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Executive Director

February 10, 2003

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Re: Request for Opinion Concerning Application of Regulation 1702(a) to Successor Liability for Sales and Use Taxes on Sale by Debtors-in-Possession

Dear Mr. ---:

This letter responds to your July 17, 2002 letter to Assistant Chief Counsel Janice L. Thurston requesting an opinion on the application of California Sales and Use Tax Regulation 1702(a) to successor liability for sales and use tax on a sale by debtors-in-possession. I apologize for the delay in responding to your request. You explain your legal analysis and describe the background for your request as follows.

“By this letter, the [XYZ], LLC, a Delaware limited liability company (‘XYZ’), requests an opinion from the State Board of Equalization (the ‘Board’) that, with respect to XYZ’s purchase of the business assets in the transaction described below (‘Transaction’), XYZ has no successor liability for California sales and use taxes under sections 6811-6814 of the Revenue and Taxation Code (‘RTC’) or under Regulation 1702 because, pursuant to Regulation 1702(a), the Transaction is a type of business transfer under which such a successor’s liability does not arise.

“Factual Statement

“XYZ has acquired substantially all of the business assets, including tangible personal property located in California, of the following four business entities (the ‘Transaction’): ABC-1 LLC; ABC-2 LLC; ABC-3 LLC; and ABC-4 LLC (collectively, the ‘Debtor LLCs’). Each of the Debtor LLCs is a debtor-in-possession under Chapter 11 Case No. 01-XXXXX et seq. (AJG), jointly administrated in the United States Bankruptcy Court for the Southern District of New York (the ‘Bankruptcy Court’). As debtor-in-possession under Chapter 11 of the Federal Bankruptcy Act, each of the Debtor LLCs has all the rights (other

than the right to certain compensation) and the powers of a trustee in bankruptcy. XYZ's purchase of these assets from the Debtor LLCs was approved by an order of the Bankruptcy Court on April 15, 2002 (the 'Order'), whose Exhibit A is the Amended and Restated Purchase and Sale Agreement ('Restated Agreement'), dated April 10, 2002. Amendment No. 1 to the Restated Agreement is dated May 8, 2002. The closing date of the Transaction was May 10, 2002.

"The transfer of the assets to XYZ from the Debtor LLCs was the second step in a two-step integrated transaction, as expressly approved by the Bankruptcy Court. Each of the Debtor LLCs is a limited liability company which is the successor-in-interest to a corporation with a parallel name. These four corporations were ABC-1, Inc. ABC-2 Corp., ABC-3 Corp. and ABC-4 Corp. (As in the underlying documents, these four corporations are collectively referred to here as the 'US Asset Sellers.')

Each of the US Asset Sellers were debtors-in-possession under the Chapter 11 case cited above. As approved by the Bankruptcy Court, each of the US Asset Sellers was merged into a separate limited liability company (already a debtor-in-possession under the same Chapter 11 case), which adopted a parallel name. Thus, ABC-1 LLC is the successor-in-interest to ABC-1 Inc.; ABC-2 LLC is the successor-in-interest to ABC-2 Corp.; ABC-3 LLC is the successor-in-interest to ABC-3 Corp.; and ABC-4 LLC is the successor-in-interest to ABC-4 Corp.

"As a result of these mergers, as a first step, the assets of each of the four US Asset Sellers were transferred to a successor limited liability company, which became a debtor-in-possession within the meaning of the Federal Bankruptcy Act with respect to the assets transferred to it and to be immediately transferred by it to XYZ. As a second step, each of the successor limited liability companies transferred its assets to XYZ, as described above.

#### "Attachments

"For your convenience, a chronology of events is enclosed as Attachment 1. A copy of the Order (without its Exhibit 'A' is included here as Attachment 2. Because the Restated Agreement is voluminous (285 pages including all Annexes and Schedules), the Restated Agreement and its Amendment No. 1 are not enclosed as Attachments to this Request. XYZ will be happy to provide a copy of them to the Board whenever the Board would like to review them.

#### "Statement of Authorities

"RTC Sections 6811 through 6814 impose certain liabilities upon the successors or assigns of a person liable for sales and use taxes who sells out his business or stock of goods or quits the business ('Successor Liability'). The Board has

promulgated regulation 1702 to implement certain aspects of these statutory provisions. 18 CCR §1702. Essentially, the general rule is that the purchaser of a business or stock of goods is required to withhold from the purchase price an amount sufficient to cover the sales and use tax liabilities of the seller until the former owner produces a receipt from the Board showing that it has been paid or a certificate stating that no amount is due. RTC §6811 & 6812(a). As a special rule, if the purchaser makes a written request to the Board for a certificate stating that no amount is due, and if the Board does not (within the time specified) issue the certificate or mail a notice of the amount that must be paid as a condition of issuing the certificate, then the purchaser is relieved from any further obligation to withhold from the purchase price as described above. RTC § 6812(b)&(c) & Regulation 1702(c).

“Successor Liability arises, however, only in the case of certain types of transfers of a business. Regulation 1702(a) provides as follows:

“When Duty to Withhold Purchase Price Arises. The requirement that a successor or purchaser of a business or stock of goods withhold sufficient of the purchase price to cover the tax liability of the seller arises only in the case of the purchase and sale of a business or stock of goods under a contract providing for the payment to the seller or person designated by him of a purchase price in money or property or providing for the assumption of liabilities and only to the extent thereof, and does not arise in connection with other transfers of a business such as assignments for the benefit of creditors, foreclosures of mortgages, or sales by trustees in bankruptcy. (Emphasis added.)

“Further, Annotation 535.0052 considered the case where a buyer and seller entered into an agreement for the sale of certain assets free and clear of all encumbrances, the seller filed a petition in bankruptcy, and the consummation of the agreement was subject to approval and ratification by the bankruptcy court. This annotation concluded as follows:

“Since the transfer of assets was conditioned on approval by the court, the sale did not occur, for sales and use tax purposes, until after the bankruptcy petition was filed. Pursuant to Regulation 1702(a), the requirement regarding withholding the purchase price does not apply to sales made to trustees in bankruptcy. The seller, as debtor-in-possession, has all the rights and powers of a trustee in bankruptcy. Under these facts, the buyer is not required to withhold from the purchase price an amount for the payment of

any sales or use tax liability of the seller. (Emphasis added.)

Opinion Requested

“XYZ is not required to withhold from the purchase price any amount for the payment of any sales or use tax liability of any of the Debtor LLCs or of the corporations to which they are successors in interest.

“Analysis

“With respect to the assets being transferred, each of the Debtor LLCs is (and its predecessor corporation was) a debtor-in-possession under Chapter 11 of the Federal Bankruptcy Act. As debtor-in-possession under Chapter 11 of the Federal Bankruptcy Act, each of the Debtor LLCs has (and its predecessor corporation had) all the rights (other than the right to compensation under 11 USC § 330) and powers of a trustee in bankruptcy. 11 USC § 1107(a). (A copy of the sections from the Federal Bankruptcy Act is included as attachment 5.) The transfer of assets from each of the Debtor LLCs to XYZ (and from the predecessor corporations to the Debtor LLCs) was conditioned upon the approval of the Bankruptcy Court and was approved by the Bankruptcy Court. As a result, the facts in this case are squarely within Annotation 535.0052 and the same conclusion should be reached.”

## **DISCUSSION**

The following is the Board’s response to your request for an opinion. For the sake of clarity and simplicity, I use the same defined terms you used in your letter. The Board agrees with your conclusion that XYZ does not have successor liability for the sales and use tax liabilities of the Debtor LLCs under the specific facts provided in your letter. The Board’s basis for this conclusion is different from XYZ’s basis for this conclusion. The Board believes that XYZ incurred successor liability pursuant to RTC section 6812(a) when it purchased the assets of the Debtor LLCs and did not withhold a portion of the purchase price as required by RTC section 6811. However, the Order provides in relevant part at Paragraph 21:

“Except as otherwise provided in the Agreement and documents executed in connection therewith, the Buyer is not assuming nor shall it in any way whatsoever be liable or responsible, as a successor or otherwise, for any liabilities, debts, commitments or obligations (whether known or unknown, disclosed or undisclosed, absolute, contingent, inchoate, fixed, or otherwise) of the Debtors or the Debtor Sellers or any liabilities, debts, commitments, or obligations in any way whatsoever relating to or arising from the Transferred Assets or the Debtor Sellers’ operations or use of the Transferred Assets on or prior to the Closing Date or any such liabilities, debts, commitments or obligations that in any way whatsoever relate to periods on or prior to the Closing

Date or are to be observed, paid, discharged or performed on or prior to the Closing Date (in each case, including any liabilities that result from, relate to or arise out of tort or other product liability claims), or any liabilities calculable by reference to the Debtor or the Debtor Sellers or their assets or operations, or relating to continuing conditions existing on or prior to the Closing Date, which liabilities, debts, commitments and obligations are hereby extinguished insofar as they may give rise to successor liability, without regard to whether the claimant asserting any such liabilities, debts, commitments or obligations has delivered to the Buyer a release thereof. Without limiting the generality of the foregoing, except as provided in the Agreement and documents executed in connection therewith or by federal statute, the Buyer shall not be liable or responsible, as successor or otherwise, for the Debtors' or the Debtor Sellers' liabilities, debts, commitments or obligations, whether calculable by reference to the Debtors or the Debtor Sellers, arising on or prior to the Closing and under or in connection with . . . (viii) any liabilities, debts, commitments or obligations for any Taxes relating to the business of the Debtors or Debtor Sellers or the Transferred Assets for or applicable to the Pre-Closing tax Period, including any Property Taxes, (ix) any liabilities, debts, commitments or obligations for any Transfer Taxes . . . .”

This language of the Order exonerates XYZ of its successor liability to the Board. This is the basis for the Board's conclusion. The Board does not express an opinion at this time regarding adequacy of notice and due process concerning the Order.

The basis for XYZ's conclusion is Sales and Use Tax Regulation 1702(a) and Sales and Use Tax Annotation 535.0052 (11/2/90). You correctly point out that Sales and Use Tax Regulation 1702(a) provides that the withhold requirement imposed on a successor does not arise in connection with sales by trustees in bankruptcy. Under the facts of this case, the sale was not by a trustee in bankruptcy but, rather, by the Debtor LLCs, acting as debtors-in-possession. You also correctly point out that Sales and Use Tax Annotation 535.0052 (11/1/90) provides in relevant part, “The seller, as debtor-in-possession, has all the rights and powers of a trustee in bankruptcy. Under these facts, the buyer is not required to withhold from the purchase price an amount for the payment of any sales or use tax liability of the seller.” As indicated in this quoted language, the annotation is limited to its specific facts. Furthermore, in the Explanatory Notes section of the Sales and Use Tax Annotations under the heading, **APPLICABILITY OF ANNOTATIONS**, in the second paragraph, it is stated, “Annotations do not have the force or effect of law. Although annotations are synopses of past advice provided by Board's legal staff, the advice is not binding and may be revised at any time.” Thus, the Board is not bound by this annotation.

The Board interprets the plain language of Sales and Use Tax Regulation 1702(a) to be limited to sales by trustees in bankruptcy. If the Regulation had intended to include debtors-in-possession, it could easily have so stated. While it is true that debtors-in-possession have many of the rights, powers, and duties of trustees in bankruptcy pursuant to 11 U.S.C. section 1107(a),

there are significant distinctions. One of the most important distinctions is that trustees in bankruptcy are independent third persons appointed by the Office of the United States Trustee to administer bankruptcy estates. (See 11 U.S.C. §§ 701, 1104(d), and F.R.B.P. and 2007.1.) Debtors-in-possession, on the other hand, are not independent third persons but the same persons that existed before the commencement of the bankruptcy cases and now administering the bankruptcy estates under the legal fiction of debtor-in-possession. (See 11 U.S.C. § 1101(1).) For these reasons, the Board does not agree with your assertion that “pursuant to Regulation 1702(a), the Transaction is a type of business transfer under which such a successor’s liability does not arise.”

Thank you for your inquiry. If I can be of further assistance to you, please write again.

Sincerely,

Bruce A. Emard  
Tax Counsel

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