

**STATE BOARD OF EQUALIZATION**

LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 324-2588
FAX: (916) 323-3387

JOHAN KLEHS
First District, Hayward

DEAN F. ANDAL
Second District, Stockton

CLAUDE PARRISH
Third District, Torrance

JOHN CHIANG
Fourth District, Los Angeles

KATHLEEN CONNELL
Controller, Sacramento

E. L. SORENSEN, JR.
Executive Director

August 6, 1999

Re: Unidentified Taxpayer

Dear Mr. ---:

This letter is in response to your letter of May 3, 1999 requesting an opinion from the Board of Equalization as to whether or not proposed transfers of assets are subject to the California sales tax. We apologize for the delay in our response. Our understanding of the transaction you pose in your letter may be summarized as follows:

1. Corporation A, a California corporation that has been in existence for about forty years, is a general engineering construction contractor operating in the State of California, which is required to and does hold a seller's permit from the Board. Corporation A is owned 100% by shareholder #1. Corporation A owns real property and tangible personal property.
2. Corporation B, incorporated on March 23, 1998 in the State of California, is also a general engineering construction contractor operating in the State of California, which is required to and does hold a seller's permit from the Board. Corporation B is owned 60% by shareholder #1, 20% by shareholder #2 and 20% by shareholder #3. Corporation B owns tangible personal property, but owns no real property.
3. For valid business reasons, corporation A and corporation B desire to form a joint venture and continue the construction operations of both corporations within the joint venture. To accomplish this, substantially all of the assets and liabilities of each corporation, excluding the real property owned by corporation A, are to be transferred to the joint venture. In exchange, each corporation will receive an interest in the capital and in the profits or losses of the joint venture

4. Each corporation's percentage ownership of the total initial capital of the joint venture will be based on the ratio of the final value of the net assets contributed by each respective corporation to the total value of the net assets contributed by both corporations. As we understand your example, corporation A will transfer tangible personal property and indebtedness with a net value of \$3,000,000 and corporation B will transfer tangible personal property and indebtedness with a net value of \$1,000,000.
5. The allocation of the net income or loss of each corporation has yet to be determined and will be based on a number of factors, most of which are unrelated to the value of the contributed property. However, you do not believe the issue of the percentage allocation of profits and losses will impact the ultimate determination of whether or not this proposed transaction is subject to sales tax.
6. Based on the above, we assume that corporation A has 75% interest in the joint venture and corporation B has 25% interest in the joint venture.

You believe that corporation A's transfer of tangible personal property to the joint venture is not subject to tax because corporation A transferred substantially all its tangible personal property without a substantial change in ownership.

You believe the same with respect to corporation B, and in your letter you state:

“Turning to corporation B, the stock ownership is not as simple as corporation A, but we believe the end result will be the same as corporation A. By applying the exact same rules to corporation B, here's the results. Corporation B transferred tangible personal property with a fair value of \$1,000,000. In exchange, corporation B received an ownership interest in the **capital** of the joint venture of \$1,000,000. Looking through corporation B to the shareholders, shareholder #1 owns 60%, shareholder #2 owns 20% and shareholder #3 owns 20% of the outstanding stock of corporation B before and after the transfer. Therefore, under Sections 6006.5(b) and 6281, shareholder #1 is considered to own 60%, shareholder #2 is considered to own 20% and shareholder #3 is considered to own 20%, of the tangible personal property both before and after the transfer. Since each of the three shareholders of corporation B own the exact same interest in the tangible personal property both before and after the transfer, which collectively equals 100% of the ownership of the property, the real or ultimate ownership of the tangible personal property meets the definition of 'substantially similar' referred to in Sections 6006.5(b) and 6281 and further defined in Section 1565(b)(2) as being 80% or more unchanged after the transfer.

You ask for our opinion on the following three matters:

- “A. Whether or not, under Section 1595(b)(4), the transfer of tangible personal property that is subject to any type of liability to a commencing joint venture subjects the transfer to California sales tax to the extent of the liabilities assumed.
- “B. Whether or not, in the fact pattern presented for corporation A, the retention of the real property within corporation A prevents corporation A from meeting the requirement that ‘substantially all’ of corporation A’s assets be transferred to the joint venture to avoid the imposition of the California sales tax on our proposed transactions.
- “C. Whether or not, in the detailed fact pattern presented related to the ownership of both corporation A and corporation B, [Rev. & Tax. Code] sections [6367,] 6006.5[b] and 6281 would exempt the transfer of assets from corporations A and B to the joint venture from California sales tax because there would be a transfer of substantially all of the assets of corporation A and corporation B and the real or ultimate ownership of the tangible personal property both before and after the transfer would be substantially similar as required by, and in accordance with the rules of, both of those sections.”

General Discussion:

I initially note that Revenue and Taxation Code section 6596, as interpreted by Regulation 1705 (both of which are attached), sets forth the circumstances under which a taxpayer may rely on a written response to a written request for an opinion. In order to come within the provisions of section 6596, all relevant facts, including the identity of the taxpayer, must be disclosed. You should provide us with the identity of your client (as well as all relevant facts) in your initial letter to us if you wish an opinion letter coming within the provisions of section 6596. Since you did not identify the taxpayer, this letter does not constitute specific written advice to the taxpayer and does not come within the provisions of Revenue and Taxation Code section 6596. This letter is not an “opinion” of the Board; rather, it constitutes general comments regarding the applicability of the California Sales and Use Tax Law to the transaction you describe.

Sales tax is imposed on a retailer’s retail sale of tangible personal property in this state, measured by a percentage of gross receipts, unless the sale is specifically exempt by statute. (Rev. & Tax. Code § 6051.) When sales tax does not apply, use tax applies to the storage, use or

other consumption of tangible personal property purchased from any retailer for the storage, use or other consumption in this state, measured by a percentage of the sales price, unless that use is specifically exempt by statute. (Rev. & Tax. Code §§ 6201, 6401.) The term “sale” includes any transfer of title or possession of tangible personal property for a consideration. (Rev. & Tax Code §§ 6006(a).)

Revenue and Taxation Code section 6367 exempts from tax the transfer of tangible personal property (other than the transfer of vehicles, vessels, or aircraft) that qualifies as an occasional sale. Revenue and Taxation Code section 6006.5(b) defines an occasional sale as any transfer of all or substantially all of the property held or used by a person in the course of those activities for which the seller is required to hold a seller’s permit or permits (or would be required to hold a permit or permits if the activities were conducted in California) where, after the transfer, the real or ultimate ownership of the property is substantially similar to that which existed before the transfer.

Revenue and Taxation Code section 6281 exempts from tax the sale or use of vehicles when they are included in a transfer of all or substantially all of the property held or used in the course of business activities of the person selling the property where, after such transfer, the real or ultimate ownership of such property is substantially similar to that which existed before the transfer.

Regulation 1595(b)(2) explains that (1) “substantially all the property” means 80 percent or more of all tangible personal property held or used by the person in the course of the activities requiring the holding of a seller’s permit, including tangible personal property located out of the state *but excluding any real property*, and further explains that a simultaneous transfer of all or substantially all of its assets to more than one entity, will qualify for the exemption if the ownership remains substantially similar, and (2) stockholders or other persons holding an ownership interest, not a security interest, in a corporation or other entity are regarded as having the real or ultimate ownership of the property of the corporation or other entity, and the real or ultimate ownership is “substantially similar” to that which existed before the transfer if 80 percent or more of the ownership of tangible personal property is unchanged after the transfer.

Response to Inquiries:

We will respond to your specific requests in items A, B and C above in the order requested:

“A. Whether or not, under Section 1595(b)(4), the transfer of tangible personal property that is subject to any type of liability to a commencing joint venture subjects the transfer to California sales tax to the extent of the liabilities assumed.”

A transfer of tangible personal property to a commencing joint venture in exchange *solely* for an interest therein is not a sale of tangible personal property. Regulation 1595(b)(4) explains:

“[s]uch a transfer is a sale if the transferor receives any consideration, such as . . . an assumption of indebtedness (whether or not the transferor retains any joint liability with respect to the indebtedness assumed by the transferee), and tax applies to that sale unless it otherwise qualifies for exemption.”

Regulation 1595(b)(1) describes consideration to include:

“. . . cash, notes, and any other property as well as any indebtedness assumed by the transferee. It is irrelevant that the indebtedness assumed may have arisen solely in connection with the transferor's acquisition of the tangible personal property transferred, the other property transferred, or some combination thereof. . . .”

The transfer to a commencing entity of tangible personal property subject to any type of liability, as well as any other indebtedness assumed by the transferee (including indebtedness secured by real property), or other consideration, constitutes consideration for the sale of tangible personal property and unless otherwise specifically exempt, the sale is subject to sales tax, as further described in Regulation 1595(b)(4):

“The gross receipts from that sale is allocated among the taxable portion and the non-taxable portion by dividing the selling price of the tangible personal property transferred to the purchaser for use rather than resale by the selling price of all property transferred and then multiplying that amount by the total gross receipts (i.e. all consideration) received by the transferor.”

Therefore, the transfer of tangible personal property that is subject to any type of liability to a commencing joint venture is a sale of tangible personal property and unless specifically exempt is subject to sales tax measured not only by the liabilities assumed, but by all other consideration (if any).

“B. Whether or not, in the fact pattern presented for corporation A, the retention of the real property within corporation A prevents corporation A from meeting the requirement that ‘substantially all’ of corporation A’s assets be transferred to the joint venture to avoid the imposition of the California sales tax on our proposed transactions.”

The definition of “occasional sale” in 6006.5(b) is conditioned on a transfer of substantially all tangible personal property. This is explained in 1595(b)(2). The transfer or retention of real property is irrelevant to the question of whether a transfer of tangible personal property qualifies as an occasional sale. Regulation 1595(c) explains that “the rules set forth in 1595(b)(2) of this regulation are applicable in determining under this paragraph whether a transfer is of substantially all the property and whether the ownership is substantially similar.” These rules define “substantially all the property” as 80 percent or more of all the *tangible personal property* held or used in the course of activities requiring the holding of a seller’s permit. The retention of the real property by a transferor of substantially all of its tangible personal property will not affect the determination of whether the transfer of tangible personal property qualifies as an occasional sale.

“C. Whether or not, in the detailed fact pattern presented related to the ownership of both corporation A and corporation B, [Rev. & Tax. Code] sections [6367,] 6006.5[b] and 6281 would exempt the transfer of assets from corporations A and B to the joint venture from California sales tax because there would be a transfer of substantially all of the assets of corporation A and corporation B and the real or ultimate ownership of the tangible personal property both before and after the transfer would be substantially similar as required by, and in accordance with the rules of, both of those sections.”

If, as we have assumed, corporation A owns a 75 percent interest in the joint venture and corporation B owns a 25 percent interest in the joint venture, then for purposes of the occasional sale exemption, shareholder #1 has a real or ultimate interest in 90 percent of the tangible personal property of the joint venture derived (derived through its ownership in corporation A: 100 percent x 75 percent = 75 percent, and through its ownership in corporation B: 25 percent x 60 percent = 15 percent). For the purposes of the occasional sale exemption, shareholders #2 and #3 each have a real or ultimate ownership interest in 5 percent of the property of the joint venture (derived through their ownership interests in corporation B: 25 percent x 20 percent = 5 percent).

Regulation 1595(b)(2) uses the following table to illustrate how to determine whether 80 percent of the real or ultimate ownership of the tangible personal property of a transferee remains unchanged after the transfer:

Stock-holders	Interests in Transferor Corporation	Interests in Transferee Corporation	Interests Common Before and After Transfer
A	40%	33 1/3%	33 1/3%
B	40%	33 1/3%	33 1/3%
C	<u>20%</u>	<u>33 1/3%</u>	<u>20%</u>
	100%	100%	86 2/3%

As you can see, the analysis required by 1595(b)(2) is on a transferor by transferor basis, not on a shareholder by shareholder basis. The transfer by 100 persons of \$100 of tangible personal property to a single entity for which each transferor receives a 1% interest in the transferee valued at \$100 is not a transfer in which the ownership interest is substantially similar to that which existed before the transfer – before the transfer, each transferor had a 100% ownership interest and after the transfer had only a 1% ownership interest. In other words, the ownership in each *transferor* must be substantially similar before and after the transfer for the transfer of that transferor's assets to qualify as an occasional sale.

The real or ultimate ownership of the tangible personal property before and after the transfers by corporation A to the joint venture may be shown as follows:

Stock-holders	Interests in Transferor Corporation A	Interests in Transferee Joint Venture	Interests Common Before and After Transfer by Corporation A
1	100%	90%	90%
2	-	5%	-
3	<u>-</u>	<u>5%</u>	<u>-</u>
	100%	100%	90%

The real or ultimate ownership of the tangible personal property before and after the transfers by corporation B to the joint venture may be shown as follows:

Interests in	Interests in	Interests Common
--------------	--------------	------------------

Stock- holders	Transferor Corporation B	Transferee Joint Venture	Before and After Transfer by Corporation B
1	60%	90%	60%
2	20%	5%	5%
3	<u>20%</u>	<u>5%</u>	<u>5%</u>
	100%	100%	70%

Although corporation A and corporation B each transferred all or substantially all of their tangible personal property to the joint venture, the real or ultimate ownership of the property is substantially similar to that which existed before the transfer only for the transfer of tangible personal property by corporation A, in which 90 percent of the real or ultimate ownership of the property is unchanged after the transfer. Corporation A's transfer of tangible personal property to the joint venture would not be subject to tax. On the other hand, only 70 percent of the real or ultimate ownership of the tangible personal property of that corporation B is unchanged after its transfer to the joint venture. The real or ultimate ownership of the property that corporation B transferred to the joint venture is not substantially similar to that which existed before the transfer, and corporation B's transfer of tangible personal property to the joint venture would be subject to tax.

If you have any further questions, please do not hesitate to write.

Very truly yours,

Janice L. Thurston
Senior Tax Counsel

JLT/cmm

cc: Sacramento District Administrator (KH)