State of California

Board of Equalization
Telephone: 324-2608
Legal Division MIC: 85

M e m o r a n d u m

490.0034

To : Mr. Orval D. Millette
District Principal Auditor
Oakland (CH)

Date: October 27, 2006

From : Rachel M. Aragon
Staff Counsel

Subject : Defective Merchandise Under Lemon Law

This is in response to your memorandum dated February 8, 1994 in which you ask whether the transaction you describe (noted below) qualifies for either a returned-merchandise or defective-merchandise allowance.

You have attached some correspondence for our review and evaluation. A memorandum from Mr. Glenn Bystrom to Ms. Barbara McCrory, Santa Rosa District Administrator, dated January 6, 1994, sets out the transactions Mr. Bystrom considered as follows:

> "Winnebago manufactured a Spectrum 2000 model motor home that was prone to catch fire in the engine compartment. Winnebago offered for a limited time to exchange these motor homes for other models. The owners would be charged anywhere from $0 to $35,000 depending on the model they chose for a replacement. The owners were also responsible for tax and license on the new motor home.
>
> "Your particular taxpayer purchased his Spectrum 2000 in Florida, and subsequently acquired the replacement motor home in Iowa after paying Winnebago an additional $12,000. He subsequently drove it to California and applied for a tax clearance.
>
> "You have correctly concluded that this transaction does not qualify under Civil Code Section 1793.2, the 'lemon law.' First, the statute requires that the customer be given the option for cash restitution versus vehicle replacement.

> Here, this option was not available. Second, in order to obtain a refund under the lemon law, the customer must be reimbursed for sales tax and license fees on the original transaction. The customer was not reimbursed. Lastly, but perhaps foremost, the original vehicle was not purchased in California, but actually in the state of Florida, thus no California Sales Tax was remitted.
>
> "You also posed the following questions regarding Sales and Use Tax Regulation 1655, 'If we consider this transaction to be returned merchandise (1655(a)), does the requirement that the tax and license fee be paid constitute 'an additional amount required to be paid?' and 'Can we allow a returned merchandise credit when the merchandise is returned to the manufacturer not the dealer?'
>
> "In short, Regulation 1655 requires that in order for a transaction to qualify for a returned merchandise credit, the full sales price, including that portion designated as 'sales tax' must be refunded to the purchaser. Further, this deduction or credit is only allowable to the retailer who paid the tax to the state. Therefore, had the original transaction taken place in California, it would not qualify as returned merchandise.
>
> "However, your inquiry as to whether the transaction qualified for allowance as defective merchandise was discussed with David Levine of our legal staff. It is David's opinion that the transaction qualifies as a replacement under warranty in the form of defective merchandise as provided by Regulation 1655(b). Therefore, if, as I assume, the original vehicle was used substantially outside of this state, the correct measure of tax would be the $12,000 consideration given for the replacement motor home."

As the memorandum from Mr. Bystrom notes, the returned-merchandise deduction requires that the portion designated as "sales tax" (reimbursement) be refunded. The returned-merchandise deduction is only allowed to the retailer who paid the sales tax to the state. In the case considered by Mr. Bystrom, the retailer who paid the sales tax to the state was Spectrum 2000, not Winnebago. Since Winnebago did not pay the sales tax on the sale of the vehicle which was returned, it is not allowed to take a returned-merchandise deduction with respect to the return. Thus, the returned-merchandise deduction is not applicable. Also, Mr. Bystrom correctly points out that the Lemon Law is not applicable to this transaction for the reasons stated in his memorandum.

The "defective-merchandise" deduction is explained in subdivision (b) of Regulation 1655 which states:

> "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 common situation in which this deduction is relevant is when the seller and the purchaser agree, in effect, to a price adjustment to the original purchase price based on a defect in the purchased property. For example, if the retailer gave the purchaser a credit or refund of $10,000 because they agreed the value was $10,000 less than the purchase price, the dealer may be entitled to deduct the $10,000 (amount refunded or credited) from the measure of tax. That is, 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.

In your draft memorandum to Glenn Bystrom, dated November 4, 1993, you ask some specific questions which we will address. You ask:

> "Why was this claim for refund [of F--- M--- C---] disallowed under Section 1793.2 of the California Civil Code, the California 'Lemon Law' and Section 1702 of Sales and Use Tax Law?"

Exhibit D to your draft memorandum is a letter from F--- M--- to one of its customers. F--- Motor Company offered to replace the customer's vehicle, but the customer was not given the option for cash restitution as required by 1793.2. The Lemon Law mandates that the customer be given such an option. Since the customer here was not, the replacement did not qualify as a Lemon Law replacement.

You also ask:

> "If the California 'Lemon Law' is not applicable to this transaction, then wouldn't Regulation 1655, Returns, Defects and Replacements part (b) or (c) be applicable? If not, why not?"

The information you provided indicates that F--- M--- was offering to replace a vehicle with a new vehicle. The customer was to be responsible for any upgrade, which was the cost difference between the factory invoice of the trade-in and the replacement. There is no indication in any of the exhibits you attached that there was any value placed on the defect. Thus, the defective merchandise deduction would not be applicable. Instead, it appears to have been a trade-in. As explained in subdivision (b) of Regulation 1654, the amount agreed upon as the allowance for a trade-in is included in the measure of tax.

Your last question is:

> "If the sale of the replacement vehicle is taxable then who is the seller of the replacement vehicle, F--- M--- C--- or [the dealer]? Why is the transaction taxable? Who is liable for the sales tax? What is the taxable measure on this transaction? How was it determined?"

The only basis for which the sale price of the second vehicle would not be fully subject to sales tax would be if the second vehicle were supplied by the manufacturer as required by the warranty to comply with its obligations under the warranty. Even if the second vehicle were supplied by the manufacturer as required by the warranty, the amount paid by the customer to obtain the second vehicle would be the minimum possible taxable amount (that is, the original transaction always remains taxable, and under the best scenario the upgrade amount would be the minimum taxable amount from the second transaction). The transaction, as explained, indicates the manufacturer offered a limited time to exchange the old F--- or L--- M--- for a new one because the old vehicles had a "history". We assume this means the vehicles had a history of repairs. Based on this, I assume this was an exchange under a warranty. If the assumption is correct, the taxable amount for this transaction is the amount paid, if any, for the upgrade.

When a manufacturer replaces a vehicle pursuant to a warranty, it is possible that title to the vehicle passes directly from the manufacturer to the customer, with the dealer acting merely as the agent of the manufacturer for purposes of delivery. Our understanding is that this would be unusual since it would require that the vehicle provided to the customer not be a vehicle from the dealer's inventory but instead would require a special delivery of a vehicle with respect to which the manufacturer retains ownership until delivery to the customer. In such cases, the customer would be liable for any amount not covered by the warranty and the manufacturer would be regarded as making a taxable retail sale with respect to such payment.

The common mechanism for automobile warranty replacement, however, is for the dealer to sell to the manufacturer the vehicle provided to the customer on the manufacturer's behalf. Thus, although the dealer physically delivers the vehicle to the customer, it is actually selling the vehicle to the manufacturer. (Whether that sale would be taxable depends on whether the replacement is pursuant to a mandatory or an optional warranty.) When there is an amount due which is not covered by the warranty (i.e., a deductible or upgrade payment) with respect to such replacement, the dealer would generally be regarded as the retailer to the customer with respect to such payment. That is, the common replacement transaction with an amount not covered by the warranty can be viewed as a sale of a portion of the vehicle to the manufacturer (taxable if provided pursuant to an optional warranty where the manufacturer is the consumer or extax for resale if provided pursuant to a mandatory warranty) and a retail sale by the dealer to the customer with respect to the amount paid by the customer to the dealer.

In this case, the manufacturer pays the dealer a $300 fee. This could indicate that the dealer is acting merely as the agent of the manufacturer, with the manufacturer the retailer of the upgrade portion of the vehicle. We do not think this is likely. It appears more likely that the replacement vehicle is withdrawn from the dealer's inventory. Since the dealer owns such vehicles, title obviously cannot pass directly from the manufacturer to the customer. The fact that the dealer is paying sales tax on the amount not covered by the warranty (the upgrade) is the consistent with this conclusion. Thus, unless you establish that title does pass directly from the manufacturer to the customer, we conclude that the dealer is selling to the manufacturer the portion of the replacement vehicle covered by the warranty and is selling to the customer the portion of the vehicle covered by the warranty.

RMA:ljt