

170.0078**M e m o r a n d u m**

To: Mr. Rick Slater
Supervisor of Collections - MIC:55

Date: October 18, 1993

From: Thomas Cooke, Tax Counsel
Legal Division - MIC:82

Subject: S--- C---, INC.
ACCOUNT NO. SY -- XX-XXXXXXX

The Board's Torrance office levied upon the taxpayer's bank accounts at --- Bank for a tax liability. The bank responded that, pursuant to the levy, it would turn over \$29,596.40 of the taxpayer's funds in Account No. XXXXXXXXXXXX to the Board and would turn over an additional \$11,663.08 in Account No. XXXXXXXXXXXX to the Board.

The Legal Division has received a letter from the law offices of L---, S--- & L--- dated September 30, 1993, in which attorney L--- P--- states that C--- F--- Corporation has a security interest in all deposit accounts in the name of S--- C--- to secure an outstanding liability of "at least" \$75,000. Mr. P--- has provided a copy of a UCC-1 filed August 10, 1992 in the Secretary of State's office in which S--- C--- granted C--- a security interest in "deposit accounts."

In the recent appellate decision of Chrysler Credit Corporation v. Superior Court (1993) 17 Cal.App.4 1303, the Board and EDD levied upon a taxpayer's account. Chrysler claimed that it had a prior security interest in the funds levied upon. The court held that there was no question that Chrysler had a perfected security interest in the collateral. The court stated that the question was whether the funds deposited into the account levied upon are the "identifiable proceeds" of the collateral such that Chrysler's security interest also attached to them (Com. Code § 9306, subd.(2).)

The court cited the general rule that the secured party has the burden of tracing funds received from the sales of collateral so as to show that they are in fact the identifiable proceeds of those sales. In certain circumstances, principles of equity may make it appropriate to shift the burden of tracing funds from the secured party to the taxpayer.

The court held that a party levying on an account has the burden of showing that it has a valid interest in the funds levied upon and that the funds in the account were not the direct proceeds of sales of collateral. The burden then shifts to the secured party to refute the showing by the levying entity.

The court stated that the ability to trace the proceeds was not destroyed the moment that proceeds from the sale of collateral were commingled with other funds in a general operating account.

The court held that a secured creditor could trace the proceeds by submitting evidence, as to every secured inventory item, of 1) the date and amount of sale, 2) the amount of proceeds due the secured party for such sale, 3) the date the total proceeds were deposited into the taxpayer's general operating account, and 4) the amount of these funds.

The court held that, if the taxpayer commingles proceeds due the secured party with other funds, the secured party will retain a security interest only in the amount of the lowest intermediate balance left in the account at any time that proceeds remain in the account. If the taxpayer "borrows" the secured party's proceeds to pay the taxpayer's current liabilities, the security interest in any "borrowed" funds is lost.

There are two methods generally used to create a security interest in a taxpayer's inventory. A lending institution may lend money to a business and take a security interest in inventory and business equipment or a supplier of inventory will "floor" the inventory, i.e., supply the inventory to the retailer and take a security interest in the inventory with proceeds from the retail sale of any inventory item payable to the supplier for the wholesale cost of that item.

In any business that has been issued a Seller's Permit, a portion of each taxable sale made by the business will usually consist of tax payable to the Board. In addition, there may be labor charges due the retailer and profit markup which are not "cash collateral" due to an entity with a security interest.

California Commercial Code section 9304(1) provides that a security interest in money can only be perfected by the secured party's taking possession, except as provided in subdivisions (2) and (3) of Section 9306.

California Commercial Code section 9306(2) provides that a security interest continues in collateral notwithstanding sale and also continues in any identifiable proceeds.

Therefore, in both the situation where a lender advances funds to the taxpayer and takes a security interest in inventory and equipment and where a supplier "floors" inventory items, a security interest will only be retained in "identifiable" cash proceeds of the sale of the inventory or equipment.

It is our recommendation that any party claiming a security interest in funds which have been levied upon by the Board be required to "trace" identifiable proceeds of collateral due the secured party. In a "flooring" of inventory, the secured party is only entitled to the wholesale price of each inventory item sold. If funds are lent to the taxpayer and the secured party takes a security interest in collateral, the secured party is not entitled to any sales tax reimbursement paid by customers when inventory items subject to the security interest are sold. If the taxpayer has collected sales tax reimbursement from its customers and failed to remit the reimbursement to the Board, any sales tax reimbursement collected but not remitted since the date the UCC-1 was filed by the secured party, cannot be proceeds from sale of collateral.

If the taxpayer has deposited the sale proceeds from the sale of inventory in a special account from which any retailer costs, sales tax reimbursement and markup are then withdrawn, the remaining funds in the account should be "identifiable cash proceeds" of the sale of inventory.

One of the accounts levied upon at --- Bank is listed as a "Payroll Account" and the other is listed as a "Lock Box Account c/o C--- F--- Corp-Western."

The "Payroll Account" is probably not "identifiable cash proceeds." In all probability, the taxpayer deposits funds in the account solely for payroll purposes. The "Lock Box Account" may be "identifiable cash proceeds" if the taxpayer has not "borrowed" the funds due C--- to pay its other liabilities and later replenished the account.

If a secured party fails or refuses to "trace" their claimed entitlement to funds levied upon by the Board, the Board should deny the secured party's claim.

We would suggest that the Collection Section respond to Mr. P--- pursuant to this opinion with a copy of the response sent to the Legal Division.

A copy of the Chrysler Credit Corporation case is attached.

If you want to discuss this approach let me know.

TJC:plh

Attachment

cc: --- District Administrator - --
Mr. Gordon Adelman - MIC:82