State of California **Board of Equalization**
Legal Division (MIC:82)

M e m o r a n d u m

395.1881

To: Mr. Jack E. Warner
Out-of-State District Principal Auditor

Date: November 14, 1990

From: David H. Levine
Senior Tax Counsel

ATSS 485-5550
(916) 445-5550

Subject: P---, Inc.
SS --- XX-XXXXXX

This is in response to your memorandum dated October 26, 1990 regarding the application of tax to sales to commencing corporations which involve consideration in the form of an assumption of liabilities. Your questions relate to a memorandum to you from Out-of-State's New York Office.

P--- transferred assets to a wholly-owned commencing corporation that assumed all liabilities on the books of the business that was transferred. The taxpayer has referred to the language of subdivision (b)(4) of Regulation 1595 stating that the measure of tax is the amount of assumed liabilities "attributable to the tangible personal property transferred." The auditor's questions relate to the meaning of this phrase. He sets forth the following five categories of liabilities about which he inquires:

> "1) Pension fund liabilities – we are not sure if these liabilities are funded or not. Per the t/p the purchaser of a business is required to assume these liabilities by state law. Would this make any difference? These liabilities, it would seem, are held in trust for the employees and we are wondering if they are properly includable in all cases or only under certain circumstances (i.e. funded vs unfunded amounts) or not at all.
>
> "2) Tax withholdings (sales, income and payroll) – Again, these amounts would seem to be held in trust for payment to the appropriate authorities. Would this fact have any bearing or are these amounts includable without regard to their nature?

"3) Capitalized leases – T/p has a large payable on the books from a capitalized lease. We are trying to determine whether this was from a true lease or a conditional sale. If the transaction was a true lease we do not believe that this item should be included in any of our calculations as you cannot sell what you do not own. If this was a conditional sale for sales tax purposes then we feel that the item is includable.

"4) Sales Rep Buyout Agreement – As the new owners wanted to use their own sales force, as a condition to the purchase the seller had negotiated a deal to buy out certain rights that their commission sales agents had. These amounts were paid by the new corporation and constituted a major part of the liabilities assumed. Should these amounts be included in the consideration.

"5) Real Estate Mortgages – Although this is not an issue in this audit would such mortgages be included in the consideration received for tangible personal property even though the assets that they attached to are not taxable?"

You and the auditor both note that we have always considered all assumed liabilities to be part of the consideration for a sale to a commencing corporation. However, you also note that this area is not without some doubt. You ask for clarification. The basic rule you state is the correct rule. All assumed liabilities are regarded as part of the consideration for the sale. However, there are certain amounts that would not be considered part of the "assumed liabilities."

Contingent liabilities that will be incurred after the sale for benefits that will be received after the sale are not assumed liabilities within the meaning of subdivision (b)(4) of Regulation 1595. An example would be an existing lease which the new corporation takes over. If the rental payments are always made in advance (e.g., on the first day of each month for that month's possession of the premises), then the commencing corporation would not be making a rental payment for benefits received by its predecessor. Thus, if the sale occurs on December 31 and on January 1 the commencing corporation makes a rental payment for the month of January, that rental payment is not part of the assumed liabilities for purposes of subdivision (b)(4) of Regulation 1595 because the commencing corporation is making a payment for benefits it will receive and not a payment for benefits its predecessor had already received. On the other hand, if rental payments were made on the first of the month for possession of the premises for the previous month, then the payment in the previous example by the commencing corporation on January 1 would be part of the assumed liabilities since the payment would be for benefits its predecessor ahd received prior to the sale. There are other agreements that would be treated in the same manner which are often referred to as operating agreements. These might include requirement and output contracts with third parties for benefits and liabilities not yet received or incurred.

Applying this rule to the pension fund liabilities, if the commencing corporation is assuming existing liabilities of the pension fund, those amounts would be used in calculating the measure of tax. Thus, if the commencing corporation assumes liabilityies that exist regardless of future services provided by the employees, those amounts are assumed liabilities used in calculating the measure of tax on the sale within the meaning of subdivision (b)(4) of Regulation 1595. On the other hand, if the commencing corporation is responsible for liabilities associated with benefits not yet received, those amounts would not be used in calculating the measure of tax. Thus, if the employer is required by the pension fund agreement to make payments into the pension fund for each month an employee works, amounts which the commencing corporation will contribute for periods in which the employee will perform services for the commencing corporation are equivalent to amounts paid under operating agreements for benefits not yet received. Those amounts would not be used in calculating the measure of tax on the sale to the commencing corporation. This same analysis applies to tax withholdings described in paragraph 2 above as well as leases described in paragraph 3, provided those leases are not debts for conditional sales but rather involve future rental payments for future possession of the leased items.

From the description of the sales rep buyout agreement, it appears that those amounts would be included in calculating the measure of tax on the sale. (We note that the description of this agreement is not sufficient for us to be certain that we understand the transaction.)

All liabilities that are assumed as part of a single sale of assets are included in calculating the measure of tax without regard to whether they originally arose from the purchase of, or are secured by, tangible personal property. The first step in calculating the measure of tax is to calculate the total amount of consideration paid for the sale. We then calculate the percentage of tangible personal property sold at retail as compared to all other items sold (for example, real estate, good will, tangible personal property sold for resale). The percentage of tangible personal property sold at retail is multiplied times the total consideration to reach the "consideration attributable to the tangible personal property transferred" within the meaning of subdivision (b)(4) of Regulation 1595.

An example of this analysis would be assets transferred to a commencing corporation in exchange for the first issue stock and an assumption of a $1,000,000.00 liability secured by the real estate. The tangible personal property is transferred free and clear and constitutes a fair market value of one-half of the total assets transferred. The consideration attributable to the tangible personal property transferred is $500,000.00. If the facts are the same except that the real estate is transferred free and clear and the $1,000,000.00 assumed liabilities arose from the transferor's purchase of the tangible personal property and is totally secured by that tangible personal property, the measure of tax remains $500,000.00.

On a different subject, in reviewing P---'s central file, I noticed something somewhat unusual. Through the last quarter of 1988, the returns reported over $4,000,000.00 in gross sales, with some amounts claimed as exempt. No amounts were claimed as for resale. The returns were signed by J--- B---, Tax Accountant. Beginning with the first quarter of 1989, gross receipts were reported at about one tenth that previously reported, and all sales were claimed as for resale. The returns were signed by R--- C---, Controller. I recognize that this might involve the sale (or resale) to the commencing corporation and that in any event the auditor will pick this up, bu I thought I would call it to your attention anyway.

If you have further questions, feel free to write again.

DHL:wak
2593C