DEPARTMENT OF DEFENSE

GENERAL SERVICES ADMINISTRATION

NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31

[FAR Case 2004–005]

RIN 9000–AJ93

Federal Acquisition Regulation; Gains and Losses

AGENCIES: Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (Councils) are proposing to amend the Federal Acquisition Regulation (FAR) by revising the cost principle regarding gains and losses on disposition or impairment of depreciable property or other capital assets.

DATES: Interested parties should submit comments in writing on or before July 20, 2004, to be considered in the formulation of a final rule.

ADDRESSES: Submit written comments to— General Services Administration, FAR Secretariat (MVA), 1800 F Street, NW., Room 4035, ATTN: Laurie Duarte, Washington, DC 20405. Submit electronic comments via the Internet to— *www.regulations.gov* or *farcase.2004–005@gsa.gov.*

Please submit comments only and cite FAR case 2004–005 in all correspondence related to this case.

FOR FURTHER INFORMATION CONTACT: The FAR Secretariat at (202) 501–4755 for information pertaining to status or publication schedules. For clarification of content, contact Mr. Edward Loeb, Policy Advisor, at (202) 501–0650. Please cite FAR case 2004–005.

SUPPLEMENTARY INFORMATION:

A. Background

The DoD Director of Defense Procurement and Acquisition Policy (DPAP) established a special interagency Ad Hoc Committee to perform a comprehensive review of policies and procedures in FAR Part 31, Contract Cost Principles and Procedures, relating to cost measurement, assignment, and allocation. DPAP announced a series of public meetings in the **Federal Register** at 66 FR 13712, March 7, 2001 (with a ''correction to notice'' published in the **Federal Register** at 66 FR 16186, March 23, 2001). Public meetings were held on April 19, 2001, May 10 and 11, 2001, and June 12, 2001. Attendees at the public meetings included representatives from industry, Government, and other interested parties who provided views on potential areas for revision in FAR Part 31. The Ad Hoc Committee reviewed the cost principles and procedures and the input obtained during the public meetings; identified potential changes to the FAR; and submitted several reports, including draft proposed rules for consideration by the Councils.

The Councils reviewed the reports related to FAR 31.205–16, Gains and losses on disposition or impairment of depreciable property or other capital assets; FAR 31.205–24, Maintenance and repair costs; and FAR 31.205–26, Material costs. On July 7, 2003, a proposed rule was published for public comment in the **Federal Register** at 68 FR 40466 under FAR case 2002–008.

The Councils, with input from the Ad Hoc Committee, reviewed the public comments and concluded that the proposed rule relating to FAR 31.205–24 and FAR 31.205–26 should be converted to a final rule, with minor changes to the proposed rule; the final rule is being published under a separate **Federal Register** notice (FAR case 2002–008). As a result of the public comments received, the Councils also decided to make substantive changes to the FAR 31.205–16 cost principle and to publish the proposed revisions as a proposed rule in this **Federal Register** notice under the new FAR case 2004–005.

The Councils are recommending several changes to the proposed rule for FAR 31.205–16. In particular, the Councils are recommending that the date of disposition for a sale and leaseback arrangement be revised. The Councils had initially recommended use of the later disposition date. However, in consideration of the public comments, which articulated a myriad of potential issues and problems that could result from the use of the later disposition date, the Councils have revised the proposed rule to state that the disposition date is the date of the sale and leaseback arrangement, rather than at the end of the lease term. The Councils believe this is a more practical approach that will reduce record-keeping and the potential for future disputes.

Interested parties are requested to provide input on the revised disposition date, based on the assumption that the FAR will specify a disposition date and will continue to limit future lease costs to the costs of ownership.

This is not a significant regulatory action and, therefore, was not subject to review under Section 6(b) of Executive Order 12866, Regulatory Planning and Review, dated September 30, 1993. This rule is not a major rule under 5 U.S.C. 804.

In response to the proposed FAR rule published under FAR case 2002–008 in the **Federal Register** at 68 FR 40466, July 7, 2003, three respondents submitted comments on FAR 31.205–16. The Councils considered all comments and concluded that, since the changes result in a rule that differs significantly from the proposed rule, it should be published as a proposed rule under a new FAR case 2004–005. Differences between the proposed rule under FAR case 2002–008 and this proposed rule are discussed in Comments 2 and 4 below.

Public Comments:

FAR 31.205–16(b)

1. *Comment*: Two respondents believe that paragraph (b) of the proposed rule is unnecessary, not reflective of the reality of the business decisions, potentially inequitable and not in the interest of either the Government or the contractor. One of these respondents also believes that the proposed rule will place a recordkeeping and reconciliation burden on the contractor that is onerous, complicated, and likely to delay contract closings.

Councils' response: Nonconcur. The Councils continue to believe that the cost principle should explicitly address sale and leaseback arrangements. The Councils believe that specifying the disposition date will eliminate potential disagreements regarding whether the disposition date should be the date of the sale and leaseback arrangement or the date the contractor is no longer leasing the asset. This position is also consistent with the input obtained during the public meetings in Spring 2001.

FAR 31.205–16(b)(2)

2. *Comment*: Two respondents state that the extension of the disposition date beyond the common language use of the term disposition is inequitable because: (1) the Government would recoup gains from a contractor who does not obtain a gain, and (2) the Government would be entitled to a gain of less than the amount of the gain actually realized by the contractor. These respondents further believe that this revision would encourage a contractor to make business decisions that are not mutually beneficial to either party. They believe this revision may encourage contractors to expend

additional allowable costs to relocate to a non-formerly owned facility in order to recoup their full expenditure for leasing. These respondents also assert that it is not always clear when a contractor has finally vacated a facility. They ask how long a contractor must vacate a property to avoid application of the sale/leaseback provisions. One of the respondents also believes that contractor access to the records of the buyer could also be a problem because the provision requires knowledge of the ultimate sales price, data the contractor may not have access to.

One respondent further asserts that the disposition of an asset involves a business decision while the leasing of the asset generally involves a separate business decision. If the asset disposed of requires replacement, that action can be accomplished in a number of ways. The calculation of the gain or loss on the disposition should not be impacted by whether the contractor intends to continue to use the asset under a different financial model.

Councils' response: Partially concur. The Councils had recommended use of the later disposition date. However, in consideration of the myriad of potential issues and problems that could result from the use of the later disposition date, the Councils concur with the recommendation that paragraph (b)(2) of FAR 31.205–16 be revised to state that the disposition date is the date of the sale and leaseback arrangement, rather than at the end of the lease term. This is a more practical approach that will reduce recordkeeping and the potential for future disputes.

3. *Comment*: Two respondents believe the contractor should recognize the gain or loss on a sale and leaseback transaction immediately upon execution of the change in control. These respondents believe that in exchange for sharing the gain, the contractor should be permitted to recover as an allowable cost the reasonable lease payments on the replacement facility, regardless of whether the replacement facility was previously owned or not. One of the respondents also states that this approach would permit timely settlement of the costs in question and result in equity to both the contractor and the Government.

Councils' response. Nonconcur. The Councils disagree with the respondents recommendation to permit the contractor to recover the lease payments that result from the sale and leaseback arrangement. The allowable lease costs relating to a sale and leaseback arrangement have long been limited in the cost principles to what the contractor would have received had they retained title. The basic tenet that underlies this provision is that a contractor should not benefit for entering into a sale and leaseback arrangement. The Councils believe this basic tenet continues to be appropriate. It is important to note that a sale and leaseback arrangement is a voluntary financing mechanism entered into by the contractor. The Councils do not believe the contractor should be entitled to recover additional monies simply because of a paper transaction that provides no significant benefit to the Government.

FAR 31.205–16(c) and (d)

4. *Comment*: A third respondent proposed that the language at paragraph (b) be withdrawn. If the proposed language is not withdrawn, the respondent recommends that it be republished as a proposed rule and address the following three fundamental issues:

a. Why is it equitable for any gain or loss to be recognized in connection with the sale-leaseback transaction?

b. What reason is there that the gain or loss cannot be recognized at the time of the transaction, perhaps with an appropriate adjustment if the sales price and the subsequent rental cost are both below market?

c. In any event, what justification is there for not limiting the amount of gain to be recognized by the amount of depreciation taken?

Councils' response: Partially concur. The Councils agree that the proposed language should be republished as a second proposed rule.

In response to comment 4a, the Councils believe that a gain or loss should be recognized when an asset is disposed of, regardless of whether that disposition relates to a sale and leaseback arrangement or some other method used by the contractor to dispose of the asset. The recognition of a gain or loss is a necessary adjustment because depreciation is an estimate of the usefulness of an asset. When the asset is disposed of, an adjustment is required to reflect the difference between the actual and estimated usefulness of the asset.

The Councils agree with the respondent's assertion that the proposed language could have been interpreted to entitle the Government to recover more than the amount of depreciation that has been taken. This was not the intent of the proposed language. Paragraph (b) includes the statement ''Notwithstanding the language in paragraph (c) of this subsection....'' Paragraph (c) is currently where the limitation exists. The Councils have therefore revised the language in paragraph (c), and added a new paragraph (d) to eliminate this concern. The language on the limitation is now contained in paragraph (d), which applies to all asset dispositions, including sale and leaseback arrangements.

C. Regulatory Flexibility Act

The Councils do not expect this proposed rule to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, *et seq.*, because most contracts awarded to small entities use simplified acquisition procedures or are awarded on a competitive, fixed-price basis, and do not require application of the cost principles and procedures discussed in this rule. For FY2003, only 2.4% of all contract actions were cost contracts awarded to small business. An Initial Regulatory Flexibility Analysis has, therefore, not been performed. We invite comments from small businesses and other interested parties. The Councils will consider comments from small entities concerning the affected FAR part in accordance with 5 U.S.C. 610. Interested parties must submit such comments separately and should cite 5 U.S.C. 601, *et seq.* (FAR case 2004–005), in correspondence.

D. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed changes to the FAR do not impose information collection requirements that require the approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq*.

List of Subjects in 48 CFR Part 31

Government procurement.

Dated: May 13, 2004.

Laura Auletta,

Director, Acquisition Policy Division.

Therefore, DoD, GSA, and NASA propose amending 48 CFR part 31 as set forth below:

PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

1. The authority citation for 48 CFR part 31 is revised to read as follows:

Authority: 40 U.S.C. 121(c); 10 U.S.C. chapter 137; and 42 U.S.C. 2473(c).

2. Amend section 31.205–16 by—

a. Revising paragraph (a);

b. Redesignating paragraphs (b),(c),(d),(e),(f), and (g), as (c),(e),(f),(g),(h), and (i); and

c. Adding new paragraphs (b) and (d).

The revised text reads as follows:

31.205–16 Gains and losses on disposition or impairment of depreciable property or other capital assets.

(a) The Government and the contractor shall include gains and losses from the sale, retirement, or other disposition (but see 31.205–19) of depreciable property in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (e) of this subsection). However, no gain or loss is recognized as a result of the transfer of assets in a business combination (see 31.205–52).

(b) Notwithstanding the provisions in paragraph (c) of this subsection, when costs of depreciable property are subject to the sale and leaseback limitations in 31.205–11(i)(1) or 31.205–36(b)(2)—

(1) The gain or loss is the difference between the fair market value on the disposition date and the undepreciated balance at the time of disposition; and

(2) The disposition date is the date of the sale and leaseback arrangement.

(c) The Government and the contractor consider gains and losses on disposition of tangible capital assets including those acquired under capital leases (see 31.205–11(i)) as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance.

(d) The Government and the contractor shall limit the gain recognized for contract costing purposes to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance (except see paragraph(e)(2)(i) or (ii) of this subsection).

(e) Special considerations apply to an involuntary conversion which occurs when a contractor's property is destroyed by events over which the owner has no control, such as fire, windstorm, flood, accident, theft, etc., and an insurance award is recovered. The following govern involuntary conversions:

(1) When there is a cash award and the converted asset is not replaced, the Government and the contractor shall recognize the gain or loss in the period of disposition. The gain recognized for contract costing purposes is limited to the difference between the acquisition cost of the asset and its undepreciated balance.

(2) When the converted asset is replaced, the contractor shall either—

(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or

(ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in paragraph (e)(1) of this subsection.

(f) The Government and the contractor shall not recognize gains or losses on the disposition of depreciable property as a separate charge or credit when the contractor—

(1) Processes the gains and losses through the depreciation reserve account and reflects them in the depreciation allowable under 31.205–11; or

(2) Exchanges the property as part of the purchase price of a similar item, and takes into consideration the gain or loss in the depreciation cost basis of the new item.

(g) The Government and the contractor shall consider gains and losses arising from mass or extraordinary sales, retirements, or other disposition other than through business combinations on a case-by-case basis.

(h) Gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs.

(i) With respect to long-lived tangible and identifiable intangible assets held for use, no loss is allowed for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). If depreciable property or other capital assets have been written down from carrying value to fair value due to impairments, gains or losses upon disposition shall be the amounts that would have been allowed had the assets not been written down.

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