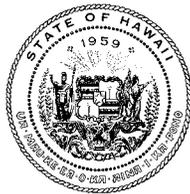


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LETTER RULING NO. 2010-02

[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]
[REDACTED TEXT]

February 10, 2010

RE: GENERAL EXCISE TAX EXEMPTION FOR SALES OF TANGIBLE PERSONAL PROPERTY TO THE FEDERAL GOVERNMENT

Dear [REDACTED TEXT]:

This responds to your letter dated [REDACTED TEXT], requesting a determination on whether [REDACTED TEXT] (the "Company"), is entitled to exempt certain gross receipts or gross proceeds earned on sales to the federal government as further discussed below.

QUESTION PRESENTED

Whether the sales of the Company's [REDACTED TEXT] products to the federal government, which include repair or replacement warranties that are included in the purchase price, are considered sales of tangible personal property for purposes of the general excise tax exemption under Section 237-25(a), Hawaii Revised Statutes (HRS); or whether such sales are services that are fully taxable.

SHORT ANSWER

Based upon the facts set forth in this letter, the Company's sales of [REDACTED TEXT] products to the federal government, which include repair or replacement warranties that are included in the purchase price, are considered sales of tangible personal property under HRS § 237-25(a), and are therefore exempt from the general excise tax.

STATEMENT OF FACTS

The Company is headquartered in [REDACTED TEXT] as a manufacturer and retailer of [REDACTED TEXT] products selling primarily to federal, state and local governments. However, the Company also sells to retailers and directly to the general public. The Company sells

Letter Ruling No. 2010-02

[REDACTED TEXT]

[REDACTED TEXT]

February 10, 2010

Page 2 of 5

[REDACTED TEXT] with a manufacturer's warranty offering to repair, replace, or refund the purchase price of defective products during the warranty period ranging from [REDACTED TEXT] days to the lifetime of the product in the hands of the original owner. All warranty repairs and replacements are performed in [REDACTED TEXT]. When a warranty claim is made, there is no consideration or money exchanged for the repair or replacement between the customer and the Company. Ordinarily, a customer simply returns the defective item and a new one is provided. The Company reserves the right to service or repair a defective product at its discretion.

The Company's relevant warranty terms, as found at [REDACTED TEXT], are as follows:

[REDACTED TEXT]

[REDACTED TEXT] We will repair, replace, or refund your original purchase price of this product, at our discretion, if it is determined by us to be defective. [REDACTED TEXT]

[REDACTED TEXT] will repair or replace free of charge any [REDACTED TEXT] manufactured by [REDACTED TEXT] for the duration of this lifetime warranty.

[REDACTED TEXT] At our discretion, we will repair, replace, or refund your original purchase price of this product if it is determined, by us, to be defective. [REDACTED TEXT]

LEGAL ANALYSIS

A. Hawaii's Exemption for Sales of Tangible Personal Property to the Federal Government.

Section 237-25, HRS, provides in relevant part, an exemption from the Hawaii general excise tax for sales of tangible personal property sold to the federal government. Specifically:

§237-25 Exemptions of sales and gross proceeds of sales to federal government, and credit unions. (a) Any provision of law to the contrary notwithstanding, there shall be exempted from, and excluded from the measures of, the tax imposed by chapter 237 all sales, and the gross proceeds of all sales, of: * *

- (3) Other tangible personal property sold by any person licensed under this chapter to the United States (including any agency, instrumentality, or federal credit union thereof but not including national banks), and to any state-chartered credit union, but the person making such sale shall nevertheless, within the meaning of this chapter, be deemed a licensed seller....

HRS § 237-25(a)(3). Notwithstanding the clear import of the general excise tax exemption for sales

Letter Ruling No. 2010-02

[REDACTED TEXT]

[REDACTED TEXT]

February 10, 2010

Page 3 of 5

of tangible personal property to the federal government, HRS § 237-25 also expressly taxes a person's sales and gross proceeds of sales of services to the federal government:

(c) Nothing in this section shall be deemed to exempt any person engaging or continuing in a service business or calling from any part of the tax imposed upon the person for such activity, and the person shall not be entitled to deduct any amount for tangible personal property furnished in conjunction therewith even though the person separately bills or otherwise shows the amount of the gross income of the business derived from the furnishing of the property.

HRS § 237-25(c) (emphasis added). The general excise tax law defines "service business or calling" as "activities engaged in for other persons for consideration which involve the rendering of a service...as distinguished from the sale of tangible property." HRS § 237-7. Therefore, to discern whether gross income is entitled to the general excise tax exemption for sales to the federal government, an analysis of the basis of the sales giving rise to the proceeds must be made to determine whether the income comprises sales of tangible personal property or services.

B. The Company's Warranty is Incidental and Inseparable from the Sale of Tangible Personal Property

Under the facts of this case, the sale of the Company's [REDACTED TEXT] products discussed in this letter is the sale of tangible personal property and the fact that the products include a lifetime repair or replacement warranty is incidental and inseparable from the sale of the tangible personal property.

All of the Company's products, regardless of the customer, come with the warranty discussed above without additional charge to the customer. When a defective item is returned, a replacement is typically issued, rather than a repair of the defective item. However, the Company reserves the right to repair or replace based upon the facts of a particular claim. The simple replacement of a defective product does not constitute a service; provided the product is replaced for a new one in its entirety without more. Where the Company repairs a defective product, such repair constitutes a service; however the service is incidental and inseparable from the purchase of the product. Because the warranty is incidental and inseparable from the purchase of the product, the gravamen of the transaction with the federal government is that of a sale of tangible personal property. Under the facts of this letter, the sale is not of services that would otherwise be taxable under the general excise tax.

In further support of this conclusion, in order to be a service taxable under HRS § 237-25(c) and precluded from the exemption for the sale of tangible personal property, the service must be performed for consideration. The warranty repair is provided free of charge. Therefore, there is no consideration for the warranty and the repair or replacement of any defective product under such

Letter Ruling No. 2010-02

[REDACTED TEXT]

[REDACTED TEXT]

February 10, 2010

Page 4 of 5

warranty.¹ Notwithstanding the fact that the warranty is included in the purchase price of the Company's products free of charge, this letter does not apply to factual situations where a seller builds into the price of tangible personal property the value of potentially separable services that are beyond mere incidence. For example, if the Company were to enter into a contract with the federal government to sell [REDACTED TEXT] that ordinarily retailed for \$[REDACTED TEXT] per item; however increased the invoice price to \$[REDACTED TEXT] per [REDACTED TEXT] because the contract also called for training and periodic servicing of the [REDACTED TEXT] above and beyond ordinary warranty coverage, such an arrangement is beyond the conclusions reached in this letter. If the foregoing hypothetical were asserted by the Company as the sale of tangible personal property, such an argument would be challenged by the Department of Taxation under the gravamen of the transaction test because the training and servicing is well beyond basic warranty coverage and is not inseparable or merely incidental to the sale of the tangible personal property. Under the facts of this hypothetical, the Department would treat the training and periodic servicing of the product as taxable services.

CONCLUSION

Based solely on the facts disclosed in this letter, the Company's gross income from sales of its products to the federal government, which include the repair or replacement warranty discussed above, are entitled to the exemption under HRS § 237-25(a)(3) as sales of tangible personal property.

This ruling is applicable only to the Company. This letter applies prospectively; provided that this letter may be relied upon retroactively to the extent the facts are consistent with the facts represented and relied upon in drawing the legal conclusions in this letter. It may not be used or cited as precedent by any other taxpayer. The conclusions reached in this letter are based on our understanding of the facts that the Company has represented. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, the conclusion in this letter will be modified accordingly. This ruling also may be subject to change due to future amendments to laws, rules, or official Department positions.

The Company has reviewed and agreed that the redacted version of this ruling attached as Exhibit A will be available for public inspection and copying.

If you have any further questions regarding this matter, please call me at 808-587-1569. Additional information on Hawaii's taxes is available at the Department's website at

¹ This ruling does not have the effect of extending the exemption for sales of tangible personal property to the federal government to the gross income received by a third-party performing warranty repair services on behalf of the Company. Where a third-party performs the warranty service and the third-party is compensated by the Company for the warranty service, HRS § 237-4(10)(A)(i) (relating to the wholesale general excise tax rate applicable to the sale of services to fulfill a manufacturer's warranty obligation) must be considered.

Please note that the Company's [REDACTED TEXT] warranty includes a provision for repairs made necessary by factors including damage resulting from [REDACTED TEXT], which will be invoiced and billed to the customer. Any gross income or gross proceeds obtained under an invoiced repair is not exempt and will be considered a separate transaction because it is outside the warranty coverage.

Letter Ruling No. 2010-02

[REDACTED TEXT]

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February 10, 2010

Page 5 of 5

<http://www.hawaii.gov/tax>.

Very truly yours,

JOSEPH B. TICHY
Administrative Rules Specialist