STATE OF CALIFORNIA

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
---.) No. ---
)
Petitioner)

The Appeals Conference in the above-referenced matter was held by Senior Staff Counsel W. E. Burkett, on January 22, 1992 in Sacramento, California. Because of Mr. Burkett's illness, the matter was reassigned to Senior Staff Counsel, H. L. Cohen. By telephone conversation on September 9, 1992, --- attorney for petitioner, waived rehearing.

Appearing for Petitioner: Director of Taxes

Attorney at Law

Appearing for the
Sales and Use Tax Department: District Principal Auditor

Supervising Tax Auditor

Protested Item

The protested tax liability for the period November 1, 1984 through September 30, 1987 is measured by:

	Item	State, Local and County
D.	Transfer of assets to a subsidiary	---

<u>Contention</u>

Petitioner contends that the transfer of assets was part of a statutory merger which is not a sale and is therefore not subject to tax.

<u>Summary</u>

Petitioner is a corporation which is engaged in leasing business equipment and automobiles. It began business in November of 1984.

On August 1, 1985, petitioner purchased all of the stock of A, and changed the name of A to B.

The covenants contained in petitioner's indentures governing its publicly issued debt prohibited petitioner from owning a domestic subsidiary that had outstanding debt (other than debt to trade creditors) if the subsidiary was engaged in a "Finance or Finance-Related Insurance Business: as such terms were defined in the applicable debt covenants (a "Finance Subsidiary"). To permit the acquisition to occur, A, which would otherwise have constituted a "Finance Subsidiary", acquired from its own subsidiary group (which remained subsidiaries of A after the purchase by petitioner), certain real estate assets in an amount sufficient to avoid classification as a "Finance Subsidiary".

Petitioner's debt covenants also required maintenance of a minimum net worth. Since investments in and advanced to non-Finance Subsidiaries were excluded from petitioner's net worth for debt covenant purposes, petitioner's purchase of A required a charge against its net worth. This charge, taken together with an existing advance by petitioner to another non-finance subsidiary C, would have caused petitioner's net worth to drop below the prescribed minimum.

To deal with this problem, petitioner transferred C to B on August 1, 1985. B then borrowed funds from a third party lender and advanced such funds to C, which in turn repaid $--- of outstanding loans from petitioner. The repayment of these loans increased petitioner's net worth (for debt covenant purposes) by an identical amount and was sufficient to permit petitioner to stay in compliance with its net worth requirements.

Although the classification of A as a non-Finance Subsidiary permitted the acquisition to occur, it was recognized that such a classification would have the effect of substantially limiting petitioner's borrowing capacity in view of borrowing base restrictions contained in the debt convenants for its public and private debt. In general terms, the borrowing base debt covenants limited the outstanding indebtedness of petitioner and its subsidiaries to 500 percent of petitioner's Capital Base (as defined in the indentures). Investments in and advances to Finance Subsidiaries of petitioner were included in determining petitioner's Capital Base, but investments in and advances to non-Finance Subsidiaries were excluded. Accordingly, in order to maximize its Capital Base, and therefore its borrowing power, petitioner determined that B must be reclassified as a Finance Subsidiary.

In order to accomplish the foregoing reclassification, but without violating the debt covenant restrictions which prohibited petitioner's domestic Finance Subsidiaries from having outstanding indebtedness, petitioner determined that it should assume B's outstanding indebtedness, obtain the release of B from liability for such indebtedness, and have B retransfer its real estate assets to those of its subsidiaries which originally held such assets (or possibly to C).

B's public debt covenants did not permit an assumption by petitioner of, and release of B from liability on, B's debt, except through merger, without the unanimous consent of the holders of such debt. The process of soliciting the necessary consents would be very expensive, time consuming and not certain of success. The alternative approach, namely modification of petitioner's debt convenants to either waive the prohibition against Finance Subsidiary indebtedness or permit inclusion of non-Finance Subsidiaries in petitioner's Capital Base, would be equally difficult to achieve, at least within an acceptable time. A substantial portion of petitioner's debt was publicly held (consisting of approximately 25 separate issues) and it was estimated that it might take at least a year to secure the consents required (on an issue-by-issue basis) for any modifications of petitioner's public debt covenants.

Given these considerations, a contractual release of B's debt (or modification of petitioner's debt covenants within an acceptable period of time) was not feasible. However, the B debt covenants did not prohibit a merger of B into petitioner if petitioner, as the survivor of the merger, specifically assumed the liability of B under all of its outstanding debt instruments. Accordingly, to both accomplish the assumption and to maintain the business of B in a separate Finance Subsidiary, petitioner originally proposed to merge B into it and, immediately following the merger, to transfer to a newly formed subsidiary all of the assets and liabilities of B, except for: (1) indebtedness assumed in the merger, which would be retained at the petitioner level, and (2) the real estate assets to be transferred to B's subsidiaries immediately before the merger.

For financial accounting purposes, petitioner would treat the assumption as a loan to the new subsidiary (hereinafter referred to as D in the amount assumed and D would set up a corresponding inter-company payable account. The practical effect of the transaction would simply be to substitute related party debt for the existing B third-party debt. Thus, D would have the same amount of liabilities as B.

C would in all respects be identical to B and would continue to conduct the business of B as it would have been conducted in the absence of the merger except for the debt substitution and real estate asset transfer occurring at and immediately prior to the time of the merger.

On October 21, 1985 petitioner and B filed a ruling request with the Internal Revenue Service seeking a determination that the proposed merger and drop down would be disregarded for federal income tax purposes and the new subsidiary would be treated as the same corporation as the old subsidiary. On August 6, 1986, the Internal Revenue Service issued its ruling, holding that the proposed merger-dropdown would be disregarded.

Before the proposed merger-dropdown could be effected, it became apparent that formation of a D would involve significant administrative difficulties. To avoid these problems, the original plan was amended in two respects. First, rather than form a new corporation and qualify it as required in 50 states, it was proposed that the assets would be transferred to an existing subsidiary of B, “H”, which by virtue of the merger upstream would become first tier subsidiary of petitioner, and which already held certain licenses and was qualified to do business in all 50 states. Second, the terms of certain existing leases and associated funding might have required approvals from others to the transfer back down to D. To avoid these problems, approximately 25 percent of the existing leases would be retained by petitioner, and about 75 percent would be transferred to H. A proportionately reduced amount of inter-company debt would also be assumed by H, which would change its name to E.

On October 20, 1986, B requested confirmation from the Internal Revenue Service that the change in factors would not change the rulings sought. On December 10, 1986, the IRS so confirmed, subject to one amendment relating to Internal Revenue Code (IRC) Section 381. This plan was executed on December 31, 1986.

The auditor regarded the transfer of assets from B to petitioner as not being subject to tax because the transfer occurred as a result of a statutory merger. The auditor regarded the transfer of assets from petitioner to E as a sale by petitioner. The amount to which tax was applied was the sum of all liabilities transferred less an amount for deferred taxes on income. Petitioner agrees that the figures developed by the auditor represent the liabilities transferred. The auditor’s conclusion that the tax applied to the amount of the liabilities transferred is based on the failure of petitioner to meet the requirements of Section 6006.5(b) of the Revenue and Taxation Code. Specifically, petitioner did not transfer to E substantially all of its assets which were used in the course of activities requiring the holding of a seller’s permit.

Petitioner submitted a memorandum dated April 9, 1992 in which it outlined its basis for contention that tax does not apply to the transaction in question. The following paragraphs summarize petitioner’s position.

Sales tax should not apply to the merger of petitioner and B and the subsequent dropdown of E because no sale occurred. A sale is “any transfer of title or possession…of tangible personal property for a consideration.” (Rev. & Tax. Code § 6006(a).) The dropdown of assets to E along with the assumption of debt by petitioner is not a sale within the meaning of § 6006. Consideration is (1) a benefit conferred upon a promisor by a promisee to which the promisor is not legally entitled, or (2) any prejudice suffered by the promisee in order to induce the promisor to enter into a bargain. (Cal. Civ.

Code § 1605.) However, in the case at hand, petitioner incurred no benefit in transferring assets and debt to E. Furthermore, the inducement to petitioner to transfer assets was not the result of a promise or detriment to E but was caused by petitioner's desire to acquire a finance subsidiary without violating certain of its debt covenants and, at the same time, not causing any sort of disruption in such subsidiaries business activities vis-à-vis its customers and creditors. E, as far as its customers and business relationships are concerned, is essentially B. Accordingly, no consideration, as defined under California law, was given in return for the asset transfer and, therefore no sale occurred.

Under certain circumstances, the assumption of a debt can constitute consideration, and a sale can exist where a parent transfers title to a subsidiary corporation in exchange for assumption of debt. See Cal-Metal Corp. v. State Bd. of Equal., 161 Cal.App.3d 759, 766 (1984). However, as demonstrated by the court and Board decisions discussed below, not all transfers of title between related corporations are sales within the meaning of § 6006, even when liability is assumed by the transferee.

Under sales tax law, the following types of transactions are not taxable:

1. Merger. For many years, the Board has treated transfers of title that occur in a merger of two corporations as not constituting a sale, even though the transfer of title is accompanied by a concomitant assumption of liabilities of the disappearing corporation. See Sales and Use Tax Regulation 1595. The reason the Board treats mergers as nontaxable is that the Board regards the transfers of title and assumption of liabilities to occur "by operation of law", by virtue of the provision in the Corporations Code that provides that title to assets of the disappearing corporation in a merger vests in the surviving corporation. It should be kept in mind, however, that a merger is a transfer of title of assets, and liabilities that accompany those assets, to a different corporation, accompanied by a partial change in ultimate ownership.

2. Macrodyne. The decision of the court of Appeals in Macrodyne Indus. v. S.B.E., 192 Cal.App.3d 581 (1987) affords another example of nontaxable inter-company transfers. In Macrodyne, the parent corporation originally conducted business through four operating divisions. Subsequently, the parent transferred three of its divisions into three wholly owned subsidiaries. All of the divisions' assets and liabilities were transferred to the subsidiaries. However, the parent remained jointly liable for the liabilities after they were transferred. The court held that no sales tax could be imposed upon the transfer of assets and liabilities because no benefit was conferred upon the transferor because the transferor remained jointly liable on the debt.

3. Mapo. Mapo v. S.B.E., 53 Cal.App.3d 245 (1975) is instructive. In Mapo, the court disregarded the corporate entity in order to relieve a corporation from paying sales tax when a subsidiary fabricated entertainment devices for its corporate grandparent and the corporation was a "mere instrumentality" of the grandparent. The court stated that the transactions in question were not of the type to which the sales tax was intended to apply. 53 Cal.App.3d at 249.

Mapo is interesting for two reasons. First, the Board's legal staff issued a private ruling holding that the legal existence of Mapo would be disregarded, and the fabrication labor ordinarily defined as a "sale" in § 6006(b) was held not to actually be a sale where the fabrication activities were under the close supervision of the corporate grandparent. The court held the ruling was substantially complied with. Second, the Court was influenced by the fact that § 6006 sales are intended to include transactions between separate entities, and not meant to be a trap for a taxpayer who engages in its normal activities in one form over another, in Mapo for the purpose of streamlining union labor arrangements. In the instant case, the purpose of the reorganization was to restructure outside debt of B as debt of petitioner in order to comply with debt covenants of petitioner.

4. Lockheed Aircraft. In Lockheed Aircraft Corp. v. S.B.E., (LA Superior Ct., May 23, 1980, No. C-163691, aff'd in an unpublished opinion November 25, 1981 (2d Cir. 61030)), the court held the new subsidiaries of Lockheed formed to effect a refinancing scheme were merely a continuation of the parent and accordingly were liable as a matter of law for the liabilities of the selling corporation.

The Lockheed court relied on general California law for the proposition that a successor corporation may be regarded as a continuation of a predecessor corporation. In this connection, see generally Witkin, Summary of California Law, Corporations, §§ 12-23 at pages 524-537. As stated by Mr. Witkin at page 532:

> "If a corporation organizes another corporation with practically the same shareholders and directors, transfers all the assets but does not pay all the first corporation'' debts, and continues to carry on the same business, the separate entities may be disregarded and the new corporation held liable for the obligations of the old." (Citations omitted.)

The Lockheed court cited the California Supreme Court decision in Ray v. Alad Corporation, 19 Cal.3d 22 (1977) as authority. In relevant part, the court in Ray stated:

> "Our discussion of the law starts with the rule ordinarily applied to the determination of whether a corporation purchasing the principal assets of another corporation assumes the other's liabilities. As typically formulated the rule states that the purchaser does not assume the seller's liabilities unless (1) there is an express or implied agreement of assumption, (2) the transaction amounts to a consolidation or merger of the two corporations, (3) the purchasing corporation is a mere continuation of the seller, or (4) the transfer of assets to the purchaser is for the fraudulent purpose of escaping liability for the seller's debts."
> 19 Cal.3d at 28.

E assumed B's liabilities as a matter of California law for each of the first three reasons stated. In addition, the reorganization scheme was not intended to be a fraud on the creditors of B. In the event petitioner could not or would not pay B's debts, E would because the transfers were not intended to impair the position of the creditors and because the failure to pay the debt would result in the creditor repossessing the asset which is owned by E. Moreover, the transaction essentially amounts to a consolidation or merger of B into E.

In discussing the third exception, the Ray court goes on to state:

> "California decisions holding that a corporation acquiring the assets of another corporation is the latter's mere continuation and therefore liable for its debts have imposed such liability only upon a showing of one or both of the following factual elements: (1) no adequate consideration was given for the predecessor corporation's assets and made available for meeting the claims of its unsecured creditors; (2) one or more persons were officers, directors, or stockholders of both corporations."

19 Cal.3d at 29. E was a continuation of B, with the same officers, directors, and stockholders. Creditors and customers of B would have no way of knowing that their continued contact with E was with a new entity having the same name. In fact, E continued the business of B with its customers without interruption and without notifying its customers that a change in entity occurred.

In Ray, the Supreme Court held that these four traditional exceptions did not apply, but still found that a corporate purchaser of a business was liable for tort liability for products manufactured by the seller before the business was sold, where the purchaser acquired the seller's trade name, goodwill, and customer lists, and continued to hold itself out to potential customers as the same enterprise. In our case, E was a continuation of most of the business of B, without change of ownership and operations, and without notification to customers or creditors that a change in entity occurred.

For federal income and California franchise tax purposes, the merger of B into petitioner followed by the dropdown into E of assets accompanied by inter-company debt is regarded as a nontaxable event. E is regarded as a continuation of the business of B.

The ruling received by petitioner from the Internal Revenue Service is consistent with Telephone Answering Service Co. v. Comm'r, 63 T.C. 423 (9174), aff'd without opinion, 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977). In Telephone Answering Service, a corporation planned to sell the stock of its wholly owned subsidiary. In order to avoid recognition of gain on the sale, the corporation liquidated and then reincorporated. The court held that the liquidation-reincorporation should be disregarded for tax purposes because the old corporation was simply the alter ego of the new corporation. In finding the old corporation to be the alter ego of the new corporation, the court considered the following factors: (1) customers were never notified of an interruption of the business; (2) the corporate offices remained unchanged; (3) the stationary and forms remained unchanged; (4) the bank accounts remained unchanged; (5) there were no significant changes in employees; (6) the shareholders were identical. The six determinative factors considered by the court in Telephone Answering Service apply with equal force to the -- liquidation-reincorporation. Accordingly, the reorganization whereby B was merged into petitioner and most of its assets accompanied by related liabilities were dropped down to E is not a "sale" as defined in § 6006.

Analysis and Conclusions

Sales and Use Tax Regulation 1595 provides in subdivision (b)(3) that tax does not apply to a transfer of property pursuant to a statutory merger. It is thus clear that the transfer of property from B to petitioner is not subject to tax.

Subdivision (b)(4) of the regulation provides that tax does not apply to a transfer of property to a commencing corporation in exchange solely for first-issue stock of the commencing corporation if there is no consideration passing from the transferee. If the transferor receives consideration, such as cash, notes, or an assumption of indebtedness, tax will apply based on the amount of such consideration which is attributable to the tangible personal property transferred unless the transaction otherwise qualifies as exempt. The form of the transaction in question is an exchange of property for first-issue stock and book entries recording a debt owed by E to petitioner. Looking strictly to the form of the transaction and the regulation, there has been a sale. The consideration is the amount owing to petitioner shown on the books of petitioner and E. While the Board is not necessarily bound by the form of a transaction, a taxpayer does not have the same freedom to disregard the form he has chosen. See W.E. Hall Company v. Franchise Tax Board. 260 Cal. App.2d 179 and Moline Properties v. Commissioner, 319 U.S. 436. If we look at the consideration from the standpoint of assumption of liability by E, that is regarded as the same as the making of a cash payment. See S.S. v. Hendler, 303 U.S. 564.

Section 6367 of the Revenue and Taxation Code exempts occasional sales from tax. Section 6006.5(b) defines "occasional sale" to include any transfer of all or substantially all of the property held or used in the course of activities requiring the holding of a seller's permit when after the transaction, the real or ultimate ownership of the property is substantially similar to that which existed before the transfer. Subdivision (b)(1) of Regulation 1595 defines "substantially all property" as 80 percent or more of all tangible personal property used in the course of activities requiring the holding of a seller's permit. Real or ultimate ownership is regarded as substantially similar to that which existed before the transfer if 80 percent or more of the ownership is unchanged. While the real or ultimate ownership is unchanged here, petitioner did not transfer 80 percent of the tangible personal property which it owned. Petitioner does not meet the explicit requirements of the regulation. The Macrodyne case cited by petitioner is distinguishable. In that case, the asset transfers were to pre-existing corporations rather than to a new corporation. In addition, Macrodyne has been at least partially limited by Industrial Asphalt Corporation, et al. v. State Board of Equalization, 5 Cal.App.4th 1237. The Mapo case is totally off point. That case involved a corporation which performed work solely for a related corporation. The Lockheed case is unpublished and has no weight as a precedent. It involved a restructuring of a corporation made to avoid bankruptcy. The restructuring was a condition imposed by creditors.

While it is true that certain types of business restructuring result in an assumption of liability through operation of law, that does not apply here. Petitioner acquired the assets and liabilities of B by merger. The liabilities of B passed to petitioner by operation of law because B ceased to exist as an entity. When petitioner transferred assets to E, petitioner continued to exist as an entity. There was an entity to which creditors could look. There was no reason for the liabilities to pass to E by operation of law. Creditors were fully protected without such a transfer.

The fact that the IRS treated the transaction as exempt from income tax has no bearing on sales tax liability. The income tax applies to gains. The IRS agreed there was not gain that would be recognized for income tax purposes. The sales tax applies to sales whether or not there is a gain.

Recommendation

Deny the petition.

11-19-92

H. L. Cohen, Senior Staff Counsel Date