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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
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May 21, 1996

Mr. R--- D. H---
--- --- LLP
Suite XXXX
XXX East --- Boulevard
---, FL XXXXX-XXXX

Re: Unidentified Taxpayer

Dear Mr. H---:

This is in response to your April 5, 1996 letter to Supervising Staff Counsel David H. Levine requesting a ruling on the application of tax on property furnished by your client pursuant to an optional maintenance agreement. I initially note that the Board staff does not issue rulings. Revenue and Taxation Code section 6596 sets forth the circumstances under which a taxpayer may be relieved of liability for taxes when reasonably relying on a written response to a written request for an opinion. In order to come within the provisions of section 6596, all relevant facts, including the identity of the taxpayer, must be disclosed. This opinion does not come within section 6596 because you have not identified your client. You should provide us with the identity of your client (as well as all relevant facts) in your initial letter to us if you wish an opinion letter coming within the provisions of section 6596.

You state:

> "Our client is a California dealer in the business of selling and/or leasing office equipment and related products. Customers have the option of purchasing equipment maintenance contracts at the time of purchase or lease of such products. These contracts are not mandatory. Several different types of contracts exist. Some provide for parts and labor, while others additionally include supplies.

> "The selling price for these contracts is derived from estimates of the combined cost of labor, parts and supplies expected to be utilized over the term of the contract. Prior experience, manufacturer specifications and customer usage are key attributes involved in the pricing determination.
>
> "Contracts are structured such that a customer is invoiced a recurring amount, typically on a monthly basis. Terms of the contract may differ, however the monthly billings are fixed, regardless of the required maintenance. The contract price includes the cost of parts and/or supplies to be used for future maintenance of the office equipment under contract. The cost of parts and/or supplies are not stated separately in the contract. Numerous contracts exist across the United States and thus changes to the structure of the contract are not feasible. Due to system limitations, our client is unable to segregate parts and/or supplies on the recurring invoices.
>
> "Difficulties arise for our client in tracking the parts and/or supplies consumed in the performance of such contracts. Should they be required to remit tax on the cost of such items, estimates would be employed based on the research conducted in determining the appropriate pricing structure. Currently, our client collects and remits sales tax on a percentage of the contract based on the ratio of estimated parts and supplies to the contract price. Prior sales tax audits in California have accepted this procedure as being in full compliance"

You ask whether your client may "collect and remit sales tax on a portion of their maintenance contracts in lieu of remitting use tax on the cost of parts and supplies consumed in the performance of the contract." For purposes of this opinion, we assume that your client removes parts and supplies from its California extax inventory in the course of fulfilling its obligations under its optional maintenance agreements. (If our assumptions are incorrect, our opinion below would be different.)

Discussion

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) This tax is imposed on the retailer who may collect reimbursement from its customer where the contract of sale so provides. (Civ. Code § 1656.1; Reg. 1700.) The retailer may not, however, collect an amount as "sales tax" unless the retailer owes that amount of tax on the sale of property to its customer. (Rev. & Tax. Code § 6901.5; Reg. 1700(b)(1).) When sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for the storage, use or other consumption in California. (Rev. & Tax. Code § 6201.) This tax is imposed on the person actually storing, using, or otherwise consuming the property. (Rev. & Tax. Code § 6201.)

You state that your client's maintenance agreements are optional.[1] The charges for such optional maintenance contracts are not part of the taxable gross receipts or sales price from your client's sales or leases of its equipment. (Reg. 1660(c)(1); Business Taxes Law Guide Annots. 490.0580 (12/13/63), 490.0700 (5/10/60).) Regulation 1655(c)(3) explains the application of tax to the property used in the performance of an optional warranty/maintenance agreement:

> "The person obligated under an optional warranty contract to furnish parts, materials, and labor necessary to maintain the property is the consumer of the materials and parts furnished and tax applies to the sale of such items to him. If he purchased the property for resale, without tax paid on the purchase price, he must report and pay tax on the cost of such property to him when he appropriates it to the fulfillment of the contract of warranty."

Thus, your client is the consumer of parts, materials, and supplies furnished in the performance of its optional maintenance agreements and tax applies on the sale of such items to it, or to its use of such property. If your client purchased the property for resale, or otherwise acquired the property without paying tax or tax reimbursement, it must report and pay use tax on the actual cost of such property. Since it appears that your client's business practices make the determination of such actual cost impossible, it should consult with the Board's audit staff to develop an acceptable reporting method.

You ask whether your client may instead collect tax reimbursement from its customers on a portion of the charge for its optional maintenance agreement. In that regard, you believe that your client is a retailer of the parts and materials supplied under the maintenance agreement since, pursuant to Regulation 1546(b)(1), the retail value of these parts and materials exceeds ten percent of your client's total charge for its maintenance agreement. We note, however, that Regulation 1546(b)(1) does not apply to situations where parts and materials are furnished pursuant to an optional maintenance or warranty agreement. Instead, Regulations 1546(b)(3)(C) and 1655(c)(3) specify how tax applies in those situations and provide that your client is the consumer of such property. Regulation 1546(b)(1) is therefore inapplicable to your client's situation.[2]

As set forth above, your client - not its customers - owes use tax on the parts it consumes in fulfilling its responsibilities under its optional agreements. This means that any amounts your client collects from its customers as tax or tax reimbursement on its charges for an optional warranty/maintenance agreement would constitute excess tax reimbursement. (Rev. & Tax. Code § 6901.5; Reg. 1700(b)(1).) Any excess tax reimbursement collected by your client must

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[1] You have not provided us with copies of these contracts or any facts on which to determine whether the contracts are optional or mandatory within the meaning of Regulation 1655(c)(1). As such, we cannot guarantee that, upon audit, a Board auditor would not disagree with your conclusion that the contracts in question are optional.

[2] You also state that prior audits have indicated that collecting tax on a percentage of your client's contracts is in compliance with California law and that you believe that these audit findings constitute "implied acceptance." We are obviously unable to determine what the reports say without completing our own review. It may or may not be that the audit statements meet the requirements of Revenue and Taxation Code section 6596. In any event, the correct rules of law are as set forth in this letter.

be refunded to those customers who paid such amounts or to this Board. (*Id*.) If your client is collecting such excess tax reimbursement, it must immediately cease doing so. (See Business Taxes Law Guide Annot. 460.0141 (1/8/92).)

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz

cc: Out-of-State District Administrator - (OH)