STATE OF CALIFORNIA **490.0510.925**

STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 324-2637
FAX: (916) 323-3387

August 7, 1995

Mr. S--- D. E---
W--- C--- C--- C--- Inc. [WCCC]
X --- --- ---, Building ---
---, CA XXXXX

Re: SR -- XX-XXXXXX
W--- C--- C--- C--- Inc.

Dear Mr. E---:

This is in response to your letter dated June 19, 1995 regarding the application of tax on W--- C--- C--- C---, Inc.'s ("WCCC") exchange of a customer's defective boat.

You state:

> "We are a Boat Distributor and have a customer whose 1994 unit is faulty or more simply a 'Lemon'.... [¶] Our intention is to take the customer's 1994 Unit back giving full credit on the purchase price and provide them with a 1995 Unit at a slight price increase...."

You ask:

> "1) How do we go about charging the customer Sales tax only on the difference in price, 2) Are there any special procedures we need to follow so that the transaction is property documented for a State Board Auditor, and 3) Is it truly 'implied' that the 'Lemon Law' can be applied to a vessel[?]"

Discussion

Your letter asks a series of questions regarding the application of tax on a particular transaction between WCCC and a particular customer. For purposes of clarity, we will consider your questions in somewhat inverse order.

"3) Is it truly 'implied' that the 'Lemon Law' can be applied to a vessel[?]"[1/]

No. The provisions of California's Lemon Law relate to a manufacturer's obligation to replace or make restitution to the buyer of **a new motor vehicle** when a manufacturer is unable to service or repair a new motor vehicle to conform to the applicable express warranties after a reasonable number of attempts. (Civ. Code § 1793.2(d)(2).) The term "new motor vehicle" is defined in Civil Code section 1793.22(e)(2) and includes, among other things, "a new motor vehicle which is used or bought for primarily for personal, family, or household purposes." Boats, however, are defined under Vehicle Code section 9840(a) as "vessels" and generally consist of "every description of watercraft used or capable of being used as a means of transportation on water...." Since the provisions of Civil Code section 1793.2(d)(2) are specific to motor vehicles and not vessels, the California Lemon Law does not apply to WCCC's sales of boats.

"1) How do we go about charging the customer Sales tax only on the difference in price[?]"

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property inside this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) This tax is imposed on the retailer who may collect reimbursement from the customer if the contract of sale so provides. (Civ. Code § 1656.1.)

The amount of sales tax owed by WCCC depends on the circumstances surrounding the specific transaction with its customer. You state that it is WCCC's intent to take back the customer's 1994 boat and provide it with a 1995 boat at a slight price increase. We cannot determine from your description, however, the basis for such a transaction. That is, we cannot determine whether this transaction is pursuant to a warranty obligation of WCCC or the boat manufacturer, whether the transaction is a return of merchandise (and sale of a new boat), or whether WCCC is providing a credit to its customer for the defects in the 1994 boat for use toward the purchase of a new 1995 boat. As such, we will discuss how tax applies in each of these situations as set forth below.

1/ This question was previously asked by WCCC via letter dated November 13, 1990. A letter response was prepared by Senior Tax Auditor Arden Taube dated December 17, 1990. Our present response does not differ from the response given in the December 17, 1990 letter.

Warranty Obligation

As noted above, the provisions of the California Lemon Law do not apply relative to the sale of boats. Nevertheless, it is unclear from your letter whether WCCC or the boat manufacturer is replacing the boat based on a warranty with the customer. Pursuant to subdivision (c) of Regulation 1655 (copy enclosed), a person obligated under a mandatory warranty may purchase materials and parts furnished under the warranty extax for resale while a person obligated under an optional warranty is the consumer of the materials and parts furnished under the warranty. A warranty is mandatory when the buyer, as a condition of the sale, is required to purchase the warranty from the seller. (Reg. 1655(c)(1).) The warrantor has the burden of establishing that property is being replaced pursuant to a warranty and is not a trade-in towards the purchase of new property.

If WCCC or the boat manufacturer is satisfying a warranty obligation to the customer by replacing the entire boat, the general transaction stream of the replacement is as follows. The manufacturer sells WCCC a boat for resale. Pursuant to the warranty, WCCC transfers the boat to the customer either on its own behalf or on behalf of the manufacturer. If the warranty was mandatory and from WCCC, WCCC is deemed to have purchased the replacement boat from the manufacturer for resale and no tax is due on that transaction because WCCC is regarded as having sold the boat as part of its original sale subject to the mandatory warranty. If the warranty was mandatory and from the manufacturer, the manufacturer purchases the replacement boat back from WCCC for resale and WCCC then transfers it to the customer on behalf of the manufacturer. No tax is due on the sale to the manufacturer since the manufacturer is deemed to have purchased the replacement boat for resale and is regarded as having sold the boat through WCCC as part of its original sale subject to the mandatory warranty. If the warranty is optional, the entity obligated under the warranty is the consumer of that boat. The sale to that person, whether it is WCCC or the manufacturer, is the taxable retail sale. The "slight price increase" paid by the customer (i.e., the difference in price between the 1994 and 1995 boats) is subject to tax whether the warranty on the boat is mandatory or optional and whether the warranty is from WCCC or the manufacturer.

Returned-Merchandise Deduction

The application of tax in situations involving the return of merchandise is explained in subdivision (a) of Regulation 1655:

> "The amount upon which tax is computed does not include the amount charged for merchandise returned by customers if, (1) the full sale price, including that portion designated as 'sales tax', is refunded either in cash or credit and (2) the customer, in order to obtain the refund or credit, is not required to purchase other property at a price greater that the amount charged for the property that is returned. Refund or credit of the entire amount is deemed to be given when the purchase price, less rehandling and restocking costs, is refunded or credited to the

customer. The amount withheld for rehandling and restocking may not exceed the actual cost of rehandling and restocking the returned merchandise....”

This means that the returned-merchandise deduction is allowed only where the retailer refunds the full sales price (plus sales tax less rehandling/restocking fees) of the merchandise to the customer, the customer is not required to purchase other property at a greater price in order to obtain the refund, and the retailer who paid the sales tax to the state is the one who refunds the full sales price to the customer. Where someone other than the retailer who paid tax to the state refunds the sales price (e.g., the manufacturer of the merchandise), the returned-merchandise deduction does not apply.

WCCC may take the returned-merchandise deduction on its sales and use tax return only where its transaction with its customer meets each of the foregoing requirements. That is, the deduction is **not** available if WCCC will refund the sales price of the 1994 boat to its customer only if the customer purchases the 1995 boat at the higher price. Where WCCC can prove that it meets the foregoing requirements, WCCC may take a returned-merchandise deduction in accordance with Regulation 1655. In any event, tax applies to the total gross receipts from the sale of the new 1995 boat to that customer.

Defective-Merchandise Deduction

Subdivision (d) of Regulation 1655 explains the sales tax deduction for defective merchandise:

> "Amounts credited or refunded by sellers to consumers on account of defects in merchandise sold may be excluded from the amount on which tax is computed. If, however, defective merchandise is accepted as part payment for other merchandise and an additional allowance or credit is given on account of its defective condition, only the amount allowed or credited on account of defects may be excluded from taxable gross receipts. The amount allowed as the 'trade-in' value must be included in the measure of tax."

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, if the retailer gave the purchaser a credit or refund of $10,000 because they agreed that the value of certain defective merchandise was $10,000 less than the purchase price, the retailer may be entitled to take a deduction of $10,000 against its gross receipts. The amount of the defective-merchandise deduction is the difference between the original price and the value of the property with the defect, limited to the amount of the actual refund or credit. Like the returned-merchandise deduction explained above, only the retailer who paid the sales tax to this Board on the original purchase **and** who refunds or credits the customer for the defective merchandise is entitled to the deduction.

If WCCC allows a credit return of the 1994 boat against the purchase of a new 1995 boat, WCCC has the burden of establishing that a portion of the credit is for a defect in the boat. Only that amount is deductible on WCCC's sales and use tax return. Tax applies to the total gross receipts from the sale of the new 1995 boat to the customer and must be reported on WCCC's sales and use tax return. For example, if WCCC and the customer agree to a $10,000 "defective" amount to be credited to the customer toward the purchase of a new 1995 boat for $50,000, WCCC must separately report both the $10,000 defect deduction and the $50,000 sale on its sales and use tax return regardless of how the invoice to the customer is prepared. That is, if the invoice for the 1995 boat indicates a balance due from the customer of $20,000 based on a sales price of $50,000 for the 1995 boat less a $10,000 "defective" credit and 1994 boat trade-in of $20,000, WCCC's sales and use tax return must separately indicate that it took a defective-merchandise deduction of $10,000 (provided WCCC meets the requirements of Reg. 1655) as well as gross receipts from the sale of the 1995 boat of $50,000.

"2) Are there any special procedures we need to follow so that the transaction is properly documented for a State Board Auditor[?]"

WCCC should maintain adequate records which may be verified in an audit to substantiate the transaction it will undertake with its customer. If WCCC's transaction with its customer meets one of the categories set forth in our response to question one above, it should be certain that it meets and documents each of the requirements set forth in that particular category. As set forth above, WCCC has the burden of establishing that it meets one of these categories and that the transaction is not a trade-in of an old boat towards the purchase of a new 1995 boat.

We hope this answers your questions. If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:cl

Enclosure (Reg. 1655)

cc: --- District Administrator