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July 22, 1992

Mr. [B]
Controller,
[V] Division
[I], Inc.
XXX --- ---
--- ---, -- XXXXX-XXXX

RE: S- -- XX-XXXXXX
Fixed Price Contracts

Dear Mr. [B]:

Assistant Chief Counsel Gary J. Jugum has tasked me to respond to your letter of May 19, 1992. You asked whether or not two contracts into which your company entered prior to July 15, 1991, qualified for the fixed-price-contract exemption from the increased sales and use tax rates which went into effect on that date. You described the terms and conditions of the contracts in your letter and attached a copy of the terms on the reverse of your customers purchase orders ("the terms"). For the sake of brevity, I have attached a copy of your letter, including the copy of the terms, rather than repeat them here.

OPINION

A. Fixed-Price Contracts Generally.

As you are aware, on June 30, 1991, the Legislature enacted Assembly Bill 2181, Statutes 1991, Chapter 85. This bill amended Sections 6051 and 6201, and added Sections 6051.2, 6051.5, 6201.2, and 6201.5, which raised the state-wide sales and use tax rate to seven and one-quarter percent. This bill also added Section 6376.1 which provides that certain contracts executed prior to July 15, 1992, in which the seller is obligated to sell or the buyer is obligated to purchase tangible personal property for a fixed price are not subject to the new rates. Subsequently, the legislature enacted Senate Bill 180, Statutes 1991, Chapter 236, which amended Section 6376.1 to provide that contracts entered into prior to July 15, 1991, qualify for the exemption and that the exemption does not apply to contracts for any period of time in which one party to the agreement has the right to terminate the agreement upon notice, whether or not the right is exercised.

In determining whether a sales contract is for a "fixed price," we have consistently required that it satisfy the following criteria: (1) it be binding prior to July 15, 1991; (2) neither party has a right to terminate the contract conditioned solely upon notice; (3) the contract must fix the amount of all costs at the outset; and (4) it must include a provision which fixes the tax obligation on a tax-included basis or sets forth either the amount or the rate of tax and does not provide for an increase in the amount of tax. We regard change orders to be separate contracts. They must qualify as being for a fixed price on their own separate and apart from the main contract which they modify.

B. Tax Consequences to [I].

You recite that [I] made a proposal and quote to its customer, [H], in March of 1990, which the latter accepted by issuing the two purchase orders at issue on February 19 and April 11, 1991. Shipment under the first contract occurred on August 15, 1991, and the equipment purchased under the second was shipped on March 31, 1992. As the parties were obligated to perform under the contracts prior to July 15, 1991, the contracts satisfy that criterion even though performance occurred afterward. They set tax at the then-applicable rate of 7%. Paragraph 13 of the terms states that the prices set forth in the purchase order include all applicable state, federal, and local taxes and does not include a provision that payments may be increased to cover a tax increase. Therefore, the contracts satisfy the first three criteria of a fixed-price contract.

Unfortunately, the portion of the copy of the terms which you sent that discusses termination for the convenience of the Buyer is not fully legible. In your letter you state that the Buyer had such a right, but its exercise would have subjected it to payment obligations, presumably for services which [I] had rendered the Buyer in connection with the sale. We consider that such an obligation is a condition of termination so that, upon receipt of such notice, the Seller's obligations under the contract are terminated, but the Buyer's duty to recompense the Seller still remains to be performed.

Thus, we conclude that the two sales contracts at issue qualify for the exemption under Section 6376.1 from the new tax rates. We also agree with you that the change orders to which you refer in your letter, being separate contracts, are subject to the new rates.

I hope the above discussion has answered your question. If you need anything further, please do not hesitate to write again.

Sincerely,

John L. Waid
Tax Counsel