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August 28, 1989

Prize merchandise and premium certificates

Dear

In your June 14, 1989 letter to the Board's legal staff, you request our opinion regarding the application of sales and use taxes to a contract between \_\_\_\_\_ and \_\_\_\_\_

The contract you enclosed is entitled "Production Agreement," and is undated but was executed by \_\_\_\_\_ on February 7, 1989. You write in summary that \_\_\_\_\_ is a retailer of consumer products which sells these products to customers nationwide by catalogs and common carriers, with shipments from a warehouse in Emeryville, California or through manufacturers' drop shipments. \_\_\_\_\_ also has retail stores located in various states including California. You describe the purpose of the contract between \_\_\_\_\_ and \_\_\_\_\_ as one which, among other things, enables \_\_\_\_\_ Division of \_\_\_\_\_ through its agent, \_\_\_\_\_ to gain access to promotional opportunities afforded by your catalog mailing list and retail stores. I have quoted below the questions you raise, followed by our response.

Question

"Section 6 - Thank-You Promotion

"As consideration for our prize merchandise we are to receive an aggregate first-year merchandise cost reimbursement of \$300,000, billable as shipped, plus 1.2% per month as a reimbursement for carrying costs of unshipped

prize merchandise. The present arrangement is to ship all of our prize merchandise from Emeryville based on shipping instructions received from the management company alluded to in paragraph 6.11. Of course, some winners will be Californians but the bulk of the winners will no doubt be out of state.

"Presumably, this situation is covered by Paragraph (d) of Regulation 1670. If so, what is the measure of tax - the merchandise cost reimbursement (\$300,000), carrying cost reimbursement (1.2%) or some other value or combination of values? Does California tax apply to shipments to winners outside California?" (Emphasis in original).

Section 6 of the contract in summary provides that will co-sponsor a promotion of sweepstakes format. During the first year of the program, a total prize fund consisting of \$300,000 in merchandise (cost value) and products constitutes the prize fund. During the second year another \$300,000 in merchandise will be part of the prize fund. Section 6.2 of the contract provides that shall be paid 1.2% per month as a carrying cost on the balance of the \$300,000 in [first year] merchandise prizes currently unawarded ...." If the program is extended for a second year, these carrying costs will again be paid to in a similar manner and amount. The prize cost reimbursement payments shall be made by on a monthly basis, in advance of each month's distribution of merchandise prizes, and in an amount equal to the cost value of those prizes.

Answer. Our opinion is that this issue is controlled not by subdivision (d) of Regulation 1670, but rather by subdivision (e) of that regulation. Subdivision (d) deals with premiums delivered with goods sold, and only applies where the purchaser of an item is certain to obtain the premium and the purchaser's receipt of the premium is not dependent upon chance or skill. By contrast, subdivision (e) provides in relevant part as follows:

"The operator of a game who awards property as a prize the winning of which depends upon chance or skill is the consumer of the property and tax applies with respect to the sale to or the use of the property by the operator."

Also applicable to this issue is Regulation 1620(a)(3)(B), which relates to shipments outside the state. In summary, subdivision (a)(3)(B) provides that sales tax does not apply to a sale when the property is required to be shipped, and is shipped, to a point outside of this state by the retailer, pursuant to a contract of sale with the customer.

The transactions to which the sales tax applies are the sales of the prize merchandise from to . If ships a prize to a recipient at an out-of-state location, sales tax will not apply to that sale under Regulation 1620(a)(3)(B) as an exempt shipment in interstate commerce. On the other hand, where TSI ships the prize to a California recipient, this is a sale completed in California, and sales tax applies to the gross receipts from sales to of the merchandise shipped. (Rev. & Tax. Code § 6012). With respect to the 1.2% per month payable to as reimbursement for the carrying cost of the unshipped prize merchandise, our opinion is that sales tax applies to this amount as a storage service which is part of the sale of the prize merchandise to . (Rev. & Tax. Code § 6012(b)(1)). However, since some of the prizes will be shipped to points inside California and some will be shipped outside of California, our view is that tax applies only to a percentage of this amount determined by the sales price of prize merchandise shipped to recipients in California divided by the total sales price of all of the prize merchandise shipped throughout the country.

Question

- \*Section 4 - Catalog Program
- Section 5 - Thank-You Promotion
- Section 8 - Automotive TSI Catalog

\*These sections call for reimbursement to us of certain of our catalog costs. May these reimbursements serve to reduce the bases upon which we report and pay use tax on catalogs sent to California stores and customers and used by us internally in California?\*

Answer. Our opinion is that the reimbursements to you from do not represent amounts paid for the sale or lease of tangible personal property, but rather constitute payments for advertising space in the catalogs distributed by . Thus, sales or use tax is not applicable to the reimbursement cost; likewise, these reimbursements do not reduce the amounts which you are required to report and pay as use tax on the catalogs you use in California.

Question

"Section 5 - Support Program  
Section 8 - Automotive TSI Catalog

"These sections call for issuance of our merchandise certificates either for consideration of less than face value or in lieu of royalties for sales generated by the automotive catalog. What, if any, is the effect on the sales tax base relating to certificates redeemed by California?"

Answer. There are two separate types of programs described in these sections of the contract. Section 5, Support Programs, provides in summary that plans to offer vehicle purchasers merchandise certificates as an alternative incentive to 's traditional cash rebate programs. Under Section 5.3, " will be reimbursed, by at 85% of face value, for all merchandise certificates redeemed by customers." The application of tax to this type of promotional program is controlled by the provisions of Regulation 1671. Subdivision (b) of this regulation describes several types of promotional plans. The type of plan applicable in the situation you describe is set out in subdivision (b)(3) as follows, where the retailer is acting through its agent, and the third party is :

"(3) The retailer incurs no expense with relation to the premium until about the time the customer obtains the premium. A third party delivers the premium to the customer in exchange for the required quantity of indicia. The retailer pays the third party on an agreed basis related to premium merchandise delivered to the customer by the third party."

The sales and use tax effect of this promotional plan is set out in subdivision (f) of this regulation as follows:

"(f) PLAN DESCRIBED IN (b) (3).

"(1) CASH DISCOUNT. If a third party delivers the premium to the customer and the retailer pays such third party on an agreed basis related to premium merchandise delivered to the customer by the third party, the retailer is entitled to a cash discount deduction for the reporting period in which he pays the third

party. The amount of the cash discount is the amount of the payment to the third party.

"If the retailer's sales are not all taxable retail sales, there must be a proration of the cash discount. See Paragraph (g) below.

"(2) SALE OF PREMIUM. The delivery of premium merchandise by a third party to a retailer's customer in exchange for a prescribed number of units of indicia is a taxable retail sale (assuming the premium merchandise is of a kind the retail sale of which is subject to tax). The selling price is the amount received by the third party."

Therefore, tax applies to the amounts which is reimbursed by for all merchandise certificates redeemed by customers where 's shipment is to a California recipient. However, if ships the merchandise to a point outside of California, the exemption from sales tax under Regulation 1620 (a)(3)(B) applies in this case also.

Section 8 of the contract provides in summary that as consideration for 's advertising in the automotive catalog, will pay a royalty to of 10% on the first \$1.5 million in sales and 15% on sales above \$1.5 million for sales of merchandise generated by the automotive edition catalogs. will make these royalty payments in the form of merchandise certificates. These certificates will be provided to at no redemption cost for use by as a discretionary promotional fund.

Our opinion is that since will receive the certificates at no cost, when the certificates are redeemed by customers, there are no sales of the merchandise by either to the customers who obtain the merchandise or to . Rather, is the consumer of the merchandise which it uses to fulfill the requirements of section 8 of of this contract for redemption of the merchandise certificates. Since is the consumer of merchandise which it uses in this manner, tax applies to the purchase price paid by for its purchases of this merchandise. Since there is no sale by of the merchandise in this situation, there is no exemption from the sales tax when ships these items to recipients located outside of California. Rather, tax applies to the entire purchase price of merchandise withdrawn from 's resale inventory in California for use in this manner. (Reg. 1668(a)(2)).

I enclose for your information copies of Regulations 1620, 1668, 1670, and 1671. Please feel free to contact me if you have any further questions or comments about this letter.

Sincerely,

John Abbott  
Senior Tax Counsel

JA:jb  
Enclosures