

Sales Tax Imposed on Asset Sale Transactions

By June Lin

Introduction

Imagine a consumer goods company that holds a seller's permit in its state of incorporation because it regularly sells tangible personal property. One day this company is acquired by another company in an asset (not stock) sale transaction. Would such an acquisition trigger sales tax? In most states the answer would be "no" because of an exemption for "occasional sales". In California the answer is most likely "yes".

When does Sales Tax Apply?

The legislative provisions relating to California sales tax may be found in the California Revenue and Taxation Code (the "Rev & Tax Code") and the California Board of Equalization Sales and Use Tax Regulations (the "California Regulations"), which are regulations issued by the State Board of Equalization pursuant to the Rev & Tax Code to implement, interpret or make specific provisions of the California Sales and Use Tax Law.

Pursuant to Section 6051 of the Rev & Tax Code, California sales tax is generally imposed on all gross receipts derived from the retail sale of tangible personal property unless a statutory exemption applies. Section 6007 of the Rev & Tax Code defines a "retail sale" as a sale for any purpose (other than resale in the regular course of business) in the form of tangible personal property. Section 6051 imposes a tax rate of four and three-fourths percent (4 3/4%), and Section 6051.2 imposes an additional one-half percent (1/2%) sales tax rate.

Occasional Sales Exemption

A commonly used sales tax exemption is the express exemption for "occasional sales of tangible personal property" as set forth in Rev & Tax Code Section 6367. One would expect that

such an exemption would cover the sale of all of a business' assets from sales tax. However, Rev & Tax Code Section 6006.5 adds a limitation to this exemption by defining "occasional sale" as a sale of property not held or used by a seller in the course of activities for which the seller is required to hold a seller's permit or would be required to hold a seller's permit if the activities were conducted in California, provided that such "occasional sale" is not one of a series of sales which might independently require a permit. This means that the sale of a business in the form of an asset sale will not qualify for treatment as an "occasional sale" and exemption from sales tax if the assets are held by the seller as part of activities requiring the seller to hold a permit for sales tax purposes.

"Occasional sale" also includes any transfer of all or substantially all the property held or used by a person when, after the transfer, the ultimate ownership of the property is substantially similar to that which existed before the transfer. This would exempt from sales tax the situation where, for example, a company sets up a wholly owned subsidiary and transfers certain of its assets into the subsidiary, because the ultimate ownership of the assets transferred is substantially unchanged.

The California Regulations provide guidance on when a seller's permit is required. Section 1595 of the Regulations states that California sales tax applies to all retail sales of tangible personal property (including capital assets), whether sold in one transaction or in a series of sales, if those assets were held or used by the seller in the course of an activity or activities for which a seller's permit is required or would be required if the activity or activities were conducted in California. Under Section 1595, a person who makes three or more sales for substantial amounts in a period of twelve months is required to hold a seller's permit regardless of whether the sales are at retail or are for resale. Each sale by the person during the twelve

month period is included in determining whether that person is required to hold a permit, or would be required to hold a permit if the activities were conducted entirely inside California. Thus, a sale occurring outside California, whether at retail or for resale, is included, even though it would not be subject to California sales tax. A person who makes a substantial number of sales for relatively small amounts is also required to hold a seller's permit. Thus, virtually all California companies that have any revenues are required to have a seller's permit.

A question that frequently arises in connection with the occasional sales exemption is whether a retailer's gross receipts derived from retail sales that are incidental and casual to its primary business are exempt. In *Bigsby v. Johnson*¹ the plaintiff, a retailer in the printing business, sold used printing equipment at retail as a part of his business operations. The plaintiff claimed an occasional sales exemption on the basis that his sale of the equipment was not the kind of retail sale ordinarily made by him. The California Supreme Court noted that, although most jurisdictions imposing sales taxes specifically exempt casual or isolated sales, a majority of them hold that the exemption does not include casual retail sales made in the course of business operations by one who is engaged in the retail sales business. The Court held that the plaintiff sold the personal property in question at retail as a part of his business operations and that such sale was subject to sales tax.

Subsequently, in *Ontario Community Foundation, Inc. v. State Bd. of Equalization*,² the California Supreme Court found little precedential value in the *Bigsby* holding, specifically noting that Rev & Tax Code Sections 6006.5 and 6367, adopted subsequent to *Bigsby* in 1947, currently provide the statutory exemption lacking in *Bigsby*. The plaintiffs in *Ontario*

¹ 18 Cal. 2d 860 (1941).

² 35 Cal. 3d 811 (1984).

Community Foundation, operators of two hospitals, had engaged in certain activities for which they were required to hold seller's permits. Specifically, the plaintiffs each (1) operated a food service facility which sold meals to patients and nonpatients, (2) sold miscellaneous personal items from its supply unit, and (3) operated a pharmacy. The food service facility, supply department and pharmacy were all operated at the same location as the hospitals. The plaintiffs subsequently transferred hospital furnishings and equipment as part of the sale of the total assets of the hospitals. The Court determined that the hospital equipment and furnishings sold by the hospitals were used in rendering medical and nursing services, and that at no time was such property used by the hospitals in the course of activities for which they were required to hold a seller's permit. The Court accordingly held that Rev & Tax Code Section 6006.5 exempted from sales tax a one-time sale of tangible personal property such as the hospital equipment and furnishings which were not held or used by the sellers in the course of activities for which they were required to hold a seller's permit.

Generally, it is not possible to draw a sharp line between the business purpose to which the tangible assets were employed, and the business purpose of the activity for which a company has obtained a seller's permit. As a practical matter, therefore, almost always the California seller of business assets will find that sales taxes will be imposed.

“True Object Test” for Service Providers

Under California law only tangible personal property is subject to taxation; services are not. Difficulty arises, however, when a company provides tangible property in connection with providing a service. If the company is providing purely a service and the transfer of property is incidental, then the company is the consumer, not the retailer, of the property and must pay sales tax when acquiring the property; the transfer of the property to the service customer is not

subject to tax. California Regulations Section 1501 codifies this distinction between a service and a sale of property. Section 1501 states that the test in determining whether a transaction involves a sale of tangible personal property or a transfer of tangible personal property incidental to the performance of a service turns on the true object of the contract. Is the real object sought by the buyer the service per se or the property transferred with the service? If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred. For example, if an accounting firm, in the course of performing tax services for its clients, provides its clients with forms, binders and other materials as an incident to the tax preparation services, it is not the retailer of such tangible personal property, and therefore no sales tax would be assessed on the provision of the services and incidental goods. See *MCI Airsignal, Inc. v. State Bd. of Equalization*³ in which the Court of Appeals affirmed the lower court's decision that the transfer of pagers by the respondent (with the respondent retaining ownership of the pagers), a company in the business of providing telephone paging services, was merely incidental to, and not the true object of the transaction.

Conclusion

Many states impose a sales tax upon the sale of tangible business assets, although the precise circumstances under which an asset transaction is subject to or exempt from sales tax can vary greatly from jurisdiction to jurisdiction. When dealing with asset sales transactions in California, it is essential that both the buyer and seller are aware of California's sales tax compliance requirements. In California, sales tax is generally imposed on an asset sale of a company unless the company being sold is a service business (where the "occasional sale" exemption may apply). In the absence of any provision in the purchase agreement to the contrary, the seller is liable for any sales tax.

³ 1 Cal. App. 4th 1527 (Cal. Ct. App. 1991).

It is important to keep in mind that unlike income tax, sales tax is transaction-based and applies regardless of whether the selling company is in a profit or a loss position. Also, sales tax is imposed even if the only consideration is the buyer's assumption of liabilities. Failure to consider these provisions can lead to significant and unforeseen sales tax assessments long after the sale is ostensibly complete. By paying proper attention to these details, pitfalls can be avoided and planning opportunities may exist for minimizing or eliminating sales tax. For example, if the existence of a seller's permit jeopardizes the exempt nature of an asset transaction, it may be possible to plan around sales tax exposure by creating a new subsidiary corporation solely to hold the assets for sale.

This article is intended to provide a general summary and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. June Lin is an attorney at Niesar & Vestal LLP in San Francisco, a law firm specializing in business law and corporate finance.