

The taxability of maintenance agreements depends upon whether charges for the agreements are included in the selling price of the tangible personal property. See 86 Ill. Adm. Code 140.301. (This is a GIL.)

March 31, 2011

Dear Xxxxx:

This letter is in response to your letter dated November 1, 2010, in which you request information. 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](http://www.tax.illinois.gov) to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

The purpose of this letter ('Letter') is to request a sales, use and telecommunications tax ruling on behalf of CORPORATION's operating subsidiaries in your state under 35 ILCS § 120/2, *et seq.* ('Sales Tax'), 35 ILCS § 105/3, *et seq.* ('Use Tax') and 35 ILCS § 630/1 *et seq.* ('Telecommunications Tax'). CORPORATION is a holding company that is not licensed to, and does not provide, wireless telecommunications service. Its operating subsidiaries listed in the Appendix to this letter are licensed to, and do provide, wireless telecommunications service in your state, including voice service, data service, and wireless Internet access; they do so under the trade name 'CORPORATION.'

CORPORATION has recently introduced a 'PROGRAM' that is included with certain eligible wireless communication plans. The PROGRAM is a combination of a wireless handset service contract and an insurance policy underwritten by COMPANY<sup>i</sup> that will, in the case of accidental damage, mechanical breakdown, warranty claims, or lost or stolen phones, provide a replacement phone to customers who have purchased a phone from CORPORATION in connection with subscribing to such an eligible wireless service plan.<sup>ii</sup>

This Letter specifically requests a ruling that CORPORATION's acquisition of replacement phones to be provided to customers under the PROGRAM is not subject to tax, and that CORPORATION is not required to collect tax on the phones so provided.

## Background

### *PROGRAM Background and Structure*

CORPORATION currently offers the PROGRAM as one of many non-optional features it includes in its premium wireless plans (referred to as 'Enhanced Plans'). The PROGRAM is not sold separately and is not available with plans other than the Enhanced Plans. For regulatory reasons, CORPORATION has entered into an agreement (the 'Agreement') arranging for COMPANY to provide the coverage under the PROGRAM through a non-contributory group 'Wireless Equipment Insurance Policy' (sometimes referred to herein as the 'Insurance Policy') that will cover lost or stolen handsets, and a non-contributory group 'Wireless Equipment Service Contract' (sometimes referred to herein as the 'Service Contract') that covers certain handset mechanical or electric failures, accidental water and certain other specified damages.

CORPORATION pays COMPANY a single premium of a specified amount per month per PROGRAM Subscriber (the exact figure varies depending on the number of total Subscribers) for both the Insurance Policy and the Service Contract. Upon enrollment, a Subscriber (i) becomes a certificate holder (*i.e.*, a beneficiary) of the Insurance Policy, which is underwritten by COMPANY, and (ii) becomes a direct contracting party with COMPANY under the Service Contract. In both cases, CORPORATION pays the premium (on behalf of the Subscribers, in the case of the Service Contract)—for which no separate charge is ever made to the Subscriber—and COMPANY is the obligor.

Under the Insurance Policy, a Subscriber whose phone is lost or stolen pays a \$100 deductible and receives a new phone (the 'Replacement Phone'). Under the Service Contract, the Subscriber is required to exchange the damaged phone for the Replacement Phone.

In both cases, the Replacement Phone will be the same as or similar to the lost, broken, inoperable or damaged phone. Pursuant to its obligations under the Agreement, CORPORATION maintains a pool of new and used phones (the 'Pool') from which it provides Replacement Phones to Subscribers. CORPORATION-owned stores maintain a small supply of Replacement Phones for walk-in Subscriber claimants, which phones are treated as part of the Pool. As explained further below, phones turned in by Subscribers pursuant to the Service Contract are refurbished and added to the Pool, to be provided as Replacement Phones.

A subscriber is entitled to a maximum of three exchanges (although only one can be for a lost or stolen phone) under the PROGRAM during the 18-month coverage period that begins when a Subscriber receives a new phone.<sup>iii</sup>

### *Customer Enrollment and Billing*

A CORPORATION wireless customer who purchases a CORPORATION handset and signs up for an Enhanced Plan is automatically enrolled as a 'Subscriber' in the PROGRAM. Upon enrollment, a Subscriber receives an enrollment package directly from the program provider, COMPANY. It is possible for a wireless customer to decline

enrollment, but the customer receives *no* reduction in the price of his or her (referred to hereafter as 'his') monthly plan for doing so (nor may a customer subscribe to a lower price plan with identical service, other than the PROGRAM, as CORPORATION does not offer any such plan).

The PROGRAM is listed on the customer's wireless bill as a feature of the wireless service Enhanced Plan, but the bill is not itemized. There is a single, bundled charge for all of the services included in the Enhanced Plan (the 'Wireless Monthly Fee'), including voice, messaging, data, Internet access (if applicable), Phone Replacement, and points.

The Wireless Monthly Fee, including the PROGRAM, is generally subject to Telecommunications Tax. Internet access is nontaxable under the Internet Tax Freedom Act ('Nontaxable Internet Service'), except in a few states that were grandfathered. To that end, the Streamlined Sales Tax Act and the federal Mobile Telecommunications Sourcing Act exclude from tax that portion of the bundled Wireless Monthly Fee allocable to Nontaxable Internet Service. CORPORATION has determined that apportionment of the data supplied over its wireless network qualifies as Internet access. Other than in those grandfathered states, a small portion of the Wireless Monthly Fee is accordingly allocated by CORPORATION each month to Nontaxable Internet Service and is not subject to tax.

#### *Obligations under the Agreement between CORPORATION and COMPANY*

Under the Agreement, CORPORATION has agreed to provide the following services to COMPANY:

1. Maintain sufficient quantities of Replacement Phones and components to satisfy claims under the PROGRAM (in the event CORPORATION is unable to fulfill a claim under the PROGRAM, COMPANY will fulfill the claim and be reimbursed by CORPORATION for its expenses and the cost of the equipment)
2. Develop, market and make available the PROGRAM in its service areas
3. Provide training to its employees and agents
4. Cooperate with COMPANY's support and administrative services
5. Record-keeping

Under the Agreement, COMPANY has agreed to provide the following services:

1. Track Subscriber enrollment
2. Provide Subscribers with notification regarding enrollment, cancellation, privacy policies, and an explanation of benefits
3. Claims administration and adjustment
4. Report to CORPORATION regarding operational and administration status

#### *Claims Processing and Handling*

A claim under the Service Contract is initiated when a Subscriber submits a request along with his damaged phone at a CORPORATION retail store, or files a claim through CORPORATION's Customer Service Center over the phone. The claim is then submitted to Assurance for adjudication and administration.

Section 6.1 of the Agreement provides:

[CORPORATION] shall maintain sufficient quantities (to the extent available) of Eligible Products and components to fulfill all claims, which [CORPORATION] will do only pursuant to instructions received from [COMPANY]. Any new equipment shall be accompanied by a full Product Warranty. [CORPORATION] agrees that any refurbished equipment will come with a fifteen (15) day mechanical and electrical failure repair or replacement limited warranty.

Assuming the damage is covered under the Service Contract, CORPORATION will, upon receiving direction from COMPANY, take the damaged phone from the Subscriber and replace it with a phone from the pool. If the claim is submitted in person at a CORPORATION store, and is approved by COMPANY, a Replacement Phone will be given immediately out of the Pool phones at the CORPORATION store (if no Pool phone is available, one is shipped overnight to the Subscriber from the pool maintained at CORPORATION's third party fulfillment center in STATE). If the claim is submitted via telephone and approved by COMPANY, the replacement Pool phone is shipped overnight to the Subscriber. In that case, the Subscriber must ship the broken or damaged phone to CORPORATION, or be charged the full undiscounted retail price of the Replacement Phone. CORPORATION gives the Subscriber an invoice showing that the Replacement Phone has been exchanged for the Subscriber's damaged phone, and that no balance is due.

COMPANY pays CORPORATION a 'Handset Reimbursement Fee' in the amount of \$188 for each Replacement Phone CORPORATION provides to a customer at COMPANY's direction. CORPORATION retains the broken or damaged phone and refurbishes it. If that is successful, it is added to the Pool, otherwise it is sold for scrap.

As under the Service Contract, a claim under the Insurance Policy can be initiated by filing a claim at a CORPORATION retail store or over the phone for adjudication and administration by COMPANY. If COMPANY approves the claim, CORPORATION will, upon direction from COMPANY, provide the Subscriber with a Replacement Phone from the Pool.

If an Insurance Policy claim is submitted in person at a CORPORATION store, a Replacement Phone will be given immediately out of the Pool phones at the store (if no Pool phone is available, one is shipped overnight to the Subscriber from the pool maintained at CORPORATION's third party fulfillment center in STATE). The Subscriber must pay a \$100 deductible before CORPORATION delivers the Replacement Phone to the customer for any lost or stolen phone. CORPORATION invoices COMPANY \$188 for the Replacement Phone, in satisfaction of which CORPORATION retains the \$100 deductible paid by the Subscriber and COMPANY pays CORPORATION the balance of \$89.

#### RULINGS REQUESTED

1. No Sales Tax is imposed on CORPORATION, and no Use Tax is imposed on Subscribers or on COMPANY, for the provision of Replacement Phones to Subscribers at the direction of COMPANY under the PROGRAM.
2. CORPORATION's acquisition of phones for the Pool are purchases for resale and are not subject to Sales Tax or Use Tax.

## ANALYSIS

1. No Sales Tax is imposed on CORPORATION, and no Use Tax is imposed on Subscribers or on COMPANY, for the provision of Replacement Phones to Subscribers at the direction of COMPANY under the PROGRAM.

The PROGRAM comprises an integrated triangular arrangement among CORPORATION, COMPANY, and the Subscriber, that, taken as a whole, constitutes a retailer's warranty that is included as an inseparable part of the original taxable sale and is thus for tax purposes a 'mandatory warranty.' See Hellerstein, *State Taxation* at 1504[4]. Hellerstein describes a mandatory warranty this way: 'Mandatory warranties are sold as an inseparable (and, in some cases, legally required) part of the product itself, with no separate charge for the warranty.' *Id.*

The PROGRAM constitutes a mandatory retailer's warranty for the following reasons. First, Subscribers who purchase a CORPORATION phone and subscribe to an Enhanced Plan are automatically enrolled in the PROGRAM, and each Subscriber is entitled to PROGRAM benefits as a result of his original purchase of the phone and Enhanced Plan subscription without separate charge for the PROGRAM. The fact that a Subscriber by law can decline coverage in the PROGRAM does not change this conclusion. There is no reduction in the Wireless Monthly Fee for doing so, and a customer cannot avoid the PROGRAM by opting for a lower price plan with identical service other than the PROGRAM as CORPORATION does not offer any such plan.

Second, Replacement Phones are functionally equivalent to the phone originally purchased, as is the case in a manufacturer's warranty, and the PROGRAM is therefore not a means to a hidden upgrade. Finally, because the Replacement Phone is functionally equivalent to the replaced phone, the Subscriber is not consuming any additional tangible goods, but is merely being restored to the position he was in after the original purchase.

There could be no sales or use tax imposed on the goods provided under a mandatory retailer's warranty. Hellerstein, *State Taxation* at ¶ 15.04[4][a][i]-[ii]. The rationale for this treatment is that the full value of the warranty has been subjected to tax as part of the initial purchase. A retail customer would be double taxed if forced to pay tax on the value of the PROGRAM, and then again on the benefits accorded under the PROGRAM. Hellerstein confirms this reasoning, stating, '[i]n fact, no state takes that position. Rather, the repair of an article under a warranty agreement without further charge to the customer is treated as a nontaxable transaction as between the [warrantor] and the customer.' *Id.* at ¶ 1504[4][a][iii]. See also, e.g., Fla. Admin. Code Ann. R. 12A-1.006(6) (Westlaw through July 2000) ('Materials and supplies used in the performance of a factory or manufacturer's warranty are exempt when the contract is furnished with the new equipment guaranteed thereunder at no extra charge and such materials and supplies are paid for by the factory or manufacturer'); NY Comp. Codes R. & Regs. tit. 20, § 527.5(d)(1) (Westlaw through July 2000) ('[r]epair or maintenance services rendered, without charge to a customer under a warranty agreement are not taxable'); Ohio Rev. Code Ann. § 5739.01(E)(10) (Banks-Baldwin Supp. 2000); 34 Tex. Admin. Code § 3.292(e)(1) (Westlaw through July 2000). Following the general practice of the states, there should not be any tax due on the exchange by the Subscriber of a damaged phone for a Replacement Phone.

In this case, because the value of the PROGRAM is already reflected in the price of the Enhanced Plans and CORPORATION collects Telecommunications Tax on the Taxable Portion of the Wireless Monthly Fee (*i.e.*, on the portion not allocated to Internet access), the value of the PROGRAM has already been taxed on the full extent permitted by law. Imposing tax again when the Replacement Phone is provided to the Subscriber would result in double tax.

The fact that COMPANY pays CORPORATION a handset reimbursement fee of \$188 for each Replacement Phone provided under the PROGRAM does not change this result, as that is merely one integral leg of the triangle comprising the warranty arrangement, and therefore is not amenable to analysis as a separate transaction and should not be taxed as a separate transaction. The \$100 deductible in the case of lost or stolen phones is not a taxable sale, but rather an anti-fraud and abuse device as no physical phone is turned in by the Subscriber when such a claim is made and granted. No such potential for abuse exists when a customer can produce proof of loss; hence, no deductible is required for claims under the Service Contract, as a customer is required to turn in the damaged phone. For the same reason, a customer is only allowed to file a claim for a lost or stolen phone once during each 18-month period.

2. CORPORATION's acquisition of phones for the Pool are purchases for resale and are not subject to Sales Tax or Use Tax.

No Sales or Use tax [sic] should be due on purchases by CORPORATION of the phones added to the Pool. Addressing whether a warranty provider should pay sales or use tax on the goods used in repairing a piece of tangible personal property, Hellerstein correctly notes that the value of such goods are included in the cost of the warranty, and therefore already subject to tax:

In a real sense, the manufacturer's purchase of parts and services from the dealer to fulfill its warranty obligation is a purchase for resale to the consumer, but a resale for which the consumer has already paid (and paid tax), although in the form of consideration allocable to the warranty. There is no good reason for taxing this transaction a second time.

*Id.* at ¶ 1504[4][a][iii]. Hellerstein's rationale applies with equal force in this case. See *also*, Fla. Admin. Code Ann. R. 12A-1.006(6) (Westlaw through July 2000) ('materials and supplies used in the performance of a factory or manufacturer's warranty are exempt when the contract is furnished with the new equipment guaranteed thereunder at no extra charge and such materials and suppliers are paid for by the factory or manufacturer'); NY Comp. Codes R. & Regs. tit. 20, § 527.5(d)(4) (Westlaw through July 2000) ('[w]here a manufacturer reimburses a vendor or repairman performing warranty work, the reimbursement is not taxable, as it was for resale'); Ohio Rev. Code Ann. § 5739.01(E)(13) (Banks-Baldwin Supp. 2002); *Mitsubishi Motor Sales of Amer., Inc. v. Zaino*, No. 01-V-181, Ohio Bd. of Tax Appeals, Oct. 11, 2002; *Mitsubishi Motor Sales of America, Inc. v. Zaino*, No. 01-V-181, Ohio Bd. of Tax Appeals, Oct. 11, 2002; 34 Tex. Admin. Code § 3.292(e)(1) (Westlaw through July 2000) ('[n]o tax is due on parts or labor furnished by the manufacturer to repair tangible personal property under a manufacturer's warranty'). See *also* *Transitowne Dodge Associates L.P.* (Advisory Opinion), NY Comm'r of Taxation and Finance, Petition No. S040810A, TSB-A-05(27)S, June 23, 2005 (excluding from use tax vehicles used exclusively by extended warranty customers entitled to loaner vehicles under terms of the warranty); Letter of Finding No. 08-0704 (Ind. Dep't of Revenue June 24, 2009).

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Thank you for your consideration of this request. Please do not hesitate to call me if you have any questions, or would like any additional information. We respectfully request a conference in the event the Department tentatively concludes an adverse ruling would be warranted. A power of attorney authorizing the undersigned to represent CORPORATION in this matter is attached. This ruling request pertains only to periods beginning October 1, 2010, and none of CORPORATION or any of its affiliates operating in your state is under audit for such periods.

#### **DEPARTMENT'S RESPONSE:**

The Department's regulation "Public Information, Rulemaking and Organization" provides that "[w]hether to issue a private letter ruling in response to a letter ruling request is within the discretion of the Department. The Department will respond to all requests for private letter rulings either by issuance of a ruling or by a letter explaining that the request for ruling will not be honored." 2 Ill. Adm. Code 1200.110(a)(4). The Department declines to issue a Private Letter Ruling. Although we are not providing you with a Private Letter Ruling, we hope the following general information will be of assistance.

The taxation of maintenance agreements has long been established as discussed in subsection (b)(3) of Section 140.301 of the Department's administrative rules under the Service Occupation Tax Act. See 86 Ill. Adm. Code Sec. 140.301(b)(3). The taxability of maintenance agreements depends upon if 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.

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 Sec. 140.301(b)(3). The gross receipts received from the customer are not subject to tax. This would include any deductible amount under the maintenance agreement. Further, since service providers incur Use Tax liability on the tangible personal property transferred to their customers incident to the completion of the maintenance agreements, they may not give their suppliers resale certificates for such tangible personal property.

We note that your letter states in several places that the replacement program is listed on the customer's bill as a feature of the wireless service plan and is not part of the purchase price of the phone. Based on the description of the program and plan in your letter, it appears the replacement program is sold separately from tangible personal property.

I hope this information is helpful. If you require additional information, please visit our website at [www.tax.illinois.gov](http://www.tax.illinois.gov) or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Richard S. Wolters  
Associate Counsel

RSW:msk

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<sup>i</sup> COMPANY is the trade name for a group of affiliated companies that provide service contracts and/or insurance contracts. Depending on the state in which a customer resides, the service contract is provided by ABC Service Corporation, XYZ, or 123, Inc., and the insurance policy is provided by INSURANCE COMPANIES.

<sup>ii</sup> Please note that CORPORATION is submitting concurrently herewith a separate ruling request with respect to the taxation of a new customer program, which will be offered along with the PROGRAM. The PROGRAM is available only with respect to certain premium plans, not all plans for which the program is offered. The two programs otherwise operate independently of one another and thus separate rulings are being requested.

<sup>iii</sup> As explained in the ruling request submitted concurrently herewith regarding the program, the 18-month period can be shortened by redeeming points. In such a case, the time period for exchanges would also reset at that time. If a customer subscribes or migrates to a service plan with Phone Replacement five months after purchasing his new phone, Phone Replacement coverage will begin when the customer makes an outbound call and ends 13 months later when the customer is eligible for a new phone.