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In this article, the authors outline the sales and use tax issues that apply to purchases made by government contractors and provide a framework for understanding those issues.

Introduction

The federal government is the largest purchaser of products and services in the United States. For fiscal 2023, the federal government obligated over $759 billion in contracts. Of those contracts, the largest dollar amount was awarded for the performance of services, including research and development, with purchases of products constituting a sizable minority of spending. Of the total $759.6 billion obligated, $478.2 billion was obligated to services including R&D, with $281.4 billion obligated to products.[1]

Given the size and scope of the government contracting market, government contractors should be familiar with sales and use tax issues surrounding their purchases. This article provides an overview of the sales and use tax issues that apply to contractors' purchases and a framework for understanding them. That framework is especially important given the lack of specific sales and use tax guidance provided by the states regarding purchases by contractors under federal contracts.

As background, the largest types of obligations for fiscal 2023, based on North American Industry Classification System codes, were for aircraft manufacturing, engineering services, R&D, direct health and medical insurance carriers, facilities support services, construction, computer systems design, shipbuilding, guided missile and space vehicle manufacturing, and other computer-related services. The jurisdictions with the most significant federal government obligations for fiscal 2023 based on place of performance were Arizona; California; Connecticut; Florida; Maryland; Massachusetts; Pennsylvania; Texas; Virginia; and Washington, D.C.[2] Accordingly, the sales and use tax guidance governing purchases by government contractors in those industries and states have particular importance.

This article does not address purchases or sales by federal government contractors providing construction services. Instead, it focuses on government contractors' purchases under contracts with the federal government to provide products, services other than construction, or both.

Sales Tax Issues Specific to Government Contractor Purchases

There are several common, but frequently misunderstood, sales tax issues that affect government contractors' purchases and transfers of tangible personal property in connection with federal government contracts. While concepts related to the sales-tax-exempt status of purchases made directly by the federal government are clear, specific issues frequently arise when contractors

[1] USASpending.gov, Start Searching Awards (last visited July 11, 2024).

[2] *Id.*

purchase directly from vendors under government contracts. Those issues include the possibility of an agency relationship between the contractor and government, the sales tax impact of specific title-vesting provisions common to federal contracts, and special sales tax exemptions for contractors' purchases of overhead materials and consumables.

Contractors as Agents for the Federal Government

Government contractors might think they are relieved from their sales and use tax obligations on their purchases made under government contracts because they act as agents for the federal government, but the requirements for contractors to establish agency are quite stringent. Such beliefs about becoming an agent for the federal government may be based on a flawed understanding of the relevant U.S. Supreme Court jurisprudence controlling those relationships — *Kern-Limerick*[3] and *New Mexico*.[4]

In *Kern-Limerick*, the Supreme Court took a fairly broad view of when a government contractor acts as a purchasing agent for the United States. In that case, a seller challenged an assessment of Arkansas gross receipts tax on its sales of tractors to a government contractor that used the tractors to build a U.S. naval ammunition depot. The contractor made the purchases under a cost-plus fixed-fee contract with the Navy. The seller claimed that its sales were exempt from Arkansas gross receipts tax because they were made directly to the Navy, rather than to the government contractor.

As part of the contract between the contractor and the government, title to all materials and supplies purchased by the contractor vested in the Navy. Purchase orders issued by the contractor stated that the federal government was the purchaser and was liable for the purchase price. Further, each purchase required advance government approval.

Based on those facts, the Supreme Court held that the sales tax assessment against the seller of the tractors was unconstitutional because the federal government was the purchaser under the contract between the Navy and the contractor.

In making its decision, the Court noted that under the contract, the government assumed the legal incidence and economic burden of the tax. The Court further relied on contractual language requiring specific government approval for each request for bid and for each purchase. It also noted that no liability of the purchasing agent to the seller arose from the transaction.

While the Supreme Court rejected the imposition of sales tax on the purchases made by the contractor in *Kern-Limerick*, it would be unusual for a government contractor's purchases to satisfy the requirements the Court enumerated to be treated as purchases by the federal government. Unlike the purchase orders used by the contractor in the case, purchase orders issued by contractors typically do not indicate that purchases are being made by the federal government. Further, the government usually does not directly assume liability for purchases made by contractors, and specific purchases by contractors generally do not require advance government approval.

In *New Mexico,* the Supreme Court clarified *Kern-Limerick* and set forth clear guidance regarding when government contractors can be treated as agents of the federal government for making purchases for sales tax purposes. The Court addressed the application of the New Mexico gross receipts and use tax to three government contractors conducting federally sponsored research, facilities management, and construction and repair services. The contractors paid New Mexico gross receipts taxes on the fixed fees they received from the federal government, but the United States sought a declaratory judgment that the contractors could not be taxed on some other receipts. The United States contested the imposition of tax on the contractors' receipt of funds advanced from the government to make purchases, on vendors' sales to the contractors, and on the contractors' use of government-owned property.

Under the contracts at issue in *New Mexico*, the contractors were reimbursed for employee salaries and other expenditures. Title to all property purchased by the contractors passed directly from the vendor to the federal

[3] *Kern-Limerick v. Scurlock*, 347 U.S. 10 (1954).

[4] *United States v. New Mexico*, 455 U.S. 720 (1982).

government. The contractors placed orders in their own names and used an advanced funding procedure whereby the United States made funds available in an account from which the contractor paid for its purchases.

The government argued that the contractors were agents of the federal government and were entitled to tax immunity because under the advanced funding procedure, they drew checks directly on federal funds instead of waiting for reimbursement.

Ultimately, the Court decided that the contractors were not government agents and were subject to the New Mexico gross receipts and use tax on advanced funds, their purchases, and their use of government-owned property.

In making its decision, the Court said that immunity from taxation "may not be conferred simply because the tax has an effect on the United States, or even because the Federal Government shoulders the entire economic burden of the levy." Similarly, the Court said immunity cannot be conferred simply because the state tax falls on the earnings of a contractor providing services to the government. The Court said that for a contractor to act as the government's agent, thus avoiding taxation, it must actually "stand in the Government's shoes." It dismissed the idea that the contractors were exempt from tax because they drew directly on federal funds, rather than waiting for reimbursement.

In discussing the taxability of the contractors' purchases, the Court distinguished *Kern-Limerick*, saying that it stood only for the proposition that a state may not impose a tax whose legal incidence falls on the federal government. The Court noted that unlike the contractors in *Kern-Limerick*, the contractors in *New Mexico* made purchases in their own names, were directly liable to vendors on their purchases, did not obtain advance government approval for each purchase, and did not inform vendors that the government was the only party with an independent interest in the sales. In its analysis, the Court said those factors "demonstrate that the contractors have a substantial independent role in making purchases, and that the identity of the interests between the Government and the contractors is far from complete. As a result, sales to [the contractors] are in neither a real nor symbolic sense sales to the United States itself."

Finally, while noting that title to the contractors' purchases passed directly to the federal government, the Court said that factor alone does not make a transaction a purchase by the United States as long as the contractor in its role as purchaser is sufficiently distinct from the federal government.

Thus, the Supreme Court in *New Mexico* made clear that it views tax immunity as appropriate only when the legal incidence of the tax falls on the government itself or when an agency or instrumentality is 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.

Taken together, the decisions in *Kern-Limerick* and *New Mexico* indicate that few government contractors will be considered agents of the federal government when making purchases in the performance of government contracts. The Court has said that only contractors with a total congruence of interests with the government will be considered government agents. It has also made clear that taxation is permitted for sales to contractors in the performance of their contracts, even when title to the property transfers directly to the federal government.[5]

Accordingly, government contractors should not consider themselves as having any kind of blanket constitutional immunity from sales and use tax liabilities, even on purchases made under government contracts that contain title-passing provisions.

Guidance for Purchases by Contractors and Subcontractors as Agents for the U.S. Government

In addition to the aforementioned Supreme Court cases, Federal Acquisition Regulations (FAR) sections 29.303(a) and (b) make clear that government contractors and subcontractors generally are not designated as agents for the federal government and may not use the government's immunity to exempt their purchases from state and local sales taxes.

[5] *Id.* at 743.

FAR section 29.303 states:

> (a) Prime contractors and subcontractors shall not normally be designated as agents of the Government for the purpose of claiming immunity from State or local sales or use taxes. Before any activity contends that a contractor is an agent of the Government, the matter shall be referred to the agency head for review. The referral shall include all pertinent data on which the contention is based, together with a thorough analysis of all relevant legal precedents.
>
> (b) 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 a 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 on the Transfer of Title to Purchases

The FAR governs the federal government's purchasing process and contains standard clauses for use in government contracts. Some of those clauses relate to passage of title of items purchased by government contractors. As discussed below, the use of various title-vesting provisions can have vastly different sales tax implications for contractors' purchases of items made under a government contract.

FAR section 52.245-1(e) governs government-furnished property and contractor-acquired property whose title vests in the government. FAR section 52.245-1(e)(2) states that under fixed-price-type contracts without express title-passage requirements, the contractor retains title to all property it acquires for use under the contract except for property that is a deliverable end item. For those contracts, only title to end deliverable items transfers to the government; title to all other purchases remains with the contractor.

FAR section 52.245-1(e)(3) governs the passage of title to materials purchased by contractors under cost-reimbursement and time-and-material contracts or cost-reimbursable line items under fixed-price contracts. Under that provision, title to all property purchased by a contractor for which it is entitled to be reimbursed as a direct item of cost passes to and vests in the government upon delivery to the government. FAR section 52.245-1(e)(3) further provides that title to all other property whose cost is reimbursable to the contractor passes to the government upon the first of the:

- issuance of the property for use in contract performance;
- commencement of processing the property for use in contract performance; or
- government reimbursement of the cost of the property.

Contractor Purchases Treated as Government Purchases Based on Title-Passing Provisions

In a few states, purchases by government contractors are considered exempt purchases made by the federal government based on the inclusion of title-passing provisions in the contract.

In North Carolina, contractor purchases are considered exempt purchases by the federal government if the contract contains a FAR title-passage clause so that the item purchased by the contractor passes to the federal government before any use by the contractor.[6]

Similarly, South Carolina provides an exemption for tangible personal property purchased under a written contract with the federal government when the contract provides that title and possession of the property transfer from the contractor to the government at or after the time of purchase.[7] Notably, the South Carolina exemption states that it does not apply to purchases of tangible personal property used or consumed by the purchaser.

The Connecticut Supreme Court has said that purchases of tangible personal property by a

[6] 17 N.C. Admin. Code section 07B.4203.

[7] S.C. Code Ann. section 12-36-2120(29).

contractor are purchases by the U.S. government when:

- the contract provides that title vests in the government;
- the government paid the costs to transport the property to the contractor's facilities;
- the government generally bore the risk of property loss, destruction, and damage; and
- the government had the right to final disposition of any remaining property.[8]

The case appears to indicate that a title-vesting provision alone is insufficient to support the position that a purchase by the contractor is a purchase by the government. However, adding other factors, like the government's paying transportation costs, bearing the risk of loss, and having final right of disposition, could lead to the conclusion that a purchase by the contractor is made by the government.

In Missouri, contractor purchases are considered exempt purchases made by the federal government if title to the property passes directly from the seller to the government. The government must also control the disposition and use of the property so that the contractor does not obtain ownership of the property.[9] If the U.S. government does not control the disposition and use of the property, the contractor's purchase could still qualify for a purchase-for-resale exemption if the contract provides that title to the property vests in the government.[10]

Contractor Purchases Treated as Purchases for Resale Based on Title-Passing Provisions

In most states, the inclusion of title-passing provisions in a government contract by itself will not allow a contractor to claim its purchases are exempt purchases for resale.[11] However, Illinois and Missouri provide that purchases by a government contractor will be considered sales-tax-exempt purchases for resale if the contract between the contractor and federal government contains title transferring clauses. In those cases, the contractor will need to provide vendors with appropriate Illinois and Missouri resale exemption certificates.

In Illinois, purchases of tangible personal property by a government contractor can be treated as exempt purchases for resale if the contract: (1) requires the contractor to provide tangible personal property to the government; and (2) specifies that the property will be transferred to the government and that transfer of title to the property from the contractor to the government will be immediate or subsequent to the completion of the contract.[12]

In Missouri, purchases under government contracts that contain FAR title-passing clauses or similar clauses that state title to property purchased by the contractor will vest with the federal government can result in a resale of the property from the contractor to the government.[13]

Exemptions for Some Purchases of Overhead Materials or Direct Consumables

In general, purchases of overhead materials and consumables by a government contractor for use or consumption in the performance of a contract are taxable. For example, the purchase of paper by a contractor providing engineering services to produce an engineering report would be considered a taxable purchase whether charged to an overhead expense or as a direct cost to a specific contract.

In contrast to that general rule, Arizona, California, Florida, and Texas provide exemptions for purchases of overhead materials and consumables limited to specific types of purchasers or purchases under contracts with specified government agencies. Illinois and Missouri provide even broader exemptions. They consider purchases of overhead materials and direct consumables exempt purchases for resale as long as contractors furnish vendors with the appropriate state resale exemption certificates.

In determining the application of those exemptions, the first question is what types of purchases constitute overhead materials or direct

[8] *United Technologies Corp. v. Groppo*, 680 A.2d 1297 (Conn. 1996).

[9] Mo. Code Regs. Ann. tit. 12, section 10-112.300(3)(A)2.

[10] *Id.* at (B)1.

[11] *See, e.g.*, Fla. Admin. Code r. 12A-1.094(3) and (4); *Raytheon Co. v. Commissioner*, 916 N.E.2d 372 (Mass. 2009); Massachusetts Ltr. Rul. 81-23 (Mar. 12, 1981).

[12] Ill. Admin. Code tit. 86, section 130.2076(a).

[13] Mo. Code Regs. Ann. tit. 12, section 10-112.300(3)(B)1.

consumables. California defines overhead materials as "supplies consumed in the performance of a contract the cost of which is charged to an overhead expense account and then allocated to various contracts based on generally accepted accounting principles and consistent with government cost accounting standards" and direct consumable supplies as "supplies, tools, or equipment consumed in the performance of a contract which are specifically identified to the contract and the actual cost of which is charged as a direct item of cost to the specific contract."[14]

Illinois and Missouri regulations allow purchase-for-resale exemptions for contractor purchases of overhead materials and direct consumables for all types of government contractors and contracts as long as title to those items passes to the federal government.[15]

Arizona limits its sales tax exemption for purchases of overhead and other tangible personal property by government contractors to purchases by manufacturers, modifiers, assemblers, or repairers if title to the purchases passes to the federal government.[16]

California's purchase-for-resale exemption for overhead materials and direct consumables applies only to U.S. government supply contracts, defined as "a contract with the United States to furnish, or to fabricate and furnish tangible personal property, including ships, aircraft, ordnance, or equipment." Thus, purchases of overhead and direct consumables by a government contractor in California under a contract to provide services would not be exempt.

Florida's sale-for-resale exemption for overhead and direct consumables applies only to purchases by the government contractor under a contract with the U.S. Defense Department or National Aeronautics and Space Administration.[17] Texas's purchase-for-resale exemption for overhead materials applies only to contracts with any branch of the DOD, departments of Homeland Security and Energy, NASA, Central Intelligence Agency, National Security Agency, National Oceanic and Atmospheric Administration, or National Reconnaissance Office.[18]

Because laws governing sales tax exemptions for contractors' purchases of overhead materials and consumables vary significantly by state, contractors should be aware of possible exemptions in the states where they make purchases to perform government contracts to ensure they take advantage of those exemptions.

Virginia's Guidance Regarding Government Contractor Purchases

Virginia has the highest dollar amount of government contract awards based on place of performance[19] and thus may have a similarly significant dollar amount of purchases made by government contractors. Luckily for those contractors, Virginia has explicit regulations governing the taxability of purchases by government contractors. Those regulations also could provide a framework for other states that haven't promulgated similar regulations.

Contracts Solely for the Provision of Tangible Personal Property or Services

Virginia provides that when a contract between a government entity and a contractor is solely for the provision of either tangible personal property or services, the application of the true object test is not necessary.[20] That means the general guidance for resale exemptions apply to purchases made under those contracts.

Just as with other contracts, purchases of tangible personal property for government contracts solely for the provision of such property other than consumables can be purchased exempt for resale if the property is transferred in the same form to the federal government. However, purchases of tangible personal property for contracts solely for the provision of services are taxable.

[14] Cal. Code Regs. tit. 18, section 1618(a)(2)-(3).

[15] Ill. Admin. Code tit. 86, section 130.2076(b); Mo. Code Regs. Ann. tit. 12, section 10-112.300(3)(B).

[16] Ariz. Rev. Stat. Ann. section 42-5159(A)(39).

[17] Fla. Stat. section 212.08(17).

[18] Tex. Tax Code Ann. section 151.006(c).

[19] USASpending.gov, *supra* note 1.

[20] 23 Va. Admin. Code section 10-210-693(B).

Mixed Contracts

Virginia defines a mixed contract as one between "a government entity and a contractor that involves the contractor both rendering a service and providing tangible personal property to the government entity under that contract."[21]

Virginia provides that for orders executed on and after July 1, 2006, the sales and use tax treatment of mixed contracts and indeterminate purpose contracts (discussed later) will be based on the application of the true object test to each individual order, not the original contract. If the true object of an order is a service, the contractor is deemed the consumer of all tangible personal property used in providing the service.[22] That is true even though title to the property may pass to the government, the government reimburses the contractor for the purchase, or both.[23]

If the true object of the order is the sale of tangible personal property, such property purchased by the contractor to fulfill that order, even if not expressly identified by the terms of the order itself, may be purchased exempt from tax for resale if it can be tied back to the order for resale.[24]

The regulation defines the word "order" as:

> A specific task assigned to a contractor pursuant to a contract with a government entity. For purposes of this regulation, the term "order" shall include, but not be limited to, task orders, delivery orders, work orders, contract line item numbers (CLINs), and shall also include orders issued under a subcontract for fulfillment of work or products required under a general contractor's prime contract with the government and add-ons to existing contracts or orders. The term "order" shall not include a vendor order issued by a contractor to a vendor.[25]

Virginia provides an example of the application of the true object test at the individual order level involving a contract for the construction of a ship.[26] The contract contains Order 1 that calls for engineering studies and design and Order 2 mandating that the contractor obtain steel and components, which will later become affixed to the ship. The true object of Order 1 is the provision of services, including engineering studies and design. As such, the contractor is deemed the taxable user and consumer of all tangible personal property purchased in fulfilling Order 1. The true object of Order 2 is the provision of tangible personal property to be incorporated into a manufactured product sold to the government, so the contractor can purchase the steel and components for resale exempt from sales tax.

A ruling of the commissioner of the Virginia Department of Taxation also helps illustrate the application of the true object test to a mixed contract at the order level.[27] A government contractor provided firearms training services to an agency of the federal government. The contract required the contractor to provide instructors, weapons, ammunition, and other equipment to be used in the training courses. The commissioner examined the CLINs that required the contractor to provide personnel and equipment to the government agency and applied the true object test to them. The commissioner determined that the true object of the CLINs was the provisions of firearms training services and that any weapons and ammunition purchased by the contractor and used during the services were used and consumed by the contractor.

Accordingly, the commissioner determined that the contractor was liable for sales and use tax on the weapons and ammunition purchased and used during the training. It also dismissed the contractor's contention that it was acting as a procurement agent for the federal government because there was no evidence that the agency's credit was bound directly in the purchase of the ammunition.

While the Virginia DOT is one of the few state tax authorities to offer guidance in its regulations regarding the level at which it will review mixed contracts, there may be a discrepancy between its

[21] *Id.* at section 10-210-693(A).

[22] *Id.* at section 10-210-693(E).

[23] *Id.* at section 10-210-693(C).

[24] *Id.* at section 10-210-693(E).

[25] *Id.* at section 10-210-693(A).

[26] *Id.* at section 10-210-693(E), Example 11.

[27] Virginia Tax Commissioner Ruling P.D. 13-73 (May 21, 2013).

regulations and the application of the true object test in its audit manual and practices. The regulations state that the true object test will apply at the order level, but the DOT's audit manual provides that the department should apply the true object test at the task order level for purchases of tangible personal property by contractors providing services to the federal government.[28]

Further, in another ruling,[29] in which the CLINs indicated there was a sale of tangible personal property, the commissioner determined that the true object test applied to the lowest level mixed order. Thus, even though the lowest level detail, the CLINs showed no mixed transaction, because the task order provided for the provision of both goods and services, the commissioner looked at the lowest level showing a mixed transaction — the task order — to determine the true object of the underlying CLINs.

So despite the clarity of Virginia's regulations, there still may be some uncertainty regarding which level Virginia examines to apply the true object test.

Applying General Sales Tax Principles to Contractor Purchases

While government contractors should be aware of title-passing and overhead materials and consumables exemptions that apply in the few states discussed above, they should also be aware of general sales and use tax guidance that could govern their purchases. If a contractor is solely providing tangible personal property to the federal government and purchases tangible personal property (not overhead materials or consumables) that will pass to the government in the same form, it should be able to provide vendors with purchase-for-resale exemption certificates. If a contractor is providing services in a state and purchases tangible personal property as part of the provision of the services, these purchases should be subject to sales tax. Government contractors should also be able to take advantage of manufacturing, R&D, and other sales tax exemptions when applicable.

The problem comes, however, regarding purchases made as part of mixed transactions in which the contractor provides both services and tangible personal property, because few states provide guidance on how to treat those purchases for sales tax purposes. That lack of guidance creates uncertainty for contractors when providing both property and services to the government under the same contract, leaving contractors to try to apply general sales and use tax principles, including the bundled transaction test, the true object test, and the inconsequential element test.

Mixed Transaction Analysis Framework

The first step in assessing how a mixed transaction will be taxed is to identify at what level a state examines sales to the federal government to determine whether the contractor has made a sale of services, tangible personal property, or both. Government contracts may contain task orders, delivery orders, work orders, and CLINs. Whether a state examines sales at the contract level or lower has relevance for whether a sale will be considered a sale of tangible personal property, services, or a mixed transaction. How a transaction is considered may ultimately determine whether its associated purchases are eligible for a resale exemption.

Once a state determines the level at which it will examine a transaction and identifies a mixed transaction, it might apply the bundled transaction test, true object test, or inconsequential element test to determine whether a sale of property or services has occurred. States that are part of the Streamlined Sales and Use Tax Agreement define a bundled transaction as the sale of two or more distinct and identifiable products (other than real property or services to real property) that are sold for a nonitemized price.[30] Bundled transactions frequently comprise the sale of tangible personal property and a nontaxable service.

The statutes for determining whether a sale is a bundled transaction are complex and outside

[28] Virginia DOT, "Field Audit Procedures, Government Contractors" (Dec. 2012).

[29] Virginia Tax Commissioner Ruling P.D. 10-27 (Mar. 31, 2010).

[30] Streamlined Sales and Use Tax Agreement, Appendix C, "Library of Definitions" (Nov. 7, 2023).

the scope of this article. If a sale is determined to be a bundled transaction, it is either fully taxable or taxable on the tangible personal property portion of the bundle if the seller can unbundle the property portion based on its books and records. For government contractors, that means they can purchase tangible personal property associated with the bundled transaction for resale because the property or bundled transaction would be taxable if sold to a customer other than the federal government. The sale-for-resale exemption would not apply to the contractor's purchases of consumables related to the sale unless the purchase is made in one of the states with exemptions for consumables discussed above.

If the mixed transaction falls outside a state's bundled transaction statute, the state would likely apply the true object test to the sale. Many states without bundled transaction statutes also apply the true object test to mixed transactions. The test is based on the facts and circumstances and is typically applied by courts or tax authorities to determine if tangible personal property is being sold incidental to a service or if a service is being sold incidental to the provision of tangible personal property.

If the state determines that the true object of the sale is a nontaxable service, the seller will be deemed the consumer of tangible personal property purchased in the performance of the contract and thus subject to sales tax unless the purchase is made in a state with a title-passing exemption provision, as discussed previously. If the state determines that the true object of the sale was the sale of tangible personal property, the contractor should be able to purchase that property (except for overhead materials and direct consumables) under the contract for resale. Overhead and direct consumables may be purchased exempt for resale if they fall under a state's title-passing exemption, as discussed.

If the mixed transaction is in a jurisdiction with an inconsequential element test, it will not be considered a sale and therefore would be nontaxable if the service being sold is a nontaxable professional, insurance, or personal service that involves sales of tangible personal property as inconsequential elements for which no separate charges are made.[31] In Washington, D.C., for example, sales as inconsequential elements include any sales of tangible personal property made in connection with the sale of a nontaxable professional, insurance, or personal service if the sales price of the property is less than 10 percent of the amount charged for the bundled services.[32]

While most states do not define professional, insurance, or personal services, Maryland provides examples of such services as those customarily provided by physicians, dentists, lawyers, accountants, insurance agents, pest exterminators, barbers, beauticians, funeral directors, and storage warehouse personnel.

Thus, the definition of professional, insurance, or personal service transactions appears extremely broad. Further, most states do not provide a specific percentage of the total bundled service charge for the tangible personal property to be considered an inconsequential element. If a mixed sale is determined to be nontaxable, the contractor's purchase of tangible personal property will be subject to sales tax unless a title-passing exemption applies. If the mixed sale is determined to be taxable, the contractor should be able to purchase materials for the sale exempt for resale — except for overhead materials and consumables, unless the overhead purchases are made in a state with a title-passing exemption.

Manufacturing and R&D Sales Tax Exemptions

In addition to resale exemptions, government contractors that engage in manufacturing or R&D activities may be able to take advantage of sales tax exemptions for purchases related to those activities. Most states have such exemptions, which may apply to equipment used in manufacturing and R&D and raw materials consumed or incorporated into final products.

[31] *See* D.C. Code Ann. section 47-2001(n)(2)(B); D.C. Mun. Regs. tit. 9, section 403.1.

[32] D.C. Mun. Regs. tit. 9, section 403.2.

Applying Sales Tax Frameworks to Contractor Purchases Made Under Mixed Contracts

Given the different state exemptions for purchases by government contractors and general sales tax principles that could apply to mixed contracts, contractors face numerous questions and outcomes for the taxability of their purchases. The examples below can guide contractors in determining whether some purchases can be made for resale exempt from sales tax.

Firm Fixed-Price Contracts

A government contractor enters into a firm fixed-price contract with the federal government for the provision of cybersecurity services. Under the contract, the contractor will purchase servers and consumables for the government. The contract contains FAR title-passing provisions under which title to the servers and consumables immediately vests in the government. The total firm fixed-price contract price is $10 million: $8 million for cybersecurity services, $1.95 million for servers, and $50,000 for consumables.

The question is whether the servers and consumables can be purchased for resale by the contractor or whether the contractor must pay sales tax on the purchases.

If the servers and consumables are shipped to a state like North Carolina that considers purchases by a government contractor exempt purchases by the federal government if the contract contains an appropriate FAR title-passage clause, the purchases would be exempt from sales tax.

If the servers and consumables were purchased and shipped to, say, Illinois or Missouri, which assume that resale exemptions apply if the contract contains a title-passing provision, the contractor could purchase the items exempt for resale by providing vendors with the applicable state resale exemption certificate.[33] In Texas, if the contractor entered into the contract with a DOD-related agency, the purchase of consumables might be eligible for a resale exemption if the contractor furnished the vendor with the appropriate resale exemption certificate. In Florida, government contractors that purchase consumables under a contract with NASA or the DOD can make exempt purchases using their direct-pay authority, a current resale certificate, or a purchaser's certificate of exemption in the form provided by the Florida Department of Revenue.[34]

If the contractor purchased and shipped the servers and consumables to a state with no title-passing exemptions, the general sales tax guidance pertaining to bundled sales would apply. For example, if the state where the contractor purchased the servers and consumables had a bundled transaction test and the sale did not meet that test, the state likely would apply the true object test. In our scenario, the true object of the sale is the provision of nontaxable cybersecurity services. Thus, under general sales tax guidance, as the purchaser of property to perform a nontaxable service, the contractor would be deemed the consumer of the servers and consumables and would have to pay applicable sales tax on the purchases.

If the transaction meets the definition of a bundled transaction under a state's sales and use tax provisions, it would be a taxable sale if not made to the federal government. Under general bundled transaction guidance, the contractor's purchases of the servers could be made tax exempt for resale. The contractor's purchases of consumables in this scenario would be taxable.

There would be similar results if the transaction took place in a state that applies the 10 percent inconsequential element test to determine the taxability of a transaction. In the example scenario, the price of the servers plus consumables ($2 million) is not less than 10 percent of the total firm fixed price of the contract ($10 million), so the entire bundled transaction would be taxable if not sold to the federal government. The servers could be purchased for resale because the entire bundled transaction is subject to sales tax. The contractor would likely still be deemed the user of the consumables and would have to pay applicable sales tax on the purchases.

[33] Ill. Admin. Code tit. 86, section 130.2076 (Illinois requires that the government contractor supply the retailer with a certificate of resale); Mo. Code Regs. Ann. tit. 12, section 10-107.100.

[34] Florida Tax Information Pub. 99A01-21 (June 30, 1999).

Conversely, under the inconsequential element test, if the price of the servers and consumables were less than 10 percent of the total purchase price, the bundled sale of the cybersecurity services and servers would be nontaxable even if made to a nonexempt entity. Accordingly, the sale of the servers and consumables to the contractor would be taxable because the contractor would be deemed to be selling a nontaxable service and therefore the consumer of the items.

If the sales of the servers and consumables were made in Virginia, the true object test would be applied to the mixed contract. While there could be uncertainty regarding which level it would be applied to, the contract has no task orders, delivery orders, work orders, or CLINs, so the contract level would be the only one to examine. As such, the transaction would clearly be deemed the sale of cybersecurity services and the contractor's purchases of the servers and consumables would therefore be taxable.

Cost-Plus Fixed-Fee Contracts

Assume the same facts as above, except the contract is a cost-plus fixed-fee contract. Under that type of contract, the actual costs of the cybersecurity services (labor), servers, and consumables are separately stated on the invoices. So, then the question becomes whether the state will treat the sale as one bundled sale or as separate sales. Given that the costs are separately invoiced, states will most likely treat the cybersecurity services and servers as separate sales. If so, the servers can be purchased tax-free for resale if the contractor provides the vendor with the applicable state resale exemption certificate. The contractor would likely still be deemed the user of the consumables and be subject to sales tax on those purchases.

However, some states may try to treat the sale as a bundled sale because the contractor is being reimbursed for its costs. Under most state definitions of the term "sales price" for sales tax purposes, costs cannot be deducted. In those states, the purchases would be treated in the same manner as in a firm fixed-price contract.

Because there are no sales being made at a task order, delivery order, work order, or CLIN level, Virginia might apply the true object test to the overall contract. In that case, Virginia would likely deem the true object to be the provision of nontaxable cybersecurity services, so the contractor would be deemed the consumer of the servers and consumables and be required to pay sales tax on the purchases.

Indefinite Delivery/Indefinite Quantity Contracts

Again, assume the same facts, except as a mixed task order for cybersecurity services, servers, and consumables under an indefinite delivery/indefinite quantity contract.

Under that type of contract, there could be a cost-plus fixed-fee CLIN for the cybersecurity services and separate fixed-price CLINs for the servers and consumables issued under the same task order. Like the cost-plus fixed-fee contract, the question is whether the state would view the sale as taking place at the task order level or CLIN level to determine if the purchases associated with the sales of the servers and consumables could be purchased for resale.

In that scenario, it seems likely that most states would view sales at the CLIN level because sales under an indefinite delivery/indefinite quantity contract are separately invoiced at the CLIN level with separate prices. As separate sales, the servers purchased and sold to the government could be tax-exempt purchases for resale if the contractor provides the vendor with the applicable state resale exemption certificate. The contractor would likely be deemed the user of the consumables unless the state had a specific exemption for purchases by government contractors.

However, in other states, the servers might not be eligible to be purchased for resale. For example, consistent with a tax commissioner ruling,[35] Virginia would likely apply the true object test to the lowest level at which a mixed transaction exists, which in this case, would be the task order level. Because the true object at the task order level is the provision of cybersecurity services — and even though there were separate CLINs for those items — the contractor would be deemed the consumer of the servers and

[35] P.D. 10-27, *supra* note 29.

consumables and would be required to pay sales tax on the purchases.

Purchases and Sales by Government Subcontractors

Subcontractors that perform work for federal prime contractors or other subcontractors have their own unique sales tax issues. In many cases, a federal prime contractor must flow down multiple FAR contract clauses to its subcontractors. Some title-passing sales tax exemptions include subcontractors while others reference contractors only. Because exemptions are narrowly construed, subcontractors might not be entitled to some exemptions granted to federal prime contractors.

Sales Tax Exemption Application to Subcontractor Purchases

While some states, like Illinois, offer specific exemptions for purchases by government contractors, those exemptions might not be available for subcontractors.

The Illinois regulations regarding government contractors do not mention subcontractors, instead stating that for the exemption to apply, there must be a contract between the purchaser and the governmental body requiring the purchaser to provide goods to the government.[36] Accordingly, given the strict construction of tax exemptions, subcontractors will likely not qualify for that exemption.

Government subcontractors might face similar issues in other states. For example, North Carolina's exemption for items purchased by contractors when there is a title-passing provision in the contract applies only to purchases made under a contract between a contractor and the U.S. government or its agencies and instrumentalities.[37] It does not appear to apply to subcontractors.

As a result of exemptions that apply only to government contractors, subcontractors might not be able to take advantage of sales tax exemptions offered to prime contractors.

Virginia's Tax Treatment of Government Subcontractor Purchases

Unlike many states, Virginia has addressed the sales and use tax treatment of government subcontractor purchases, specifying that subcontractors to prime contractors will be treated the same as the prime contractors. Subcontractors should apply the true object test to the overall purpose of the subcontract, unless the subcontract contains individual orders, in which case the true object test should be applied to each order to determine the tax application.[38]

Virginia provides an example in which a general contractor enters into a contract with the federal government to furnish, install, and maintain a telecommunications system. The contractor furnishes the system, Subcontractor 1 installs the system, and Subcontractor 2 provides maintenance and repair services. Subcontractors 1 and 2 should apply the true object test to each order received under the subcontract with the general contractor to determine the application of sales tax to their purchases.[39]

In another example regarding the taxability of subcontractor purchases, a contractor and state agency enter into a facilities management contract that includes the provision of trash bags. The contractor issues a task order to a subcontractor to provide trash removal services as part of its provision of facility management services, and the subcontractor submits an order to a vendor for a large quantity of trash bags. In this example, the true object test is applied at the task order level. Because the true object of the task order received by the subcontractor from the prime contractor constitutes an order for the provision of services (trash removal), the subcontractor must pay retail sales tax on the purchase of the trash bags.[40]

Virginia also requires subcontractors to maintain suitable records and documentation to accurately determine the true object of an order entered into in furtherance of a contract between a prime contractor and a government entity. Subcontractors must also present resale

[36] Ill. Admin. Code tit. 86, section 130.2076.

[37] 17 N.C. Admin. Code section 07B.4203.

[38] 23 Va. Admin. Code section 10-210-693(I)(1).

[39] *Id.*

[40] *Id.* at section 10-210-693(E).

certificates to vendors when they make purchases for resale to government contractors.[41]

Given the general lack of guidance regarding the tax treatment of subcontractors, Virginia provides a useful template for government subcontractors trying to ascertain how other states might treat their purchases.

Government Subcontractors' Need to Obtain Resale Certificates From Customers

With a few exceptions discussed in more detail later, states do not impose sales tax on sales directly to the federal government. Unlike government contractors, subcontractors might need to obtain resale exemptions certificates from prime contractors or other subcontractors if selling taxable items. That is because the prime contractor or other subcontractor making the purchases from the subcontractor is not the federal government or an agent thereof.

Failing to obtain and retain resale exemption certificates from government contractors that make the ultimate sale to the federal government could lead to sales tax assessments for subcontractors, even when sales for resale were made. Accordingly, subcontractors should be diligent in their compliance with administrative requirements for resales.

Sales to the Federal Government

In addition to the guidance regarding purchases by federal government contractors and subcontractors, there are special sales tax provisions for contractor sales to the federal government. Generally, such sales are tax exempt, with a few states imposing sales tax on sellers rather than purchasers, as discussed later. Contractors also should be aware that several states and localities might apply gross receipts taxes to their revenue.

Supremacy Clause

It is a settled constitutional principle that a state may not, consistent with the supremacy clause,[42] lay a tax "directly upon the United States."[43] Accordingly, most states do not impose taxes on contractor sales to the federal government. However, contractors should be mindful of administrative requirements that might be necessary to document the tax-exempt nature of their sales. Documentation could include contracts, work orders, task orders, CLINs, or other receipts and invoices showing that payments for products and services were made directly by the federal government.

States That Tax Sales to the Federal Government

While most states do not tax sales to the federal government, Arizona, Hawaii, and New Mexico do.[44] They impose taxes on the seller of the property or services, not the purchaser. Accordingly, the nature of the tax imposes legal liability on vendors and contractors, rather than the federal government. As such, those taxes do not constitute taxes on the federal government and therefore are permissible.

Arizona taxes sales of tangible personal property to the federal government but reduces the taxable base of those sales by 50 percent. However, it does not tax sales of tangible personal property to the federal government by a manufacturer, modifier, assembler, or repairer. Hawaii taxes sales of services to the federal government and sales of tangible personal property if invoiced with services. New Mexico taxes sales of services to the government but provides an exemption for sales of tangible personal property.

Revenue-based state taxes levied on contractors, like those described in this section and the gross receipts taxes section, are considered to be in the nature of general and administrative expenses and may be reimbursable depending on the contract type and whether such taxes are material.[45] Contractors providing services under cost-reimbursement services contracts with the

[41] *Id.* at section 10-210-693(I)(2).

[42] U.S. Const. Art. VI, cl. 2.

[43] *Mayo v. United States*, 319 U.S. 441, 447 (1943), quoted by *New Mexico*, 455 U.S. 720. *See also McCulloch v. Maryland*, 17 U.S. 316 (1819).

[44] Ariz. Rev. Stat. Ann. section 42-5061(J); Ariz. Rev. Stat. Ann. section 42-5061(I)(1); Haw. Rev. Stat. section 237-25(a); Hawaii Tax Facts 99-2, "Business Tax Incentives" (rev. Feb. 2021); N.M. Stat. Ann. section 7-9-4; New Mexico Bulletin FYI-240, "Transactions with Government Agencies" (July 2014).

[45] Defense Contract Audit Agency Ch. 68-2.6, "Revenue Based State Taxes."

federal government might fail to include those taxes in general and administrative reimbursable costs, and often are not even aware of their responsibility for those taxes.

Gross Receipts Taxes

Although this article focuses on sales taxes, government contractors should also be aware that some states and localities tax the gross receipts of businesses, even if they make sales only to the federal government.

Such state taxes include the Delaware gross receipts tax, Ohio commercial activities tax, Oregon corporate activity tax, Nevada commerce tax, Washington business and occupation tax, and Tennessee business tax (state and local). Locality gross receipts taxes include the Virginia business, professional, and occupational license tax; the West Virginia business and occupation tax; and the Los Angeles business tax. As with the taxes imposed by Arizona, Hawaii, and New Mexico, the above gross receipts taxes place liability not on the federal government but on the sellers of goods and services to the government, and are therefore permissible.

Understanding Sales, Use, and Gross Receipts Tax Liabilities for Contractors and Subcontractors

While understanding the often complex sales tax and gross receipts tax laws related to purchases by and sales of government contractors may be difficult, contractors and subcontractors face consequences, including lost profit margins, unrecoverable tax liabilities, future due diligence issues, and Defense Contract Audit Agency (DCAA) audits, for noncompliance. Those consequences underscore the importance of proper sales and gross receipts tax compliance.

Loss of Profit Margins

Government contractors frequently bid in response to requests for proposals or quotes or in sealed-bid solicitations or invitations. In trying to win bids, contractors may calculate or propose slim profit margins. Failing to include sales tax on purchases or gross receipts or sales taxes on sales in proposals or bids may reduce or eliminate contractor profit margins.

Unrecoverable Taxes

If a contractor fails to properly pay its sales and gross receipts tax liabilities incurred in connection with a government contract, it might be unable to recover those costs from the federal government, depending on the type of contract under which it made purchases, like a firm fixed-price contract.

Even if a government contract allows recovery of assessed taxes, if work is completed or a contract is closed before the statute of limitations has passed, a contractor might incur tax liabilities that it cannot recover. Statutes of limitations for sales and gross receipts taxes allow states to assess taxes for up to three or four years after the later of the due date or actual filing of a return — which could be after a contract is ended — and they do not expire if the contractor has not filed applicable returns. As a result, government contractors facing a sales or gross receipts tax liability might not be able to recover their tax costs from the government.

Alternatively, if sales tax liabilities are recoverable, a contractor might decide not to charge the federal government for the taxes to maintain a favorable working relationship.

Due Diligence Issues

Even if a government contractor that has failed to comply with its sales and use and gross receipts tax liabilities avoids state tax assessments, exposures for those taxes could come up in due diligence reviews if the contractor tries to sell its business or pursue additional financing. Accordingly, contractors should factor in their business plans when considering sales and gross receipts tax compliance.

DCAA issues

A contractor could also face issues with the DCAA if it improperly pays sales tax on purchases that were otherwise eligible for exemption and tries to pass those costs on to the government. Those issues could lead to further DCAA scrutiny of the contractor's accounting and estimating processes and controls, as well as an increased risk of audit.

Conclusion

There are five key concepts related to sales and gross receipts taxes that government contractors need to consider:

1. few contractors will be considered agents of the federal government when making purchases;
2. some states have specific sales tax exemptions for government contractor purchases based on title-passing provisions, and for overhead materials and consumables based on type of purchaser or contracting agency;
3. state bundling sales tax provisions may be applicable to government contractor sales that include both services and tangible personal property and this may affect whether associated purchases can be made exempt for resale;
4. sales and gross receipts taxes could apply to government contractors' sales in some states and localities; and
5. contractors face serious financial consequences for not complying with applicable sales and gross receipts tax laws.

Stringent Agency Requirements

One important takeaway is that based on the standards in *New Mexico*, few contractors will be considered government agents in making purchases for a federal contract. The legal incidence of sales taxes on purchases by contractors is not considered to fall on the government, and the standards set by the Supreme Court for a contractor to be considered an instrumentality of the government are stringent.

Accordingly, government contractors should not assume there is a blanket exemption from sales tax obligations on their purchases and should carefully investigate when they are able to make purchases exempt from sales tax.

Possible Exemptions

Government contractors should initially determine whether their purchases qualify for exemption in the few states that base exemptions on title-passing provisions or have specific exemptions for overhead materials and consumables. If purchases do not qualify for those exemptions, contractors should determine at which level states determine whether they are making sales to the federal government to conclude if they are providing services, tangible personal property, or both. The general sales tax guidance regarding resale should apply if the contractor is providing only services or tangible personal property.

Manufacturing, R&D, and other possible sales tax exemptions could also apply to the contractor's purchases.

Bundling and Mixed Transaction Guidance

If providing both services and tangible personal property under the same contract, a contractor must determine at what level the state will examine the sales to determine if any are bundled. If the sales are bundled, contractors may need to look at the applicable states' sales tax bundling guidance. Those complex statutes can then be applied to determine if the contractor can make tax-exempt purchases associated with bundled sales.

Sales and Gross Receipts Taxes on Sales to the Government

Some states impose sales and gross receipts taxes on sellers, which means contractors could be subject to taxes on their sales to the federal government. Contractors should be concerned if they are selling to the federal government tangible personal property in Arizona or services in Hawaii and New Mexico because sales tax will apply to those transactions.[46] Also, contractors' sales could be subject to gross receipts taxes in such states as Delaware, Nevada, Ohio, Oregon, Tennessee, and Washington, as well as in some localities, like Los Angeles.

Potential Consequences of Noncompliance

As discussed, sales taxes imposed on purchases by government contractors and sales and gross receipts taxes imposed on contractor sales can be extremely complicated. Federal

[46] See Arizona, Hawaii, and New Mexico statutory provisions, *supra* note 44.

government contractors must navigate sales and gross receipts tax laws and regulations specific to their activities in applicable states. They must figure out how to comply with those complicated requirements, typically with limited formal sales tax guidance from the states.

Further, failure to properly comply with sales and gross receipts tax laws can result in significant negative consequences, including potential tax exposure and failure to properly bid on contracts.

Given the complexity and potential downsides of sales and gross receipts tax noncompliance, it is important that government contractors engage qualified sales tax professionals to assist them with compliance. ■