M e m o r a n d u m

315.0210

To: Mr. Jack E. Warner
District Principal Auditor
Out-of-State District

August 23, 1990

From: David H. Levine
Senior Tax Counsel

ATSS 485-5550
(916) 445-5550

Subject: I---

This is in response to your memorandum dated July 17, 1990. I--- is a computer software service company primarily engaged in computer disk repair and customization services. I--- has not applied for a permit and has not paid California sales or use tax. In its letter to Out-of-State District Administrator James Caldwell dated June 20, 1990, P--- M---, it representative, has set forth some facts and has proposed a settlement. You have asked us to respond directly to P--- M---. As you and I discussed, since taxpayer is proposing a settlement, and since no audit has yet been conducted and the facts are not clear, we believe that the proposed settlement is an audit and administrative decision at this time and not a legal decision. Therefor, I am writing to you with our opinion regarding the application of tax to I---'s business so that you may thereafter respond to I---'s proposed settlement.

Prior to getting into the specifics of this case, I wish to first address an issue that may be involved in this matter, that is, the application of tax to warranty repairs. This issue is discussed in a memo by Freda of your office which is attached to your memo. You also attached part of a letter I wrote dated September 8, 1988. In that letter, I indicated that a repairer is a consumer under an optional maintenance contract only if that repairer is the seller of the item being repaired and that if the optional warranty agreement was subcontracted by the seller to another person, the general rules under Regulation 1546 would apply to that person's repairs. This opinion, which was based on a hearing report that was incorrect on this issue, is hereby overruled.

A repairer who entered into a warranty contract which is not required as part of the sale of tangible personal property is providing an optional maintenance contract under Regulations 1546(b)(3)(C) and 1655(c)(3) whether or not that person was also the seller of the property for which the warranty is issued. That person is the consumer of materials and parts furnished in performing the repairs and tax applies to the sale of such property to the repairer or to the use by

the repairer of that property. The reason for this conclusion is explained in a memorandum I wrote dated October 21, 1988, a copy of which is attached. Annotations 490.0540 (4/25/51) and 490.0680 (5/21/54) also support this conclusion. The analysis in my September 8, 1988 letter regarding mandatory maintenance contracts remains applicable.

P--- M--- describes I---'s business as follows:

> "I--- performs research and development, warranty repair and customization services for certain affiliated companies. I--- itself does not sell disks or other computer equipment at wholesale or retail. I--- performs these services for customers of its affiliated companies which are engaged in the manufacture and distribution of computer software and hardware equipment. The affiliated companies pay a fixed fee for these services based on a prearranged pricing schedule according to the type of service performed.
>
> "The customization services involve consulting, designing and implementing computer systems and data retrieval systems within the meaning of California Regulation 1502 and, as such, are exempt from sales tax. I---'s primary business function is to provide support services to modify software or repair disks sold by other affiliates to suit the specific needs of their customers. However, because the company has, in effect, entered into an optional maintenance contract with its affiliates it is responsible for a use tax on the cost of all materials stored, used or consumed within California (see California Regulation 1546)."

I--- has not described the contracts between the sellers (I---'s affiliates) and the consumers, and those contracts are relevant to I---'s tax liability. I--- states that the affiliate companies pay a fixed fee for the services provided by I---, and as Freda notes, this may simply be a repair contract for repairs, as necessary. Since the fixed fee is based on the type of service actually performed, it appears most likely that these are contracts for repair and not warranty contracts. If so, the general rules set forth in Regulation 1546(b) would apply to I---'s repairs. However, if this is the case, and if the affiliates were required to repair these items pursuant to mandatory warranties the charge for which was included in the affiliates taxable gross receipts, then any parts for which I--- is regarded as a retailer under subdivision (b) of Regulation 1546 would actually have been sold to the affiliates for resale (i.e., parts with a retail value of more than 10 percent of I---'s total charge or for which a separate charge is made). If the affiliates were obligated under optional warranties, I--- would be the retailer of these parts, and sales tax would apply because the affiliates would be regarded as consumers under the optional warranties. In either case, I--- would owe use tax on property for which I--- is regarded as the consumer in performing its repairs unless it paid its vendors sales tax reimbursement with respect to that property.

Although not likely based on P--- M---'s description, I--- may have a warranty contract with its affiliates. This would be the case if, for example, the affiliates pay I--- x dollars per year to make any repairs necessary to the subject property and if I--- is entitled to the x dollars even if I--- were required to make no repairs to the subject property. (This is as opposed to the situation discussed above in which, for example, the affiliates agree to pay I--- y dollars for a certain type of repair and pay I--- the y dollars only if that repair is performed.) In such situations, if I---'s obligations under the contracts with its affiliates are the same as the affiliate's obligations under mandatory warranties the charge for which was included in the affiliates' taxable gross receipts, then I--- performs the repairs on behalf of the affiliates (i.e., the sellers of the items repaired). I--- would be regarded as selling to the affiliates any parts transferred to the customers. That sale would be for resale, with tax having already been paid measured by the charge for the mandatory warranty. Under any toher warranty contract I--- has with its affiliates, I--- would be regarded as providing an optional warranty, and would be a consumer of all parts used to perform the required repairs.

It appears from the facts set forth in the letter from P--- M--- that this repair issue is the only issue involved in I---'s tax liability. However, it is not entirely clear that we have been provided all relevant facts. For example, P--- M--- states that I--- does not sell disks or other computer equipment at wholesale or retail. However, perhaps I--- performs labor on such items for consumers that we would regard as fabrication constituting a sale of tangible personal property. Also, it is not clear whether the affiliates pay California sales and use tax. Since I--- is presumably a retailer and its affiliates are presumably owned or controlled by the same interests which own or control I---, the affiliates may be regarded as retailers engaged in business in this state required to collect use tax on their sales for use in California. (See Rev. & Tax. Code § 6203(g).)

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

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Attachment

cc: Mr. Donald J. Hennessy

Mr. John Abbott – I recommend this opinion with reference to both optional and mandatory warranty contracts be annotated.

Mr. Bruce Henline, Sacramento District Principal Auditor – This relates to a hearing report arising in your district

(all w/attach.)