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November 19, 1997

Mr. T--- L---
L--- & A---
XXXX --- --- Parkway
Suite XXX
--- ---, California XXXXX

Re: S--- T---
SZ -- XX-XXXXXX

Dear Mr. L---:

Your letter to Program Planning Manager Dennis Fox dated June 9, 1997 has been referred to me for response. We apologize for our delay in responding. You ask how tax applies with respect to spare parts incorporated during the process of repairing tape drives.

As relevant here, S--- T--- (the "Company") has facilities in California and Oklahoma. The California facility performs the actual repairs. The facility in Oklahoma is the customer service center, and it performs the warehousing, shipping, and billing in connection with the repairs. The Company performs three basic types of repairs: "in-warranty," "extended warranty," and "out-of-warranty."

The in-warranty repairs are performed on tape drives that are covered by the original manufacturer's warranty, which would have been required as part of the purchase of the drive. Customers are not billed for in-warranty repairs (that is, there is no deductible or other cost to the customer when "in-warranty" repairs are performed). These in-warranty repairs constitute the majority of the Company's tape drive repairs. In addition, an extended warranty is offered to some customers on an optional basis whereby they may pay an additional amount for a secondary service period. For purposes of this opinion, I assume that repairs under the optional extended warranty are handled in the same manner vis-a-vis the customer as are the repairs under the mandatory manufacturer's warranty, that is, at no cost to the customer (such as a deductible or other additional expense beyond the original cost of the extended warranty).

Damaged tape drives received from customers are booked into a separate "Non-Functional Drive WIP" account. The company purchases new spare parts extax for resale which are booked into a "Piece Parts Functional" account, into which only new parts are booked. The Company maintains a separate spares account, "Repaired PCBs," for repaired printed circuit boards. These printed circuit boards may be repaired and reused several times before they are no longer repairable.

The flow for a typical out-of-warranty repair is as follows. The customer returns the damaged tape drive to the Oklahoma service center. That facility enters the repair order into the system and determines whether a replacement drive should be shipped to the customer immediately (i.e., swapping the defective drive for a new or refurbished replacement).[1] If so, the service center ships the replacement drive directly to the customer by common carrier.[2] The damaged drive is sent to the California repair center, and it books the defective drive into the Non-Functional Drive WIP. Parts necessary to effect the repairs are withdrawn from both Piece Parts Functional and Repaired PCBs inventories and the drive is repaired. The repaired drive is then transferred in the books of the Company from the Non-Functional Drive WIP to the CSR Drives Functional account.[3] The repaired drive is then shipped back to the Oklahoma service center where it is placed into the inventory account of the service center. If a replacement drive had not already been shipped to the customer, a repaired drive is then shipped to the customer by common carrier (if a repaired drive is not shipped to the customer until after the repairs, the reason would presumably be that the identical drive received from the customer is returned to the customer after repairs).

The company bills its California customers tax unless it obtains the necessary documentation to establish that the customer is making a purchase for resale. The discussion below pertains to situations where the Company has not taken a timely and valid resale certificate in good faith.

Although you do not separately discuss the "flow" of a warranty repair, I assume that it is similar to the flow of an out-of-warranty repair, and that the Company sometimes ships a replacement drive and sometimes repairs and returns the identical drive received from the customer.

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[1] You also mention circumstances where a drive may be replaced with one that is unique to that customer. It is not entirely clear what this entails and I am therefore unable to specifically address it. If you have questions on this type of situation that are not covered in my opinion, please provide us additional information and your specific questions.

[2] The Company neither takes delivery of the drives shipped by its service center nor installs them at the customer's site, whether sending a replacement drive or returning the identical drive, after repairs, that had been received from the customer.

[3] It is not clear how the Company handles its accounts when the identical drive received from the customer is repaired and returned, as opposed to the exchange situation that appears to be covered by the explanation above.

QUESTIONS

"In-Warranty Repairs

"(1) Although parts consumed under 'in-warranty' repairs are exempt from use tax, the Company does utilize some tax-paid materials under these repairs (repaired printed circuit boards).

May the Company obtain a credit for tax-paid materials used in repairs performed 'in-warranty'?

"Out-of-Warranty Repairs

"(2) What is the taxation of spare parts used in out-of-warranty repairs?

"(3) If the Company is considered the consumer of spare parts, are such parts consumed in Oklahoma City at the point repaired drives are withdrawn from inventory for shipment to customers?

"(4) Would there be a different application of tax if parts were shipped to California FOB destination rather than common carrier?

"Extended Warranty Repairs

"(5) What is the taxation of spares parts used in extended warranty repairs?"

DISCUSSION

Prior to discussing your questions, I note that in your analysis, you have relied on several letters that are not backups for published annotations. As you probably know, we have recently completed our historical annotation project. The goal of the project was to annotate those opinions which state rules on which the staff relies in determining the correct application of tax. An opinion might not have been annotated for several reasons. The opinion might have been incorrect, misleading, or incomplete, or the rule stated in the opinion may have been correct, but already covered in the statute, regulations, or existing annotations.

Thus, I must caution you that it is inadvisable to rely on prior correspondence except for the points that have been annotated. If an opinion (or part of an opinion) was not annotated because the rule in question is covered in existing annotations, then, of course, you should rely on those annotations rather than the non-annotated correspondence. If the reason the

correspondence (or part of it) was not annotated was that it was wrong, misleading, or incomplete, then it is obvious why you should not rely on it. Although it appears that the opinions of this type that you have cited are consistent with my opinion below, I have not relied on them for the reasons expressed above.

In-Warranty Repairs

You are correct that the Company is regarded as having purchased for resale parts installed onto drives provided to customers as part of in-warranty repairs.[4] When the Company has paid California sales tax reimbursement or use tax to its vendor of parts incorporated into a defective drive that is then provided to a customer as part of an in-warranty repair, the Company may take a tax-paid purchases resold *deduction* for the purchase price of such tax-paid parts resold as part of the in-warranty repairs, provided the Company's measure of California tax liability on its retail sales equals or exceeds the measure of the tax-paid purchases resold deductions. (BTLG Annot. 545.0070 (2/2/82).) Of course, the Company may only take a deduction with respect to the property purchased tax-paid and incorporated during the current in-warranty repairs. With respect to items returned to the Company and repaired more than once, the Company may take a tax-paid purchases resold deduction only with respect to the purchase price of tax-paid property incorporated during the current repair session.

Out-of-Warranty Repairs

Initially, the application of tax depends on whether the customer receives the identical drive returned to the Company, or instead receives a replacement drive. When the Company repairs a defective drive and returns that identical drive to the customer, the Company is performing repairs pursuant to the contract with its customer. (See Reg. 1546.) It is not clear whether the Company itemizes its charges for parts separate from its charges for repair labor. It is required to do so when the retail value of the parts and other materials furnished in connection with the repairs is more than 10 percent of the total charge. When the Company separately itemizes the charge for parts and materials (and when the retail value of such property is more than 10 percent of the total charge, even if not separately stated), the Company is the retailer of all parts incorporated into the repaired drives returned to its customers. Tax applies to the fair retail selling price of those parts (presumably the amount itemized for the parts), which the Company must collect and remit to the Board.

The Company is the consumer of parts and materials installed into drives when it is fulfilling a repair contract (i.e., the Company returns to the customer the identical drive received

[4] I assume that whether the customer receives the identical drive sent to the Company or a replacement drive, the Company knows exactly what parts had been incorporated into the particular drive shipped to the customer during the repairs and whether those parts were tax paid or not. If not, issues would be raised that are not addressed in this opinion. Rather, this opinion is specifically based on the understanding that the Company tracks the particular parts incorporated in each particular drive during repairs, and whether those particular parts are tax paid or not.

from the customer) if it bills in lump sum and the retail value of the parts and materials furnished in connection with the repairs does not exceed 10 percent of the total charge. It owes tax on its cost of such property if it is regarded as having used the property in California. For the reasons discussed in the next section, it is regarded as consuming those parts in California, and must either pay California sales tax reimbursement or use tax to its vendor of the parts or must report and pay tax directly to the Board on the cost of such parts.

When the customer receives a replacement drive, the Company is making a sale of the replacement drive. The measure of tax is the entire charge to the customer, whether or not the Company itemizes the charges allocable to the parts that had been incorporated into the replacement drive during its repair. (Reg. 1546(b)(4).) The Company must collect that tax and remit it to the Board. Please note that this analysis applies whenever the identical drive sent to the Company for repairs is not returned to the customer as part of that particular repair, even if the replacement is made from a small inventory of "unique configurations."[5]

Extended Warranty Repairs

Based on the facts stated above (e.g., these are true optional warranties and the customers pay no additional charges for repairs such as deductibles), the Company is the consumer of parts it incorporates into the drives repaired pursuant to extended warranties. If it did not pay California sales tax reimbursement or use tax when purchasing the property, it must report use tax on its cost of such property if it is regarded as using the property in California.

When the Company purchases parts it knows it will incorporate into drives while performing extended warranty repairs, it may *not* purchase those parts extax for resale. When the Company purchases such property from California vendors, those vendors owe sales tax and will presumably collect sales tax reimbursement from the Company. The discussion below does *not* apply to parts the Company purchases in California for the specific purpose of incorporating into drives during extended warranty repairs.

As noted above, the Company may purchase parts incorporated into drives during in-warranty repairs for resale. You state that the majority of the Company's repairs are these in-warranty repairs. Thus, it appears that the majority of the repair parts the Company purchases will be resold. Under these facts, where the Company is purchasing commingled parts for incorporation into drives during in-warranty repairs (for resale) and into drives during extended warranty repairs (for use), it may properly purchase all those parts for resale. (See, generally,

[5] It is possible that a repairer would maintain an inventory of the *customer's* property for replacement purposes. In such a situation, the repairer would, in effect, be warehousing the customer's property. Since the repairer would be repairing the customer's property (and not its own), it would generally bill the customer when the repairs are performed for each particular unit, and not when the repaired unit is later transferred to the customer per the customer's instructions. It does not appear from the facts stated in your letter that this scenario is applicable here.

BTLG Annot. 570.0435 (5/19/95) for examples of when a person may properly purchase commingled goods for resale and when it cannot.)

When the Company properly purchases commingled parts for resale, it must report use tax on its cost of those parts it thereafter uses in California. (Reg. 1668(a)(2).) Similarly, the Company must report use tax on its use of parts in California that it purchases from out-of-state vendors without paying California use tax. Thus, the question presented for these situations is whether the Company is regarded as using the parts in California. The answer to this question depends on whether the Company is repairing a customer's drive or its own. When the Company receives a defective drive from a customer, repairs it pursuant to the extended warranty, and then returns that same drive to the customer, the Company has used the repair parts in California when it withdraws them from extax resale inventory and then incorporates the parts into the customer's defective drive pursuant to its obligations under the extended warranty.[6] The Company must report use tax on its purchase price of such property.[7]

The Company does not always fulfill its obligations under the extended warranty by repairing and returning to the customer the identical drive that the customer had sent to the Company. It may replace a customer's defective drive with another drive that had been repaired previously and which is held in the Company's inventory for such purposes. When the Company does so and then sends the defective drive to California for repairs, it has sent its *own* drive for repairs, as opposed to the situation in the previous paragraph where it is repairing a drive owned by its customer. After the drive is repaired in California, it will be sent back to Oklahoma and placed into the Company's exchange inventory. In this situation, when the Company sends an exchange part from its Oklahoma exchange inventory by common carrier to its customer in California to fulfill its obligations under the extended warranty, the Company would generally be regarded as consuming the repair parts in Oklahoma when it transfers possession of the exchange part to the common carrier for shipment to California.[8]

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[6] You cite annotation 490.0483 (4/27/94) for the proposition that the consumption would normally occur when the repairer fulfills its obligation to the customer under an optional warranty, that is, when the repaired product is shipped to the customer. As you appear to acknowledge, this annotation does not deal with the question of when consumption occurs, just that if the consumption is deemed to have occurred in California, tax applies. In fact, there was no question regarding whether the incorporation of parts in California into a customer's property pursuant to an optional warranty was a use in California. Rather, the annotation deals with the supply of parts to fulfill a warranty, not the use of the parts by the warrantor to perform repairs pursuant to the warranty.

[7] The same analysis applies when the Company is the consumer of repair parts while performing out-of-warranty repairs. This would be the case when the Company repairs and returns the identical drive received from the customer and bills in lump sum where the retail value of the parts and materials furnished in connection with repair work is 10 percent or less of the total charge. Under these circumstances, the Company consumes the parts and materials in California when it repairs the drive. It owes use tax on the cost of such property.

[8] Since the Company is fulfilling a contract obligation when it ships the exchange part, it is possible that the contract could be structured in such a way that title to the exchange part passes to the customer in California. If the contract is silent as to title passage but provides that the shipment is f.o.b. the customer's destination in California, title would generally be regarded as having passed in California. (BTLG Annot. 495.0625 (9/18/95).) If such were

For purposes of completeness, I note that the analysis above regarding location of use applies regardless of the state in which such use occurs. For example, assume the situation where the facilities were reversed, that is, the repair facility located in Oklahoma and the service center located in California. Since the use of repair parts incorporated into customer-owned defective drives as part of optional warranty repairs occurs at the repair facility (i.e., the customer receives the identical drive back), the use in this hypothetical would be regarded as having occurred in Oklahoma. Since the use of repair parts incorporated into defective drives that will be exchanged pursuant to optional warranties occurs at the location of title passage (i.e., Company-owned drives), in this hypothetical the use of such parts would generally occur in California when the service center ships the exchange drives to the customers, wherever those customers are located.

I hope the discussion above answers your questions. If you have further questions, feel free to write again.

Sincerely,

David H. Levine
Supervising Tax Counsel

DHL/cmm

cc: Mr. Dennis Fox (MIC:92)
Mr. Vic Anderson (MIC:40)
Ms. Leila Khabbaz (MIC:40)
--- --- District Administrator (GH)

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the case, the Company would be regarded as having made a taxable use of the parts in California when title passes to the customer.