M e m o r a n d u m

535.0032

To: Mr. William D. Dunn
Assistant Principal Tax Auditor

Date: September 21, 1993

From: Elizabeth Abreu
Tax Counsel

Subject:

This is in response to your memorandum dated July 2, 1993 concerning questions about successor liability as applied to the above-named petitioners. According to the documents in the petition file and the materials you provided us, the facts are as follows:

The petitioners owned a shopping center which had several tenants, including a grocery store that occupied about 60 percent of the area of the shopping center. The grocery store was an anchor tenant which attracted customers to the other six tenant businesses. Without this anchor tenant, the petitioners might have lost other tenants in the shopping center.

From 1986 to 1989 the petitioners extended financial assistance to the owner of the grocery store in an effort to keep this tenant. On December 23, 1987, the petitioners signed a continuing guarantee in which they guaranteed to pay up to $80,000 of any indebtedness incurred by the owner of the grocery store to _____ the grocery store's main supplier. The petitioners also lent the grocery store owner $45,000 to infuse cash into the business and help continue its operations.

The petitioners' attempt to help the grocery store owner proved to be fruitless. On or about March 19, 1989, the owner left the store. The petitioners took over the operation of the store the following day and changed the name of the store.

Because the grocery store was an anchor tenant and because petitioners could be liable under the guarantee for the owner's debts, the petitioners felt compelled to keep the business going. The petitioners and the owner signed a document dated March 20, 1989 and entitled "Sales Agreement and Escrow Instructions." The agreement referred to the owner as "sellers" and to the petitioners as "buyers." Under the terms of the agreement, the owner sold the lease of the premises, the owner's interest in equipment, furniture, and fixtures, inventory of stock in trade, and the name and goodwill of the business. The purchase price set forth in the agreement was $63,000. The petitioners operated the business during escrow.

In August 1989 the petitioners requested a certificate from the board releasing them from successor liability. The board issued a demand for $63,000 on September 30, 1989. Funds were disbursed from escrow but only a small amount was paid to the board. Instead, most of the funds

were disbursed to other lienholders whose liens encumbered the property of the grocery store. On February 20, 1990 the board issued a notice of successor liability to the petitioners for $49,096.11 in tax, plus interest and penalty for a total of $67,885.05.

You raise three issues with respect to this case. The first is whether the petitioners, as third party guarantors, should be considered "original purchasers" of the inventory. If so, the petitioners did not purchase the inventory since they already owned it. The second issue is whether the payment made by petitioners into escrow and paid to _____ is consideration since petitioners were liable to _____ as guarantors. Finally, you ask whether the petitioners can be liable as successors when the full $63,000 purchase price was committed to other creditors who had claims with higher priority than the board's claim.

A. Guarantee Issues

Petitioners' representative argues that petitioners are not liable as successors because, as guarantors, petitioners already owned the inventory and therefore there could be no sale. Alternatively, petitioners paid no consideration to the seller since petitioners were already liable to _____ under the guarantee. The representative's arguments are based on the following excerpts on pages 14 and 15 of Tax Tip Pamphlet No. 23:

> "Normally, when one party transfers the equity in an automobile and the transferee merely assumes the payments, we have a sale or purchase, the consideration being the making of the payments for which the transferor was liable. This is so regardless of whether or not the transferee pays the transferor anything for the equity acquired.
>
> "We often encounter a situation where a person who buys an automobile must obtain a co-signer or guarantor of the loan in order to obtain credit. The buyer then defaults in the loan payments and the co-signer or guarantor is obliged to continue the payments to the finance agency.
>
> "The co-signer or guarantor of a note is considered to be one of the original purchasers of the automobile. Thus, when he/she takes over responsibility for the payments, he/she is not assuming a new obligation, but rather, is fulfilling an obligation under the original contract. He/she was, as a matter of law, just as liable for the payments as was the original purchaser. Therefore, a new sale did not take place, and use tax does not apply. The foregoing would also apply to mobilehomes and commercial coaches."

We are not certain on what basis a guarantor of an automobile loan is regarded as the owner of the automobile. In any event, this passage has no application to the transactions here.

In this case, the guarantee was not made in connection with the purchase of any particular property. Rather, the guarantee states that petitioner _____ unconditionally guarantees and promises to pay _____:

> "[A]ny and all indebtedness of… _____ to _____. The word 'indebtedness' is used herein in its most comprehensive sense and includes any and all advances,

> depts., obligations, and liabilities of _____, or any one or more of them, heretofore, now, or hereafter made, incurred or created, whether voluntary or involuntary and however arising, whether direct or acquired by _____ by assignment or succession…"

There are no terms in the guarantee or in any other agreement executed prior to the sale in issue which indicate that title to the inventory vests in petitioners. Therefore, petitioners were not owners of the inventory at the time of the sale.

Because of the manner in which this transaction was structured, there was a sale of the business. The sales agreement specifically provides that the prior owner was selling the business for a purchase price of $63,000 and that the property subject to the sale included the inventory. The purchase price was paid into escrow, and the escrow agent distributed the funds to the creditors of the prior owner, including _____. The prior owner received a benefit, i.e., consideration, by having its liabilities to _____ extinguished. Its contingent liability to the petitioners was also extinguished since the petitioners were no longer liable under the guarantee.

B. Priority Claim Contention

This issue was addressed previously by the Legal Division in a letter dated December l2, 1990, to the petitioners' attorney. This letter, a copy of which is attached, concluded that the fact that secured liabilities may be in an amount as much as the purchase price does not avoid the clear statutory provisions that a successor is liable for his predecessor's sales tax liability (up to the amount of the purchase price) if the successor does not obtain the certificate provided for in Revenue and Taxation Code section 6813. The letter gives an 'example of how a different conclusion could lead to the avoidance of the liability by manipulation of the purchase price.

This is not the only way manipulation could occur. For example, suppose a business owns unencumbered assets worth $100,000. The business owes the board $30,000, but no lien has been filed. The business obtains a $100,000 loan secured by the assets, pockets the loan proceeds, and then shortly thereafter sells the business for $100,000, with proceeds of the sale paying off the loan.

Petitioners argue that they were forced to purchase the business. A similar argument was made in Knudsen Dairy Products Co. v. SBE (1970) 12 Cal. App. 3d 47, to which the court responded:

> "The major consideration in this case from Creamery's standpoint was to keep pix afloat as a going business. A key asset which Creamery, through Dairy, acquired was the continuing of pix as a sales outlet and the prevention of pix's insolvency. This cannot be accomplished at the expense of depriving the state of that which is due it on a valid and existing tax liability." (12 Cal. App. 3d at 56-57.)

(916) 445-5550

December 12, 1990

Your letter dated November 1, 1990 to our Santa Rosa District Office regarding successor liability for sales tax has been referred to the Legal Division for response. (Your letter was actually addressed to the Franchise Tax Board. Since the Board of Equalization administers the sales tax, we are responding.)

_____ purchased equipment and fixtures for operating a grocery store from _____. Thereafter, the _____ sold the store back to the _____. The purchase price of $63,000 was placed into escrow. There were a number of creditors' claims, including the claim of the Board of Equalization for sales taxes owed by the _____. In a letter addressed to you dated September 26, 1989, you were notified that in order for the Board to issue a Certificate of Payment of Sales and Use Tax with respect to the tax liabilities, the amount of the purchase price, $63,000, would have to be deposited with the Board. This payment was not made and a certificate therefore was not provided. The amounts in escrow were apparently paid out in November 1989 with the Board receiving but a small portion of that escrow disbursement.

A notice of successor liability dated February 20, 1990 was issued to the _____ pursuant to the provisions of Revenue and Taxation Code section 6811 et seq. for $49,096.11 in tax, plus interest and penalty for a total of $67,885.05. The person to whom a notice of successor liability is issued may file a petition for reconsideration. (Rev. & Tax. Code § 6814.) The _____ filed no petition for reconsideration and the successor liability is therefore now final.

You apparently believe that successor liability should not be imposed upon the _____ since the secured creditors demanded payment before releasing their liens on the inventory. Initially, I note that there is no provision for administrative review of this issue at this time since the _____ failed to file a petition for reconsideration and the successor liability is final. The _____ must pay the liability and may thereafter file a claim for refund. However, even if the _____ file a claim for refund, there is unfortunately no statutory basis for relief.

The fact that secured liabilities may be in an amount as much as the purchase price does not avoid the clear statutory provisions that a successor is liable for his predecessor's sales tax liability (up to the amount of the purchase price) if the successor does not obtain the certificate provided for in Revenue and Taxation Code section 6813. I note that you were notified on behalf of the _____ of need for a certificate prior to disbursement of the funds in escrow. If your contention were correct, the purchase price could easily be manipulated in order to avoid payment of sales tax and successor liability. For example, a corporation may own a business with secured liabilities of $70,000 and a sales tax liability of $30,000. The corporation wishes to sell its business, which constitutes all its assets, for $100,000, which will leave the corporation with nothing after the sale. However, rather than offering $100,000, the purchase offers $70,000 since the sale cannot be completed unless the creditors are paid the $70,000 owed to them. If your contentions were correct, the purchasers would have no successor liability because the purchase price of $70,000 was needed to payoff the creditors, and the selling corporation, although owing the $30,000 in sales tax, would not pay it because it had no assets. This is not what the law provides.

If a sale cannot be completed because the secured creditors and the Board of Equalization cannot all be paid, then it would obviously be unwise on the part of the purchaser to complete the sale. The fact that the _____ found it more difficult to walk away from the purchase than would a different purchaser who was not the original seller to the _____ has no relevance to the application of the _____ statutory liability as successors who failed to obtain the Certificate of Payment of Sales and Use Tax.

Sincerely,

David H. Levine
Senior Tax Counsel