

**STATE BOARD OF EQUALIZATION**

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*Controller*, Sacramento

June 26, 1996

E. L. Sorensen, Jr.  
*Executive Director*

Ms. [J]  
Office Manager  
[R]  
XXX --- ---  
--- ---, CA XXXXX

Re: [R]  
Account No. S- -- XX-XXXXXX

Dear Ms. [J]:

In a letter dated October 7, 1994, we responded to your letter dated September 13, 1994, regarding the taxation of an underallowance on a trade-in constituting part of the consideration paid for a new automobile. Upon review of our October 7, 1994 letter, we have determined that a more detailed discussion may be helpful to clarify the application of tax to underallowances on trade-ins.

As explained in our October 7, 1994 letter, when a used automobile is traded in on the purchase price of a new automobile, the dealer accepting the trade-in must include in the measure of tax the amount agreed upon between the seller and the buyer as the allowance for the merchandise traded in. (Reg. 1654(b)(1).) "Should, however, the board find that the allowance stated in the agreement is less than the fair market value, it shall be presumed that the allowance actually agreed upon is such market value." (*Id.*)

Generally, the allowance stated in the agreement between the seller and buyer will be accepted as the amount to be included in the measure of tax. However, if the allowance stated in the agreement is less than the fair market value, the stated value will not be accepted if there is sufficient evidence to establish that the underallowance on a trade-in was not a bona fide transaction between the seller and the buyer; that is, the dealer deliberately underallowed the trade-in value of an automobile to reduce the measure of tax. A dealer's intent to evade paying the proper amount of tax due may be evidenced by, among other things, recorded trade-in allowances that are consistently below market value and which are not attributed to trade-in automobiles that are in less than fair condition; gross profit margins that are consistently lower on transactions involving trade-ins than on transactions without trade-ins and which are not attributed to business practices pursued by the industry, such as trades on loss-leader automobiles, or trades during promotional sales; and a widespread pattern of underallowances

occurring consistently throughout the audit period. Under such circumstances, the board would tax the underallowance as additional gross receipts and consider whether a 25 percent intent to evade penalty should be imposed. (Rev. & Tax. Code § 6485.)

Additionally, if an underallowance is an isolated transaction, the board would examine whether the difference in the trade-in value and the fair market value listed in the Kelley Blue Book is attributable to the condition of the particular automobile. If a dealer underallowed the value of the trade-in because the automobile was in less than fair condition, the underallowance would not be subject to tax. However, if a dealer deliberately underallowed the trade-in value of an automobile to reduce the measure of tax, the underallowance would be taxed as additional gross receipts and the board would consider whether a 25 percent intent to evade penalty should be imposed. (Rev. & Tax. Code § 6485.)

In summary, an underallowance will be taxed under circumstances where the underallowance was the result of a dealer deliberately structuring a transaction to reduce the measure of tax. By doing so, the board would redetermine the fair market value of a trade-in only in situations where a transaction is structured for the purpose of evading tax, rather than a transaction where the dealer has negotiated a good deal.

If [R] has distributed copies of our October 7, 1994 letter, we would appreciate it if you would make the same distribution of this letter so that the recipients may receive this clarification with regard to the application of tax on underallowance on trade-ins. If you have any further questions, please feel free to contact me at (916) 324-2614.

Sincerely,

Sophia H. Chung  
Tax Counsel

SHC:rz

cc: San Francisco District Administrator (BH)