

M e m o r a n d u m**395.0007**

To : Pardip N. Dayaram
Senior Tax Auditor, AA

Date: April 26, 2002

From : Trecia M. Nienow
Tax Counsel

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Subject: R--- - S---
Permit No. SR -- XX-XXXXXX

Your September 13, 2001 memorandum to Program Planning Manager Charlotte Paliani regarding the above taxpayer was assigned to me for response. We apologize for the delay in our response. You attached your September 19, 2000 memorandum to the Legal Division, a copy of the Legal Division's memorandum in response to you dated January 18, 2001, as well as some audit working papers and certain documents pertaining to the sale.

You indicate that as a result of a meeting with the taxpayer and his representatives, additional information is presented in a memorandum dated September 5, 2001 from Purchaser's attorney, A--- L. S---, Esq. You note that Mr. S--- was primarily responsible for putting together the asset sales contract. You attached the memorandum from Mr. S--- requesting our review of this new information presented and request an opinion as to whether sales tax applies to the transaction between R--- F---, LLC, a Delaware limited liability company ("Purchaser"), U--- S--- F---, Inc., a Delaware corporation ("USFI"), and J--- S--- & Co., a Delaware corporation ("JSC"). USFI and JSC are collectively referred to as "Sellers."

DISCUSSION

The transaction between the parties is a single integrated transaction, in which Sellers transferred tangible personal property into a newly formed LLC in exchange for cash. This transaction was carried out (within a 24 hour period) pursuant to several interdependent agreements, which required Sellers to transfer tangible personal property to a commencing entity, receive an interest in the entity, and to transfer that interest to the Purchaser for cash. This transaction does not qualify as a non-taxable transfer to a commencing entity under Regulation 1595(b)(4). Regulation 1595(b)(4) explains that a transfer of property to a commencing entity (e.g., a limited liability company) in exchange *solely* for an interest in that commencing entity is not a sale; however, the transfer is a sale if the transferor receives *any* consideration, and tax applies to that sale unless it otherwise qualifies for exemption. Here, in addition to the membership interest, Sellers received consideration at the time of transfer, that

being the commitment by Purchaser to buy Sellers' interest for cash concurrent with Sellers' transfer of tangible personal property to the commencing entity. Moreover, Regulation 1595(b)(4) does not provide a means by which to avoid tax when the transfer of property to a commencing entity in exchange for a membership interest also includes the simultaneous sale of such membership interest.

This transaction was originally structured as an asset sale whereby Sellers agreed to sell to Purchaser specific assets owned and used by USFI in its manufacturing division (the "Business"). After all parties had reached agreement, as reflected by the execution of the Acquisition Agreement dated August 7, 1998 ("Agreement"), the parties executed a First Amendment to the Acquisition Agreement ("Amendment"). This Amendment changed the transaction, in part, from the transfer of tangible personal property directly to the Purchaser in exchange for cash, to a transfer of tangible personal property to a newly created Delaware limited liability company ("LLC") formed on August 27, 1998, followed immediately by Sellers' transfer of its LLC interest to the Purchaser in exchange for cash. Copies of the Agreement and Amendment were provided to us for review. However, the Agreement was incomplete since none of the attached schedules were provided. Moreover, the transaction as structured was contingent on the finalization prior to closing of the Transaction Documents specified in the Agreement at ¶6.10 and defined on page 6 to mean the Supply Agreement, the Services Agreement, the Employee Benefits Agreement, the Trademark License Agreement, the Agreement Concerning the Leased Real Property, and the Employee Benefits Agreement, among others, copies of which were not provided to us for review. We understand however, that there was a concurrent closing, dependent upon the closing of the Agreement, as amended, of each of these Transaction Documents and other related documents on August 28, 1998.

Mr. S--- in his September 5, 2001 memorandum states that the Purchaser would not have entered into the Agreement without the Sellers' committing to purchase a certain volume of product required under the Supply Agreement.¹ In addition, we understand that the Amendment to the Agreement was created in order to finalize the Supply Agreement to meet the condition of closing. Mr. S--- further states that Sellers "agreed to contribute all of the assets comprising the [California] facility to a wholly owned subsidiary . . ." (i.e., LLC), but not the tangible personal property located at the manufacturing facility in ---, Indiana "which was acquired directly by the Purchaser . . ." or the assets of other business operations owned by Sellers² "and to sell that subsidiary . . . to the Purchaser." In that regard, we note that the terms of the Amendment³ are consistent with Mr. S---'s statements and bind Sellers to sell all the membership interests in the LLC after Sellers transferred tangible personal property into the LLC.

¹ The Supply Agreement was a long-term agreement under which the Purchaser would supply food and non-food products to Sellers who committed to purchase significant volumes of products from the Purchaser each year over a six-year period.

² The Agreement indicates at page 2, as part of the definition of "Business," that certain business operations of Sellers will be excluded from the sale.

³ Sellers, in order to avoid a potential sales tax liability they anticipated might arise as a result of the restructure, obtained an indemnification from Purchaser with respect to any tax liability (specifically including sales, use and other applicable tax, as well as related penalty, interest or fines). (See Amendment, Art. 5.)

Since the transaction was contingent upon the parties completion of the Transaction Documents prior to close, and dependent on Seller's contribution of the tangible personal property comprising the [California] facility to a commencing LLC prior to close, these requirements were conditions precedent to close. (See Civ. Code § 1436.⁴) Moreover, the law contemplates that several contracts are parts of one transaction and are to be taken together, if they relate to the same matters, are between the same parties and are made as parts of substantially one transaction. (See Civ. Code § 1642.⁵) By the very terms of the Agreement and Amendment provided to us, it is clear that this is a single integrated transaction for the transfer of tangible personal property in exchange for cash.

The documents provided and information obtained indicate a newly formed LLC with no prior operating history was created on August 27, 1998. Sellers were required to and did transfer the tangible personal property located at the [California] facility, which included the assets related to the Business⁶ (see Agreement, ¶2.1.1), to the LLC for the purpose of its concurrent sale to Purchaser. On August 28, 1998 (one day after the LLC was formed), Sellers transferred its LLC interest to Purchaser for cash as required by the Agreement, as amended.

As indicated above, a transfer of tangible personal property to a commencing entity in exchange *solely* for an interest therein is not a sale for purposes of Regulation 1595(b)(4). This is true because the interest received by the transferor is not regarded as having measurable value at the time of the transfer. However, the transfer is a sale if the transferor receives *any* consideration other than the interest in that commencing entity. Regulation 1595(b)(1) describes consideration received by the transferor to include cash, notes, and any other property as well as any indebtedness assumed by the transferee. In that regard, Sellers did not contribute tangible personal property in exchange solely for a membership interest in the commencing LLC as they also received a contractual commitment from Purchaser to purchase this interest for cash, concurrent with such transfer of assets. The commitment by Purchaser to pay cash to Sellers for their membership interest constitutes consideration above and beyond the membership interest received by Sellers. Since Sellers received consideration in addition to the membership interest it received in exchange for the transfer of the property involved, such a transfer is a sale and tax applies to that sale unless it otherwise qualifies for exemption.

Furthermore, in a single integrated transaction, the Sellers, initially owning tangible personal property, as evidenced by the Agreement, transferred its tangible personal property, and concluded the transaction with the receipt of cash. This is clearly evidenced by the Agreement, Amendment and related documents that, pursuant to Civil Code section 1642, must be regarded as part of a single integrated transaction resulting in the transfer of tangible personal property for

⁴ Civil Code section 1436 states "A condition precedent is one which is to be performed before some right dependent thereon accrues, or some act dependent thereon is performed."

⁵ Civil Code section 1642 states "Several contracts relating to the same matters, between the same parties, and made as parts of substantially one transaction, are to be taken together."

⁶ The Business was an integrated operation defined as "the manufacturing, processing and packaging [of] food and related non-food products of Sellers, as such businesses are currently conducted by the manufacturing division of Sellers . . ." (see Agreement, Art. 1).

cash. Accordingly, when the Sellers transferred tangible personal property to a commencing LLC contingent upon a concurrent contract to sell the membership interests in that LLC for cash, such a transaction is a sale of tangible personal property for cash and is subject to tax.

Mr. S--- goes on to explain that the Purchaser from the outset sought to obtain the Business as a legal entity rather than as a collection of assets. It appears however, this desire was not compelling enough to prevent the Purchaser from originally entering into the transaction on August 7, 1998 when it was structured as an asset sale. Mr. S--- also explains that the Sellers agreed to restructure the transaction in order to finalize the Supply Agreement. These explanations however, do not rebut the fact that this was a single integrated transaction entered into for a specific purpose, that being to sell tangible personal property to Purchaser for cash. Clearly, a structure that meets the business needs of the owners is important. However, the reason for the restructure is merely an explanation as to why assets were transferred to the LLC prior to the sale of its membership interests, and is irrelevant to the issue of whether there was a transfer of tangible personal property for consideration, to which no exemption applies.

Because Regulation 1595(b)(4) does not apply when the transfer of property is not solely in exchange for a membership interest, as is the case here, it is unnecessary to apply tests of the step transaction doctrine.

Lastly, we understand that taxpayer's representative, A--- A---, ---, believes (e.g., see letter dated July 6, 2001) that if the transaction is deemed a transfer of tangible personal property, a significant portion of this transfer would be exempt from tax under Regulation 1595(a)(3) since most of the assets were used in the manufacture and sale of food products. Regulation 1595(a)(3) explains that persons may be engaged in entirely separate endeavors that do not require the holding of a seller's permit, such as a business which sells services and no tangible personal property. Where this occurs, tax does not apply to the transfer of property held or used by that person in its non-selling endeavors which do not require the holding of a seller's permit, unless the transfer is one of a series of sales sufficient in number, scope and character as to require the holding of a seller's permit. As noted above, the tangible personal property transferred at the [California] facility included assets related to the Business that was conducted by the manufacturing division of Sellers. Under these facts, we understand that the division constituted an integrated operation consisting of the selling of food and related non-food products. Every person engaged in the business of selling tangible personal property of a kind the gross receipts from the retail sale of which are required to be included in the measure of sales tax is required to hold a seller's permit. (Rev. & Tax. Code § 6066; Reg. 1699.) As such, the Business was required to hold a seller's permit notwithstanding the fact that the Business' sales of food are exempt. In particular, the food and related non-food products do not appear to be entirely separate endeavors (see Regulation 1595(a)(5)(B)1.⁷ or Regulation 1595(a)(5)(B)2.) That is, the operations of manufacturing, processing and packaging of food and related non-food

⁷ Tax applies to the sale of assets of a business that is not essentially a service enterprise. Examples of this are sales of grocery stores making both exempt sales of food products for human consumption and taxable sales of other tangible personal property.

products appear to be a single, non-service operation engaged in sales operations requiring the holding of a permit, and not that of a service enterprise with a separate selling activity like that of a movie theater that sells popcorn. Since the Business was required to hold a seller's permit, tax applies to the transfer of tangible personal property related to the food product business as well as to the non-food product business in accordance with Regulation 1595(a)(5)(B)1. (See also Sales and Use Tax Annot. 395.1255 (12/21/92).)

Please let me know if you have any further questions.

TMN

cc: Mr. Ray Harispe (AA)
Mr. Michael Templeton (AA)
Ms. Charlotte Paliani (MIC:92)
Mr. Vic Anderson (MIC 40)