

**M e m o r a n d u m****490.0583**

To : Mr. Vic Anderson, Supervisor  
Audit Evaluation and Planning Section

Date: October 2, 1997

From : David H. Levine  
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Subject: U--- S--- S--- Corp.  
SY - XX-XXXXXX

This is in response to your memorandum dated September 2, 1997 regarding the application of tax to certain charges for insurance made in connection with sales of tangible personal property. The order form that taxpayer includes when soliciting sales of tangible personal property is structured as follows. There is a series of blank lines for the customer to list the items ordered and their prices. There is then a blank line for the customer to insert the total for the merchandise ordered, a blank line for the customer to insert tax computed based on a percentage of the amount listed on the total line, a blank line for the customer to insert a handling charge from a chart included on the form, a line with a pre-printed charge of \$1.50 for insurance, and a blank line for the customer to insert the total of all figures on the lines above it. The issue is whether the customer's payment of the pre-printed charge for \$1.50 is includible in the measure of tax. You explain:

“We had previously advised the district that this fee which is preprinted on the taxpayer's order form was an exempt optional insurance charge (see the attached memo dated February 28, 1997) because customers received the merchandise whether or not they paid the fee. However, upon reflection, we are now not certain that this advice was correct and are requesting your review and advise.

“The district has informed us that it is the taxpayer's policy to ship all merchandise that is ordered if they receive at least 75% of the total bill. If the taxpayer receives at least 75% of the total bill, no effort is made to collect the balance which is eventually written off. It is also the taxpayer's policy to replace merchandise that is damaged or lost in transit regardless of whether the \$1.50 replacement fee is paid. The district has also informed us that approximately 90% of all customers pay the total charge including the replacement fee. However, approximately 10% of the taxpayer's customers are aware of the company policy and therefore do not pay the fee or simply refuse to pay the fee.

“Our original opinion was based on an interpretation of the December 18, 1992 letter (copy attached) which led to annotation 490.0585. This interpretation was that all of the taxpayer’s customers were being treated equally (i.e., all had the opportunity not to pay the fee and to still obtain the merchandise); therefore, the customers had an option and the fee was therefore optional and not subject to tax.

“However, another interpretation of this letter has arisen. That is that the 90% of purchasers who paid the fee did not know the taxpayer’s policy and therefore did not know that they had an option (there is no indication on the purchase order that this charge is optional). Since the fee was preprinted on the invoice and they paid it, they must have felt that it was mandatory. If these customers did not know that they had an option, then, in reality, they did not have an option.

“These customers would be considered akin to the nonpreferred customers mentioned in the annotated letter. Therefore, with respect to these customers, the fee was mandatory and is therefore subject to tax.

“Finally, another viewpoint is that since it is policy to replaced [sic] the merchandise for free regardless of whether the fee is paid, the fee is not actually a replacement/insurance charge but simply an additional charge that is a part of the gross receipts and is subject to tax.”

The correct view is the second view. Although your explanation of this view is very succinct, given the history of this matter, my normal long-winded approach to explanations may be useful. Anyone reading this who needs to know only the bottom line can just stop here and re-read your explanation of the second view.

The general rule is that a truly optional charge that does not itself constitute the sale of tangible personal property (such as for fabrication) is not taxable as part of the sale of tangible personal property, with exceptions not relevant here. This is true whether or not the customer gets real value for having paid that optional charge. Thus, the third view is not correct. It does not matter whether the charge is actually a charge for insurance or a charge for nothing at all. Rather, the question presented is whether, for purposes of sales and use tax, the pre-printed charge for insurance is a mandatory charge. If so, it is subject to tax. (As discussed below, however, the fact that the charge here is actually for nothing at all is relevant to an understanding of what is happening.)

I believe that the backup to annotation 490.0585 (12/18/92) was misinterpreted in your first opinion, likely due to imprecise language in the backup. The transactions considered by the writer (who happened to have been me) were sales resulting from the common situation of face-to-face negotiations and no pre-printed charge in the contract. Under such circumstances, that some customers do not purchase the maintenance agreement supports a conclusion that the

maintenance is optional rather than mandatory as long as there are no facts inconsistent with that conclusion. In reviewing the opinion now, I see that the word “shows” can be read to mean something I did not intend since I was using general language for a general situation. Although having only a slightly different meaning, a word that would have better conveyed my meaning would have been “indicates.”

The question presented in the annotation was whether an item is regarded as mandatory or not based on regular business practices or on a transaction-by-transaction basis, that is, whether the item should be regarded as optional because some people did not purchase it. The answer, of course, was no. The percentage of purchasers purchasing the item, or not, may be indicative of whether or not it is optional, but not determinative. Rather, as stated in the annotation and its backup, this is a question of fact to be determined on a transaction-by-transaction basis.

Two examples of this will be helpful. First, a retailer offers insurance related to the purchase of tangible personal property. One customer (the retailer euphemistically calls this person the retailer’s single “preferred customer”) must purchase insurance from the retailer in order to purchase tangible personal property. No other customer is required to purchase the insurance and none does. The fact that only one person purchased insurance indicates that the insurance is optional; however, the facts show that such a conclusion is not true with respect to that one person purchasing the insurance. The charge to the “preferred customer” is taxable even though that person is the only customer to purchase the insurance.

The second example is a situation where a retailer makes many sales, and in every situation except a single sale, the purchaser pays for insurance. The retailer has the same contract for each and every transaction. It has a provision offering insurance which explicitly states that the insurance is wholly optional. The retailer never even brings up the subject of insurance unless the customer asks, and there is no pre-printed amount in the total column. However, the retailer is selling expensive, specialized, fragile glass products that are picked up by the purchaser at the retailer’s location. The insurance covers any damages that might result during the transportation from the point of delivery to the customer at the retailer’s place of business to the purchaser’s location. The single purchaser who did not elect to purchase insurance is a large company who self-insures whenever possible and who has specialized ability to transport these fragile items safely. None of the other purchasers can afford to take the same risk as this large customer. The fact that only one person avoided paying the insurance charge is indicative that the insurance is mandatory; however, the facts show that such a conclusion would be in error. The insurance charge is a nontaxable optional charge.

Different considerations animate the analysis of a transaction that is normally completed on a face-to-face basis without a pre-printed dollar figure than those considerations necessary to analyze a mail order situation where the customer places his or her order on a pre-printed order form such as that involved here. Nevertheless, the bottom line remains the same: a charge will generally be regarded as a taxable mandatory charge when the customer believes that the charge must be paid in order to purchase the tangible personal property, especially if that is what the

retailer wishes the customer to think. That some may know that they can avoid the charge (similar to the “preferred customers” discussed in the annotation) does not mean that the charge is regarded as optional for sales and use tax purposes when paid by those who are under the retailer-caused misapprehension that they must pay the charge in order to purchase the property.

The taxpayer admits that it sends the products ordered as long as it receives 75 percent of the total bill. That someone can obtain taxpayer’s products even when paying only 75 percent of the total bill does not mean that a person who actually pays the full amount of the bill is making a mandatory payment of 75 percent and an optional payment of 25 percent. Thus, it is clear that the fact that taxpayer ships the products even if a customer does not pay the \$1.50 charge is not determinative, nor is it relevant that taxpayer may not actively seek payment of such amounts. I note in this context that it is not clear whether taxpayer in any way sends a bill for such amounts to a customer who does not pay it, nor is it clear whether taxpayer carries the amount in any manner in any of its books as an account receivable from the customer. In your memorandum, you state that amounts not paid are “eventually written off.” This means to me that taxpayer does record certain amounts in its books as accounts receivable. What is unclear to me is what this figure is based on. If this amount that is “eventually written off” by taxpayer includes the \$1.50 insurance charge, then there can be *no* credible argument that this charge qualifies as a nontaxable optional charge and no further discussion or analysis would be warranted. Since I am unclear on this point, I will continue.

The invoice in the present case does not in any way indicate that the charge is optional. The charge is pre-printed in the total column and the purchaser would have to affirmatively cross it out (with no instructions indicating that the order would be shipped if the purchaser does so) in order to correctly total a grand total that does not include such amounts. Under such circumstances, can such a charge be regarded as optional? I think not. Some people will always cross off charges such as those at issue here, and will refuse to pay them even if the retailer will not accept the order when they do so. While we probably all know people like this, they are nevertheless the exception and taxpayer knows it. (Based on the information before me, I would guess that they comprise no more than 10 percent of the population.) In the present case, these are taxpayer’s “preferred customers” because taxpayer has apparently decided to forego the additional profit and sell to them anyway. There are then the customers to whom this charge is directed, and it is only *their* viewpoint which is relevant to the application of tax to the charges *they* paid.

If taxpayer’s customers would pay this amount even if it were clearly stated to be an optional charge, then taxpayer would clearly do so since the customers would be happier about choosing to pay the charge than having to pay the charge, and taxpayer would not be engaged in this discussion with us. However, if the charge were truly optional, far fewer persons would opt to pay it. Thus, this charge is directed to those persons who would not pay this charge if optional. Ninety percent of taxpayer’s purchasers pay this charge. As discussed above, this is not determinative; however, it is indicative of what is happening. This is particularly true when the charge is for nothing at all.

When taxpayer designed the form, it was not concerned about customers who would refuse to pay the fee under any circumstances. They did not pay the fee when it was pre-printed on the form with no indication that it was optional, and they certainly would not have paid the fee if it had been clearly marked as an optional fee. Taxpayer was concerned, however, about those customers who would pay the fee, but only if mandatory. Thus, it designed the form so that any of these customers who had doubts as to whether the fee was optional or mandatory would conclude it was mandatory and pay the amount. Taxpayer's secret policy is not part of the contract and is not relevant to this discussion.

The claim that taxpayer does not treat a customer who pays the insurance charge differently than one who does not with respect to replacement of damaged goods does not help taxpayer's argument, it hurts because what it tells us about the true circumstances. This claim can be restated as: the \$1.50 insurance charge is actually for nothing at all. In an arms length commercial agreement between unrelated parties, I think we can safely assume as an axiom of commercial reality that *no one* would voluntarily pay extra to someone knowing it to be for nothing at all. (I guarantee that 90 percent of a company's customers would not do so.) Here, however, taxpayer is claiming that its purchasers did just that. To state the claim in this way is to dismiss it out of hand.

We are not required to close our eyes to reality in the administration of the Sales and Use Tax Law. The fact that there are people who will refuse to pay a charge like this does not mean that the charge is optional to other people who paid it because they thought they must. In a mail order situation such as here, a retailer pre-prints a charge in the total column for the very purpose of having certain of its customers think the charge is mandatory and to pay it. When a retailer accomplishes its purpose and its customers pay the fee because they think it is mandatory, the retailer will not prevail with the argument that, notwithstanding that the customer thought just what the retailer wanted the customer to think, the customer did not really have to pay the charge. The presumption in these types of situations is that an amount pre-printed on the order form is a mandatory charge. Showing that some customers did not pay it will not overcome the presumption. Showing what a customer may be told about the charge *if the customer were to ask* is also irrelevant. Rather, to show that such a pre-printed charge is truly optional for purposes of the Sales and Use Tax Law, the order form must *clearly and unequivocally* state that the charge is optional and may be crossed out by the customer.

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cc: Mr. Dennis Fox (MIC:92)  
Van Nuys District Administrator (AC)