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September 20, 2005

Ms. Laurieann Duarte  
FAR Secretariat  
General Services Administration  
Regulatory Secretariat (VIR)  
1800 F Street N.W.  
Room 4035  
Washington, D.C. 20405

**Re: Proposed Changes to Government Property Provisions –  
FAR Case 2004-025**

Dear Ms. Duarte:

I am submitting these comments pursuant to 70 F.R. 54878, September 19, 2005, with respect to proposed revisions to the FAR addressing government property. My comments pertain exclusively to two issues: (1) elimination of passage of title to property accounted for in overhead under cost type contracts<sup>1</sup>; and (2) providing unlimited discretion in contracting officials to insert the "as is" government property clause in both fixed price and cost type contracts. Both revisions are inimical to the public interest and, in the case of

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<sup>1</sup> For the past eleven years I have been extensively involved in issues relating to state sales tax "sale for resale" exemptions and refunds related to overhead property acquired by contractors. I litigated the only recent ASBCA cases relating to this issue, General Dynamics Corp., ASBCA No. 49339, 97-2 BCA ¶ 29,167 (on summary judgment), and National Steel and Shipbuilding Co., ASBCA No. 50960 (disposed of by settlement). I served as an expert witness on passage of title on behalf of Raytheon in Strayhorn v. Raytheon E-Systems, Inc., 101 S.W.3d 558 (Tex. Ct. App. 2003), petition for review denied, 2003 Tex. LEXIS 320 (Tex. 2003). I have also written extensively on the subject: Johnson, "Price Adjustment Clauses for State and Local Taxes in Federal Government Contracts; *Aerospace* and Taxes Charged to Contracts Through Overhead," 26 Pub. Contr. L. J. 599 (1997); Johnson and Buie, "Taxes, Refunds, Credits and Cash: Handling the Government's Share of Sales and Use Taxes Refunded Under *Aerospace Corp. v. State Board of Equalization*," 28 Pub. Contr. L. J. 449 (1999); Johnson, "'Cash Versus Credit': The Application of Federal Appropriations Law to Refunds and Rebates in Contractor Overhead," 30 Pub. Contr. L. J. 9 (2000); Johnson, "The Implication of the Virginia State Sales Tax Increase for Federal Contractors," Federal Contracts Report, Vol. 81, No. 21, p. 2 (June 2004).

the title passage issue, will overturn existing law and result in hundreds of millions of dollars of increased costs under government cost type contracts.

### Title to Overhead Property Under Cost Type Contracts

Under FAR provisions that have been in place since the end of WWII, the Government acquires title to property acquired by contractors and accounted for in indirect cost (overhead) in two different ways. For fixed price contracts containing the Progress Payments clause (FAR 52.232-16) title to overhead property passes pursuant to paragraph (d)(2). Under cost type contracts title to overhead property passes under FAR 52.245-5(c)(3).<sup>2</sup>

On the basis of these title passage provisions, at least six states<sup>3</sup> have exempted contractor purchases of overhead property from state sales and use taxes. These exemptions, which are the result of the application of state law and do not involve any federal constitutional immunity, have resulted in significant savings to the Government under cost type contracts and subcontracts.<sup>4</sup> As just one example, the *refunds* in California for open contractor sales tax years following the 1990 decision in *Aerospace*<sup>5</sup> totaled approximately \$500,000,000, much of which related to cost type contracts and inured to the Government's benefit.<sup>6</sup> This figure does not take into account the permanent decrease in state sales and use taxes to be reimbursed by the Government now and in the future, not only in California but in all of the states that have recognized the *Aerospace* precedent. These decreased sales and

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<sup>2</sup> Johnson, "The Implication of the Virginia State Sales Tax Increase for Federal Contractors," *Federal Contracts Report*, Vol. 81, No. 21, p. 2 (June 2004); see also Wyatt, "The 'Three Musketeers' of Overhead Property: *Motorola*, *Hughes*, and *Raytheon* Cases," *Journal Of Contract Management*, p. 23 (Summer 2005).

<sup>3</sup> California, Missouri, Arizona, Maine, Texas and Illinois.

<sup>4</sup> In Illinois, the exemption was implemented by regulation. See Ill. Adm. Code § 130.2706, effective August 13, 2001. In California, Missouri, Arizona and Maine, state court decisions resulted in application of the exemption. *Aerospace Corp. v. State Board of Equalization*, 218 Cal. App. 3d 1300 (1990); *McDonnell Douglas Corp. v. Director of Revenue*, 945 S.W.2d 437 (Mo. 1997) (en banc); *Motorola, Inc. v. Arizona Dep't of Revenue*, 993 P.2d 1102 (Ariz. Ct. App. 1999); *Bath Iron Works v. State Tax Assessor*, No. AP-00-80 (Me 2000); *Strayhorn v. Raytheon E-Systems, Inc.*, 101 S.W.3d 558 (Tex. Ct. App. 2003), petition for review denied, 2003 Tex. LEXIS 320 (Tex. 2003).

<sup>5</sup> *Aerospace*, *supra*, 218 Cal. App. 3d 1300.

<sup>6</sup> Johnson and Buie, "Taxes, Refunds, Credits and Cash: Handling the Government's Share of Sales and Use Taxes Refunded Under *Aerospace Corp. v. State Bd. of Equalization*," 28 Pub. Cont. L.J. 451 (1999).

use taxes have made additional much needed appropriations available to the procuring agencies for the purchase of vital defense equipment.

The exact provision that has produced this significant savings under cost type contracts is the following portion of the current clause in FAR 52.245-5(c):

(3) Title to all other property [property other than that to which the contractor is entitled to be reimbursed as a direct item of cost], 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 for use in contract performance; or
- (iii) Reimbursement of the cost of the property by the Government, whichever occurs first.<sup>7</sup>

The proposed revision to the FAR would eliminate this provision, and with it the exemption enjoyed by the Government from sales and use taxes on contractor overhead property allocable to cost type contracts. The new "all purpose" Government Property clause at FAR 52.255-1 would now state with respect to passage of title only the following:

*(e) Title to Contractor-acquired property.* 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 . . . .  
(emphasis added).

It seems clear that the FAR drafters have failed either to be aware of or focus on the costly impact of this revision, which would eliminate the state law "sale for resale" exemption for overhead property allocable to cost type contracts. This conclusion seems all the more likely, as the regulatory system envisaged by the proposed revisions would defy both logic and consistency. Thus, no exemption from state sales and use taxes would now be available for overhead property under cost type contracts, under which the Government

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<sup>7</sup> See the California, Missouri, Arizona and Texas cases cited in footnote 4, above.

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*directly* reimburses the contractor with each payment voucher. But the exemption would continue to be available under fixed price contracts containing the Progress Payments clause, where the Government shoulders the cost of the taxes only through payment of the contract price. If the FAR drafters have made a policy decision based on some unarticulated logic that title should not pass to overhead property under cost type contracts, they should be consistent in their approach to the same question under fixed price contracts. If the proposed revision reflects a decision to benefit the state treasuries at the expense of the Federal Government under cost type contracts, there should be no reason for a different policy under fixed price contracts.

For these reasons the proposed revision should be withdrawn and full consideration given to the issues noted.

#### Government Property Furnished "As Is"

Under current regulations, the "As Is" Government Property clause, FAR 52.245-19, is permitted to be used *only* in fixed price, time and materials and labor hour contracts. See FAR 45.308-2. Moreover, the "As Is" clause may *only* be inserted in such contracts where the pre-condition of an opportunity for a meaningful pre-contract inspection is met. FAR 45.308-1(b). By contrast, the "As Is" clause may *not* be inserted in cost type contracts under any circumstances. See FAR 45.106(f)(1), mandating the clause at FAR 52.245-5 for cost type contracts.

Under the proposed revision, contracting officials, in lieu of current law, would have untrammelled discretion to insert the "As Is" provision in *any* type of contract without limitation. Proposed 52.245-1 would state in paragraph (d):

- (iii) The Government may, *at its option*, furnish property in an "as is" condition. (emphasis added).

The quoted provision, included in the new "one size fits all" Government Property clause, would apply to cost contracts as well as to fixed price contracts. Moreover, the proposed regulation and clause would no longer refer to the precondition of FAR 45.308-1(b) mandating a meaningful pre-contract inspection. In addition, as noted above, this precondition applies only to fixed price, time and material and labor hour contracts. Even if the provision were determined to continue to be applicable to such contracts, *it would have no application to cost type contracts*. Instead, under cost type contracts, the contractor would

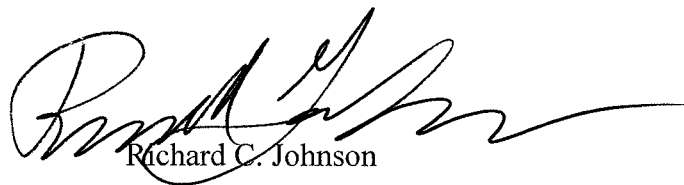
be entirely at risk for the condition of the property, *with no contractual right to a pre-contract inspection*.<sup>8</sup> To impose such a draconian rule on a cost type contractor would fundamentally alter the nature of cost contracting itself, under which minimum risk is allocated to the contractor in return for limited fees on estimated cost. Fixed price contractors may include contingencies in their prices where government property is furnished "as is." Cost type contractors, however, may not,<sup>9</sup> and would thus be exposed to far greater risk than their fixed price counterparts – in effect a contracting world turned upside down. It seems unlikely that the drafters of the revision have given adequate thought to this bizarre result.

### Conclusion

The two points that this comment addresses share a common thread. By tinkering with a long-established and well-settled area of government property law in apparent ignorance of the consequences, the drafters have produced results they could neither have anticipated nor desired. In the view of this writer, the root of the problem lies in the attempt to combine the various Government Property clauses into a single cumbersome provision, blurring and even demolishing the common-sense distinctions that have existed for many years between fixed price and cost type contracts. Accordingly, I suggest that the FAR Secretariat withdraw the proposed revision and return it to the drafters for the additional analysis it merits.

Sincerely,

SMITH PACHTER MCWHORTER & ALLEN, P.L.C.



Richard C. Johnson

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<sup>8</sup> The proposed revision does not purport to alter FAR 45.308-1, but the unlimited "option" language of the new Government Property clause might well be construed to overcome the admonition of FAR 45.308-1 for a meaningful pre-contract inspection. Moreover, the proposed revision *does* eliminate FAR 45.106(f)(1), which currently mandates inclusion of the clause FAR 52.245-5, to the exclusion of FAR 52.245-19, in all cost type contracts. Thus, under the proposed revision, there would be no limit whatsoever on the Government's ability to insert the "As Is" language in cost type contracts.

<sup>9</sup> FAR 31.205-7.