

**STATE BOARD OF EQUALIZATION**

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-3723

March 23, 1990

Mr. K--- C. B---, Partner

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XXX --- ---, Suite XXXX

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Dear Mr. B---:

This is in response to your letter of March 14, 1990.

You have requested our opinion as to the proper measure of tax with respect to a specifically described transaction.

We understand that Vendor and Customer have entered into an agreement under which Customer agrees to use Vendor as its exclusive supplier of those laboratory services normally supplied by Vendor to its customers. The laboratory services provided consist primarily of the fabrication of positive release prints to be used by Customer in the distribution of motion pictures.

The significant provisions of the agreement are as follows:

- 1) The term of the agreement is one year.
- 2) Customer agrees to purchase a total of \$10,000,000 (measured at current list prices) of covered purchases over the term of the agreement.
- 3) Vendor bills Customer at regular list prices, with invoices payable one hundred twenty (120) days from the date of the invoice.
- 4) Vendor agrees to pay Customer the sum of \$1,000,000 upon execution of the agreement.
- 5) Vendor agrees to pay Customer an amount equal to 15 percent of the total amount of all invoices (excluding certain items). The amount is paid to Customer within eleven working days after the end of each of Vendor's fiscal months for all invoices transmitted during that month. Thus, the

amount with respect to a particular invoice is paid to the customer fifteen (15) to forty-five (45) days after the date of the invoice.

- 6) In the event that the aggregate purchase of Customer over the term of the agreement is more or less than \$10,000,000, an adjustment will be made to the total amounts otherwise paid under the contract. If total purchases over the live of the contract exceed \$10,000,000, then Vendor will pay Customer \$7,000 for each \$100,000 of excess, rounded down to the previous multiple of \$100,000. If total purchases are less than \$10,000,000, Customer will pay to Vendor \$7,000 for each \$100,000 of shortfall or portion thereof. Vendor will prepare a statement of total purchase over the term of the agreement within thirty days after the end of the term and any payment due under this provision shall be made within ten days of Customer's receipt of the statement.
- 7) Vendor is not obligated to provide any services under the agreement, other than to supply Customer with the fabrication services identified above.

We are in agreement with your identification of the issues. You note that, in accordance with Revenue and Taxation Code section 6006(b), the sale of fabrication services is subject to sales or use tax in California. The issue to be resolved is the measure and timing of sales proceeds subject to sales tax.

You analyze the measure of tax issue as one involving cash discounts. Under Revenue and Taxation Code section 6012, which defines "gross receipts," the measure of sales tax, and section 6011, which defines "sales price," the measure of use tax, the measure of tax does not include "cash discounts allowed and taken on sales." The Board has concluded previously that the measure of tax does not include volume discounts allowed and taken.

As we discussed by telephone, the agreement in question is unusual, although perhaps not of a type unknown in the motion picture industry. At best, Customer here is exercising what is known as "market power".

We would hesitate to call the million dollar advance payment or the monthly payments by Vendor to Customer as discounts. A discount is normally a reduction recognized at the time of payment. We would likewise hesitate to refer to the amounts in question as rebates. A rebate is normally an amount returned, after payment.

The advance payment and the monthly payments are more in the nature of interest-free loans than anything else. The payments made by Customer thus would consist of two components, the return of the advance payment and a payment for services rendered.

What is critical here is that this is one integrated agreement. The only way that the gross billing would be subject to tax would be if we were to interpret the million dollar advance and the

monthly payments as an expense of doing business of Vendor, recoverable from Customer as a part of the charge for the fabrication services performed. The only real "expense" that Vendor has with respect to the advance payments is the interest foregone on the amounts in question until their repayment. But, this expense is illusion - - an opportunity foregone.

At any rate, we are in agreement with your ultimate conclusion that what you describe as "volume discounts" and "advance discounts" are not includable in the measure of tax. In other words, the measure of tax consists only of the net amount paid by Customer, which, in this case, is the contract amount less the return of the advance. We are in agreement that the advance discount should be handled in the manner specified in your letter.

Very truly yours,

Gary J. Jugum
Assistant Chief Counsel

GJJ:sr