

Memorandum

490.0016

**To :** Mr. Robert E. Pieroni (MIC 39)  
Supervising Tax Auditor, Refund Unit

**Date:** October 27, 2006

**From :** Sophia H. Chung  
Staff Counsel

**Subject:** S--- D--- S---, Inc.  
Account No. SR -- XX-XXXXXX

This is in response to your memorandum dated January 9, 1996, to Mr. David H. Levine, Supervising Staff Counsel, regarding the claim for refund of sales tax filed by S--- D--- S---, Inc. ("S---") for the period of July 1, 1994, to June 30, 1995.

You provide the following factual background. In 1991, S--- sold computer software to a purchaser pursuant to a sales contract which provided that any disputes between the parties shall be resolved through arbitration. On February 4, 1994, the purchaser filed a "Demand for Arbitration," seeking a refund of the purchase price of the computer software. The resulting arbitration award ordered the purchaser to return the software to S--- and ordered S--- to refund a portion of the purchase price to the purchaser. S--- was also ordered to pay the arbitration costs.

You ask whether the amount refunded by S--- to the purchaser pursuant to the arbitration award is equivalent to a refund made pursuant to a litigation settlement. If it is not, you ask for guidelines for determining the amount of the defective merchandise deduction S--- is entitled to deduct provided that it satisfies all of the requirements of Sales and Use Tax Regulation 1655.

Sales and Use Tax Regulation 1655 provides that amounts refunded by the seller on account of defects in the merchandise sold may be excluded from the amount upon which tax is computed. However, the provisions of Regulation 1655 only apply to transactions voluntarily entered into between the buyer and the seller, and not to those entered as a result of litigation. As you have indicated, a payment made pursuant to a settlement of litigation does not qualify for a defective merchandise deduction under Regulation 1655.

In the present case, under the sales contract, the parties agreed to resolve all disputes through arbitration. Arbitration is a process of dispute resolution in which a neutral third party renders a decision after a hearing at which both parties have an opportunity to be heard. Where arbitration is voluntary, disputing parties select the arbitrator who has the power to render a binding decision. The arbitration award at issue herein ordered S--- to refund a portion of the purchase price to the buyer. S--- did not voluntarily refund the purchase price. Thus, the amounts paid by a seller to a buyer in accordance with an arbitration award are analogous to damages paid by a seller to a buyer as a result of litigation arising out of a sale transaction. (See Southern California Edison Company v. State Board of Equalization (1972) 7 Cal.3d 652.) Therefore, because the payment by S--- to the buyer was made pursuant to the arbitration award, S--- does not qualify for a defective merchandise deduction under Regulation 1655.

SHC:rz

cc: Mr. David H. Levine