The Forgotten Tax

Business changes often trigger unexpected sales tax liability

BY DANIEL M. DAVIS

IT'S FRIDAY and you've had a busy week. You created a two-owner corporation for a machine shop proprietor and one of his employees, drafted an agreement for a retailer taking on a partner and set up a corporate subsidiary for the repair division of a computer firm.

Your clients didn't want these transactions to be taxable events, so you went over the facts with your tax partner. She assured you there would be no income tax liability.

She was right—but only about income tax. Each transaction still resulted in a tax liability. No one had thought about the sales tax.

California sales tax is easy to forget. Academicians ignore it, seminars rarely address it and resource materials give it scant coverage. As a result many legal and accounting professionals underestimate sales and use tax until clients are hit with their first audit.

The rules seem simple enough. Subject to limited exclusions, the sales tax is imposed on gross receipts from retail sales of tangible personal property in California. It is an excise tax on the "privilege" of selling at retail. Related to sales tax is use tax, an excise tax on the storage, use or other consumption of tangible personal property in California. The use tax is intended to reach transactions that escape sales tax because the subject property, although meant for use in California, is bought from out-of-state retailers.

In practice, however, the rules are not so simple. Look back at your hypothetical work week. In your first job—creating the corporation for the machine shop owner and his employee—the owner contributed all his business assets, which consist of tools and freestanding equipment worth $100,000 and nonremovable leasehold improvements worth $50,000. Since the corporation also took over the owner's business debt of $100,000, his net investment was $50,000: $150,000 in assets less $100,000 of debt. The employee invested $50,000 in cash, and in exchange the corporation issued half of its common stock to each of the two individuals.

The original owner could have incurred an income tax liability if the basis (cost less depreciation) of the assets he contributed was less than his debt. You had checked and found his basis exceeded the debt; for income tax purposes he was home free. But now an auditor has told him he owes $4,000 in sales tax on the transfer of property to the corporation. Your client wants to know why.

> ***With planning, you can avoid or minimize sales and use tax, just as you do with income tax.***

Under sales tax law, any time a retailer transfers for consideration tangible personal property in California, the sales tax applies unless the transfer falls under an exemption. To understand the rule, you must know a few definitions.

A "retailer" is generally any person making more than two sales of tangible personal property for substantial amounts within a 12-month period or any person who makes a substantial number of small sales. The term "substantial" is not quantified. But your client owned a machine shop. He rarely sold any property. For the most part, he performed labor on items provided by customers.

So you have to look to another definition. For tax purposes a "sale" includes many transfers not commonly thought of as sales. Under Revenue and Taxation Code section 6006(b), fabricating or processing tangible personal property—as opposed to repairing or installing such property—is specifically included in the definition of sale when done for consideration, even though the customer furnishes the property to be worked on. Taxable fabrication includes processes as simple as bending a customer's iron bar or drilling holes in a customer's sheet metal assembly, so long as those processes alter the function of the bar or assembly. It would be an unusual machine shop that did not perform such "sales" regularly.

Now that you know your client is a retailer, you must refer back to the general rule that any time a retailer transfers tangible personal property in California for consideration, the sales tax applies unless the transfer falls under an exemption. First you examine the term "tangible personal property." The leasehold improvements transferred by your client are excluded: He is a lessee without removal rights, and the improvements are treated as real estate with respect to him. The tools and freestanding equipment, however, are tangible personal property.

Your next step is to look for an exemption. If the equipment were inventory the new corporation intended to resell, the transfer to the corporation would be exempt as a sale for resale. But the equipment will be used rather than resold, so this exemption does not apply.

Many corporate and partnership transactions are saved from taxation by another statutory exemption. Section 6006.5(b) provides that where there is a transfer of substantially all the property used in the course of activities for which a seller's permit is required, no sales tax will apply if the ownership after the transfer is substantially similar to the previous ownership. For this purpose "substantially" means 80 percent or more.

The machine shop owner transferred 100 percent of the property used in the

course of his business, which satisfies the first condition of the exemption. But after the transfer the corporation owns all of the business and the former owner owns only 50 percent of the corporation. Once again the exemption does not apply.

There is one last hope. Regulation 1595 exempts any contribution to a commencing corporation made solely in exchange for the first issue of stock, even when there is no common 80 percent ownership. Your client has indeed made a contribution to a commencing corporation in exchange for first-issue stock. The problem is that the contribution was not *solely* an exchange for first-issue stock. The corporation also assumed your client's debt.

Thus your client's transfer is treated as a partial sale. The tax is figured by dividing the tangible personal property by the total property and multiplying the resulting fraction by the taxable consideration. The tangible personal property consists of the tools and equipment valued at $100,000; the total assets are the tangible personal property plus the leasehold improvements of $50,000. Applying the sales tax formula, $100,000 divided by ($100,000 plus $50,000) results in a taxable fraction of two-thirds.

You multiply the fraction by the taxable consideration, which is the debt of $100,000 assumed by the corporation. (The first-issue stock, although consideration, is nontaxable.) The figure you come up with is a taxable amount of $66,667, which at 6 percent makes sales tax of $4,000 due.

Since the owner had originally paid tax on the equipment when he bought it, he could have avoided sales tax liability by transferring only the leasehold improvements and retaining both the equipment and the debt. He then could have leased the equipment to the corporation and used the proceeds to pay the debt.

The employee who received the other 50 percent of the stock has no liability since he contributed no tangible personal property to the new corporation. Even if he had contributed property and the property had been subject to liabilities, no sales tax would be due. As an employee he had not been in a business requiring the holding of a seller's permit.

Similar transfers to a commencing partnership would have a similar outcome, since the law and regulation apply to both corporations and partnerships. Assuming similar facts, the retailer who took on a partner in your second transaction of the week could well be in the same predicament as the machine shop owner.

In the third transaction, you created a corporate subsidiary for the repair division of a computer firm. The division, which is 100 percent owned by the parent corporation, is in a leased industrial building. Its assets are test equipment, office equipment and furniture valued at $750,000 and a parts inventory valued at $75,000. It has assumed debt for equipment loans totaling $450,000. The adjusted basis of its furniture and equipment is $480,000, more than the debt assumed, so once again no income tax liability results from the transfer.

Since all the transferred assets were used by the parent company in a business requiring the holding of a seller's permit (computer sales and repairs), there is a potential sales tax liability on the transfer to the new corporation. The repair operation alone requires the holding of a seller's permit, since a substantial number of parts will be sold in the course of repairs.

Once again you examine possible exemptions. The repair parts are exempt because they are intended for sale to customers and thus are "sold" to the new corporation for resale. The furniture and equipment, however, will be used rather than resold. So far the $750,000 value of

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the fixed assets appears taxable.

But what about section 6006.5(b)? That section, you will recall, says transfers of substantially all property used in an activity requiring a seller's permit are exempt if after the transfer the ownership remains substantially unchanged. The exemption was lost in the other cases you handled because the ownership did not stay substantially the same. In this case, however, the parent corporation retains 100 percent ownership of its new subsidiary, so the second condition of section 6006.5(b) has been met.

Unfortunately, the first condition requires a transfer of substantially all the property used by a person (including a corporation) in the course of activities for which a seller's permit is required. The parent corporation had been required to hold a seller's permit to both sell and repair computers. Although it transferred all the property used in its repair division, it kept the property used to conduct sales activities. Assuming the property used in the sales division was more than 20 percent of the total, the exemption would not apply.

The parent corporation appears to be in the same fix as your machine shop client. It made a partial "sale" to its new subsidiary because it was relieved of equipment debt totaling $450,000. The taxable asset value of $750,000 for the equipment and furniture is divided by the total asset value ($750,000 plus $75,000 inventory), resulting in a ratio of 91 percent. The taxable consideration—$450,000 relief of debt—is then multiplied by 91 percent to arrive at a taxable sale of $409,500. At 6 percent, a tax of $24,570 is due.

As in the case of the machine shop owner, the tax could have been avoided if the parent corporation had transferred only the repair parts. The equipment could have been retained and leased to the subsidiary and the lease proceeds used to pay the debt.

These examples illustrate just a few situations that can trigger an unexpected sales tax liability. When your client holds or should hold a seller's permit, similar problems can result from almost any transaction involving tangible personal property. With planning, you can avoid or minimize sales and use tax, just as you do with income tax. The important thing is to recognize a potential problem exists.

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