

**STATE BOARD OF EQUALIZATION**1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)

July 21, 1975

Mr. K. R. M---
Tax Accountant
The P--- --- C---
XXX --- Street
--- ---, CA 94105

Dear Mr. M---:

SZ -- XX XXXXXX

This is in response to your letter of July 11, 1975, which was addressed to Mr. Glenn Rigby of this office. Your letter was referred to the undersigned for reply.

We understand that The P--- --- C--- ("P---") has recently undertaken a program, for the first time, to sell at retail an entire line of decorative type telephones to its customers ("D---"). Since several places of business are involved, P--- has secured numerous seller's permits.

P--- actually transfers title only to the --- housing and not title to the communication apparatus contained therein, which is retained by P---. Sales tax is reported to the Board at the time of sale in the normal manner. The customer may, without restriction, take the entire unit to wherever he may desire to move, including areas within and without the United States not serviced by the B--- S---.

Both touchtone as well as the rotary dial feature are available in D---. However, a housing that accommodates the rotary dial feature will not accommodate touchtone, and the housings are not, therefore, interchangeable. Not all areas serviced by the B--- S--- offer touchtone service. Touchtone is not compatible with exclusively rotary dial service but many areas, such as San Francisco, offer both. If, for example, a customer purchased the housing for a D--- touchtone model telephone in the San Francisco area, used it for an extended period here, and then moved to another area in California where touchtone service was not available, the D--- would, for all practical

purposes be useless to him. Needless to say, this could create a good deal of customer ill will and under these circumstances, P--- has "voluntarily" adopted the policy of exchanging the customer's used D--- touchtone model, including both the housing and the communication apparatus contained therein, for an otherwise identical new D--- rotary model completely without charge. P--- may possibly incur legal liability if it failed to adopt such policy. The new telephone is of the identical color, design, and price as the exchanged telephone (unless a price change has been effected during the interim in which event there is still no charge). P--- does not have the policy of permitting the exchange of a rotary model for a touchtone model upon a customer's moving into a touchtone service area as rotary models are entirely compatible with touchtone service.

You request confirmation of your conclusions as follows:

1. P--- is entitled to a deduction for returned materials under the circumstances set forth above for the full selling price of the D--- touchtone model initially sold to the customer as provided for in Section 6012(c)(2) of the Revenue and Taxation Code and Sales and Use Tax Regulation 1655(a).
2. The deduction is allowable during the period in which the exchange is effected.
3. No net taxable gross receipts will be reportable as a result of the transfer of the new unit to the customer, since the amount of tax thereon will invariably be offset by the deduction for returned materials.

The central question is whether the exchange of the D--- touchtone model for a new D--- rotary model should be regarded as an exchange or trade-in transaction under our Regulation 1654 "Barter, Exchange, "Trade-ins"" or as a returned merchandise transaction under our Regulation 1655 "Returns, Defects, and Replacements." A copy of both of these regulations is enclosed with this letter for your reference.

Although it could be argued that these transactions should be treated as trade-in transactions, since the customer may have the use of a D--- touchtone model telephone for an extended period of time prior to the exchange and since the exchange transaction occurs because of a change in circumstances of the customer which causes the customer to need a new and different item of property, we think the better view is that these exchanges should be treated as returned merchandise transactions. Of particular importance is the fact that the customer receives credit for the full purchase price of the returned item and not merely an allowance in accordance with the depreciated value of the item based upon its usage.

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We can thus confirm your analysis as to the proper application of the tax to the transactions under consideration, as outlined above. We assume, of course, that the selling price of the replacement D--- rotary model equals or exceeds the selling price (inclusive of sales tax) of the D--- touchtone model so that the customer receives full credit for the sale price paid for the D--- touchtone model.

Very truly yours,

Gary J. Jugum
Tax Counsel

Enclosures