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July 1, 1996

Re: Request for Legal Opinion
Successor's Liability

Dear _____,

We have your letter of May 13, 1996 for response. You requested a legal opinion, however you did not identify your client. Under Revenue and Taxation Code section 6596(d) only the person making the written request may rely on the board's written advice. Since your client is not identified, it may not rely on the following discussion, which is set out hereafter only as a matter of general information to you.

In your hypothetical you explained that Corporation "A" holds a perfected security interest in corporation "B's" inventory, equipment, receivables, and accounts to secure a promissory note and accounts receivable due from "B" to "A". "A" is contemplating foreclosing on its security interest. "A" is also considering purchasing certain intangible property owned by "B" which is not encumbered by "A's" security interest. The consideration for the purchase of intangibles would be a credit or set off against "B's" indebtedness to "A". If "A" acquires the intangible property of "B" it intends to operate "B's" business using the tangible personal property it expects to acquire through foreclosure. If "A" does not acquire the intangible property, it intends to resell the tangible personal property to an unrelated third party.

I will try to answer your specific questions based on your hypothetical in the order you set them out:

1. If "A" does not transfer any cash to "B", how can it 'withhold' an amount?

This question was answered by the Court of Appeals in *Knudsen Dairy Products Co. v. State Bd. of Equalization* (1970) 12 C.A.3d 47 where the court stated:

"the term "withhold" as used in the statute does not necessarily mean having physical assets in hand, but simply means dealing with the purchase consideration in such a manner as to deny to the seller the benefit of the purchase consideration and to thereby make a portion of it available for the satisfaction of the tax liability."

In a simple case, assume "X" owed "Y" \$100,000. "X" also has unpaid sales tax liability of \$40,000. "X" and "Y" agree that "Y" will acquire the business of "X" for \$80,000, payable by credit against the outstanding \$100,000 obligation. "X" would still owe the remaining \$20,000 to "Y". In that

case, “Y” must pay the \$40,000 unpaid sales tax to the board when it acquires the assets, and it would presumably increase the balance “X” owes it by a corresponding amount, leaving “Y” in possession of the business, the sales tax liability paid, and “X” indebted to “Y” for \$60,000.

2. If “A” cannot “withhold” an amount, can “A” be held liable as a successor?

See above. If the sales tax liability is not paid upon transfer, even if the consideration is solely forgiveness or credit against debt, “A” would be liable under the successor liability provision.

3. If “A” is liable as a successor, in question 2, what is the amount it would be liable for?

A purchaser who fails to withhold is liable for either the amount of the unpaid tax, or the amount of the agreed upon purchase price, whichever is less. (Rev. & Tax. Code § 6812.)

4. If A”A acquires the intangible assets by a reduction of their accounts receivable from “B”, does this then create a successor’s liability situation?

With more, no. Successor liability arises upon transfer of a “business” or “stock of goods.” The intangible assets you described (Leasehold rights and DBA) do not constitute either a business or a stock of goods. However, if the scenario plays out as your described it earlier in your letter, where A acquires not just the intangible assets but also the tangible assets and will operate the business, then we will consider the “business” to have been transferred, and successor liability would apply.

5. If “A” is liable as a successor, in question 4, what is the amount it would be liable for?

The rule set out in the answer to Question 3 applies. In the scenario where both the tangible and intangible assets of the business are acquired by an entity who subsequently operates the business, the measure would be the amount of tax owed, or the value of the purchase price which would include tangible and intangible assets.

6. If “A” acquires the assets of “B” in such a manner as to not be considered the successor of “B” and the assets are subsequently sold to a “third party,” can the “third party” be held liable as a successor of “B”?

If “A” had no tax liability nor successor’s liability at the time of the sale, then the purchaser from “A” has no duty under Revenue and Taxation Code section 6811 to withhold any of the purchase price for the tax liability of “B”.

7. If the “third part” is liable as a successor, in question 6, what is the amount it would be liable for?

Not applicable.

Although not directly addressed by your questions, several other observations seems appropriate to your described situation:

If the tangible assets are actually acquired by a duly conducted foreclosure action, rather than a voluntary surrender or repossession, and “A” is the successful bidder at the foreclosure sale (even if their bid is a “credit bid”), this transaction would fall within the transfers pursuant to foreclosure of a mortgage exception to successor liability contained in Sales and Use Tax Regulation 1701(a). “Mortgage” has the meaning given to it in Civil Code section 2924 and applies to personal property as well as realty.

You should be cognizant of the fact that if “A” is a retailer, as defined in the Sales and Use Tax Law, its sales to a third party of the tangible personal property acquired from “B” at foreclosure will subject “A” to sales tax on the sale. In such case, if “A” does not pay sales tax on that sale, the third party purchaser may incur successor’s liability for any such liability owed by “A” if the sale is found to constitute the sale of a business or stock of goods.

We hope this answers your questions; however, if you need further information, feel free to write again.

Very truly yours,

John S. Butterfield
Tax Counsel