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Memorandum

To: Headquarters – Evaluation and Planning (RN)

Date: January 28, 1969

From: Tax Counsel (TPP:GJJ) – Headquarters

Subject: REDACTED TEXT

This is in reply to your memorandum of December 13, 1968, in which you request us to review the above referenced taxpayer's method of calculating defective merchandise credits.

Taxpayer sells refrigeration compressors. In the course of selling new units taxpayer often receives old, inoperative units in trade. Some of these units were sold originally by taxpayer and some were sold by other dealers. Taxpayer bills its customers for the full sales price of the new compressor, plus tax, and at the same time issues a credit invoice in the amount of a predetermined "REDACTED exchange" price. The "REDACTED exchange" schedule provides an exchange price basis for various models of taxpayer's compressor". It appears that models are classified, for exchange purposes, into four categories--under warranty, out of warranty but less than six years from date of manufacture, more than 6 years from date of manufacture but less than 8 years, more than 8 years from date of manufacture but less than 11 years. The exchange value allowed varies indirectly with the age of the units.

By the terms of taxpayer's exchange policy, exchange transactions are allowed only when a motor compressor is "actually defective." When a compressor is found to be defective, taxpayer follows the billing procedure outlined above. Taxpayer treats the entire net exchange price as a defective merchandise allowance. Apparently taxpayer deducts such amounts from its gross receipts from the current return period.

Taxpayer cites the second sentence of the third paragraph of a letter dated August 25, 1955, from Mr. Bill Holden, then of this office, to taxpayer's parent company, REDACTED TEXT, in support of its treatment of the exchange transactions.

Taxpayer has misinterpreted the remarks of Mr. Holden.

The sentence in question states that, "If the old compressor is being returned because it is defective, the measure of tax on the first sale [that is the sale of the old compressor] may be reduced by the amount of any credit which is given the customer on account of the defect." [Emphasis added.] From this statement, taxpayer concludes that all returned compressors may be treated as defective merchandise for the purpose of computing the sales tax and that the defective merchandise credit is equal to the entire credit allowed for equipment taken in trade.

First, ruling 66 allows a defective merchandise credit to be taken on a sale where the buyer retains the property. Ruling 66 does not address itself to the trade-in question. Merchandise traded

in is covered by ruling 65. That ruling provides that the amount upon which tax is computed includes the agreed allowance for property traded in. We have recognized that there may be cases where both ruling 66 and ruling 65 apply. Thus when an allowance is made for defective merchandise which is also accepted by the retailer as part payment on the purchase of other merchandise, the value of the merchandise traded in, in its defective condition, must be included in the taxable gross receipts. The retailer may claim a defective merchandise allowance against the first sale but must not include therein the trade-in allowance made for the merchandise. (See annotations 1336.20, 1336.70.)

Second, we doubt whether ruling 66 applies to any of these transactions. Ruling 66 is not intended to cover merchandise which is several years old, which fails after many years of productive use, and which fails as a result of use and not because of a defect inherent in the merchandise when it was first sold. At a minimum we find it inconceivable that a compressor of the type sold by taxpayer can operate for eight years and then fail because of a "defect" as that term is used in ruling 66.

Nothing in this memorandum is intended to conflict with what was said by Mr. Holden in his 1955 letter. His statements were and remain accurate statements of the law. Taxpayer's interpretation of those remarks strike us as totally unreasonable.

GJJ:ph