State of California Board of Equalization

# M e m o r a n d u m

**330.2790**

To: Mr. Jack E. Warner
Out-of-State Auditing

April 12, 1990

From: David H. Levine
Tax Counsel

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Subject: C--- F--- C---
SS-- XX XXXXXX

This is in response to your memorandum dated March 5, 1990. You have forwarded a memorandum from your New York district office regarding two different transactions, and you ask our opinion.

Merger Transaction

C--- C--- C--- (C---) was a wholly owned subsidiary of C--- F--- C--- (F---). C--- had 11 wholly owned subsidiaries, one of which was C--- C--- L--- S--- (L---). On December 31, 1986, C--- was merged into its parent F---, the surviving corporation. Simultaneously, approximately 75% of the assets previously owned by C--- were transferred by F--- to L---, whose name was then changed to C--- C--- C--- (New C---). The indebtedness assumed by F--- in the merger was retained by F---, and an equivalent amount was treated as a loan to New C--- in connection with the transfer of assets and was set up as an intercompany payable account. That is, New C--- did not assume the actual indebtedness previously owed by C---.

The auditor as concluded that the merger of C--- into F--- is not subject to tax, but that the simultaneous transfer to New C--- is subject to tax to the extent of the assumed liabilities. The auditor reviewed several opinions from the Legal Staff, including Assistant Chief Counsel Gary Jugum's April 29, 1988 memorandum concerning the application of the Macrodyne case. The auditor concluded that all of the conditions of Macrodyne were met except that the assets of the entire division (which had previously been C---) were not transferred to New C---. The auditor therefore concluded that Macrodyne did not apply and that the sale was subject to tax. Since the audit will require considerable time to conduct, the auditor has requested a legal opinion prior to proceeding.

**Note:** Macrodyne was overruled by Beatrice v. SBE, which makes clear that any assumption of liabilities is consideration. DHL 6/18/97.

Based upon the ruling request made by F--- to the IRS dated October 21, 1985 and the ruling issued by the IRS, it appears that the merger between F--- and C--- was a statutory merger in compliance with the statutes of each of the two states of incorporation. Therefore, we agree that the merger transaction was not a sale subject to sales tax. (Reg. 1595(b)(3).) We also agree that the Macrodyne case does not apply to the transfer by F--- to New C---.

As explained in Mr. Jugum's memorandum, we do not believe that Macrodyne applies to a situation where less than all of the assets of a division is transferred to a wholly owned subsidiary. However, there is an even more basic reason that Macrodyne does not apply. New C--- did not assume the actual liabilities of F--- associated with the transferred assets. As disclosed in the ruling request to the IRS, the very reason for this transaction was to release C--- from liability for that indebtedness. Under the agreement dated December 31, 1986 between F--- and New C---, New C--- assumed an intercompany debt to F--- in an amount equal to the liabilities assumed by F--- in the merger. That is, F--- carried the financing for its sale to New C---. Macrodyne applies only in certain cases of assumed liabilities, and not in cases where new debt is created between the buyer and the seller, such as in this case.

This type of analysis is no longer necessary since Macrodyne is no longer valid. There was assumption of indebtedness and thus a sale. No further analysis is required. DHL 6/18/97.

Since Macrodyne does not apply, the transaction is subject to sales tax unless a specific exemption applies. Based upon the facts presented, the relevant exemption is provided by Revenue and Taxation Code sections 6006.5(b) and 6367. To qualify for this occasional sale exemption, F--- must have transferred substantially all (at least 80%) the assets it used in the course of activities requiring a seller's permit, and the ownership after the transfer must be substantially similar to that which existed before the transfer (at least 80% unchanged). (Reg. 1595(b)(2).)

Since New C--- is a wholly owned subsidiary of F---, the second prong of the test is satisfied. I assume that F--- held tangible personal property for use in the course of activities requiring a seller's permit other than the assets previously held by C--- and that F--- did not transfer at least 80% of all such assets to New C---. This means that the first prong of the test is not satisfied, and tax applies to the sale to New C--- because it does not qualify for the occasional sale exemption.

A final note is that if the only tangible personal property used by F--- in selling activities were those assets previously held by C---, then further analysis would be necessary. The percentage of assets transferred to New C--- was 75% of all assets (tangible personal property and, probably, other property) previously held by C---, and not necessarily 75% of the tangible personal property used in selling activities (it is possible that 80% or more of the tangible personal property previously held by C--- was transferred).

MTE Transactions

C--- (the auditor refers to this person as F--- after noting that C--- appears on all the documents) purchased MTE from T--- B--- S--- [T---] for lease to T--- B--- [B---] who subsequently subleased the MTE to T--- B--- Service. C--- purchased the MTE ex tax and did not report use tax measured by fair rental value. The notation "Tax Exempt Resale #SR -- XX-XXXXXX" (the seller's permit number of T--- B---, Inc.) appears on the invoices from T--- to C---.

An addendum to the agreement between C--- and B--- contains a terminal rental adjustment clause (TRAC). In the event B--- does not exercise the option to purchase the MTE at fair market value at lease termination, he is responsible for soliciting prospective purchasers and for the difference between the realized sale proceeds and the residual value of the equipment as set forth in the lease addendum. C--- contends that TRAC clause leases are sales at inception rather than true leases.

The auditor believes that the transaction between C--- and B--- is a true lease since B--- has an option not to purchase the equipment at the end of the lease term, notwithstanding some obligations of solicitation and responsibility for sale proceed differences. The auditor also notes that C--- claims depreciation tax benefits associated with the equipment. The auditor believes that if the transaction is a sale at inception, C--- could claim it to be a nontaxable sale for resale since it is known that a sublease is involved and that, if the transaction is a true lease, C--- is responsible for use tax as a lessor of MTE.

The lease of MTE is not a sale or purchase of tangible personal property. (Rev. & Tax. Code §§ 6006(g)(4), 6010(e)(4).) Rather, the sale of MTE to a person for the purposes of leasing is a retail sale. Unless the seller accepts a timely and valid resale certificate in good faith, the sale is subject to sales or use tax measured by purchase price. T--- apparently did not take a valid resale certificate with respect to its sale of MTE to C---. Therefore, unless T--- can establish that C--- resold the MTE prior to use, it appears that sales tax is applicable to the transaction. If C---'s lease with B--- is actually a sale at inception, then T--- will be able to establish that it sold MTE to C--- for resale to B---. Otherwise, T--- made a retail sale because C--- was a lessor (consumer) of MTE.

We have previously considered a lease with the following provisions to be a sale at inception:

> "Lessee is required to purchase the units for ____% of the purchase price (balloon payment) or sell the units to a third party and remit the balloon payment to the lessor. If the latter option is elected, and if the proceeds exceed the balloon payment, the lessee keeps the excess. If the proceeds are less than the required balloon payment, lessee is required to make up the difference; however, lessee will not have to pay an amount in excess of ___% of the purchase price. In addition, the lessors will not claim any deduction, credit, or exemption with respect to the leased property for federal or state income tax purposes."

This lease was regarded as a sale at inception because the lessor would not retake possession at the end of the lease term: the lessee was required to purchase the leased property or sell that property, in effect, for the lessee's own account. The facts regarding depreciation were relevant only because the issue was whether a sale-leaseback would be regarded as a financing transaction. (See Reg. 1660(a)(3).) That is, whether income tax benefits are taken by a lessor has no relevance if the only question is whether the transaction is a sale at inception. (Reg. 1660(a)(2).)

In the lease at issue, the lessee has an election to purchase all, but not less than all, the property subject to the lease schedule at fair market value. If the lessee elects not to exercise the option, the lessee is required to solicit bids for the leased units from third parties. If the realized value (the option price or the amount paid to the lessor upon sale to a third party) is less than the estimated residual value of the MTE as specified in the lease, then the lessee must pay the amount of that difference to the lessor. If the realized value of any unit exceeds that unit's estimated residual value as specified in the lease, then the lessor pays the lessee an amount equal to that excess. If the unit is not sold within 30 days after the end of the lease term, the realized value is regarded as zero (i.e., the lessee pays the lessor the residual value). If the property is thereafter sold, the proceeds are refunded to the lessee to the extent of amounts paid to the lessor with respect to that unit (if the lessee had paid the lessor the residual value, as required, the lessee apparently retains all sale proceeds).

My understanding of this agreement is that the "leased" property is never returned to C---. Thus, this agreement is similar to the lease mentioned above, and we believe that this agreement is also a sale at inception. Under the agreement, we would regard the interest held by C--- as merely a security interest, and when the MTE is sold to a third party, we would regard B--- as being the actual seller to the third party. However, please note that this conclusion is based on the understanding that the provisions of the contract provide that possession of the MTE is never returned to C--- (i.e., that the parties interpretation of the contract is the same as my understanding). If this understanding is incorrect and it is possible for C--- to retake possession without there being a default, we would likely regard this contract as a true lease.

C--- has contended that this lease is a sale at inception. Based upon the analysis above, we agree. Thus, the sale by T--- to C--- was a sale for resale. Since C--- sold the MTE to B---, and since B--- acquired the MTE for purposes of leasing (I assume by a lease which is not a sale at inception), we conclude that C--- made a retail sale of the buses to B---. Unless C--- took a valid and timely resale certificate, or unless B--- timely reported tax measured fair rental value, we believe that C--- owes sales tax on its sale of MTE to B--- measured by the full contract price, less the deductions allowed under Regulation 1641.

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