State of California

Board of Equalization
Legal Division MIC:82

M e m o r a n d u m

490.0745

To : Mr. Aaron Phillips
Audit Review & Refunds Section

Date: June 19, 1995

From : David H. Levine
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Subject: Memorandum dated March 16, 1995
regarding --- --- --- [X]

This is in response to your memorandum dated April 26, 1995. Your section wrote us a memorandum dated March 10, 1995 regarding questions raised by [X] in a letter dated January 6, 1995 regarding Regulation 1655, and the Legal Division responded in a memorandum dated March 16, 1995. You question the accuracy of the analysis in the memorandum. The writer utilized an unsupported "profit analysis" regarding the underlying reason for the defective merchandise and returned merchandise deductions and did not adequately consider the facts presented. A profit analysis in this context has no relevance. The March 16, 1995 memorandum is specifically disapproved, and it is not to be released to anyone. This memorandum supersedes and replaces our previous response to the March 10, 1995 memorandum.

[X] asks about two categories of transactions. It describes the first as follows:

> "A dealership sells a new vehicle and collects [sales tax reimbursement from the customer]. After several repairs, but short of meeting the state lemon law, the customer requests that the manufacturer refund the purchase price without legal litigation. The manufacturer, through the dealership, refunds the purchase price and all applicable sales tax for customer satisfaction."

[X] asks whether the dealer can take a returned merchandise deduction. The first question I have with respect to [X]'s statement of facts is what it means by "several repairs, but short of meeting the state lemon law." This seems to represent a fundamental misunderstanding of the application of the Lemon Law. If the vehicle is defective and [X] cannot repair it to conform to the applicable express warranties after a reasonable number of attempts, the refund may very well qualify as a Lemon Law restitution in accordance with subdivision (d) of Civil Code section 1723.2. I note that a reasonable number of repair attempts could be 3, or 1, or perhaps as few as none (it probably could not qualify if the repair attempts were fewer than none). If [X] knows that a defect cannot be cured, would we require it to futilely "attempt" to repair something that cannot be repaired? Of course not. The reasonable repair attempts

requirement is an upper limit on how many repair attempts the manufacturer has made before it is required to give the customer restitution (or replacement if the purchaser so chooses). It is not a lower limit on when the manufacturer and the purchaser agree that the Lemon Law restitution and replacement requirements apply.

If the transaction satisfies all requirements of the Lemon Law, including that the parties specifically agree[1] that the vehicle has a nonconformity which substantially impairs the use, value, or safety of the vehicle and the manufacturer will satisfy the requirements of subdivision (f) of Civil Code section 1793.22 to notify any future purchasers of the nonconformity, [X] would be entitled to a refund under Civil Code 1793.25. It appears that the transactions may, in fact, so qualify. Be that as it may, the remainder of this opinion is based on [X]'s conclusion that the returns will not come within the provisions of California's Lemon Law.

Prior to answering the specific question presented (refund of customer's purchase price), I will discuss replacements since this analysis sheds light on the particular transaction at issue, illustrating the type of fact pattern that is involved in these types of transactions and the nature of the analytical inquiry required. It is often difficult to ascertain exactly what is happening in these types of circumstances. For example, if the manufacturer were not involved, would the transaction be a trade-in or a warranty replacement? The answer depends on the actual facts. Sometimes, a person decides two or three weeks after the purchase of a vehicle that she wanted a different vehicle, and she trades in the old (two or three weeks old) vehicle on the new vehicle. This is a taxable sale measured by the amount paid in cash for the second vehicle plus the trade-in value allowed for the first vehicle. On the other hand, a transaction that looks virtually identical may instead be a warranty replacement. If it were, only the amount paid by the customer would be a taxable sale. The dealer would owe tax, or not, on its purchase price of the warranty replacement depending on whether pursuant to a mandatory warranty (no tax) or optional warranty (tax).

When the manufacturer is involved in a trade-in situation, this adds an additional layer of complexity to the analysis. The manufacturer, for reasons other than warranty, may participate in facilitating the purchaser's trading in of the first vehicle for the second. Usually, it is not the manufacturer who makes any sale to the customer. Rather, in the usual situation, the dealer is the person who actually contracts with the customer for both transactions and then, perhaps, the manufacturer makes some sort of allowance to the dealer. The analysis of this type of transaction is the same as the situation involving only the dealer and the purchaser, with one additional step. That is, if the transaction is structured as a sale from the dealer to the customer, the transaction would generally be treated as a sale from the dealer to the customer. Tax is

[1]In reality, the customer generally does not care how the refund is characterized as long as the customer gets his or her money back. It is the manufacturer that cares because it does not always want to fess up that the vehicle is a lemon. Thus, we often see refund agreements in which the parties agree that the manufacturer admits no liability but wishes to settle a disputed claim. That is, the purchaser agrees to the condition proffered by the manufacturer. A refund pursuant to such an agreement never qualifies as a Lemon Law refund for our purposes because the parties have specifically agreed that it is not a Lemon Law replacement.

measured by the cash paid for the second vehicle and the value allowed as trade in for the first vehicle. If the allowance given by the manufacturer to encourage the dealer to sell the second vehicle at a certain price is to sell that vehicle to the dealer for a lower price than normal, that "allowance" would not generally factor into the calculation of the measure of tax. On the other hand, if the manufacturer makes some sort of cash payment, credit, or other form of allowance, that amount would be included in the gross receipts from the sale of the second vehicle, similar to a manufacturer's coupon.

In a (non Lemon Law) warranty situation, when the manufacturer is involved, we normally regard the manufacturer as the person providing the repairs to the customer, and the dealer as acting on the manufacturer's behalf.[2] Assuming the manufacturer satisfied its warranty obligations by replacing the vehicle, the general transaction stream of the replacement would be as follows. The manufacturer sells the dealer a car, for resale. Pursuant to the warranty, the dealer transfers the vehicle to the customer; however, the dealer does not do so on its own behalf, but rather on behalf of the manufacturer. That is, the dealer sells the car purchased for resale from the manufacturer back to the manufacturer so that the manufacturer may fulfill its duties under the warranty. If the warranty had been mandatory, the manufacturer purchases the replacement car from the dealer for resale. No tax is due on the transaction because the manufacturer is regarded having sold the car as part of its original sale subject to the mandatory warranty. If the warranty is optional, the sale by the dealer to the manufacturer is a taxable retail sale. If the customer paid any amount, whether the warranty is mandatory or optional, that amount would be taxable.

A similar analysis is necessary when there is a refund of the type at issue here, with one significant difference. Similar to the warranty replacement situation (or warranty repair), the first question is the identity of the person giving the refund. In a warranty situation, the identity of the person fulfilling the warranty obligations does not change the conclusion of the analysis: if the replacement is pursuant to a mandatory warranty, no tax applies; if the replacement is pursuant to an optional warranty, whoever is fulfilling its warranty obligations is the consumer of the replacement property. However, in a refund situation, if the identity of the person making the refund is the original retailer, a returned merchandise deduction is possible if the requirements are satisfied. As correctly noted in the previous memorandum, if the person making the refund is someone other than the retailer who reported sales tax on the original transaction, no deduction is available to the person making the refund, or to anyone else.

[2]I will not go into a full discourse on the subject, but I note that this does not always have to be the case. If a dealer performing warranty repairs did not sell the vehicle, then it is clear that the manufacturer is providing the warranty coverage directly to the customer. However, if the repairing dealer is also the person who sold the vehicle and the warranty, then that dealer has a direct warranty contractual relationship with the customer. That is, the dealer has a warranty obligation to the customer separate from the obligation of the manufacturer since it is the seller of the vehicle and the seller of the warranty. Of course, if the dealer performed the warranty work on its own account, it would seek reimbursement from the manufacturer under the warranty the manufacturer sold to the dealer (who then sold it to the customer). My understanding is that in practice, the manufacturer cuts out the middle man and that any work performed by the dealer is on the manufacturer's behalf (i.e., pursuant to a repair contract with the manufacturer). Thus, the dealer and the manufacturer treat these types of transactions the same whether the repairing dealer is the selling dealer or not.

Thus, in the present matter we come down to one question: who is the person who contracted with the customer to give the refund? If the dealer made the refund literally on behalf of the manufacturer and the agreement for the refund was entered into between the manufacturer and the customer, then no deduction is available. On the other hand, if the person actually entering into the agreement to refund the money to the customer was the dealer, and the dealer made the refund on its own behalf, then the returned merchandise deduction is available if all its requirements are satisfied. This is true without regard to any agreement between the manufacturer and the dealer for reimbursement to the dealer of amounts the dealer refunded to the customer. That is, the returned merchandise deduction is not conditioned on any net loss of profit by the retailer. The retailer may lose the full amount of the refund, may lose only the profit it had gained on that sale, or may lose nothing because of full reimbursement by someone else: profit is irrelevant.

The problem here is not stating the rule, it is applying it. In the warranty situation the trade practices make it clear what is happening (that is, the manufacturer performs its warranty obligations directly to the customer rather than reimbursing the dealer under the dealer-manufacturer contract for the dealer's fulfillment of the dealer's own warranty obligations). In a refund situation such as at issue here, each transaction is different, and the problem is therefore similar to a trade-in type transaction which may qualify as a warranty replacement or may instead simply be a trade in. That is, a return that may qualify for the returned merchandise deduction in which the manufacturer reimburses the dealer for the dealer's refund to the customer looks very similar to a nonqualifying refund by the manufacturer which is processed by the dealer on the manufacturer's behalf.

[X]'s statement of facts in its January 6, 1995 letter is that the manufacturer, "through the dealership," refunds the purchase price. This indicates that it is, in fact, the manufacturer contracting directly with the customer for the refund, and that any contract signed by the dealer is signed on behalf of the manufacturer. If so, no returned merchandise deduction is allowed.

The next question of [X] relates to the defective merchandise deduction. The same analysis as discussed above is necessary in this context. That is, the first issue is the identity of the person who contracted to refund or credit an amount to the customer on account of defects in the vehicle. If the manufacturer, no defective merchandise deduction is available. If the dealer, then it may apply.

The previous memorandum again relied on the profit analysis to conclude that the defective merchandise deduction does not apply. In this context, it is even clearer than in the returned merchandise context that the profit analysis is invalid. The theory behind the defective merchandise deduction is that there is a defect in the property sold such that, if the parties had known at the time of the sale, the sale price would have been less. That is, the deduction is for a price adjustment that would have been made at the time of sale if the parties knew the relevant facts. For example, a person purchased a computer several months ago with a Pentium chip at a

selling price of $3,500. Upon discovery of the "Pentium bug" the purchaser seeks to return the computer. Instead the parties agree that, had the purchaser known of the defect at the time of the purchase, she would have still purchased the computer if the price had been discounted $200. The dealer refunds that amount to her. The dealer may take a defective merchandise deduction of $200. Does it matter whether the dealer loses $200 profit? Absolutely not. In this type of scenario, the dealer may very well receive reimbursement of some or all of the amount refunded to the customer.[3]

I note that [X] asks how tax applies when "the dealership gives a full refund or credit ...." Thus, the question remains, who is the person actually making the refund or credit? It could be the dealer even if the customer had some preliminary negotiations directly with the manufacturer if those negotiations simply led to an arrangement between the manufacturer and the dealer where, if the dealer agreed to refund or credit certain amounts, the manufacturer would reimburse the dealer. On the other hand, the person making the refund could actually be the manufacturer even if all negotiations were conducted by the dealer provided the dealer was always acting on the manufacturer's behalf. This is a question of fact based on the specifics of the transaction in question. Of course, as you know, even if a dealer is entitled to a defective merchandise deduction, the deduction is limited to the amount of the credit or refund for the defect, and does not include any "trade in" value of the defective vehicle.

If you have further questions, please write again.

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cc: Mr. William D. Dunn
Mr. Robert L. Buntjer
Mr. Robert Pieroni

[3]If the dealer had an explicit or implied warranty duty to make good on the defect, then the manufacturer certainly would have the same duty with respect to its sale to the dealer. Thus, the dealer may very well have a contract right to receive reimbursement of such amount from the manufacturer. The manufacturer may also have a standing policy to reimburse dealers for legitimate amounts refunded to customers on account of defects in order to maintain customer good will and loyalty. This appears to be the very situation with Chevrolet. As in the case of the returned merchandise deduction, this is only relevant as it relates to the question of the identity of the person actually agreeing with the customer to refund those amounts.