STATE OF COLORADO

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GIL-2007-33

Bill Ritter, Jr.
Governor

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Executive Director

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December 28, 2007

Re: Information Letter request dated November 1, 2007

Dear XXXXXXXXX,

This is letter is submitted in response to your letter dated November 1, 2007, in which you ask for an informal opinion regarding the taxability of samples.

Issue
What is the measure of tax on samples given away by a distributor in Colorado?

Background
You represent a beverage distributor, which is headquartered in [State] and which makes sales in Colorado. Distributor is obligated to the beverage manufacturer to engage in certain marketing activities, including the distribution of free samples to the general public, to athletes, and to those attending sporting events.

The distributor accounts for these samples as follows. Upon receipt of a purchase order from the distributor, the manufacturer issues the distributor an invoice at the current inventory price ("Price"). The beverage is booked on distributor's G/L as "Inventory in Transit." Upon distributor's receipt and storage of the beverage, the goods are moved to into an active inventory account in the G/L at Price. The goods are then available to distribution, either as a sale to retailers or as free samples.

When goods are withdrawn from inventory for distribution as free samples, the goods are removed from the active inventory account and placed into a sub-account reflecting disposition as a sale or sample/promo. Once the goods are placed into the sample/promotional account, distributor generates an off-setting credit memo equivalent to the Price minus Sample Price (lower than Price), which is then sent manufacturer for adjustment on an aggregate monthly basis. For example, manufacturer's price to distributor for can to be sold is $1.00 and the price for a sample can is $.60. Distributor initially pays $1.00 per can when it acquires the can for active inventory. The can is later removed from active inventory for distribution as a free sample. Distributor issues to manufacturer a credit memo for the sample can, and manufacturer issues distributor a credit of $.40.

You provide the following rationale for the procedure.

> A key benefit of the agreed upon procedure is that it simplifies the cost accounting of sample/promotional items and facilitates consistent invoicing methodology for branding related business activity. Rather than initially invoicing the distributor for usage of "sample" on a projected/estimated basis in conjunction with inventory intended for sale, the manufacturer has decide to invoice the distributor for all inventory at current inventory pricing, and approve/apply a retroactive credit for goods that the distributor demonstrates were used as "samples." This ensures that the entities are avoiding a potential bottleneck delay during the initial invoicing process, ultimately minimizing the unnecessary journal entries as a result of product usage reconciliation. In addition, the credit process substantiates the usage of the produce by the distributor and ensures the distributor provides the manufacturer with the appropriate documentation necessary to approve the credit.

Discussion

As an initial matter, we agree that when a wholesaler withdrawals product from its inventory and distributes it as a free sample to the general public, the distributor is the consumer of the product and is liable for use tax. §39-26-202, C.R.S. Moreover, department regulation (39-)26-713(2)(b) states that the measure of the use tax is the wholesaler's or retailer's cost of acquisition.

Tangible personal property that was purchased tax free for resale or an ingredient of a manufactured or compounded product, and subsequently withdrawn from stock for the purchaser's own use or consumption, shall be taxed at the acquisition cost of all materials. The tax liability attaches at the time the tangible personal property is withdrawn from stock. The tax must be reported on the appropriate return provided by the Department.

However, this regulation does not address your specific issue, which is whether the price upon which the tax is calculated is the original acquisition cost ($1.00) or the sample product price ($.60).

You analogize this arrangement to that of a retailer's coupon in which the sales tax paid by the purchaser is based on the discounted price. A retailer's coupon reduces the actual selling price and the tax is measured by the discounted price. See Department Sales Tax Special Regulation 11 (Retailer coupons that reduce the sales price). In this case, the manufacturer is the retailer and is selling the product at a discounted price to the distributor / purchaser. However, the retailer's coupon is not analogous to the present case in some respects. The discount here occurs, if at all, only after the initial sale to the distributor. The final price is not known until the product is later removed from inventory for distribution either as a free sample or as a wholesale sale to a retailer for a sale to the ultimate consumer.

As an initial matter, this issue is appears to be one of a first impression for the department as far as I can determine. I should also note that, because sales tax is a transaction tax, and the tax is generally unaffected by later events (e.g., damage or destruction of the goods), there is reluctance to allow parties to adjust a transaction once it is complete. See, e.g., *Southern California Edison Co. v. State Board of Equalization*, 7 Cal 3d 652 102 Cal Rptr 766, 498 P2d 1014 (1972) (retailer not entitled to sales tax refund for a price adjustment made subsequent to sale and based on damages paid by retailer to purchaser).

The Colorado supreme court's decision in *International Business Machines v. Department of Revenue*, 601 P2d 622 (Colo. 1979) is instructive, although it addresses a slightly different issue. IBM had purchased goods from suppliers and placed the goods into inventory. The company later withdrew some product for its own internal use. The issue before the court was whether the use tax was calculated on IBM's cost of acquisition from suppliers or on the price IBM would have charged a buyer for the goods (i.e., the "value-added" price).

Where, as here, the buyer's ultimate disposition of the item purchased cannot be known at the time of purchase, the transaction's tentative characterization as "wholesale" may be corrected to "retail" by considering later events.

So, too, here, the terms of the sale from manufacturer to distributor cannot be known until the product is withdrawn from inventory. The initial sale price ($1.00) is only tentative and the price becomes final ($.60) once the product is removed from inventory for distribution either as a sample or for resale to a retailer. Compare, also, *Callos Home Medical Equipment v. Lindley*, BTA, Dkt. No. 82-C-1216, 10-16-85 (tax measured on price allowed by Medicare, not initial price in invoice. "We find that the purchase transactions here in question remain executory until such time as appellant receives actual payment from the third party payor agency.") and California Sales Tax Counsel Ruling No. 295.0020 (tax measured on adjusted sale price based on future calculation of cost is appropriate).

Not all arrangements where the initial purchase price is reduced by a later credit will qualify for a reduced tax base. A credit memo or cash rebate given by a manufacturer to a distributor and calculated on the volume of distributor's purchases from the manufacturer is often viewed as a credit that must be included in the purchase price. This is so even though the credit is arguably a reduction of the price to reflect the cost of samples purchased by the distributor from the manufacturer and used by the distributor to promote the product. See, e.g., Texas Comptroller's Decision No. 18,266, 12/09/1986; Texas Comptroller's Decision No. 10,572, 06/18/1980; California Sales Tax Counsel Rulings No. 295.0940.175. Not all states agree with this reasoning. See, e.g., *Columbus Southern Lumber Company v. Peck*, 113 NE (2nd 1, Ohio, 1953) (tax correctly computed on subsequent downward price adjustment which could only be determined after purchaser reached agreed-on sales volume).

Although I am not prepared to outline under what circumstances parties to a transaction may later readjust the price, I am persuaded that it is appropriate to use the final (discounted) purchase price to measure the tax because there is a pre-existing agreement; the agreement anticipates the price adjustment and treats the initial price as tentative until some future event (withdrawal from inventory); the credit memo is not based on the distributor achieving a certain sales volume; and, had there been no time delay determining the final price, the discount price would be a proper measure of the tax.

This case is also dissimilar to a typical retailer's coupon in that a purchaser is not required to perform an act (other than pay the discounted purchase price) as part of the transaction. And when a retailer receives consideration for its coupon, the consideration is added to the purchase price when calculating the tax. Compare, California Code of Regulations 1671.1(b)(4) (payment by the buyer to the retailer for retailer's coupon book is included in the calculation of the sales tax). Similarly, in a slightly different context, when a retailer receives consideration from the manufacturer (e.g., reimbursement) for a discount given to the purchaser, the tax is measured on the full purchase price without reducing the price by the discount given to the purchaser. Department Special Regulation 11. In the present case, the purchaser/distributor is required to perform an act (engage in distribution of free product samples) and the manufacturer arguably receives value from that performance (market promotion of its product).

Nevertheless, I am persuaded that this is not a circumstance in which the purchase price should include the value of the distributor's performance. This agreement is less of a *quid pro quo* exchange of value where distributor's performance is given to manufacturer in exchange for manufacturer's discount price, than it is an agreement between manufacturer and distributor to engage in a common or joint enterprise to promote and encourage the sale and consumption of their product. Each contributes something of value (discounted price and performance) toward the common goal. Distributor's performance is a more akin to a condition precedent upon which the discount is given, and not as *quid pro quo* consideration flowing to the manufacturer in exchange for the discount price.

Therefore, based on the reasons set forth here, the use tax is calculated using the discounted price ($.60), not the initial price ($1.00).

Finally, the Department makes a good faith effort to provide accurate and complete answers to questions posed to it by taxpayers. However, the information and answers provided here are not binding on the Colorado Department of Revenue, nor do they replace, alter, or supersede Colorado law and regulations. The Executive Director, who by statute is the only person having authority to bind the Department, has not formally reviewed and/or approved this response.

Respectfully,

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