

# Memorandum

535.0074

To : Mr. Robert A. Leon  
Senior Tax Representative  
Oakland District Office

Date: October 23, 1995

From : Thomas J. Cooke  
Staff Counsel

Subject: K--- W--- C---, Inc.  
Account No. S- -- XX-XXXXXX-001  
B--- H---, Inc.  
Account No. S- -- XX-XXXXXX

Michael P. Kitchen of the Board's Audit Refund Section has forwarded your memorandum to him dated July 28, 1995, to the Legal Section for the legal opinion that you requested.

In your memorandum, you state that you need clarification as to whether a deed in lieu of foreclosure (where there is no foreclosure proceeding pending, or no notice of default filed), is equivalent to a foreclosure. You state that there is a difference of opinion in your district on this question. One view is that it is equivalent to a foreclosure and no successor's liability is warranted. Another view is that the acceptance of a deed in lieu of foreclosure is consideration for the extinguishing of the debt and successor's liability is appropriate.

Successor's liability is imposed under Revenue and Taxation Code section 6812 under certain circumstances when a person purchases a business or stock of goods. If there is no "purchase" within the meaning of section 6812, there is no successor's liability under section 6812. When property is retaken pursuant to certain foreclosures, the transfer is not regarded as a "sale" or "purchase" under the Sales and Use Tax Law. Since certain foreclosures are not regarded as sales, the person retaking property pursuant to the foreclosure is not liable as a successor under section 6812. This is the basis for the statement in subdivision (a) of Regulation 1702 that a successor to a business is not subject to the withhold requirements of section 6811 if the transfer is pursuant to a foreclosure of a mortgage.

Similar to the discussion above, transfers pursuant to foreclosures not constituting “sales” or “purchases” under the Sales and Use Tax Law are not subject to sales or use tax (if there is no sale, there is no sales tax). Thus, the analysis of whether a transaction is a sale for purposes of determining whether sales or use tax applies is the same analysis applicable to the determination of whether there is a sale, and hence successor’s liability, under section 6812 and Regulation 1702. Sales and Use Tax Annotations 365.0040 and 365.0060, which explain when a transfer is a sale subject to sales tax or instead is a foreclosure which is not a taxable sale, is therefore relevant to the question of whether successor’s liability arises:

365.0040 “Where tangible personal property is sold under a purchase money mortgage and the purchaser-mortgagor is in default and the seller-mortgagee reacquires the property, and the only consideration received by the mortgagor is cancellation of the unpaid balance of the mortgage note, the transfer to the mortgagee does not constitute a taxable sale. However, where tangible personal property is subjected to a nonpurchase money mortgage and the mortgagor defaults and transfers his beneficial interest and title in the mortgaged property to the mortgagee in consideration of cancellation of the mortgagor’s obligation, the transfer of title to the mortgagee constitutes a taxable retail sale.” (6/27/67)

365.0060 “Where mortgagors of chattels default in payment, and by agreement in lieu of foreclosure, the chattels became the property of the mortgagee, and the chattel mortgage and original notes are canceled, a taxable sale of the chattels occurs. The measure of the tax is the amount by which the parties agree the indebtedness is reduced.” (3/16/55)

These annotations explain that there is no taxable sale when a mortgagee reacquires property by deed in lieu of foreclosure when the only consideration received by the purchaser-mortgagor is cancellation of the unpaid balance of the mortgage note. Since the purchaser-mortgagor will not be regarded as purchasing the property, it will not be liable as a successor under section 6812. On the other hand, the transfer of property reacquired by deed in lieu of foreclosure by mortgagees who are not also sellers of the property will be subject to tax. Since such mortgagees will be regarding as purchasing such property, they will be liable as successors under section 6812.

In 1989, B--- H---, Inc. executed a “Secured Promissory Note” and a “Corporation Deed of Trust” to enable B--- to borrow \$18,000,000.00 from K--- I--- L--- I--- C---. In 1990, B--- executed a separate “Secured Promissory Note” to enable it to borrow an additional \$2,000,000.00 from K--- I--- L--- I--- C---. Our review of these documents does not permit us to determine if K--- was the seller of the tangible personal property or if these documents constitute a “purchase money mortgage.”

We note that in his letter dated July 21, 1995 to the Board, K--- B. C--- states that “When payments were late, B--- H--- simply deeded the property to K--- in lieu of a foreclosure transaction.”

We also note that the Corporation Quitclaim Deed recorded on September 17, 1993, transfers the property to K--- W--- C---, L.P., an Illinois limited partnership. K--- W--- C---, L.P. was not the mortgagee of the property. Therefore, this quitclaim deed cannot be considered a deed in lieu of foreclosure.

We further note that in the application for a seller's permit executed by K--- W--- C---, Inc. on October 5, 1994, this corporation stated that it paid a purchase price of \$12,700,000.00 for the business.

Only a “mortgagee” can foreclose on property to avail itself of the “foreclosure” exception provided in Regulation 1702(a). If K--- W--- C---, Inc. purchased the property from another entity or if B--- was directed by the mortgagee, K--- I--- L--- I--- C---, to deed the property to another entity in lieu of foreclosure by the mortgagee, K--- W--- C--- cannot claim the “foreclosure” exception provided in Regulation 1702(a).

TJC/cmm

cc: Mr. Michael P. Kitchen (MIC:39)