March 30, 1999

General Services Administration

FAR Secretariat (MVR)
1800 F Street, N.W.
Room 4035
Washington, D.C. 20405

Attention: Ms. Laurie Duarte

Re: FAR Case 98-006, Interest and Other Financial Costs,
64 Fed. Reg. 4760 (Jan. 29, 1999)

Dear Ms. Durante:

On behalf of the Section of Public Contract Law of the American Bar Association ("the Section"), I am submitting comments on the above-referenced matter. The Section consists of attorneys and associated professionals in private practice, industry and Government service. The Section’s governing Council and substantive committees contain members representing these three segments, to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the Association’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

I. Summary

On January 29, 1999, a rule proposing changes to Federal Acquisition Regulation ("FAR") 31.205-20, Interest and Other Financial Costs, was published in the Federal Register. 64 Fed. Reg. 4,760 (Jan. 29, 1999). In relevant part, this rule proposes to change FAR 31.205-20 to make the following types of costs unallowable: "[i]nterest charges and other amounts paid as a consequence of late contractor payments."

The Federal Register Notice (the "Notice") explains that a recent ruling by the United States Court of Appeals for the Federal Circuit in Lockheed Corp. v. Widnall, 113 F.3d 1225 (Fed. Cir. 1997), "has raised a significant issue regarding the allowability of interest charges paid as a consequence of late contractor payments." The Notice states that it "is Government policy to encourage contractors to pay their financial obligations on time." It continues, "Government reimbursement of contractor interest charges for an underpayment of taxes or other expenses resulting from late contractor payments of legal obligations is counter to this policy and an inappropriate expenditure of public funds." Therefore, according to the reasoning of the Notice, the Lockheed decision has necessitated a change to FAR 31.205-20 to ensure that interest paid on an underpayment of state taxes and "other expenses resulting from late contractor payments of legal obligations" are not allowable costs.

The Section’s comments on the proposed changes to FAR 31.205-20 follow. First, the comments include background information on the original intent behind the current version of FAR 31.205-20, as well as a discussion of the recent Lockheed Corp. v. Widnall decision. Second, the comments address the Section’s concern that policy reasons justifying the proposed changes to FAR 31.205-20 are not apparent from the proposed rule, and that there are policy reasons not to make the proposed change. Among the policy
considerations that weigh against making the proposed change are: (1) the fact that the proposed regulation bears no relation to the reason for the current regulation, which is to preclude the allowability of interest in the context of raising capital; (2) the proposed regulation could create a perverse incentive for contractors to overpay obligations, including taxes, where the amount finally due may be in doubt; and (3) the Government is not financially injured by the status quo. Third, the comments address the Section’s concern that the proposed language is overly broad, potentially sweeping a significantly greater number of costs than just the type of interest costs at issue in the Lockheed case into the fold of unallowability under FAR 31.205-20. Fourth, the comments address the fact that the meaning of "late contractor payments" in the proposed regulation is so unclear as to likely instigate significant future litigation.

II. Background

A. The Cost Principle

Federal Acquisition Regulation 31.205-20, Interest and Other Financial Costs, (formerly ASPR/DAR 15-205.17), currently reads as follows:

Interest on borrowings (however represented), bond discounts, costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, costs of preparing and issuing stock rights, and directly associated costs are unallowable except for interest assessed by State or local taxing authorities under the conditions specified in 31.205-41. (But see 31.205-28.)

The regulation, which was promulgated in essentially its current form in November of 1959, explicitly disallows "interest on borrowings." Board decisions and the Lockheed case clarify that the intent of the regulation was to preclude the allowability of interest in the context of raising capital. In Sanders Associates, Inc., ASBCA No. 8481, 65-2 BCA ¶ 4942 at 23,352, the Board stated that the cost principle disallows interest on borrowings "for reasons of policy as a means of according equality of treatment between a contractor who provides his own capital and a contractor who operates on borrowed money, the theory being that the two contractors will be given the same fixed fee (or profit allowance, if a fixed price contract) and that equality of treatment will be accomplished by requiring the contractor who operates on borrowings to absorb his interest cost out of his fee or profit allowance."

Another Board decision clarified the point that certain types of interest costs under the regulation were allowable and recognized that the cost principle was limited to the allowability of "interest on borrowings." In Navgas, Inc., ASBCA No. 9240, 65-1 BCA ¶ 4533, the Board permitted the contractor to recover interest on judgments and interest on accounts payable, because neither was "interest on borrowings."

B. Lockheed Corporation v. Widnall.

1. Background Facts.

For the tax years 1973 and 1974, Lockheed computed its California franchise tax liability and paid the full amount of the tax thus believed to be due. In 1982, the Internal Revenue Service audited Lockheed’s federal income tax returns for 1973 and 1974. The IRS questioned and ultimately disallowed several Lockheed deductions for bad debt expense, reserve for devalued inventory, the purchase of a country club membership, and reserves for anticipated warranty work. In spite of these disallowed deductions, no adjustments were due on Lockheed’s 1973 and 1974 federal income taxes because Lockheed was able to carry over net operating losses to those years.

However, the adjustments for disallowed deductions on Lockheed’s federal income tax returns necessitated an adjustment of taxable income for California franchise tax purposes. Because the State of California does not allow net operating losses to be carried over, the disallowed deductions resulted in additional 1973 and 1974 California franchise tax liability as well as interest assessments. No penalty was assessed by the State of California. Lockheed paid the additional franchise tax liability and interest assessments in 1982.

2. The Armed Services Board of Contract Appeals Decision.

When Lockheed attempted to allocate a portion of the interest assessment through its corporate residual expense pool, the Contracting Officer issued a final decision that denied Lockheed’s claim for interest on the
additional franchise taxes from 1973 and 1974. Lockheed appealed this decision to the Armed Services Board of Contract Appeals ("ASBCA"). In a 3-2 decision, the ASBCA sustained the contracting officer's decision, holding that the interest paid on an underpayment of state taxes was not allowable as reimbursable corporate overhead because it represented "interest on borrowings" within the meaning of DAR 15-205.17. Moreover, the ASBCA found that the sole exception to the unallowability of interest assessed by a state or local taxing authority is under the conditions set forth at DAR 15-205.41, requiring that the non-payment of tax must be at the direction of the contracting officer or due to the failure of the contracting officer to issue timely direction after a request from the contractor. The ASBCA found that the contracting officer had not directed the non-payment of taxes, nor had the contractor requested direction from the contracting officer regarding non-payment of these taxes.


Lockheed appealed this decision to the Federal Circuit. The Federal Circuit reversed the ASBCA's decision, holding that DAR 15-205.17, by its plain terms, applies to "interest on borrowing," and does not "make all interest payments unallowable." Lockheed Corp. v. Widnall, 113 F.3d 1225, 1227 (Fed. Cir. 1997). The Federal Circuit reasoned that a borrowing is generally defined as a loan and "a loan does have an intent element; it requires an intent to receive something with the intent to return the same or an equivalent." Id. Moreover, the court explained that

[N]othing in the record shows that Lockheed had an intent to borrow money from the State of California. An inadvertent tax deficiency is not generally a method of raising capital. To the contrary, the record provides ample evidence showing that Lockheed prepared its tax returns in good faith and did not intend to underpay its taxes. It did not, by its tax filings, seek to obtain capital or otherwise to finance its operations. Accordingly, the tax assessment was not a borrowing, and it necessarily follows that the interest on the tax assessment is not "interest on borrowings."

III. Comments

A. The Policy Reasons for Changing the Regulation Are Not Apparent.

1. The reasons for the proposed change are unrelated to the original reason FAR 31.205-20 disallowed interest on borrowings.

As discussed in the background section above, the original intent of FAR 31.205-20 was to preclude the allowability of interest in the context of raising capital. The ASPR Committee considered that the allowance of such interest would provide an incentive for contractors to borrow money in order to perform their Government contracts, even where the cash requirements for performance of the contract could be met out of the contractor's available capital. The situation facing the ASPR Committee was one of equity and fairness for contractors choosing to finance performance through borrowing versus contractors choosing to finance performance with their own available capital. Whichever choice contractors make, they are treated the same for the purposes of Government contracting. If interest on borrowings had been an allowable cost, contractors that chose to finance performance through borrowing would have a decided advantage. Thus, the Government maintained neutrality and did not seek to influence the manner in which contractors chose to conduct their business.

The proposed changes do not further the original intent of FAR 31.205-20. In the ordinary course of filing both federal and state tax returns, contractors make business judgments regarding appropriate tax liability and deductions. Not every tax liability or deduction has bright lines to guide the contractor. Particularly in the numerous gray areas for tax deductions, contractors make prudent, good faith business decisions regarding deductions that the contractor believes are allowable. As the Federal Circuit recognized in the Lockheed decision, "[a]n inadvertent tax deficiency is not generally a method of raising money." 113 F.3d at 1227.

Nor will the Lockheed decision create an incentive for contractors to deliberately underpay their taxes or to pay their taxes late as a form of deliberate "borrowing." State and local taxing authorities can, and do, impose penalties, in addition to interest, when taxpayers engage in late filing and/or deliberate or less than good faith under payment of taxes due. These penalties often exceed the amount of interest due, and are not reimbursable costs on federal contracts. The risk that such penalties will be assessed in a late filing or deliberate underpayment situation far outweighs any benefit to be gained.

2. The proposed regulation could create a disincentive for contractors to save tax costs.

The proposed regulation could create a perverse incentive for contractors to be overly conservative in computing state tax liability. The ultimate result would be the payment of greater state tax liability, which would be passed onto the Government through higher contract costs for goods and services.

Under the current regulations and case law, contractors have a financial incentive to save money on tax costs, and thereby save contract costs, by taking more aggressive, good faith positions with regard to state tax liability and deductions. For liability that is ultimately increased, or deductions that are disallowed, the contractor will pay interest and the Government will reimburse the interest assessments. However, these assessments merely represent the time value of money, with the end result that the Government and the contractor are in the same relative economic position as they would have been had the correct tax been paid at the outset. Moreover, there are undoubtedly countless instances where the tax liability is not increased and the deductions are allowed, resulting in overall savings to the contractor and to the Government. If the proposed regulation is adopted, it would discourage contractors from seeking these cost savings.

3. The Government is not financially injured by paying interest.

Because subsequent adjustments of tax liability resulting in either refunds or additional taxes owed (with interest) are a rather commonplace occurrence for U.S. taxpayers, the interest is most appropriately viewed as a component of tax cost. Viewed in this manner, it is difficult to understand the assertion in the NPRM that the payment of these interest costs is "an inappropriate expenditure of public funds." Ultimately, the Government is not financially injured by allowing interest on state tax payments. Indeed, the Government receives a benefit when contractors take good faith positions that result in lowering contract costs. The interest paid merely represents the time value of money, and the status quo works to reduce state tax costs overall.

We suggest that if intentional or willful underpayment or nonpayment of taxes is the issue, the regulation can be more narrowly drawn to disallow interest in such circumstances. The test should be whether there is a good faith basis for the position taken by the contractor.

B. The Proposed Regulation Is Overly Broad, Encompassing More Than the Type of Interest Costs at Issue in Lockheed

Although it does not explicitly say so, the NPRM strongly implies that the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council are seeking to overturn the Lockheed decision. Assuming that overturning the Lockheed decision is the sole intent of the NPRM, the proposed language is far too broad, affecting much more than simply the allowability of interest on "underpaid" state and local tax liability.

In its current form, the proposed regulation would make "[i]nterest charges . . . paid as a consequence of late contractor payments" unallowable. Such a broadly worded regulation would sweep a significantly greater number of interest costs than just the type of interest costs at issue in the Lockheed case into the fold of unallowability under FAR 31.205-20. Indeed, any type of cost that a contracting officer could construe as interest on a "late payment" could be considered unallowable. These costs could include, among others: (1) interest on audit resolution adjustments; (2) interest on judgments; and (3) interest on settlements (even where the liability underlying the settlement was uncertain, but the contractor made a prudent business decision to settle rather than litigate).

If in fact the regulators mean to reach only interest on tax payments, the changes should be made to the Taxes cost principle at FAR 31.205-41, rather than to 31.205-20. This would effectively limit the scope of the change and would remove any inference that the costs at issue constitute interest on borrowings (which they clearly do not).

C. "Late Contractor Payments" Is Such a Vague Term That It Will Likely Be Subject to Significant Future Litigation

As discussed above, the proposed regulation would make "[i]nterest charges and other amounts paid as a consequence of late contractor payments" unallowable. The term "late contractor payments" is left undefined. Undoubtedly, such a vague term will cause significant future litigation as the parties disagree over whether payments are "late" and whether interest charges and "other amounts" were paid as a consequence.
Indeed, the term "late contractor payments" is so vague that there is a plausible argument that the interest costs at issue in the Lockheed case would be allowable under this proposed regulation. According to the Federal Circuit’s findings in the Lockheed decision, Lockheed timely filed its state franchise tax returns for years 1973 and 1974 and paid its computed tax liability in full. 113 F.3d at 1225. Only after the IRS questioned and disallowed several deductions from Lockheed’s federal return, was Lockheed forced to amend its state franchise tax return. The adjustments to the state tax returns resulted in additional tax liability to the state of California for franchise taxes as well as interest.

An amendment to a state tax return that results in additional tax liability and interest is not by necessity a "late payment." The courts or the boards could easily construe the words "late payment" narrowly in the tax context to mean a known and assessed tax liability that is not paid on time. Under such a construction, the costs at issue in the Lockheed case would be allowable under the proposed regulation.

* * *

In summary, the Section believes that the proposed change should be withdrawn. At a minimum, however, it should be moved to the Taxes cost principle and more narrowly drawn so as to reach only bad faith nonpayment or underpayment of taxes, and not discourage good faith attempts to reduce tax costs.

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Sincerely,

David A. Churchill
Chair, Section of Public Contract Law

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