

**STATE BOARD OF EQUALIZATION**

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December 6, 1993

BURTON W. OLIVER
Executive Director

Mr. [R], Controller
[S]
P.O. Box XXXX
--- ---, CA XXXXX

Dear Mr. [R]:

Re: [S]
S- -- XX-XXXXXX
Fixed-Price Contracts

This is in response to your letter of September 17, 1993, in which you requested our opinion about fixed-price contracts entered into prior to July 1, 1993. You asked the following three questions:

- “1) Are fixed price contracts entered into prior to July 1, 1993 grandfathered at the 6-3/4% tax rate for material supplied after July 1, 1993?
- 2) Does this Purchase Order qualify as a fixed price contract eligible for the 6-3/4% rate?
- 3) If we have purchase orders that do not qualify as a fixed price contract, can we charge the 6-3/4% tax if our customer provides us with a certificate in the same form as the one attached to the [D] letter, which states that they are purchasing material from us pursuant to a fixed price contract entered into prior to July 1, 1993?”

On June 30, 1993, the Legislature enacted Senate Bill 509, Statutes 1993, Chapter 73. Among other items, this bill added Revenue and Taxation Code Section 6376.2 which provides that certain contracts entered into prior to July 1, 1993, in which the seller is obligated to sell or the buyer is obligated to purchase tangible personal property for a fixed price are exempted from 1/2 percent rate of tax. The Legislation extends the 1/2 percent state sales and use tax rate through January 1, 1994, and provides that the sales and use tax rate approved by the California electorate on November 2, 1992 becomes operative January 1, 1994.

In determining whether a construction contract is for a "fixed price" we require that it satisfy the following criteria: (1) it be binding prior to July 1, 1993, (2) neither party has an unconditional right to terminate that contract, (3) the agreement must fix the amount of all costs at the outset; and (4) the agreement must include a provision which fixes the tax obligation on a tax-included basis or sets forth either the amount or the rate of tax and does not provide for an increase in the amount of tax.

We are not able to express a definitive opinion as to whether a purchase order is evidence of a fixed-price contract, but, based upon the limited information available, we are able to make some general observations. You sent a purchase order which by itself is not a contract. For a purchase order to become a contract, there must be acceptance. Shipment is a reasonable mode of acceptance. We will assume that acceptance occurred by July 1, 1993.

As the parties were obligated to perform under the contracts prior to July 1, 1993, the contracts satisfy the first criteria even though materials were supplied afterward.

As to the second criteria, Revenue and Taxation Code Section 6376.2(a)(2) provides in pertinent part the following:

"For purposes of this subdivision, tangible personal property shall not be deemed obligated pursuant to a contract for any period of time for which any party to the contract has the right to terminate the contract upon notice, whether or not the right is exercised."

The Board interpreted identical language in previous statutes to require that the contract not permit one party to terminate the contract conditioned only upon notice (see former Regulation 1521.5(b)). If the terminating party owes any duties to the non-terminating party after notice is given, then the termination is not unconditional.

The termination clause in the purchase order is as follows:

"TERMINATION. (a) At any time prior to delivery, Buyer may terminate this Order in whole or in part for any reason by written or telegraphic notice to Seller, subject to an equitable adjustment between the parties as to any work in progress. However, no such adjustment will be made in favor of Seller with respect to any goods which are in Seller's standard stock. Upon notice of termination, Seller will discontinue work on this Order as directed. With respect to goods which are not in Seller's standard [unreadable] Seller shall be paid and accept, as full compensation hereunder, the pro-rata value of all work properly completed, including a reasonable amount for Seller's profit thereon, less compensation Seller has already received for work performed. Prior to such payment, Seller shall deliver to Buyer completed goods with all applicable warranties or dispose of the goods as Buyer may reasonably direct.

(b) Termination hereunder shall not relieve Buyer or Seller of any of their obligations with respect to goods delivered or portions of the Order which are not terminated. Moreover, in the event Buyer terminates this Order or any portion thereof due to a breach or repudiation by Seller, such termination shall be in addition to, and shall not limit, any other rights or remedies provided by law or available hereunder.”

The seller is obligated to perform the contract. The termination clause on the sample purchase order operates to complete performance of at least a portion of the duties initially incurred. If the buyer is the terminating party, it must make an equitable adjustment for any work in progress. The termination clause presents the possibility that buyer may terminate the order with notice prior to seller performing any acts. This does not obviate the fact that once work started, buyer is obligated to compensate seller. This is distinguished from buyer able to back out at any time prior to delivery. Therefore, the buyer doesn't have the right to cancel solely on notice and the second criteria is established.

The third and fourth criteria are met as the purchase order states that the “lump sum price (tax included) not to exceed \$1,280,000.00”. The order has tax included and fixes all costs at the outset.

Therefore, in response to your first two questions, fixed-price construction contracts entered into prior to July 1, 1993, have a 1/2 percent lower tax rate for materials supplied after July 1, 1993. The purchase order provided qualifies as a fixed-price construction contract eligible for the 1/2 percent lower tax rate, assuming that it was accepted by July 1, 1993.

As to the third question, if a general contract qualifies as being for a fixed price under Revenue and Taxation Code Section 6376.2 and is subject to the tax rates in effect prior to July 1, 1993, then the fixtures and materials subcontracts established pursuant to the general contract also qualify as fixed price. A seller may rebut the presumption that all gross receipts are subject to the sales tax by timely taking an exemption certificate. The certificate must certify that the property will be used for a purpose entitling the seller to regard a portion of the sales tax as exempt and the certificate must be taken in good faith.

If you need anything further, please do not hesitate to write again.

Sincerely,

Carl J. Bessent
Staff Counsel

CJB/md