

Private Letter Ruling No. 06-002

Redacted Version

Sales Tax

Does a sales and use tax exemption apply to indirect or overhead costs on projects performed by contractor for the federal government?

April 17, 2006

Facts

The Jefferson Parish Sheriff's Office, Sales Tax Department conducted a sales and use tax examination on a contractor that contracts with both governmental entities as well as non-government entities. Presumptively, the contractor's operations take place within Jefferson Parish. During the examination, an issue arose as to whether certain purchases made by the contractor in the performance of contracts with the federal government were exempt from sales and use taxation.

According to the facts presented, the contractor maintained that all transactions related to indirect costs, i.e., purchases related to overhead charges, were subject to an exemption from sales tax based on the percentage of government contracts they perform in comparison to the percentage of non-government contracts performed. The contractor purchases its equipment and materials tax-free and subsequently accrues and remits taxes to the State of Louisiana and Jefferson Parish, reducing its tax remittance by the percentage of work performed for government contracts. The contractor has taken the basis for claiming the exemption from an appellate case arising and decided in the State of California, *Aerospace Corp. v. Bd. of Equalization* (1990) 218 Cal. App. 3rd 1300, 267 Cal. Rptr. 685, discussed below.

The Sales Tax Department of Jefferson parish stated that its' office does not question the contractor's exemption from sales tax related to the direct costs of materials consumed within the manufactured product to be purchased by the federal government. It further stated that it had never been the practice of the Jefferson Parish Bureau of Revenue and Taxation to exempt taxable products and/or services or a percentage thereof that are the indirect costs of the contractor because a portion of its business activity is performed for the federal government.

Overhead materials, consumables, and items falling within the designation of overhead or indirect costs, by way of illustration, are such items as purchased parts (e.g., batteries, resistors and transistors) and raw materials (e.g., metal, plastic) which are consumed in operations and are not incorporated into a final product delivered to a customer; equipment and materials (e.g., test tubes, chemicals, chemical solvents) used in

operations; low value plant equipment (e.g., timers, meters, amplifiers, conduit,) the cost of which is not capitalized; perishable tools (e.g. hammers, drills, screwdrivers, saws, gloves, rain-suits, grinders); maintenance and repair supplies (e.g., janitorial supplies); low value office equipment (e.g., typewriter stands, card files) the cost of which is not capitalized; and office supplies (e.g., stationery, printed forms, paper clips, etc.). Also typically included as items of overhead and indirect costs are rents and rentals, property taxes, and energy costs. This list is illustrative and not exclusive of other items that are considered indirect or overhead costs.

Ruling Requested

Sales Tax Department of Jefferson Parish requested a ruling from the Department of Revenue as to its policy and practice exempting from taxation indirect costs or a percentage thereof based upon a Louisiana contractor performing/manufacturing for the federal government transactions that would otherwise be taxable if performed or manufactured for a private consumer.

Legal Analysis

The question of whether or not sales to the federal government are subject to sales taxation generally rests upon three factors: 1) implied constitutional immunity; 2) congressional action establishing an exemption from taxation for certain congressionally created entities or waiving constitutional immunity; and 3) state tax statutes regulating such incidents of taxation. Since Jefferson's inquiry involves the activities of a contractor engaged in manufacture of items for the U.S. Government, to the extent possible, this analysis will highlight legal precedents within that area.

Implied Immunity

Two seminal cases establish the basis for state taxation on sales to the U.S. Government under the doctrine of implied constitutional immunity. The doctrine of implied immunity from state taxation stems from the idea that the federal government enjoys sovereign immunity from burdens placed upon it by the states¹. In *State of Alabama v. King & Boozer*² and its companion case *Curry v. U.S.*³, the U.S. Supreme Court considered the issue of whether or not a contractor engaged in contracts with the federal government were immune from state taxation as result of the immunity enjoyed by the federal government and the direct consequence of the government being the recipient of the contractor's work.

¹ U. S. Const. Art. 6, cl. 2 : "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."

² 314 U.S. 1, 62 S.Ct. 43, 86 L.Ed 3 (1941)

³ 314 U.S. 14, 62 S.Ct. 48, 86 L.Ed. 9 (1941)

In *Alabama v. King*, the contractor entered into a cost-plus fixed-fee contract with the U.S. Government for construction of an army camp. The contract provided that the government would reimburse the contractor for all actual expenditures in performance of the approved work, and provided that title to all work, completed or in course of construction, would be in the Government. The contract retained substantial control for the Government's contracting officer. The Government contended that the tax was invalid because the contractors were acting for and on behalf of the Government and that this was sufficiently a government purchase to fall within the immunity. In essence, the Government argued that the economic burden of the tax would be shifted to the government because of its contract to reimburse the contractor. In further support of its position, the Government argued that title to the lumber passed to the government on shipment by the seller, and that it maintained significant control over the purchases of the contractor, including to approve the price and/or furnish the materials itself if it so desired, and could inspect and approve the materials before shipment.

The Court, upholding previously established principles, held that regardless of the amount of control exercised by the Government, neither the reservation or the exercise of that power could create the status of "agent" of the Government for the contractor to enter into contracts or to pledge the credit of the Government. It further stated that the circumstance that title to the lumber passed to the Government on delivery did not create an obligation against the Government to the vendor under a cost-plus contract more than under a lump sum contract.

In *Curry v. United States*, the Supreme Court also held the principle to a question of use tax and stated, at 17-18:

For the reasons stated at length in our opinion in *King* case, we think that the contractors, in purchasing and bringing material into the state, and in appropriating it to their contract with the government, were not agents or instrumentalities of the government; and they are not relieved of the tax, to which they would otherwise be subject, by reason of the fact that they are government contractors. If the state law lays the tax upon them rather than the individual with whom they enter into a cost-plus contract like the present one, then it affects the Government, like the individual, only as the economic burden is shifted to it through operation of the contract.[T]he Constitution, without implementation by Congressional legislation, does not prohibit a tax upon Government contractors because its burden is passed on economically by the terms of the contract or otherwise as a part of the construction cost to the Government.

The principles established in the above cited cases prevail in law today, and the 'economic burden' argument has been abandoned. A thorough analysis of the ongoing constriction of the supremacy clause within the context of state taxation is thoroughly analyzed in *Jefferson County v. Acker*, 92 F.3d 1561, C.A. 11 (Ala.) 1996. Thus, there is no valid argument under the facts presented in the instant matter to support the

supposition that indirect costs incurred by a contractor providing work to the U.S. Government are not subject to sales tax. Additionally, it is noted that the courts do not distinguish between the type of tax, either sales or use, or the type of contract, either cost-plus or lump sum, as determinative to the incident of taxation.

Congressional Action

The second factor of the inquiry, whether congressional action establishes an exemption from taxation for a congressionally created entity, or whether congressional action waiving constitutional immunity, applies is not at issue under the facts presented. The private contractor is engaged in the manufacture of ships. According to the facts and documents presented, the U.S. Government is purchasing ships under a contract between the company and the U.S. Government. The *Alabama v. King* and *Curry v. U.S.* Court stressed the absence of congressional exemption with respect to state taxation of contractors under cost-plus contracts for the construction of governmental projects.

State Law

There is no statute in Louisiana law that exempts sales tax paid by a contractor on items identified as ‘indirect costs’ of a contractor in the production of its items for sale to the U.S. Government. Further, the Department of Revenue has historically collected sales and use taxes on the items comprising ‘indirect costs’.

Louisiana sales tax statutes provide some exemptions from sales and use tax for contracts between contractors and the U.S Department of the Navy.

R.S. 47:301(7)(c) provides:

The term “lease or rental”, as herein defined shall not mean or include a lease or rental of property to be used in performance of a contract with the United States Department of the Navy for construction or overhaul of U.S. Naval vessels.

Thus, the contractor would have an exemption from payment of state sales taxes on lease or rentals and the Department of Revenue would apply a suitable methodology to attribute the expense of rental equipment such as trucks and forklifts between its use for shipbuilding for the U.S. Navy and non-Navy production.

R.S. 47:301(10)(g) provides:

The term “retail sale” does not include a sale of corporeal movable property which [sic] is intended for future sale to the United States government or its agencies, when title to such property is transferred to the United States government or its agencies prior to the incorporation of that property into a final product.

The purpose of this exemption was to allow contractors that manufacture for the U.S. Government to purchase corporeal movable property without the necessity for up-front payment of sales tax and later recovery through refund. It does not create a new or different exemption from sales tax for the contractor, and does not apply to indirect or overhead costs. Louisiana does not tax the sale of movable property that is incorporated into a final product for sale whether the end user of the final product is a private party or governmental entity.

There are no other Louisiana exemptions relevant to overhead or indirect costs related to construction by a shipbuilding contractor that would apply to the facts presented.

Position asserted by the Contractor

The contractor in the instant matter argues that it is not required to pay sales tax on items attributable to overhead or indirect costs used in the execution of its business enterprise for which a portion was performed for the U.S. Government. The contractor seeks to eliminate a percentage of its total sales tax due on overhead cost items by the percentage of work performed for the Government. It takes this position by virtue of a recent case decided in California, *Aerospace Corp. v. Bd. of Equalization*⁴.

Aerospace Corp. involved a request for refund of sales and use taxes levied on Aerospace Corp. for its use of certain materials purchased by it for the performance of its contracts with the federal government. The facts established that Aerospace Corp. “was at all times mentioned, a nonprofit corporation organized and operated exclusively for scientific purposes. The principal purposes for which Aerospace was organized, as expressed in its articles of incorporation, are to engage in research, development and advisory services for the United States government. Aerospace’s principal specialties are space systems, selected ballistics missile activities and related technology for national security purposes. Aerospace’s principal customer for these specialties is the United States Air Force. Aerospace is not a manufacturer of space or missile equipment but is categorized by the Department of Defense (DOD) as a “DOD-sponsored Federal Contract Research Center,” the sponsor being the United States Air Force.” At 1303.

The *Aerospace* case is distinguishable from the facts and circumstances of your inquiry in two significant ways. First, the corporation is a non-profit that was organized and operates exclusively for scientific purposes, and does not manufacture products for the U.S. Government. The opinion states that it is a research center for the United States Government. While the opinion does not consider the issue of implied immunity or congressional exemption, it appears that Aerospace Corp. could be considered an agency or instrumentality of the Government. As such, the issues surrounding the constitutionality of taxation of the entity are wholly different from that of a private contractor engaged in construction of products for the U.S. Government. As was stated in *Jefferson County v. Acker*, supra, “[a] nondiscriminatory state or local tax is unconstitutional only “when the levy falls on the United States itself, or on an agency or

⁴ 218 Cal. App. 3rd 1300, 267 Cal. Rptr. 685 (1990).

instrumentality so closely connected to the Government that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned.”⁵

Second, the decision in *Aerospace* was decided on the basis of sales and use tax regulations of the State of California. There is no indication within the decision that there are any universal principles that might apply to tax law and regulations of Louisiana. Again, the pronouncements of *Jefferson County v. Acker, supra*, apply. *Jefferson County* stated that the federal courts are the ultimate arbiters of substance of state tax, for the purposes of the intergovernmental tax immunity doctrine, but state law defines the attributes comprising the substance of the tax. *Id.* at. 1569-1570. Thus, it is state law that determines the operational effects of the tax. As an aside, while there was reference to ‘federal regulations’ within the discussion of the *Aerospace* case, these regulations pertained to the contractual agreements between the parties as to timing of ownership of the materials at issue, and not to the relevant tax laws.

Conclusion

In short, *Aerospace* is not a relevant opinion on the question of whether ‘indirect costs’ are exempt from sales and use taxation in Louisiana. To the contrary, doctrinal federal law does not protect contractors from payment of sales tax on items sold to the U.S. Government. Louisiana sales and use tax law exempts the U.S. Government from payment of sales tax on purchases as an end user. However, other than the exception of R.S. 47:301(7)(c), there is no general sales or use tax exemption from the operating or overhead costs of a private contractor used in the operation of its business enterprise for contracts with the U.S. Government.

I hope that this has been of assistance to you. You may telephone me if you have additional questions at 225-219-2780.

Sincerely,

Cynthia Bridges

By: Johnette L. Martin

⁵ *Citing, United States v. New Mexico*, 455 U.S. 720, 102 S.Ct. 1373, 71 L.Ed.2d 580 (1982).

This correspondence constitutes a private letter ruling (PLR) by the Louisiana Department of Revenue, as provided for by section 61:III.101 of the Louisiana Administrative Code. A PLR provides guidance to a specific taxpayer at the taxpayer's request. It is a written statement that applies principles of law to a specific set of facts or a particular tax situation. A PLR does not have the force and effect of law, and is not binding on the person who requested it or on any other taxpayer. This PLR is binding on the department only as to the taxpayer to whom it is addressed, and only if the facts presented were truthful and complete and the transaction was carried out as proposed. It continues as authority for the department's position unless a subsequent declaratory ruling, rule, court case, or statute supersedes it.