

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS

2111 Wilson Boulevard, Suite 400

Arlington, VA 22201

www.codsia.org

(703) 247-9490

February 23, 2000

The following is a summary of the February 23, 2000, meeting with Deputy Under Secretary of Defense (Acquisition Reform) Stan Z. Soloway regarding recent developments pertaining to state use taxes and their potential impact on federal contracting.

Attendees: Mr. Soloway and representatives from the Acquisition Reform office, the Office of the Director of Defense Procurement, Navy General Counsel, the Navy Litigation Office; and industry representatives from the Contract Services Association (CSA), the National Defense Industrial Association (NDIA), and the Council of Defense and Space Industry Associations (CODSIA).

I. Background.

A detailed point paper (attached below) was provided listing the relevant facts, federal constitutional and state law issues, present status, and specific requests of industry representatives which have been made regarding a tax assessment by the Washington State Department of Revenue on Seaward Services, Inc. The contract included the operation of 7 vessels ranging from 72 to 186 feet at the Naval Undersea Warfare Center (NUWC) at Bangor, Washington. Noted in the point paper was that Seaward Services is operating a 5-year option contract with the United States Navy worth close to \$9.3 million and that the use tax levied by the state of Washington was close to \$4.9 million, or roughly half the size of the contract. Under the contract, the Navy retains ownership of the ships.

II. Concerns Expressed by Industry.

- Industry representatives present at the meeting disagreed with the premise upon which the assessment was made and suggested that it was an indication of the state of Washington's efforts to cover a loss of revenue due to a reduction in its revenue base under recently adopted state legislation. Fear was expressed that similar measures in other states may lead to a broader interpretation of state use tax statutes resulting in higher state taxes on contractors using federal property.
- The state of Washington's claim justifying the imposition of its use tax statute was that Seaward Services was receiving benefit from the use of the government property (i.e., the ships) because it directly benefited from the federal contract. The Seaward Services case may be considered a test case of this standard because it is the first time that government property essential to performance of the contract was used by a state to justify the imposition

of a state use tax. In past cases, when the contractor benefited from use of government general use property in its possession, taxation based upon the benefit to the contractor was upheld.

- Such expansion of the standards under which federal property in private possession can be taxed will not only dramatically increase the cost of contracts with the government, but also constitutes a tax on the federal government which, as noted in the point paper, is unconstitutional.
- The contractor may not be aware of a later attempt by a state to collect such taxes after the time of contract negotiation and its claim for reimbursement of such costs may go unheeded by the government. The fact that the law may be already on the books at the time of negotiation would also give weight to an argument that the federal government should not pay the costs of the state tax.
- State taxes are also an issue in A-76 cost-comparison competitions. In calculating the cost of performance of a contract, a contractor is able to deduct from the cost federal taxes, but not state taxes. Since the federal government cannot be taxed by the state, increased state taxation of contractors presents an inherent, unfair advantage to the federal government in the A-76 process.

III. Concerns of Government Representatives.

- The Acquisition Reform office expressed concern that enabling states to broaden the circumstances under which states could tax contractors for use of government property presents a significant issue in terms of potential cost to the government, increased litigation, and in contract negotiation; citing the vast amount of government property currently in private possession.
- The Navy Litigation Office agreed that there are constitutional issues which merit further review by the Department of Justice (DOJ), the federal agency designated to address such issues.
- The scope of the rise of similar attempts to levy contractors in this manner, however, was questioned due to the lack of precedent and empirical evidence of other states' specific intent to follow suit. It was also suggested that situations identical to those found in the Seaward Services case are perhaps rare.

IV. Further Action.

- Mr. Soloway recommended that the issue be addressed at his level of authority or above within the DoD, that Air Force and Army representatives be made aware of the issue and a meeting was tentatively scheduled to address the matter internally in approximately two weeks.

- Industry representatives were advised to provide information regarding the issue to their contacts and follow-up with the Acquisition Reform office regarding developments.
- The Navy Litigation Office will forward a packet of information to the DOJ outlining the constitutional concerns and the possibility that state laws such as the one in question in Washington may not be upheld due to constitutional considerations. Mr. Soloway indicated that the time necessary to gain a response from the DOJ, a process which usually takes 30 days, should be expedited if possible.
- A possible solution was the issuance of a federal guidance clarifying how contractors may be reimbursed for unanticipated state use taxes and how to include such costs in the contract negotiation process. Possible changes to the A-76 process to ensure fairness to private contractors were also discussed.

Tim Nunnally-Olsen
Administrative Officer

Point Paper – Seaward Services & Washington State Use Tax

Facts

- * October, 1996: Seaward Services receives a cost plus award fee Navy contract to operate 72 to 186 foot vessels at the Naval Undersea Warfare Center (NUWC), Bangor, Washington.
- * Contract N000406-96-D-5178 is a 5 year option contract (base + four).
 - For base + four years, the contract was worth \$9,277,120.
- * Seaward Services receives custody of seven vessels and used the vessels to operate, maintain, and provide logistics support to NUWC.
- * Prior to the contract's award, the services provided by Seaward were performed directly by Naval personnel using the same vessels.
- * Navy retained ownership of the vessels, Seaward Services was the custodian responsible for their operation and operated the vessels with no Government personnel on board.
- * Navy retained control over each vessel's mission, schedule, level of maintenance (performed by both the Seaward Naval personnel), and the fuel vendor.
- * Navy can and does use the vessels without Seaward crews for non-contract related purposes.
 - Seaward may not gain access to nor use the vessels without prior Navy permission.
 - Seaward does not have the right or authority to use the vessels for non-contract related purposes.
- * Vessels have no commercial uses.
- * December 1999, the Washington State Department of Revenue assessed a use tax (\$4,880,791) against Seaward for its use of the vessels to perform the contract.
 - Use tax was based solely on the base contract year.
 - Use tax amount is approximately one half the contract's value.
- * "Use" is any act by which a person takes or assumes dominion or control over the property.
- * Assessment was based on purchase value of the vessels.
- * Washington state believes that Seaward's dominion, operational control over and subsequent use of federal personal property creates a use tax liability.
- * Several other states have statutory use taxes applicable to Government contracts (e.g, California, Nevada, New Mexico, etc.)

Federal Constitutional Issues

- * States may not impose a direct tax on Federal Government or its property.
- * States may tax private parties on the beneficial use they receive from Federal Government property (even if the Federal Government retains title to the property).
 - It is Constitutionally irrelevant whether or not the Federal Government reimburses the contractor for the cost of a use tax.
- * States may not tax a private party who is so closely connected to the Government that the two cannot realistically be viewed as separate entities at least for the purpose of the activity being taxed.
 - An agency relationship is insufficient to create such a relationship.
- * State tax may not exceed the value of the property's "beneficial use."
- * State tax may not discriminate against Federal property versus non-federal property.

State Law Issues

- * Washington state assessed the use tax assuming that a "bailment" exists between Seaward

Services and the Navy.

- * Washington state tax decision held that a bailment can exist in Government-owned property where the Government relinquishes sufficient control of the property to the contractor (temporary right of possession plus use creates a bailment).
 - Where a contract specifically authorizes a contractor to make use of Government property, actual subsequent use will be presumed.
- * Tax liability arises at the time the property is first put to use in the state if a bailment exists.
- * Use tax is assessed according to the “reasonable rental value” for the use of the property.
- * “Reasonable rental value” is determined according to the rental price at the same location, for similar products of like quality and character.
- * If no similar product exists, “the reasonable rental may be computed by prorating the retail selling price over the period of possession had by a bailee and payable in monthly installments.” WAC 458-20-211(7)(a).
- * Washington state use tax statute includes certain exemptions (*e.g.*, assessment violates either the State or Federal Constitutions).
- * Assuming that use tax on Seaward’s use of the Naval vessels is valid, Seaward may attack the quantum of the assessment for two reasons: (1) State improperly assessed tax based on the vessel’s retail selling price versus the reasonable rental value; and (2) the assessment should be based upon Seaward’s actual use rather than solely the base contract year.

IV. Present Status

- * Navy Litigation Office is involved in contesting the assessment and seeks Department of Justice intervention
- * Seaward (and the contracting community) must contest the use tax assessment on Federal and State constitutional grounds.
- * Washington state recently lowered its tax base and Seaward is a test case.
- * Should the assessment stand, all Government contractors using GFE subject to similar taxes.
- * Potential on FAR Part 45 Rewrite.
- * Potential cost increases to contractors and the Government.

V. Request

- * OSD support behind Navy’s request for Justice Intervention.
- * OSD support behind Seaward and Navy appeal of tax.