INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202

REPORT
NO. 91-047

February 15, 1991

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION
ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)
ASSISTANT SECRETARY OF THE AIR FORCE (FINANCIAL MANAGEMENT AND COMPTROLLER)
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY
DIRECTOR, DEFENSE LOGISTICS AGENCY

SUBJECT: Report on the Audit of DoD Immunity From State Taxation (Project No. 0CA-0075)

Introduction

This is our final report on the audit of DoD Immunity from State Taxation for your information and use. We made the audit from July to September 1990. The objective of the audit was to determine whether DoD was unnecessarily paying state sales taxes. We also determined if sales taxes were being applied to direct purchases by DoD, and if contracting officers were ensuring that contactors were taking full advantage of existing immunity from state taxes. We reviewed state tax laws and determined if sales tax expenses were actually incurred and remitted by contractors to the appropriate state tax authorities. Finally, we made an evaluation to determine if adequate internal controls were established covering the approval and payment of state sales taxes by DoD contracting offices and Defense contractors.

Discussion

The audit showed that state sales taxes were properly assessed on DoD contracts and were not applied to DoD direct purchases. Government buyers and disbursement officers were generally aware of DoD's tax exempt status and took adequate steps to avoid paying sales taxes on direct local purchases. Also, sampled invoices of these purchases showed that vendors were generally aware of DoD's tax exempt status and did not bill DoD for sales tax on these purchases. The audit found that proper sales tax clauses were appropriately inserted in all reviewed contracts.

The audit showed that contracting officers were adequately ensuring that DoD contractors were taking full advantage of legal state tax exemptions. Also, Government contracting personnel believed that sales taxes represented a relatively low-risk cost element when compared to total costs. Defense contractors generally avoided paying sales taxes on direct contract purchases while incurring and remitting taxes on indirect (overhead) cost items, as required by the various state tax regulations. We also determined that the impact of sales taxes on contractors' overhead and general and administrative rates was, in most instances, less than 1 percent. In addition, the audit found that whenever necessary, contractors were raising and challenging the issue of sales tax exemption on DoD contracts with state authorities. The internal controls were also adequate for the payment of state sales taxes on purchases for DoD.

Scope of Audit

We initially selected three Government buying activities in Virginia, Texas, and California for review. These activities represented a cross section of the Services and the Defense Logistics Agency (DLA) in states with substantial Government contracts. Contracts reviewed were used as a basis to expand the audit scope and to select five contractor locations for further review and analysis. We also held discussions with state tax authorities in Virginia, Texas, and California to determine current philosophy and policy and to learn the nature and extent of sales taxes imposed on U.S. Government contractor operations.

We reviewed regulatory guidance on state sales taxes for Virginia, Texas, and California. We also obtained and reviewed legal cases and decisions covering sales tax issues. At each selected location, we determined if state sales taxes were properly paid or avoided per state tax regulations and requirements. We also determined if contracting officers were ensuring that full advantage was taken of existing immunity from state taxes. The activities visited or contacted during the audit are listed in Enclosure 1.

This performance audit was made from July through September 1990 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, we included such tests of internal controls as were considered necessary. We reviewed regulations, policies, and procedures incorporating requirements of state sales tax provisions for FY's 1988, 1989, and 1990. We also reviewed purchase orders, vendor billings/invoices, and public vouchers for 1988, 1989, and 1990 and contractor financial reports/statements on indirect rates from 1988 and 1989. Our review included information that was based on computer-generated data. Nothing came to our attention as a result of specified procedures that caused us to doubt the acceptability of the

computer-generated data. By using other data and information, we concluded that the computer-generated data could be relied on to achieve the audit's objectives.

Internal Controls

We reviewed the program documentation and implementation of the internal controls related to the approval and payment of state sales taxes by DoD contracting offices and contractors. Although no formal written policies and procedures covering sales taxes were found, it was noted that Government accounting and financial personnel were fully aware of Government exempt status. Also, the contractors' established accounting systems adequately prevented payment of sales taxes on direct purchases for Government contracts. The internal controls applicable to DoD's management of the approval and payment of state sales taxes were effective in that no material deficiencies were disclosed by the audit.

Background

The Federal Government and its activities are immune from paying sales taxes either by implied constitutional immunity or by Federal statutory provisions. However, the tax burden from sales, use, and other state taxes is imposed on Federal contractors. As the Federal Government contracts out more functions, which are traditionally done in-house, the Government will face an increasing tax burden. In some instances, Federal contractors, as agents for the Government, were exempted from state taxation.

The Federal Acquisition Regulation (FAR), section 29.302, on the subject of taxes states that:

> When it is economically feasible to do so, executive agencies shall take maximum advantage of all exemptions from state and local taxation that may be available. If appropriate, the contracting officer shall provide a Standard Form 1094, U.S. Tax Exemption Certificate (see Part 53), or other evidence listed in 29.305(a) to establish that the purchase is being made by the Government.

This guidance does not apply to contractors. However, FAR, section 29.303, states that:

> When purchases are not made by the Government itself, but by a prime contractor or by a subcontractor under a prime contract, the right to an exemption of the transaction from sales or use tax may not rest on the Government's immunity from direct taxation by States and localities. It may rest instead on provisions of the particular state or local law involved, or, in some cases, the transaction may not in fact be

> expressly exempt from the tax. The Government's interest shall be protected by using the procedures in 29.101.

FAR, section 29.101, advises contracting officers and contractors to consult legal counsel when tax questions arise.

Prior Audit Coverage

We did not identify any prior audits that specifically addressed the area of DoD immunity from state taxation during the last 5 years.

Report Staffing

We provided a draft of this report to the addressees on December 5, 1990. Because there were no recommendations, no comments were required of management, and none were received. Therefore, we are publishing this report in final form. Any comments on this final report should be provided within 60 days of the date of this memorandum.

We appreciate the courtesies and cooperation extended to the audit staff. The audit team members are shown in Enclosure 2. The distribution of this report is shown in Enclosure 3. Please contact Mr. Richard Jolliffe, Program Director, at (703) 614-6260 (AUTOVON 224-6260) or Mr. Timothy Staehling, Project Manager, at (703) 614-6248 (AUTOVON 224-6248) if you have any questions concerning this report.

Edward R. Jones
Deputy Assistant Inspector General
for Auditing

Enclosures

cc:
Secretary of the Army
Secretary of the Navy
Secretary of the Air Force

ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics), Washington, DC

Department of the Army

Assistant Secretary of the Army (Research, Development and Acquisition), Washington, DC

Department of the Navy

Assistant Secretary of the Navy (Research, Development and Acquisition), Washington, DC
Naval Shipyard, Long Beach, CA

Department of the Air Force

Assistant Secretary of the Air Force (Research, Development and Acquisition), Washington, DC
San Antonio Air Logistics Center, Kelly Air Force Base, TX

Defense Agencies

Headquarters, Defense Contract Audit Agency, Alexandria, VA
- Liaison Office, San Antonio Air Logistics Center, Kelly Air Force Base, TX
- Resident Office, Pratt & Whitney Government Products Division, West Palm Beach, FL
- Sub-Office, Honeywell Military Avionics Division, Minneapolis, MN
- Resident Office, Hughes Aircraft Ground Systems Group, Fullerton, CA
- Branch Office, Pasadena, CA
- Branch Office, Oxnard, CA

Headquarters, Defense Logistics Agency, Alexandria, VA
- Defense General Supply Center, Richmond, VA
- Defense Plant Representative Office, Pratt & Whitney, West Palm Beach, FL
- Defense Plant Representative Office, Honeywell Military Avionics Division, Minneapolis, MN
- Defense Plant Representative Office, Hughes Aircraft, Fullerton, CA
- Defense Contract Management District West, El Segundo, CA

Non-Government Activities

Pratt & Whitney Government Products Division, West Palm Beach, FL
Honeywell Military Avionics Division, Minneapolis, MN
Hughes Aircraft Ground Systems Group, Fullerton, CA
Pacifica Services, Pasadena, CA
Western Instrument Corporation, Ventura, CA
State of Virginia, Department of Taxation, Richmond, VA
State of Texas, Comptroller of Public Accounts, Austin, TX
State of California, State Board of Equalization, Sacramento, CA

AUDIT TEAM MEMBERS

David K. Steensma, Director, Contract Management Directorate
Richard B. Jolliffe, Program Director
Timothy J. Staehling, Project Manager
John H. Christian, Team Leader
Walter J. Skolic, Jr., Team Leader
Frederick R. Mott, Auditor
Kathryn M. Holmes, Auditor

FINAL REPORT DISTRIBUTION

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Assistant Secretary of the Army (Financial Management)
Auditor General, U.S. Army Audit Agency

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Secretary of the Navy
Assistant Secretary of the Navy (Financial Management)
Director, Naval Audit Service

Department of the Air Force

Secretary of the Air Force
Assistant Secretary of the Air Force (Financial Management and Comptroller)
Auditor General, Air Force Audit Agency

Defense Agencies

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency

Non-DoD

Office of Management and Budget
United States General Accounting Office, NSIAD Technical Information Center

Congressional Committees:

Senate Subcommittee of Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
Senate Ranking Minority Member, Committee on Armed Services
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Ranking Minority Member, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcomittee on Legislation and National Security, Committee on Government Operations