STATE OF CALIFORNIA

BOARD OF EQUALIZATION

In the Matter of the Petition for	)	
Reconsideration of Successor's	)	DECISION AND RECOMMENDATION
Liability Under the Sales and	)	
Use Tax Law of:	)	
	)	
Taxpayer	)	

The preliminary hearing on the above taxpayer's petition for reconsideration was held on March 6, 1987, in Sacramento, California.

Hearing Officer: James E. Mahler

Appearing for Petitioner:

Appearing for the Board: Rey Obligacion
Tax Auditor

Protested Item

The liability was asserted against petitioner as successor to ______.

Taxpayer's Contentions

Petitioner raised the following contentions in its petition for reconsideration dated September 22, 1986. We have reordered and renumbered the contentions for ease of discussion.

1. Petitioner is not a purchaser and/or a successor within the meaning of Section 6811 et seq. of the Sales and Use Tax Law.

2. In effect, the assets were purchased by taxpayer from ______ that legal and equitable owner of those assets by virtue of its superior liens, and not from ______.

3. Petitioner did not purchase a business and/or stock of goods within the meaning of Section 6811 et seq. of the Sales and Use Tax Law.

4. Assuming for purposes of argument only that petitioner is a successor, no funds would have been received by the Board from the transaction between petitioner and ______ because each of the assets purchased by petitioner were encumbered by ______ liens which were superior in right to any lien of the Board. ______ liens exceeded the fair market value of the

assets purchased by petitioner, so that there was no surplus of funds over and above the liens of ______ to which the Board might otherwise have been entitled to under the successor liability sections.

5. Liability for any tax, interest or penalties due is solely that of ______, Sales and Use Tax Account No. ______ and/or any officer or other person having control or supervision of, or who was charged with the responsibility for the filing of returns or payment of tax, or who was under a duty to act for ______ in complying with any requirements of Part 1 of Division 2 of the Revenue and Taxation Code.

6. The amounts of tax, interest and/or penalties due, if any, have not been correctly determined.

7. No penalties should have been assessed against petitioner. Petitioner will comply with the requirements of Section 6592 of the Sales and Use Tax Law.

By letter dated November 12, 1986, petitioner also raised the following contention.

8. Under the doctrine of equitable subrogation, petitioner succeeds to and becomes entitled to the position of ______ the primary perfected secured creditor and lienholder, thereby becoming protected from all claims of unperfected or general creditors and/or junior, subsequent lienholders. Such succession and entitlement by petitioner would preclude the enforcement of collection of sales tax liability, in that any efforts regarding such liabilities would have been to no avail against ______.

Summary

______ is a corporation which sold automobiles, parts and accessories under a franchise agreement with the ______. It was engaged in business from July 1, 1984 through February 9, 1986. ______ then closed its doors, layed off its employees and stopped selling to the public. ______ principal shareholders, ______ and ______ requested ______ assistant in locating a suitable purchaser for the dealership's saleable assets.

______ had previously operated a successful ______ dealership in Texas. ______ advised ______ that ______ was going out of business and offered him an opportunity to acquire the dealership franchise. ______ was interested and began negotiating with ______.

On February 14, 1986, ______ granted ______ an option to purchase "certain" assets of ______. ______ formed the petitioner corporation and, on March 27, 1986, petitioner exercised the purchase option. Petitioner has since been engaged in the business of selling automobiles, parts and accessories on the same business premises used by______.

According to the agreement of sale and the bill of sale between petitioner and ______ petitioner purchased "certain assets" of ______ described as: parts and accessories, new vehicles including demonstrators, used vehicles, leasehold improvements, machinery, shop equipment, furniture, signs and office equipment. The price (net various adjustments) was $2,592,412.05, of which $2,214,697.09 was allocated to ______ new vehicle inventory.

According to testimony at the preliminary hearing, petitioner did not purchase ______: accounts receivable (including contracts in transit as well as dealer incentive and rebates due from ______; broken parts or damaged new vehicles (unless repaired prior to the date of sale); the lease of the business premises (petitioner negotiated a new lease with the lessor, a subsidiary of ______; or the business name and goodwill ______ had "negative goodwill" and petitioner did not want to be associated with the prior business in any way).

Petitioner expressly did not assume any of ______ liabilities. Petitioner did hire one former employee of ______ but he was treated as a new employee and did not received vacation credits or other benefits he had accrued while working for ______.

At the time of sale, ______ owed $2,654,341.95 to ______ on flooring loans made for ______ new vehicle inventory. The principal amount was $2,609,987.88, representing the entire cost of the new vehicle inventory to ______ and the remainder was interest. The debt was secured by a financing statement which ______ had filed with the Secretary of State on July 27, 1984. The financing statement covered all ______ assets "not or hereafter acquired" and expressly included ______ receivables.

It appears that petitioner financed most of the purchase price by borrowing $2,214,697.09 (that is, the entire portion of the price allocated to new vehicle inventory) from a subsidiary of ______. While the record is not entirely clear, the lender apparently paid the loan proceeds directly to ______. The remaining $357,714.96 of the purchase price was paid directly to ______ by a check drawn on petitioner's trust account with a local law firm. None of the purchase money was paid directly to ______ its shareholders.

The price paid by petitioner was not sufficient to cover ______ entire debt to ______. ______ also have a right to ______ receivables, however, and it may we have collected the balances due from those sources. In any event, we understand that ______ made no attempt to collect the balance due either from petitioner, or from ______ or from ______ shareholders. ______ had insisted on this point during the sale negotiations, in which ______ had apparently participated, since he was individually liable as a co-signer on ______ flooring loan.

In addition to the amounts owed ______ was also indebted to a number of unsecured creditors in total amount of $165,162.15. It appears that most of these liabilities were for courtesy deliveries, sublet repairs and purchase of advertising. According to testimony at the preliminary hearing, none of the unsecured creditors received any payment at all, and non of them attempted to collect from petitioner.

______ also owed a sales and use tax liability at the time of sale. The amount of tax was $204.589.89, of which $84.079.09 was self-reported but unpaid taxes for the fourth quarter 1985, and the remaining $120.510.80 was tax discovered in an audit and assessed by a determination dated July 10, 1986. The liabilities also included interest and penalties.

The audited liability was for periods through February 9, 1986. A portion of the liability resulted from disallowance of claimed exemptions on 14 transactions with a total measure of $271,185 (Audit Item E). On one of these transactions, a claimed interstate commerce exemption was disallowed because evidence in the deal jacket showed that the vehicle had been delivered in California. In two other transactions, claimed interstate commerce exemptions were disallowed because the deal jackets did not reveal where the vehicles had been delivered. The other eleven transactions were disallowed because the deal jackets were missing, so no information was available. According to testimony at the preliminary hearing, the auditor had examined a total of 485 claimed exempt transactions and disallowed only these 14.

Another portion of the audited liability involved tax on the final sale of assets to petitioner (Audit Item H). This item was originally measured by $320,000, the sales price allocated to non-inventory tangible personal property on an estimated basis. The staff subsequently obtained a copy of the bill of sale showing the actual allocation of the selling price, so a reaudit was initiated to reduce the measure of this item to $116,546.

According to our informal calculations, approximately $180,000 of ______ unpaid tax liability was for transactions where tax reimbursement was apparently collected from customers, but no tax was paid to the state. Included in this category are the admittedly taxable sales self-reported on the no-remittance return for the fourth quarter of 1985, admittedly taxable sales which were not reported for the first quarter of 1986 because no return was filed, and various deficiencies which the auditor found in ______ tax accrual accounts.

______ did not pay the tax liabilities, and a notice of successor's liability was thereupon issued to petitioner. The notice included various penalties in the total amount of $32,510.08 as follows: a 10% penalty in the amount of $8,407.91 pursuant to Revenue and Taxation Code Section 6591 for failure to pay the self-reported liability for the fourth quarter of 1985; two penalties in the total amount of $12,051.09, one imposed under Revenue and Taxation Code Section 6484 for negligence in reporting for the period July 1, 1984, through December 31, 1985, and the other imposed under Revenue and Taxation Code Section 6511 for failing to file a first quarter 1986 return; and a 10% penalty in the amount of $12,051.08 imposed, under Revenue and Taxation Code Section 6565 for failure to pay the determination resulting from the audit.

Analysis and Conclusions

Revenue and Taxation Code Section 6811 provides:

> "If any person liable for any amount under this part sells out his business or stock of goods or quits the business, his successors or assigns shall withhold sufficient of the purchase price to cover such amount 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."

During the periods involved herein, Section 6812 of the Code further provided:

> "If the purchaser of a business or stock of goods fails to withhold purchase price as required, he becomes personally liable for the payment of the amount required to be

withheld by him to the extent of the purchase price, valued in money...."

1. Petitioner argues that it was not a purchaser from ______ within the meaning of Section 6812. The basis for this argument is that the entire purchase price was paid directly to ______ and not to ______.

In Knudsen Diary Products Co. v. State Bd. of Equalization, 12 Cal.App.3d 47, the court stated at p. 54:

> "In a purchase and sale, the purchase price need not necessarily flow directly to the seller. The fact that the purchase price went to a third party...does not militate against the finding that [plaintiff] was a 'purchaser.' To hold otherwise would permit a taxpayer to avoid liability by the simple device of having the purchase price paid through an intermediary."

Similarly, in this case, petitioner was a purchaser from ______ even though the purchase price was paid directly to ______.

Petitioner also argues that it was not a successor to ______ under Section 6811. Petitioner relies on Federal Tax Court rulings that a person is absolved of federal income tax transferee liability to the extent he or she pays the transferor's debts which had priority over the government's tax claim. (Phyllis Jane Eyler, 87 T.C. Memo, 123; Gobins v. Commissioner, 18 T.C. 1159.)

The federal rulings have no application here. Under Federal Income Tax Law, transferee liability is imposed when a transferor is rendered insolvent by transfers for less than adequate consideration. Transferee liability is absolved when the assets are re-transferred to the original transferor, and payment of the transferor's priority debts is regarded as re-transfer to the transferor. (See IRC Section 6901, and cases cited thereunder.) In California, successor's liability attaches on the purchase of a business or stock of goods, and payment of the seller's debts is includable in the purchase price for purposes of the successor liability statutes. (Knudsen Dairy Products Co. v. State Bd. of Equalization, supra, 12 Cal.App.3d 47.) More specifically, payment of the seller's debts does not constitute a re-transfer of the business or stock of goods to the seller, and therefore affords no basis for relief from successor's liability.

Petitioner also relies on certain language appearing in the court's decision in People v. Buckles, 57 Cal.App.2d 76, where the court stated at page 79 that the purpose of the successor liability statutes is "to prevent a retailer who has failed to pay the state all of the tax due under the act from selling his business and departing with the purchase price...." In its brief filed before the Board in the Buckles case, the Board argued that the statutory purpose was to protect the state's revenues from retailers who would sell their business and "leave the state or dissipate the money." Petitioner believes that the statutory purpose does not apply here on the ground that ______ did not "depart with" or "dissipate" the purchase price.

We believe that petitioner is reading the language of the court's opinion and the Board's brief too literally. In our opinion, a purchaser has "departed with" the purchase price whenever the funds are made available for his or her use and benefit, rather than paid to the state in satisfaction of the tax liability. Here, petitioner's payment of the purchase price to ______ benefited ______ since ______ liability to ______ was therefore eliminated or at least substantially reduced.

2. Petitioner next points out that ______ could have foreclosed its security interest and then sold the property to petitioner. The result would have been the same from a business point of view, since petitioner would have acquired ______assets. For tax purposes, however, successor's liability would not have attached since the Board would not regard the foreclosure as a purchase. (Sales and Use Tax Reg. 1702(a).) Petitioner argues that, since the transaction could have been handled as a foreclosure and purchase from ______ the substance was a foreclosure.

The fact remains, however, that the transaction was set up as a purchase from ______. ______ was identified as the seller in all the sale documents. ______ did not foreclose on its security interest and did not sell anything to petitioner. Since the parties chose to structure their transaction as a sale by ______ they must accept the consequences of their choice. (See Freeman v. Commissioner, 303 F.2d 580.)

3. In People v. Gabriel, 57 Cal.App.2d 788, plaintiff purchased all the fixtures, equipment and building of a restaurant which had been closed for several months prior to the transaction. The court found that plaintiff had not purchased any "business" and was not a successor to the restaurant. Relying on this case, petitioner argues that it did not purchase ______ business.

We find it unnecessary to decide whether petitioner purchased ______ business, since successor's liability also attaches on the purchase of a stock of goods. Petitioner did purchase ______ stock of goods, namely all or substantially all ______ inventory of new vehicles, used vehicles and parts, as well as all or substantially all the machinery, office furnishings and other tangible personal property used in the business. Petitioner is therefore a successor to ______. The Gabriel case is not to the contrary since no stock of goods was involved there.

Petitioner argues that ______ had no stock of goods which could have been purchased. The basis for this argument is that all ______ assets were subject to security interest. According to petitioner ______ had at best a "possessory interest" in the property, and a mere possessory interest should not be considered a stock of goods. This argument ignores the fact that ______ had a right to sell the inventory in the regular course of its business. Since ______ acquired its inventory for the purpose of sale, and held the inventory for sale in the regular course of business, the inventory was part of ______ stock of goods for purposes of the successor liability statutes.

4. Petitioner points out that ______ debt to ______ exceeded the amounts paid by petitioner. Petitioner therefore believes that obtaining a tax clearance certificate or attempting to withhold the purchase price would have been "idle acts." In either case, according to petitioner, the sale would have been cancelled and would have foreclosed its security interest as soon as the parties discovered the unpaid tax liability.

We decline to speculate about what might have happened if petitioner had requested a tax clearance certificate or attempted to withhold the purchase price. Perhaps the sale would have fallen through, or perhaps the parties would have found a way to pay the liability. We cannot now know what the outcome would have been, and the reason we cannot know is because petitioner failed to comply with Sections 6811 and 6812. We can say with confidence, however, that compliance with those sections would not have been an idle act, since it would at least have forced the parties to confront the issue of ______ unpaid taxes.

Petitioner also argues that the state could not have collected the unpaid taxes from ______ since ______ security interest allegedly exceeded the value of ______ assets and would allegedly have been superior to any state tax lien. Petitioner believes that it is unfair and illogical for the state to be in a better position against a successor than it would have been in against the primary obligor.

Again, petitioner's argument rests on speculation. Although the purchase price paid by petitioner was less than the debt owed to ______, ______ had other assets which were not transferred to petitioner, particularly the accounts receivable, including contracts in transit, dealer incentives and rebates. We do not know if those assets would have been subject to collection or would have been sufficient to cover ______ unpaid tax liability, since the transaction was completed without notice to the Board in the form of a request for tax clearance.

More importantly, the state does not in fact have superior rights against petitioner. Whatever legal remedies are available to collect the liability from petitioner, those same remedies were also available against ______. If the state is actually in a better position against petitioner, it is only because petitioner may have more assets subject to collection. Almost by definition, that is true in every successor's liability case. If it were not, there would be no point in having a successor liability statute.

5. For the reasons stated above, we conclude that petitioner is a successor and a purchaser under Sections 6811 and 6812. While we agree that ______ is the primary obligor, petitioner is also liable as a successor because it failed to obtain a tax clearance certificate or withhold the purchase price as required.

6. A reaudit of ______ has reduced the measure of tax on the final sale of equipment. The successor's billing to petitioner should be adjusted to reflect that reduction. Petitioner also argues that a reduction should have been made in Audit Item E. The argument runs as follows: In almost all cases where deal jackets were available for claimed exempt transactions, the claimed exemptions were allowed. Therefore, for the eleven transactions where deal jackets were missing, it is unreasonable to assume that the claimed exemptions would have been unsupported if the evidence had been available.

We find no merit in this argument. Sales and Use Tax Regulation 1698 and common sense both require that records must be retained to support all claimed exemptions. Without such a rule, retailers could obtain exemption for any transaction, whether proper or not, by the simple expedient of not maintaining records. ______ failure to maintain records for these transactions therefore precludes any exemption.

7. Petitioner next requests relief from the various penalties. With one exception, we agree that relief should be granted.

The Section 6484 negligence penalty was imposed because of various deficiencies in ______ recordkeeping procedures. However, this was ______ first sales and use tax audit, and the recordkeeping deficiencies resulted in an understatement that was something less than 3% of total reported sales. Under these circumstances, we recommend that the negligence penalty be deleted.

With respect to the section 6511 and Section 6565 penalties, successor's liability may properly be imposed only for taxes, interest and penalties which accrued through the date that the successor purchased the business or stock of goods. The Section 6511 penalty did not accrue until April 30, 1986, the due date of ______ 1Q86 return, and the Section 6565 penalty did not accrue until August 9, 1986, the date the determination against ______ became final. Since both these penalties accrued after petitioner purchased the stock of goods, they should be deleted from the notice of successor's liability.

However, the Section 6591 penalty accrued on January 30, 1986, the date the self-reported liability for 4Q85 should have been paid. Accordingly, this penalty was properly included in the notice of successor's liability. See Sales and Use Tax Reg. 1702(b).) The penalty may be relieved by the Board if ______ submits a statement under penalty of perjury explaining why the taxes were not timely paid. (See Rev. & Tax. Code, § 6592.) Since we have not as yet received such a statement, we cannot at this time recommend deletion of the Section 6591 penalty.

8. Petitioner is entitled to raise objections to the original determination which ______ might have raised, including claims for deductions or credits. Petitioner goes a step further, however, and seeks subrogation to any defenses against collection which might have been raised by ______. According to petitioner, the Board could not have collected any liability from ______ because of its allegedly superior lien, and subrogation to the lien would therefore preclude any collection from petitioner.

The logic of this argument escapes us. If the liability in fact could not have been collected from ______ it is because ______ was neither a purchaser nor a successor, not because of its allegedly superior lien. Furthermore, petitioner could not acquire by subrogation any greater rights than those originally held by ______. Assets not subject to the lien, such as petitioner's current revenues, would therefore still be available for collection.

More specifically, ______ had certain rights over ______ assets by virtue of its lien. Assuming that the lien had priority and that petitioner became subrogated, petitioner might rely on the lien to prevent seizure of those assets by junior creditors of ______. But subrogation would not extinguish any liabilities, and certainly would not prevent seizure of petitioner's assets by persons to whom petitioner itself owes a debt.

Although ______ is the primary obligor on the original determination, the successor's liability is imposed directly on petitioner itself by statute. The liability is petitioner's, not ______, and arises because of petitioner's failure to obtain a tax clearance or withhold the purchase price as required. Subrogation, even if appropriate, would not protect petitioner's assets from seizure to satisfy that liability.

In any event, petitioner is not entitled to subrogation under the facts of this case. The courts have uniformly held that a purchaser who assumes personal liability for encumbrances on the property as part of the purchase price, and who pays a senior lien but neglects to pay a junior, may not avoid foreclosure of the junior lien by claiming subrogation to the senior. "[H]e cannot shield himself from the effect of his own negligence by a resort to the priority which had belonged to the earlier lien." (Annotation, 37 A.L.R. 384.) While petitioner is personally liable by operation of law rather than by assumption, because of its failure to comply with the successor's liability statutes, we see no reason why a different rule should apply.

Recommendation

Adjust the notice of successor's liability in accordance with the reaudit of the predecessor. Delete the penalties except the Section 6591 penalty.

______________________________	10/22/87
James E. Mahler, Hearing Officer	Date