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August 26, 2003

Ms. L--- C. B---
 Senior Tax Manager

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XXX --- --- ---, Suite XXX
 --- ---, California XXXXX

**Re: A---, Inc. (SR Y -- XXX-XXXXXX)
 P--- S---, Inc. (SU -- XX-XXXXXX)**

Dear Ms. B---:

By letter dated March 26, 2003, (March Letter) Senior Tax Counsel Randy Ferris responded to your tax opinion request dated February 5, 2003. As explained in the March Letter, you did not provide copies of the relevant contract(s) between A--- Inc. (A---) and P--- S---, Inc. (P---). Thus, the March Letter was not an opinion on which either party could rely for purposes of Revenue and Taxation Code section 6596. Subsequently, you sent a letter dated April 8, 2003, with which you provided an unexecuted copy of the purported "Supply Agreement" (Agreement)¹ between A--- and P---, and requested an opinion letter regarding "the nontaxable treatment of penalty charges paid by P--- to A--- in accordance with Section 2.11 of the Supply Agreement." This letter is in response to your subsequent request.

DISCUSSION

To restate the scenario as described in your February 5, 2003 letter:

"A--- and P--- have entered into a supply agreement whereby A--- shall supply P--- with chip wafers for research and development activities. 'Chip wafers' are arrays produced by A--- consisting of densely packed genetic sequences on a solid support. Pursuant to the supply agreement, P--- is obligated to purchase a minimum number of chip wafers per month at a set dollar amount per unit. The contract provides for a sales price on a per chip wafer basis that is based upon the actual costs incurred by A--- in the manufacture and supply of each chip wafer.

¹ For purposes of this opinion letter, I assume that the Agreement has been executed and is now in effect between the parties, and the parties have not entered into any addendum agreements or changed the terms of the Agreement in any way. If any of the assumptions I have made are incorrect, my answer may be different.

“A--- does not begin to manufacture the chip wafers for P---’s purchase until the company has received the monthly purchase order from P---. P--- is required to submit a monthly purchase order to A--- by the 15th day of every month. Delivery of the chip wafers to P--- occurs within two months from the date a purchase order is submitted. Title to the chip wafers passes from A--- to P--- at the point of shipment (F.O.B. shipping point).

“Should P--- fail to purchase the minimum number of chip wafers for a given month, P--- is required to pay A--- a penalty amount pursuant to the following formula: (the minimum purchase amount for the month less the actual number of chip wafers ordered) multiplied by (the actual cost per chip less the actual direct material cost per chip). Since A--- does not begin to manufacture chip wafers until it receives P---’s monthly purchase order, P---’s failure to order the minimum number of units does not result in an excess supply of chip wafers[,] and P--- cannot subsequently purchase the chip wafers for which P--- was required to pay a penalty.”

Based on my review of the copy of the Agreement, under Section 2.5(b) P--- must make “Required Monthly Orders.” According to the Agreement, this means that P--- must submit a monthly purchase order to A--- “for the maximum numbers of Wafers that can be produced...using at least ninety-nine percent (99%) but not more than one hundred and one percent (sic) (100%) of the number of Reserved Synthesis Steps for the calendar month....” If P--- fails to submit the “Required Monthly Orders,” Section 2.11 states:

“Section 2.11 Failure to Submit Required Monthly Order. In the event P--- fails to place a Required Monthly Order in any given month as long as P---’s delay in placing orders was not a result of A---’ unreasonable delay in procuring masks for P--- according to Section 2.3, A--- will, on the last delivery date permitted for such orders pursuant to Section 2.8, invoice for, and P--- will be obligated to pay A---, an amount determined in accordance with the following formula: (the applicable number of Reserved Synthesis Steps – the number of ordered synthesis steps) * (the then-current Actual Cost per synthesis step – then-current Actual Cost of direct material per synthesis step),^[2] provided that the product of such formula shall never be less than the number (0).”

² I note that the formula for determining damage payments in Section 2.11 is different than the formula described in your February 5, 2003 letter. You state the formulas as: “(the minimum purchase amount for the month less the actual number of chip wafers ordered) multiplied by (the actual cost per chip less the actual direct material cost per chip).” From the Agreement, it is not clear exactly what the term “synthesis step” means. However, for purposes of this discussion, I assume that “synthesis step” is synonymous with “chip wafer” as the tangible personal property being transferred is termed in the February 5, 2003 letter and “Wafer” or “Chip” as the tangible personal property is termed in the Agreement. (See Agreement, Sections 1.2, 1.18.)

As explained in our initial letter a “sale” occurs when title or possession of tangible personal property is transferred for consideration. When a taxable sale occurs, sales tax is imposed on the retailer measured by its gross receipts from the retail sale of tangible personal property in this state, unless some exemption applies. (Rev. & Tax. Code, § 6051.) Even though sales tax is imposed on the retailer, the retailer may, by agreement with the purchaser, collect sales tax reimbursement from the purchaser. (Civ. Code, § 1656.1.) When sales tax does not apply, use tax applies to the storage, use or other consumption of tangible personal property purchased from any retailer for the storage, use or other consumption in this state, measured by a percentage of the sales price, unless that use is specifically exempt by statute. (Rev. & Tax. Code, § 6201.) “Gross receipts” (for purposes of the sales tax) and “sales price” (for purposes of the use tax) generally include all amounts received with respect to the sale or use of tangible personal property, with no deduction for the cost of materials used, labor or service costs, or other expenses of the retailer, unless there is a specific statutory exclusion. (Rev. & Tax. Code §§ 6011 [defining sales price], 6012 [defining gross receipts].)

There is no specific statutory exclusion from sales price or gross receipts for the amount of damages paid by the retailer to the purchaser. (See Rev. & Tax. Code, § 6011, subd. (c), 6012 subd. (c); see also *Southern California Edison Co. v. State Bd. of Equalization* (1972) 7 Cal.3d 652, 661 [reasoning that because there was no specific statutory exclusion in Section 6011 from the initially agreed to sales price, subsequent damage payments, termed “Voluntary Price Adjustments” by the parties, did not reduce the sales price].) Thus, payments made by the retailer pursuant to a liquidated damages³ clause do not reduce the gross sales price for sales and use tax purposes. (See Sales and Use Tax Annotations 295.0367 [06/23/93]; 295.0368 [07/30/76].)

In contrast, when the purchaser makes payments for damages to the retailer, the question becomes whether these payments are part of the gross receipts from the sale of tangible personal property. Some payments for damages by the purchaser are included in gross receipts or sales price. Whether damage payments are part of gross receipts or sales price depends on if the damage payments are also a part of the consideration for the transfer of title or possession of the tangible personal property. (See Rev. & Tax. Code, § 6006; 6010, 6011, 6012.) If so, without any specific statutory exclusion from gross receipts or sales price, the damage payments are included in the measure of tax. (See *Southern California Edison Co. v. State Bd. of Equalization* (1972) 7 Cal.3d 652, 661.)

³ Liquidated damages are damages that are specified and set at predetermined amount in a contract. (See Com. Code § 2718, subd. (a).)

We interpret the above principle to mean that where a payment for the harm caused is also the bargained consideration for the transfer of tangible personal property, then the payment, regardless of how it is characterized by the parties, is part of gross receipts absent some exclusion or exemption. For example, payment for damages in the form of late fees, when a lessee retains the leased property for longer than the agreed lease term, are part of gross receipts because in that instance the payment is also for the continuing use of the property. The lessee knows that by breaching the lease agreement (i.e., retaining the leased property over the term of the lease) it will have to pay damages due to its continuing possession of the leased property. To that extent the amount received by the lessor as damages is also a part of the consideration for the lessee's continuing possession of the leased property. (See Sales and Use Tax Annotation 330.3424 [08/21/91]; 330.3625 [07/08/93].) However, payment for damages stemming from a purchaser making late payments on merchandise is not considered part of gross receipts. This is because it is a payment for the harm inflicted on the seller for the seller's loss of the time value of the money it should have received from the buyer in a timely fashion. (See Sales and Use Tax Annotation 330.3425 [05/01/74].)

Here, to the extent that Section 2.11 provides for payments to be made to A--- on the event of a breach of the Agreement by P--- (i.e., not ordering the maximum amount of Wafers), it is a liquidated damages clause. However, when P--- makes a monthly purchase order for less than the "maximum numbers of Wafers that can be produced" by A---, Section 2.11 also operates to increase P---'s cost for the Wafers (or, conversely stated it operates to increase A---'s retail selling price for the Wafers).⁴ When P--- makes its monthly purchase orders it must take into account that pursuant to Section 2.11, it will cost more per Wafer to purchase fewer than the maximum number of Wafers from A---. Thus, in this instance the additional payment set forth in Section 2.11 is part of the bargained for consideration for the transfer of title to or possession of the Wafers. Accordingly, the damage payment required in Section 2.11 is included in the measure of tax as part of the gross receipts from the taxable sale of the Wafers.⁵

If you have additional questions, please write again.

Sincerely,

Chris A. Schutz
Tax Counsel

CAS/ef

cc: --- --- District Administrator (--)

⁴ I note that the parties could have achieved the same result by simply increasing the retail selling price of the Wafers, when P--- ordered fewer Wafers. In effect, Section 2.11 is the mechanism by which this is done.

⁵ I note that for purchase orders where P--- orders no Wafers and Section 2.11 still requires P--- to pay A--- damages, those damage payments are not subject to tax when no tangible personal property is transferred.