PRIVATE TAXPAYER RULING LR10-001

January 15, 2010

The Department issues this private taxpayer ruling in response to your letters of December 12, 2007, February 29, 2008, and January 6, 2010, requesting a ruling on behalf of your client, . . . ("Company"). You request the Department to rule as to the applicability of Arizona transaction privilege tax to the portion of a motor vehicle lease payment pertaining to an optional vehicle service contract ("VSC") purchased by the lessee at the inception of the lease. Pursuant to Arizona Revised Statutes ("A.R.S.") § 42-2101, the Department may issue private taxpayer rulings to taxpayers and potential taxpayers on request.

Statement of Facts:

The following facts are excerpted from your December 12, 2007 letter:

> [Company] is engaged in the business of leasing motor vehicles in Arizona and many other states. [Company] contracts with … ("Company Two") to administer each of the leases on behalf of [Company], including the collection of payments under the leases.
>
> The motor vehicle lease agreements compute the monthly lease payment for a leased vehicle beginning with the "gross capitalized cost" of the vehicle, which is generally equal to (i) the agreed-upon value of the vehicle, as equipped at the lease signing, plus (ii) the agreed-upon value of any accessories or optional equipment to be added after the lease signing, plus (iii) the cost of any VSC purchased by the customer for the leased vehicle, plus (iv) the acquisition fee. The gross capitalized cost is then reduced by the "capitalized cost reduction," which is generally equal to any cash (or trade) down payment made by the customer. Finally, the monthly lease payments are computed based on the difference (amortized over the term of the lease) between the gross capitalized cost of the vehicle, as adjusted above, and the residual value of the vehicle at the end of the lease term (such difference being referred to hereinafter as the "lease base amount").
>
> Each VSC generally provides that [Company Two], rather than the customer, will be responsible for any repairs that need to be made to the vehicle during the contract period. Each VSC is entirely optional [at] the discretion of the customer (*i.e.*, no VSC is required to be purchased as part of any lease agreement).
>
> In the first alternative scenario ("Alternative A"), both the lease agreement and each of the monthly lease payment invoices sent to the customer separately state the portion of each lease payment that is attributable to any VSC purchased at the time of the lease, and the portion that is attributable to anything other than the VSC (*e.g.*, the value of the leased vehicle and any add-on accessories or equipment, and the acquisition fee).

In the second alternative scenario ("Alternative B"), the monthly lease payment invoices do not separately state the portion of each lease payment that is attributable to the purchase of the VSC, but the lease agreement does separately state this amount.

In the third alternative scenario ("Alternative C"), neither the lease agreement nor any of the monthly lease payment invoices separately states the portion of each lease payment that is attributable to the purchase of the VSC. However, the lease agreement does separately state the cost of the VSC and the cost of the vehicle (as well as the cost of any add-on accessories or equipment, acquisition fee, *etc.*) in computing the gross capitalized cost, which is in turn used to calculate the monthly lease payment.

In each of the three scenarios, a customer may also elect to purchase a VSC after the lease signing. In this event, the price paid for the VSC is not amortized as part of the monthly lease payment; instead, the customer pays the entire cost of the VSC at the time of purchase.

The following statements are excerpted from the terms of the "Closed End Vehicle Lease Agreement" submitted as a "representative copy of a standard lease agreement between [COMPANY] and the lessee" accompanying your letter dated February 29, 2008:

OPTIONAL SERVICE CONTRACT
An optional service contract promises to perform services or provide benefits relating to the maintenance or repair of the Vehicle. These coverages are not provided by the Lessor. I must pursue all matters relating to these coverages through the provider. The terms and conditions for these coverages are in a separate contract which I have read and received.

Price $ _____ Provider: _____

The following statements are excerpted from the terms of the "Vehicle Service Contract" submitted as a "representative copy of a standard Vehicle Service Contract (VSC)." Your February 29, 2008 letter indicates the submitted VSC is one of eighteen different forms of VSCs, which all have similar contractual terms. (Each form is based on a particular type of leasing program or vehicle, *e.g.*, new, pre-owned, certified pre-owned, commercial use, etc.)

ADMINISTRATOR means [Company Two].
…
THIS CONTRACT IS NOT MECHANICAL BREAKDOWN INSURANCE, AN EXPRESS, IMPLIED, GENERAL OR EXTENSION OF A WARRANTY, AND IS NOT A CONDITION OF THE SALE OF THE VEHICLE. THIS CONTRACT MAY DUPLICATE SOME WARRANTY COVERAGE.

II. COVERAGE

> [Company Two] will arrange for the repair or replacement of covered parts, and any component damaged by a covered part, as provided below, or pay the REPAIR COST for repair or replacement due to a MECHANICAL BREAKDOWN during the CONTRACT PERIOD. The CONTRACT PERIOD begins on the EFFECTIVE DATE and ends on the EXPIRATION DATE or EXPIRATION MILEAGE (shown on the IDENTIFICATION PAGE), whichever occurs first.

Issue:

Is income derived from a vehicle service contract included in a vehicle leasing agreement subject to the transaction privilege tax imposed under the personal property rental classification?

Your Position:

Your position is that the income derived from a lessee's purchase of a vehicle service contract is exempt from transaction privilege tax. You cite to A.R.S. § 42-5061(A)(3), which provides an exclusion from the tax base under the retail classification for income derived from "[s]ales of warranty or service contracts. …" You also cite to the following rules (in pertinent part) from the Arizona Administrative Code ("A.A.C."), Title 15, Chapter 5, Article 1, which apply to sales under the retail classification:

> **R15-5-105 *Services in Connection with Retail Sales***
> Gross receipts from services rendered in addition to selling tangible personal property at retail are subject to tax unless the charge for service is shown separately on the sales invoice and records.
>
> **R15-5-137 Warranty or Service Provisions and Tangible Personal Property Used in Conjunction with Warranty or Service Provisions**
> …
> B. An exclusion from gross receipts is not allowed for a warranty or service provision on the sale of tangible personal property if the property cannot be sold without the acceptance of the warranty or service provision.
>
> **R15-5-138. Warranty or Service Contracts and Tangible Personal Property Used in Conjunction with Warranty or Service Contracts**
> …
> B. Gross receipts from the sale of warranty or service contracts are not subject to tax when the contracts are sold as a distinct and separate item and the charge for the warranty or service contract is stated separately on a sales invoice.
> …

In the legal analysis section of your letter, you state that "[t]he clear intent of these authorities is that only the portion of the monthly lease payment that is actually attributable to the lease of taxable items should be subject to tax."

Discussion:

[Company] is engaged in the business of leasing tangible personal property for a consideration. Income derived from this activity is subject to the transaction privilege tax imposed under A.R.S. § 42-5071 *Personal property rental classification*, rather than under A.R.S. § 42-5061 *Retail classification*. A.R.S. § 42-5071(B) states that the tax base for the personal property rental classification is the gross proceeds of sales or gross income derived from the business, and allows specific deductions from this tax base for certain categories of income.

While A.R.S. § 42-5071(B) provides deductions from the tax base that cross reference to specific deductions found under the retail classification, the exclusion for income derived from sales of warranty or service contracts [A.R.S. § 42-5061(A)(3) as cited in your letter's legal analysis section] is not cross referenced as an available deduction under the personal property rental classification. Exemptions under one business classification cannot be claimed by a person subject to the transaction privilege tax under a different business classification. *See Brink Electric Construction Company v. Arizona Department of Revenue*, 184 Ariz. 354, 909 P.2d 421, (App. 1995). The rules cited from the Arizona Administrative Code, Title 15, Chapter 5, Article 1, applicable to the retail classification, are therefore inapplicable to the issue of the taxability of warranty or service contracts connected to a lease of tangible personal property.

A.A.C. R15-5-1502 addresses the gross income that is subject to tax under the personal property rental classification. A.A.C. R15-5-1502(D) provides:

> Gross income from the rental of tangible personal property includes charges for installation, labor, insurance, maintenance, repairs, pick-up, delivery, assembly, set-up, personal property taxes, and penalty fees even if these charges are billed as separate items, unless a specific statutory exemption, exclusion, or deduction applies.

Arizona Transaction Privilege Tax Ruling *TPR 03-7* addresses the issue of the imposition of transaction privilege tax on the business of leasing automobiles on a long-term basis. In the discussion section of this ruling, the taxability of service contracts is referenced. In pertinent part, TPR 03-7 states:

> "Capitalized cost reduction" is the amount paid by the lessee that reduces the gross capitalized cost. "Gross capitalized cost" means the agreed-upon value of the vehicle and any items that the lessee pays for over the term of the lease, <u>such as service contracts or insurance</u>. The gross capitalized cost less the capitalized cost reduction is the "adjusted

> capitalized cost." The adjusted capitalized cost is the amount used in calculating the base monthly lease payment. The amount paid as a capitalized cost reduction ultimately reduces the amount to be paid on the periodic lease payments.
>
> The capitalized cost reduction represents income derived by the automobile lessor from engaging in the business of leasing tangible personal property. With the exception of a trade-in, all amounts received by the automobile lessor are subject to tax under the rental classification, including any cash payment, manufacturer's rebate, credit card bonus, or any other item for which credit is given to the lessee. The amount of credit allowed for a vehicle that is traded in on the leased vehicle is not subject to tax.
>
> (Emphasis added)

Ruling:

The Department rules that all of [Company's] income derived from sales of optional vehicle service agreements that are included in a leasing agreement is subject to the transaction privilege tax imposed under the personal property rental classification. This applies regardless of how the charges for the vehicle service agreement are invoiced or referenced in the lease agreement.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your correspondences dated December 12, 2007 and February 29, 2008.

This response is a private taxpayer ruling and the determinations herein are based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different Department position.

The determinations in this private taxpayer ruling are applicable only to the taxpayer requesting the ruling and may not be relied upon, cited nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.