STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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Executive Director

August 5, 1993

Mr. B--- D---
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XXX South --- Street
--- ---, CA XXXXX-XXXX

Dear Mr. D---:

This is in reply to you June 22, 1993 letter requesting our opinion as to the application of sales tax to the following facts you described:

> "For purposes of this ruling assume the transferor is required to hold a California Seller's Permit due to its activities in the State and will transfer less than 80% of the tangible personal property held or used in the course of such activities. The assets will be contributed to either a new corporation in exchange for the first issuance of stock ... or to an existing corporation with no stock issued in exchange.... In addition to the assets being transferred, certain liabilities will be transferred and assumed by the subsidiary. Included in these liabilities will be the following contingent liabilities that have been accrued for financial statement purposes and that we believe are not taxable consideration due to their contingent nature:
>
> - Deferred Taxes - This amount represents the income tax effect of differences between the company's book and tax basis of assets. For example, it includes tax on the temporary difference that results from the company's use of accelerated depreciation methods for income tax purposes versus straight line depreciation for book purposes.
>
> - Early Retirement Program - The company is offering an early retirement program in the near future. The company has established a contingent liability for its estimate of the cost that will ultimately be associated with this program.

A) The transfer of assets and liabilities may occur prior to the period during which the early retirement program will be offered.

B) The transfer of assets and liabilities may occur during the window period for which the early retirement program is offered. However, certain employees will not yet have elected to participate in the early retirement program as of the asset transfer date (e.g., period to elect to participate in the program is 9/1/93 - 12/31/93. Assets are transferred on 10/1/93). Accordingly, at the transfer date a portion of the liability associated with this program will still be contingent since such liability will relate to the estimate of the number of employees that will ultimately elect the program.

- Warranty Liability - A reserve has been established for future product warranty costs based on the company's experience with such costs in prior years.

Given this information, you asked that we confirm whether this Board would consider the assumption of any of the contingent liabilities discussed above to be part of the sale price of the assets.

Yes, we believe the transferee assuming the contingent liabilities is consideration given for the assets. As you noted, each of the liabilities has been accrued for purposes of reporting on financial statements. The Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No.5, Accounting for Contingencies (FAS5) provides at paragraph 8 that:

"8: An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both of the following conditions are met:

a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated." (Emphasis in original.)

Paragraph 1 of FAS5 defines a loss contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

Given that it is probable that future events will occur confirming the fact of the contingent liabilities you noted, and the liability is accrued in accordance with generally accepted accounting principles, we believe the transferee's assumption of the liability is

consideration given for the assets transferred.

Mr. Al Floria sent for our review opinion from the Board's legal staff dated June 1, 1987 which concluded that a subsidiary's assumption of reserves for contingent liabilities did not constitute consideration. That opinion was based on the view that,

> "Where the subsidiary incurs liabilities which arise after the transfer of tangible property, and are for benefits received by the subsidiary after that transfer, this is not assumed indebtedness within the meaning of Regulation 1595(b)(4), and therefore does not constitute taxable consideration for the transfer."

An example of a liability which arises after the transfer and is for benefits received by the transferee after the transfer, would be the transferee assuming the transferor's lease. For instance, if the transferor's lease agreement requires rental payments to be made in advance, then the transferee's liability for a rental payment would be for a benefit (the next month's rent) the transferee receives after the transfer. There are other agreements, often referred to as operating agreements, which we would treat in the same manner. These would include requirement and output contracts with third parties for benefits and liabilities not yet received or incurred.

As noted in the June 1, 1987 memorandum, we do not consider the characterization of the liabilities for income tax purposes to be determinative for sales and use tax purposes.

Sincerely,

Ronald L. Dick
Senior Staff Counsel

RLD:ph