

490.0000 RETURNS, DEFECTS AND REPLACEMENTS—Regulation 1655

See also Goods Damaged in Transit.

(a) RETURNED MERCHANDISE

(1) IN GENERAL

[490.0016](#) **Arbitration Award.** In 1991, a taxpayer sold computer software to a purchaser pursuant to a sales contract which provided that any disputes between the parties shall be resolved through arbitration. In February 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 the taxpayer and ordered the taxpayer to refund a portion of the purchase price to the purchaser. The taxpayer was ordered to pay the arbitration costs.

In this case, under the 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. The arbitration award at issue herein ordered the taxpayer to refund a portion of the purchase price to the buyer. The taxpayer did not voluntarily refund the purchase price. Thus, the amounts paid by the seller to the buyer in accordance with the arbitration award are analogous to damages paid by the seller to the 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 the taxpayer to the buyer was pursuant to the arbitration award, the taxpayer does not qualify for a defective merchandise deduction under Regulation 1655. 2/6/96.

[490.0030](#) **Interdivisional Returns.** An out-of-state manufacturing division of a corporation transferred tangible personal property to a division located in California for use by the California division. Use tax was paid with respect to the cost of the property to the manufacturing division when it purchased the component parts from third party suppliers. The property proved to be defective and was returned to the manufacturing division. That division replaced the defective property. The taxpayer claimed a returned merchandise deduction for return of the defective property.

Since there was no sale by the manufacturing division, there is no basis for regarding the transfers as being within the provisions for returned merchandise deduction. 8/31/76. (Am. 2000-1).

[490.0034](#) **Manufacturer Replacement.** An out-of-state motor home manufacturer produced a model that was prone to catch fire in the engine compartment. The manufacturer offered for a limited time to exchange these motor homes for other models. The owners would be charged from \$0 to \$35,000 depending on the model they chose for the replacement. The owners were also responsible for tax and license on the new motor home.

A taxpayer purchased the particular model motor home from a dealer in Florida and subsequently acquired the replacement motor home in Iowa after paying the manufacturer an additional \$12,000. The taxpayer subsequently drove it to California and applied for a tax clearance.

This transaction does not qualify under Civil Code section 1793.2 (the Lemon Law) because the customer must be given the option for cash restitution versus vehicle replacement. Also, the customer must be reimbursed for sales tax and license fees on the original transaction. In addition, the original vehicle was not purchased in California and, thus, no sales tax was remitted to California.

This transaction also does not qualify for a returned merchandise deduction since it was not returned to the original seller (Florida dealer). It was returned to the manufacturer. Furthermore, the returned-merchandise deduction is only allowed to the retailer who paid the sales tax to California.

The Iowa dealer made a sale of the motor home in part to the manufacturer (i.e., the portion paid by the manufacturer for the dealer to make the exchange) and in part to the customer (the charge for the upgrade). The charge to the manufacturer is either for resale (if the replacement is pursuant to a mandatory warranty)

or at retail (if the replacement is pursuant to an optional warranty). Even if the latter, since the transaction occurred in Iowa, California tax does not apply because the manufacturer used the property in Iowa by making the replacement. The part of the sale to the customer, the upgrade charge, was a retail sale to the customer. Since the customer purchased that motor home for use in California, it owes California use tax on the upgrade charge. 4/13/94.

490.0035 Merchandise Returned After Extended Use. A telephone company introduces a new line of telephones in touch-tone or rotary dial modes. The telephone company transfers title only to the telephone housing and not to the communications apparatus contained therein. The housing that accommodates the rotary dial features will not accommodate touch-tone and the housings are not, therefore, interchangeable. A touch-tone telephone is useless in a telephone service area with exclusive rotary dial service.

To maintain customers' goodwill, the telephone company has voluntarily adopted the policy of exchanging the customers' used touch-tone model (including both the housing and the communication apparatus contained therein) for an otherwise identical new rotary model completely without charge when the customer moves to a telephone service area with rotary dial service only. This exchange policy applies regardless of when the customers purchased the new line telephones, or the service area is serviced by another telephone company, or the customers move to another state or to a foreign country.

This exchange policy does not apply to customers moving into a touch-tone service area as rotary models are entirely compatible with touch-tone service. The exchange for a new rotary model is of the identical color, design and price as the exchange telephone (unless a price change had been effected during interim in which event there is still no charge). Under the above circumstances, the exchange of the new line touch-tone telephone for a new line rotary telephone is regarded as a returned merchandise transaction. The selling price of the replacement new line rotary telephone must equal or exceed the selling price (inclusive of sales tax) of the new line touch-tone model so that the customer receives full credit for the sales price for the touch-tone model.

Although it could be argued that this transaction should be treated as a trade-in transaction, since the customer may have the use of a touch-tone 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, this transaction is better treated as a returned merchandise transaction. 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. 7/21/75.

490.0040 Option to Resell. Returned merchandise exclusion does not apply to package display stands which the customer resells to the original vendor pursuant to an option in the sales contract. There was not return of merchandise because of objective or subjective dissatisfaction. The exercise of the option to resell does not constitute a return of merchandise as contemplated in section 6012(c)(2). 6/4/57.

490.0070 Repossession of Franchise. A franchisor repossesses a franchise and continues to operate it prior to resale. The repossession by the franchisor in cancellation of the remaining balance on the mortgage does not result in a "sale." If the franchisor does not attempt to resell the franchise, tax will not apply to the franchisor's use of fixtures and equipment therein, unless it can be established that the repossession was a sham. However, if the return of the equipment by the franchisee is eligible for the returned merchandise deduction, a subsequent use by the franchisor would be subject to tax.

When the franchise is resold, the franchisor is liable for sales tax on the sale. 1/4/71.

490.0080 Rescission vs. Second Sale. A rescission, not a second taxable sale, occurred when the buyer of a business defaulted on his fourth installment payment and the buyer and seller agreed that the business be returned to the seller. The retention of the first three installment payments by the seller does not defeat the rescission since such payments can be considered payment for the use of and profits from the business during the period the buyer was in possession. However, the original sale is taxable and no returned merchandise deduction is allowable because the full purchase price was not refunded. 9/4/64.

490.0085 Restocking Charges. To determine the costs of rehandling and restocking for purposes of Regulation 1655, the direct costs of any specific step in the sequence of actions occurring in the retaking of goods and their return to suppliers, are properly included. This would include, where applicable:

- (1) Costs to handle the customer's request for authorization to return the merchandise.
- (2) The cost of freight from customer to retailer.
- (3) The cost of placing property in a special "assemble and hold" area.
- (4) Costs to issue credit memo to the customer.
- (5) Costs to obtain authorization from the supplier for the return of the merchandise.
- (6) Costs of sending merchandise to the supplier.

The above items are illustrative only and not all inclusive. 2/3/75.

490.0088 Returned Merchandise Deduction. For purposes of Regulation 1655(a), a retailer has given "credit" for returned merchandise at the time the credit is entered on his books and the customer is notified in writing that the credit is available for use. It is not necessary for the retailer to wait until the credit has been used by the customer in order to claim the deduction on the retailer's tax return. 8/1/60. (Am. 2000-1).

490.0090 Returned Merchandise Deductions. A retailer sells paint to a customer who is a commercial painter. The paint delivered was incorrect which resulted in a loss of time on the job by the customer. The retailer issues a credit memo for the paint plus an amount to cover the customer's loss of time. Only the portion of the credit allocable to the return of the paint is deductible from gross receipts. The amount credited for the loss of time did not result in a bad debt, defective merchandise, or returned merchandise deduction. 6/21/72.

490.0091 Returned Merchandise Deduction—Conditions. A firm purchases equipment for its own use and uses it. Later it begins negotiations with a third party lender to enter into a sale and leaseback transaction that will not qualify as a financing transaction nor as an acquisition sale and leaseback. The third party lender suggests that, instead of a sale and leaseback, the firm should arrange with the original vendor to "return" the equipment in exchange for a full refund of the original purchase price. The reason the vendor would be willing to refund such amounts is that the third party lender would agree to purchase the equipment for the original purchase price, that is, the amount refunded to the firm. The third party would then lease the property to the firm. The reason for structuring a transaction that otherwise constitutes a sale and leaseback in this fashion is to attempt to qualify for the returned-merchandise deduction.

The original vendor in this transaction is not entitled to a returned-merchandise deduction. A retailer is entitled to a returned-merchandise deduction when, upon return of the property by the purchaser, the retailer refunds the entire purchase price, plus sales tax reimbursement or use tax, and the purchaser is not required to purchase other property at a price greater than the purchase price of the returned property. The retailer is not entitled to the deduction if it imposes other conditions on the refund. For example, no deduction is allowed if the retailer conditions the refund on the purchaser's obtaining a new buyer for the property. Thus, when a retailer will "refund" the original purchase price only if the purchaser arranges for a new buyer to purchase the property at that same original purchase price, notwithstanding that at that time the fair market value of the property may be less than the original purchase price, the retailer is not entitled to a returned-merchandise deduction. 5/12/95.

490.0092 Sale and Leaseback. Vendor sold equipment to consumer in October. Sales tax was paid on the transaction. In December, after having made functional use of the property, consumer contracted to sell the equipment to lessor and lease it back. At that time, consumer gave vendor a resale certificate, and vendor

credited consumer for the amount of “sales tax” included in the original purchase price. Lessor then paid the balance of the invoice to vendor, without payment of any tax or tax reimbursement, and then made a timely election to report tax on rentals payable. The vendor thereafter filed a claim for refund for the sales tax it had paid the Board on its sale to consumer.

Even if there were a valid issue as to whether consumer’s sale to lessor qualified under section 6010.65 or Regulation 1660(a)(3), this issue is irrelevant in determining whether the original sale is subject to tax. Vendor did not take a timely resale certificate. Since consumer functionally used the property prior to selling the property to lessor, vendor’s sale to consumer cannot be regarded as a sale for resale. The vendor cannot claim a returned merchandise deduction under these facts. There must be an unconditional return of the property to the vendor and a full refund of the purchase price. Here, the vendor simply accommodated the consumer, acting as a conduit, by billing the amount remaining due to lessor. Regardless of the documentation the parties might create in order to make the transaction appear to be a return of property followed by a sale to someone else, in fact, there has been no return at all. Even if this type of transaction could be viewed as a return, the vendor accepted that “return” only on the condition that the purchaser furnish a replacement buyer at an equal or greater price than the original purchase price. This cannot qualify for the returned merchandise deduction, and the claim for refund must be denied. 9/28/93. (M99-1).

[490.0093](#) **Sale of Auto.** A purchaser of a new automobile sued the dealer and manufacturer for rescission of the purchase and sales agreement, alleging breach of warranties because the automobile had many defects. The parties entered into a settlement in which they agreed that the purchaser could receive a refund of the purchase price or could credit that amount towards the purchase of another automobile which would cost an additional \$1,000.

If the purchaser chooses the credit, the sale of the second automobile is subject to tax and the credit is regarded as a trade-in allowance for the first automobile. The provisions of Regulation 1655, Returned Merchandise and Defective Merchandise, apply only to transactions voluntarily entered into between the buyer and seller and not to those transactions entered into which are forced by litigation. 10/25/90.

[490.0095](#) **Settlement of Litigation.** When a return of merchandise and a refund of money is made in settlement of litigation, the returned merchandise deduction is not applicable. The amounts returned to a purchaser pursuant to a settlement are in the nature of damages which do not differ in any realistic sense from any other damages paid by the seller as a result of wrongful actions in the conduct of the transaction. 5/3/90.

[490.0100](#) **Storing Property on Seller’s Behalf** , amounts to returning merchandise if other conditions are met. 3/27/51.

(2) “FULL SALE PRICE”

490.0120 **Automobile Registration and License Fees.** An automobile is returned to the selling dealer. The dealer returns to the purchaser the purchase price of the automobile and sales tax reimbursement, but not the registration or license fees.

The dealer would be regarded as returning the full price of the vehicle despite the fact that the dealer retains the license and registration fees. Such fees are not considered to be part of the sales price of the vehicle for sales tax purposes. 4/16/76.

[490.0128](#) **Cost of Trip Not Refunded.** A retailer is engaged in the business of locating new and used machinery for sales to prospective customers. Six machines were located in a distant city. The retailer and the prospective customer journeyed to the distant city to inspect the machines. The prospective customer purchased the six machines with the understanding that they could be returned. The machines were returned and the purchaser was credited for the return less freight and handling and the cost of the trip to the distant city.

In this situation, a deduction for returned merchandise is not allowable since the full sales price as set forth in Regulation 1655(a) was not refunded to the purchaser. Refund or credit of the entire amount is deemed to be given when the purchase price, less rehandling and restocking cost, is refunded to the customer. The cost of the retailer's journey to the distant city is not a rehandling and restocking cost. 9/17/71.

[490.0160](#) **Overhead Cost.** A sells to B two machines. One is sold for \$153,757 plus \$9,994.21 tax and the other is sold for \$155,125 plus \$10,083.13 tax. The total price is \$328,959.34 (which reflects a 5% quantity discount). B returns one machine. In calculating the refund A recalculates the sales price of the machine retained, but the sales price used does not reflect the 5% quantity discount. The difference between the recalculated amount and the total original sale represents the credit (5% quantity discount) allowed.

The returned merchandise deduction is not allowable under these circumstances. Regulation 1655(a) provides that only rehandling and restocking charges may be deducted. In this case the amount deducted from the original sale is not rehandling or restocking. 2/6/90.

490.0180 **Rental Charge.** When a sale of equipment is rescinded and a rental is substituted as a charge for use of the equipment, no refund is allowable. A charge for usage or "rent" is inconsistent with the requirements of section 6012 that for a returned merchandise deduction there be a return of the "full sale price." 5/17/57.

490.0200 **Repossession.** Sale of a freezer and a substantial amount of food on a conditional sales contract was made with a down payment which was less than the price of the food. Upon default in payment of installments, seller repossessed the freezer within 90 days, but could not repossess the food. Seller contended that by foregoing the balance owed on the contract he had returned the full sale price of the freezer to the purchaser. The contract was silent as to the application of the down payment toward either the freezer or the food.

Under these circumstances, down payment is applied pro rata to the sale price of each and the seller has not refunded the full price of the freezer. 11/19/53.

[490.0220](#) **Rescission of Sale.** Where, by mutual agreement, a sale of assets is rescinded and assets are returned to seller, the original sale remained taxable by reason of the fact that the seller retained portions of the purchase price. 12/14/53.

[490.0223](#) **Restocking Is Service.** In order to qualify for a returned merchandise deduction, the retailer must refund the full retail selling price less any restocking charges. The charge for restocking returned merchandise is a charge for service and is not subject to tax. The retailer must refund the full sales tax reimbursement, not merely the tax on the net amount of the credit after the restocking charge. 6/24/88.

[490.0228](#) **Returned Merchandise.** Property was purchased from a retailer with tax reimbursement added to the price. It was subsequently returned to the manufacturer's service center because of unsatisfactory performance. Being unable to cure the defect to the customer's satisfaction, the manufacturer refunded the purchase price to the customer, but did not refund the amount of sales tax reimbursement. Under the Sales and Use Tax Laws, the manufacturer was not required to refund the sales tax reimbursement to the customer.

In addition, neither the manufacturer nor the retailer are entitled to a returned merchandise deduction because the deduction is only available to the retailer if the retailer refunds the entire sale price and sales tax reimbursement to the purchaser. 2/13/90.

[490.0240](#) **Salesman's Commission,** where that is charged customer despite the return of merchandise the full sales price is not returned and accordingly a deduction may not be taken. 4/14/52.

[490.0260](#) **Special Order Merchandise—Returned.** Charges made to a retailer by a manufacturer for the return to the manufacturer of special order merchandise returned for credit by a customer should be regarded as part of the retailer's restocking and rehandling costs. 4/6/65.

[490.0280](#) **Subsequent Billing for Charges.** In order for a retailer to be entitled to a deduction on account of merchandise returned, section 6012 of the Sales and Use Tax Law requires that the “full sale price” be refunded. Where the credit memorandum indicates a refund or credit of the full sale price followed, however, by a billing for a charge designated as delivery, use, or rental, it would appear that in substance the requirements of the statute have not been complied with, regardless of whether the billing is designated as a delivery charge, usage charge, or rental. The fact is that a charge is made to the customer on account of the transaction resulting in the return of merchandise which in substance and effect is not to refund credit to the customer the “full sale price” as required by section 6012. The fact that tax may have been paid measured by the amount of this delivery, usage, or rental charge does not alter the fact that the customer has not received a refund or credit of the full sale price. Whether the customer purchases other merchandise or not would appear immaterial since he pays the full price of the replacement merchandise plus the charge made on account of having returned the original merchandise. If the customer had originally been charged for the delivery of the merchandise and if title to the merchandise had passed to the customer prior to delivery so that under section 6012 the delivery charge would not be a part of taxable gross receipts, then failure to refund the delivery charge would not prevent the taking of a deduction for returned merchandise. 11/7/51. (Am. 2002–2).

490.0300 Tax Reimbursement. An automobile is purchased with the requirement that it contain a certain type of transmission. Delivery is made of a vehicle containing a different type of transmission and the dealer agrees to and subsequently delivers a used automobile of the same year and model containing the transmission desired. Total sales price remains unchanged, the contract being altered only to reflect that it covered the second car.

The second transaction is taxable, but at the same time, retailer is entitled to a returned merchandise deduction which would offset the tax on the second transaction, provided he refunds or credits the purchaser for the amount of tax reimbursement charged on the first transaction. 4/19/54.

490.0320 Trading Stamps. A customer purchases a \$2 article paying 6¢ sales tax and is also given trading stamps which cost the seller 5¢ and which cost is deducted from gross receipts as a cash discount.

The customer returns the merchandise but is unable to return the trading stamps. The seller therefore charges the customer 10¢ for keeping the stamps, and refunds to the customer \$1.96.

The amount of cash discount is the amount paid by the retailer for the trading stamps. Under the example above, the original selling price of the article was, accordingly, \$2.01 and, unless that amount is refunded, the deduction for returned merchandise should not be allowed. 7/17/53.

[490.0325](#) **Trade-In of Defective Aircraft.** A California firm purchased a new 1982 aircraft directly from the factory and paid the California use tax on the purchase price of \$490,000. About a year later, the aircraft was found to be defective which made it unsafe and unsuitable for the purchaser’s use. The purchaser reached an agreement with the manufacturer that the aircraft could be returned. The manufacturer and purchaser agreed that a new 1984 model aircraft would be substituted for the defective older aircraft. The purchaser was required to pay the manufacturer an additional \$60,000 which reflected the difference in value between the defective aircraft \$490,000 and the new aircraft which was \$550,000.

The transaction will not meet the returned merchandise deduction requirements unless the vendor refunds the full purchase price of the original aircraft and does not require the purchase of a replacement greater than the value of the credit given. From the facts presented in this case, the buyer is required to purchase an aircraft of greater value in order to obtain the deduction.

Based on the foregoing, the purchaser would be liable for use tax on this transaction measured by \$60,000 plus the trade-in value of the aircraft. The only amount which may be excluded from the \$550,000 sales price of the new aircraft is the amount which the seller allows or credits against the sales price on account of the defects in the 1982 aircraft. If no allowance or credit was given on account of the defects, no

deduction could be taken against the sales price. Of course, the amount of the allowance or credit for the defect must be reasonable and records must be kept to substantiate the allowance or credit. 1/16/85.

490.0340 Transportation Charges. In order for a lumber retailer to claim a returned merchandise deduction, he must refund the “full sale price.” Since transportation charges to the buyer by carrier are no longer includable in the measure of tax irrespective of where title passes, they need not be refunded in order to claim the deduction. Thus, “full sale price” for purposes of the returned merchandise deduction should be construed to include only amounts required to be included in the measure of tax under sections 6011 and 6012. 11/30/64.

490.0380 Transportation Charges. Deductions for returned merchandise should be disallowed where the seller fails to refund or credit that portion of the sales price represented by delivery charges occurring prior to the sale as well as the tax thereon. The delivery charges referred to are for the delivery of the goods to the customer and not for retaking it.

An additional charge for retaking the goods would not prevent the allowance of the deduction, provided the conditions specified in Regulation 1655. 9/1/53.

490.0400 Unused Portion Returned. If the seller refunds the amount of the sales price and sales tax attributable to the unused portion of paint returned by the purchaser, the seller may exclude from the measure of his tax liability the sales price of the returned merchandise. 6/24/57.

(b) REPLACEMENTS GENERALLY—MAINTENANCE CONTRACTS

Leases, see also Leases of Tangible Personal Property—In General.

490.0420 Agency. The dealer actually furnishing the replacement may be regarded as the agent of the dealer who sold the car, and the sale to such agent may be regarded as a sale for resale. 10/22/52.

490.0429 Bundled Hardware and Software Maintenance Contract (Optional). A contract for optional hardware maintenance is not a contract for the sale of tangible personal property and no sales or use tax applies to the charge. On the other hand, a contract for software maintenance under which the customer will receive updates or error corrections on tangible media is a contract for the sale of tangible personal property. Furthermore, if a software maintenance contract includes a mandatory charge for consultation, that charge is included in the measure of tax from the sale of the software maintenance contract. Therefore, when a bundled contract includes a software maintenance portion and a hardware maintenance portion, the charge for the hardware portion of the contract is nontaxable. The contract should be prorated between the taxable software maintenance portion and the nontaxable hardware maintenance portion of the contract. 7/15/96.

490.0430 Bundled Optional Maintenance Contract. A taxpayer is engaged in the business of selling lump-sum optional maintenance contracts for office computer printers. The taxpayer does not sell the printers. One of the types of optional maintenance contracts the taxpayer sells is a “bundled optional maintenance contract.” Under this contract, the taxpayer maintains the printers, including repair labor and new parts to maintain the printers in working condition. In addition, the taxpayer provides new disposable toner/ink cartridges for the printers as needed. The contract is sold for fixed monthly, quarterly, or yearly amounts, and the fixed amount does not fluctuate due to the volume of either parts or cartridges needed.

The taxpayer’s contract to maintain the printers and to provide new disposable toner/ink cartridges for the printers is the sale of both an optional maintenance contract and of tangible personal property (the toner/ink cartridges) for a lump-sum price. The sale of the optional maintenance contract is not subject to tax. The taxpayer is the consumer of the parts and material furnished in the performance of maintaining the printer in working condition and tax applies to the sale of such items to the taxpayer, or to its use of such property. On the other hand, the toner/ink cartridges are not regarded as materials consumed by the taxpayer in maintaining the printers. Rather, they are sold by the taxpayer and those sales are subject to tax.

An allocation between the taxable and nontaxable charges must be made. Therefore, the taxpayer should segregate on the invoice to its customer, and in its records, the taxable fair retail selling price of the toner/ink cartridges from the nontaxable charges for the optional maintenance contract. 8/26/96.

[490.0432](#) **Bundled Optional Maintenance Contracts—Printers.** A taxpayer offers two types of optional maintenance programs for printers. One provides for the necessary parts and labor to maintain the printer (standard maintenance contract). The other provides for both the standard maintenance contract and also includes disposable toner/ink cartridge as needed. The latter contract is referred to as the “bundled optional maintenance contract.”

The seller of the maintenance contract is the consumer of parts and materials used to maintain the printer under both contracts. However, it is the retailer of the toner/ink cartridges furnished under the “bundled maintenance contract.” The taxpayer should segregate the retail selling price of the toner/ink cartridges in its invoices and its records. 8/26/96.

[490.0440](#) **Credits.** Credits granted by a manufacturer to a car dealer reducing the dealer’s purchase price of replacement parts to an amount equivalent to the purchase price paid by an independent warehouse distributor were held not to represent consideration received for sales where the making of sales at reduced prices to fleet operators normally serviced by distributors was a condition of the adjustment of the purchase price of the parts. 3/14/69.

[490.0460](#) **Lemon Law—Auto Leases.** Although an auto manufacturer is required by the California Lemon Law to repurchase defective vehicles sold or leased to consumers, it is not entitled to refunds of use tax paid back to lessees on such repurchases. Civil Code section 1793.25 was added to the Lemon Law to require the Board to reimburse the manufacturer for sales tax which was included in making restitution to a consumer under the Lemon Law, if the dealer had paid the sales tax on the original retail sale of the subject vehicle. This section pertains only to refunds of sales tax, precluding the granting of refunds of use tax. However, a lessee may obtain a refund of use tax if he received a credit on rentals in accordance with Regulation 1655. The provisions of Regulation 1655 are applicable to leases which are “continuing sales.” 7/31/90.

[490.0477](#) **Optional Service Contract—Replacement Units.** Under an optional service contract, a firm provides next day delivery of a replacement unit for any failed equipment. The repair shop is located outside of California. The replacement unit becomes the customer’s property and the customer’s unit becomes the firm’s property. The unit which is replaced is repaired and becomes part of the replacement inventory. If the unit replaced is not found defective, the customer is charged. The division providing the replacements is located outside of California. The contract falls within the purview of Regulation 1546(b)(3)(C). The firm is the consumer of property used to fulfill its obligations under the contract. Since the firm completes its obligation under the contract when the replacement unit is delivered to the carrier the “use” occurs outside of California. Since no use occurs in California, no use tax is due.

If the unit is not defective and a charge is made, the firm must collect use tax on exchange units shipped to California. 8/5/88.

[490.0480](#) **Real Property—Repairs to.** Lubrication under elevator maintenance contracts is repair to realty and the contractor is the consumer of the oil and other materials used. 1/30/50.

[490.0483](#) **Repair Parts Purchased for Warranty Repairs.** Parts and materials furnished in connection with the performance of mandatory warranties are regarded as sold to the customer as part of the original sale and may be purchased for resale. Parts and materials furnished in connection with the performance of optional warranties are regarded as consumed by the seller. If the seller purchases parts and materials which may be sold or may be consumed and it is unknown at the time of purchase which will be sold, the seller may purchase all such parts and materials for resale. Tax will be due when parts and materials are withdrawn from inventory for consumption. However, parts properly purchased for resale and thereafter used outside the state on optional warranties are not subject to tax pursuant to section 6009.1. If the parts used on optional warranties are of a kind which may not be purchased for resale, the sales tax is applicable

to sales to the warrantor notwithstanding that some of the parts may be used outside the state. The warrantor may not issue a resale certificate for such parts. 4/27/94.

(c) WARRANTIES

Watch repairmen, see also Miscellaneous Repair Operations.

(1) IN GENERAL

[490.0495](#) **Appliances Warranties.** A California appliance service company is hired by an out-of state firm to do appliance repairs in California to fulfill the out-of-state firm's obligations under an optional warranty.

The out-of-state firm is the person obligated to repair the appliance under the optional warranty contract. Thus, it is the consumer of, and must pay tax on, all parts and materials purchased. It is not proper for the out-of-state firm to provide the appliance service company a resale certificate. The service company is the retailer of the parts sold to the out-of-state firm. 12/21/92.

[490.0500](#) **Automobile Warranty.** Replacement parts purchased ex-tax and furnished to automobile purchasers under a factory warranty are not subject to sales tax at the time they are installed in the vehicle, since the tax paid at time of sale of vehicle includes the replacement parts under the warranty. Neither is use tax due on such warranty parts. 10/31/63.

[490.0510](#) **Automobile Warranty.** The unexpired portion of a new car warranty, which a second retail purchaser of the car receives by paying a \$25 transfer fee and which is subject to a \$25 deductible clause, is a continuation of the original mandatory warranty. Amounts billed to the manufacturer for parts and the \$25 transfer fee are not subject to sales or use tax. The pro rata portion of the \$25 deductible charge allocable to parts is subject to sales tax. 10/22/71.

[490.0510.200](#) **Automobile Warranty—\$100 Deductible.** When a new car warranty is subject to a \$100 deductible clause, the \$100 deductible is taxable in accordance with the ratio of parts to labor. 5/15/90.

[490.0510.350](#) **Buyer's Warranty.** A California resident purchased from an Arizona dealer a boat manufactured by a company in Wisconsin. After the purchase, the buyer discovered a crack in the boat. The Wisconsin company agreed to have the crack repaired under a buyer's warranty (i.e., mandatory warranty included in the selling price). The boat was taken to a boat repair shop in California.

Since the crack was repaired under a mandatory warranty, there is no tax owing on the purchase of parts either by the repairer or the manufacturer. The furnishing of parts by the repairer would be a nontaxable sale for resale. The purchaser paid use tax on the purchase price of the boat, including the mandatory warranty, at the time it was registered with DMV. 3/10/92.

[490.0510.925](#) **Lemon Law—Boat Replacement.** The provisions of the California Lemon Law do not apply to the sale of boats. However, the manufacturer or the dealer of the boat may be obligated under a warranty with the customer to replace a defective boat.

When a boat is replaced pursuant to a mandatory warranty, the person obligated under that warranty is regarded as purchasing the replacement boat for resale. No tax is due with respect to the transfer of the replacement boat to the customer because the replacement boat is regarded as having been sold as part of the original sale subject to the mandatory warranty. This is true whether the person obligated under the warranty is the dealer or the manufacturer. Thus, if the dealer is the person obligated under the mandatory warranty and it removes a boat from resale inventory to replace a defective boat, no tax applies to the transfer of the replacement boat to the customer. When the manufacturer is the person obligated under the mandatory warranty, the manufacturer generally purchases the boat from the dealer (i.e., it purchases a boat back that it had sold to the dealer for resale). The manufacturer then instructs the dealer to deliver the replacement boat to the customer on the manufacturer's behalf. The manufacturer is purchasing the boat

from the dealer for resale, and no tax applies to the manufacturer's transfer of that replacement boat to the customer.

On the other hand, if the warranty is optional, the entity obligated under the warranty is the consumer of that boat. The sale to that person, whether it is the seller or the manufacturer, is the taxable retail sale.

If the customer pays a "slight price increase" (i.e., the difference in price between a 1994 and 1995 boat), the increase is subject to sales tax whether the warranty on the boat is mandatory or optional and whether the warranty is from the seller or the manufacturer. 8/7/95.

490.0511 Lemon Law—Business Vehicles. The Lemon Law does not apply to vehicles purchased primarily (more than 50 percent of the time) for business purposes. 5/17/94.

490.0511.100 Lemon Law Effects on Residual Portion of Warranty. If an automobile manufacturer provides that a new car express warranty is available to a subsequent purchaser of a vehicle and that the purchaser is entitled to utilize service and repair facilities in the same manner as is available to the original purchaser, the vehicle will be regarded as a "new motor vehicle" for purposes of the lemon law. 3/6/95.

490.0512 Lemon Law Reimbursement. A manufacturer who claims a refund for tax paid with respect to a vehicle returned under the Lemon Law must pay full restitution in order to qualify for the refund. Restitution must include any transportation charges and manufacturer-installed options, and any collateral charges such as sales tax reimbursement, license fees, registration fees, and other official fees. The amount also includes any incidental damages to which the buyer is entitled, including but not limited to towing, reasonable repairs, and car rental costs. The amount excludes non manufacturer items installed by a dealer or the buyer.

If there is no breakdown of what is being reimbursed, the manufacturer's claim may be granted if the purchaser was reimbursed in excess of the amount computed by the Board as being required restitution. 5/17/94.

490.0512.300 Lemon Law Reimbursement—Court Settlement. A customer purchased a new vehicle from a new car dealer for her personal and family use. About a year after purchasing the vehicle, the customer filed a complaint against the dealer and distributor of the vehicle in a Superior Court in California. In the complaint, the customer alleged that she began experiencing numerous problems with the vehicle and that the vehicle was defective. The complaint further alleged: (1) breach of implied warranty under the Song Beverly Act, Civil Code section 1792; (2) breach of express warranty under the Song-Beverly Act Lemon Law, Civil Code sections 1793.2(d) and 1794; (3) breach of obligation imposed by the Song Beverly Act; and (4) against the dealer only—negligence in repair.

The parties subsequently entered into a settlement agreement which provided that the customer would release any interest that she had in the vehicle and dismiss her complaint and to release the distributor and the dealer from any claims, demands, actions, etc., asserted in the lawsuit or otherwise relating to the vehicle. In return, the distributor agreed to pay the customer the amount paid for the vehicle less an amount for damage to the vehicle. The distributor also agreed to pay the attorney fees and costs of the customer. The settlement agreement also provided that it was a compromise of a disputed claim and that the execution of the agreement and payment of the consideration would not be deemed to be, nor construed as, an admission of an inability to service or repair the vehicle, as admission of a breach of warranty, or as admission of any other liability to the customer. The distributor of the vehicle then filed a claim for refund of sales tax reimbursement that it refunded to the customer under the California Lemon Laws.

A manufacturer is entitled to a refund under Civil Code section 1793.25(a) if the payment made to the customer is restitution under Civil Code section 1793.2(d)(2)(B). The fact that provisions in the settlement agreement state that the manufacturer does not admit any nonconformity or failure to comply with the repair, disclosure, or warranty requirements of Civil Code section 1793.22(f)(1) does not preclude a finding that the settlement was pursuant to the Lemon Law and thereby prevent a refund to the manufacturer under Civil Code section 1793.25. In this case, it can be reasonably inferred from the facts that the payment made

to the customer was restitution under Civil Code section 1793.2 (d)(2)(B) and, thus, the refund should be allowed. 10/13/95.

[490.0513.075](#) **“Lemon Law”—Taxability of Mileage Charge.** Under the “Lemon Law” the manufacturer must pay an amount equal to the actual price paid or payable by the buyer, including any sales tax and any incidental damages to which the buyer is entitled. The manufacturer may deduct for usage of the defective vehicle and the amount must be deducted from the original vehicle selling price before calculating the sales tax refund. In other words, the “charge attributable to use” is subject to tax. Any refund or credit for sales tax previously paid is limited to the net amount of the credit or refund after the “charge attributable to use.” 7/12/93.

[490.0515](#) **Optional Warranties.** Optional warranties may be provided by other than the seller of the property. A repairer who enters into a warranty contract which is not required as part of the sale of tangible personal property is providing an optional maintenance contract under Regulations 1546(b)(3) and 1655(c)(3) whether or not that person was also the seller of the property for which the warranty is issued. That person is the consumer of materials and parts furnished in performing the repairs and tax applies to the sale of such property to the repairer or to the use by the repairer of that property. 8/23/90.

[490.0515.010](#) **Optional Warranties.** A seller of equipment also sold optional lump-sum maintenance agreements to its customers. This seller then subcontracted the actual maintenance work, also for a lump-sum amount. Irrespective of whether the optional maintenance agreement was purchased from the seller of the equipment or from some other party, the sub-contractor actually doing the repair work is the consumer of the parts used because that subcontractor was performing repairs under the optional maintenance agreement it sold. 10/21/88.

[490.0516](#) **Repair and Service Contracts.** Company A installs, services, and repairs computer disks which are manufactured by B, a related corporation. B sells the disks it manufactures to original equipment manufacturers (OEMs) for incorporation into computers sold to consumers. The OEMs and their dealers provide warranties to the consumers of the computers. These warranties may be included in the sales price of the computer (i.e., mandatory warranties) or may be optional warranties. The OEMs and dealers may, in turn, contract with A to perform necessary repairs.

If A’s contract with the OEMs and dealers provides that A is reimbursed based on repairs actually performed, whether on a time and material basis or on a standard amount per unit actually repaired (general repair contracts), the type of warranty between the OEMs/dealers and the end customer is relevant. Whether A is a seller or a consumer of the parts and materials furnished is determined under the general rules of Regulation 1546 (b). When A is the seller, it is making a sale for resale if the repairs are pursuant to the OEM’s or dealer’s mandatory warranty; A is making a taxable retail sale when the repairs are pursuant to an optional warranty.

However, when A’s contract with OEMs and dealers provides that A (who is not the seller of the computer disks to the OEMs or dealers) is reimbursed on a flat fee basis (e.g., A is paid a fixed amount for each warranty which it undertakes to fulfill, or a lump-sum annual fee based on units sold), the maintenance contract between A and the OEMs/dealers is considered an optional warranty or maintenance contract. As such, A is the consumer of the parts and materials furnished. This would be true whether the OEMs’ or dealers’ warranties with their customers were optional or mandatory. 8/23/90.

[490.0517](#) **Replacement of Motorhome—“Lemon Law.”** When a manufacturer replaces a motorhome pursuant to Civil Code section 1793.2, more commonly known as the “lemon law,” the replacement motorhome is considered a “replacement under warranty.” The tax liability is measured by any amount that customer pays in excess of the credit received. If the value of the replacement property is less than the credit received for the original property, the customer must be refunded the difference, including applicable sales tax reimbursement.

Replacement pursuant to litigation qualifies for this treatment only if it satisfies all the requirements of Civil Code section 1793.2. Thus, the manufacturer would be required to pay, or to reimburse the buyer, for

the amount of any license, registration or other official fees which the buyer is obligated to pay in connection with the replacement of the motor vehicle portion of the motorhome. Otherwise the replacement of the motorhome does not come within the provisions of Civil Code section 1793.2, and the transfer of the replacement would be considered a taxable sale. 5/14/90.

490.0520 Returned Merchandise. Where a small loader was exchanged for a larger one pursuant to express and implied warranties given on the sale of the smaller unit, a returned merchandise deduction is proper. The buyer has an election of remedies upon breach of warranty, one of which was the return of the purchase price. Therefore, the conditions requiring refund or credit for the full purchase price and the buyer not required to purchase an item of equal or greater value are met. 6/9/65.

490.0530 Road Hazard Warranties—Tires. A tire retailer has an optional road hazard warranty on new tires. This warranty only covers road hazards such as running over a piece of glass and has nothing to do with defects in the materials. When a customer comes in with a road hazard claim, the amount charged the customer would be a pro-rated amount based on the remaining percentage of tread left on the old tire. If the tire can be repaired, it would be repaired without cost to the customer.

Since the warranty is optional, the retailer is the consumer of parts and materials furnished in the performance of the warranty, and sales or use tax applies to the sale of such items to the retailer, or to the use of such property. Thus, when the retailer provides its customer with a new tire under the optional warranty, the retailer must report and pay use tax on the cost of that portion of the tire covered by the warranty and report the pro-rata charge to its customer as a taxable sale. 2/6/95.

490.0540 Solicitor (or His Assignee)—of Warranties, not sold originally with sets, is consumer of parts or materials furnished pursuant to such warranties. 4/25/51.

490.0560 Television Sets. Under a lump-sum agreement the picture tube of a used television set is replaced, the balance of the set is overhauled, new parts installed where needed, and the parts and labor are guaranteed for one year. The repairer is the retailer of whatever parts are furnished, whether originally furnished or pursuant to the warranty. The transaction involves exempt repair labor. Sales tax applies to the sale price of the parts, same to be determined by the fair retail price of such parts. 10/21/55.

490.0563 Third Party Service Repair Contracts. A taxpayer located in California performs third party service/repair calls for customers. The taxpayer is hired by customers who are located out of state and have no employees in California. The taxpayer is hired to perform repairs on products which are covered by some type of maintenance agreements issued by its customers.

If the taxpayer's customers contract for the repairs because they are obligated pursuant to optional maintenance agreements, they are the consumers of the parts the taxpayer sells. Therefore, the taxpayer's sales of parts to them are retail sales and sales tax applies to such charges for those parts. If taxpayer's customers are obligated pursuant to mandatory maintenance agreements, they are the retailer's of the parts they purchase. Thus, taxpayer's sales of the parts to them are nontaxable sales for resale.

When the repair service is performed on office equipment owned by the federal government, the application of the tax is the same as explained above. Although sales of tangible personal property directly to the United States are exempt from sales tax, this exemption does not apply here since the taxpayer will not be making the sales to the United States. Rather, taxpayer's sales of the parts are to the out-of-state customer under either an optional or mandatory maintenance agreement. (Regulations 1546(b)(3)(A) and 1655(c)(1).) 1/28/94.

490.0571 Optional Maintenance Contracts. The repairer is the consumer of tangible personal property used in the performance of optional maintenance contracts on property owned by the U.S. government, even if the contract contains a title clause declaring that title passes to the owner of the item being repaired upon installation to that item, and even if the repairer makes no use of the property other than installation to the item being repaired. 8/22/90; 5/29/96.

(2) WARRANTY CHARGES—WHEN INCLUDABLE IN TAX MEASURE

490.0580 Insurance. Warranty insurance charges, if required from the customer at the time of sale, form part of the purchase price and are subject to sales tax; if the insurance is optional, the charges are not part of the sales price and no tax is due. 12/13/63.

490.0583 Mail Order Form—Preprinted Insurance Charge. When a retailer who sells property via mail order preprints a charge of \$1.50 for insurance on a separate line in the total column on its order form, the charge is includable in the measure of tax as a mandatory charge. The fact that some customers may cross out the charge and refuse to pay it does not make it optional. For a charge to be truly optional for purposes of the Sales and Use Tax Law, the order form must clearly and unequivocally state that the charge is optional and may be crossed out by the customer. 10/2/97. (M98–3).

490.0585 Maintenance Contract—Optional vs. Mandatory. The fact that a purchaser with significant economic power is able to lease property without a maintenance contract is not indicative of whether a maintenance contract is optional or mandatory. A seller may have different policies for preferred customers. If non-preferred customers are required to contract for a maintenance contract, such contracts are mandatory and part of the gross receipts. 12/18/92.

490.0600 Manufacturer. A warranty issued by a manufacturer of appliances for which a charge is made to the retailer who passes the charge along to the customer, the amount of the charge is included in the measure of tax as an integral part of the sale, and is subject to the tax. (Distinguished from optional television warranties.) 12/19/52.

490.0620 Parts Furnished by Dealer Under Used Car Warranty. An automobile dealer sells optional warranties to purchasers of qualified used cars on behalf of the manufacturer of the cars. The premiums are paid over to the manufacturer. When a purchaser makes a claim on the dealer for service under the warranty, he is required to pay the dealer a maximum of \$25. The dealer performs the warranty work, making out an invoice with separately stated charges for parts and labor, which he submits to the manufacturer. The manufacturer pays the dealer the amount of the billing, less the \$25 paid by the purchaser. Under such circumstances, the original premium paid by the purchaser for the warranty is not part of the dealer's taxable gross receipts. The dealer, however, is the retailer of the parts furnished under the warranty and sales tax is applicable to the selling price of such parts. 11/30/66.

490.0630 Performance Bonds. A taxpayer manufactures and sells fire trucks. Some buyers require the taxpayer to obtain performance bonds in order to assure that the trucks perform to specification. The bond is in the taxpayer's name. The cost of the bond is passed on the buyers as a separate charge on the invoice.

Since the bond is not required by the taxpayer as a condition of the sale, the charge is regarded as a charge for an optional warranty. The charge passed on to the buyers is not subject to tax. 2/23/95.

490.0660 Service Guarantees on Automobiles. The sale of automobile guarantees as a part of the sale of the automobile it warrants should be treated for tax purposes in the same manner as are television warranties, that is, any amount charged for the warranty should be included in the taxable measure. However, when the warranty is sold on a strictly optional basis, the tax does not apply. The sale of parts by the repairman to the guarantor are considered as being made to a consumer and therefore taxable. 7/18/57.

490.0680 Service Policies. Where an appliance dealer sells a television service policy in the nature of an optional warranty (not mandatory upon purchaser), even if sold with the set, or as a "second-year" policy, it is a service contract not includable in taxable gross receipts. The dealer is regarded as the consumer of any parts used in performing this independent service. 5/21/54.

490.0700 Service Protection Contract. A separate charge for a service protection contract which is actually an optional labor and parts warranty, does not constitute taxable gross receipts from the original sale of an appliance. 5/10/60.

[490.0720](#) **Service Warranty.** A mandatory charge for a service warranty on tangible personal property must be included in the gross receipts from the sale of the property, whether or not the charge is separately stated on the customer's billing. 5/12/66.

[490.0727](#) **Software/Hardware Post-Warranty Service Agreement.** Taxpayer, in connection with sale of network computing products including workstations, servers, software and microprocessors, offers customers post-warranty services on a contractual basis after the initial product warranty has expired. The post-warranty support services are offered through a four level multi-tiered program. Each level of support is sold for a single price and provides the customers with bundled hardware maintenance, operating system enhancements, and specific software telephone/on-line support, including patches and enhancements.

Since the customers are offered an optional lump-sum service agreement for both hardware and software maintenance, the service agreement is regarded as both an optional maintenance agreement on the equipment as well as an optional maintenance agreement for the software. Tax does not apply to that portion of the "hardware only" support agreement which relates to actual hardware maintenance. However, tax does apply to that portion of the agreement which represents the charges for the maintenance of the operational programs (software) since such software maintenance agreements consist of providing updates in tangible form (on storage media) to a prewritten operational program. Tax also applies to charges for consultation services (i.e., technical support) related to the operational program maintenance agreement unless the consultation is optional and such fees are separately stated. (Regulation 1502(f)(1)(C).) 4/22/97. (Am.2008-1).

(Note: Effective January 1, 2003, 50 percent of the charge for optional software maintenance agreements is subject to tax. Prior to that date, generally 100 percent of the charge was subject to tax.)

[490.0740](#) **Television.** The retailer of a television set who sells a parts warranty to the purchaser, which warranty is mandatory, is required to return the tax to the state on the total charge, inclusive of the charge for the warranty. The charge for the warranty is properly regarded as a part of gross receipts from the sale of tangible personal property and the tax does not apply with respect to the furnishing of replacement parts by the retailer pursuant to the warranty. The sale of such parts as are furnished pursuant to the warranty will be regarded as included within the original sale, and such parts may, of course, be bought by the retailer under a resale certificate and he does not become liable for the tax on the cost thereof.

In the event the parts warranty is optional, the seller of the warranty should be treated as the consumer of such parts, materials, and supplies as he may furnish under the warranty subject to tax measured by the purchase price of such parts, materials, and supplies to him. 5/20/50.

(d) DEFECTIVE MERCHANDISE

[490.0745](#) **Automobiles.** A dealership sells a new vehicle and collects sales tax reimbursement from the customer. After several repairs, but short of meeting what the dealer believes to be the Lemon Law requirements, the customer requests that the manufacturer refund the purchase price without legal litigation. The manufacturer, through the dealership, refunds the purchase price and all applicable sales tax to satisfy the customer.

If the vehicle is defective and the dealer cannot repair it to conform to the applicable express warranties, the refund may nevertheless qualify as a lemon law restitution in accordance with subdivision (d) of civil code section 1723.2. The reasonable repair attempts requirement of the Lemon Law is an upper limit on how many times the manufacturer has attempted to repair the defect before the restitution and replacement provisions of the Lemon Law apply. It is not a lower limit on when the manufacturer and purchaser may agree that a Lemon Law defect exists.

The refunding may also qualify as a returned merchandise deduction. The main question to be answered is who contracted with the customer to make the refund. If the dealer made the refund literally on behalf of the manufacturer and the agreement for the refund was entered into between the manufacturer and the customer, no deduction for returned merchandise is available. On the other hand, if the person actually

entering into the agreement to refund the money to the customer was the dealer and the dealer made the refund on its own behalf, the returned merchandise deduction is available if all of its requirements are satisfied. This is true without regard to any agreement between the manufacturer and the dealer for reimbursement to the dealer of the amount the dealer refunded to the customer. 6/19/95.

490.0748 **Defective Merchandise.** A refrigeration compressor which ultimately fails as the result of many years of productive use and not because of a defect inherent in it when it was first sold is not eligible for defective merchandise credit when it is turned in on the purchase of a replacement compressor, even though some credit may be allowed by the retailer. Such a credit would be in the nature of a trade-in which may not be deducted from the selling price of the replacement compressor. 1/28/69.

490.0750 **Defective Trailer.** A firm purchases a trailer in September 1992. The trailer was defective and after numerous attempts to fix the problem, the dealer agreed to replace it. A new trailer with a sales price of \$18,105 was furnished. A credit of \$9,400 for the "trade-in" was allowed. The manufacturer paid \$8,705 on account of the defective condition of the first trailer. The firm paid \$1935.55 which covered sales tax and registration fees.

The appropriate amount of sales tax due on the transaction is measured by the sales price (\$18,105) less the amount credited by the manufacturer on account of the defective condition of the trailer (\$8,705). The dealer should refund the excess tax reimbursement and file a claim for refund. 2/25/94.

[490.0760](#) **Drilling Bits.** A retailer who sold a carbide-tipped bit which proved defective upon initial use, sold the customer a new bit, and subsequently refunded the entire selling price of the original bit, including sales tax reimbursement, was entitled to take a deduction for defective merchandise. Where the retailer sold a bit which the customer damaged after substantial use and subsequently sold the customer a new bit, giving credit for the selling price of the original bit, less a charge for use thereof, the retailer was not authorized to take a deduction for defective merchandise under Regulation 1655 nor for returned merchandise under Regulation 1655. 12/17/64.

490.0780 **Lease with Purchase Option.** Equipment was leased with option to purchase, the lessor electing to report use tax measured by his rental receipts. When the lessee exercised his option, the lessor reported sales tax measured by the option purchase price. The equipment proved defective; the lessor replaced it, charging the lessee an amount equal to the original lease payment, plus option purchase price and giving full credit for the rental payments and option purchase price previously paid. Under such circumstances, the lessor was entitled to take the deduction for defective merchandise when he reported the sale of the replacement equipment. 7/2/65.

490.0800 **Trade-In Involved.** When an allowance is made for defective merchandise which is also accepted by the retailer as part payment on the purchase of other merchandise, the value of the merchandise traded in its defective condition must be included in taxable gross receipts. The retailer may claim a defective merchandise allowance, but must not include therein the trade-in allowance made for the merchandise. 11/12/64.

490.0820 **Trade-In Allowance.** A battery with a 24-month guarantee is purchased for \$20 plus 60¢ tax. The battery fails at the end of 12 months. The customer returns the defective battery, worth \$1 as junk, and is given a defective merchandise allowance of \$10. A new battery is sold to the customer for \$10 plus 30H tax. In computing gross receipts the retailer should regard the \$1 junk value of the defective battery as a trade-in allowance and the remaining \$9 as a defective merchandise allowance. In the alternative, the defective merchandise allowance could be regarded as \$10 provided the trade-in value of \$1 is added to the taxable gross receipts from the second sale. 6/25/58.