M e m o r a n d u m

140.0500

To: Mr. William D. Dunn
Audit Program Manager

Date: December 21, 1995

From: Sophia H. Chung
Staff Counsel

Subject: Underallowance on Trade-Ins

This is in response to your memorandum to Gary J. Jugum, Assistant Chief Counsel, dated October 6, 1995. The Legal Division's opinion regarding the taxation of an underallowance on a trade-in constituting part of the consideration paid for a new automobile is set forth below.

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).) Regulation 1654(b)(1) provides that, "[s]hould, 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." Accordingly, if an underallowance on a trade-in is the result of a bona fide transaction between the seller and the buyer, additional tax should not be computed on the underallowance. Under such circumstances, the fair market value of the trade-in is presumed to be the price actually agreed upon by the seller and the buyer. (See Hawley v. Johnson (1943) 58 Cal.App.2d 232.) The board should not redetermine the fair market value of the automobile merely because the agreed upon price is below the price listed in the Kelley Blue Book. Likewise, the board should not, and does not, redetermine the fair market value of a trade-in when the agreed upon price is above the price listed in the Kelley Blue Book.

However, an auditor may rebut the presumption provided in Regulation 1654(b)(1) that the agreed value of the trade-in represents the fair market value if there is sufficient evidence to establish that the dealer deliberately underallowed the trade-in value to reduce the measure of tax. Under such circumstances, the board should tax the underallowance as additional gross receipts and a 25 percent intent to evade penalty should also be imposed. (Rev. & Tax. Code § 6485.) The taxpayer's intent to evade 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.

If an underallowance is an isolated transaction, further examination is necessary to determine 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 the dealer underallowed the value of the trade-in because the automobile was in less than fair condition, the underallowance should not be taxed. However, if the dealer deliberately underallowed the trade-in value to reduce the measure of tax, the underallowance should be taxed as additional gross receipts and an intent to evade penalty should be imposed thereon.

In summary, the Legal Division's opinion is that an underallowance should be taxed only under circumstances where an intent to evade penalty will be imposed. 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.

SHC:rz

cc: Mr. Gary J. Jugum
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