

ST 17-0001-PLR 2/9/2017 REPAIRS

This letter discusses the taxation of express warranties and extended warranties. See 86 Ill. Adm. Code 140.141 and 86 Ill. Adm. Code 140.301(b)(3). (This is a PLR.)

February 9, 2017

RE: Request of Written Advice Regarding Extended Warranty Contracts

Dear Xxxxx:

This letter is in response to your letter dated April 13, 2016 in which you requested information, and the supplemental materials you provided dated November 14, 2016. The Department issues two types of letter rulings. Private Letter Rulings (“PLRs”) are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department’s regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter (“GIL”) is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Section 1200.110 governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request. In your letter you have stated and made inquiry as follows:

COMPANY (“COMPANY”), respectfully requests written advice from the Illinois Department of Revenue (the “Department”) discussing whether COMPANTY’s extended warranty contract known as WARRANTY (“WARRANTY”) should be classified as an optional warranty, not subject to sales or use tax.

ISSUES

1. Is the sale of WARRANTY Extended Warranty Contracts subject to Illinois Retailer’s Occupation tax or Service Occupation tax?
2. If sales of WARRANTY are not subject to Illinois Retailer’s Occupation tax or Service Occupation tax, would a customer’s enrollment in the PRODUCT UPGRADE PROGRAM subject sales of WARRANTY

Extended Warranty Contracts to Illinois Retailer's Occupation tax or Service Occupation tax?

FACTS

The following summarizes the factual background associated with COMPANY, the PRODUCT UPGRADE PROGRAM and associated transactions for which COMPANY is requesting technical advice regarding the applicability and collection of Illinois tax.

COMPANY, a STATE company, designs, manufactures and markets consumer electronics, software and personal computers. The Company's most popular consumer electronics products include the PRODUCT 1 line of computers, the PRODUCT 2 tablet computer and the PRODUCT smartphone. This ruling request is specific to transactions associated with the PRODUCT, specifically COMPANY's newest versions, the PRODUCT 3 and PRODUCT 4.

The PRODUCT

The PRODUCT combines a mobile phone, an PRODUCT 5 and a mobile internet communications device in a single handheld device. It runs on COMPANY's proprietary ZZZ operating system and includes a user-friendly touch screen used for performing functions such as surfing the internet, dialing telephone numbers and text messaging. PRODUCTS are available for purchase from COMPANY (through its Online Store or physical Retail Stores) or an authorized retailer. Authorized retailers include retail outlets of mobile telecommunications carriers ("carrier") CARRIER 1, CARRIER 2, CARRIER 3 and CARRIER 4 operating in the United States, as well as other retailers of consumer electronics (e.g. RETAILER 1 and RETAILER 2). Currently, COMPANY sells five different models of PRODUCT: PRODUCT 3; PRODUCT 4; PRODUCT 6; PRODUCT 7 and the PRODUCT 8. PRODUCT models are available in varying colors and differing amounts of storage ranging from 16GB to 128GB.

Currently, COMPANY's list prices for PRODUCT 3 models are \$\$\$, \$\$\$, or \$\$\$ for the 16GB, 64GB, or 128GB models respectively. COMPANY's list prices for the PRODUCT 4 models are \$\$\$, \$\$\$ or \$\$\$ for the corresponding 16GB, 64GB, or 128GB versions. Notably, when customers sign a new 2-year contract with a carrier, certain mobile carriers will subsidize the purchase of an PRODUCT approximately \$\$\$ reducing the out-of-pocket cost of the phone to the customer to between \$\$\$ and \$\$\$, depending on the model of PRODUCT purchased.

WARRANTY Extended Warranty

PRODUCTs come with one year of hardware repair coverage through COMPANY's manufacturer's warranty and up to 90 days of complimentary technical support from COMPANY. When purchased separately by the customer, WARRANTY extends the coverage on PRODUCT to two years from the original purchase date of the PRODUCT

and adds up to two incidents of accidental damage coverage, each subject to a service fee plus applicable tax. Currently, WARRANTY for PRODUCT 3 and PRODUCT 4 costs \$\$\$.

WARRANTY provides repair or replacement coverage, both parts and labor, from COMPANY-authorized technicians that includes the PRODUCT, the battery, and included earphones and accessories. Coverage under the WARRANTY extended warranty program entitles the purchaser to:

- Direct access to COMPANY experts for technical support and troubleshooting;
- Mail-in repair;
- Carry-in repair at COMPANY Retail Stores or other COMPANY Authorized Service Providers; and
- Express replacement service.

Please see the attached WARRANTY for PRODUCT Terms and Conditions for further details.¹

COMPANY PRODUCT UPGRADE PROGRAM

In September 20XX, COMPANY announced its PRODUCT UPGRADE PROGRAM. The PRODUCT UPGRADE PROGRAM is designed for users who want the newest model of PRODUCT every year. Generally, the program consists of an installment loan used to purchase and activate an eligible PRODUCT (“Financed PRODUCT”) and an upgrade option which requires a trade-in of the Financed PRODUCT to receive a new eligible PRODUCT (“Upgraded PRODUCT”). By entering into the PRODUCT UPGRADE PROGRAM, customers bind themselves to specific terms and conditions governing all aspects of the program. The following summarizes key provisions in the attached PRODUCT Upgrade Program Terms & Conditions-US:

I. Eligibility

In order to enroll in the PRODUCT UPGRADE PROGRAM purchasers must:

- Have a valid U.S.-issued personal eligible credit card (debit, corporate, and prepaid cards are not accepted);
- Apply for and enter into a #-month, #% APR installment loan (“Installment Loan”) for the full retail price of the Financed PRODUCT with COMPANY’s bank partner, BANK. (an unrelated party to COMPANY);
- Purchase an WARRANTY extended warranty contract applicable to the Financed PRODUCT, the cost of which is added to the principal amount of the Installment Loan; and

¹ Also available at: <http://WEBSITE>

- Activate the Financed PRODUCT on a new or existing wireless service plan with an eligible carrier under the carrier's terms.

II. Upgrade

The exercise of the Upgrade Option to purchase a new eligible PRODUCT is subject to the following conditions:

- To qualify, the Upgrade Option must be exercised prior to the expiration date of the Installment Loan;
- The customer must have paid the equivalent of at least # installment payments under the Installment Loan plus any taxes and fees at the time of enrollment;
- WARRANTY extended warranty contract must have been continuously maintained with the Financed PRODUCT;
- The original Financed PRODUCT must be turned in and in good physical and operational condition; and
- The customer may enroll in a new PRODUCT UPGRADE PROGRAM which includes applying for and entering into a new # month #% APR installment loan ("New Installment Loan") on the Upgraded PRODUCT, as well as purchasing a new WARRANTY extended warranty contract.

The terms of the PRODUCT UPGRADE PROGRAM explicitly state that the customer is responsible for all applicable taxes and fees and payable in their entirety with the first installment payment. The trade-in value of the financed PRODUCT is considered to be the repayment for the remaining installment payments. Moreover, the Terms also require that all applicable taxes and fees which relate to the Upgrade Option on the new eligible PRODUCT are similarly payable, in their entirety, with the first installment payment of the New Installment Loan.

COMPANY plans on refurbishing the traded-in PRODUCT in house and reselling them through its own distribution channels.

III. Invoicing at Time of Purchase

The customer invoice at the time of purchase will separately state the cost of the Financed PRODUCT at its full, unsubsidized retail price. Separately, the invoice will state the cost of the WARRANTY extended warranty contract. There is no cost to enroll into the PRODUCT UPGRADE PROGRAM and enrollment is automatic upon meeting the eligibility requirements. Enrollment in the PRODUCT UPGRADE PROGRAM is not listed on the customer invoice.

AUTHORITY

Retailer's Occupation Tax:

35 ILCS 120/2 provides, in part:

A tax is imposed upon persons engaged in the business of selling at retail tangible personal property....

35 ILCS 120/2-10 states that this tax is measured by the seller's gross receipts from sales made in the seller's course of business.

Service Occupation Tax:

35 ILCS 115/3 provides, in part:

A tax is imposed upon all persons engaged in the business of making sales of service (referred to as "servicemen") on all tangible personal property transferred as an incident of a sale of service.

Maintenance Agreements Under the Service Occupation Tax Act:

86 Ill. Adm. Code 140.141(c) provides, in part:

Maintenance agreements are contracts to provide repairs for a particular item within a stated time period and for a pre-determined fee. The party agreeing to provide service under a maintenance agreement may or may not be a seller of the item. However, the maintenance agreement is not included in the retail selling price of the item covered by the maintenance agreement and, for that reason, the selling price of the maintenance agreement is not subject to Retailers' Occupation Tax and Use Tax liability when the item is sold at retail. Consequently, repairs made under a maintenance agreement result in tax liability.

Extended warranties are contracts to provide repairs for a particular item for a stated period of time after a manufacturer's express warranty has expired. An extended warranty is not included in the selling price of the item covered by the extended warranty and, for that reason, the selling price of the extended warranty is not subject to Retailers' Occupation Tax and Use Tax liability when the item is sold at retail. Consequently, repairs made under the extended warranty result in tax liability.

Extended warranties are a form of maintenance agreement and are subject to tax just as maintenance agreements are subject to tax.

Ill. Admin. Code 140.301(b)(3)

Maintenance Agreements. If a serviceman enters into an agreement to provide repair service for a particular piece of equipment for a stated period for a predetermined fee, the serviceman shall pay Use Tax to his supplier (or to the Department if the supplier is not registered to collect tax) on the cost price of tangible personal property purchased for transfer by the serviceman incident to completion of the maintenance agreement.

III. Dept. of Rev. General Information Letter ST 02-0172-GIL, 08/06/2002 provides in part:

The taxability of maintenance agreements is dependent upon whether the charge for the agreement is included in the selling price of tangible personal property. If the charge for a maintenance agreement is included in the selling price of tangible personal property, that charge is part of the gross receipts of the retail transaction and is subject to Retailers' Occupation Tax liability. No tax is incurred on the maintenance services or parts when the repair or servicing is completed.

If maintenance agreements are sold separately from tangible personal property, the sale of the agreement is not a taxable transaction. However, when maintenance services or parts are provided under the maintenance agreement, the company providing the maintenance or repair will be acting as a service provider under the Service Occupation Tax Act. The Service Occupation Tax Act provides that when a service provider enters into an agreement to provide maintenance services for a particular piece of equipment for a stated period of time at a predetermined fee, the service provider incurs Use Tax based upon its cost price of tangible personal property transferred to the customer incident to the completion of the maintenance service. See 86 Ill. Adm. Code 140.301(b)(3).

ANALYSIS

Under Illinois law and consistent with the guidance provided by the Illinois Department of Revenue, COMPANY's sales of WARRANTY are not subject to Illinois Retailers' Occupation Tax and Service Occupation Tax.

WARRANTY is an optional extended warranty agreement sold separately from the sale of an PRODUCT and stated separately on the invoice. Ill. Adm. Code 140.141(c) states that "[m]aintenance agreements are contracts to provide repairs for a particular item within a stated time period and for a pre-determined fee." Further, 140.141(c) provides that when "the maintenance agreement is not included in the retail selling price of the item covered by the maintenance agreement...the selling price of the maintenance agreement is not subject to Retailers' Occupation Tax" and that "extended warranties are a form of maintenance agreement and are subject to tax just as maintenance agreements are subject to tax."

Additionally, the state has issued frequent guidance that if maintenance agreements are sold separately from tangible personal property, the sale of the agreement is not a taxable transaction.²

Based on the above, WARRANTY is properly described under the Illinois definition of an extended warranty or maintenance agreement. COMPANY's sales of WARRANTY are optional to the customer at any time during the term of the initial 1-year manufacturer's warranty. In addition, WARRANTY customers are subject to terms and conditions separate from that of the PRODUCT contract. If the customer decides to purchase WARRANTY at the same time they purchase an PRODUCT, charges for the WARRANTY service are listed separately on the invoice. As such, the purchase of WARRANTY is that of a separate and distinct service offering, and the purchase of an PRODUCT in a tandem transaction would be in no way conditional upon the sale of WARRANTY.

Further, in accordance with 35 ILCS 115/3, which states that Service Occupation Tax is imposed on persons engaged in the business of making sales of service ("servicemen") on tangible personal property transferred as an incident of a sale of service, sales of WARRANTY are not subject to Service Occupation Tax. Pursuant to Ill. Adm. Code 140.301(b)(3), if a serviceman enters into an agreement to provide repair service for a particular piece of equipment for a stated period for a predetermined fee, the serviceman shall pay Use Tax to his supplier (or to the Department if the supplier is not registered to collect tax) on the cost price of tangible personal property purchased for transfer by the serviceman incident to completion of the maintenance agreement. This is because the maintenance agreement is a legally-binding contract that makes the serviceman (COMPANY) the end user of the tangible personal property transferred to its customer incident to the sale of service. Therefore, once COMPANY performs services under WARRANTY, it will be acting as a service provider and thus subject to Use Tax based on the cost price of tangible personal property transferred.

Under Illinois law and consistent with the guidance provided by the Illinois Department of Revenue, enrollment in the PRODUCT UPGRADE PROGRAM does not alter the applicability of Illinois Retailers' Occupation Tax and Service Occupation Tax on the sales of WARRANTY extended warranty contracts.

COMPANY's latest offering, the PRODUCT UPGRADE PROGRAM, is a new intangible right for customers enrolled in WARRANTY, which is one of the four eligibility requirements that gives customers the ability to enroll in the PRODUCT UPGRADE PROGRAM. If the customer chooses to exercise this right, the old PRODUCT will be returned to COMPANY and considered repayment of any the outstanding balance on the Installment Loan and the end of the customer's contract. At the time of upgrade, the customer will enter into a new contract and new Installment Loan and pay sales tax on

² See Ill. Dept. of Rev. Info. Bulletin No. FY 91-45, 02/01/1991 and Ill. Dept. of Rev. General Information Letter ST 02-0172-GIL, 08/06/2002.

the full price of the Upgraded PRODUCT. The customer may choose not to purchase WARRANTY, thereby disqualifying that customer from the PRODUCT UPGRADE PROGRAM prospectively, but without otherwise affecting the customer's eligibility to finance the Upgraded PRODUCT.

The purchase of WARRANTY and other requirements under the PRODUCT UPGRADE PROGRAM are separate and distinct transactions, each of which should not affect the taxability of the other. Specifically, the customer has the option to finance his or her purchase of an PRODUCT. The same customer may or may not choose to purchase an WARRANTY extended warranty to cover the PRODUCT purchased, and the same customer may or may not choose to purchase the PRODUCT or WARRANTY with a U.S.-issued personal credit card. However, if a customer so chooses, he or she may enter into a set of transactions that qualifies him or her for enrollment in the PRODUCT UPGRADE PROGRAM. Nevertheless, each transaction continues to be separate and distinct, as well as separately stated on the invoice.

As such, a customer's participation in the PRODUCT UPGRADE PROGRAM will not change the tax treatment of WARRANTY, as it continues to be a nontaxable maintenance agreement under the Illinois Retailers' Occupation Tax Act and Service Occupation Tax Act. However, once COMPANY performs services under WARRANTY, it will be acting as a service provider and thus subject to Service Occupation Tax Based on tangible personal property transferred.

CONCLUSION

1. Based on the above authority and analysis, we believe that sales of the WARRANTY Extended Warranty contracts are appropriately classified as sales of a maintenance/extended warranty agreement and are not subject to Illinois Retailers' Occupation Tax and Service Occupation Tax pursuant to Ill. Admin. Code 140.141(c) and further described in Ill. Dept. of Rev. General Information Letter ST 02-0172-GIL, 08/06/2002.
2. Moreover, enrollment in COMPANY's PRODUCT UPGRADE PROGRAM conveys an intangible right to upgrade the customer's PRODUCT at some future date. The purchase of an WARRANTY Extended Warranty Contract is a pre-requisite to enroll and exercise upgrade rights under the PRODUCT UPGRADE PROGRAM but does not change the characterization of WARRANTY. Accordingly, the sale of WARRANTY Extended Warranty contract continues to not be subject to Illinois Retailer's Occupation Tax and Service Occupation Tax.

COMPANY respectfully requests a conference call or in-person meeting so that representatives of COMPANY's tax Department may address any questions regarding this request for ruling.

In the event that the department intends to either decline issuance of a ruling or issue a ruling that WARRANTY is taxable, we respectfully request to be notified before any final decision is made and be given the opportunity to discuss the issues and implications of such intention with the Department, as well as to withdraw this ruling request.

DEPARTMENT'S RESPONSE:

The Retailers' Occupation Tax Act imposes a tax upon persons engaged in this State in the business of selling tangible personal property at retail to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. Use Tax is imposed on the privilege of using, in this State, any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 86 Ill. Adm. Code 150.101. These taxes comprise what is commonly known as "sales tax" in Illinois.

The taxability of maintenance agreements depends upon whether charges for the agreements are included in the selling price of the tangible personal property. If the charges for the agreements are included in the selling price of the tangible personal property, those charges are part of the gross receipts of the retail transaction and are subject to tax. In those instances, no tax is incurred on the maintenance services or parts when the repair or servicing is performed. A manufacturer's warranty that is provided without additional cost to a purchaser of a new item is an example of an agreement that is included in the selling price of the tangible personal property. Charges for maintenance agreements that are not optional and are not sold separately from the tangible personal property are part of the gross receipts of the retail transactions and are subject to tax, regardless of whether the charges are separately stated.

If maintenance agreements are sold separately from tangible personal property, sales of the agreements are not taxable transactions. However, when maintenance services or parts are provided under the maintenance agreements, the service or repair companies will be acting as service providers under provisions of the Service Occupation Tax Act that provide that when service providers enter into agreements to provide maintenance services for particular pieces of equipment for stated periods of time at predetermined fees, the service providers incur Use Tax based on their cost price of tangible personal property transferred to customers incident to the completion of the maintenance service. See 86 Ill. Adm. Code 140.141 and 140.301(b)(3). The sale of an optional maintenance agreement or extended warranty is an example of an agreement that is not generally a taxable transaction.

Sales of the WARRANTY Extended Warranty contracts as described here are sales of maintenance agreements and are not subject to Retailers' Occupation Tax at the time they are sold. This is true even when the purchase of the WARRANTY Extended Warranty contract is a condition for entering into and exercising upgrade rights under COMPANY's PRODUCT UPGRADE PROGRAM as described here. This conditional requirement does not change the fact that the

purchase price of the PRODUCT itself does not include the WARRANTY Extended Warranty contract or that the WARRANTY Extended Warranty contract must be purchased separately from the PRODUCT.

The factual representations upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the factual representations recited in this ruling are correct and complete. This Private Letter Ruling is revoked and will cease to bind the Department 10 years after the date of this letter under the provisions of 2 Ill. Adm. Code 1200.110(e) or earlier if there is a pertinent change in statutory law, case law, rules or in the factual representations recited in this ruling.

I hope this information is helpful. If you have further questions concerning this Private Letter Ruling, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Richard S. Wolters
Chairman, Private Letter Ruling Committee

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