STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 327-5428

October 26, 190

A--- M---, Inc.
XXX --- Way
---, CA XXXXX

Dear Mr. W---:

Re: SR – XX-XXXXXX-010

Enclosed is a copy of the Decision and Recommendation pertaining to the petition for redetermination in the above-referenced matter.

I have recommended that petition be granted as explained in the Decision and Recommendation.

You are advised that this recommendation has not yet become final and that there are three options available to the Board's Department of Business Taxes:

1. If, after reviewing the Hearing Decision and Recommendation, the Department believes it has new evidence and/or contentions not previously considered by the Hearing Officer, it may file a Request for Reconsideration within 30 days from the date of this letter and clearly set forth any new contentions. If new evidence is the basis for filing the request, the evidence must be included. The Department will direct any such request directly to me with a copy to you. I will subsequently notify you whether the request has been taken under review or whether the request is insufficient to warrant an adjustment. If I conclude that no adjustment is warranted, I will then notify the Department of the procedures it can follow to request an oral hearing before the Board.

2. If, after reading the Hearing Decision and Recommendation, the Department finds that there is no basis for filing a Request for Reconsideration, but nevertheless desires to have an oral hearing before the Board, a written request must be filed within 30 days from the date of this letter with Ms. Janice Masterton, Assistant to the Executive Director. A copy of any such request will be sent to you.

3. If neither a request for Board hearing nor a Request for Reconsideration is received within thirty (30) days from the date of this letter, the Hearing Decision and Recommendation will be presented to the Board for final consideration and action.

Very truly yours,

Susan M. Wengel
Hearing Officer

SMW:te
Enc.

cc: S--- M---
H---, F---, J--- & A---, Inc.
XX South --- Street
--- ---, CA XXXXX-XXXX
(w/enclosure)

Mr. C--- C---
L--- L---, Inc.
XXX --- Way
---, CA XXXXX
(w/enclosure)

Ms. Janice Masterton
Assistant to the Executive Director (w/enclosure)

Mr. Glenn Bystrom
Principal Tax Auditor (file attached)

--- --- – District Administrator (w/enclosure)

STATE OF CALIFORNIA

395.0378

BOARD OF EQUALIZATION

APPEALS UNIT

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
A--- M---, INC.	)	No. SR – XX XXXXXX-010
Petitioner	)	

The above-referenced matter came on regularly for hearing before Hearing Officer Susan M. Wengel on April 16, 19XX, in --- ---, California.

Appearing for Petitioner:

S--- M---
Attorney

G--- W---
President A---
M---, Inc.

C--- C---
President
L--- L---, Inc.

Appearing for the Department of Business Taxes:

Vern Oswald
Senior Tax Auditor

John Wishart
Supervising Tax Auditor

Protested Item

The protested tax liability for the period October 1, 19XX through June 30, 19XX is measured by:

Item		State, Local, County SCCT and SCTA
A.	Taxable sale of service division.	$XXX,XXX

Contentions of Petitioner

1. No sale occurred because no consideration was received by petitioner.

2. If a sale did occur, it is exempt as an occasional sale.

Summary of Petition

Petitioner is a corporation that prior to July of 1986 had two divisions. The service division performed integrated testing services and was managed by C--- C--- (C---) who owned 39.7% of petitioner's stock. The systems division manufactured integrated circuit test equipment and was managed by E--- W--- (W---) who also owned 39.7 % of petitioner's stock. The remainder of petitioner's stock was owned by three other shareholders who were not actively engaged in the business of either division.

The systems division manufactured testing equipment which it sold to larger companies such as N--- S---. These companies have budgets substantial enough to allow them to purchase their own expensive testing equipment. Smaller companies cannot usually afford to purchase this expensive equipment so the service division was created to provide testing for these businesses. Customers for the service division could also be larger companies who wanted to have petitioner test their products until they could acquire their own testing equipment. Service division customers could also be companies who had so much merchandise to test that they tested half of it themselves and had the services division test the remaining merchandise.

Both of petitioner's divisions were located in the same building and shared the same telephone number. The divisions were, however, physically separated from each other by a wall that divided the building. Each division had its own separate address and receiving/shipping docks. The divisions shared the same attorney and the same dental and medical plan. They also shared a sales staff and an accounting staff until about 1985 when each began to use its own personnel. The utilities were billed as one amount, however, the bill was apportioned to each division based on square footage and power consumption.

The customer bases for each division were not dependent on each other. Although there were some customers who used both divisions, the system division was attracting customers who wanted to purchase integrated circuit testing equipment. The service division attracted customers who wanted testing services. It made no sales of tangible personal property.

The divisions each had its own engineering, operations and technical staffs. Each division was operated by a different major shareholder and had separate supervisory personnel.

When management differences arose between W--- and C---, it was decided to place each division in a separate corporation. In 1978, petitioner had created a wholly

owned corporate subsidiary called L--- L---, Inc. (L---). This subsidiary was not actively conducting business so petitioner in July of 19XX used the corporation to transfer all the assets and liabilities of the service division plus a proportionate share of several of petitioner's liabilities. [1] According to this plan of reorganization, C--- was to relinquish his stock in petitioner in exchange for 79.4% of the stock in L---. The 39.7% of stock in petitioner previously owned by C--- was transferred to W--- so that he would hold 79.4% of petitioner's stock. The remaining minority shareholders kept their 20.6% of petitioner's stock and were given 20.6% of the stock in L---. Each minority shareholder reserved the right to require W--- and C---, respectively, to buy their stock once the reorganization was completed.

The Department of Business Taxes (Department) in auditing petitioner's records ascertained that the transfer of the assets from the service division to L--- in exchange for the assumption of liabilities by L---, was a sale within the meaning of Revenue and Taxation Code Section 6006. They further determined that the transfer of assets between a parent and a wholly owned subsidiary was a taxable sale and not exempt as an occasional sale.

Petitioner contends that the transfer is a tax-free exchange under the Internal Revenue Code and should be a tax-free transfer for sales tax purposes, also. In the alternative, petitioner contends that even if a sale took place, it is exempt as an occasional sale.

It is noted that subsequent to the sale L--- has expanded its operations and now performs minor repair work. It now holds its own seller's permit.

Analysis and Conclusions

1. Petitioner's first contention is that no sale occurred because no consideration was received by petitioner. We cannot agree. Assets and liabilities were transferred from petitioner to L---, a separate corporate entity. After the transfer C--- no longer had an ownership interest in petitioner and W--- no longer had an interest in the service division. Once the transfer was completed, both petitioner and L--- conducted their business as separate entities. As petitioner's brief states, the divisions were separated into two corporations because both divisions had separate needs and disputes arose between W--- and C--- over how petitioner's corporate affairs should be conducted. Under the provisions of Revenue and Taxation Code Section 6006 this transfer of title or possession is a sale and subject to California's sales tax.

[1] L--- was also to remain responsible for a portion of a bonus paid to an employee of petitioner and half of any payment due on a note to S--- B—C--- and D--- Company.

Petitioner contends that the case of Macrodyne Industries, Inc. v. State Board of Equalization (1987) 192 Cal.App.3d 579 is controlling and that an assumption of indebtedness by a subsidiary upon the transfer of an operating division by the parent does not constitute consideration. This case is clearly distinguishable from the present fact situation. In Macrodyne, the assets and liabilities of the divisions were transferred to the subsidiaries, however, the transfer agreement stated that Macrodyne would remain jointly liable for the same liabilities after the transfers. There was no such agreement in this appeal with the exception of several minor liabilities. Both entities remained liable for half of any payment due to S--- B--- C--- and D--- Company and for bonus payments to R--- S---, an employee of petitioner.

The Macrodyne case is further distinguished from the present appeal in that after the transfer in Macrodyne, the subsidiaries had directors and officers in common and maintained the same relationship with the parent as they had maintained before the transfer. In this appeal the ownership interest changed and so did the business relationship between petitioner and L---. The transfer was made so that W--- would be the majority shareholder and manager of the systems operations and C--- would be the majority shareholder and manager of the service operations. Once the transfer was completed, both entities functioned entirely on their own.

It must be concluded that unless the sale qualifies as an occasional sale, the transfer from petitioner to L--- was a transfer for a consideration and is subject to California sales tax.

2. Petitioner's second contention is that if a sale did occur, it is exempt as an occasional sale. The Department has taken the position that the systems division, which sold testing equipment, and the service division, which made no retail sales, were operating together so as to constitute one business. Because petitioner held a seller's permit the Department's position is that the sale of the assets of the service division are subject to sales tax.

Revenue and Taxation Code Section 6367 provides an exemption for sales that are occasional sales. This statute is interpreted by Sales and Use Tax Regulation 1595(a)(1) which provides in part:

> "Tax applies to all retail sales of tangible personal property including capital assets whether sold in one transaction or in a series of sales, held or used by the seller in the course of an activity or activities for which a seller's permit or permits is required or would be required if the activity or activities were conducted in this state."

This regulation goes on to state that:

> Tax does not apply to the sale of property held or used in the course of an activity not requiring the holding of a seller's permit unless the sale is one of a series of sales sufficient in number, scope and character to constitute an activity for which the seller is required to hold a seller's permit or would be required to hold a seller's permit if the activity were conducted in this state."

Petitioner's systems division was clearly making the type of sales for which a seller's permit was required and this finding is not in dispute. The sole issue is whether the two divisions were separate businesses with no relationship between the two activities except for common ownership or whether the service division and the sales divisions were operated together so as to constitute one business. This finding is crucial as Sales and Use Tax Regulation 1595 denies the occasional sales exemption if the divisions constitute one business but allows the exemption if there are two separate businesses. Section (a)(3) of Regulation 1595 provides:

> "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 locations and a real estate brokerage 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 this section applies, the sale of the service division will be exempt as an occasional sale.

Section (a)(5)(B)(2) of Regulation 1595 provides:

> "Where a service enterprise and a sales business are operated together so as to constitute one business, tax will apply to the sale of the assets of the business. For example, if a car wash and gasoline station are operated at the same premises and the care wash is available only to persons who buy gasoline or if the price of the car wash is reduced if gasoline is purchased, tax applies to the sale of the car wash."

If this section applies, the sale of the service division will be subject to the sales tax.

In making a determination whether petitioner's divisions constitute one or two businesses, it appears to this hearing officer that the key language in Regulation 1595 is the language relating to the interrelationship of the activities performed by each division. It is acknowledged that common ownership was present and that one switchboard was shared by both divisions. Likewise, the divisions shared a dental and a medical plan. They, at one time, also shared a common sales staff and accounting staff. These duties were separated at lease a year prior to the sale, however, so that each division had its own sales and accounting personnel. The regulation implies that certain activities of ownership can be present and yet the businesses can remain separate entities.

The testimony at the hearing emphasized the separation of control over the two divisions and the conflict over management of the business that resulted. With the systems division operated by W--- and the service division operated by C---, conflicts arose as to the way the corporate affairs should be conducted. By this point in time, the divisions shared a building but were divided by a wall so that each division had its own address and loading dock. The utilities were shared but the percentage of each entity's payment was based upon the power consumption and square footage of the building occupied by each division. Each division had its own customer list, although some of the names appeared on both lists. The service division's customer list was comprised mainly of smaller businesses which could not afford to buy the testing equipment. Some larger companies used the service division, however, while waiting to receive the new testing equipment. Customers of this type would be on the customer list of both divisions.

While many of the above-mentioned activities were shared by the divisions, the actual operations of the businesses appear to have been kept separate. A customer which bought testing equipment from the systems division was under no obligation to use the service division. The company did not, through its service division, perform warranty or repair work on the equipment sold by the systems division. Likewise, if a customer used the service division to test

circuit boards, it was not obligated to buy any equipment from the systems division. Furthermore, there is no evidence that a customer of one division would receive any benefit, such as a discount, if it used the services of the other division. It is noted that 40% of the service division's equipment was comprised of testing equipment manufactured by the systems division. There was no obligation of the service division, however, to use petitioner's equipment. The majority of the testing equipment used by the service division was obtained from other manufacturers.

It must be concluded that even though the divisions shared common ownership and other services related to common ownership, the divisions were separate businesses which did not rely upon each other for day to day operations. Unlike the gasoline station and the car wash example used in Regulation 1595(a)(5)(B)(2), the services of the service division were not limited to customers buying equipment from the systems division. Neither division relied upon the other for its daily operations or for its future customers. As the service division was not engaged in any activities which would have required it to obtain a seller's permit, it is concluded that the sale of the service division is an exempt occasional sale.

Recommendation

It is recommended that the petition be granted.

Sept. 5, 1990

Susan M. Wengel, Hearing Officer Date