STATE OF CALIFORNIA

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December 21, 1995

Mr. R--- G--- M---
M---, M--- & P---
XXX West ---, Suite XXX
--- ---, California XXXXX-XXXX

Re: Unidentified Taxpayer;
Occasional Sales

Dear Mr. M---:

This is in response to your letter dated October 3, 1995 regarding the application of tax to a proposed partnership dissolution and transfer of assets to a limited liability company ("LLC") by hypothetical taxpayers.

You state:

"Presently there are two partners in the limitedpartnership (hereinafter ... the 'Partnership'). One(general) partner is [a] Corporation (hereinafter ... the'Corporation'). The other (limited) partner is the GiftTrust (hereinafter ... the [']Gift Trust[']).

"Presently the Corporation is owned 81.32% by Mr. & Mrs. Taxpayer as community property. Their son, Child Taxpayer, individually owns the other 18.68% of the Corporation.

"Child Taxpayer is the sole Trustee of the Gift Trust. The Gift Trust is an irrevocable generation skipping trust created by his parents, Mr. & Mrs. Taxpayer. The present beneficiaries of the Gift Trust are Child Taxpayer, his wife, his living issue and spouses and ex-spouses of his issue. The Trustee has the full discretion whether to pay the income and principal to the present beneficiaries of the Gift Trust.

"The primary business of the Partnership is equipment leasing although the Partnership also sells and repairs equipment. The Partnership has several different sites where it operates. The Partnership currently holds a sales tax permit.

"The Partnership agreement sets up two classes of interests: preferred and non-preferred. The Corporation holds the preferred interest. The preferred interest is similar to cumulative non-
participating preferred stock. The preferred interest does not participate in any increase in value of the assets or business of the Partnership.

"The preferred interest is entitled to a 10% return based upon the amount of its capital account. Any cash available for distribution is first applied to the payment of the 10% return to the preferred interest holder. If there isn't sufficient cash in one year to pay the 10% return, then any cash available in a subsequent year is applied to pay any amount in arrears before the non-preferred interest holder receives any cash distribution.

"Upon liquidation the cash available for distribution must be distributed in the following order: (1) 10% return to the preferred interest holder, (2) any 10% return to the preferred interest holder in arrears, (3) repayment of the capital account of the preferred interest holder, and (4) the balance to the non-preferred interest holder.

"The Gift Trust holds the non-preferred interest. Each year the non-preferred interest holder is entitled to all cash available for distribution after the payment of the 10% return to the preferred interest holder plus any amount in arrears.

"The Corporation had an initial capital account of $72,600. The Gift Trust had an initial capital account of $11,900. The capital accounts of both partners have increased. The Partnership is in arrears in paying the 10% return to the corporate general partner.

"The Corporation has 85.92% of voting rights in the Partnership. The Gift Trust has 14.08% of voting rights in the Partnership.

"**Proposed Transactions:**

"The first proposed transaction would involve the complete liquidation of the Partnership. The Corporation would receive equipment and other assets in the amount specified in the Partnership agreement. The Partnership agreement provides that the Corporation would receive the amount of its capital account, plus the 10% return for the current year based on the amount of its capital account (adjusted for a short taxable year) plus any of the 10% return that was in arrears, in exchange for its interest in the Partnership. Assets will be distributed at their fair market value at the time of distribution.

"The Gift Trust would receive the remainder of the assets of the Partnership (and not reflected in its capital account already), in exchange for its interest in the Partnership.

"All of the assets of the Partnership will be distributed to the two partners in a single transaction. The assets that the Corporation would receive in liquidation would consist of cash, receivable, equipment as well as other assets. The assets that the Gift Trust would receive in liquidation would consist of cash, receivables, equipment as well as other assets. Assets distributed to both partners in complete liquidation would be subject to liabilities.

"After the liquidation, the Corporation would take over one of the sites previously owned by the Partnership and carry on the same business as the dissolved Partnership.

"The second proposed transaction would involve the Gift Trust transferring its share of the assets received from the dissolved Partnership to a Limited Liability Company.

"Because the Gift Trust wishes to avoid personal liability and because a trust cannot carry on a business without being taxed as a corporation under Treasury Regulation §301.7701-2, the Gift Trust will form a Limited Liability Company (LLC) under the California Corporations Code § 17050.

"The LLC will shield the Gift Trust from personal liability. In addition, the LLC will be taxed as a partnership under the Internal Revenue Code and therefore the income of the LLC will not be subject to double taxation (once at the corporate level and once at the shareholder level) as the Gift Trust would be if it carried on a business itself.

"Immediately after the Gift Trust receives the distribution of assets from the dissolved Partnership, the Gift Trust would contribute the Partnership assets to the newly formed LLC. The assets contributed to the LLC would be subject to liabilities. The LLC would take over the remaining sites and carry on the same business of the dissolved Partnership.

"Concurrently with the Gift Trust's contribution of the assets to the newly formed LLC, Mr. & Mrs. Taxpayer will contribute cash to the LLC in an amount equal to 5% of the value of the assets contributed by the Gift Trust to the LLC. Thereafter the Gift Trust would own 95% of the interest in the LLC and Mr. & Mrs. Taxpayer would own 5% of the LLC."

You ask our opinion as to the application of tax on a series of separate transactions involving the Partnership, Corporation, Mr. and Mrs. Taxpayer, and Child Taxpayer. Before responding to these requests, however, we note that some tangible personal property is

ultimately being transferred from the Partnership to a LLC owned by the Gift Trust and Mr. and Mrs. Taxpayer by way of multiple transactions between the several parties. These types of transactions require a two-tier analysis. First, each step in the series of transactions must be analyzed for the purpose of ascertaining if there is a taxable transaction between two parties. Second, the transactions must be collectively analyzed for the purpose of determining whether, under the California Sales and Use Tax Law, the intervening steps of the transaction should be disregarded and the transactions should be analyzed only on a before and after basis, with all intervening steps of the transaction disregarded for sales and use tax purposes. (See, e.g., Business Taxes Law Guide Annot. 395.1840 (3/1/66; 7/28/86).) That is, the individual series of transactions between the parties will be disregarded if they are undertaken solely for the purpose of avoiding or altering the California sales or use tax liabilities of the parties. With that in mind, I will first discuss whether tax applies to each of the individual transactions between the parties.

A. Individual Transactions

> "[1.] [W]ould ... the proposed complete liquidation of the Partnership ... qualify for the occasional sale exemption under Revenue and Taxation Code § 6367 and § 6006.5 ... [such that] no sales tax would be due as a result of the liquidation[?]"

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt from taxation by statute. (Rev. & Tax. Code § 6051.) A sale includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (Rev. & Tax. Code § 6006(a).) When sales tax does not apply, use tax is imposed on the sales price of property purchased from a retailer for the storage, use or other consumption in California. (Rev. & Tax. Code §§ 6201, 6401.)

Revenue and Taxation Code section 6367 provides an exemption from sales tax for the occasional sale of tangible personal property other than vehicles, vessels, or aircraft.[1] In pertinent part, Revenue and Taxation Code section 6006.5 defines an occasional sale to include certain sales by persons not required to hold a seller's permit, and certain transfers of all or substantially all the property held or used by a person to a different entity maintaining the same real or ultimate ownership of the property.[2] Even when a transfer does not qualify as an occasional sale, it may not be regarded as a taxable sale. As relevant here, Regulation

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[1] A sale of a vehicle, vessel, or aircraft is exempt as an occasional sale when such property is included in a transfer of all or substantially all the property held or used in the course of business activities of the person selling the property and the real or ultimate ownership of the property is substantially similar to that which existed before such transfer. (Reg. 1595(c).)

[2] Your letter demonstrates that you understand the provisions of Regulation 1595(b)(2) regarding the transfer of substantially all the property held or used by a person in the course of activities requiring a seller's permit where "80 percent or more" of the ownership of that tangible personal property is unchanged after the transfer. Since you assert that Annotation 395.2400 (8/26/69) makes the Partnership's distribution a non-taxable event as a pro-rata distribution, we assume that the Corporation will not receive 80 percent or more of the Partnership's tangible personal property upon its dissolution even though the Corporation has 85.92 percent of the voting rights in the Partnership. If this is not the case and the Corporation will receive 80 percent or more of the Partnership's tangible personal property, the Partnership's liquidation may qualify as a non-taxable transfer of the Partnership's property to the Corporation provided the transfer meets the requirements of Regulation 1595(b)(2).

1595(b)(4) explains that tax does not apply to transfers of property to commencing corporations or partnerships solely in exchange for a first interest in the commencing entity provided the transferor does not receive consideration (e.g., cash, notes, or an assumption of indebtedness) for the transfer. Board staff has applied these principles to situations involving the contribution of property to commencing entities as well as the liquidation of assets from corporations or partnerships. (See Business Taxes Law Guide Annots. 395.1800 to 395.2560.)

In this case, the Partnership is making a complete liquidation of its assets to the Corporation and Gift Trust. When an entity distributes its assets as a complete liquidation ratably to its owners (i.e., a distribution of assets to partners or shareholders in the same percentage as their ownership interests in the entity), the transfer will not be taxable unless consideration is received for the transfer. (See, e.g., Business Taxes Law Guide Annot. 395.2340 (5/7/56).) That is, the liquidation of a partnership's assets is not taxable if the only item received by the transferor partnership is the return of the interest in the entity (i.e., the partnership interest) for the purpose of cancellation and there is no other consideration such as an assumption of liabilities.

You state that the assets of the Partnership will be distributed to the Corporation and Gift Trust in the same ratio as each partner's interest in the Partnership. You also state that assets distributed to both partners in complete liquidation of the Partnership would be subject to liabilities. We understand this to mean that each partner will assume certain of the Partnership's liabilities previously associated with the assets to be distributed to the partners. Under this scenario, each partner's assumption of the Partnership's liabilities constitutes consideration by the partners to the Partnership such that the Partnership's distribution of those assets is a sale which is subject to tax unless the sale qualifies as an exempt occasional sale. Since the Partnership maintains a seller's permit, it appears that the transfer of these assets will not qualify as an exempt occasional sale under subdivision (a) of section 6006.5.

You assert that Business Taxes Law Guide Annotation 395.2400 (8/26/69)[3] makes the Partnership's distribution a non-taxable transaction since the assets are distributed in the same ratio as the partnership interests. Annotation 395.2400 correctly summarizes the *first* requirement that must be met in order for a partnership's distribution of assets to its partners to be regarded as a non-taxable transaction (i.e., ratable distribution of assets to the partners). The partnership may not, however, receive any consideration for the transfer of the assets if the distribution is to be regarded as a non-taxable event. This second requirement is based on case law finding that the assumption of a liability is consideration (see, e.g., *Beatrice Co. v. State Bd. of Equalization* (1993) 6 Cal.4th 767, 783; *Newco Leasing, Inc. v. State Bd. of Equalization* (1983) 143 Cal.App.3d. 120, 126; *Cal-Metal Corp. v. State Bd. of Equalization* (1984) 161 Cal.App.3d 759, 766) and therefore subjects a retail transfer of assets with an assumption of liabilities to tax. Thus, the liquidation of a partnership's assets is not subject to tax only if the

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[3] Business Taxes Law Guide Annotation 395.2400 (8/26/69) provides:

"If, upon dissolution of a partnership, the assets are distributed in the same ratio as the partnership interests, the distribution does not constitute a taxable sale."

item(s) received by the transferor partnership is the return of the interest in that entity for the purpose of cancellation *and* it receives no other consideration such as the assumption of its liabilities. This is consistent with Regulation 1595(b)(4) which makes a contribution to a commencing corporation or partnership not taxable only if property is transferred in exchange for a first interest in the commencing entity *and* the transferor does not receive consideration (including an assumption of indebtedness) for the transfer.

> "[2.] [Would] the proposed transfer by the Gift Trust to the newly formed LLC ... qualify for the occasional sale exemption under Revenue and Taxation Code § 6367 and § 6006.5 ... [such that] no sales tax would be due as a result of the transfer of assets to the LLC[?]"

As set forth above, Revenue and Taxation Code section 6367 exempts the occasional sale of tangible personal property other than vehicles, vessels, or aircraft. Revenue and Taxation Code section 6006.5(b) defines an occasional sale as any transfer of all or substantially all the property held or used by a person in the course of those activities where after the transfer the real or ultimate ownership of the property is substantially similar to that which existed before the transfer. Regulation 1595(b)(2) further interprets Revenue and Taxation Code section 6006.5(b) as follows:

> "Tax does not apply to a transfer of all or substantially all the property held or used by a person in the course of activities forwhich the person is required to hold a seller's permit or permits or would be required to hold a seller's permit or permits if the activities were conducted in this state, provided that after the transfer the real or ultimate ownership of the property is substantially similar to that which existed before such transfer. `Substantially all the property' means 80 percent or more of all the tangible personal property held or used in the course of activities, including tangible personal property located outside of this state. If a person engages in two or more separate selling activities, for each of which the person is required to hold a seller's permit or would be required to hold a seller's permit if the activity were conducted in this state, a transfer of 80 percent or more of the tangible personal property held or used in the combined activities must be made in order to qualify for the exemption described in this paragraph. Stockholders, bondholders, partners, or other persons holding an ownership interest rather than a security interest in the corporation or other entity are regarded as having the real or ultimate ownership of the property of the corporation or other entity.
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> "The real or ultimate ownership is "substantially similar" to that which existed before a transfer if 80 percent or more of that ownership of the tangible personal property is unchanged after the transfer...."

You state that the Gift Trust will receive a ratable distribution of the Partnership's property upon liquidation. We understand that this property constitutes 100 percent of the Gift Trust's total property (real and personal) and that this entire amount will be transferred to the

LLC. Concurrently with the Gift Trust's transfer to the LLC, Mr. and Mrs. Taxpayer will contribute cash to the LLC in an amount equal to 5 percent of the value of the assets contributed by the Gift Trust to the LLC. In examining this step of the transaction only, the Gift Trust's transfer to the LLC is exempt from tax as an occasional sale since it is transferring at least 80 percent of the tangible personal property it held or used as a Gift Trust to the LLC and the Gift Trust will maintain at least 80 percent ownership of the LLC at the conclusion of the transfer.

B. Collective Transaction

The foregoing series of transactions between the parties will be disregarded if they are undertaken solely for the purpose of avoiding or altering the California sales or use tax liabilities of the parties. That is, where there is no valid business purpose for structuring a series of transactions to achieve the ultimate transfer of the Gift Trust's portion of property from the Partnership to the LLC other than for the avoidance of California sales or use tax, the series of transactions will be disregarded and the transaction will be viewed as a taxable sale of tangible personal property from the Partnership to the LLC.

We assume from your letter that the Partnership is liquidating its assets based on valid and legitimate business reasons. We also understand that the Gift Trust will transfer its assets to the LLC in

order to be taxed as a partnership and not as a corporation. Under these facts and assumptions, we would not disregard the series of transactions between the Partnership, Gift Trust, and LLC for sales and use tax purposes and not view the series of transactions taken as a whole as a taxable sale of tangible personal property from the Partnership to the LLC.

Please note that Revenue and Taxation Code section 6596 sets forth the circumstances under which a taxpayer may be relieved of liability for taxes when relying on a written response to a written request for opinion. To come within that section, the request for opinion must identify the taxpayer as well as all relevant facts relating to the particular transaction. Our opinion above does not come within section 6596 since you have not identified the taxpayers subject to the foregoing transaction.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:rz
cc: --- --- District Administrator - --