STATE OF CALIFORNIA
BOARD OF EQUALIZATION

395.2000

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law I--- I---, INC. dba C--- P--- F--- C--- S--- Petitioner	DECISION AND RECOMMENDATION OF HEARING OFFICER Account No. SX -- XX XXXXXX

This matter came on regularly for hearing in Van Nuys, California, on September 18, 1974.

Appearing for the taxpayer were Mr. W--- F--- D---, attorney, and Mr. M--- M. D---, assistant secretary. Messrs. Tibbetts and Vener appeared for the board.

Protested Item
(Period 8/31/70 to 3/18/73)

	State & Local Tax	BART	SCRT
Transfer of tangible personal Property to EHR Corporation	$2,422,627	$433,419	$1,004,468

Contentions of Taxpayer

1. The transfer did not involve a sale of tangible personal property.

2. In any event the transfer qualifies as an exempt transfer by I--- I--- of D---, Inc., effective as of August 30, 1974.

Summary of Petition

The taxpayer is a corporation which held title to and operated a chain of restaurants nationwide.

In December of 1970 the taxpayer closed a deal whereby certain of its restaurant businesses and assets (but not the liabilities), with certain exceptions not pertinent here, were transferred to EHR, a new corporation created by the taxpayer. In form the transfer was made in exchange for the initial issue of EHR stock (10 shares, par value $100 each). Thereafter, but on the same date, the taxpayer closed a transaction entered into by a separate contract whereby the 10 shares of stock which it received from EHR was transferred to M--- H---, Inc. (MHI) in exchange for the assumption of the liabilities of the restaurant businesses, and other considerations. At the time of this transfer the taxpayer owned 81 percent of the stock of MHI, but it owed MHI a substantial amount on a notes payable currently due. The consideration passing from MHI to the taxpayer as a result of this transfer has been detailed by the taxpayer's representative as follows:

C--- P--- (CP) restaurant liabilities	$ 5,000,544.00
Notes payable payment	5,676,040.00
Cash (by check)	647,109.00
Promissory note	1,440,784.00
Total value of consideration	$13,646,477.00

The audit staff determined that the transfer of the fixed assets of the restaurants constituted a sale of tangible personal property and computed a deficiency measured by the transfer value of the assets.

It is the taxpayer's contention that each transfer was carried out separately for a good business purpose and that no tax is due. Its representative reasons that no tax is due on the transfer of the assets to EHR because the transfer of the assets was made to a commencing corporation solely in exchange for stock (Annotated Letter Ruling No. 395.1820). It is further contended that no tax is due on the stock transfer with MHI because such transfer did not involve any tangible personal property. The stated business reasons for carrying out the transfers by the separate agreements is set forth in a supplemental memorandum submitted by the taxpayer's representative on October 3, 1974, a copy of which is attached hereto and incorporated herein by reference.

Other information:

The audit staff has not yet determined which entity paid the liabilities of the restaurant businesses and from what source the funds were provided to pay these amounts. The auditor was advised that these records were not currently available.

As a second and independent ground for exemption, it is contended that the transfer was actually effective on August 30, 1970, at which time the former owner of the restaurants, I--- I--- of D---, Inc. (IID) was merged into the taxpayer. While each of the contracts speak in terms of prospective action, both recite that they were to be effective as of 8-30-70. The transfers in question were closed on December 30, 1970.

Analysis and Conclusions

It is well settled that the incidence of taxation to a transfer of property depends on the substance of the transaction, and is not controlled solely by the means employed to transfer the title (Commissioner v. Court Holding Co., 324 U. S. 331). Nevertheless, a taxpayer may carry out his business transactions in a fashion calculated to minimize the tax liability so long as the transfer has business substance and is not a mere sham (See U.S. v. Cumberland, 338 U.S. 451).

Where a transaction is carried out in a series of steps, each dependent and conditional on the other, then the essential nature of the transaction is to be viewed as a whole for tax purposes (Ashland Oil Refinery Co. v. Commissioner, 99 Fed.2d 588). A transaction may not be separated or "atomized" unto its components by either the taxpayer or the taxing agency (Roeding Securities Inc. v. U.S., 176 Fed. Sup. 844; Morgan v. Helvering, 117 Fed.2d 334; Kinney v. U. S., 358 Fed.2d 738). A transitory ownership of corporate stock is not necessarily of legal significance (Ashland Oil Refinery Co. v. Commissioner, supra; also W. E. Hall Co. v. Franchise Tax Board, 260 Cal.App.2d 179).

In the instant case, it seems to us that the taxpayer's objective in entering into the intercompany agreements was twofold: (1) it sought to divest the corporation of the restaurant businesses, and the liabilities which accompanied them; and (2) it desired to obtain satisfaction of the notes payable obligation due to the related corporation, MHI. While the transfer of the businesses was carried out, in form, by a separate agreement, it is apparent that this transfer was not independent of the exchange with MHI. It is manifestly clear that the taxpayer did not desire to independently deliver these income-producing businesses to a separate corporation and retain the current obligations and the long-term debt.

As we view it, the substance of the transaction involved an agreement by the taxpayer to transfer the entire businesses and assets to the new corporation in exchange for MHI's promise to assume the liabilities, cancel the note payable balance, and the other stated considerations. We, therefore, conclude that in substance the consideration given by MHI was in exchange for the entire restaurant businesses. Having purchased the entire restaurant businesses, and assumed the liabilities, it was entitled to the indicia of their ownership, the corporate stock.

The ruling relating to the exemption of a transfer to a commencing corporation in exchange for its initial issue of stock was not intended to provide a means of tax avoidance. Its use is not authorized where the transfer was carried out as part of a transaction involving transfer of ownership of the corporate assets to a third party for a consideration.

As an aside, we also observe that the assumption of the business liabilities of the restaurants by MHI probably was not required "to obtain ready acceptance of the existing CP division creditors". The taxpayer was liable for the business obligations of the restaurant division before the transfer, and insofar as we are aware, it remained liable for the debts after the transfer was completed. The fact that MHI expressly assumed the obligation would not operate to relieve the taxpayer from the liabilities. Nor can we see that the approval of the CP creditors would have been required for the transfer of the liabilities to EHR (or MHI for that matter).

The means by which these creditors were satisfied remains undetermined to this date. In the event any further proceedings are required, this verification must be undertaken and reported on.

We are unable to accept the alternate contention that the transfer of the assets was made directly from IID to ERH and thus qualified for exemption under Revenue and Taxation Code section 6006.5(b).

There is ample evidence that EHR did not come into existence until about November 20, 1974, and that the merger of IID was completed on August 30, 1974. In the intervening period the businesses were in fact operated by this taxpayer.

Recommendation

It is recommended that the taxes be redetermined without adjustment.

11/19/741

W. E. Burkett, Hearing Officer Date

Reviewed for Audit:

Principal Tax Auditor Date