

DOCUMENT RESUME

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[Sales Tax Refunds Due from Naval Petroleum Reserve].

LCD-79-300; B-66927. December 13, 1978. 7pp.

Report to James R. Schlesinger, Secretary, Department of Energy; by J. Dexter Peach, Director, Energy and Minerals Div.

Issue Area: Are Agencies Maintaining Government Facilities Cost-Effectively? (713); Federal Government Trusteeship over Energy Sources on Federal Lands. (1614).

Contact: Logistics and Communications Div.

Budget Function: Natural Resources, Environment, and Energy: Energy (305).

Organization Concerned: Department of the Navy.

Congressional Relevance: House Committee on Interior and Insular Affairs; Senate Committee on Energy and Natural Resources.

The operation of Naval Petroleum Reserve (NPR) No. 1, Elk Hills, California, was reviewed because previous reviews have indicated problems in the operating contractor's system of estimating and billing costs to the Navy. Most of these problems have been resolved, but one question remains concerning recovery of previously paid sales taxes. Until April 1976, purchases made in California by NPR contract operators were subject to the State's sales tax, with certain exceptions. At that time, the U.S. Supreme Court decided that the sales tax applied to the purchaser not to the seller. The NPR contractors may have paid at least \$1 million in sales taxes which may be recoverable if the Supreme Court decision is retroactive. If the decision applies retroactively, the Secretary of Energy should recover the sales taxes paid on all tangible personal property purchases made from April 1973 through April 1976. (RRS)



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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ENERGY AND MINERALS
DIVISION

B-66927

December 13 1978

The Honorable James R. Schlesinger
The Secretary of Energy

Dear Mr. Secretary:

We have reviewed the operation of Naval Petroleum Reserve (NPR) No. 1, Elk Hills, California, because our previous reviews and discussions with Department of Navy and Defense Contract Audit Agency personnel indicated problems in the current operating contractor's system of estimating and billing costs to the Navy. We examined the system and found that most of the problems have been resolved. We discussed certain minor exceptions with NPR No. 1 officials and identified certain issues that are discussed below. Factual matters in the report were given to contractors for comment. Their comments have been incorporated into the report where appropriate.

As you know, NPRs were administered by the Department of the Navy until September 30, 1977. However, we have directed the recommendation on page 6 to you, since the reserves are now within the jurisdiction of the Department of Energy. This recommendation concerns recovering previously paid sales taxes.

STATE SALES TAX DUE
TO THE NAVY

Until April 1976, purchases made in California by NPR contract operators were subject to the State's sales tax, with certain exceptions as determined by the California Board of Equalization (Board), a State agency which administers, enforces, and collects sales and use taxes. Application of the sales tax was in accordance with Board regulation 1615 which states 1/ in part:

1/The California Board of Equalization regulation 1615 was rescinded on April 1, 1976. Pertinent portions of it have been revised and incorporated into Board regulation 1521.

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"Either the sales tax or the use tax applies with respect to sales of tangible personal property (including materials, fixtures, supplies and equipment) to contractors or subcontractors for use in the performance of contracts with the United States for the construction of improvements on or to real property in this State. The fact that the contract may provide principally for the manufacture or acquisition of tangible personal property is immaterial. The sales tax, but not the use tax, applies even though the contractor purchases the property as the agent of the United States."

The regulation exempted machinery and equipment purchases that met each of four following conditions.

1. The purchased item is not used by the contractor in making the improvements (as distinguished from supplies and tools, such as steam shovels, cranes, trucks, and hand or power tools, actually used to perform construction work).
2. The item either is not attached to the realty or, if attached, is readily removable as a unit.
3. The item is installed to perform a manufacturing operation or some other function not essential to the structure itself.
4. Title to the property passes to the United States before the contractor makes any use of it.

Around 1950 the Board determined that the following items, which are periodically purchased by NPR contract operators, were exempt under the above criteria

- pumping units and gas engines,
- compressors and engines,
- office equipment,

- well pumps,
- automotive equipment,
- hoist repair, and
- office supplies. 1/

A Standard Oil Company of California (SoCal) representative at the reserve said that the policy of the contract operator had been to pay sales tax on all purchases, exempt and nonexempt, then apply to the State for a rebate on the exempt items. Exempt items were billed to the Navy net of sales tax. However, in practice this policy was not always followed which resulted in apparent overpayment of sales taxes by the Navy on pumping units and gas engines.

We brought this matter to the attention of NPR No. 1 officials in February 1977 and suggested that they request the Defense Contract Audit Agency to audit the exemptions to determine if overpayments were made. NPR officials requested the audit, and, as of July 1977, the auditors had found \$10,676 in overpaid sales taxes for the second and third quarters of 1974. The auditors expected to find considerably larger amounts in the remaining periods since they involved more activity.

In commenting on portions of this report, SoCal and Williams Brothers (the previous and current operators, respectively) indicated that the above billing policy was inaccurate. Both operators stated that the policy was to bill at the exempt items' actual cost, including sales taxes. In our opinion, the divergent statements of billing policy need to be clarified by the Department of Energy to properly resolve the extent of overpayments.

On July 7, 1977, the Officer-In-Charge of NPR No. 1 requested a refund from SoCal, the operator during the second and third quarters of 1974. NPR's legal counsel said that the statute of limitations for filing a claim

1/The office supplies exemption was actually added after 1950.

to the State of California on second quarter 1974 taxes would expire on July 31, 1977; therefore, on July 27, 1977, the Navy filed on its own behalf to protect the Government's interest in case SoCal did not file on time. SoCal informed us that it had responded to the Officer-In-Charge on July 26, 1977, confirming an earlier oral recommendation to NPR staff that the Navy should directly file for refund in order to minimize any question as to which party had standing to seek a refund. SoCal stated also that it had filed claims for refund on July 28, 1977.

We met with headquarters representatives of the Office of Naval Petroleum and Oil Shale Reserves to discuss this report. They believed that they have taken appropriate steps to recover all overpaid sales taxes. They gave us certain documentation which confirmed that some claims for refunds have been filed with the Board by the operators (previous and current) and by the Navy.

We believe that the steps set in motion should be continued until a firm, complete, and satisfactory resolution of this matter is reached protecting the Government's interest.

POTENTIALLY RECOVERABLE SALES TAX

As discussed above, the contract operators' policy was to pay sales tax on all purchases of tangible personal property as required by Board regulation 1615, excluding only those items specifically exempted by the regulation. The Board regulation was considered to be a proper exercise of the State's taxing authority. For many years, California courts ^{1/} upheld the validity of the tax under the rationale that the tax applied to the seller rather than the purchaser; therefore, it did not violate Federal constitutional principles. However,

^{1/}See e.g., Western Lithograph Co. v. State Board of Equalization, et al., 11 Cal. 2d, 156 78 P. 2d 731 (1938); and General Electric Co., et al., v. State Board of Equalization, 111 Cal. App. 2d 180, 244 P. 2d 427 (1952).

in April 1976 the U.S. Supreme Court decided that the sales tax applied to the purchaser and not the seller. 1/

In June 1976 the Navy Judge Advocate General advised the Director of the Naval Petroleum and Oil Shale Reserves that all purchases of tangible personal property made by contract operators of the NPRs located in California, if made in their capacity as purchasing agents for the Federal Government, should no longer be subject to the State sales tax. 2/ On July 10, 1976, the Officer-In-Charge of NPR No. 1 directed the contractor to cease paying California State sales tax on all purchases of tangible personal property made in conjunction with operating the NPR. The Board has issued a notice of determination to the current operator stating that it owes about \$2.9 million for sales and use taxes representing the Board's estimate of taxes payable from November 14, 1975, to December 31, 1977, the period the operator had ceased paying taxes on all tangible personal property. The current operator has filed a petition for redetermination of the Board's finding.

NPR headquarters representatives have sought the assistance and advice of the Department of Justice in this matter.

We believe that merely ceasing to pay the tax on future purchases is not adequate. Under section IV(e) (7) of the current operating agreement, one of the contractor's functions is to furnish or acquire machinery, equipment, materials, tools, supplies, facilities, labor, services, plus construction and maintenance of structures and facilities required for performing work under the agreement. Section VIII (b) and (c) provides that title to all equipment, machinery,

1/Diamond National Corp., et al., v. State Board of Equalization, 425 U.S. 268, rehearing denied 425 U.S. 1000 (1976).

2 See e.g., Kern-Limerick, Inc., et al., v. Scurlock, Commissioner of Revenues For Arkansas, 347 U.S. 110 (1954), which held that a State's sales tax could not validly be applied to a contractor who purchased articles under an agreement whereby he was to act as an agent for the Government and title to articles purchased by him was to pass directly from the seller to the United States.

and other property purchased by the contractor, the cost of which the contractor is entitled to recover as a reimbursable cost from the Navy, shall pass to and rest in the Navy/SoCal unit or the Navy upon delivery by the vendor.

To gauge the magnitude of sales taxes paid, we sampled the purchases for tubular products for the 18-month period from June 1974 through December 1975 and found that about \$1 million was paid. We believe a detailed audit of all tangible personal property purchases made over the 3-year period before the Supreme Court decision may identify sales taxes amounting to well over \$1 million. The 3-year period would be the statute of limitations time frame if the Supreme Court decision is determined to apply retroactively.

Thus, under the court decisions previously cited and the facts developed during our review, we believe that at least \$1 million in sales taxes have been paid which may be recoverable. At issue here is whether the Supreme Court decision will be held to be retroactive.

RECOMMENDATION

We recommend that you determine whether the Supreme Court decision applies retroactively and if so, recover the sales taxes paid on all tangible personal property purchases made from April 1973 through April 1976.

Department of Energy representatives stated that their only alternative is to request the Department of Justice to file suit against the State of California. They feel that until such action is initiated and ruled upon, it is uncertain if the Supreme Court's decision is retroactive. The representatives further stated that the Department of Energy has contacted the Department of Justice concerning this matter. We believe that this course of action should be continued until a firm decision regarding this matter is made.

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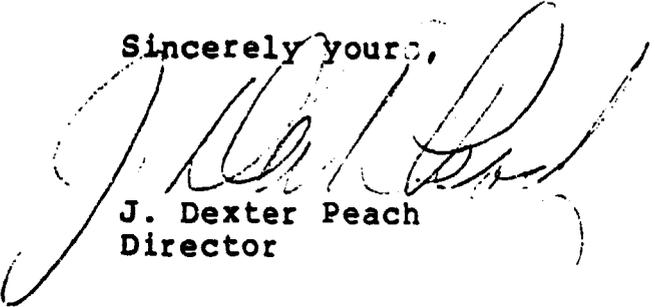
Section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than

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60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the House Committees on Appropriations, Government Operations, and Interior and Insular Affairs; the Senate Committees on Governmental Affairs and Energy and Natural Resources; and the Senate Appropriations Committee, Subcommittees on Interior and Public Works. We are also sending copies to the Secretary of the Navy and the Director of the Office of Management and Budget.

Sincerely yours,



J. Dexter Peach
Director