

Memorandum

565.1810

VIA FAX AND U. S. MAIL

To : Mr. ---
San Diego District (FH)

Date: June 26, 2002

From : Jeffrey H. Graybill
Senior Tax Counsel

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Subject: Title Passage Clauses

This responds to your memorandum to District Principal Auditor --- ---, dated July 18, 2001, regarding the use of title passage clauses in contracts between U. S. government contractors and their subcontractors. Your memorandum was forwarded by --- --- to the Legal Division for a response. A copy of your memorandum is attached. I apologize for the delay in responding.

I first want to thank you for the time you gave me during our telephone conversation of June 21, 2002. It was helpful to be able to discuss your memorandum, and the background of the questions you asked.

Your questions arise in the context of contracts under which the United States has contracted with a prime contractor to provide some tangible personal property. (The "Prime Contract.") The prime contractor then enters into a subcontract with a subcontractor (the "Subcontract"), and the subcontractor may in turn contract with a supplier under a supply contract (the "Supply Contract"). I assume for purposes of this memorandum that none of the contracts in question are for construction of improvements on or to real property, so we are not concerned with Revenue and Taxation Code section 6007.5 and Regulation 1521 (b)(1). If these are construction contracts for improvements to real property, our opinion would be different.

The Prime Contract may or may not include a title passage clause from the Federal Acquisition Regulation ("FAR"). Such clauses essentially state (for purposes of this memorandum) that if the prime contractor purchases either overhead supplies that will be consumed in the performance of the Prime Contract, or direct consumables (which are items of equipment necessary for the prime contractor to complete its performance, but for which the government does not desire delivery or possession), title to the goods passes to the government prior to their use by the prime contractor. Such clauses are important for the prime contractor, because a prime contractor typically makes purchases of overhead supplies or direct consumables

with a resale certificate, and if title does not pass to the government before use by the prime contractor, it will be required to pay use tax arising from such purchases. When the U. S. government contract (the Prime Contract) has a title clause, the prime contractor can avoid the taxes.

Your questions arise in connection with Subcontracts issued by prime contractors, and Supply Contracts issued by subcontractors. Apparently the practice has become to include clauses in these contracts that purport to pass title to the overhead supplies and direct consumables before use by the subcontractor. These clauses come in two forms. In the first model, which is reflected in question #1 in your memorandum to Kenneth Fox, the parties re-write the title clause from the FAR, but they substitute the name of the prime contractor for the federal government, and they insert the name of the subcontractor for the name of the prime contractor. You asked if such a provision in the Subcontract would suffice to relieve the subcontractor of the duty to report and pay tax on its sale to the prime contractor, and whether it would relieve the duty of the prime contractor to report and pay use tax on its purchase, if it made the purchase using a resale certificate.

The second form of modified clause occurs when, rather than re-write the title passage provision, the parties simply incorporate the FAR clause by reference, and add a paragraph to the Subcontract or Supply Contract stating that where the FAR clause states that 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. As with the first model, your question is whether such an effort to state that title passes before use will be effective to avoid the payment of tax.

Gross receipts from sales to the U.S. government are exempt from sales tax. (Reg. 1614.) However, when the prime contractor uses tangible personal property that it will sell to the government before the sale, the prime contractor owes use tax on the purchase price it paid for the property (assuming it issued a resale certificate to its vendor). The prime contractor can avoid payment of the use tax via the title passage provision in the contract with the government. So your question is, can the same theory apply to the Subcontract and the Supply Contract, and if the theory applies, does it do so in connection with both the re-written clause and the clauses that are incorporated by reference and "modified" with a provision that changes the names of the identified parties?

Regulation 1628(b)(3)(D) explains that the sale occurs at the time and place when the retailer completes its performance with respect to physical delivery of the property, unless the parties have specifically contracted otherwise. In the case of each of the title passage clauses discussed above, the parties are in fact contracting for title to pass at a time prior to the retailer's use of the property.

Therefore, as long as the Prime Contract includes a FAR clause that passes title to the government before use, the provision in the Subcontract to pass title to overhead supplies and

direct consumables to the prime contractor before use should be effective to avoid the application of sales tax or use tax to that transaction. In other words, when the subcontractor acquires some overhead supplies and direct consumables for use in performing its contract with a prime contractor, title will pass to the prime contractor immediately and before use by the subcontractor, and when the prime contractor has title, under the title passage clause in its Prime Contract with the government, the title it received will pass immediately to the government. However, when the Prime Contract does not include a title passage clause, tax will be owed by some party, depending upon where the title has vested when the use of the property occurs.

If you need further assistance, please feel free to write again.

JHG/bb

Attachment: Mr. --- --- Memorandum to Mr. --- ---

cc: Mr. --- --- (FH)
Ms. --- --- (MIC: 92)