From: Jarvis, Sharon
Sent: Tuesday, June 01,2004 11 :16 AM
To: Rosenthal, Dave
Cc: Simpson, Laureen; Lyle, Geoff; Anderson, Vic
Subject: Annot. 330.2849 (10/29/87)

Please review the above annotation and backup. I think the annotation should be rewritten to more accurately reflect the backup. The first sentence of the annotation does not refer to the taxpayer as being in the business of selling laundry soap, as well as hand soap. Furthermore, the last paragraph of the annotation is incorrect in its statement in the fourth sentence that, "If the taxpayer reports the tax on this first-load charge, no further tax is due." What the Supplemental D&R actually says is that if tax is paid on sales of the soap (meaning all sales), no additional tax is due. It does not limit the payment of tax to the first load of soap, but states that the taxpayer's charges for soap are regarded as charges for both the sale of the soap and the lease of the dispensers. (Page eight, paragraph one of the Supplemental D&R.)

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

330.2849
10/29/87

In the Matter of the Petition)
for Redetermination Under the)
Sales and Use Tax Law)
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)

DECISION AND RECOMMENDATION
No. SR ----

The original Decision and Recommendation in this matter, which is "incorporated herein by this reference, was issued by Hearing Officer Robert H. Anderson. Mr. Anderson recommended a reaudit to adjust certain items, but recommended no adjustment to other items. A reaudit following Mr. Anderson's recommendations was completed on August 4, 1987.

In the meantime, petitioner submitted additional evidence and arguments regarding the items for which Mr. Anderson had recommended no adjustment. The purpose of this supplemental report is to review the additional materials. Mr. Anderson has retired, so the case has been reassigned to James E. Mahler, Hearing Officer.

Taxpayer's Contentions

1. The audit should have allowed deductions for bad debts.

2. The difference between recorded and reported taxable sales resulted from a computer error.

3. The dispensers are sold or given to the customers as premiums under Sales and Use Tax Regulation 1670(d).

Summary

1. The original audit made no allowance for bad debts. Petitioner has submitted copies of income tax returns showing that bad debts were claimed. Petitioner contends that it is also entitled to bad debt deductions for sales and use tax purposes.

2. The auditor found taxable sales recorded in petitioner's records which had not been reported to the Board. Petitioner contends that these book entries were made through computer error. (We construe this as a claim that the recorded taxable sales never

in fact occurred.) Petitioner has offered to present supporting evidence, but has not as yet done so.

3. Petitioner's business includes sales of soap to hotels, car rental companies, liquor stores and other businesses. Petitioner also transfers dispensers for the soap to the customers. Some of the dispensers are for hand soaps and shampoos (hereinafter referred to as "hand dispensers") and some are for laundry or dishwashing soaps (hereinafter referred to as "laundry dispensers").

The hand dispensers are made of plastic and are designed to be attached to bathroom walls. Petitioner transfers one or more hand dispensers to each customer along with the first load of soap sold to that customer, since the soap cannot be used without a dispenser.

The hand dispensers cost petitioner $3 each, and a load of soap for the dispensers costs petitioner $28. Petitioner sells the first load of soap for $58. The invoice for the first load states that the dispenser is "lease only-no charge-dispensers leased".

Petitioner advises us that customers are not required to purchase additional soap after the first load. If they do, petitioner continues to charge $58 for each load of soap. The invoices for reorders continue to use the "lease only" language with regard to the dispensers. If a customer stops buying soap from petitioner, petitioner makes no attempt to retrieve the hand dispensers, since it regards them as "disposable".

The laundry dispensers are not described in the record. We do not know their size or whether they are incorporated into washing machines. Petitioner advises us that the laundry and dishwashing soaps cannot be used without a dispenser, so petitioner provides one or more dispensers to each customer along with the first load of soap.

The laundry dispensers cost petitioner $300 each, and a load of soap for these dispensers costs petitioner $25. Petitioner sells the first load of soap for $48, which is substantially less than the cost of the soap and the dispenser together. Again, the first invoice for soap states that the dispenser is "lease only-no charge-dispenser leased".

Petitioner advises us that customers are also not required to purchase additional soap for the laundry dispensers after the first load. If they do, petitioner continues to charge $48 for each load of soap. Petitioner states us that it "receives no lease income on these dispensers; its profits being made solely on the soap which is sold for use in these dispensers". According to our calculations, petitioner must sell 14 loads of soap before it recovers its costs and begins to make a profit on these transactions.

The invoices for reorders continue to use the "lease only" language. Petitioner has not informed us what it would do if a customer stopped buying the soap. In view of the relatively large costs for laundry dispensers, however, we assume that petitioner would attempt to retrieve them from its customer.

For both the hand and laundry dispensers, petitioner merely delivers the soap and dispensers to the customer, with no additional services such as restroom cleaning. Nor does petitioner refill the dispensers on recorders. It delivers soap to the customer and the customer refills the dispenser itself.

Petitioner buys both types of dispensers without paying tax reimbursement to the vendors. Petitioner advises us that it does not issue resale certificates to the vendors because it "is not reselling the dispensers; rather they are given as a premium ...." Since the vendors do not charge tax reimbursement and apparently do not receive resale certificates, we assume that petitioner buys these dispensers outside California. We asked petitioner whether the vendors are located in this state, but petitioner did not respond.

We also asked petitioner why it uses the “lease only” language on its billing invoices. Again, petitioner did not respond.

For income tax purposes, petitioner claimed depreciation deductions on the dispensers during the audit period. After Mr. Anderson issued his decision and recommendation, petitioner filed amended income tax returns to delete the depreciation deductions. Deletion of these deductions apparently did not result in any tax change.

Analysis and Conclusions

1. Claiming bad debt deductions for income tax purposes is one prerequisite to bad debt deductions for sales tax purposes. (See Sales and Use Tax Reg. 1642.) There are other requirements as well, however, and we do not know whether those other requirements have been met. We recommend a second reaudit to review this matter and allow bad debt deductions as appropriate.

2. Petitioner's own records showed taxable sales which had not been reported to the Board. Petitioner now attempts to impeach these records, claiming that they resulted solely from computer error. We are not inclined to accept such an argument without some supporting evidence. Petitioner should present its evidence to the audit staff during the second reaudit.

3. The Board's staff has previously found that persons who 'perform restroom cleaning services are consumers of soap and dispensers provided to the customer as a part of the services. (Sales and Use Tax Annot. 515.1480 [2/2/79].) This annotation does not apply here, since petitioner merely provides the soap and dispensers with no associated services. The original audit nevertheless found that petitioner is a consumer of the dispensers. The audit relied on the definitions of "use" and “sale” in the Revenue and Taxation Code Sections 6009 and 6006, respectively.

Section 6009 provides:

> “ ‘Use’ includes the exercise of any right or power over tangible personal property incident to the ownership of that property, and also includes the

possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease, except that it does not include the sale of that property in the regular course of business."

With certain exceptions not relevant here, Section 6006 defines the term "sale" to mean and include:

"(a) Any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration. 'Transfer of possession,' includes only transactions found by the Board to be in lieu of a transfer of title, exchange, or barter.

* * *

"(g) Any lease of tangible personal property in any manner or by any means whatsoever, for a consideration ...."

The original audit found that petitioner transfers title or possession of the dispensers to its customers. Since the billing invoices show no separate charge for the dispensers, the audit concluded that the transfers are not for a consideration, and are therefore not sales under Section 6006. Since the transfers involve an exercise of a right or power incident to the ownership of the dispensers, but are not sales, the audit regarded the transfers as uses under Section 6009, Use tax was therefore asserted.

In his original decision and recommendation, Mr. Anderson indicated a belief that petitioner is not selling the dispensers. He found it unnecessary to decide the point, however, since petitioner had made a taxable use of the dispensers during the audit period, prior to any sale, by depreciating them for income tax purposes. He relied on McConville v. State Board of Equalization, 85 Cal.App.3d 156.

Relying on subdivision (d) of Sales and Use Tax Regulation 1670, petitioner contends that it sells the dispensers to its customers as premiums. Somewhat inconsistently, however, petitioner also contends that the dispensers are "given" as premiums, are not resold by petitioner, and that petitioner derives no income from the dispensers. (This of course is the original audit's position, that petitioner is liable for use tax because it loans or gives the dispensers away for no consideration.) Finally, petitioner also contends that it has removed any intervening use which may have resulted from depreciation of the dispensers by filing amended income tax returns.

At the risk of adding further complication to what should be a relatively straight-forward case, we have concluded that: Petitioner does not transfer title in the dispensers to its customers; petitioner does transfer possession for a consideration, which is a lease and therefore a sale for sales and use tax purposes; and petitioner makes no intervening use of the dispensers. We have also concluded that the lease price is included in the

charge for the soap and, to the extent tax has already been paid on sales of soap, no additional tax is due. Our reasons are as follows.

First, with respect to the laundry dispensers, it seems clear that petitioner does not transfer title to its customers. Petitioner is careful to use the "lease only" language on all its billing invoices. While petitioner has not explained its reasons for using this terminology, we have no doubt that it is intended as a reservation of title. Since these dispensers are relatively expensive, it would make no economic sense for petitioner to transfer title to customers who have no contractual obligation to continue buying soap from petitioner. Furthermore, petitioner's decision to claim depreciation deductions during the audit period is evidence that, at least in the opinion of petitioner's accountants, title in the dispensers remained with petitioner.

The location of title in the hand dispensers is a more difficult question. Petitioner transfers possession of these dispensers to its customers, and does not expect to recover them, which suggests an outright transfer of title or at least a transfer of possession in lieu of title. On the other side of the coin, however, retention of title is suggested by petitioner's use of the "lease only" terminology, and by its claiming of depreciation deductions during the audit period. On balance, we believe that petitioner intended to retain and did in fact retain title in the hand dispensers, as well as in the laundry dispensers.

Since petitioner retains title in the dispensers, petitioner is not making "title sales" under subdivision (a) of Section 6006. Petitioner does transfer possession, however. The question is whether the transfer of possession is a loan (which would be a use under Section 6009) or a lease (which would be a sale under subdivision (g) of Section 6006). The answer depends on whether the transfer of possession is for a consideration. More specifically, since petitioner charges its customers for the soap, the question is whether any portion of that charge can be allocated to the dispensers.

In previous cases where two items have been transferred to customers together, and a charge is made for item A with no separate charge for item B, but item B is necessary or at least helpful to the use and enjoyment of item A, we have consistently treated the transaction as a sale of both items. (See Sales and Use Tax Annots. 280.0160 [10/2/50], involving beer can openers transferred with the beer, and 280.0180 [9/30/53], involving book matches transferred with cigarettes.) Since item B is necessary or helpful to the use of item A, it is reasonable to assume that the customers desired and bargained to acquire item B as a part of the sale transaction, and that the price paid for item A was in fact a price for both items. That reasoning applies here, since the dispensers are necessary to the use of the soaps. Accordingly, we conclude that part of the selling price of the soap is properly allocable to the dispensers.

Subdivision (c) of Sales and Use Tax Regulation 1670, dealing with marketing aids, is not to the contrary. Marketing aids are transferred for the purpose of generating future retail sales by the recipient, so the transferor has an economic incentive to give the marketing aids away for no charge. The dispensers involved herein are not marketing aids.

Subdivision (d) of Regulation 1670 provides:

> "When a person delivers tangible personal property as a premium together with other merchandise sold, and the obtaining of the premium by the purchaser is certain and not dependent upon chance or skill, the transaction is a sale of both articles. Tax applies to the gross receipts received from the purchaser for the goods and the premium except when the premium is delivered along with a food product for human consumption or other exempt item. In such case tax applies to the gross receipts from the sale of the premium, which will be regarded as the cost of the premium to the retailer, in the absence of any evidence that the retailer is receiving a larger sum. If there is no such evidence, and if sales tax or use tax has been paid, measured by the sale price of the premiums to the retailer, no further tax is due. "

In our opinion, this subdivision is not directly relevant either. The subdivision speaks of "gross receipts", implying a title sale rather than a leasing sale. Nevertheless, since we have concluded that petitioner is selling the dispensers along with the soap, we believe that subdivision (d) may be applied by analogy.

For sales and use tax purposes, therefore, we regard petitioner's charges for soap as charges for both the sale of the soap and the lease of the dispenser. If tax has been paid on such charges (and assuming no intervening use), no additional tax is due. If the charges for soap have been claimed as exempt for any reason, however, petitioner may still be liable for tax on the lease receipts, which we will regard as equal to the cost of the dispensers to petitioner. The second reaudit should verify that tax has been paid on all charges for soap.

Finally, with regard to the intervening use question, we note that McConville dealt with property allegedly held for title sale. The claiming of depreciation deductions on the property was inconsistent with the allegation that the property was held for title sale, since depreciation deductions cannot be claimed on such property. The property in question here was held for leasing sale, however, and depreciation deductions may properly be claimed by a lessor. Accordingly, claiming depreciation deductions is not inconsistent with an allegation that the property was held for leasing sale, and is not an intervening use for sales and use tax purposes.

Recommendation

San Diego District is to initiate a second reaudit in accordance with the views expressed herein.

James E. Mahler, Hearing Officer	10/29/87 Date