution lines within the meaning of section 6016.5 are, on and after the effective date of that section, improvements to real property. They may not be treated as “machinery and equipment” under Regulation 1521, with a resulting exemption for a contractor who installs them under a contract with the United States, whether or not they are used to power machinery and equipment. 5/29/73; 7/22/81.

[565.0276](#) **Federal Credit Unions.** Construction contracts performed for federal credit unions are not treated as U.S. government contracts pursuant to section 6384 because credit unions are not the United States. Rather, they are incorporated federal instrumentalities not wholly owned by the United States. Construction contracts performed for federal credit unions are treated as any other construction contracts, i.e., the contractor is the retailer of fixtures and the consumer of materials. However, since Regulation 1614(a)(4) specifically exempts from the tax sales to federal credit unions, the contractor should not collect sales tax reimbursement nor report such sales of fixtures as taxable. The sales of materials to the contractor are properly subject to tax as the contractor is the consumer thereof. 4/11/90.

565.0280 **Fire Alarm Systems.** Exterior fire alarms systems are improvements to real property. 4/14/66.

565.0288 **Fuel Cell.** A contract for the installation of an experimental fuel cell as an adjunct of a plant which generates process steam and electricity is a construction contract. Even though there is a possibility that the fuel cell will be removed at the conclusion of a test period, the fuel cell is a fixture and the contractor is the retailer.

If the contract is with the U.S. government, the contractor is regarded as the consumer of the fuel cell and the sale to the contractor or use of it by the contractor is subject to tax. 3/29/95.

565.0290 **Heat Exchangers.** Hot water generator tanks (heat exchangers) and expansion tanks installed at an Air Force Base pursuant to a contract with the U.S. Government are fixtures, not machinery and equipment. The heat exchanger units are a type of water heater used in conjunction with steam-producing boilers to conduct heat from steam inside coils to the water.

Water heaters are considered essential to, and accessory to, buildings and structures. At least since the revision of Regulation 1521, effective April 1, 1976, affixed water heaters of all types which are connected to water systems have been classified as fixtures, not machinery and equipment, regardless of whether they provide hot water for housekeeping, creature comfort, manufacturing, or service functions. 5/10/79.

565.0340 **Modular Anechoic Chamber Units.** Anechoic chamber units, which are radio frequency-shielded chambers, assembled from prefabricated panels and bolted together and to the floor of an existing building, are "materials" since a chamber is not "readily removable as a unit" nor "installed for the purpose of performing a manufacturing operation." 11/12/65.

565.0380 **Open Hearth Furnaces.** Brick and other material used in repairing the linings of open hearth furnaces are "materials." 10/4/56.

565.0400 **Paint Spray Booths and Built-In Floor Scales.** Paint spray booths installed in sections and bolted to the floor, adapted to the structure itself for the specific purpose of a special type of painting, constitute "fixtures."

A five ton built-in floor dial floor scale is regarded as a material or fixture rather than machinery and equipment.

Sales tax applies to the sale to the contractor of parts and materials entering into the paint spray booths and scales, or fabricated parts therefor, or, in the case of the scale, the entire scale. 4/24/53.

565.0420 **Pipe Line.** A subcontractor who fabricates and lays reinforced concrete pipe, including grading of the trench, mortaring of pipe joints, placing the sections, pointing completed joints and testing of the line, will be regarded as the consumer of the materials used in the performance of the contract. Tax applies to the sale of such materials to the subcontractor. 4/23/53.

565.0440 **Pipelines.** Pipelines installed along the shoreline and out to a pier for purposes of supplying marine vessels with fuel and water constitute improvements to realty. Similarly, pipes installed as part of a fueling system for jet bombers which extend from storage tanks to day tanks are improvements to realty. 10/31/67; 11/7/67; 6/13/79.

565.0460 **Pneumatic Lifts.** Pneumatic lifts are considered "improvements on or to real property" and are not machinery and equipment. 5/24/55.

565.0500 **Pumps.** Deep well water pumps used to furnish water for a government game refuge are improvements to realty under section 6384 of the law. 5/24/65.

565.0520 **Repairing Real Property.** Sales of tangible personal property to contractors for use in repairing, reconditioning, maintaining, or improving a housing project owned by the Federal Housing Administration are subject to sales tax, pursuant to sections 6007.5 and 6384 of the Revenue and Taxation Code, as sales of tangible personal property to a contractor or subcontractor for use in the performance of contracts with the United States for the construction of improvements on or to real property in this state. 7/26/67.

565.0540 **Road Oil.** The application of road oil to logging roads even though it only lasts for periods ranging from three to five months, constitutes an improvement to realty, and therefore the sale of road oil to a contractor for use in construction contracts with the U.S. Government is a taxable sale. 12/7/61.

565.0580 **Sand Dredging Facility.** A contractor entered into an agreement with the United States Government to provide a sand bypassing facility plant. The plant is trailer mounted on a mobile jack-up barge and includes diesel engines, pumps, motor control and monitoring system, and crane, complete with submerged pipelines, jet pumps, booster pumps, a fuel system and discharge point piping. The plant is designed to be moved within a given area and after two years the barge mounted equipment will be removed. The barge and the equipment installed thereon are not improvements to realty; however, the submerged pipelines are improvements to realty. As such, the contract for the barge and attached equipment is an exempt sale of machinery and equipment to the United States, while the contractor is the consumer of the submerged pipeline. 1/19/90.

565.0581 **Sand Dredging Facility.** A contractor entered into an agreement to provide a sand bypassing facility plant which is a trailer mounted on a mobile jack-up barge and includes diesel engines, pumps, motor control and monitor system, crane complete with submerged pipelines, jet pumps, booster pump, fuel system and discharge point piping. It is designed to be moved within a given area and after two years the barge mounted equipment will be removed. The barge and the equipment installed thereon are not improvements to realty. The submerged pipelines are improvements to realty. The contract for the barge and attached equipment is an exempt sale to the United States. The contractor is the consumer of the submerged pipeline. 12/5/89.

565.0600 **Screenline Equipment.** Screenline equipment furnished and installed in premises leased by the Federal Government for post office facilities, constitutes “fixtures” rather than machinery and equipment, and the sale thereof to the contractor is taxable as it is used in the performance of a contract to improve real property. The measure of the tax is the price paid by the contractor for the material, exclusive of installation costs, markup or fabrication costs of the contractor. 3/18/57.

565.0620 **Sprinkler System.** The installation of an automatic sprinkler protection system for United States constitutes the construction of an improvement to realty and tax therefore applies to sale to contractor of materials and supplies. 8/20/51.

565.0626 **Telephone Cable Installed in a Building—U.S. Government Contract.** A taxpayer installs telephone cable to connect PBX equipment in a building to the exterior street line. The cable is pulled or laid in existing ducts, conduits, raceways, plenums, or surface mounts between buildings in the same complex, between floors within a building, or between instruments and their common equipment. The type of installation permits removal without disturbing the building structure. The work performed constitutes the performance of a construction contract. This type cable becomes a part of the building and is a fixture. The mere fact that it can be removed without material damage is not determinative. The cable is intended to remain in place and would not be replaced often. 4/19/94.

565.0628 **Title Clause.** Generally, U.S. contractors are consumers of materials and fixtures used in the performance of contract with the United States for the construction of improvements to real property in this state. There are certain circumstances in which the inclusion of a specific contract provision may allow a contractor to avoid tax on materials and fixtures purchased by the contractor out of this state.

On April 1, 1984, the U.S. government adopted the Federal Acquisition Regulation (FAR) which replaced other acquisition regulations commonly referred to as ASPR, FPRS and DAR.

FAR provision 45.106(f)(1) requires, with certain exceptions, the insertion of clause 52.245–5, Government, Property, in contracts when a cost-reimbursement, time-and-materials, or labor-hour contract is contemplated. Subsection (c) of 52.245–5 states:

“(2) Title to all property purchased by the contractor for which the Contractor is entitled to be reimbursed as a direct item of cost under this contract shall pass to and vest in the Government upon the vendor’s delivery of such property.”

“(3) Title to all other property, the cost of which is reimbursable to the Contractor, shall pass to and vest in the Government upon—

- (i) Issuance of the property for use in contract performance;
- (ii) Commencement of processing of the property or use in contract performance; or
- (iii) Reimbursement of the cost of the property by the Government, whichever occurs first.’’

Only property coming within subsection (c)(2) would pass title to the Government upon delivery to the Contractor. If that delivery takes place at an out-of-state point, the subsequent use of the property on a contract to improve realty in California would not be taxable, as title would have passed to the U.S. before the property entered this state. If the property involved comes within subsection (c)(3), the property would be subject to tax. 7/5/89.

565.0635 Title Clause—U.S. Government Contract. A firm has a contract to build a geothermal pumping and gravity head conversion system for a private party. The private party holds a prime contract with the United States to build and operate an experimental research program. The contract between the firm and the private party provides that title to the property involved in the contract shall pass to and rest in the United States government upon delivery by the firm’s vendor. The contract further provides that such vested title shall not be affected by incorporation or attachment to nongovernment property nor shall any such government property, “become a fixture or lose its identity as personality (sic) by reason of its affixation.”

The contract is a contract to improve realty and sales tax applies to sales to the firm notwithstanding the contract language. 4/30/80.

565.0640 Title—Generator. A Canadian manufacturer of generators has a contract with the U.S. Bureau of Reclamation for supplying and installing generators, which are used to generate hydro electric power, at a project site in Northern California. If title to the generators passed to the federal government while the generators were still in Canada, sales tax would not apply because the sale occurred in Canada. Use tax would not be applicable because the Canadian manufacturer did not have title in California. 12/30/88.

565.0645 Title Passage Outside California. A United States construction contractor purchases construction materials, fixtures, machinery, and equipment outside California for use on a construction contract inside the state. The contract with the United States provides that title to all property purchased by the contractor passes to the United States upon acquisition by the contractor. No tax is due on the property purchased outside California since title passed to United States at the out-of-state location. 12/7/83.

565.0650 Transformers, Switchgear, etc. The installation of transformers, switchgear, conduit, cable, etc. by an independent electrical contractor pursuant to a contract with the federal government constituted improvements to real property. The ex-tax purchase of these items by the contractor was properly subject to use tax because the contractor was the “consumer” for sales and use tax purposes. The exemption from sales tax for tangible personal property sold to the U.S. Government is inapplicable in this instance. 9/23/76.

565.0682 U.S. Government Fuel Waste Disposal Facility. The scrubbers, blowers, tanks, pipes, pumps, control system, etc., installed in a fuel waste disposal facility built to clean up and remove hazardous waste materials that accumulated at an Air Force base are fixtures, not machinery and equipment. Sales of these items to United States government contractors are taxable. 3/22/91.

565.0688 U.S. Title Clauses. Pursuant to section 6007.5 U.S. contractors are consumers of materials and fixtures which they furnish and install in the performance of a contract with the U.S. for improvement of realty located in California. Contract provisions purporting to transfer title to property to the U.S upon acquisition by the contractor are ineffective as to construction materials and fixtures purchased in California. 11/2/93.

(c) “MACHINERY AND EQUIPMENT”

565.0700 **Auxiliary Generator.** A diesel generator set used to supply power to a computer for a missile-tracking device may qualify as “machinery and equipment” if the power generated by it is not used for a housekeeping function such as building lighting provided it otherwise meets the four conditions set forth in the regulation. 12/23/64.

565.0720 **Demountable Noise Suppressor Systems.** Demountable noise suppressor systems readily removable as a unit and intended to be moved from air base to air base as the need arises constitute “machinery and equipment.” 7/12/66.

565.0730 **Gas Turbine Generators.** Gas turbine generators, which were designed to provide power for the launch site during a lift-off of rockets at Vandenburg Air Force Base, are skid mounted and bolted to the floor of a specially made building. The units can be readily removed with a crane.

In the case of *C. R. Fedrick v. State Board of Equalization* (1988) 204 Cal.App.3d 252, the court concluded that compressors bolted to concrete foundations were fixtures even though they could be easily disassembled and removed. The court also gave consideration to the fact that although they could be moved, they were not actually relocated often.

In this case, the generators were constructed to adapt to the use and purpose of the realty. The generators qualify as fixtures. Accordingly, the U.S. government construction contractor is the consumer of the generators and sales of the units to the contractor are subject to sales tax. 9/18/91.

565.0860 **Portable Equipment.** Dictating and transcribing machines and portable doctor call units which do not become affixed to real property and which are titled in the United States Government may be purchased for resale by a third-tier contractor, by a sub-contractor and by the prime-contractor whose sale to the United States is exempt from tax. 2/11/66.

565.0880 **Retorts.** Retorts used in performing a manufacturing function in the manufacture of magnesium, are “machinery and equipment.” 4/30/53.

(d) PROPERTY USED BY CONTRACTOR—“SPECIAL TOOLING”

565.1120 **Transfer of Title from Government to Contractor—Effect of.** Personal property purchased by a nonprofit educational institution for use in a specific scientific research for the United States Government is not taxable because ASPR 13-707 provides that the United States Government acquires title to all property purchased under a cost reimbursement type contract even before such property is used. The government’s subsequent transfer of the title of the property to the contractor without consideration does not alter the tax-exempt classification of the original sale of the property to the government. 10/14/69.

(e) TITLE-PASSAGE CLAUSES

565.1140 **Aerospace Claim for Refund.** Advice was requested as to whether a taxpayer is entitled to a tax refund under the case of *Aerospace Corp. v. St. Bd. of Equalization*. The following two situations were involved.

- (1) A manufacturer is a supplier of parts and a subcontractor to a U.S. Government prime contractor. The subcontractor allocates overhead purchases to the prime contractor contract. The subcontractor’s contract, (fixed price) does not have the progress payment clause nor FAR reference numbers. However, the prime contractor’s contract does contain the progress payments clause.

The fact that the manufacturer allocates all or a portion of overhead purchases to a contract with a government contractor does not, in itself, operate as a title-passage method. Therefore, sales to the manufacturer of overhead items consumed in pursuance of its contract with a government contractor are subject to tax when the requisite title-passage clauses are absent in its contract.

- (2) An Aerospace company manufactures products only for the U.S. Government. All of its contracts are prime government contracts of which some have “Progress Payment” title clauses, FAR 52.232-16 and some do not. All of the contracts are managed by the same cost accounting systems and contract costs (including overhead material), are charged to the government monthly.

The Aerospace court’s decision pertained only to the second sentence of Regulation 1618 (b) (2). The court left the remaining principles embodied in the regulation intact. Therefore, the manufacturer’s purchase of overhead materials are considered to be taxable except for those materials allocated to contracts which have the appropriate “progress payment” title clauses. Purchases of overhead allocated to others contracts remain subject to tax. 10/15/91.

565.1141 Aerospace Contracts. Contract clause FAR 52.216-7 has an effect on title passage by determining what costs are allowable in cost-reimbursement contracts other than facilities contracts and FAR 52.216-13 has little effect on title passage since it applies to facilities contracts and persons engaged in contracts with the U.S. to improve real property. Neither of these clauses accelerates passage of title to property purchased by the contractors under the Aerospace decision. 12/14/92.

565.1149 Auto Repairs—U.S. Government Contractors. A general title provision pursuant to a contract with the United States would not necessarily pass title to parts used to repair vehicles owned or leased by a U.S. Government contractor.

However, if the contract does provide for accelerated passage of title to the parts prior to any use by the contractor, if both parties understand the provision as applying to parts purchased by the company and installed onto vehicles not owned by the United States, the title provision is controlling and the contractor is regarded as having purchased the property for resale. 12/18/92; 1/20/94.

565.1190 Canned Software. Notwithstanding recitals issued by a software publisher concerning end use limitations, canned software may be purchased for resale by a U.S. Government contractor if the contract with the United States contains an accelerated title clause passing title to the United States prior to use. 1/14/92.

(For application of tax to leased software, see Annotation 565.1325.)

565.1200 Cost Reimbursement Contracts. Sales to contractors of equipment and materials under a “cost reimbursement” contract with the U.S. Department of Health, Education and Welfare are exempt sales for resale to the United States provided:

1. There is an appropriate title clause passing title to the property to the government prior to any use by the contractor;
2. The contractor is reimbursed by the United States for his actual costs;
3. Control over the property is placed in government from time title vests in United States; and
4. The property is not used to construct improvements on or to real property. 5/8/67.

565.1230 Employee’s Reimbursable Expenses. Reimbursable employee expenses purchased by a company through the use of its credit card and properly charged to an overhead account by a U.S. contractor are allowable as sales to the United States pursuant to the *Aerospace* decision. On the other hand, purchases by employees who are reimbursed by the company are not allowable as sales to the United States, even though such costs may be charged to an overhead account. 7/15/92.

565.1260 Government Demonstration Contract. A taxpayer is a bioengineering company whose research is funded primarily by grants, cooperative agreements, or contracts with various departments of the United States government. The taxpayer is currently working on a demonstration project with the United States government to produce methane from municipal solid waste and tuna sludge, which methane

will be used to produce electricity. The taxpayer will purchase equipment for the project from various vendors and will be reimbursed by the government. The contract with the United States government contain title passage clause which is substantially identical to that provided by FAR 52.245-5(e).

Under the title passage clause, title of items of direct cost passes to the government upon the vendor's delivery of the property to the contractor. Title to "all other property," the cost of which is reimbursable as an item of indirect cost, passes to the government upon issuance of the property for use in performing the contract, commencement of processing of the property for use in contract performance, or reimbursement of the cost by the government, whichever occurs first. The Board has previously determined that, under the Aerospace rule, the clause provides for accelerated passage of title to items of both direct and indirect (i.e., overhead items) cost to the United States prior to use by the contractor. Therefore, under this title passage clause, the taxpayer may purchase property for use in performance of the contract for resale to the United States, which purchase is excluded from tax under Regulation 1668. The taxpayer should timely issue its vendors resale certificates substantially conforming to Regulation 1668. The following resale to the United States is exempt from tax under section 6381. 12/11/95.

565.1292 Impact of DCAA Audits of Federal Contractors. Audits by the Defense Contract Administration and Audit Agency generally have no impact on tax paid to the Board by federal contractors because of disallowed cost.

Under FAR and DOD title clauses, passage of title to the U.S. government is not contingent upon the government reimbursing the contractor for the purchase price of the property. Therefore, the subsequent disallowance of the expense, especially pursuant to a DCAA Audit, cannot be held to cancel the original transference of the title. The DOD FAR Supplement, Subpart 242.70, does not give the DCAA authority to rescind contracts. 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. Generally, a voluntary refund is to be used as a set-off against future debt. The regulations do not 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 contractor. Such transactions are exempt from tax under section 6402. In case of nondurable overhead items, there is a likelihood they do not exist. There can be no transfer of title to property not in existence. 4/10/91.

565.1300 Intent to Pass Title. Title passage clauses, such as "title . . . shall rest in the government and/or buyers", that are ambiguous and show no clear intent to pass title prior to use by the seller do not operate to accelerate the passage of title to overhead materials to the United States. Title clauses consistent with the *Aerospace* case generally are contained in FAR 52.232-16(d). This section does not provide for title in "government and/or buyer" but rather specifically refers only to "the government." 4/21/92.

565.1301 Intent to Pass Title—FAR 52.232-32. A United States contractor enters into a government supply contract using the Federal Acquisition Regulation (FAR) 52.232-32 title passage clause instead of FAR 52.232-16. The difference between these two clauses is that the first is a "performance-based payments clause" and the second is a "progress payments clause."

These two clauses are similar but they are not interchangeable as they have different vestiture periods. Under FAR 52.232-16, title to direct consumable supplies and overhead materials passes to the U.S. government immediately upon the date of the contract for property acquired or produced before that date. Under FAR 52.232-32, title to the property passes to the U.S. government immediately upon the date of the first performance-based payment under the contract for property acquired or produced before that date. Assuming that the date of the first performance-based payment will be some time after the date of the contract, FAR 52.232-32 may make U.S. government supply contractors more susceptible to use tax liability. This is because of the lag time between the contract date and the first progress payment date. During this lag time, the contractor has an increased chance of using the property before title is vested in the U.S. government. 4/2/03. (2004-1).

565.1325 **License of Canned Software.** A U.S. government contractor obtains a license for canned software from a vendor for its own use on a U.S. government contract that contains a title passage clause. The license is for a one year period with an obligation to return the software and any copies at the termination of the one year period. Thus, it is a lease of software rather than a purchase. The contractor will not sublicense the program to the government but rather uses it to evaluate certain criteria.

Under the court case of *United States v. SBE*, (9th cir., 1982) 683 F. 2d 316 leases to government contractors are not exempt from tax even though the contractor uses the leased property to perform a contract with the United States and will be reimbursed for the cost of the lease by the United States. The incidence of the tax is on the lessee (the contractor in this case). The lessee's passing of such cost on to the United States does not make the lease one to the United States. The charges to the contractor for the software are subject to the use tax which must be collected by the lessor. 6/22/95.

(For application of tax to purchased software, see Annotation 565.1190.)

565.1362 **Overhead Materials.** A taxpayer builds, converts, and repairs ships for the U.S. Navy. The taxpayer is not reimbursed by the government for overhead materials as direct items of cost. It has fixed price contracts which contain progress payment clause 252.217-7106 which states, in relevant part:

“(e) All material, equipment, and other property or work in process covered by progress payments made by the government shall upon the making of such progress payments become the sole property of the government, and shall be subject to the provision of Clause 252.217-7105 entitled TITLE hereof.”

Clause 252.217-7105 states, in relevant part:

“Unless title to materials and equipment acquired or produced for, or allocated to, the performance of this agreement shall have vested previously in the government by virtue of the other provisions of this agreement, title to all materials and equipment to be incorporated in any vessel or part thereof, or to be placed upon any vessel or part thereof in accordance with the requirements of the job order, shall vest in the government upon delivery thereof”

“[A]ll such contractor-furnished materials and equipment not incorporated in any vessel or part thereof, or not placed upon any vessel or part thereof, shall become the property of the contractor, except those materials and equipment the cost of which has been reimbursed by the government to the contractor.”

In order for title to the overhead materials to pass to the government prior to use by the contractor, there must be an appropriate title provision between the contractor and the government such as in the *Aerospace* case. The only title provision included in this contract is the progress payment clause. That clause provides that the payment is measured by the labor and materials incorporated in the vessel. In fact, the title clause provides that contractor-provided materials not incorporated in the vessel become the property of the contractor. Overhead materials do not include materials which are incorporated in the vessel. Thus, the government does not acquire title to the overhead materials at all in this contract, let alone prior to the taxpayer's use. Therefore, the taxpayer is liable for the use tax on the cost of the overhead items. 2/15/96.

565.1375 **Overhead Materials—DFARS Title Clause.** DFARS 52.217-7006 title clause in a U.S. Government contract provides that title to any contractor-furnished materials passed to the government as to all property “to be incorporated in the vessel in the performance of a job order, when that property is delivered to the dock. Overhead materials are not intended to be incorporated in, or placed on, any vessel.” Therefore, the DFARS clause does not cover overhead materials at all. Also, at the completion of the job, title to “all contractor-furnished materials and equipment not incorporated in, or placed on any vessel” shall revert to the contractor unless the government has already reimbursed the contractor for its cost. The “materials and equipment” to which the last phrase of DFARS 252.217-7006(b) refers are the “materials and equipment to be incorporated in a vessel” title to which passed to the United States upon delivery to the dock and to which it wishes to retain title because it has already paid the taxpayer for the cost thereof.

Thus, DFARS 52.217-7006 clause does not pass title to overhead items because (1) overhead items are not intended to be incorporated into a vessel, and (2) the government does not acquire title indirectly to property not covered by a specific title clause. That the government bears a financial burden of the purchase of the property does not mean that title to it passes to the United States (*United States v. New Mexico* (1972) 450 U.S. 720). 12/13/95.

565.1380 Overhead Materials—United States Supply Contracts. Taxpayer, a government supply contractor, is one of several subsidiaries of Corporation X with which it shares facilities in California. Corporation X acts as a holding company and provides some services to the taxpayer and its other subsidiaries. The taxpayer's purchasing department buys all overhead materials. Some items purchased are purchased directly by the taxpayer for itself or one of the other entities, but most items purchased on a recurring basis, like pencils, paper, printer supplier, 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. The taxpayer then assigns to its contracts the costs allocated to it.

The United States had audited the taxpayer and concluded that its method of allocating costs to government contracts was permissible under applicable FAR provisions. Accordingly, when the taxpayer uses the method of allocating costs of supply items approved by the United States for its contracts, the taxpayer may purchase such items for resale to the United States provided its contract passes title to such items to the United States prior to any use. 11/30/96.

565.1400 Passage of Title. The passage of title to property to the United States is not contingent upon the government reimbursing the contractor for the purchase price of the property.

Typically Department of Defense (DOD) contracts provide with respect to indirect cost items, that 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.

In many instances, the United States acquires title to the "government-furnished" property prior to reimbursing the contractor for its cost. The Federal Acquisition Regulations (FAR) require that the clauses setting forth the above principles be inserted into the contract. Under the *Aerospace Corp. v. State Bd. of Equalization* (1990) 218 Cal.App.3d 1300, 1313 [267 Cal.Rptr. 685]), these clauses control the passage of title. 4/10/91.

565.1415 Passage of Title—Qualified Production Services. A taxpayer contracted with the United States government to perform certain work which constituted "qualified production services" under Regulation 1529. Thus, under Regulation 1529, the taxpayer is the consumer of property it purchases to provide such services. At issue is whether or not *Aerospace* overrides the regulation and permits the taxpayer to buy property for resale to the United States government.

Aerospace held that the resolution of this issue is determined by the clauses of the contract. Since the contract at issue does not contain a title clause passing title to overhead items to the United States prior to use, the taxpayer is the consumer of the items that it purchased to perform qualified production services as provided in Regulation 1529. Therefore, it may not purchase such property for resale to United States. 7/29/96.

565.1460 Property Purchased for Resale. Any tangible personal property acquired pursuant to a construction contract with the U.S. Government that is not incorporated on or into real property may be purchased for resale to the government. The contract must contain appropriate title clauses passing title to

such property to the government prior to use and provide that such property is totally consumed and exclusively utilized in performing the contract. 12/17/84.

565.1520 Purchase of Meals by Government Contractor. As a result of the decision in *Aerospace v. State Board of Equalization* (1990 218 Cal.App.3d 1300), a government contract may treat indirect costs, such as overhead expenses, properly allocable to its government contracts as purchases for resale to the United States if the government contract involved contains appropriate title passage clauses. A restaurant may sell meals ex-tax to a government contractor if the contractor issues a valid and timely resale certificate which includes a statement that the specific property is being purchased for resale to the Federal government, pursuant to the contract and in the regular course of business.

(Note: The sale must be to the contractor and not merely to employees of the contractor who receives expense reimbursement.) 11/15/93.

565.1585 Resale Certificate—U.S. Government Overhead Items. In a situation where a U.S. Government contractor is buying an overhead item (such as tax reference books) which it will use in the performance of both government and commercial contracts, and those government contracts contain the appropriate title passage clauses, the *Aerospace* decision permits the contractor to allocate part of the purchase price to its government contract.

Accordingly, the contractor may purchase the item for resale by issuing a resale certificate to the seller. It must then report and pay use taxes on the amount of the sale price allocable to the commercial contract. 2/26/92.

565.1600 Resale Certificates. Where a contractor is buying an overhead item which it will use in the performance of both its commercial and governmental contracts and those governmental contracts contain the appropriate title passage clauses, the *Aerospace* decision permits the contractor to allocate part of the purchase price to its government contracts. The contractor may thus purchase the item ex-tax by issuing a resale certificate to the seller. The contractor must then report and pay use tax on the amount of the sales price allocated to the private and commercial contracts. 2/26/92.

565.1685 Software Maintenance Contracts. Canned software packages can be purchased for resale under the *Aerospace Corp. v. SBE* (1990) 218 Cal.App.3d 1300 decision even though there are restrictions against transfer in the licensing package, provided the contract that the contractor has with the United States has the appropriate set of title clauses.

When the general principles embodied in the FAR title clauses conflict with specific principles provided in an agency-peculiar procurement supplements to FAR, the agency supplements control. For example, some supplements have provided that, if the software displays a legend, it is subject to the restrictions with respect to passage of title. In these cases, title to the software stays with the contractor (e.g., DFAR 252.227-7013). Thus, in these cases, reference needs to be made to the supplements as well as the FAR clauses in determining whether an appropriate title clause is in effect. 6/13/94; 1/30/96.

565.1700 Special Tooling. A taxpayer entered into a contract with the Navy to develop and deliver two prototype aircraft. As part of the contract, the taxpayer 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 particular aircraft being developed and related supplies and parts.

Contract Clause H, “Contractor Investment in Special Tooling and Special Tooling Equipment,” provides in part that the contractor will acquire, own, and retain title to all new production special tooling and special tooling equipment. This clause also states that in the event the contractor elects to dispose of the ST/STE, the government will have the right of first refusal to acquire ST/STE at a mutually agreed price.

The contract also contains FAR contract clauses in the agreement. Clauses 52.245-17, Special Tooling (Apr 1984) and 52.245-18, Special Tooling Equipment (Apr 1984), were checked off as being included in the contract. The designation for each clause also had under it, in handwriting, the following phrase: “Also

see section H, Special Contract Requirements entitled ‘Contractor Investment in Special Tooling and Special Test Equipment’.”

Under these facts, the taxpayer purchased 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 the taxpayer for its costs of manufacturing or acquiring the ST/STE and that its acquisition provided a benefit to the Navy does not in itself create a sale to the Navy. (*United States v. New Mexico* (1982) 455 U.S. 720, 735). 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 to be regarded as purchasing the property for resale (no tax). (*Lockheed Aircraft Corp. v. S.B.E.* (1978) 81 Cal.App.3d 257; 265–266.)

No such clauses exist in this contract. Actually, Clause H specifically provides that the taxpayer retains title to ST/STE. The provisions of FAR 52.245–17 and 52.245–18 do not mandate a different result since these clauses were modified in handwriting to incorporate the provisions of Clause H. Even if these two FAR clauses provided for some sort of title transfer, those terms were modified by the terms of Clause H.

Thus, the taxpayer retains full title to the ST/STE with the government getting a right of first refusal in the event the taxpayer decides to dispose of the property. There was no sale to the Navy. Therefore, the taxpayer owes tax measured by the cost of the ST/STE. 8/28/95.

565.1800 Title Clauses. One must look to the clause included in the contracts, whether fully set forth or incorporated by reference, to determine if tangible personal property purchased by a government contractor for use in performing his contract(s) passed to the United States prior to use by the contractor. Lacking such clauses, there is no accelerated title passage. Inferences cannot be made that such a clause is a required part of the contract. 5/20/93.

565.1804 Title Passage at Out-of-State Point. An out-of-state construction contractor enters into a contract with the United States to improve realty in California. The contract provides for passage of title to all property when payment is received. The contractor purchases property outside California and fabricates the property outside California. The property is not installed in California until after payment is received. Since title passed on payment, and payment occurred before the property was brought into California, no tax is due. The property belonged to the United States when it entered the state. 2/24/95.

565.1805 Title Passage Clauses. There can be no sales to the United States Government if the appropriate title passage clauses are not contained in the contracts, even though the government acquisition regulations require that such clauses be included with respect to certain kinds of contracts. 7/15/92.

565.1810 Title Passage Clauses. A prime contract between the U.S. government and a prime contractor contains a title passage clause from the Federal Acquisition Regulation (FAR) such that title to overhead supplies and direct consumables passes from the prime contractor to the U.S. government prior to any use by the prime contractor. According to Regulation 1628(b)(3)(D), similarly patterned title passage clauses in a subcontract between the prime contractor and its subcontractor(s) or in a supply contract between the subcontractor(s) and its supplier(s) also serve to pass title to the U.S. government prior to any use by the prime contractor. When the prime contract does not include a FAR title passage clause, tax will be owed by one of the parties, depending upon where the title has vested when the use of the property occurs.

These clauses can be in one of two forms. The first form is an actual rewriting of the FAR clause with the name of the prime contractor substituted for the federal government and the name of the subcontractor substituted in place of the name of the prime contractor. The second form is an incorporation of the FAR clause by reference and the addition of a paragraph to the contract stating that where the FAR clause states the buyer is the government, the parties intend that the buyer is the prime contractor, and where the FAR clause refers to the prime contractor as retailer or seller, the parties intend such reference to be to the subcontractor. Either type of clause should be effective to avoid the application of sales tax or use tax to that transaction. 06/26/02. (2003–2).

565.1925 **Title Passage Prior to Use.** A review of Federal Acquisition Regulations (FAR) leads to the following conclusions regulating the passage of title of property to the United States under a contract with U.S. Government contractors:

(A) Government Property in General

For title to overhead materials or direct cost items to pass to the government prior to use by the contractor, the contract must provide for passage of title upon allocation of the property to the contract. This applies regardless of whether the contract is fixed price or cost reimbursable.

(B) Special Tooling and Special Test Equipment

Title to special tooling and special test equipment does not pass immediately to the U.S. The U.S. must take affirmative action in order to obtain title.

(C) Research and Development Contracts with Nonprofit Educational or Research Institution

On fixed price contracts, title to supplies passes to the U.S. upon formal acceptance unless the contract provides for earlier passage of title. On cost reimbursement contracts title to equipment having an acquisition cost of less than \$1,000 vests in the contractor. Title to equipment having an acquisition cost of over \$1,000 passes as set forth in the contract. Title to direct cost property passes to the U.S. upon allocation to the contract. Title to special test equipment remains with the contractor. Title to special tooling and special test equipment remains with the contractor until the U.S. takes affirmative action to obtain title. 3/13/92.

565.2500 **United States Contractors.** A U.S. contract did not contain a progress payment title clause passing title to the property in question prior to use. The contract did have a provision passing title to all materials and equipment acquired for the vessel. Direct consumable supplies do not fit this category as they may be for use on the vessel, but are clearly not for the vessel. The sale of such direct consumable supplies to the contractor was, thus, not a sale for resale but, instead, was a taxable retail sale. 2/13/86.