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March 13, 1995

Mr. J--- A. V---, ---.
----, ---- & ---
XXXXX E. --- Street, Suite XXX
---, CA XXXXX

Dear J---:

As we discussed, I wrote a memorandum regarding occasional sales and other transactions covered by Regulation 1595 in connection with the training of our new attorneys. I have reviewed it and determined that it does not contain anything that cannot be released to the public. I am therefore enclosing a copy for use in connection with the Eagles Lodge meeting this month.

Sincerely,

David H. Levine
Supervising Staff Counsel

DHL:cl

Enclosure

cc: Mr. Peter W. Michaels w/copy of enclosure
Mr. E. L. Sorensen, Jr. " " "
Ms. Elizabeth Abreu " " "

State of California

Board of Equalization
Legal Division MIC:82

M e m o r a n d u m

395.0078

To : Sales and Use Tax Attorneys

Date: March 23, 1994

From : David H. Levine

Subject: Rules on Occasional sales
and business reorganizations
and other nontaxable transfers

There are 4 basic steps in analyzing the application of sales and use tax:

1) Is it a sale of tangible personal property?

2) If so, is it a sale at retail [or, if the sale occurs outside California, is the property purchased for use in California]?

3) If so, is that retail sale exempt?

4) If not, what is the measure of tax?

Most of the discussion herein focuses on retail sales of tangible personal property with respect to which we must ascertain whether the sale is an exempt occasional sale. Some of the discussion, however, will concern the first step in the analysis, that is, whether there has been a sale of tangible personal property. If not, of course, no further analysis is necessary: the transaction is not a sale and therefore cannot be subject to sales or use tax (this would not be exempt, it is simply a nontaxable transaction). We will first discuss retail sales of tangible personal property which will be subject to sales or use tax unless exempt.

Please note the importance of correctly categorizing transactions as "exempt sales" or as "nontaxable transactions." One type of nontaxable, but not exempt, transaction is a sale for resale. The reason it is not taxable is that it does not meet our taxing statute (retail sale). Technically, to say that a transaction is exempt is also to say that the transaction is a retail sale. That is, the reason that an exempt sale is not taxable is that the Legislature has adopted

the applicable exemption to exempt that otherwise taxable retail sale. Since a truly exempt sale is a retail sale, the retailer may purchase the property extax for resale if the property is obtained solely for purposes of the exempt sale. Different rules apply when a transaction is nontaxable for reasons other than exemption. That is, the property cannot be purchased extax for resale (unless the reason for the nontaxability is that the property is purchased for resale).

The import of the discussion above is that if a transaction is characterize as "exempt," that should mean that the property can be purchased extax for resale in the exempt sale: no tax on any transaction. When the transaction in question is nontaxable for any reason other than a retail sale exempt by statute, the term "exempt" or "exemption" should not be used. For example, an optometrist is not regarded as a retailer when transferring prescription glasses to clients. (Rev. & Tax. Code § 6018.) Does this mean that the optometrist is making exempt sales of glasses? As explained above, if this were the case, the optometrist could purchase the glasses for resale (no tax), and then make an exempt sale (no tax). However, since the transfer by the optometrist is not an exempt sale, the optometrist may not purchase the glasses for resale. Rather, the optometrist is not regarded as making a "sale" of the glasses. The optometrist is a statutory consumer and the sale of the glasses to the optometrist is the taxable retail sale. Thus, the transfer of the glasses by the optometrist to his or her patient is not an exempt sale; for purposes of the Sales and Use Tax Law, it is not a sale at all.

1. **"Occasional sale" is defined in Revenue and Taxation Code section 6006.5.** Occasional sales are not exempt under section 6006.5, they are just defined therein.

2. Section 6006.5 has three definitions of occasional sale, but since the third, sales of certain property by hay producers, is not a big ticket definition, we will talk about **two definitions of occasional sale**, subdivision (a) and subdivision (b). For ease of reference herein, a reference to an (a) occasional sale means an occasional sale as defined in subdivision (a) of section 6006.5, and a (b) occasional sale refers to an occasional sale as defined in subdivision (b) of section 6006.5. We will return to these critical definitions later.

3. **There are two sections that provide exemptions for occasional sales.** Section 6367 is the provision that exempts occasional sales as defined in section 6006.5, but section 6367 specifically excludes certain sales which are defined as occasional sales under section 6006.5 from the exemption. Section 6281 exempts some of the sales which are excluded from the exemption provided by section 6367. Unlike section 6367, which refers to a particular type of transaction ("occasional sale") which is defined elsewhere in the Sales and Use Tax Law, section 6281 spells out the transactions which it exempts without the need for reference to another provision of the code for subsidiary definitions (i.e., the main definitions of our law are always relevant, such as "sale").

4. Sales of vehicles, vessels, and aircraft are not exempt under section 6367. **Except for a sale of a vehicle, vessel, or aircraft, if the sale is an "occasional sale" as defined in section 6006.5, it is exempt from tax under section 6367.**

5. **Subdivision (a) of section 6006.5 defines "occasional sale" to include a sale of property not held or used by a seller in the course of activities for which he or she is required to hold a seller's permit** or would be required to hold a seller's permit if the activities were conducted in the state. It adds the further restriction that an occasional sale is not a sale which is one of a series of sales by a person sufficient in number, scope, and character to constitute an activity for which he or she is required to hold a seller's permit. This, in essence, is merely a restatement and clarification of the first requirement that the person making the sale not be a seller who has (or needs) a seller's permit with respect to the property being sold.

6. **Anyone who desires to engage in business as a seller in this state must obtain a seller's permit. (Rev. & Tax. Code § 6066.)** If a person who has a permit, or who should have had a permit, sells property used in the course of activities for which the permit was held (or should have been held), <u>that sale cannot be an (a) occasional sale</u>. For example, if someone sells a hardware store to a new owner who will continue the business, the sale of the inventory is a sale for resale (we do not need to analyze the question of whether the sale of the inventory for resale is an exempt occasional sale since it is not taxable in any event). What about the other property that was not being held for resale? The definition of an (a) occasional sale excludes sales of property used in the course of activities requiring a permit. The hardware store's cash register was used in the course of the hardware store's selling activities. Its sale is not an (a) occasional sale. Same with the desk in the back that the owner used to tally the day's receipts, and the shelves, and virtually everything in the hardware store. That is, no part of the sale of the hardware store will qualify as an (a) occasional sale.

7. On the other hand, **sometimes a business has an activity requiring a permit and a completely separate activity which is a service enterprise**. These questions can be difficult. In <u>Ontario Community Foundation, Inc. v. State Board of Equalization</u> (1984) 35 Cal.3d 811, a hospital was sold. The hospital had a gift shop and a cafeteria, and it held a permit for those selling activities. Upon sale of the hospital, we refused to recognize the sale of the service enterprise (the health care aspect, which comprised the substantial portion of the assets sold) as separate from the selling activities, taking a unitary approach (the hospital needed, and had, a permit, and we regarded the assets it sold to have been held or used in the course of activities requiring the permit). The court disagreed, and said that, although the sale of the cafeteria and gift shop assets were taxable, the sale of the rest of the hospital assets qualified as an exempt (a) occasional sale.

After <u>Ontario</u>, we amended Regulation 1595 (see subdivision (a)(3)):

> "SEPARATE BUSINESSES. A person engaged in an activity or activities requiring the holding of a seller's permit or permits may also be engaged in entirely separate endeavors which do not require the holding of a seller's permit or permits. Tax applies to the sale of tangible personal property held or used in the course of an activity requiring the holding of a seller's permit. Tax does not apply to the sale of property held or used by the seller in the

> non-selling endeavors which do not require the holding of a permit. For example, a person may own a hardware store at one location and a real estate brokerage business at another location, with no relationship between the two activities except that of common ownership. Under these circumstances, a sale of furniture used in the brokerage business would not be a sale of property held or used in an activity requiring the holding of a seller's permit. A sale of tangible personal property used in the hardware business would be a sale of property held or used in an activity requiring the holding of a seller's permit."

If a business is sold that is regarded as having a distinct service enterprise that is separate from the selling activity, sales tax applies to the retail sale of the property held or used in the selling activity, but the sale of the property used in the service activity would be an exempt (a) occasional sale (unless property of the service enterprise had been sold in a series of sales requiring a permit - see below). What if there is a selling activity and a separate and distinct service enterprise, but the person collects receipts from both enterprises at the same cash register. This would make it appear as if the service enterprise is not separate from the selling activity: perhaps the sharing of the cash register "infects" the service enterprise with the selling virus, perhaps not. One thing is certain: the sale of the register would <u>not</u> be an exempt (a) occasional sale.

8. **When is a person not engaged in an activity requiring a permit?** If you finally get around to getting a decent 40" TV and you sell your old TV, you probably do not need a permit. I say probably because I am not sure: I do not yet have enough facts. What else have you sold? What else will you sell? The basic rule is that three or more sales in <u>any</u> twelve month period requires the holding of a permit. (Reg. 1595(a)(4)(A).) The "any twelve month period" is like a ruler - you move the ruler back and forth along the time line in which the sale in question occurred, and if you find two other sales within the 12-month ruler, <u>none</u> of them are occasional sales because they were part of a series of sales requiring a permit. That is, when you sell your TV on April 1, to determine whether that sale is an exempt (a) occasional sale, I need to know what other sales you had back to April 1 of last year as well as what other sales you will have until April 1 of next year. If you sold your old computer last November and then sell a dining room table in August, these three sales in a twelve month period would require a permit - none would be exempt.

What about the character and scope requirements? The character requirement essentially is that the sales have to be related in some way, as are the sales above. This requirement is <u>seldom</u> an issue. The scope requirement essentially relates to the selling price of the property. Until recently, this requirement has seldom been an issue <u>for us</u>. It has always been a big issue for affected sellers. I note, however, that Revenue and Taxation Code section 6019 further defines "retailer" to include any person making more than 2 sales in any twelve month period. If we were to rely solely on this section, it would appear that the dollar amount of those sales should be irrelevant. However, the regulation implies otherwise. Subdivision (a)(5)(A)2 of Regulation 1595 states that when a person with a service enterprise makes more than 2 sales of substantial amounts in a 12 month period, those sales are subject to tax.

For example, a person with a large service enterprise sells the business for $50,000,000. Prior to making the sale, it sells office equipment to its employees, cheap. The new Pentium computer went to the office manager for $1000. The 10 new 486 computers went to secretaries for $500 each. The service enterprise makes 10 other sales ranging from $50 to $600, for total miscellaneous sales of $10,000, a very small amount compared to the selling price of $50,000,000 for the business. Has the service enterprise failed to exercise prudent tax planning? Yes. The scope requirement is not analyzed as a comparison to the final sale. It is an objective analysis. In a recent claim for refund heard by the Board, Pratt North Plaza Associates argued that its sales to employees prior to the liquidating sale did not infect its right to an exemption because its sales to employees were so small compared to the value of the final sale. The Board disagreed, stating:

> "The Board concludes that the second paragraph of Regulation 1595(a)(1) applies to the service enterprises discussed in Regulation 1595(a)(5)(A)2, and that, therefore, an operator of a service enterprise is required to hold a seller's permit when, in any twelve month period, more than two sales for substantial amounts are made of tangible personal property used in the service enterprise, or a substantial number of sales for relatively small amounts are made of tangible personal property used in the service enterprise. The Board further concludes that $400 is a `substantial' amount for purposes of Regulation 1595, but leaves for another day the question of whether amounts less than $400 are `substantial'." (In re Pratt North Plaza Associates (10/28/93).)

So, any sale of $400 is clearly counted in the test of three or more sales in any 12 month period, without regard to how that compares to the selling price of the business. However, as noted in the opinion, the Board did not address the issue of sales below $400. Unless and until the Board tells us otherwise, I believe that any sale of $100 or more clearly counts, and perhaps sales below that figure. Please remember that this applies when there are 3 sales. If there are 50 sales, a much lower dollar amount is necessary because of the relationship of "number, scope, and character."

Since at least three sales are required for a person to be required to have a permit by virtue of those sales, what about Harry? Harry is a retired law enforcement official and he decides to start a hardware store. He is required to obtain a seller's permit because he intends to engage in the business of selling hammers and nails, etc. He does not locate his store in a well populated area, but instead out in the boonies because, he says, "this area's next." He finds a location on a road with considerable traffic, but not because of businesses or homes near the road, but because it connects 2 freeways. He gets his permit and opens on April 1. On April 10, Mr. and Mrs. Smith are out for their Sunday drive (they are the drivers that people talk about when they talk about "Sunday drivers") and they happen to find themselves on a 2 lane road in the boonies, but with traffic. Ten people are lined up behind our Sunday drivers, honking. The Smiths finally find a driveway and pull in: Harry's Hardware. As they

enter the store, Harry awakes from his nap to see his first customers, and they buy a hammer. As it turns out, not one other customer enters the store. By the end of June, Harry gives up.

Harry made only one sale at his hardware store, a single hammer. Was that sale an occasional sale? No. Harry "desired" to engage in the business of selling tangible personal property in California, and he therefore obtained a seller's permit as required by section 6066. The sale of the hammer was in the course of that activity, an activity requiring the holding of a seller's permit, and that sale was therefore not an (a) occasional sale, even though it was the only sale made by Harry in the regular course of his business. What about Harry's sale of the business? It was only the second sale made by Harry and he will make no more. Should that be an occasional sale because he made fewer than 3 sales in any 12 month period? No! He was required to hold a seller's permit, and the sale of the hardware store was the sale of property used in the course of the (unsuccessful) activity which required the holding of that permit.

9. **Can a sale of an automobile be an (a) occasional sale?** Yes. And no. It depends on your perspective. The sale of an automobile is often thought of as not qualifying as an (a) occasional sale, and for purposes of giving people answers they can understand, that response is probably close enough. Actually, however, if I sell my automobile and it is my only sale during any 12 month period, it does meet the requirements of "occasional sale" as defined by subdivision (a) of section 6006.5. However, that the sale meets the definition of occasional sale under subdivision (a) of section 6006.5 does not answer the question of whether that sale is exempt, since section 6006.5 is definitional only. As noted above, the general occasional sale provision, section 6367, specifically excludes sales of vehicles, vessels, and aircraft from the exemption. Thus, a sale of a vehicle, vessel, or aircraft is **never** exempt under section 6367. As noted in section 6367, a sale of a vehicle, vessel, or aircraft may, however, be exempt under section 6281. This will be discussed more later.

At this point, it may be useful to digress and discuss sales of automobiles by persons not required to hold a permit by virtue of their sales of automobiles (it also applies to sales of vessels and aircraft). As noted at the beginning of this memorandum, the second step of the four-step sales tax analysis is whether the sale is at retail. More technically accurate, I could ask whether the sale is a sale at retail by a retailer. That is actually what our taxing statutes, sections 6051 and 6201, require. "Retailer" is defined as a seller who makes retail sales. (Rev. & Tax. Code § 6015.) "Seller" is defined as a person engaged in the business of selling tangible personal property. (Rev. & Tax. Code § 6014.) If you look at these definitions in the context of a sale meeting the definition of an (a) occasional sale, you will discover that all the definitions dovetail. That is, a person whose sale qualifies as an (a) occasional sale is not a "seller" as defined by section 6014 and therefore cannot be a "retailer" as defined by section 6015 since that definition applies to persons who are "sellers."

10. **Any person who makes a retail sale of a vehicle, vessel, or aircraft is a retailer**. (Rev. & Tax. Code § 6275.) Thus, even though a person selling a vehicle may not be a retailer under section 6015 because that person is not a seller of vehicles, any person who sells

a vehicle is a retailer with respect to the sale of the vehicle. Thus, even if I make no sales of tangible personal property in any twelve month period except for a sale of my automobile, meaning I am not a "seller" under section 6014 nor a "retailer" under section 6015, I nevertheless am a "retailer" of the automobile under section 6275. Since that sale is a retail sale by a retailer, it does meet our taxing statutes and, unless there is an exemption, that sale is taxable. Does that mean that, as a retailer, I must have a permit and report sales tax on the sale? No, because of sections 6014 and 6283.

Although I am a retailer of the automobile, I am not a "seller" as defined in section 6014 because I am not in the business of selling automobiles. Since I am not a seller, I am not required to hold a seller's permit under section 6066 by virtue of my sales of automobiles. Therefore, my sale of the automobile is exempt from **sales** tax under section 6283 (exempting from sales tax sales of vehicles, vessels, and aircraft sold by persons not required to hold seller's permits by virtue of their sales of such property). Does that mean that there is no tax? Of course not - I already told you that such sales meet our taxing statute and are not exempt occasional sales (even if they are (a) occasional sales). The section 6283 exemption is only for sales tax, not use tax. Use tax would always apply to sales in California which are subject to sales tax (because such sales are made by retailers for use in California) except for the exemption provided by section 6401. That section exempts from use tax the use of property that the gross receipts from the sale thereof were included in the measure of the sales tax. Since a sale of a vehicle by a person not required to hold a seller's permit by virtue of sales of vehicles is exempt from sales tax, the gross receipts from such sale would not be included in the measure of the sales tax. Hence, there is no exemption from use tax for purchases of automobiles from people like you and me (i.e., non-dealers), nor is there an exemption for occasional sales as defined by section 6006.5 for such sales.

The remainder of the discussion herein relates to transfers that are not (a) occasional sales exempt under section 6367.

11. **A (b) occasional sale is completely different than an (a) occasional sale.** While an (a) occasional sale refers to sales by persons not required to have a seller's permit by virtue of sales of tangible personal property, a (b) occasional sale is explicitly for such sales. That is, a (b) occasional sale is a certain type of sale made by a person who is required to hold a seller's permit.[1] The basic type of sale that is covered is a business reorganization where there is no real change of "ultimate" ownership. The definition of a (b) occasional sale is a sale of substantially all the property of a person when the real or ultimate ownership of that property remains substantially the same. So, there are two conditions: 1) substantially all of the seller's tangible personal property must be transferred; and 2) the ownership of that property must be substantially the same before and after the transfer.

[1] Subdivision (b) refers to a sale, as defined, by a person "in the course of those activities ...." *"Those* activities" refers to the activities of a person requiring the holding of a seller's permit as mentioned at the end of the previous subdivision.

12. We will now digress slightly to talk about "persons." **There are certain basic terms in the Sales and Use Tax Law that are its building blocks**, such as "seller" (Rev. & Tax. Code § 6014), "retailer" (Rev. & Tax. Code § 6015), "sales" (Rev. & Tax. Code § 6006), and "purchases" (Rev. & Tax. Code § 6010). One of the most essential is the definition of "person." Since a "retailer" must be a "seller," and since a "seller" must be a "person," we must have a transfer between two "persons" before we can have a sale for which a retailer is liable for tax.[2] Revenue and Taxation Code section 6005 defines person to include:

> "any individual, firm, copartnership, joint venture, association, social club, fraternal organization, corporation, estate, trust, business trust, receiver, assignee for the benefit of creditors, trustee, trustee in bankruptcy, syndicate, the United States, this State, any county, city and county, municipality, district, or other political subdivision of the State, or any other group or combination acting as a unit."

This is a pretty extensive listing. To state it differently, just about any separate entity qualifies as a "person" under the Sales and Use Tax Law.[3] However, a division of a corporation is not a separate entity, and it is not listed in section 6005. Thus, a division is the same person as is the corporation of which it is a part, and two divisions of a corporation are also the same person. If one division of a corporation transfers property to another division of that same corporation, and there is a bookkeeping entry of debt and credit between the two divisions, we nevertheless would not regard the transfer as a sale because there has not been a transfer of property from one person to another. It would be the same as if you transferred a screwdriver from your garage toolkit to your car toolkit and entered in your bookkeeping a debt from your car toolkit to your garage toolkit.

On the other hand, corporate subsidiaries are not equivalent to corporate divisions. A subsidiary is a corporation, and "corporation" is specifically defined as a person by section 6005. Thus, a subsidiary is a person. This means that if one subsidiary transfers tangible personal property to another subsidiary for consideration (which includes assumptions of liability, intercompany debts and credits, and the like), that is a sale under section 6006, and if at retail, that sale is subject to tax under section 6051, unless specifically exempt by statute. That both subsidiaries are owned by the same person, the corporate parent, is irrelevant. To restate the rule, once we have established that an entity is a separate "person" under section 6005, we never care about the identity of the owner of that person. Well, almost never.

13. Having completed our digression, we return now to (b) occasional sales. **The (b) occasional sales definition** (and the section 6281 exemption, discussed later) **is the one and**

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[2]Section 6019, which further defines "retailer," does not refer to "person" or to "seller." It does, however, contain its own listing of entities which could be retailers under its definition, and that listing is essentially the same, though much shorter, than the one included in section 6005.

[3]Noticeably absent from this listing is a reference to *other* states. Although not relevant to our discussion here, it is something to remember - other states are not "persons" for purposes of our Sales and Use Tax Law.

only time in the analysis of sales and use tax that we care who "owns" the person who is the taxpayer. Before discussing what I mean, an example may be helpful. Remember Harry? He is the owner of the hardware store. When he first opened it, he opened it as a sole proprietor. After the Smith's stopped by on that Sunday to buy their hammer, Harry was sure his store would be a success. For many reasons, including limiting his liabilities, Harry decided to incorporate. He transferred all the assets of the hardware store, subject to certain liabilities, to the newly formed corporation, Harry, Inc., in exchange for stock. Harry is a person, and he transferred tangible personal property to another person, Harry, Inc., in exchange for consideration, assumption of liabilities.[4] The transfer was therefore a sale. Some of the store's contents were sold for resale, but some were not. Thus, unless there is an exemption, tax applies. Does this *feel* like a transaction that should be taxed? Harry transferred all the assets of the hardware store and, if we disregard the technical definitions of persons and the fact that a shareholder owns an interest in the corporation but does not own the actual corporation property, nothing has really changed. Harry used to own the whole hardware store and sold all the assets held or used in the course of his activities requiring a seller's permit. Now he owns and controls the whole corporation that owns the whole hardware store. That is the basic reason for the exemption for (b) occasional sales: if we look through everything, everything is exactly the same, or at least *substantially* the same.

What if the same thing happened as described above, except that Harry sold the lawnmower portion of the business to a third party and the remainder to the new corporation? We need to know the percentage **of all the tangible personal property of the business** was sold to the third party. This calculation includes *all* the tangible personal property, whether resale inventory or trade fixtures, and whether in this state or outside this state. Here, let us assume that all Harry sold was the lawnmowers themselves, and that the value of these mowers comprised 15 percent of the total value of the business's tangible personal property. Under subdivision (b)(2) of Regulation 1595, substantially all the property of the business means 80 percent or more of all tangible personal property of the business. Thus, the new business, Harry's, Inc. purchased substantially all of Harry's tangible personal property held or used in the course of activities for which Harry held a permit (85 percent).

What if the transactions were the same as discussed in the previous paragraph, except Harry also needed an infusion of more cash, and to do so Harry had 10 percent of the stock issued to his brother Joe for cash? Is that such a difference from the example above that now the things are not substantially the same within the meaning of the regulation? No, it is still close enough. Under subdivision (b)(2) of Regulation 1595, we regard "real or ultimate ownership" to be "substantially similar" if 80 percent or more of that ownership is unchanged after the transfer. Here, Harry owned 100 percent before the transfer, and had ultimate ownership of 90 percent after the transfer. (Review subdivision (b)(2) for a further analysis.) Thus, this transaction qualifies as a (b) occasional sale.

[4]Although Harry also received stock for the transfer, that stock had no value at the time of the exchange and therefore is not included in the calculation of any taxable gross receipts. (See Reg. 1595(b)(4).)

What if one subsidiary sells all its assets to another subsidiary of its parent? That clearly qualifies - the parent is the owner of the stock of the transferor subsidiary, and is the owner of the stock of the transferee subsidiary: the ultimate ownership of the transferred property remains the same. The harder question is when "grandkid" subsidiaries transfer among themselves, and when there are transfers between the "children" subsidiaries and the "grandkid" subsidiaries. Business Taxes Law Guide Annotation 395.2540 (6/29/54) covers such a situation. The conclusion in that annotation is that, even if there is more than one step between the "final" owner and the subsidiaries, the final owner will be regarded under subdivision (b) of section 6006.5 as the real or ultimate owner of assets held by any of its wholly-owned subsidiaries and their wholly-owned subsidiaries.

14. Perhaps you recall that **the section 6367 exemption for (b) occasional sales does not apply to sales of vehicles, vessels, and aircraft**. Does that mean that a person doing a business reorganization and transferring a vehicle from one wholly-owned entity to another can never avoid tax on that transfer? No. Section 6281 exempts certain transfers meeting requirements set forth in section 6281. Those requirements essentially restate the (b) occasional sale definition word for word with one major exception. A (b) occasional sale is always a sale of assets held or used in the course of "those activities" (activities requiring a seller's permit). Section 6281 replaces that phrase with "used in the course of business activities." What is the reason for the difference? As between an (a) occasional sale and a (b) occasional sale, a transfer can only be one or the other (or neither). If a person does not need a permit, his or her sale would be an (a) sale, and if that person does need a permit, his or her sale would be of property held or used in the course of those activities and therefore could qualify under (b). Since a sale of a vehicle, vessel, or aircraft is never exempt under section 6367, it is possible for a person who is not required to hold a permit to make a sale of a vehicle subject to use tax. Thus, an exemption for corporate reorganization sales of vehicles, vessels, and aircraft that simply restated the definition of (b) would mean that only those sellers of vehicles, vessels, and aircraft who required a seller's permit by virtue of their sales of such property could qualify for the business reorganization exemption with respect to vehicles, vessels and aircraft.

For example, a law firm wishes to incorporate. This is a big uptown firm and it owns all the vehicles it provides to its attorneys (the partners have BMWs, and the associates have Toyotas). The firm also has a Lear Jet and a prop plane (guess who gets to use the jet). It has made no sales of tangible personal property, and will make no sales of tangible personal property in the next twelve months. It transfers all its assets to a new corporation (We're Important Law Firm, Inc.) in exchange for stock. The firm still owes money on all its assets, the planes, the autos, and the books in its immense law library, and We're Important Law Firm, Inc. assumes those liabilities. This is a sale, at retail, and is subject to tax measured by the assumed liabilities (and any other consideration paid for the transfer) unless there is an exemption. The sale of the books and the tangible personal property other than the autos and planes is an (a) occasional sale because the firm did not need a permit, and this was not one of a series of sales requiring a permit. The sale of such property is exempt under section 6367. The sale of the autos and planes is not exempt under section 6367. The sale of the autos and

planes does not even qualify as a (b) occasional sale because the firm did not use them in activities requiring a permit. The firm did, however, use them in the course of its business activities. Therefore, the sale of the autos and planes is exempt under section 6281 because the firm sold over 80 percent of its business assets (it actually sold 100 percent) and the ownership remained at least 80 percent the same (it actually remained 100 percent the same).

15. At this point, I am **tired of occasional sales**, and so we will move on. Subdivision (b)(4) of Regulation 1595 states that tax does not apply to a transfer of property to a commencing entity (corporation or partnership) **solely in exchange for first issue stock or interest in that commencing entity**. If, however, the transferor receives any consideration such as cash, notes, or an assumption of liabilities, tax applies to that consideration (unless the sale is otherwise exempt). Many people, even the California Supreme Court, refer to this provision as an exemption. It is, emphatically and unequivocally, **not an exemption**. Rather, we do not regard a qualifying transfer as being a sale of tangible personal property for measurable consideration.

If a corporate shell is established, with no money in the bank and no assets, the shares cannot have any value. We will call this corporate shell Newco. If Newco transfers only its worthless shares in exchange for lien-free tangible personal property, at the moment of the transfer Newco has not given anything of value for the tangible personal property. Sure, a nanosecond after the transfer the shares have value because now Newco has property, that was not the case **at the moment of the transfer**. Thus, at the moment of transfer there was no measurable consideration for the transfer, and this is the basic theory behind subdivision (b)(4). (See Business Taxes Law Guide Annotations 395.1880 (6/5/70), 395.2280 (1/3/63).)

A hypothetical may be helpful. When Newco is created, the incorporators deposit $1,000 in the Newco account so that Newco can pay franchise fees, etc., when they come due. While the $1,000 is still in the bank, Newco issues its stock in exchange for $1,000,000 in lien-free tangible personal property. What is the measure of tax? The stock is worth $1,000 because it is all the stock in Newco and Newco has a value of $1,000, its only assets being that money in the bank. Thus, the transferors have sold the tangible personal property for consideration valued at $1,000 and that is the measure of tax.[5]

16. **What constitutes a commencing entity?** Newco is incorporated as a shell corporation on January 1, 1992. It has no assets. On January 1, 1994, it issues its first issue of stock and exchanges that stock for assets. Newco is a commencing corporation. That it

[5]In practice, I believe that it is common for Newcos to have a little money in the bank for franchise and other fees. I also think that, in practice, we do not actually tax these transactions measured by the small amount in the bank. However, the reason for our failure to do so is not that the analysis above is incorrect. Rather, it probably is not worth the trouble of trying to assess on this very small measure of an otherwise non taxable transaction. Nevertheless, even though we do not generally impose tax on the couple of bucks in the bank, I believe this hypothetical helps explain the concept.

was incorporated 2 years ago does not matter.[6] As long as it has not actually issued stock or conducted business, it is a commencing entity.

17. **What if there is other consideration besides first issue stock?** Some or all of the property of a business may have related debt (i.e., the debt incurred when obtaining that property, and which the property may secure). Thus, in these types of transactions, where a person is creating or spinning off a new corporation and exchanging property for stock, some of the property often has related debt. My experience is that businesses do not want to pay off that debt prior to the transfer, but instead simply transfer the assets subject to that debt and the transferee (Newco) pays off that debt. When this is the case, the transferee (Newco) is giving measurable consideration for the property. That consideration is the assumption of liabilities. If the transferor receives only the first issue stock and the transferee's assumption of the transferor's liabilities, the measure of tax is the amount of the liabilities. That is the amount, valued in money, that Newco is regarded as having paid for the transfer. For the same reason discussed above in section 14, the stock is regarded as having no measurable value, at the moment of the transfer, and does not factor in the measure of tax.

The actual measure of tax is calculated by determining the value of the tangible personal property transferred at retail compared to the value of all property transferred, and multiplying that percentage times all consideration paid for the business. For example, in exchange for an assumption of liability of $2,000,000, a business worth $10,000,000 is transferred, with equal values for real estate, good will, tangible personal property for resale, and tangible personal property for use. The sale of the first three components is not taxable; however, the sale of the tangible personal property for use is subject to tax. The measure of that tax is the percentage that the value of that property bears to the value of all assets transferred (25 percent) times the amount of the consideration paid for the transfer ($2,000,000), or $500,000. It is irrelevant whether the assumed liabilities relate to the tangible personal property transferred for use or not. For example, if the entire $2,000,000 in liabilities being assumed was incurred with respect to the transferor's purchase of tangible personal property for use, we would nevertheless allocate a portion of that consideration to each component of the transferred property according to the relative value of each such component. That is, we would impose tax on $500,000, not $2,000,000. Similarly, the transferor does not escape taxation if the liabilities assumed by the transferee were incurred with respect to the purchase of real property. The transferee is purchasing the entire business, and the consideration for that purchase is allocated accordingly.

18. **Liquidations may not be taxable.** When an entity distributes its assets as a complete liquidation ratably to its owners (i.e., a distribution of assets to the owners (e.g., partners and shareholders) in the same percentage as their ownership interests in the entity), the transfer will not be taxable unless there is some measurable consideration. (See, e.g.,

[6] It is not uncommon for a corporation to create one or more shell "Newco" corporations so that they are ready for use when necessary.

BTLG Annots. 395.2260 (10/5/56), 395.2280 (1/3/63), 395.2340 (5/7/56).) What do I mean by "measurable consideration"? You should already know.

The classic example of measurable consideration in this type of transaction is an **assumption of liabilities**. Just as is the case with the commencing entity analysis, an assumption of liabilities by the recipient of property in a liquidating transfer is consideration for that transfer and is taxable. That this is the case is consistent with the reason for the liquidation analysis. When a corporation liquidates and transfers all its property to shareholders in accordance with their ownership interests and receives all its stock in exchange, the only purpose for obtaining the stock is to cancel it. We do not place a value on such stock when the other requirements of this analysis are met (e.g., prorata distribution and the entity is actually liquidating).[7] This is **NOT an exemption**. It is regarded as a nontaxable transfer.

These types of transactions are often called "**liquidating dividends**." You might think that you do not have to cover the assumption of liabilities aspect of the analysis when someone inquires about liquidating dividends. **You would be wrong.** I do not know whether an entity can transfer property in a liquidation, subject to debts, and still call that transfer a "liquidating dividend" for corporate law purposes. In any event, transactions which the taxpayer calls a "liquidating dividend" come before us for consideration under circumstances where the transferee assumes liabilities. Thus, you must **always** mention that a liquidation that meets the requirements is not taxable **if the only consideration received by the transferor is the return of the interest in the entity (e.g., stock) for the purpose of cancellation, but if it receives any other consideration, such as an assumption of liabilities, the transfer is taxable to the extent of that other consideration** (unless it is an exempt occasional sale).

19. Even though a **liquidation of assets** may not be a taxable transfer, it **may be a taxable use of the transferred property**. (BTLG Annot. 395.2300 (7/20/59, 12/13/82, 2/24/83).) If the property is resale inventory, the withdrawal from resale inventory for a nontaxable liquidating transfer is a use other than resale in the regular course of business. Tax applies to that use measured by the transferor's purchase price. This is an example of why I insist that nontaxable transfers not be mischaracterized as "exempt." If a liquidating dividend were an exempt transaction, there would be no use tax on a distribution of resale inventory because that liquidating distribution would be a "sale." It is not, and so that distribution of resale inventory is a taxable use.

20. **Capital Contributions are not taxable.** (See BTLG Annots. 395.1520 (1/11/55), 395.1960 (5/25/51).) A capital contribution means that a shareholder (or partner, etc.) transfers property into the business entity and gets nothing in return. It is a contribution, a gift. The way it differs from a true gift is that the transferor owns part or all of the transferee

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[7] I realize that this is not entirely consistent with the commencing entity analysis. In that analysis, the stock actually has no value at the time of the transfer. In this analysis, the stock has no value after the transfer. In essence, we treat the birth and the death of an entity the same - it does have a certain balance.

and therefore derives a benefit from the transfer. Of course, if the "contributor" transfers the property subject to a debt assumed by the transferee, there is a taxable sale measured by the assumed liabilities.

For example, Big, Inc. wholly owns Small, Inc. Small has assets of $1,000,000, and Big values the shares of Small that it holds at $1,000,000. Big decides to transfer $1,000,000 of tangible personal property to Small. Big balances its books by removing $1,000,000 from its tangible personal property asset ledger and increasing the value of the Small shares, **in its (Big's) own books**. This is a nontaxable capital contribution - Big can balance its internal books any way it wants. But remember, **capital contributions are NOT exempt, they just are not taxable sales.** However, we reach a different conclusion if, instead of increasing the book value of Small stock in its own books, Big enters into its books an intercompany credit of $1,000,000 owed by Small to Big, or Small enters into its books an intercompany debt of $1,000,000 owed by it to Big, or, more likely, both Big and Small make these entries in their books. Under this scenario, there is a sale of tangible personal property for consideration, the $1,000,000 Small owes Big. That is the measure of tax. That is, intercompany debt constitutes consideration, and we must therefore look at the actual bookkeeping entries of the transferor and the transferee to determine if, in fact, any consideration was paid for the transfer.

21. **Statutory mergers are not taxable**. (Reg. 1595(b)(3).) If two corporations merge under California law, or similar laws of other states, we regard the transfer of property pursuant to that merger to be by operation of law and not to be a sale. Since it is not a sale, no tax applies. Regardless of what anyone says, at the Board or the Supreme court, **statutory mergers are NOT exempt**, they are just nontaxable joinings.

22. **Sale of stock is not taxable**. (BTLG Annot. 395.1250 (5/8/87).) A corporate shareholder does not own the assets of the corporation (this is different than a partner who, under Corporations Code section 15025, owns the partnership property as a tenant in partnership). The shares represent an ownership interest in the corporation itself, and only the corporation owns the assets of the corporation. Thus, when a shareholder sells stock, there is no sale of tangible personal property, there is a sale of an ownership interest in the corporation. Since it is not a sale of tangible personal property, it is not taxable (you should know what is coming: **it is not exempt**).

Under IRC section 338, certain sales of stock are treated as sales of the corporation's property so that the basis of that corporation's assets are "stepped up," just as would be the case if the corporation actually sold the assets. How does this affect our analysis? It does not. What happened was a sale of stock, and that is the sales tax analysis that applies. That the parties may have obtained a benefit for income tax purposes similar to that obtained for a sale of tangible personal property is irrelevant. The contrary is also true. If there is a sale of tangible personal property and for some income tax purposes it were to be treated as other than a sale of tangible personal property, we would not care: if it is actually a sale of tangible personal property, we treat it as such without regard to income tax treatment. (It is obviously

up to taxpayers to understand the implications of their transactions for sales tax versus those applicable to income tax, and to consult tax advisors when necessary to do so.)