

**M e m o r a n d u m****395.2110**

To : Mr. Vic Anderson, Supervisor  
Audit, Evaluation, Planning and Settlement  
Section

Date: August 25, 1997

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Subject: W---  
SR -- XX-XXXXXX

This is in response to your memorandum dated August 15, 1997 regarding the application of tax to the use of property involved in a merger. By letter dated February 28, 1995, Mr. W--- V--- W--- inquired, on behalf of his unidentified clients, about the application of tax to a series of transactions which he now represents as being the transactions currently under review. Tax Counsel Kelly Ching responded by letter dated April 26, 1995. The --- --- District office believes that Ms. Ching's response may have failed to consider the implications of certain annotations (whose principles have now been incorporated into Regulation 1595).

Since Mr. V--- W--- did not identify his clients, Ms. Ching's letter did not come within the provisions of Revenue and Taxation Code section 6596, and she so advised him. Thus, the only question before us now is the correct application of tax, not a question of reasonable reliance on Ms. Ching's letter. As explained below, Ms. Ching's analysis was correct.

W--- purchased property for resale to incorporate into an amusement park attraction that maintained its identity as tangible personal property (as opposed to becoming real property). W--- then contributed that attraction to IJR in a nontaxable commencing corporation transfer, and IJR leased the attraction to W--- 2 (W2). As relevant here, Ms. Ching advised that W--- improperly purchased the property for resale since W--- was transferring the property to IJR in a nontaxable commencing corporation transaction and was not reselling it. (Although the parties were not identified in Mr. V--- W---'s letter or in Ms. Ching's response, when referring to these letters I will use the appropriate names now that they have been identified.) Thus, she concluded that W--- was required to report use tax on its purchase price of such property. District office advises that W--- thereafter did so, except as noted below.

Ms. Ching then advised that IJR's lease to W---2 was subject to tax since IJR did not pay tax on purchase price (nor could it since it did not purchase the property). IJR did collect tax from W---2 on rentals and reported and paid the tax to the Board. In response to Mr. V--- W---'s question as to how tax would apply if IJR and W---2 thereafter merged, Ms. Ching explained

that “only [IJR’s] sale of the property (e.g., in a continuing sale) is taxable; its own use is not. Thus, any use by [IJR] of the fixtures and machinery and equipment after leasing the property will be nontaxable, without regard to whether such use occurs upon termination of the lease to [W---2] or after merging into [W---2].”

District office cites two annotations, 330.3650 (12/11/86) and 395.2150 (9/23/71), that it believes are “parallel” to the subject merger and conflict with Ms. Ching’s analysis. Unlike the situation here, both these annotations relate to property purchased by the disappearing corporation extax for resale. When a person purchases property extax for resale and then uses the property, it owes tax on such use. The application of this rule in the context of property purchased extax for lease, leased, and then used by the lessor is subdivision (c)(6) of Regulation 1660. The lessor owes tax on purchase price with a credit for any tax already paid on rentals payable. Subdivision (b)(3) of Regulation 1595, also cited by District office, applies this rule to mergers, incorporating the annotations cited above. It is the disappearing corporation’s *purchase price of property purchased for resale* that is subject to tax if, after the merger, the surviving corporation uses the property rather than reselling, as is often the case when one of the parties to a merger was making a taxable lease of property to the other party to a merger.

A person who does not purchase property for resale, and who otherwise does not owe tax on its use of property, may use such property without use tax liability. For example, a person who purchases equipment outside California and who uses it outside California for one year prior to bringing it into California does not owe tax on the use of the property in California. That person may use the property in any manner it wishes without payment of use tax. However, if it leases the property, the lease is a continuing sale subject to tax because the person would not have paid California tax or tax reimbursement on purchase price. If the person thereafter stops leasing the property and starts using it again, the person would obviously not owe tax on that use because the person would still not be regarded as having purchased the property for use in California. If that person then merged with another person, the survivor would stand in the place of the constituent corporations. Thus, the survivor is also not regarded as having purchased the property for use in California and may use the property tax free. This is true even if the survivor had been leasing the property from the disappearing corporation in a taxable continuing sale prior to the merger.

The same analysis applies to the use of property acquired by gift. If I make a gift of a computer to Joe, Joe may use that computer tax free because he did not acquire the computer by purchasing it from a retailer. (If I had purchased the computer for resale, I would be the person owing tax on the use of the computer, that is, the making of a gift of it.) Of course, since he would not have paid tax on purchase price, any lease of the computer by Joe would be taxable. If he thereafter starts using it again, no tax is due on that use. For purposes of this analysis, the nontaxable commencing corporation transfer is the same as a gift. That is why Mr. V--- W--- was advised that W--- owed tax on purchase price, since W--- purchased the property for resale and then used it by way of a nontaxable transfer to a commencing corporation. IJR, as the transferee in a nontaxable commencing corporation transfer, was not a purchaser who owed tax on its use of the property. IJR was free to use the property in any manner it wished tax free.

Thus, once the lease ended and IJR used the property itself (i.e., used by the survivor of the merger), no further tax was due since there was no longer a sale (the lease) and there was no purchase by the user of the property.

I believe the analysis above answers all the questions asked by District office. I note that W--- apparently underreported tax on its purchase price of the property and District office asks how this relates to IJR's tax basis in the property. For sales and use tax purposes, it is irrelevant to IJR's liability. Of course, W--- owes the full tax on cost, and interest thereon for any late payment of such tax.

If you have further questions, feel free to write again.

DHL/cmm

cc: Mr. Dennis Fox (MIC:92)  
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