

Memorandum**315.0209**

To: Mr. Wayne Grupe
Associate Tax Auditor
San Diego District Office - FH

Date: February 18, 1994

From: Sukhwinder K. Dhanda
Staff Counsel, Legal Division - MIC:82

Subject: J. F. K--- - OPTIONAL WARRANTY CONTRACTS
ACCOUNT NO. SR – XX-XXXXXX

This is in response to your memorandum received December 17, 1993 requesting a legal opinion as to the application of tax to optional warranty contracts provided by manufacturers of service station equipment.

J. F. K--- is an authorized repair facility for W--- D--- and G---, two manufacturers of service station equipment. The manufacturers sell the optional warranty policies to oil companies and then contract with repair facilities, such as J. F. K---, to do the actual repair work.

As indicated by your audit, J. F. K--- has not reported or paid sales tax on the replacement parts used in repairing the equipment under the warranties. W--- D--- has not reported or paid sales tax on the parts consumed under the warranty contracts. G--- states that tax was reported and paid on the material cost of the parts consumed under warranty. Both manufacturers agree that they are the consumers of the parts used in the performance of repairs but they argue that the tax liability is based upon the material cost of the parts since they manufacture the parts.

J. F. K---'s attorney (R--- T---), in a letter dated June 23, 1993, requested an opinion as to the application of tax to four separate methods used by J. F. K--- in performing the repair work for the manufacturers. J. F. K--- maintains an inventory of replacement parts and materials which it purchases over the course of the year from various manufacturers. J. F. K--- does not pay tax on the purchase of these items (presumably they are purchased for resale).

Before answering the specific questions posed in Mr. T---'s letter, the two contractual relationships at issue must be analyzed. The first is the relationship formed between the customer and the manufacturer (warrantor), that is, whether the warranty is mandatory or optional. Regulation 1655(c)(1) states that a warranty is mandatory when the buyer, as a

condition of the sale, is required to purchase the warranty from the seller. The measure of tax includes any amount charged for the mandatory warranty. The sale of replacement parts to the person obligated to furnish them under a mandatory warranty is considered a sale for resale and is not taxable.

A warranty is optional when the purchaser is not required to purchase the warranty from the seller and is free to contract with anyone the purchaser chooses. The person obligated under an optional warranty contract to furnish parts, materials and labor necessary to maintain the property is the consumer of the parts and materials furnished and tax applies to the sale of such items to him or her.

The second contractual relationship relevant to the discussion is the relationship between the manufacturer (warrantor) and the repairer. As you know, Regulation 1546 deals with the application of tax to parts provided in connection with repair work. If the retail value of the parts and materials furnished in connection with the repair work is more than 10 percent of the total charge, or if the repairer makes a separate charge for the parts and materials, the repairer is the seller of those parts and materials and, if that sale is at retail, tax applies to the fair retail selling price of the property. If the retail value of the parts and materials furnished is 10 percent or less of the total charge, and if no separate charge is made for the parts and materials, then the repairer is the consumer of the property and tax applies to the sale of the property to him or her. With respect to the repair contracts at issue in the present case, I assume that the fair retail value of the parts is more than 10 percent of the total repair charge, or that the charge for the parts and materials is separately stated. Based on this assumption, the repairer is the seller, and not the consumer, of any parts and materials it furnishes as part of the repairs.

Mr. T---'s basic question is as follows:

"[I]s J. F. K---, Inc. obligated to collect, report, and pay sales tax on the materials and parts furnished to carry out its subcontract with the manufacturer, or is it the manufacturer's responsibility to collect, and pay sales tax on the materials and parts consumed in carrying out the repairs?"

Each of the four methods used by J. F. K--- in performing the repair work, as described in Mr. T---'s letter, are quoted below followed by our analysis.

- "1. Standard Warranty Repairs: K--- takes material from stock to effectuate the repairs. Upon completion of the warranty repairs, the manufacturer replaces the expended items from stock without charge. J. F. K--- returns the old part to the manufacturer, together with an invoice for handling charges, labor, travel, and in some cases freight. In some cases, the manufacturer will provide the repair part (so that J. F. K--- does not have to take the part out of stock) if J. F. K--- timely returns the defective parts. J. F. K--- pays no sales tax on the transaction."

J. F. K--- is selling the parts it furnishes. If the warranty is a mandatory warranty, J. F. K--- is selling those parts for resale, and may purchase them ex-tax (for resale). No further tax would be due beyond that paid on the original sale. If the warranty is an optional warranty, then J. F. K--- is selling the parts to the manufacturer at retail, and owes sales tax measured by the fair retail value of the parts.

"2. Type A 'Lump Sum' extended warranty contracts. J. F. K--- receives a fixed fee to service a group of service stations for the manufacturer. Upon completion of the repairs, the defective repair parts are returned to the distributor for replacement in inventory. Monthly, J. F. K--- invoices the manufacturer for its fees and reflects the usage of repair parts, the cost to J. F. K--- and the sales tax thereon. Thereafter, J. F. K--- pays the sales tax on the parts used in the repairs."

In your draft response letter to Mr. T---, you state that these Type A "Lump-Sum" Extended Warranty Contracts are negotiated after the sale and are not required as a condition of the sale. Therefore, these contracts are optional warranty contracts. Here, the person obligated under the optional warranty contract to furnish parts, material and labor necessary to necessary to maintain the property is the manufacturer. As explained in Regulation 1655(c)(3), the manufacturer is the consumer of the materials and parts the manufacturer furnishes. Tax applies to the sale of such items to the manufacturer or use tax applies to the use of the parts. J. F. K---, when it performs the subcontract work for the manufacturers, is the retailer of parts it provides. J. F. K--- is liable for sales tax based upon its gross receipts (i.e., the fair retail value) from its sale of such parts to the manufacturer.

"3. Type B 'T&M' extended warranty contracts. J.F. K--- performs maintenance for the manufacturer using stock from inventory. The manufacturer is invoiced for cost of parts plus markup and labor and other expenses. The manufacturer is not charged sales tax on the parts expended. J. F. K--- pays no sales tax on the transaction."

Once again, the manufacturer is the consumer of the replacement parts furnished under the optional warranty. When J. F. K--- provides parts as a part of its repair work, it is the retailer and owes sales tax based upon the fair retail value of the parts.

"4. Type C 'T&M' extended warranty contracts. J.F. K--- performs maintenance for the manufacturer using parts purchased from a distributor. Upon completion of the transaction, the defective parts are returned to the distributor for which J.F. K--- receives full credit. The manufacturer is not charged by J.F. K--- for the cost of the parts used, only labor and mileage. The material part of the transaction is handled between the distributor and the manufacturer. J.F. K--- pays no sales tax on the transaction."

As discussed above, the manufacturer is the consumer of the parts provided under the optional warranty contract. The question here is whether J. F. K--- or the distributor is the

retailer of the parts. If J. F. K--- never owns the parts and the distributor sells them directly to the manufacturer, then the distributor is the retailer. If, however, the distributor sells the parts to J. F. K---, then J. F. K--- is selling the parts to the manufacturer and is the retailer. Under the facts here, we conclude that J. F. K--- first takes title to the parts in question. That is, we conclude that J. F. K--- first purchases the parts from the distributor and then sells them to the manufacturer when it provides those parts in the repair. The fact that J. F. K--- receives full credit when it returns the part to the distributor does not change the fact that there is a sale (for resale to the manufacturer) of the parts from the distributor to J. F. K---.¹ J. F. K--- is the retailer of the parts it provides and is responsible for the sales tax based upon the fair retail value of the parts.

In summary, based upon the assumption that the retail value of the parts is 10 percent or more of its total charges (or that the charge for the parts is separately stated), J. F. K--- is the seller of the parts it provides in its repair work for the manufacturer. If the warranty provided by the manufacturer to the service stations is a mandatory warranty, then the sale to the manufacturer of parts by J. F. K--- is considered a sale for resale and is not taxable. It appears that scenario 1 of Mr. T---'s letter may come within this rule. If the warranty provided by the manufacturer is optional, then the manufacturer is the consumer of the parts and materials the manufacturer furnishes and tax applies to the sale of such items to the manufacturer. When the repair is on property covered by an optional warranty, that sale of parts is at retail and is subject to sales tax measured by the fair retail value of the parts. Of the four scenarios set forth in Mr. T---'s letter, it appears that in 2, 3, and 4, J. F. K--- is selling parts when doing the repair work for the manufacturers under optional warranties the manufacturers provided to their customers. These sales are at retail and are subject to sales tax measured by the fair retail value of the parts.

One of the manufacturers agrees that it is the consumer of the parts but believes that its tax liability should be measured by its cost of materials since it manufactures the part. The only situation in which the manufacturer's cost of materials would be the appropriate measure of tax would be if J. F. K--- was merely installing the parts owned by the manufacturer. Once the part is sold by the manufacturer, this rule can no longer apply since the parts are thereafter sold back to the manufacturer. It is this sale back to the manufacturer that is the taxable retail sale. Since we conclude that title to the parts passes to J. F. K---, we conclude that J. F. K--- is making taxable retail sales to the manufacturers when repairing property covered by optional warranties.

If you have any questions, feel free to write again.

¹ Revenue and Taxation Code section 6006, defining a "sale", states that a "sale" includes "any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration. (Emphasis added).

Mr. Wayne Grupe

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bc: --- --- District Administrator - --