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**IMPACT OF SALES AND USE TAXES
ON CORPORATE TRANSACTIONS**

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Mr. Faber graduated from Swarthmore College with high honors and from Harvard Law School, cum laude.

I. Introduction.

- A. The states have not taken a consistent approach to the imposition of sales taxes on corporate organizations, reorganizations, acquisitions, and liquidations. The statutes are often poorly designed and they have illogical and haphazard consequences, treating economically identical transactions in different ways and different transactions similarly.**
- B. Sales tax statutes are broadly crafted.**

 - 1. “Sale” is normally defined to include every transfer of title or possession except to the extent that specific exceptions are prescribed by the legislature.**
 - 2. Thus, sales of businesses are excepted from the sales tax only if the legislature thinks to do so and only if the legislature can draft appropriate concepts in appropriate language.**
- C. Provisions in sales tax statutes that deal with corporate acquisitions are often illogical and inconsistent.**

 - 1. Legislatures have often intended to except corporate acquisitions, apparently because of a belief that a tax designed to apply to the prototypical sale of goods at a hardware store in the ordinary course of business should not apply to the bulk sale of an entire business.**
 - 2. The legislatures have often failed to implement this intention in a logical and consistent way. The statutes often do not deal with the whole universe of transactions with the result that economically similar transactions are treated differently.**
 - 3. Corporate acquisition provisions often do not get much attention in the drafting process. They are a minor part of the statute. Legislators and their staffs, while often lawyers, are typically not familiar with corporate transactions.**
- D. This outline primarily surveys the treatment of corporate transactions under the sales tax laws of California, Georgia, Illinois, Maryland, Missouri, New Jersey, New York, Oklahoma, Texas, and Vermont. It is intended to be illustrative of the problems encountered and not to be comprehensive.**
- E. Sales tax statutes are often administered in a formalistic manner. The doctrine that substance prevails over form is less well developed in the sales tax area than it is in the income tax area. Compare Nixon, Hargrave, Devans & Doyle (Advisory Opinion, N.Y.S. Department of Taxation and Finance, 1994), TSB-A-94(25)S (purchase of stock of corporation followed by pre-arranged liquidation**

within 30 days not treated as a direct purchase of assets for sales tax purposes), with Revenue Ruling 67-274, 1967-2 C.B. 141, and Resorts International, Inc. v. Commissioner, 60 T.C. 778 (1973), modified, 511 F.2d 107 (5th Cir. 1975) (treating the same sequence of transactions as a direct purchase of assets for income tax purposes). In The TJX Companies, Inc., (N.Y.S. Division of Tax Appeals 1995), CCH New York State Tax Reporter ¶402-246, aff'd on other grounds (N.Y.S. Tax Appeals Tribunal 1997), CCH New York State Tax Reporter ¶ 402-638, the transfer of assets to a subsidiary followed by a pre-arranged sale of the subsidiary's stock that was treated as a deemed asset sale for income tax purposes under Internal Revenue Code §338(h)(10) was held not subject to sales tax.

II. Sales of businesses.

- A. Some states have (or purport to have) an exemption for sales of businesses generally without regard to the form of the transaction or the nature of the consideration received.
 1. California exempts the sale of the assets of a business activity when the product of the business would not be subject to sales tax if sold in the ordinary course of business. Revenue and Taxation Code § 6006.5(a).
 - a. Arguably this provision takes the wrong approach. The philosophy of a retail sales tax should exempt the sale of a business when its products are subject to sales tax so as to avoid pyramiding multiple layers of tax.
 - b. The exemption is drafted in terms of activities requiring a vendor's permit. Thus, the exemption would not apply if only a small part of the activities produced taxable products because a vendor's permit would be required.
 2. Illinois has a sweeping exemption that applies to the sale of any property where the seller is not engaged in the business of selling that property. Retailers Occupation Tax § 1; Regs. § 130.110(a).
 - a. This will often exempt all of the seller's assets except inventory, and that will usually be exempted because the buyer will hold it for resale. Illinois Department of Revenue Private Letter Ruling No. 91-0251 (March 27, 1991). If the buyer does not plan to hold it for resale, however, the exemption will not apply. Aconite Corp. v. Commissioner of Revenue, 1995 Minn. Tax LEXIS 64 (Minnesota Tax Court 1995) (under a similar statute, Minn. Stat. §297A.25(12)(a)).

- b. The application of this provision to property that is sold as a normal incident to the seller's business but that is not inventory is unclear (e.g., demonstrators).
3. Texas exempts the sale of "the entire operating assets" of a "business or of a separate division, branch, or identifiable segment of a business." Code § 151.304(b)(2).
- a. A separate segment will be found "if . . . the income and expenses attributable to the separate division . . . could be separately ascertained from the books of account or record." Code § 151.304(c).
 - (1) It is not necessary that all the operating assets of a corporation be sold as long as a separate segment can be isolated.
 - (2) The assets sold need not comprise a separate business, as long as they are an identifiable unit. Thus, separate elements in a vertically integrated business will apparently qualify.
 - (3) Parts of a unitary business may not qualify if separate accounting is not feasible because of the extent of integration.
 - b. Because the exception only requires the sale of the "operating assets," the inventory (which is not an operating asset) need not be sold. Decision of the Comptroller of Public Accounts, Hearing No. 19,708 (October 6, 1986). CCH Texas Tax Reporter ¶ 60-590.421.
 - c. Areas of uncertainty.
 - (1) What part of the operating assets must be sold to be the "entire" operating assets? Is the exemption lost if a de minimis amount is retained? See Decision of the Comptroller of Public Accounts, Hearing No. 32,398 (December 6, 1994) 1994 Tex. Tax LEXIS 589 (exemption not lost when small amount of furniture comprising 16 of 25,000 asset accounts and of insignificant value was not transferred). But see Decision of the Comptroller of Public Accounts, Hearing Nos. 28,823 & 28,824 (August 25, 1992) 1992 Tex. Tax LEXIS 208 (purchase of all but three business assets of the seller does not constitute the purchase of "the entire operating assets"). The determination of the

assets that are included in the “segment” or “division” is of critical importance.

- (2) Does the distribution of some of the operating assets to the seller’s parent corporation immediately before the sale result in a loss of the exemption? See Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605, reh’g denied, 305 U.S. 670 (1938) (distribution to shareholders will cause a transaction to fail to meet the requirements for tax-free treatment under those of the tax-free reorganization provisions of federal law that require a sale to be of “substantially all” of the seller’s assets).
 - (3) Must all of the operating assets be sold to one buyer in one transaction?
4. Some states exempt sales in connection with the “liquidation” of a business or a corporation.
- a. Oklahoma.
 - (1) The statute exempts a transfer “in connection with the winding up, dissolution or liquidation of a corporation only when there is a distribution in kind to the shareholders of the property of such corporation.” Statutes § 1360(A)(2).
 - (2) Areas of uncertainty.
 - (a) Does the exemption apply to sales to third parties as long as some assets are distributed to the shareholders in kind as part of the same transaction?
 - (b) If it does, is there a minimum amount of assets that must be distributed to the shareholders?
 - (c) Is the exemption limited to a situation in which the business is discontinued, which is suggested by the tone of the language? Is the exemption lost if the “corporation” is no longer engaged in business but its business is continued by the buyer of its assets or sby its shareholders?
 - (d) The statute speaks in terms of a liquidation, etc. of a “corporation.” Does the exemption apply to the liquidation of only one of several businesses of a

corporation? If not, can the exemption be obtained by transferring the business to be liquidated to a separate corporation shortly before the transaction?

b. Georgia.

- (1) The regulations (but not the statute) exempt a sale of property that is used in the operation of a business if the sale is pursuant to a “complete and bona fide liquidation” of the business. Regs. § 560-12-1.07.
- (2) A “business” is a “separate place of business” that must register as a vendor. The exemption clearly applies to the sale of only one of a corporation’s several businesses. There will be interpretative questions at the margins respecting the definition of a business.
- (3) A “liquidation” is a sale of all of the business’s assets over a period of not more than 30 days.
 - (a) It is not clear if the exemption applies if the business is continued by the buyer.
 - (b) The exemption seems to apply even if the business is sold to several buyers in several transactions.
 - (c) There is no requirement that any assets be distributed to the shareholders in kind.

c. Missouri.

- (1) The statute exempts transfers “incident to the liquidation or cessation of a taxpayer’s trade or business.” Revised Statutes § 144.011(2).
- (2) The statutory language requires a complete liquidation of the taxpayer’s business. Loethen Amusement, Inc. v. Director of Revenue, Case No. RS-86-0130 (Administrative Hearing Commission 1987), aff’d, 753 S.W.2d 334 (Mo.Ct. App. 1988).
- (3) Areas of uncertainty.
 - (a) It is not clear if the exemption applies if the business is continued by the buyer.

- (b) The exemption apparently applies to transfers to several buyers in several transactions. There is no time limit (unlike the Georgia rule), but the transfers apparently must be made pursuant to a single plan.

5. **Casual sale exemptions.**

- a. Most states have some form of exemption for casual or isolated sales. The theory of the exemption is to exclude from the sales tax occasional sales by people who are not in the business of selling property. The exemptions may apply to sales of businesses by corporations.
- b. For an interesting application of a casual sale exemption, see Alabama Revenue Ruling 96-002 (1996), CCH Alabama State Tax Reporter ¶ 300-026. Regulations § 810-6-1-.33 exempts from the tax casual or isolated sales by a person “not in the business of selling.” The Alabama Department of Revenue ruled that the exemption applied to the sale of substantially all of the assets of a communications business. Although the taxpayer did not appear to be “in the business of selling” anything (it had no inventory), the Department explained its holding by saying that the taxpayer’s “regular course of business is not the selling of its assets,” suggesting that the exemption would apply to a company that was in the business of selling as long as it did not regularly sell the type of assets involved in the sale under consideration.
- c. Virginia’s casual sale exemption applies to the sale “of all or substantially all the assets of any business....” Virginia Code §§ 58.1-609.10(2) and 58.1-602.

B. Some states tax sales of businesses generally but exempt mergers and other types of corporate adjustments. See Faber, “Sales Tax Aspects of Corporate Reorganizations,” State Tax Notes, May 8, 1995.

- 1. These provisions often bear a relationship to the federal tax-free reorganization rules (I.R.C. § 368), but the nature of the relationship is sometimes unclear.
- 2. Some states have a narrowly drawn exemption for a transfer to a corporation in a “merger” but only if it is in exchange for the buyer’s stock.

- a. See New Jersey Revised Statutes § 54:32B-2(e)(4)(B), New York Tax Law § 1101(b)(4)(iii)(A), Vermont Statutes Annotated § 9742(2).
- b. The statutory language has been narrowly construed.
- (1) The exemption does not apply to a transfer in exchange for the buyer's parent's stock in a reorganization under Internal Revenue Code § 368(a)(2)(D). N.Y.S. Regs. § 526.6(d)(7).
- Planning: consider reversing the transaction and having the buyer form a transitory subsidiary that merges into the target in a reorganization under Internal Revenue Code § 368(a)(2)(E).
- (2) The exemption does not apply to a transfer of assets to the buyer in exchange for the buyer's stock in a tax-free reorganization under Internal Revenue Code § 368(a)(1)(C) because the transaction is not a statutory merger under local law. N.Y.S. Regs. § 526.6(d)(6)(iv); Boccard Industries, Inc., TSB-H-87(128)S (N.Y.S. Tax Commission 1987).
- (3) The exemption does not apply to the extent that the consideration received in the merger consists of cash or other property.
- (4) The exemption may not apply to the extent that the seller's liabilities are assumed in the merger. But, see , N.Y.S. Department of Taxation and Finance Advisory Opinion, 1994 TSB-A-94(25)S (1994), holding, without discussing the point, that the merger of a subsidiary corporation into its parent in which the subsidiary's liabilities were assumed by the parent was not subject to sales tax.
- c. The availability of the exemption is not linked to qualification of the merger as a tax-free reorganization for federal income tax purposes under Internal Revenue Code § 368.
- For example, the exemption is not lost if the merger fails to qualify as a tax-free reorganization because of a lack of continuity of proprietary interest or business enterprise.
3. Maryland exempts all transfers pursuant to transactions that are tax-free reorganizations for federal income tax purposes under Internal Revenue Code § 368. Tax General Article § 11-209(c)(1)(i).

- a. The exemption applies to transfers in exchange for the stock of the buyer's parent as well as to transfers in exchange for the buyer's stock.
- b. The exemption applies to transfers that are not statutory mergers under state law.

For example, it applies to a transfer of a corporation's assets for stock of the buyer or the buyer's parent that qualifies as a tax-free reorganization under Internal Revenue Code § 368(a)(1)(C).

- c. The exemption apparently applies without regard to the nature of the consideration received for the assets.

For example, the exemption applies even to that part of the consideration consisting of cash or the assumption of liabilities.

- d. The exemption will not apply if the transfer fails to qualify as a tax-free reorganization for federal income tax purposes (e.g., if a post-transfer sale of stock by a target shareholder causes a failure to meet the continuity of proprietary interest requirement, if a post-transfer sale of assets by the buyer causes a failure to meet the continuity of business enterprise requirement).

4. Oklahoma exempts transfers in a "reorganization." Statutes § 1360(A)(1).

- a. A "reorganization" is defined as a statutory merger or consolidation or the acquisition of "substantially all of the properties of another corporation when the consideration is solely all or a part of the voting stock of the acquiring corporation." Statutes § 1360(A)(1).

(1) The second part of the definition is apparently intended to cover non-merger transfers that are exempt from federal income tax as tax-free reorganizations under Internal Revenue Code § 368(a)(1)(C), but the language is considerably more restrictive than the federal language.

- (a) Stock of the buyer's parent can be received in a "C" reorganization but not under the Oklahoma statute.
- (b) The "solely voting stock" requirement has no exceptions. Is the exemption lost if the buyer assumes seller liabilities as part of the transaction? If the exemption is not lost, is it limited to that part of the consideration consisting of voting stock?

- (c) Does a pre-sale spinoff of assets cause a failure to meet the “sub-stantially all” test, as it does for federal income tax purposes? See Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605, reh’g denied, 305 U.S. 670 (1938).
 - (d) What proportion of the corporation’s assets must be transferred to meet the “substantially all” test?
 - (2) The statute is unclear as to whether the voting stock requirement applies to mergers.
 - b. The statute describes I.R.C. § 368-type transactions, but it does not expressly refer to that section.
 - (1) Arguably, the continuity of proprietary interest and business enterprise tests under federal law do not apply.
 - (2) Does this mean that a merger in which the sole consideration for the transfer of assets is cash is not subject to the sales tax? Will the Oklahoma courts create a continuity of proprietary interest requirement as the federal courts did in the income tax area?
5. Missouri exempts a transfer of “substantially all” of a corporation’s tangible personal property to another corporation in a statutory merger or consolidation. Revised Statutes § 144.011.1(1).
- a. There is no requirement as to the nature of the consideration received. The exemption would literally apply to a merger in which all the consideration received was cash. Will the courts require a continuity of proprietary interest as do the federal courts for income tax purposes?
 - b. The exemption apparently applies when the consideration is stock of the buyer’s parent.
 - c. The exemption is not available in case of a transfer of all of the seller’s assets in a non-merger transaction, even if all of the consideration received is buyer stock (i.e., a tax-free reorganization under Internal Revenue Code § 368(a)(1)(C)).
 - d. It is not clear whether federal reorganization rules apply in determining whether the “substantially all” test is met.

- (1) What proportion of the seller's assets must be transferred?
 - (2) Does a pre-transfer spinoff jeopardize qualification?
6. California exempts transfers pursuant to a statutory merger. Regs. 1595(b)(3).
 - a. There is no requirement as to the nature of the consideration received. The exemption would literally apply to a merger in which all of the consideration received was cash. Will the courts require a continuity of proprietary interest as do the federal courts for income tax purposes?
 - b. The exemption apparently applies when the consideration is stock of the buyer's parent.
 - c. The exemption is not available in case of a transfer of all of the seller's assets in a non-merger transaction, even if all of the consideration received is buyer stock (*i.e.*, a tax-free reorganization under Internal Revenue Code § 368(a)(1)(C)). SBE Ruling 395.2100 (May 12, 1988), CCH California Tax Reporter ¶ 60-590.89(j).
7. Iowa exempts transfers pursuant to statutory mergers if "not for any consideration." Rule 701-15.20 (422, 423) (adopted August 7, 1997). Although the assumption of liabilities could be viewed as "consideration" under this provision, the Department of Revenue and Finance has confirmed that it does not take this view. In fact, it has suggested that mergers will not be subject to sales tax even if the consideration includes cash. See correspondence between Peter L. Faber and the Department reprinted in State Tax Notes, November 3 and December 1, 1997.
- C. Most states have exemptions that apply to the transfer of some assets in the sale of a business that would apply to the transfers of those assets even if not as part of a sale of a business.
 1. Inventory is covered by the resale exemption.
 2. Equipment used predominantly in production.
 3. Intangible property.
 4. Real estate.
- D. Internal Revenue Code Section 338 transactions.

1. Federal income tax treatment.
 - a. For federal income tax purposes, a corporation that buys 80% or more of a target corporation's stock can elect to have the basis of the target's assets adjusted to reflect the purchase price for the stock. Normally, this means that they get a basis equal to their fair market value. The mechanism by which this is accomplished is to hypothesize a fictional sale of the assets by the target to itself as a "new" corporation.
 - b. Under Section 338(h)(10), the sale of stock of a corporate subsidiary or an S corporation is treated, if both the buyer and the seller elect, as if the target sold its assets to itself while a member of the selling parent's consolidated return group or while still an S corporation and then liquidated. The sale of the target's stock is disregarded.
2. Many states recognize Section 338(h)(10) for income and franchise tax purposes; others do not. See, generally, Faber, 1520 T.M., Mergers and Acquisitions: Income Tax Problems.
3. The deemed hypothetical sale under a Section 338 election should not be subject to sales tax. The deemed sale is merely a fictional device that is used to calculate the basis adjustment and the corresponding income tax cost. No sale of assets actually takes place; they remain owned by the same corporation. Several state tax departments have so held. See, e.g., Florida Department of Revenue, Technical Assistance Advisement No. 89A-054 (1989); Virginia Department of Taxation, PD 94-106 (1994). The same result was reached in The TJX Companies, Inc., (N.Y.S. Division of Tax Appeals 1995), CCH New York State Tax Reporter ¶402-246, aff'd on other grounds (N.Y.S. Tax Appeals Tribunal 1997), CCH New York State Tax Reporter ¶ 402-638, where the sale of stock was preceded by a transfer of assets from the parent to the subsidiary in anticipation of the sale of stock. See, also, California State Board of Equalization Prop. Regs. § 1595 (October 3, 1996).

III. Transfers in exchange for an equity interest in the transferee.

- A. States generally have an exemption from the sales tax for transfers to an entity in exchange for an equity interest in the entity. The exemptions are analogous to the income tax exemptions for transfers to a controlled corporation (I.R.C. § 351) or a partnership (I.R.C. § 721). The exemptions vary considerably in scope and detail.
- B. Scope of exemption.
 1. Some states exempt such transfers at any time.

- a. Illinois exempts any transfer of property by a person not engaged in the business of selling that property. Retailers Occupation Tax § 1. Regs. § 130.110(a). This covers all property except inventory, and that is covered by the resale exemption.
 - b. Missouri.
 - (1) Any transfer to a corporation solely in exchange for stock or a “security” of the corporation or any transfer to a corporation that constitutes a capital contribution by a shareholder is exempt. Revised Statutes §§ 144.011(3) and (4).
 - (a) The transferor need not control the transferee (as under I.R.C. § 351).
 - (b) The meaning of “security” is unclear. Under the analogous provisions of federal income tax law, a “security” is a debt instrument with a maturity date that suggests something of a long-term investment in the issuer (e.g., at least 5 years).
 - (2) There is a similar exemption for transfers to a partnership, but only if in exchange for an equity interest in the partnership. Transfers in exchange for “securities” are apparently taxable.
 - c. Georgia’s exemption applies only to a “business reorganization.” Code § 48-8-3(21). This suggests that there must be an existing business and that the exemption would not apply to the incorporation of a new business.
2. Some states limit the exemption to transfers occurring upon the organization of the transferee entity. Later transfers are taxable.
- a. In New York (Tax Law § 1101(b)(4)(iii)(D)), New Jersey (Revised Statutes § 54:32B-2(e)(4)(E)), and Vermont (Statutes Annotated § 9742(5)), there is an exemption for a transfer to a corporation “upon its organization in consideration for the issuance of its stock.”
 - (1) It is not clear when a transfer to a corporation will be deemed to be “upon its organization.” Compare the New York cases of Noar Trucking Company, Inc. v. State Tax Commission, 139 A.D.2d 869 (3d Dep’t 1988) (transfers 10-22 months after business started held to be taxable), and

K-B Transport, Inc., CCH New York Reporter 1988-1989 New Matters Transfer Binder at ¶ 252-284 (Division of Tax Appeals 1988) (transfers 20 months after incorporation held to be exempt where delay was caused by regulatory problems).

- (2) A transfer on the activation of a dormant “shell” corporation that was formed some time before is taxable. N.Y.S. Regs. § 526.6(d)(5)(iii). Solution: form a new corporation and do not use the dormant one.
 - (3) A transfer of property to an existing corporation as a capital contribution with no new issuance of stock is not taxable. N.Y.S. Regs. § 526.6(d) (8)(ii). This technique can be used when transfers are proportional to stockholdings.
 - (4) Surprisingly, in all three states a transfer to a partnership in exchange for a partnership interest is exempt even if the transfer does not occur upon the partnership’s organization. New York Tax Law § 1101(b)(4)(iii)(E), New Jersey Revised Statutes § 54:32B-2(e)(4)(F), Vermont Statutes Annotated § 9742(6).
- b. California has a blanket exemption for startup situations and a more limited exemption for later transfers.
- (1) A transfer to a “commencing” corporation or partnership in exchange for an equity interest is exempt. Regs. § 1595(b)(4).
 - (2) A later transfer is exempt only if it is of “substantially all” of the transferor’s property that requires a vendor’s permit and the real or ultimate owners of the property after the transfer are “substantially similar.” Regs. § 1595(b)(2).
 - (a) “Substantially all” of the property means 80% or more of the tangible personal property.
 - (i) Real property is not counted. SBE Ruling 395.1500 (January 24, 1955), CCH California Tax Reporter ¶ 60-590.83(g).
 - (ii) The “substantially all” test is not met when all of the transferor’s capital assets are transferred but the inventory is not. SBE Ruling 395.1280 (December 16, 1952),

- (b) Continuity of ownership.
 - (i) “Substantially similar” means 80% or more.
 - (ii) Ultimate owners include bondholders as well as equity owners, but only if the bonds are issued in serial form with interest coupons attached, are convertible into stock, are payable at a certain date, and have acceleration provisions on default. SBE Ruling 395.1560 (December 23, 1959), CCH California Tax Reporter ¶ 60-590.85(h).
 - (iii) It is not clear whether owners can be aggregated or whether each transferor must retain the same interest in each asset.
- c. Maryland exempts transfers “on organization of a corporation.” Tax General Article § 11-209(c)(1)(ii).
 - (1) The transfer must be within six months after the filing of the Articles of Incorporation and within 30 days after the corporation starts business. Regs. § 03.06.01.13.C(1). (This objective test might be challenged if the failure to meet it arises from causes beyond the parties’ control.)
 - (2) A transfer to a partnership in exchange for a partnership interest is exempt even if it does not occur upon the partnership’s organization. Regs. § 03.06.01.13.C(4).
- d. Oklahoma exempts a transfer to a corporation “for the purpose of organization of such corporation.”
Statutes § 1360(A)(3). This seems to include later transfers if they are part of the initial organization of the corporation.
- e. Some states exempt a transfer only if the transferor has the same proportionate interest in the asset after the transfer.
 - (1) See, e.g., Georgia (Code § 48-8-3(21)), Oklahoma (Statutes § 1360(A)(3)), Texas (Code § 151.304(b)(3); see Rule 34

TAC § 3.316(e)(2), defining “substantially similar” ownership as 80% or more).

- (2) This effectively limits the exemption to:
 - (a) Corporations with one shareholder, or
 - (b) The incorporation of a partnership where the stock is not distributed to the partners but continues to be owned by the partnership (thus precluding a subchapter S election).

f. Texas limits the exemption to transfers of “substantially all of the property used by a person in the course of an activity.” Code 151.304(b)(3).

(1) “Substantially all” means 80% or more. Rule 34 TAC § 3.316(e)(3). It is not clear whether this test is based on fair market value or on some other measure.

(2) Presumably, the “activity” must be continued by the transferee. This limits the exemption to a pre-existing and continuing business.

g. Virginia’s casual sale exemption extends to the “reorganization” of a business. This has been held to apply to the transfer of the assets of a business to a new subsidiary in exchange for the subsidiary’s stock in a § 351 transaction even where the later sale of the subsidiary’s stock was contemplated. Ruling of Commissioner, P.D. 96-75 (May 3, 1996), CCH Virginia State Tax Reporter ¶ 202-956.

h. Is the exemption lost if the transferee transfers the property to a related entity? See N.Y.S. Department of Taxation and Finance Advisory Opinion TSB-A-98(2)S (1998) (exemption not lost when property transferred to a related entity).

C. Treatment of consideration other than an equity interest in the transferee.

1. Cash and other property.

a. Some states exempt the entire transfer regardless of the consideration received.

- (1) See, e.g., Georgia (Code § 48-8-3(21)), Illinois (Retailers Occupation Tax § 1, Regs. § 130.110(a)), Oklahoma (Statutes § 1360(A)(3)), Texas (Code § 151.304(b)(3)).
- (2) Maryland exempts the entire transfer as long as it is “principally” in exchange for stock. Tax General Article § 11-209(c)(1)-(ii).
 - (a) “Principally” means 50% or more than the amount received for tangible personal property. Regs § 03.06.01.13.B(2).
 - (b) Stock does not include securities that at the holder’s option are redeemable for cash or convertible into debt. Regs § 03.06.01.13.B(1)

b. Some states impose a tax on that part of the transfer that is in exchange for cash or other property.

- (1) See, e.g., California (Regs. § 1595(b)(4)), New Jersey (Revised Statutes § 54:32B-2(e)(4)(E)), New York (Tax Law § 1101(b)(4)(iii)(D), Regs. § 526.6(d)(5)(iv)), Vermont (Statutes Annotated § 9742(5)).
- (2) Missouri exempts transfers for “securities” as well as for stock. Revised Statutes § 144.011(3). This may be changed in light of the deletion of “securities” from qualifying consideration under I.R.C. § 351. Contra, N.Y.S. Regs. § 526.6(d)(7)(ii).

2. Assumption of liabilities.

a. Those states that exempt the entire transfer regardless of the consideration received exempt transfers in exchange for the assumption of liabilities.

b. Those states that tax the receipt of other property normally do not make special reference to the assumption of liabilities.

- (1) California’s regulations, however, specifically state that with respect to a contribution to a commencing corporation the tax applies if the transferor receives consideration such as an “assumption of indebtedness”. Cal. Regs. § 1595(b)(4); see also, Beatrice Company v. SBE, 6 Cal. 4th 767 (1993) (assumed liabilities on transfer to subsidiary

are subject to sales tax); SBE Ruling 395.1880 (June 5, 1970), CCH California Tax Reporter ¶ 60-590.87(i).

- (2) New York exempts assumed liabilities only if they are secured by transferred assets. Regs. § 526.6(d)-(5)(v).
 - (3) Maryland, which exempts transfers only if “principally” in exchange for stock, does not take assumed liabilities into account in applying the “principally” test, but only if the transferor does not regularly sell tangible personal property or a taxable service. Tax General Article § 11-209(c)(2).
- c. Assumed liabilities must be allocated among transferred assets. See, e.g., Tops, Inc., CCH New York Tax Reporter 1991-1992 New Matters Transfer Binder at ¶ 400-216 (Division of Tax Appeals 1991) (liabilities allocated to all assets based on value and not first to tangible personal property).
 - d. Assumption of liabilities on transfer of property to partnership in exchange for partnership interest. Compare Industrial Asphalt, Inc. v. State Board of Equalization, 5 Cal.App.4th 1237 (1992), and Cal-Metal Corp. v. State Board of Equalization, 161 Cal.App.3d 759 (1984) (sales tax when liabilities assumed on transfer to partnership), with Matter of Beautiful Visions Co. et al (no sales tax when liabilities are assumed on transfer to partnership) (N.Y.S. Div. of Tax App. 1994), CCH New York State Tax Reporter, 1993-94 Transfer Binder, ¶401-413.

IV. Spinoffs.

- A. If a corporation spins off an unincorporated division to its shareholders in a tax-free distribution under Internal Revenue Code §355, it will have to transfer the division’s assets to a separately-incorporated subsidiary (pre-existing or newly created) and distribute the subsidiary’s stock. If properly structured, the transfer and distribution will be a tax-free reorganization under § 368(a)(1)(D).
- B. The transfer of assets to the subsidiary may be subject to sales tax.
 1. In general, the principles discussed in Part III of this outline, dealing with transfers in exchange for an equity interest in the transferee, will apply.
 2. If there is an exemption from the sales tax for a transfer to a corporation that is controlled by the transferor, there is a danger that a later distribution of the transferee’s stock to the transferor’s shareholders will cause a failure to meet the control requirement.

3. See Faber, "State and Local Tax Aspects of Corporate Spinoffs" State Tax Notes February 26, 1996, and Tax Notes, April 8, 1996.

V. Recommendations for change.

A. Sales of businesses should generally be exempt from the sales tax.

1. The sales tax should generally apply only to sales in the ordinary course of business to the ultimate consumer of tangible personal property.
 - a. Taxing inputs of any kind into the production process leads to a pyramiding of the tax. (This would logically lead to exempting all purchases by a manufacturer, not just purchases of production equipment.)
 - b. Even if one is not ready to exempt all purchases by a manufacturer, one can still justify exempting sales of businesses. A sale of a business, unlike a purchase of furniture by a manufacturer, adds nothing to the production of goods. It does not move the goods closer to the ultimate consumer. It merely results in a change of ownership of the whole process.
2. The exemption should apply to the sale of a "business," even if it is not the seller's only business (e.g., to the sale of a division of a corporation).
 - a. The rationale for the exemption should apply even if not all of the seller's businesses are sold.
 - b. Defining a "business" may not always be easy, but there is precedent for it. See, e.g., I.R.C. §§ 355, 1060; Texas Code § 151.304(c).

B. Sales tax exemptions should not be linked to income tax exemptions.

1. A sales tax is an excise tax on the transfer of property at retail. An income tax is a tax on gain. The policies underlying the taxes are different.
2. The reorganization provisions of the Internal Revenue Code defer tax; they do not avoid it.
 - a. The shareholders and the corporations take a carryover basis in the property and stock transferred. The gain will eventually be taxed (subject to I.R.C. § 1014).

- b. In a tax-free reorganization that includes an asset transfer, a transfer of assets occurs and the continued ownership of those assets by the target shareholders is a fiction.
- 3. A statutory merger in exchange for stock, although something of a hybrid as between a stock sale and an asset sale, involves a transfer of assets to a new corporation and should be treated as a transfer of assets followed by a liquidation. WestShore Fuel, Inc. v. U.S., 598 F.2d 1236 (2d Cir. 1979).