STATE OF COLORADO

DEPARTMENT OF REVENUE
State Capitol Annex
1375 Sherman Street, Room 409
Denver, Colorado 80261
(303) 866-3091
FAX (303) 866-2400

Bill Ritter, Jr.
Governor

Roxy Huber
Executive Director

PLR-2008-002
December 22, 2008

XXXXXXXXXXXXXXXXX
Attn: XXXXXXXXXXXXX
XXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXX

Re: XXXXXXXXXXXXXX

Dear XXXXXXXXXXXXX,

You submitted on behalf of XXXXXXXXXXXXXXXXXXXX ("Company") a request for a private letter ruling. This letter is the department's private letter ruling.

Issue

What is the proper tax treatment of wholesale and retail sales of equipment whose price is discounted as an inducement for the consumer to enter into a contract for XXXXXXXXXX [a non-taxable service]?

Background

The Company is a provider of [a non-taxable service] with offices located outside of Colorado. The Company markets and sells its [service] both directly to consumers and through third-party agents ("Dealers"). Use of the Company's [service] requires consumers to sign a one-year contract and purchase certain equipment. A consumer can purchase the required equipment only from a Company authorized Dealer or the Company. The Company purchases components of the equipment from suppliers who are located in states outside of Colorado where it is fabricated. The Company then issues its suppliers a resale certificate, takes ownership and briefly maintains an inventory of equipment in warehouses outside of Colorado. Equipment is shipped from these warehouses to Dealers both inside and outside of Colorado.

The Company requests guidance on the following four scenarios.

Scenario A
The Company purchases the equipment from its suppliers for a total cost of [Price A] and issues a resale certificate to each supplier. The Company sells the equipment to a Dealer for [Price B, which is less than Price A]. The Dealer provides the Company with a resale certificate and the Company does not charge Dealer Colorado sales or use tax.

A Colorado consumer is signed up for [the service] either directly through a Dealer, or through the Company which refers the new consumer to a Dealer. Dealer sells the equipment to the consumer for [Price B], installs the equipment at consumer's location, and bills, collects and remits all applicable Colorado sales and use taxes for equipment and installation service. Although not expressly stated in your letter, I presume that the tax collected by the Dealer from the consumer is based on the sales price of [Price B]. The Company compensates the Dealer with a commission. The Company bills consumers for [the service] over the period of the contract.

Scenario B
The Company purchases the equipment from its supplier for a total cost of [Price A] and issues a resale certificate to each supplier. A Colorado consumer signs up for [the service] directly with the Company. The Company sells equipment to the Colorado consumer for [Price B]. An authorized installer obtains the equipment from the nearest Dealer and installs the equipment at consumer's location. The Company submits a credit memo to the Dealer for the equipment originally purchased by Dealer. The Company bills, collects, and remits all applicable Colorado state and local sales and use taxes for equipment and installation service based upon the sales price of [Price B]. The Company bills the consumer for [the service] over the period of the contract.

Scenario C
The Company purchases equipment from its supplier for a total cost of [Price A] and issues a resale certificate to each supplier. The Company sells equipment to a Dealer for [Price B]. The Dealer provides the Company with a resale certificate and the Company does not charge the Dealer sales and use taxes on the purchase.

A consumer outside of Colorado signs up for [the service] either directly through a Dealer or through the Company, which refers the new consumer to the Dealer. The Dealer sells equipment to the consumer for [Price B], installs the equipment at consumer's location outside of Colorado, and bills, collects, and remits all applicable out-of-state sales and use taxes for equipment and installation service based upon the sales price of [Price B]. The Company compensates the Dealer with a commission. The Company bills the consumer for [the non-taxable service] over the period of the contract.

Scenario D
The Company purchases the equipment from its suppliers for a total cost of [Price A] and issues a resale certificate to each supplier. A consumer outside of Colorado signs up for [the service] directly with the Company. The Company sells the equipment to consumer for [Price B]. An authorized installer obtains the equipment from the nearest Dealer and installs the equipment at consumer's location outside of Colorado. The Company submits a credit memo to the Dealer for the equipment originally purchased by Dealer. The Company bills,

collects, and remits all applicable out-of-state sales and use taxes for equipment and installation service based upon the sales price of [Price B]. The Company bills consumer for [the service] over the period of the contract.

Discussion

Scenario A

The fundamental question posed in this scenario is the tax consequence, if any, that attaches to the transfer of equipment to the consumer at a price below the Company's cost of acquisition. Resolution of this scenario requires us to consider a number of sales and use tax issues.

As an initial matter, we note that a sales tax liability is created when tangible personal property is transferred to another in exchange for consideration. §39-26-104(1)(a) and 102(5) and (7)(a), C.R.S. In general, tax is computed on the purchase price paid by the consumer. §39-26-104(1)(a), C.R.S. In the present case, the transfer of tangible personal property (equipment) to the consumer for consideration creates a sales tax liability for the consumer.

We also begin by noting generally that a retailer incurs use tax liability when it uses property in its inventory for its own purposes, such as for marketing. Thus, for example, a distributor who gives away free samples of its inventory to retailers and consumers as a marketing strategy is liable for use tax calculated on its costs of acquiring the sample from its supplier. See, *International business Machines v. Charnes*, 601 P.2d 622 (Colo. 1979). Similarly, a bank that gives away a toaster to new consumers who agree to engage the bank's services is liable for use tax on the acquisition costs of the toaster (assuming the bank has not previously paid sales tax when it purchased the toaster). In Scenario A, the Company arguably has given away a significant portion the equipment to the consumer as a marketing effort to induce the consumer to purchase the Company's [non-taxable service]. The donated portion is the difference between the price paid by the consumer and, at a minimum, the cost paid by the Company to the supplier.

Having considered the interplay of these and other related issues discussed below, the department concludes that sales tax paid by the consumer in Scenario A should be computed on the Company's cost (i.e., the price the Company paid the supplier for the equipment). The department further concludes that neither the Company nor Dealer is liable for use tax on the equipment. These conclusions are premised on the assumptions that the commission paid by the Company to the dealer is not a manufacturer's rebate, and that the Company has not shifted to the [non-taxable service] a value of the equipment that exceeds the Company's cost of acquiring the equipment. We reach our conclusions for the following reasons.

The Company's marketing strategy of selling equipment below cost is sustainable in the long term only if that portion of the Company's costs for the equipment not reflected in the price paid by the consumer is recovered in the price of the [service]. Shifting some or the entire price of the equipment to the price for [the service] would not be an issue if [the service] itself was subject to sales tax because sales tax would also be collected on the price of [the service]. However, [sales of the service] are not subject to sales tax in Colorado. Thus, by allocating some portion of the price for taxable equipment to the non-taxable [service], the sales tax obligation of this transaction is artificially reduced and improperly avoided.

We further acknowledge that a retailer is generally free to price its goods and services as it best sees fit and the tax consequences are then determined based on how the retailer structures its sales. However, a retailer cannot distort sales tax obligations by shifting the price of taxable goods to non-taxable goods (or services) by bundling the sale of these items and reducing or eliminating the price of the taxable goods. The structure adopted by the Company here results in a distortion of the sales tax.

The issue, then, is how to calculate sales tax in such cases. For the reasons outlined above, we will presume, in the absence of evidence to the contrary, that the price of the taxable item on which sales tax is computed is at least the Company's cost to acquire the goods from its supplier. This is consistent with how use tax is computed in the similar case when a retailer uses an item from its inventory for marketing, such as when it gives away a taxable item as a sample (use tax is based on retailer's cost of acquisition).[1]

Some states[2] that have addressed this issue assess use tax on the retailer on the theory that the sale at a below-market price does not constitute a sale and, therefore, the retailer is not entitled to purchase the goods free of tax from its supplier.[3] The department is reluctant to adopt the position of some of these states that a sale does not occur if the price the retailer sells the item is more than a nominal price, but less than its costs.[4] For example, a retailer who sells its goods during a liquidation sale is incurring sales tax liability even if the price of those goods is below the company's cost of acquiring the goods but more than a nominal price. Other states have created a presumption that a sale at a price which is 25% of the retailer's cost is presumed not to be a sale but merely a promotional give-a-way that subjects the retailer to use tax.[5] Such a presumption does have merit, but the approach does not capture that portion of the price of the taxable item that is recovered in the price of the non-taxable item or service.

We note that our analysis is consistent with Colorado law that applies in the converse case of the sale of discounted taxable items sold in conjunction with taxable services. Sections 39-26-102(7)(b), C.R.S. provides that sales tax cell phones sold at a discount and bundled with taxable wireless telecommunications services is calculated on the discount price charged the consumer. The seller does not incur use tax on that portion of the cell phone price not reflected in the cell phone price. §39-26-202(1)(c), C.R.S. This approach is presumably premised on the fact that the portion of the value of the cell phone not reflected in the cell phone price is recovered in the price of the taxable wireless telecommunications services.

[1] We do not imply here that the sales tax must be the same as the use tax if the Company gave away the equipment. Sales tax must be paid on any portion of the price of the taxable item reflected in the price of the non-taxable item. We have concluded here that, in the absence of evidence to the contrary (such as a market for the equipment independent of the [service]), the Company's cost is the best measure of the price for the equipment.
[2] Some states take the position that sales tax is computed only on the discount price paid by the consumer even if the item is bundled with non-taxable services.
[3] Mass. Regs. Code 64H.1.4(1)(example 5).
[4] *Mercury Cellular Telephone Company v. Calcasieu Parish of Louisiana, et al.,* 773 So 2d 914 (La. 2000) (retailer liable for use tax for cell phones offered for free, nominal price, or at a price substantially below the retailer's costs, as a marketing tool to induce consumers to purchase wireless telecommunications services).
[5] Texas Comptroller's Decision No. 47,362, 10/13/2006

Other states impose a use tax liability on retailers who sell goods at a price below its cost of acquisition.[6] The consumer pays sales tax on the discounted purchase price and the retailer pays use tax on the difference between the price paid by the consumer and the retailer's cost of acquisition. This approach is consistent with what appears to be the economic realities of the transaction: the sale represents both a sale to a consumer and a use by the retailer. However, this approach is somewhat unusual in that it splits a transaction into a sales tax and use tax liability. Although we do not reject the idea that such an approach is not possible, we elect to treat the transaction as subject only to sales tax.

At least one state requires the retailer to calculate sales tax based on the fair market value of the item.[7] The fair market value is the price that the retailer sells the item separate from any other purchase. This approach has the effect of eliminating any inappropriate shift in pricing of taxable items to non-taxable items. We also recognize, however, that a retailer may offer a "loss leader" to consumers on the assumption that the forgone profit the retailer would otherwise realize on a separate sale of item will be offset by a greater gain from the sale of goods or services tied-in to the sale of the loss-leader. Valuing the loss-leader at its fair market value may not reflect the economic realities in such circumstances.

We believe the better analysis in this particular case is that the sales tax is computed based on the price the Company purchases the equipment from its supplier. Important to our determination is the assumption that the equipment has no market value other than as equipment necessary for the provisioning of the Company's [service]. If there were evidence that the equipment could be separately sold without also acquiring the Company's [service], we might well come to a different conclusion. However, the facts presented in your letter do not disclose that this is the case.

The approach we outline here addresses the circumstance of a single transaction in which the taxable and non-taxable items are sold together. Cell phones and wireless services are often sold in a similar manner. Scenario A, however, is slightly different in that it encompasses two situations. In one case, the Company sells both the [service] and the equipment to the consumer. In the second case, there appears to be two sellers: the Dealer (who purchased the equipment from the Company) sells the equipment to the consumer and the Company sells the [service] to the consumer. Some states have concluded that when there are two separate sales transactions (e.g., a retailer sells equipment as one transaction and sells the tied-in service in another transaction), the retailer of equipment incurs use tax liability for the discounted or donated item. It appears from the facts presented in your letter that this is a bundled transaction in which the purchase of the equipment would not occur but for the purchase of [service].[8] We conclude that treating these two transactions as one is

[6] See, e.g., Nebraska Revenue Ruling 1-98-1, 09/14/1998

[7] North Carolina Sales and Use Technical Bulletins No. 21-3,04/01/2007

[8] Even if we viewed these as two separate, independent transactions, we would likely conclude that tax is due on the difference between the price at which the Company acquired the equipment from its supplier and the price at which the Company sold the equipment to the consumer or Dealer. As noted above, a retailer incurs use tax liability when it uses goods in inventory for its own purposes, such as transferring the property to a consumer without charge as an inducement to the consumer to purchase other goods of the retailer. A retailer that sells a taxable item below its costs as an inducement for the consumer to enter into a separate transaction for a non-taxable good or service, the retailer has converted a significant portion of the taxable item for its own

appropriate because it reflects the economic realities and simplifies the tax treatment by treating both as sales transactions.

The determination we make here is limited to the case where the discount for the taxable item is expressly contingent on the consumer's purchase of the non-taxable service. Thus, for example, this approach is not appropriate, for reasons discussed above, where the retailer has tied-in two taxable items, such as a "buy-one, get one" free sale, or offers for sale a taxable item at a price below its costs and not conditioning the discount on the consumer's agreement to purchase another good or service.

We turn now to the question of how the tax is collected. The most straight-forward case is when the Company sells both the equipment and the [service]. In both cases, the Company is the retailer and must collect the tax from the consumer. The issue is more complicated when the Dealer sells the equipment and the Company[9] is the seller of the [service]. The Dealer may or may not be aware of the Company's cost of acquisition for the equipment and, therefore, may not be in a position to calculate the correct sales tax, which includes the difference between the Company's cost of acquisition and the sale price to the Dealer. The better approach is to have the Dealer collect sales tax from the consumer based on the sale price charged by the Dealer to the consumer, and the Company will collect from the consumer sales tax calculated on the difference between the Company's cost and the price charged by the Dealer. This is appropriate because the Company is selling a portion of the equipment as part of its sale of the [service]. The Company is also aware of the price difference between the price it acquires the property and the price at which the Dealer sells the equipment to the consumer. The Company may collect the sales tax from the consumer as a one time charge, or treat the sale as a credit sale and collect a prorated portion of the tax on the installment payments.

We mentioned earlier that our ruling would be different if the Company gave Dealers a manufacturer's rebate. A manufacturer rebate is a payment from a manufacturer to a retailer who sells the manufacturer's goods at a discount. In general, the price upon which sales tax is computed must include a manufacturer's rebate. Our caution is based on your statement that Dealers receive a commission from the Company. It is unclear from the facts you provide whether the commission a Dealer receives from the Company is a manufacturer's rebate or a non-taxable commission for signing a consumer to the [service]. In determining whether the commission is a taxable rebate or a non-taxable commission, the Department will look to the substance of the transaction and is not bound by the terminology adopted by the Company in its contracts with Dealers. The department will consider a number of factors, including whether the equipment can be purchased separately and has a price greater than the price at which the equipment is sold to the Dealer, and whether the Company pays the commission regardless of whether the consumer purchases the equipment.

<u>Scenario B</u>
Scenario B involves three separate transactions. It appears that the Company initially sells the equipment to a Dealer. This is a sale for resale transaction and, therefore, is exempt from sales and use tax. The Company then sells the equipment to a consumer. This is a

---

purposes. Use tax would appear to apply on the difference between the price incurred by the retailer to acquire the taxable item and the price it sells the item.

[9] In the second circumstance, the Dealer is acting as the agent of the Company for the sale of [the service].

retail sale and the consumer is liable for sales tax. The Company's credit memo appears to be a repurchase of the equipment it sold to the Dealer. Again, this is a sale for resale from the Dealer to the Company and, therefore, is exempt from sales and use tax. The sales tax treatment described in Scenario A applies to this scenario.

Scenario C
This scenario involves the sale and delivery of goods by a retailer to a consumer who is located outside of Colorado. Colorado does not impose sales tax on goods that are delivered by the retailer to a destination outside of Colorado. Similarly, Colorado does not impose a use tax on the consumer who, as in this case, uses the goods outside of Colorado.

Scenario D
As discussed in our responses to Scenarios B and C, Colorado does not impose a sales tax on goods sold and delivered by a retailer to a consumer who is located outside of Colorado. Similarly, the Company's sale of equipment to the Dealer and the Company's subsequent repurchase of the equipment from the Dealer are both sales for resale and, therefore, exempt from sales and use tax.

Miscellaneous Matters
Please note that the department does not collect sales and use taxes for "home-rule" cities and counties. You can find a list of these jurisdictions by visiting our web site at:

www.revenue.state.co.us (go to Taxation > Forms > Businesses > Sales and Use > DRP 1002)

Contact those governments for information about their taxes.

This ruling is premised on the assumption that the Company has completely and accurately disclosed all material facts, and is subject to the limitation and qualifications set forth in the ruling. The department reserves the right, among others, to independently evaluate the Company's representations. This ruling is null and void if any such representation is incorrect and has a material bearing on the conclusions reached in this ruling. Enclosed is a redacted version of this ruling which the department will publish on its website.

Respectfully,

Neil L. Tillquist
Colorado Department of Revenue