



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0043
(916) 445-1441 • FAX (916) 322-7175
www.boe.ca.gov

BETTY T. YEE
First District, San Francisco

SEN. GEORGE RUNNER (Ret.)
Second District, Lancaster

MICHELLE STEEL
Third District, Rolling Hills Estates

JEROME E. HORTON
Fourth District, Los Angeles

JOHN CHIANG
State Controller

KRISTINE CAZADD
Executive Director

March 9, 2012

Dear Interested Party:

Enclosed are the Agenda, Issue Paper, and Revenue Estimate for the March 20, 2012 Business Taxes Committee meeting. This meeting will address the proposed amendments to Regulation 1618, *United States Government Supply Contracts*.

Action 1 on the Agenda concerns proposed amendments to Regulation 1618 to address the deletion of Federal Acquisition Regulation 52.245-17, *Special Tooling*, and clarify the application of tax on purchases of direct and indirect consumable supplies. Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in this issue.

Thank you for your input on these issues and I look forward to seeing you at the Business Taxes Committee meeting at **10:00 a.m.** on **March 20, 2012** in Room 121 at the address shown above.

Sincerely,

Jeffrey L. McGuire, Deputy Director
Sales and Use Tax Department

JLM: 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 email)

Mr. Robert Thomas, Board Member's Office, Fourth District

Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichel, 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. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Kristine Cazadd
Mr. Randy Ferris
Ms. Christine Bisauta
Mr. Robert Tucker
Mr. Cary Huxsoll
Ms. Susanne Buehler
Ms. Kirsten Stark
Ms. Leila Hellmuth
Ms. Judi Pierce
Ms. Lynda Cardwell

AGENDA — March 20, 2012 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1618, *United States Government Supply Contracts*

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.~~ Effective June 14, 2007, “Tools” as used in this definition includes “special tooling” that was previously covered by Federal Acquisition Regulation (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 and consistent with government cost accounting standards.

(b) Application of Tax.

(1) 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.

(2) Whether title to direct consumable supplies ~~and~~ or indirect consumable supplies (i.e., 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~~

(A) For direct consumable supplies, which are charged direct to the United States government contract, title passes to the United States government pursuant to the title passage clause(s) associated with that specific contract.

~~(A)~~(B) For indirect consumable supplies (i.e., overhead materials) which are charged to an expense account which is then allocated to various locations, cost centers or contracts,

AGENDA — March 20, 2012 Business Taxes Committee Meeting
Proposed Amendments to Regulation 1618, *United States Government Supply Contracts*

~~some of which are engaged in other than United States government cost reimbursement contracts and/or fixed price contracts with a progress payments clause,~~ it will be considered that title ~~did not~~ passed to the United States government prior to use of the property, and tax will not apply with respect to the purchase or use of the property charged to the expense account, ~~unless if~~ the item is ~~specifically accounted for as being charged~~ allocated 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-allocated~~ to a specific United States government supply contract when it is allocated pursuant to:

~~(1)~~ 1. Accounting standards promulgated by the Cost Accounting Standards Board (Office of Federal Procurement Policy, Office of Management and Budget), if applicable; otherwise,

~~(2)~~ 2. Generally accepted accounting principles that are equitable, consistently-applied, and appropriate to the particular circumstances.

Direct consumable supplies identified in subdivision (b)(2)(A) and indirect consumable supplies (i.e., overhead materials) which may be allocated in ~~this-the~~ manner identified in subdivision (b)(2)(B) 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 through June 13, 2007, 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.

Issue Paper Number **12-001**



BOARD OF EQUALIZATION
KEY AGENCY ISSUE

- Board Meeting
- Business Taxes Committee
- Customer Services and Administrative Efficiency Committee
- Legislative Committee
- Property Tax Committee
- Other

Proposed Amendments to Regulation 1618, *United States Government Supply Contracts*

I. Issue

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

II. Alternative 1 - Staff Recommendation

Staff recommends the Board approve and authorize publication of proposed amendments to Regulation 1618 to:

- Address the deletion of FAR 52.245-17, *Special Tooling*,
- Separate for clarity the discussion of the application of tax on purchases of direct consumable supplies and indirect consumable supplies, and
- Update the wording throughout the regulation for clarity.

Mr. Joe Vinatieri and the Aerospace Industries Association (AIA) agree on the proposed amendments. The proposed amendments are attached as Exhibit 2.

III. Other Alternative Considered

Do not amend Regulation 1618.

Issue Paper Number 12-001

IV. Background

FAR is the United States Government regulation governing the “acquisition process,” which is the process through which the government purchases goods and services, including the passage of title to the United States Government when purchasing goods from government supply contractors. FAR Parts 1 through 51 discuss policies and procedures and Part 52 provides the clauses that are inserted into contracts. FAR is updated regularly but in 2007 there was a major rewrite of Part 45, *Government Property*, and the related clauses in Part 52.2, *Text of Provisions and Clauses*. Several government property clauses were combined into one clause. Regulation 1618 provides guidelines for the application of tax to purchases and sales made by United States Government supply contractors and references FAR. 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 passes 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 0411.00 through 0411.25 and Exhibits 10A through 10F. The audit manual sections discuss the application of tax to direct and indirect consumable supplies based on the type of contract (fixed price or cost-type) and the specific title clauses included in the contract.

Staff recommends Regulation 1618 be updated to reflect the new consolidated clause under FAR 52.245-1 and the deletion of the separate clauses for “special tooling” and “special test equipment.”

Staff met with interested parties on August 18, 2011, November 29, 2011, and January 17, 2012, to discuss and refine the proposed changes to the regulation. At these meetings, staff and interested parties also discussed revisions to Audit Manual Chapter 4, sections 0411.00 through 0411.25 and Exhibits 10A through 10F, to reflect the changes to FAR. The proposed revisions to the audit manual have been postponed until the May 2012 Business Taxes Committee meeting to allow staff and interested parties to further discuss and possibly resolve some of the outstanding audit procedure issues.

The proposed amendments to Regulation 1618 are scheduled for discussion at the March 20, 2012 meeting of the Business Taxes Committee.

V. Discussion

Regulation 1618 – Exhibit 2

Revisions Based on Changes to FAR

In the 2007 FAR rewrite, FAR 52.245-17, *Special Tooling*, was deleted. However, subdivision (a)(2) of Regulation 1618 currently provides in part:

“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.

In addition, subdivision (b)(2) of the regulation currently provides, in part:

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.

Issue Paper Number 12-001

Staff and AIA propose to amend the regulation to reflect the deletion of FAR 52.245-17. Following the deletion of FAR 52.245-17, special tooling is included in “direct consumable supplies” as defined by the regulation.

Revisions Recommended for Clarity

Before the *Aerospace* decision, the regulation separately discussed the application of tax to sales of direct consumable supplies and indirect consumable supplies. When the regulation was amended after the decision, the discussion of the application of tax to direct consumable supplies was combined with the discussion of the application of tax to indirect consumable supplies. Staff and AIA agree that clarification is needed in this area and propose reorganizing subdivision (b) and rewording the discussion of indirect consumable supplies (overhead materials) to provide clarification of whether title passes to the United States Government prior to use.

Non-substantive Changes to the Regulation

In addition, staff and AIA propose various non-substantive grammatical changes and corrections throughout the regulation.

VI. Alternative 1 - Staff Recommendation

Staff and AIA recommend the Board approve and authorize publication of proposed amendments to Regulation 1618, *United States Government Supply Contracts*, as proposed in Exhibit 2.

A. Description of Alternative 1

Regulation 1618

The proposed amendments to Regulation 1618 include:

- Throughout the regulation - Number previously unnumbered paragraphs to provide points of reference and to comply with regulatory numbering protocol.
- Subdivision (a)(2) - Delete the last sentence to reflect that FAR no longer excludes “special tooling” from the definition of tools, and add an effective date for the inclusion of special tooling in direct consumable supplies.
- Subdivision (a)(3) - Add a statement that the allocation of overhead materials must be consistent with government cost accounting standards.
- Subdivision (b)(2)(A) and (B) - Separate the discussion of the application of tax to supplies into direct consumable supplies and indirect consumable supplies.
- Subdivision (b)(2)(B) - Delete the reference to title passage when indirect consumable supplies are allocated to contracts, some of which are other than government cost reimbursement contracts or fixed price contracts in which title transfers prior to use.
- Subdivision (b)(3) - Add a sunset date for the application of FAR 52.245-17. Following the sunset date, special tooling is included in the definition of direct consumable supplies.

B. Pros of Alternative 1

- Reflects current FAR provisions in the regulation.
- Clarifies tax applications of direct consumable supplies and indirect consumable supplies.

Issue Paper Number 12-001

C. Cons of Alternative 1

None.

D. Statutory or Regulatory Change for Alternative 1

The regulation requires amendment. No statutory change is required.

Operational Impact of Alternative 1

Staff will notify taxpayers of the amended regulation through outreach efforts.

E. Administrative Impact of Alternative 1

1. Cost Impact

The workload associated with publishing the regulation, audit manual, and outreach efforts are considered routine. Any corresponding cost would be absorbed within the Board's existing budget.

2. Revenue Impact

None. See Exhibit 1.

F. Taxpayer/Customer Impact of Alternative 1

None.

G. Critical Time Frames of Alternative 1

Implementation of the regulation will begin 30 days following approval of the regulation by the State Office of Administrative Law.

VII. Other Alternative

A. Description of Alternative 2

Do not amend the regulation.

B. Pros of Alternative 2

None.

C. Cons of Alternative 2

The regulation will not accurately reflect current FAR provisions.

D. Statutory or Regulatory Change for Alternative 2

None.

E. Operational Impact of Alternative 2

None.

Issue Paper Number 12-001

F. Administrative Impact of Alternative 2

1. Cost Impact

None

2. Revenue Impact

None. See Exhibit 1.

G. Taxpayer/Customer Impact of Alternative 2

Regulation will not accurately reflect the current provisions of the FAR.

H. Critical Time Frames of Alternative 2

None

Preparer/Reviewer Information

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

Current as of: February 28, 2012

REVENUE ESTIMATE

STATE OF CALIFORNIA
BOARD OF EQUALIZATION



Proposed Amendment to Regulation 1618, *United States Government Supply Contracts*

I. Issue

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

II. ALTERNATIVE 1 - STAFF RECOMMENDATION

Staff recommends the Board approve and authorize publication of proposed amendments to Regulation 1618 to:

- Address the deletion of FAR 52.245-17, *Special Tooling*,
- Separate for clarity the discussion of the application of tax on purchases of direct consumable supplies and indirect consumable supplies, and
- Update the wording throughout the regulation for clarity.

Mr. Joe Vinatieri and the Aerospace Industries Association (AIA) agree on the proposed amendments. The proposed amendments are attached as Exhibit 2.

III. Other Alternative Considered

Do not amend Regulation 1618.

Background, Methodology, and Assumptions

Alternative 1 – Staff Recommendation

There is nothing in staff recommendation that would impact sales and use tax revenue. Staff recommendation only amends Regulation 1618 to conform to the FAR or Title 48 Code of Federal Regulations (CFR), Part 52. Staff recommendation would:

- Throughout the regulation - Number previously unnumbered paragraphs to provide points of reference and to comply with regulatory numbering protocol.

FORMAL ISSUE PAPER 12-002

- Subdivision (a)(2) - Delete the last sentence to reflect that FAR no longer excludes “special tooling” from the definition of tools, and add an effective date for the inclusion of special tooling in direct consumable supplies.
- Subdivision (a)(3) - Add a statement that the allocation of overhead materials must be consistent with government cost accounting standards.
- Subdivision (b)(2)(A) and (B) - Separate the discussion of the application of tax to supplies into direct consumable supplies and indirect consumable supplies.
- Subdivision (b)(2)(B) - Delete the reference to title passage when indirect consumable supplies are allocated to contracts, some of which are other than government cost reimbursement contracts or fixed price contracts in which title transfers prior to use.
- Subdivision (b)(3) - Add a sunset date for the application of FAR 52.245-17. Following the sunset date, special tooling is included in the definition of direct consumable supplies.

Other Alternatives Considered

Alternative 2 – Do not amend Regulation 1618.

There is nothing in the alternative 2 that would impact on sales and use tax revenue.

Revenue Summary

Alternative 1 – Staff recommendation does not have a revenue impact.

Alternative 2 – Does not have a revenue impact

Preparation

Mr. Bill Benson, Jr., Research and Statistics Section, Legislative and Research Division, prepared this revenue estimate. Mr. Robert Ingenito, Chief, Research and Statistics Section, Legislative and Research Division, and Ms. Susanne Buehler, Chief, Tax Policy Division, Sales and Use Tax Department, reviewed this revenue estimate. For additional information, please contact Mr. Benson at (916) 445-0840.

Current as of March 5, 2012.

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.~~ Effective June 14, 2007, “Tools” as used in this definition includes “special tooling” that was previously covered by Federal Acquisition Regulation (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 and consistent with government cost accounting standards.

(b) Application of Tax.

(1) 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.

(2) Whether title to direct consumable supplies and or indirect consumable supplies (i.e., 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~~

(A) For direct consumable supplies, which are charged direct to the United States government contract, title passes to the United States government pursuant to the title passage clause(s) associated with that specific contract.

~~(A)(B)~~ F—or indirect consumable supplies (i.e., 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 clause,~~ it will be considered that title did not pass to the United States government prior to use of the property, and tax will not apply with respect to the purchase or use of the property charged to the expense account, unless if the item is specifically accounted for as being charged/allocated 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-allocated to a specific United States government supply contract when it is allocated pursuant to:

~~(1)~~— 1. A accounting standards promulgated by the Cost Accounting Standards Board (Office of Federal Procurement Policy, Office of Management and Budget), if applicable; otherwise,

~~(2)~~ 2. G generally accepted accounting principles that are equitable, consistently-applied, and appropriate to the particular circumstances.

Direct consumable supplies identified in subdivision (b)(2)(A) and indirect consumable supplies (i.e., overhead materials) which may be allocated in ~~this the~~ manner identified in subdivision (b)(2)(B) 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.

~~(2)(3)~~ Special Tooling. Effective December 29, 1989 through June 13, 2007, 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.