SELECTED AREAS OF COST

Chapter 68 – Taxes

Authoritative Sources

FAR 31.205-41 Taxes

48 CFR 9904.403 Allocation of Home Office Expenses to Segments

This chapter provides general guidance in reviewing the allocability and allowability of taxes, including Federal, state, and local taxes; employment taxes; employment taxes of successor contractors following mergers or consolidations; Federal excise taxes; foreign taxes; and environmental taxes.

This chapter addresses the following topics:

68-1 Unallowable Taxes

68-2 State and Local Taxes

68-3 Employment Taxes

68-4 Employment Taxes of Successor Contractors

68-5 Employment Taxes in Mergers and Consolidations

68-6 Federal Excise Taxes

68-7 Foreign Taxes

68-8 Environmental Taxes

68-1 Unallowable Taxes

In accordance with FAR 31.205-41(b) the following types of taxes are expressly unallowable as costs under Government contracts:

(1) Federal income and excess profits taxes.

(2) Taxes in connection with financing, refinancing, or refunding of operations, or reorganizations (see also FAR 31.205-20 and 31.205-27).

(3) Taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government, except when the contracting officer determines that the administrative burden of obtaining the exemption outweighs the benefits accruing to the Government (see FAR Part 29).

(4) Special assessments on land that represent capital improvements.

(5) Taxes (including excises) on real or personal property or on the value, use, possession or sale thereof, which is used solely in connection with work other than on Government contracts (see also CAM 7-1403.1b below).

(6) Any excise tax in subtitle D, chapter 43 of the Internal Revenue Code of 1986, as amended. That chapter includes excise taxes imposed in connection with qualified pension plans, welfare plans, deferred compensation plans, or other similar types of plans (see also CAM 7-606c above).

(7) Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income as reflected by the books of account and financial statements (see also CAM 7-1403.4a below).

(8) Any tax imposed under 26 U.S.C. 5000C (see also CAM 7-1407 below).

Contractors that elect Subchapter S Corporation tax status are not taxed at the corporation level and thus are not normally required to pay state or local income taxes or to accrue such tax liability. Instead, the corporate income passes through to the shareholders and is taxed on the shareholders' personal income tax returns. Accordingly, state and local taxes that are passed through to the individual shareholders are not an expense of the corporation and as a result, are not allowable costs under Government contracts. Auditors should ensure that contractors who have elected Subchapter S tax status, or any other tax status (e.g., Limited Liability Corporation) in which taxes on the pass-through income of the corporation are required to be paid by the individual shareholders, are claiming only those taxes which are required to be paid or accrued by the contractor. Individual shareholder state and local income taxes claimed by the contractor on their pass-through income to the shareholders are unallowable in accordance with FAR 31.205-41, Taxes, and should be questioned.

68-2 State and Local Taxes

State and local taxes, including property, franchise, and income taxes, are allowable contract costs in accordance with FAR 31.205-41. However, if the taxes are paid late or in error, any penalty, or interest on borrowings, assessed by the state or local government is an unallowable cost except in the limited circumstances described in FAR 31.205-41(a)(3).

68-2.1 General Audit Considerations

Care must be exercised regarding the propriety of allocation of certain taxes to Government work. For example, the allocation to all work of the contractor of personal property taxes levied against the contractor's commercial inventories may not be proper where similar taxes are not levied against Government contract inventories.

FAR 31.205-41(b)(5) states that taxes (including excises) on real or personal property, or on the value, use, possession, or sale thereof, which is used solely in connection with work other than on Government contracts are not allowable. FAR 31.205-41(c) states that these taxes should be allocated to the respective category of work unless the amounts involved are insignificant or comparable results would otherwise be obtained. The costs of taxes incurred on property used in both Government and non-government work shall be apportioned to all such work based upon the use of such property on the respective final cost objectives.

If the contractor claims taxes for which there exists a question of illegal or erroneous assessment, the amount of such taxes should be identified and described in advisory audit reports and contract audit closing statements. If it is subsequently determined that the taxes have been improperly assessed, a credit or refund may be pursued by the Government (See FAR 31.205-41(a)(2)).

(1) The auditor should follow up as appropriate to assure that a proper share of credits or refunds received by the contractor is passed on to the Government (See FAR 31.205-41(d)).

(2) If the contractor has failed to take actions as specified in FAR 31.205-41(a)(2), the costs should be questioned or disapproved.

Penalties assessed by state or local tax authorities are unallowable in accordance with FAR 31.205-15 even if they are unavoidable or incurred inadvertently. However, FAR 31.205-41(a)(3) provides a specific exception to the disallowance of penalties when incurred as a result of following the contracting officer's direction or permission not to pay taxes assessed by a state or local government.

Generally, interest associated with an intentional underpayment of state or local taxes is unallowable per FAR 31.205-20 because the interest can be considered to be “interest on borrowings.” “Intentional,” as used here, means intentionally paying less than the contractor reasonably believes is due. However, interest associated with an underpayment of taxes, where the contractor’s intent to borrow cannot be shown, is allowable. If the contractor’s underpayment was directed or agreed-to by the contracting officer, FAR 31.205-41(a)(3) allows any resulting interest.

Interest incurred as a result of late payments (e.g., not paying financial obligations by the due date) represents “interest on borrowings” and is therefore unallowable per FAR 31.205-20.

68-2.2 Allocation Problems and Methods

State income or franchise taxes sometimes present unique allocation problems. From a taxing standpoint, when a corporation is engaged in activities in several states it becomes necessary to determine the share of a corporation's income to be attributed to each state. The states have developed three primary methods of dividing the income of a multi-state taxpayer: separate accounting, specific allocation, and formula apportionment. Each method is discussed below.

(1) Separate Accounting. The separate accounting method is based on the premise that a multi-state taxpayer can be divided into separate entities so that its activities within the taxing state can be segregated from its activities elsewhere and accounted for separately. This method is seldom acceptable to the states.

(2) Specific Allocation. The specific allocation method provides for the designation of specified items of income in their entirety as either within or outside the state. This method is infrequently used by itself, but is often combined with the formula apportionment method discussed below.

(3) Formula Apportionment. This is the most frequently used method. The percentage of income to be assigned to a particular state is determined by averaging a number of ratios. For example, one ratio frequently used is the ratio of in-state sales to out-of-state sales. Similar ratios are commonly based on property and on payroll. The average of the ratios used is then multiplied by the net income subject to apportionment (defined by the state) to arrive at the taxable income for the state.

Through the use of the method described in (3) above, it is possible that a multi-state taxpayer may be assessed a large corporate state income or franchise tax by a particular state and in actuality have very little income recorded on the books of its operations within that state. Apportionment of unitary income in excess of local book income within the state is justified by courts on the assumption that all component activities, wherever located, contribute proportionately to all corporate income.

Contractors often include the above discussed taxes, along with other indirect expenses, in an established burden center for allocation to operating divisions located in various states. In reviewing these allocations, the general rule for the auditor to follow is to determine that the amount allocated to operations within a particular state approximates the amount of tax paid to such state. The further allocation of this amount to cost centers or contracts within the state should be made through divisional G&A. However, in those cases where a division is doing business in several states, the auditor may find that more equitable results are obtained by applying the method used by the state in assessing the tax, or through an established burden center of the contractor other than G&A. The following guidance relates to the allocation of state franchise taxes to a company's segments:

(1) CAS 403.40(b)(4) requires that central payments or accruals (which may include state and local income taxes and franchise taxes) made by a home office on behalf of its segments shall be allocated directly to segments to the extent that all such payments or accruals of a given type or class can be identified specifically with individual segments. Any such types of payments or accruals which cannot be identified specifically with individual segments shall be allocated to benefited segments using an allocation base representative of the factors on which the total payment is based. (Also see CAM Section 8-403.)

(2) Lockheed Corp. and Lockheed Missiles & Space Co., ASBCA Case No. 27921, 86-1 BCA ¶ 18,614, aff'd, 817 F.2d 1565 (Fed. Cir. 1987) and U.S. Court of Appeals for the Federal Circuit Case No. 86-1177 contain extensive and detailed discussions of the allocation of state franchise taxes to segments. In the ASBCA case, the Board ruled that Interpretation No. 1 to CAS 403 is not binding as to the meaning of CAS 403 because the promulgation of the Interpretation did not follow the statutory requirements for issuance of a standard and that a segment's income (or loss) was an appropriate factor to consider in the allocation of state franchise taxes to segments. The ASBCA decision was upheld by the Court. However, in rendering its decision, the Court's rationale departed somewhat from that of the ASBCA. It did not believe the validity of Interpretation No. 1 was relevant to its decision. The decision effectively relegated Interpretation No. 1 to the status of elaborating upon the CAS 403.60(b) illustration concerning taxes. The Court ruled that the one example in CAS 403.60(b) did not defeat the plain meaning of "factors" as used at CAS 403.40(b)(4). Since segment net income is a causal factor, the Court ruled that CAS 403.40(b)(4) permitted it in an allocation formula. In the Claims Court case No. 49-89C. Hercules, Inc. v. U.S., 26 Cl.Ct. 662 (1992), the Court re-emphasized that net income is permitted, but not required, as an allocation factor.

(3) The Court's ruling does not mean that all allocation methods that use segment book income are automatically compliant. In fact, the Court only held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4), because the parties had stipulated that if CAS 403 permitted net income as an allocation factor, then the Lockheed method complied with CAS 403. In the ASBCA case that was the subject of the appeal, two other allocation methods that used income as an allocation factor were considered and rejected. The Lockheed method which the Court ruled is compliant and the two methods using income (the Factor Analysis, and Proration Percentage) that the ASBCA held were noncompliant are described and illustrated at 68-2.3.

Allowing income as an allocation factor broadens the choices of possible allocation methods and makes the evaluation of tax allocations more difficult. Each situation must be carefully evaluated to determine if the particular methodology makes appropriate use of segment book income. The following two key areas deserve special attention when evaluating any methodology which uses segment book income:

(1) The first is evaluating the contractor's methodology for determining the propriety of segment book income. For tax purposes, most states do not use segment book income as a unitary income apportionment factor because of concerns that companies could easily manipulate segments' books to show income only at segments that are in low-tax or no-tax jurisdictions. This risk of income manipulation is why most states choose not to accept the taxpayer's identification of segment income. Because proper identification of income is a high-risk area, the auditor should carefully assess a contractor's determination of segment book income to ensure the methodology is sound and consistently applied.

(2) The second is ensuring that taxes are confined to segments doing business in the taxing jurisdiction. This issue was dealt with in the Claims Court case No. 49-89C. Hercules, Inc. v. U.S., 26 Cl.Ct. 662 (1992). The Court ruled that a contractor is not in full compliance with CAS 403 if the taxes of a jurisdiction are not allocated to only those segments that do business in the taxing jurisdiction.

68-2.3 Illustrations of Allocation Methods That Use Income as an Allocation Factor

The illustrations below supplement the guidance in 68-2.2 and are intended to be used as a guide when evaluating allocation methods that use segment book income. The following facts will be used for all three illustrations:

A company has a California Franchise Tax expense of $11,000,000 and five segments --- A, B, C, D, and E with property, payroll, and sales of:

Segments	A	B	C	D	E	TOTAL
PROPERTY:						
Total (in millions)	$1,500	$800	$600	$ 400	$200	$3,500
Calif. (in millions)	750	720	600	100	20	2,190
Calif. %	50%	90%	100%	25%	10%	62.6%
PAYROLL:						
Total (in millions)	$700	$ 300	$250	$ 100	$80	$1,430
Calif. (in millions)	280	240	250	30	8	808
Calif. %	40%	80%	100%	30%	10%	56.5%
SALES:						
Total (in millions)	$2,000	$1,000	$800	$600	$300	$4,700
Calif. (in millions)	600	800	760	240	45	2,445
Calif. %	30%	80%	95%	40%	15%	52%
AVG CALIF. %	40%	83.3%	98.3%	31.7%	11.7%	57%

The five segments had the following net income/(loss):

Segment	Net Income (loss) (in millions)
A	$(200)
B	125
C	180
D	90
E	20
Total Net Income	$ 215

Lockheed Two-Step, Four-Factor Method: The ASBCA and the Federal Circuit Court held that Lockheed's two-step, four-factor formula complied with CAS 403.40(b)(4). The first step entails calculating each segment's net income derived from or attributable to a particular state's sources (e.g., California sources) using the ratio of in-state property, payroll, and sales, to total property, payroll, and sales for the segment. In the second step, Lockheed totals individual segment net income derived from or attributable to profitable in-state sources and then assigns taxes only to each profitable segment in the proportion that the segment's profits bear to total profits. Segments with no net income get no allocation and segments that do get allocations get them based upon relative profitability.

STEP 1:

Segment	Segment net income (loss) (in millions)	Times	Segment apportionment %	Equals	Segment net income from Calif. Sources (in millions)
A	$(200)	X	40.0%	=	$0*
B	125	X	83.3%	=	104
C	180	X	98.3%	=	177
D	90	X	31.7%	=	29
E	20	X	11.7%	=	2
Total Segments net income from Calif. sources					$312

*Note: Credits are not permitted; therefore, segments with losses always are assigned $0 income.

STEP 2:

Segments	Total Tax (in millions)	Times	Segment Contribution (in millions)	Equals	Allocation (in millions)
A	$11	X	0	=	$0
B	11	X	104/312	=	3.67
C	11	X	177/312	=	6.24
D	11	X	29/312	=	1.02
E	11	X	2/312	=	.07
Total Segments Allocations (in millions)					$11.00

Factor Analysis Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA considered and rejected an allocation method that used income entitled the "Factor Analysis Method."

Under this method a segment's share of total California Franchise Tax liability is calculated by first determining the percentage that the segment's net income is of the total net income (segment net losses result in negative percentage). A second percentage is calculated by averaging the ratio of the segment's California property, payroll, and sales to the total California property, payroll, and sales. Next the two percentages are averaged by adding them together and dividing by two. The resulting percentage is then multiplied by the total California Franchise Tax expense to obtain the amount of tax or credit allocated to the segment.

The ASBCA concluded that the Factor Analysis Method did not comply with CAS 403 because it allows credits for loss segments. Including credits for losses yielded allocations in excess of the actual amount actually paid. Following is an illustration of this method:

STEP 1:

Segment net income as % of total income (loss) (in millions)	Segment Calif. property, payroll, and sales as % of total Calif. property, payroll, and sales (in millions)
A (200)/215 = (93%)	(750/2190 = 34% + 280/808 = 35% + 600/2445 = 25%) / 3 = 31%
B 125/215 = 58%	(720/2190 = 33% + 240/808 = 30% + 800/2445 = 33%) / 3 = 32%
C 180/215 = 84%	(600/2190 = 27% + 250/808 = 31% + 760/2445 = 31%) / 3 = 30%
D 90/215 = 42%	(100/2190 = 5% + 30/808 = 4% + 240/2445 = 10%) / 3 = 6%
E 20/215 = 9%	(20/2190 = 1% + 8/808 = 1% + 45/2445 = 2%) / 3 = 1%

STEP 2:

Segment	Sum of two % divided by 2	Times	Total Tax	Equals	Allocation (Credit) (in millions)
A	((93%) + 31%) / 2 = (31%)	X	$11	=	$(3.41)
B	(58% + 32%) / 2 = 45%	X	11	=	4.95
C	(84% + 30%) / 2 = 57%	X	11	=	6.27
D	(42% + 6%) / 2 = 24%	X	11	=	2.64
E	(9% + 1%) / 2 = 5%	X	11	=	.55
Total Segments Allocations (in millions)					$11.00

Note: Together, segments B, C, D, and E are allocated $3,410,000 more in tax expense than the total California Franchise Tax liability.

Proration Percentage Method: In the first Lockheed Corp. and Lockheed Missile & Space Co., ASBCA case (No. 22451, 80-1 BCA para. 14,222), the ASBCA also considered and rejected a second allocation method that used income. This one was called the Proration Percentage Method. Under this method a segment's share of the state tax liability is calculated by multiplying the segment's net income or net loss by the ratio of in-state property, payroll, and sales, to total property, payroll, and sales. The product is then multiplied by the state tax rate to yield the amount of tax or credit allocated to the segment.

The ASBCA rejected the Proration Percentage Method because it in effect allocates only on the basis of profit and loss. In other words, there is no consideration of each segment's apportionment factors. Moreover, this method also included credits for losses and would result in allocations to profitable segments in excess of actual taxes paid. Following is an illustration of this method:

Segment	Segment net Income/(loss) (in millions)	Times	Calif. Apportionment %	Times	Calif. Franchise Tax Rate	Equals	Allocation (credit) (in millions)
A	$(200)	X	57%	X	9%	=	$(10.2)
B	125	X	57%	X	9%	=	6.4
C	180	X	57%	X	9%	=	9.2
D	90	X	57%	X	9%	=	4.6
E	20	X	57%	X	9%	=	1.0
Total Allocation (in millions)							$11.00

68-2.4 Guidance in Determining Allowable State and Local Taxes

Tax Accruals

Contractors sometimes make provisions to account for estimated state income or franchise taxes when there are significant differences between taxable income, as determined in accordance with state regulations, and income for the period, as determined in accordance with generally accepted accounting principles. These differences may result from items such as (a) recognizing in the income statement possible losses that may not be deductible for tax purposes until they occur, (b) computing depreciation for income statement purposes by use of a method different from that used for tax purposes, or (c) by recognizing revenue for tax purposes before it would be recognized in the income statement in accordance with generally accepted accounting principles. Provisions are made for taxes related to such items based on an assumption that a tax liability exists, and will ultimately materialize, as a direct result of such transactions. For example, in the case of a straight line method of depreciation

being used for income statement purposes and an accelerated method for tax purposes, the tax savings in the early years of the asset's life will ultimately be offset by higher taxes in the later years of the asset's life. Therefore, the provisioning of an additional amount for taxes in the early years of the asset's life to offset the higher taxes in the later years in effect tends to relate the state income tax expense for the period to the income as shown in the financial statements. The opposing view contends that if a contractor follows a consistent program of asset replacement, which would be necessary to a continuing concern, tax savings on new assets should offset higher taxes on expiring assets.

The auditor should obtain the best evidence available that supports the amount of costs incurred. In determining allowable costs under Government contracts, the best evidence available to support the amount of state income or franchise tax incurred is the amount paid. The auditor should not attempt to estimate the amount of tax currently being paid that is applicable to future or prior periods, for purposes of determining allowable costs under Government contracts. Similarly, amounts estimated by contractors as tax liabilities in excess of the amounts actually paid should not be considered in determining allowable contract costs. Income tax accruals designed to account for the tax effects of differences between taxable income and pretax income, as reflected by the books of account and financial statements are unallowable (See FAR 31.205-41(b)(7)).

Income tax accruals designed to estimate additional taxes to be paid resulting from tax audits by the state or local tax authorities are considered contingencies that are unallowable under FAR 31.205-7(b). However, tax accruals designed to relate the amount paid on the basis of a taxing authority's fiscal year to the contractor's accounting period are allowable in accordance with FAR 31.205-41(a). (See also 68-1)

Tax Credits and Refunds

Many states follow the same or basically similar procedures as provided in the Internal Revenue Code for net operating loss carry-backs. In most states, a net operating loss can be carried back for 3 years or forward for 5 years. We are primarily concerned with carry-backs for state income or franchise taxes. Operating loss carry-backs will result in a refund of prior years' taxes which have been paid by the contractor and reimbursed by the Government.

The Government's right to share in these refunds is covered by FAR 31.205-41(d), which provides that "Any taxes, interest, or penalties that were allowed as contract costs and are refunded to the contractor shall be credited or paid to the Government in the manner it directs." This requirement is also addressed in FAR 31.201-5 and the "Allowable Cost and Payment" clause at FAR 52.216-7. In Hercules Inc. v. United States, 292 F.3d 1378 (Fed. Cir. 2002) issued June 5, 2002, the United States Court of Appeals for the Federal Circuit concluded that the principal requirement of FAR 52.216-7, Allowable cost and payment, and FAR 31.201-5, Credits, is to provide the Government with a refund when a cost that has been reimbursed to a contractor is later

reduced. The Court found that these clauses require the refund be passed to the Government in the same ratio as the tax payment was originally reimbursed by the Government. Accordingly, if the contractor receives a refund of previously reimbursed tax, the auditor should determine the Government's share of the refund based on the Government reimbursement of that expense in the year in which the cost was originally incurred.

Example: ABC Company claims $1,000,000 in state income tax expense in the G&A pool in 2016. The Company receives a $500,000 refund of its 2016 income tax in 2018. The Government participation in the G&A allocation bases are:

Fiscal Year	2016	2017	2018
Percentage	65%	70%	55%

The percentages represent cost reimbursable contracts containing the FAR 52.216-7 contract clause. The Government's share of the refund is determined as follows:

Amount of Refund	Times	Government Participation for 2016	Equals	Government Share of Refund
$500,000	x	65%	=	$325,000

If the Company accounts for the refund in the fiscal year received (2018), the Government would receive $275,000 ($500,000 x 55%). The auditor must assure the remaining Government share of $50,000 ($325,000 – 275,000) is credited to the Government in accordance with FAR 31.201-5, Credits.

68-2.5 Changes in Method of Measuring Taxable Income

State tax regulations have usually permitted a taxpayer to initially select one of several acceptable methods of stating the elements that determine taxable income and later, under specified conditions, to change from the initial selection to another acceptable method. Some elements for which alternate acceptable methods have been allowed are

(1) income from long-term contracts,

(2) inventory pricing, and

(3) depreciation methods.

The Tax Reform Act of 1986 (TRA) repealed the acceptability of the completed contract method for measuring annual taxable income for long term contracts awarded after February 26, 1986. Since the TRA, the IRS has implemented additional restrictions on methods that can be used to measure annual taxable income. Although the changes

in method are intended primarily to apply to Federal income taxes which are not allowable on Government contracts under FAR 31.205-41(b)(1), State income taxes, which are allowable on Government contracts, will in many cases also be affected since a number of States have adopted Federal tax regulations to determine State taxes.

Under the provisions of the change, contractors must recognize income from long term contracts using either the percentage of completion method or the percentage of completion-capitalized cost method. Both methods must be based on a cost-to-cost relationship rather than an estimate of physical completion (engineering cost method or other modified methods not based on cost) which was previously permitted. The percentage of completion method based on a cost-to-cost relationship recognizes income from long term contracts based on the proportion of the estimated contract price that costs incurred through a period bears to the total expected costs reduced by the amounts of contract price that were included in income in previous years. Under the percentage of completion-capitalized cost method, only a certain percent of the items of each contract need to be recognized under the percentage of completion method and the remaining percent of the items are to be accounted for under the taxpayer's normal method (e.g., the completed contract method). Costs to be used in determining the percentage of completion are:

(1) direct material and direct labor costs, and

(2) depreciation, amortization and cost recovery allowances on equipment and facilities directly used to construct or produce the subject matter of the contract.

It should be noted that the prescribed cost-to-cost relationship is an example of circumstances where the tax law is at variance with appropriate cost accounting.

Any changes made in the method of measuring income for long term contracts as a result of changes in tax regulations (e.g., a change from the completed contract method to the percentage of completion method or the percentage of completion-capitalized method) should be considered to be a change in cost accounting practice because it alters the measurement of State tax costs for a cost accounting period by assigning taxable income or loss to other periods. Because measurement and assignment of cost are involved, the change in determining contract income is a change in cost accounting practice as described in CAS. Since the change is not being required by any change in CASB rules, regulations and standards, it should be considered a unilateral change unless and until the cognizant Federal agency official (CFAO) determines that the change is desirable. (See CAS Working Group Paper 81-25.)

When a contractor is required by the tax laws to change its accounting practices, changing from a no longer acceptable method to an acceptable method may be considered a desirable change. However, a final determination on this matter is the responsibility of the CFAO. Unless the CFAO makes the determination that the change meets the requirement to be considered a desirable change (i.e., not detrimental to the interests of the Government), the change would be considered a unilateral change

covered by paragraph (a)(4)(iii) of the CAS clause (FAR 52.230-2) and no increased costs as a result of the change would be permitted (see also CAM 8-303).

Auditors should also be aware that the TRA includes a look-back provision. This provides that, to the extent that the percentage of completion applies to a long term contract, a taxpayer who does not accurately predict the eventual contract price must recompute its tax liability for the years that such method was used on the basis of the actual contract price and costs. If the recomputed tax liability exceeds the previously reported tax liability, the taxpayer must pay interest; if the recomputed tax liability is less, the taxpayer is entitled to interest. This provision may affect State tax costs to the extent that this look-back provision is incorporated into State laws. Accordingly, auditors should review the look-back computations to determine if any unallowable penalties and interest are included in costs charged to Government contracts or if the Government is due a credit.

68-2.6 Special Considerations   Revenue Based State Taxes

Some state taxes (e.g., New Mexico and Washington) are imposed on the seller, and are computed by multiplying the total revenues (with limited exceptions) received from doing business in the state by the applicable tax rate. There is no legal obligation for the seller to collect the tax from the buyer. For the purpose of Federal immunity, this makes these state taxes different from conventional sales taxes. If the tax is imposed on the seller and there is no legal obligation to collect the tax from the buyer, then the seller is not exempt from paying state sales taxes on sales to the Government unless there is an express Government sales exemption in the applicable tax code. However, normally the seller has a legal obligation to collect the tax from the buyer. When there is a legal obligation to collect the tax from the buyer, and the buyer is the Government, the sales are exempt from state sales tax as a matter of federal supremacy. State law dictates whether the Government is the buyer or not in transactions involving Government contracts. For example, the Connecticut Supreme Court, applying Connecticut statutes, found that the United States is the actual buyer of personal property sold by third parties to a cost-reimbursement Government contractor because the one who takes title to the property is the United States. It held such sales exempt from Connecticut sales tax. In contrast, services sold by third parties to Government contractors were not exempt since a different statutory test applied and it identified the contractor as the buyer, not the Government. Determinations of whether state and local taxes are allowable contract costs under FAR 31.205-41 must be made on a case-by-case basis based on each state's tax laws. Questions regarding state-law exemptions and federal sovereign immunity should be addressed to the contracting officer's designated legal counsel because they require interpretations of statutes, regulations, and case law (FAR 29.101).

Revenue based state taxes are levied on the contractor's revenue from doing business in the state, which generally comprises many contracts. Accordingly, the state tax should be distributed to contracts using the contract revenue that is subject to the state tax as the allocation base.

Revenue based state taxes are overall costs of doing business in the nature of G&A expenses. However, these taxes, if material, should not be accounted for in the G&A pool. Any method of distributing material amounts of revenue based state taxes through overhead, G&A, or any other cost based allocation would be inappropriate, since the taxes are based on revenue rather than cost.

Revenue based state taxes should be included in the total cost input base for G&A allocation. Exclusion of these taxes through the use of a special allocation under CAS 410.50(j) is inappropriate, since such special allocations apply to final cost objectives, not specific cost elements.

68-3 Employment Taxes

The Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) each impose a tax upon employers for each calendar year, the amount of which is based upon a specified percent of the wages paid by the employer to his individual employees. The taxes are limited to the annual maximum wages established by statute for each individual employee. These rates and wage limits vary periodically. The taxes imposed by the FUTA are levied and collectible in part by the state and in part by the Federal Government. The guidance in this paragraph is concerned with the phase of these taxes levied on employers and not on employees.

Generally, if during a calendar year an employee receives remuneration from more than one employer, the annual wage limitation does not apply to the aggregate remuneration received from all employers, but instead applies to each individual employer. Exceptions to this rule are discussed below in 68-4 and 68-5.

The auditor should familiarize himself or herself with the rates and wage limitations in effect for each calendar year and ascertain that the contractor is not paying taxes in excess of the statutory requirements. He or she should also obtain supporting documentation for the various state unemployment rates being used by the contractor in those states in which it is paying the tax. Attention should also be given to tax credits or reductions granted the employer in state unemployment tax rates because of favorable employment experience. In such cases, the auditor should accept as allowable costs only the actual (net) amounts which the contractor is required to pay.

Where historical data are the basis for cost projections or estimates, consideration should be given to the effect that prospective changes in the tax rates and annual wage limitations will have on such forecasts. The auditor should assure that where expense accruals are made for these taxes they are adjusted periodically so that costs charged to contracts do not exceed the actual cost.

68-4 Employment Taxes of Successor Contractors

Successor contractor situations generally relate to yearly service or maintenance contracts at Government installations where, under recompetition, a new contractor receives a cost-reimbursement type contract award, usually cost-reimbursement type, and takes over performance as of the beginning of the fiscal year, 1 July, and retains many of the same employees. In this regard, Revenue Ruling 68-105 (C.B. 1968-1, 418) holds that a new contractor may qualify as a successor contractor, where the property used in the performance of the contracts is the same Government-owned property. It is immaterial that no interest in the property used was acquired directly from the predecessor employer.

Section 3121(a)(1) of the Federal Insurance Contributions Act (FICA) and 3306(b)(1) of the Federal Unemployment Tax Act (FUTA), respectively, and the applicable regulations provide that the wages paid by a predecessor to an employee shall, for purposes of the annual wage limitation, be treated as having been paid to the employee by a successor, if

(1) the successor during a calendar year acquired substantially all the property used in a trade or business, or used in a separate unit of a trade or business, of the predecessor;

(2) the employee was employed in the trade or business of the predecessor immediately prior to the acquisition and is employed by the successor in his or her trade or business immediately after the acquisition; and

(3) the wages were paid during the calendar year in which the acquisition occurred and prior to the acquisition.

The method of acquisition by an employer of the property of another employer is immaterial. The acquisition may occur as the result of purchase or any other transaction where substantially all the property is acquired by the new employer.

If the new employer (contractor) meets these criteria, he or she may qualify as a successor employing unit so that for the purpose of establishing the wage limitations, remuneration paid to continuing employees by the predecessor during the calendar year and prior to the acquisition shall be considered as having been paid by the successor. The statutory minimums then apply to the combined earnings under both contractors. Additionally, the successor may be eligible to file with state authorities and obtain a lower merit unemployment tax rate based on the predecessor's experience at the location.

Where a contract changes hands under the foregoing circumstances, or the auditor has knowledge that such a change is to occur shortly, it is a matter of some urgency that the auditor takes the following steps on a timely basis.

(1) Ascertain whether the new contractor has determined that it qualified as a successor. If there is any doubt or question as to its status, the contractor should obtain a ruling from IRS.

(2) Determine that the successor obtains the predecessor's earnings record and tax payments records for the current year on the continuing employees.

(3) Determine that the successor, if qualified, ceases from incurring further costs for FICA and FUTA as soon as an employee's total combined earnings under both the predecessor and successor reach the statutory wage limitations.

(4) Where a lower merit rating is available under FUTA, based on the predecessor's experience at the location, determine that the successor has filed with state authorities and has obtained and is using the more favorable unemployment tax rate. However, there are some states which do not recognize predecessor experience as being eligible in obtaining a lower merit tax rate.

(5) In the event that taxes have been paid in excess of the proper amounts, determine that the successor obtains refunds and properly credits the Government.

(6) Advise the contracting officer of any failure of the successor to take full advantage of its status as a successor employing unit under both FICA and FUTA.

68-5 Employment Taxes in Mergers and Consolidations

The Internal Revenue Service has ruled (Revenue Ruling 62-60, C.B. 1962-1, 186) that, in the absorption of one corporation by another in a statutory merger or consolidation, the resultant entity is regarded as the same taxpayer and same employer as the absorbed corporation for FICA and FUTA purposes. Thus, there is no interruption in the employment status of the continuing employees and they are considered to have been in one employment throughout the year.

Where contractors have undergone statutory mergers or consolidation, the auditor should determine that FICA and FUTA taxes on the continuing employees are paid on the basis of a single employment for the year. Additionally, the auditor should ascertain whether credits for contributions to state unemployment funds and merit rating credits available to the absorbed corporation have been utilized by the surviving corporation.

68-6 Federal Excise Taxes

Such taxes are allowable unless:

- Exemptions are available to the contractor (FAR 31.205-41(b)(3)). When there are substantial amounts involved (in either incurred or projected costs) and where there is a reasonable probability that the benefits of an exemption will outweigh the administrative burdens involved, the auditor should investigate the possibility

that an exemption exists. If an exemption does not exist, appropriate inquiry or recommendation should be made to the contracting officer regarding the desirability of obtaining one;

- An excise tax on real or personal property or on the value, use, possession or sale thereof, which is used solely in connection with work other than on Government contracts (FAR 31.205-41(b)(5) (see also 68-2 above).
- An excise tax in subtitle D, chapter 43 of the Internal Revenue Code of 1986, as amended (FAR 31.205-41(b)(6) (see also Chapter 53, Pension Costs).
- An excise tax imposed under 26 U.S.C. 5000C (FAR 31.205-41(b)(8). This section of the FAR specifically disallows the 2 percent excise tax on certain Federal procurement payments to foreign persons imposed by the James Zadroga 9/11 Health and Compensation Act of 2010.

68-7 Foreign Taxes

When a contractor performs Government contracts in foreign countries, whether under a Foreign Military Sales (FMS) contract or for domestic requirements, certain host countries impose taxes on the contractor. FAR 31.205-41(a)(1) specifically addresses the allowability of Federal, state, and local taxes without addressing the allowability of foreign taxes. Because foreign taxes are analogous to state or local taxes, they are considered to be allowable contract costs.

When a contractor has paid an income tax to a host country, it can subsequently claim a foreign tax credit against its Federal income tax under Internal Revenue Code Section 901. If a contractor claim for a foreign tax credit is accepted by the Internal Revenue Service, it will result in a reduction in Federal income tax liability by the full amount of the credit. In that situation, the contractor would be duplicating the recovery of foreign income tax expenditures---first as a contract cost and second as a reduction in its Federal income tax liability.

This situation is addressed in contract clauses at FAR 52.229-6, 52.229-8, and 52.229-9 as well as in FAR 31.205-41(d).

(1) For fixed-price contracts, FAR 52.229-6(h) requires that if a contractor obtains a reduction in its U.S. tax liability because of the payment of any tax or duty which was included in the contract price, the amount of the reduction shall be paid or credited to the U.S. Government as directed by the contracting officer.

(2) For cost-reimbursable contracts awarded on or after March 7, 1990, FAR 31.205-41(d), 52.229-8 and 52.229-9 require that contractors and subcontractors pay or credit to the U.S. Government the amount of such reductions as directed by the contracting office unless the contract costs are being reimbursed by a foreign government. In the case of a foreign government reimbursing the contract costs, the contractor or subcontractor must repay the U.S. Treasury for any reduction in U.S. tax liability. FAR 52.229-9 specifically requires the payment to the Treasury and prohibits credit to a contract in such a case.

(3) For cost-reimbursable contracts awarded prior to March 7, 1990, FAR 31.201-5, "Credits," should be cited to assert the Government's right to recover such reductions in U.S. tax liability.

Generally, foreign income taxes on the employee’s salaries and wages are unallowable because they are a liability of the employee, not the contractor. However, contractors may be able to reimburse the employee and claim, as part of foreign differential pay, the difference between the employee’s total income tax payment and the amount the employee would have incurred had the employee remained on domestic assignment. Refer to Chapter 20, Domestic and Foreign Taxes – Differential Allowances for guidance on the evaluation of employee foreign tax differential allowances.

Foreign taxes may include taxes levied for social insurance contributions in addition to income taxes. Social insurance contributions generally include payments for such items as retirement pay insurance, health insurance, unemployment insurance, nursing care insurance, and accident insurance. The employee’s share of the social insurance contribution is generally not allowable because it is the employee’s responsibility, not the contractor’s. The contractor’s share of the social insurance contribution is generally allowable in accordance with FAR 31.205-41(a)(1).

68-8 Environmental Taxes

The Superfund Amendments and Reauthorization Act of 1986, Public Law 99-499, designated funding sources for the Hazardous Substance Response Trust Fund ("Superfund"). Among the sources is the Environmental ("Superfund") Tax enacted by Section 516 and codified at Section 59A of the Internal Revenue Code. The tax is placed in the subtitle devoted to income tax provisions. The positioning of the statute in this subtitle and the direct relationship of the tax rate to income denotes this as a tax on income. The tax is equal to 0.12 percent of that portion of the corporation's modified alternative minimum taxable income which exceeds $2,000,000.

For contracts awarded prior to January 22, 1991, the Superfund Tax is considered to be an expressly unallowable Federal income tax in accordance with FAR 31.205-41(b)(1). (Rockwell International Corporation v. Widnall, No. 96-1265 (April 1, 1997), aff”g ASBCA No. 46544, 96-1 BCA para 28,057.) Effective January 22, 1991, FAR 31.205-41(a) was revised to make the Superfund Tax a specifically allowable cost for contracts entered into on or after that date.