

# ARIZONA DEPARTMENT OF REVENUE

## ARIZONA TRANSACTION PRIVILEGE TAX RULING TPR 92-5

(Note: On 8/21/2020 the Title 42 cites were updated to show their new numbers. See footnotes for details. No substantive changes were made.)

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### **ISSUE:**

Warranty or service contracts, implied warranties and the use of tangible personal property in completion of warranty contracts, implied warranties or a "warranty or service provision."

### **APPLICABLE LAW:**

A.R.S. § 42-5061(A)(3)<sup>1</sup> excludes from the tax base under the retail classification the gross income or gross proceeds of sale of:

Sales of warranty or service contracts. The storage, use or consumption of tangible personal property provided under the conditions of such contracts is subject to tax under § 42-5156<sup>2</sup>.

A.R.S. § 42-5155<sup>3</sup> provides:

There is levied and imposed an excise tax on the storage, use or

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<sup>1</sup> The original document cited A.R.S. § 42-1310.01.A.3 which was renumbered as A.R.S. § 42-5061(A)(3).

<sup>2</sup> The original document cited A.R.S. § 42-1408.01 which was renumbered as A.R.S. § 42-5156.

<sup>3</sup> The original document cited A.R.S. § 42-1408 which was renumbered as A.R.S. § 42-5155.

consumption in this state of tangible personal property purchased from a retailer, as a percentage of the sales price.

A.R.S. § 42-5156<sup>4</sup> provides:

[the use tax] shall be levied and collected ... [on] the cost of tangible personal property provided under the conditions of a warranty or service contract. Every person storing, using or otherwise consuming in this state tangible personal property provided under the conditions of a warranty or service contract is liable for the tax. For the purpose of this section, "cost" means the cost of the tangible personal property to the provider of the warranty or contract.

A.R.S. § 42-5061(F)<sup>5</sup> states:

If a person is engaged in an occupation or business to which subsection A of this section applies, the person's books shall be kept so as to show separately the gross proceeds of sales of tangible personal property and the gross income from sales of services, and if not so kept the tax shall be imposed on the total of the person's gross proceeds of sales of tangible personal property and gross income from services.

Title 47 Uniform Commercial Code:

A.R.S. § 47-2207(C) provides:

Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other

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<sup>4</sup> See footnote number 2.

<sup>5</sup> The original document cited A.R.S. § 42-1310.01.F which was renumbered as A.R.S. § 42-5061(F).

provisions of this title.

A.R.S. § 47-2301 provides that:

The obligation of the seller is to transfer and deliver and that of the buyer is to accept and pay in accordance with the contract.

A.R.S. § 47-2313(A) states:

Express warranties by the seller are created ... [by]

1. Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain that the goods will conform to the affirmation or promise.
2. Any description of the goods which is made part of the basis of the bargain ....
3. Any sample or model which is made part of the basis of the bargain ....

Subsection B provides that:

It is not necessary to the creation of an express warranty that the seller use formal words such as "warrant" or "guarantee" or that he have a specific intention to make a warranty. However, an affirmation merely of the value of the goods or a statement purporting to be the seller's opinion or commendation of the goods does not create a warranty. (Emphasis added.)

A.R.S. § 47-2314 provides:

- A. Unless excluded or modified (§ 47-2316), a warranty that the goods shall be merchantable is implied in a contract for their sale if the seller is a merchant with respect to goods of that kind  
....

B. Goods to be merchantable must be at least such as:

1. Pass without objection in the trade under the contract description; and
2. In the case of fungible goods, are of average quality within the description; and
3. Are fit for the ordinary purposes for which such goods are used; and
4. Run, within the variations permitted by the agreement, of even kind, quality and quantity within each unit and among all units involved; and
5. Are adequately contained, packaged and labeled as the agreement may require; and
6. Conform to the promises or affirmations of fact made on the container or label if any.

C. Unless excluded or modified (§ 47-2316), other implied warranties may arise from course of dealing or usage of trade.

A.R.S. § 47-2316 states that:

B. Subject to subsection C of this section, to exclude or modify the implied warranty of merchantability or any part of it the language must mention merchantability and in case of a writing must be conspicuous, and to exclude or modify any implied warranty of fitness the exclusion must be by a writing sufficient if it states, for example, that "there are no warranties which extend beyond the description on the face hereof".

C. Notwithstanding subsection B of this section:

1. Unless the circumstances indicate otherwise, all implied warranties are excluded by expressions like "as is", "with all faults" or other language which in common understanding calls the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty; and,
2. When the buyer before entering into the contract has examined the goods or the sample or model as fully as he desired or has refused to examine the goods there is no implied warranty with regard to defects which an examination ought in the circumstances to have revealed to him; and
3. An implied warranty can also be excluded or modified by course of dealing or course of performance or usage of trade.

## **DISCUSSION:**

### A. Sale of the warranty or service contract.

The application of the concept of the sale of a warranty or service contract in relation to the types of agreements now available to consumers has become increasingly difficult. What appears to be a straight-forward concept in statute can become quite difficult when attempting to determine what is taxable or tax exempt in applying this exemption. The concept of the taxation of a warranty contract which is not separately stated or of a warranty which is a part of the sale of the product is a function of the requirements or benefits associated with the sale.

A warranty which is part of the sale of the product, is referred to in this ruling as a "warranty or service provision." A "warranty or service provision" is defined as a manufacturer's or vendor's warranty provision which automatically, and for no extra charge, comes with the tangible personal property when purchased. A "warranty or service provision" is, by its nature, not exempt from tax as the sale of a warranty or service contract. A statutorily exempt warranty or service contract is separately identifiable. Gross receipts

from the sale of tangible personal property which includes a "warranty or service provision" are subject to the tax in their entirety.

#### B. Implied warranties.

Statute provides guidelines on the existence of express and implied warranties. See A.R.S. § 47-2314(B). for the minimum standards regarding the merchantability of goods. When a buyer purchases an item from a vendor there are certain basic assumptions as to the merchantability of the product which are innate to that purchase. An implied or express warranty of merchantability, by its nature, warrants the condition of the item being purchased.

However, A.R.S. § 47-2316 "Exclusion or modification of warranties," addresses sales of items which do not include an implied warranty of merchantability. Clearly designated sales of "as is" property or property sold with an exclusion of implied warranty, do not fall within the general guidelines of merchantability. When property is sold according to the concepts and requirements of A.R.S. § 47-2316, the sale of such property does not include an implied warranty.

#### C. Sale or use of the tangible personal property.

In general the provisions of A.R.S. § 42-5156<sup>6</sup> apply to the use of "covered property" in satisfying the conditions of a warranty contract. "Covered property" is that property whose cost is included by the terms of the warranty and there is no charge to the customer for such property when services under the warranty are performed. Where the original contract was sold tax exempt and the cost of repair or replacement property is included under the contract (covered) then the property used would be subject to the use tax unless the original sale of the property was subject to the transaction privilege tax.

However, property used in completion of the terms of the agreement does not fall under the provisions of A.R.S. § 42-5156<sup>7</sup> if the original sale of the property has a "warranty or service provision" rather than a separately stated

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<sup>6</sup> See footnote number 2.

<sup>7</sup> See footnote number 2.

warranty contract. A "warranty or service provision," by its nature, is included in the sales price of the property sold and is therefore subject to the tax. When tangible personal property is used in fulfillment of the terms of such a provision, that property (if covered), would not be subject to the use tax.

Exemption of parts provided in completion of a repair under an implied warranty of merchantability follows the concept of property sold with a "warranty or service provision." The purchaser assumes the property being purchased meets the standards of other like-kind property. Therefore, assuming that such property meets the statutory requirements of merchantability, under the uniform commercial code; property subsequently used to complete any needed repairs would not be subject to the use tax.

#### D. Charges for labor.

A.R.S. § 42-5061(A)(2)<sup>8</sup> provides that services rendered in addition to selling tangible personal property at retail are not subject to the transaction privilege tax. This theory follows when a vendor performs the service of installation and/or repair under a warranty or service contract, a "warranty or service provision" or under an implied or express warranty of merchantability. However, labor charges must be separately stated in order to be exempt.

### **RULING:**

#### Warranty or Service Contract

When a retailer sells a warranty or service contract the sale of the contract must be separately stated in order to be exempt.

A sale of tangible personal property which includes a "warranty or service provision," as defined in this ruling, is not considered to be the sale of a warranty or service contract. Therefore where the "warranty or service provision" is included with the product the vendor may not arbitrarily allocate part of the sales price as exempt.

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<sup>8</sup> The original document cited A.R.S. § 42-1310.01.A.2 which was renumbered as A.R.S. § 42-5061(A)(2).

Examples:

A computer system is purchased with a separately stated extended warranty contract. The gross receipts from the sale of the computer system are subject to the tax. The gross receipts from the sale of the separately stated warranty contract are not subject to the tax.

A new car is purchased with a standard 3 year, 36,000 mile warranty or service provision. Since the warranty or service provision automatically comes with the car at no extra charge, the entire gross receipts from the sale of the car are subject to tax.

A used car dealer offers for sale a separately stated third party extended 3 year warranty. The sale of such a warranty is not subject to the transaction privilege tax regardless of whether or not the contract is satisfied by the dealer or by a third party.

Tangible Personal Property

The sale of tangible personal property, which is used to complete the provisions of a warranty or service contract and which is not covered as part of the contractual agreement, is subject to transaction privilege tax under the retail classification.

Tangible personal property which is used to meet the conditions under a contractual warranty agreement and which is covered under the terms of the contract is not subject to tax under the retail classification since the property is not actually sold. However, the vendor is responsible for payment of the use tax on covered property unless the covered property was not purchased tax exempt and the transaction privilege tax was paid on the original sale of the covered property.

The original sale of property with a "warranty or service provision" is not the sale of a warranty contract. The "provision" is subject to tax as part of the sale of the tangible personal property. As such, the subsequent use of tangible personal property in completion of the contract would not be subject to tax under either the retail classification or under the use tax if such

property is covered under the contractual terms of the original agreement.

Parts used to repair property sold under an implied warranty of merchantability, if the original sale meets all of the statutory requirements under the Arizona Uniform Commercial Code, are not subject to the use tax provisions under Title 42, Chapter 5, Article 4<sup>9</sup> "Use Tax." In cases where the claims are honored no additional tax is due since the customer's claim arises under the initial sales contract and transaction privilege tax has already been paid on the receipts from the sale. Therefore, parts taken from inventory or purchased for the purpose of resolving a claim of warranty, other than a statutorily exempt warranty contract, are not subject to transaction privilege or use tax. However, tangible personal property taken from inventory or purchased for other purposes, including promotional items, are subject to transaction privilege or use tax. Disputes may arise between a seller and a buyer regarding the scope of an express or implied warranty. In instances where a buyer's claim is brought in good faith and parts are taken from the seller's inventory or are purchased by the seller for the purpose of resolving the buyer's claim, such parts are not subject to transaction privilege or use tax. Parts used for repair or replacement would not qualify as tax exempt when those parts are used for purposes of continuing goodwill or promotion and have no basis in an express or implied warranty claim.

#### Examples:

A warranty contract was purchased as an optional item and was separately stated as part of the sale of a motorboat. The contract covered all parts and labor for a specified period of time. The purchaser returned the boat for "repair." Parts used to repair the item under the terms of the warranty contract were in stock. The vendor had provided an exemption certificate when the repair parts were purchased. The vendor is responsible for reporting and paying the use tax on those repair parts used in fixing the boat.

A warranty contract was purchased as an optional item and was separately stated as part of the sale of a washing machine. The contract only covered repair labor for a specified period of time. The purchaser called a repair person to "repair" the washing machine. Parts used to repair the machine

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<sup>9</sup> The original document cited Title 42, Chapter 8, Article 2 which was renumbered as Title 42, Chapter 5, Article 4.

under the terms of the warranty contract are taxable under the retail classification as a sale to the consumer whether the vendor has the property in stock or if the vendor has to purchase them. In the case of purchase the vendor would have a valid sale for resale and would be exempt on the purchase of the parts from another dealer.

A stated warranty was included as part of the purchase of a refrigerator. The provision covered all parts and labor for a specified period of time. The purchaser returned the refrigerator for "repair." All parts are considered to have been paid for as a part of the original purchase of the refrigerator. As such, no party is subject to any tax on parts.

A motor vehicle buyer returns to the dealership and requests that the vehicle be repaired without additional charge. The buyer is making a claim under the initial contract of sale. The original purchase did not have a warranty or an exclusion of implied warranties. The vendor honors the request of the buyer as meeting the statutory requirements under an implied warranty of merchantability. As such, no party is subject to any tax on parts.

A computer is purchased in "as is" condition. There is no implied warranty pursuant to statutory provisions in A.R.S. § 47-2316. A week after purchase the computer malfunctions. The purchaser goes back to the seller stating that "I am a long-time customer of this establishment, I know I bought this thing `as is' but this is ridiculous." The purchaser does not reasonably believe that he has a good faith warranty claim nor does a good faith warranty claim in fact exist. The vendor, in order to maintain good business relations, honors the request of the purchaser and repairs the computer. Any parts used to repair the computer would be subject to the use tax.

Paul Waddell, Director

Signed December 2, 1992