STATE OF CALIFORNIA

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October 4, 2006

Mr. A--- -. M---
Senior Tax Accountant

XXXXX --- Boulevard
---, CA XXXXX-XXXX

Re: Measure of Sales Tax
On Purchases Made With Price Adjustments or Trade
Discounts Earned by Achieving Volume Commitments

Permit No. SY --- XX-XXXXXX

Dear Mr. M---:

I am writing in response to your letter dated June 2, 1993, requesting an opinion on what is the appropriate measure of sales tax due on purchases made with credits, earned by adhering to volume commitments.

According to your letter dated June 2, 1993, the facts are as follows:

In January, 1990, D--- H--- Corp. (M--- is a wholly owned subsidiary of D--- H--- Corp.) entered into an agreement with ABC entitled "Enterprise Agreement" covering purchases made by M--- from ABC for a three year contract period.

The agreement provides purchase price incentives to M--- for meeting and/or exceeding a dollar amount of purchases. If the dollar amount of purchases, called "Cumulative Revenue Commitment" in the agreement, are met, ABC will issue a credit at the end of the contract period.

Although we find the terms of the contract (no attachments) you enclosed unclear, we interpret the contract as follows:

The contract period is thirty-six (36) months, divided into two eighteen (18) month periods referred to throughout the contract as segments one and two. Segment one began on January 1, 1990. Segment two commenced on July 1, 1991. Both parties agreed that M--- would meet certain goals (called "segment revenue commitments") of at least fifty-two million five hundred thousand dollars ($52,500,000) in purchases of products and services from ABC in each of the eighteen month segments. M--- agreed to a total "Cumulative Revenue Commitment" of one hundred five million dollars ($105,000,000) for the entire thirty-six month (36) contract period.

At the end of each eighteen month segment, and at the conclusion of the thirty-six month contract, M--- either receives a credit toward future purchases for meeting agreed upon volume commitments or is assessed adjustment charges for failing to fulfill the terms of the contract. Adjustment charges applicable at the end of a segment are debited to a non-interest bearing reconciliation account.

Under the volume commitments/discounts program, discounts for products acquired during the contract period are based on the quantity by category, duration and discount schedules applicable to each Volume Commitment. If the Segment Revenue Attainment[1] is equal to or greater than the applicable Segment Revenue Commitment, no adjustment charges will apply to any volume commitment listed in Attachment A that ends during that segment.

When the Cumulative Revenue Attainment is equal to or greater than the Cumulative Revenue Commitment, ABC will issue you a credit at the end of the contract period. This credit will be issued as an on-account credit to be used against invoices for ABC products, programs, and services. Upon your request, and if the applicable segment revenue attainment is equal to or greater than the applicable segment revenue commitment, ABC will issue the credit at the end of the segment.

There are several programs mentioned in the enterprise agreement. Your inquiry is whether the volume discount mentioned above will be excluded from the measure of tax if taken to reduce outstanding accounts receivable or if used as a trade discount to reduce the price of future purchases. Our understanding is that there are essentially three possible outcomes. Under situation number one, M--- achieves the revenue commitments and applies the amount (described in your letter as a credit) as a volume discount to reduce the purchase price on future purchases. In situation number two, M--- again achieves the volume commitments, but this time takes the amount as a credit to reduce outstanding accounts receivables, accumulated pursuant to purchases made under the contract. In situation number three, M--- fails to meet revenue commitments and owes ABC the difference between the actual revenue attainment and the agreed upon revenue commitment.

[1]The segment revenue attainment is composed of all products, programs and services acquired by M--- from ABC, during the specific segment period.

Revenue and Taxation Code section 6051 imposes a sales tax on all retailers measured by their gross receipts from retail sales of tangible personal property. "Gross receipts" is defined in Revenue and Taxation Code section 6012(a) as the total amount of the sale price of the retail sales of retailers, valued in money, whether received in money or otherwise. The total amount of the sale price includes any amount for which credit is allowed by the seller to the purchaser. (Rev. & Tax. Code § 6012(b)(3), Rev. & Tax. Code § 6011(b)(2).) A cash discount, however, is not included in the measure of tax. (Rev. & Tax. Code § 6012(c)(1).)

We have previously determined that certain volume discounts are to be treated as cash discounts within the meaning of Revenue and Taxation Code section 6012(c)(1). You cite Business Taxes Law Guide Annotation 295.0920, which states:

> "295.0920 **Christmas Club Plan,** allowing discount on December purchases based on percentage of purchases throughout rest of year, treated as deductible trade discount.[2] 11/14/50."

An amount deducted from the initial computation to reach the agreed price is not part of the taxable measure because there was never an obligation to pay that amount. In the Christmas club plan annotation above, the customer was awarded a credit for reaching a certain dollar amount of purchases. Later, the customer used the credit to reduce the dollar amount of that customer's purchases prior to reaching the final agreed upon purchase price. The customer's taxable measure was also reduced by using the trade discount to reduce the final purchase price. Similarly, M--- may use its volume discount to reduce the purchase price of future purchases from ABC, and the amount of that reduction that was based on taxable purchases of tangible personal property is not included in the measure of tax (that is the amount of the reduction based on nontaxable purchases, such as repair service may not be used to reduce the measure of tax).

Likewise, price adjustments may be excluded from taxable gross receipts if they are part of a single integrated agreement that contemplates price adjustments. The price adjustments can be taken if the customer is actually given a refund in cash or discount in an amount equal to the agreed upon adjustment. The enterprise agreement between M--- and ABC explicitly grants M--- a discount for meeting or exceeding a dollar amount of purchases. Assuming M---'s volume discounts are part of a single integrated agreement between M--- and ABC, the amounts taken to reduce outstanding accounts receivables accumulated from purchases made under the contract are not included in the measure of tax to the extent that the amount of the reduction was acquired from taxable purchases of tangible personal property.

Thus, the actual amount taken as an allowable trade discount or deduction from accounts

[2]The term "trade discount" means an allowance or reduction of the price for volume purchases based on the number or dollar amount of units purchased or sold.

receivable incurred under the contract may be excluded from the measure of tax to the extent that the discount or deduction was based on taxable purchases of tangible personal property. Similarly any adjustment charges paid by M--- to ABC must be used in the calculation of the measure of tax. When M--- pays ABC such adjustment charges, those payments increase ABC's gross receipts and they must be included in the measure of tax.

My conclusions are based on the facts and assumptions stated above. If you have further questions, please write again.

Sincerely,

Gerald Morrow
Staff Counsel

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