M e m o r a n d u m

315.0211

To: Mr. Donald J. Hennessy October 21, 1988

From: David H. Levine

Subject: Optional Warranties

I wrote a letter dated September 8, 1988, a copy of which is attached, regarding the application of sales and use tax to an optional warranty. The facts upon which the letter was based include a situtation where sellers of equipment sold their customers optional lump-sum maintenance agreements. Those sellers then subcontracted with Taxpayer to perform that service, also pursuant to lump-sum agreements. My letter states that the seller of the equipment is the consumer of parts used in fulfilling the optional lump-sum maintenance agreement it sells to the customer. The ten percent rule of Regulation 1546 would be applied to ascertain whether Taxpayer is the consumer of parts it uses to fulfill its agreement or is the retailer of the parts to the seller of the equipment. This is based upon the analysis of a hearing report with respect to D--- I--- C--- E--- dated July 18, 1983. I disagree with this analysis and would like to send a follow-up letter correctly stating the application of tax.

The D--- hearing report states at page 4:

> "As is apparent from the text of [Regulation 1546(b)(3)(A)] – wherein the contracting parties are referred to as 'buyer' and 'seller', paragraph (b)(3) of Regulation 1546 is only intended to apply in situations where maintenance agreements are entered into in conjunction with a sale of tangible personal property between the parties. Paragraph (b)(3) is intended to answer the question – what are the gross receipts with respect to the sale of the property. If the maintenance agreement is optional, receipts related to the maintenance agreement do not constitute gross receipts from the sale of tangible personal property. Wehere there is no sale of tangible personal property, there is no need for the rule of paragraph (b)(3). The taxability of maintenance charges made where there is on sale of equipment and maintenance is dependent upon the rule stated in paragraph (b)(1) – tax applies to the fair retail value of the parts if the retail value of the parts is more than 10 percent of the total charge."

It is correct that the purpose of subdivision (b)(3)(B) is to specify the gross receipts form the sale of tangible personal property, but the remainder of the quoted analysis is incorrect. This regulation stands for the proposition that a lump-sum maintenance contract is either part of a sale of tangible property or is a service. The purpose for referring to "'buyer" and "seller" is to distinguish between mandatory and optional lump-sum maintenance contracts. A lump-sum maintenance contract required as part of the sale of tangible personal property is mandatory, and the charge is part of the grosss receipts from that sale of tangible personal property. All other lump-sum maintenance contracts come within the provisions of subdivision (b)(3)(C) of Regulation 1546. This is confirmed by the provision quoted in the hearing report, subdivision (b)(3)(A). It states that a lump-sum maintenance is optional "when the buyer is not required to purchase the maintenance contract from the seller, i.e., he is free to contract with anyone he chhoses." There is nothing in the regulation which suggests that when the buyer does so choose to contract with someone other than the seller that the lump-sum maintenance contract the regulation defines as optional is no longer within that definition because not obtained from the seller.

The D--- hearing report also refers to Regulation 1655(c)(3), which states that the person obligated under an optional warranty is the consumer of the materials and parts furnished, for the proposition that the person selling the warranty to the customer is the person so obligated. This obviously overlooks the fact that, even if that warranty is contracted out, if that contract is a lump-sum warranty, the subcontractor is also obligated under an optional warranty contract. Under Regulation 1655(c)(3), it is this subcontractor who is the consumer of parts and materials furnished pursuant to the subcontractor's optional warranty contract. This is confirmed by Regulation 1546(b)(3)(C) which states that "[i]f the repair work is performed under an optional lump-sum maintenance contract providing for the furnishing of parts, materials, and labor necessary to maintain the property, the repairer is regarded as the consumer of the parts and materials furnished." (Emphasis added.)

The regulatory language supports my analysis of these transactions. Without going into the details, the administrative burden of applying the analysis in the D--- hearing report analysis is substantial from all parties' standpoint, the Board, the retailer, the repairer, and the customer. I have discussed this with three members of the staff outside of Legal. Vin Root, an auditor in Santa Barbara, states that his district follows my anaylsis above. Although Bill Dunn stated that he may have signed off on the D--- hearing report for audit, he does not remember it and does not follow its reasoning. He believes that the field is following my analysis as set forth above, and he also stated that if he were analyzing it himself he would also follow my analysis. Finally, I discussed this with Bruce Henline, The District Principal Auditor for Sacramento, the District in which D--- arose (he was not the District Principal at the time of the D--- hearing). Mr. Henline stated that Sacramento District follows my analysis. He is not familiar with the D--- analysis.

I would like authorization to write a follow-up letter to Mr. K--- correcting the misstatements on this subject which were based on the D--- hearing report. I also believe that we should recommend to Mr. Henline that Sacramento District follow-up with D--- to insure that D--- is reporting tax as it is entitled to do rather than reporting it in conformity with the D--- hearing report.

DHL:ss

cc: Ron Dick