STATE OF CALIFORNIA

BOARD OF EQUALIZATION

395.2155

In the Matter of the Petition for Redetermination of State and Local Sales and Use Taxes: C--- A--- S--- CORPORATION Petitioner	DECISION AND RECOMMENDATION OF HEARING OFFICER Account No. SR -- XX-XXXXXX-010

The above-entitled matter came on regularly for hearing on Tuesday, January 30, 19XX at 10:30 a.m., in Downey, California.

Appearances:

For Petitioner:	Mr. M. K. J---, Controller M--- – C--- Corporation
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For the Board of Equalization:	Mr. Don Farness, Supervisor Long Beach District
	Mr. R. Kamnikar, Auditor Lon Beach District

Protest

Pursuant to a close-out audit of Petitioner's records covering the period from April 1, 1967 through June 30, 1970 and a determination issued on December 17, 1971, Petitioner protests the following items:

Item	Measure of Tax
Sales of tooling:	$55,036
Ex-tax purchases of tooling consumed:	15,0830
Sales of assets to M--- – C---:	$224,413

Contentions

Petitioner contends that the sales of tooling ($55,036) which included three separate transactions were exempt for the following reasons:

1. G--- tooling, $10,771, amounted to rework on G---'s tooling and amounted to labor only which was not taxable

2. B--- H--- invoice, $16,700, was an R & D government contract for the U.S. Army and therefore not taxable

3. F--- – H---, $27,565, was or involved a U.S. Government prime contract and therefore not taxable.

With respect to the tooling consumed, it was contended originally by Mr. C---, Controller for C--- A--- S---, that it was computed incorrectly and included nontaxable items such as labor rework.

It should be noted that originally this item was measured by $185,549 and after a reaudit it was reduced to $72,491. Of the $72,491 Petitioner did not protest $56,661 thus leaving the measure at $15,830. Following is Petitioner's computation of the amount not protested:

> "The total tooling sales of $508,036 determined by the auditor on Schedule 10C is at selling price and bears no readily ascertainable relationship to cost. The company, during the period April 1, 1968 through June 30, 1970, purchased tooling of $327,521 per schedule from the general ledgers, of which $297,406 was purchased from Profile. Therefore the tooling consumed should be computed as follows:
>
> 327,521 X 17.3% or 56,661
>
> "Part of the problem arises from the fact that the sales invoices not only include purchased tooling, but also C--- generated items such as labor expediting charges, rework, changes and labor set-ups as well as a mark-up for G & A and profit."

Finally, with respect to the sale of assets to the parent corporation, M--- – C---, Petitioner contends this was not a sale, but a bookkeeping transfer that was subsequently reversed.

SUMMARY

During the period covered by the audit, Petitioner was a corporation engaged in the business of fabricating and selling aircraft component parts and sales of tooling.

The three sales described above under Petitioner's contentions (G---, B--- H--- and F--- H---) were included in the audited determination and deemed taxable sales for the following reasons:

G---: The auditor noted that the tooling rework amounted to additions and not repair and restoration of worn tooling. Therefore, the work amounted to fabrication labor which under subsection (b) of Section 6006 of the California Revenue and Taxation Code is a sale.

B--- H---: Invoice No. 4332 (copy in work papers) merely indicates the $16,700 was for tooling to produce part No. 625-010-006-1 Spar as identified on OMTR No. 902640. Nothing was produced to support any exemption such as this being a sale to the U.S. Army or a sale for resale to B--- who sold the tooling to the Army. Thus, the auditor had no basis for concluding it was an exempt sale.

F--- H---: This item is much the same as the B--- H--- situation. Nothing has been produced to support an exemption except a letter from the F--- people which reads as follows:

> "Since the terms and conditions as contained in our purchase order has a clause TAXES which reads 'Unless provided to the contrary hereunder, the price of this Purchase Order <u>includes all Federal, State and Local taxes</u>,' any Sales Tax which may be applicable would be your liability.
>
> "For your information purchase orders which contain the numbers 168P, 169P and 181 were placed under Government Prime Contracts and title to the tooling <u>is or eventually will</u> be vested in the United States Government and therefore may be exempt from California Sales Tax."

The auditor included the self-consumed tooling because he stated it represented tooling not billed to customers but was consumed and amortized over the sales prices of parts. In other words, the Petitioner did not sell the tooling but instead recovered costs by pricing the sales of the parts in such a way that the customer paid for the tooling.

Following is Petitioner's explanation of the sales of assets and the reasons why it should not be deemed taxable:

<u>Corporate History:</u> At June 30, 1969, M--- D--- Corporation was merged into C--- M--- Co., Inc. (Petitioner herein) and the name was changed to C--- A--- S--- Corporation. At June 30, 1970 (the close of the audit under consideration) C--- A--- S--- Corporation was merged into the parent, M--- – C--- Corporation and operated from that date on as a division of M--- – C---.

C--- M--- Co., Inc., originally operated two plants (--- and ---, Washington) while M--- D--- Corporation had one plant (---) until 1969 when a plant was opened at ---, California.

--- and --- were closed on June 30, 1970, and the --- plant was closed on June 30, 1971. Thus, everything was conducted at --- after the closings.

It was the intention of management to transfer equipment from the closing plants to ---, as the opportunity arose. In order that the books would not reflect a chaotic situation because of the corporate and divisional change, it was decided that the equipment transfers from the closed plants to --- (all equipment belonging to Petitioner) would be handled through a gathering account on the M--- – C--- Corporation books and a rental charge for depreciation would be billed Petitioner at ---. As of July 1, 1970, all equipment from the corporate gathering account was transferred to the division through an intercompany charge which was immediately forgiven and became part of the divisional equity. (Petitioner on June 30 was merged into M--- and became a division of that entity.)

On May 1971, the rental charge as well as all other corporate charges were forgiven. Therefore, at this time, the situation existed as if all the equipment transactions had gone directly to the division in the first place. The delays ensued because the plants could not be closed as quickly as projected and the corporate and divisional legal work took more time than anticipated.

Petitioner contends that, however, only book entries were made with no payments, and even these entries were reversed through the forgiveness technique.

The auditor noted that when Petitioner was a corporation and therefore a separate legal entity separate and apart from M--- – C--- Corporation, assets were transferred to the books of M--- and the transfers were recorded by setting accounts receivable (Petitioner) and payable (by M---). The transfers were made in June 1960. Following the transfers, M--- depreciated the equipment as its own capital asset and paid the property tax on it.

In June 1970 there was a statutory merger wherein Petitioner was merged into M---. At the time of the merger nothing had been paid to Petitioner for the assets transferred and no sales tax had been reported and paid by Petitioner to the state when the assets were transferred in 1969. Presumably, no tax was paid because the corporate officials did not consider the transaction taxable or that they did not consider that any sale was intended since there was to ultimately be a statutory merger of the two entities.

CONCLUSIONS

Sales of tooling:

G---. No evidence was presented to support a conclusion that the labor was to repair and restore worn-out tooling. Accordingly, it is presumed that the audited liability is correct.

B--- H---. No evidence was produced to support a conclusion that the sale to B--- should be exempt from sales tax. Accordingly, it is presumed that the audited liability is correct.

F--- H---. The letter from the purchaser, F---, contains inconclusive statements and is not evidence to support a conclusion that the title to the tooling passed to the United States before any one made use of it. Thus, it is presumed that the audited liability is correct.

Consumed tooling. Nothing was offered to support an exemption from use tax on the tooling in question. Again, it is presumed that the audited liability is correct.

Presumption of Correctness. A certificate of delinquency carries with it the presumption that the Board's determination is correct. The taxpayer has the burden of proving not only that the determination, based upon his records, is incorrect, but also of producing evidence from which another and proper determination may be made. People v. Schwartz (1947) 31 Cal.2d 59.

Sale of assets to M--- – C---. When the assets were transferred to the books of M--- – C--- and a receivable and payable recorded on the respective books of the transferor and transferee there was, at that moment, a sale. Tax was due and payable on that transaction with the return that covered the period when the transfer occurred. The State of California became a creditor as far as the tax was concerned.

No tax was reported and paid with the return that covered the period when the sale occurred. Subsequently, the seller was merged into the buyer, and this happened before any rescission of the sale or cancellation and forgiveness of the debt occurred.

> The sales price at which a wholly owned subsidiary corporation sold property to its parent or to another subsidiary constituted "gross receipts" of the wholly owned subsidiary where the buyer and seller were operated as separate corporate entities and the buyer gave the seller credit on its books for the amount of the sales price. Northwestern Pacific Railroad Co. v. State Board of Equalization (1945) 21 Cal. 2d 524.

> The exchange of assets between two affiliated corporations to effect a territorial division of a business is a retail sale. Pacific Pipeline Construction Co. v. State Board of Equalization (1956) 49 Cal. 2d 889.

Petitioner appears to believe that no sale occurred because the transferor was a wholly owned subsidiary of the transferee, and no sale was intended even if one did occur. Further it appears that Petitioner feels that the whole thing became a nullity because of the statutory merger and subsequent reversal or forgiveness of the debt created when the transfer was made.

> In interpreting a business transaction for tax purposes the taxing authority is not necessarily bound by the language the taxpayer chose to describe it or by the bookkeeping entries chosen to record it; but a taxpayer does not have the same freedom to disregard the form he has chosen for a business transaction as does the government in applying taxing statutes to the transaction. W.E. Hall Co. v. Franchise Tax Board (1968) 260 Cal. App. 2d 179; Moline Properties v. Commissioner of Int. Rev., 319 U.S. 436 (87 L.Ed. 1499, 63 S.Ct. 1132.)

In summary the transfer of the C--- A--- S---' assets to M--- – C--- Corporation was a credit sale notwithstanding the relationship of the two entities. This brings up the second issue which relates to the effect of a statutory merger on the creditor-debtor relationship when the creditor is merged into the debtor.

Section 4116 of the California Corporations Code provides that upon merger or consolidation pursuant to this article (Title 1, Div. 1, Part 8, Chapter 3, Article 1) the separate existence of the constituent corporation (merged corporation) ceases, and the consolidated or surviving corporation shall succeed, without other transfer, to all the rights and properties of each of the constituent corporations, and shall be subject to all of the debts and liabilities of each, in the same manner as if the consolidated or surviving corporation had itself incurred them.

In Mutual Building & Loan Association of Pasadena v. Wiborg (1943) 59 Cal. App. 2d 325, the court, in considering the above referenced section, said at page 323:

> By virtue of the merger, the separate corporate existence of Title Guarantee suffered the fate of all merged corporations, to wit, they became a part of the muscle and the bloodstream of the mergee corporation transfusing into the mergee all of its (their) rights and privileges.
>
> * * *
>
> While the Title Guarantee merger with Title Insurance caused it to lose its identity as to its separate existence, yet it became an integral part of Title Insurance, and carried with it all of its rights, powers, liabilities, and assets except the indicia and attributes of a corporate body, distinct from that into which it is merged.

When Petitioner was merged into M--- - C---, M--- C--- acquired all of the liabilities of Petitioner. One of them was a debt for tax owed to the State of California as a result of the sale that occurred almost a year earlier, and on which no tax had been reported and paid. That debt was not extinguished by reason of the merger as far as the state is concerned.

Suppose, for example, that the principals of C--- A--- S--- had recognized the transfer as a sale and had reported and paid the sales tax on it. Then, in the course of events the statutory merger occurred as it did; it goes without saying that the surviving corporation would not be entitled to a refund of that sales tax paid to the state.

As far as the creditor (Petitioner herein) and the debtor (M--- - C---) is concerned, liability for the debt was extinguished by operation of law the instant Petitioner was merged into M--- - C--- because the surviving corporation became both a creditor and a debtor. However, as pointed out, the liability to the state for tax owed by Petitioner before the merger was not extinguished by the merger. It became a liability of M--- - C---.

The only way, under the Sales and Use Tax Law, to get around the liability for the tax owed the state (M--- – C---'s ;liability after the merger) would be via the bad debt or returned merchandise routes, and the merger wiped out both possibilities because the creditor-seller ceased to exist as a separate legal entity. In other words, there was no longer a debt (after the merger) and without it there could not be a bad one. M--- - C--- could not declare it as a bad debt for income tax purposes when the creditor also became a part of the muscle and bloodstream of the mergee corporation.

Finally, in answer to Petitioner's explanation as to why the transfers were made when they were and were handled as they were we refer to the case of Freeman v. Commissioner (1962) 303 F.2d 580, wherein the court said:

> In matters of tax liability, substance is generally preferred to form and is often determinative of tax consequences; however, if a taxpayer having a choice of methods of accomplishing an economic or business result pursues a particular method he must abide the tax consequences of his choice even though another method would have resulted in less severe or nonexistent tax consequences.

In sum, it is concluded that the transfer of assets from Petitioner to M--- – C--- Corporation was a sale giving rise to sales tax liability, a debt owed to the State of California, which was not extinguished by reason of the merger wherein Petitioner was merged into the purchaser.

RECOMMENDATIONS

Redetermine; make no further adjustments to the audited liability.

	FEB 23 1973
Robert H. Anderson, Hearing Officer	Date

REVIEWED FOR AUDIT:

	3-1-73
Principal Tax Auditor	Date