Cite as Det. No. 93-303, 14 WTD 054 (1994).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition	)	D E T E R M I N A T I O N
For Correction of Assessment of	)	
	)	No. 93-303
	)	
[Taxpayer 1]	)	Registration No. . . .
	)	FY. . ./Audit No. . . .
	)	FY. . ./Audit No. . . .
	)	
[Taxpayer 2]	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 106: CASUAL AND ISOLATED SALE -- STEP TRANSACTION RULE. A taxpayer may not avail itself of the Kimbell-Diamond rule and claim that two separate transactions are merely steps of a single transaction for tax purposes. The Washington Supreme Court's ruling in Estep v. King County, 66 Wn.2d 76, 401 P.2d 332 (1965) explicitly rejects the step transaction doctrine in real estate excise tax situations and the reasoning of the court is equally applicable to other excise taxes.

[2] RULE 106; RCW 82.04.040, .150, and .220: CASUAL AND ISOLATED SALE -- RETAIL SALES TAX -- BUSINESS AND OCCUPATION TAX. Where a registered taxpayer sells its capital assets in a casual and isolated sale, there is no business and occupation due. However, the registered taxpayer is required to collect retail sales tax on the transaction. Further, the sale of inventory, even in bulk, cannot be a casual and isolated sale, therefore, business and occupation taxes apply to that sale.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

The taxpayers contend that the transfer of inventory, equipment, and other assets to a newly formed corporation, which was structured as a sale for federal tax purposes, was in reality a corporate reorganization and thus exempt from taxation as an adjustment to beneficial interest in the business.

FACTS:

Coffman, A.L.J. -- The taxpayers are in the business of retailing and wholesaling tangible personal property. The Department of Revenue (Department) audited the books and records of Taxpayer 1 for the period of October 1, 1988 through May 31, 1990. The original tax assessment was issued on November 12, 1992, and showed tax and interest owing. The Department issued a post audit adjustment on January 28, 1993. The post audit adjustment reduced the total tax and interest due the Department. The reduction was based on the submission of documentation showing that retail sales tax had been paid on certain capital assets.

The Department also audited the books and records of Taxpayer 2 for the period of January 1, 1990 through December 31, 1991. The Department issued a tax assessment on November 10, 1992 showing taxes and interest due and owing.

These appeals have been consolidated because the taxation of a transaction between the taxpayers is central to both appeals. Taxpayer 1 made an election to be treated as a S Corporation for federal income tax purposes. Prior to January 1, 1990, Taxpayer 1 operated from "profit centers" located in Washington and another state. For business reasons, Taxpayer 1 decided that it was necessary to separate its other state and Washington "profit centers." The taxpayers state that they originally planned to accomplish this by means of tax-free corporate reorganization under the Internal Revenue Code. However, to accomplish this, it would have been necessary for Taxpayer 1 to form a subsidiary and then distribute the stock of the subsidiary to its shareholders. If this were to have occurred, Taxpayer 1 believed that it would have lost its S Corporation status.

The shareholders of Taxpayer 1 determined that this consequence was unacceptable. Therefore, Taxpayer 1 made a distribution to its shareholders of cash. These shareholders formed Taxpayer 2 which purchased the Washington assets of Taxpayer 1. The stock ownership of Taxpayer 2 was in the identical proportions as Taxpayer 1. The purchase price was the book value of those assets.[1] Taxpayer 2 paid for the assets by assuming all liabilities associated with the Washington activities and executing an obligation payable to Taxpayer 1 for the net value.

Taxpayer 1 did not collect retail sales tax on the capital assets transferred. Additionally, Taxpayer 1 did not pay business and occupation taxes on its transfer of inventory. Taxpayer 2 did not pay use tax on the capital assets. The tax assessment against Taxpayer 1 included some items that are not being protested. Taxpayer 1 is protesting the assessment of uncollected retail sales tax and the business and occupation tax imposed on the transfer of the inventory. Taxpayer 2 likewise does not dispute portions of the assessment, but protests the assessment of use tax/unpaid retail sales tax. To the extent that the retail sales tax is paid by Taxpayer 1, or Taxpayer 2 pays the use tax, a corresponding adjustment will be made to the tax assessment against the other.

The petition of Taxpayer 2 states the argument relating to a §368(a)(1)(D) reorganization as follows:

> Such a transaction is, under the facts of this case, a transfer by a corporation [Taxpayer 1] of part of its assets to a controlled corporation [Taxpayer 2] followed by a distribution of the controlled corporation's stock in a spin-off. The instant transaction involved a distribution of the controlled corporation's stock <u>directly</u> to the shareholders rather than the swap of assets for stock (plus boot) followed by a distribution to the shareholders of the controlling corporation of the controlled corporation's stock. While this transaction departs from the literal wording of the statute, it constitutes a 368(a)(1)(D) reorganization under the step-transaction doctrine applied by both the Internal Revenue Service and the courts in the area of corporate reorganizations.
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> The step transaction doctrine asserts that an integrated transaction must not be broken into independent steps or conversely, that the steps must be taken together in attaching tax consequences. [Citations omitted.]

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[1] Therefore, Taxpayer 1 had no gain or loss on the transaction with Taxpayer 2 for federal income tax purposes. Thus, Taxpayer 1 is not concerned whether the transaction in fact is a "D" reorganization under I.R.C. § 368(a)(1)(D).

> Thus under the step transaction doctrine a (D) reorganization occurred here regardless of which of several different step transaction analyses is taken:
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> (i) Under the "end result test separate transactions will be amalgamated into a single transaction when it appears that they are really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. The test is based on the assumption that a given end result should have the same tax effect, whether achieved directly or through several intervening steps." [Citations omitted.] The end result here is that a portion of [Taxpayer 1]'s assets were spun off into [Taxpayer 2] with all of [Taxpayer 1]'s shareholders holding exactly the proportion of shares in both corporations. The end effect is the same as if [Taxpayer 1] had swapped assets for stock and boot and distributed the [Taxpayer 2] shares to its own shareholders, pro rata.
>
> Under the so-called "interdependence" or mutual interdependence test, the court ascertains "whether on a reasonable interpretation of objective facts, the steps were so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series." Each step must be examined to determine whether it had a reasoned economic justification standing alone or whether it was dependent for its success upon each of the other steps. . . . In this case, because a substantial purpose of the transaction was to create brother-sister affiliates the result of creating brother-sister corporations could not have been achieved had the transaction taken any other effect.

Taxpayer 1 states that because it is involved in a corporate reorganization as discussed by Taxpayer 2 above, it is unreasonable for it to be subject to the business and occupation tax on its transfer of inventory. Additionally, Taxpayer 1 argues that WAC 458-20-106 (Rule 106) is incorrect because it makes a distinction between a transfer for stock and other transfers for valuable consideration.

The Department's Audit Division concluded that the transfer of inventory from Taxpayer 1 to Taxpayer 2 was not a casual or isolated sale. Therefore business and occupation tax was due on that portion of the transaction. The taxpayers contend that to impose the business and occupation on the transfer of inventory, but not on the transfer of capital assets, is flawed.[2]

ISSUES:

1. Whether a transaction that is structured as a sale for federal income tax purposes can be treated as an adjustment of beneficial interest in the business for state tax purposes.

2. Whether a transfer of inventory as part of a transaction can be subject to the business and occupation tax, while the balance of the transaction be exempt from the business and occupation as a casual and isolated sale.

DISCUSSION:

1. Retail Sale of Capital Assets.

Sales between two corporations are subject to taxation even if they are between a parent and 100% owned subsidiary. Washington Sav-Mor Oil Co. v. State Tax Comm'n, 58 Wn.2d 518, 364 P.2d 440 (1961). The transfer of assets from Taxpayer 1 to Taxpayer 2 was structured in the form of a sale. That is, the assets and associated liabilities were transferred to Taxpayer 2 in exchange for a promise to pay Taxpayer 1 the net book value of those assets. Therefore, unless an exemption applies, the transaction is subject to taxation.

The taxpayers base their claim for exemption on Rule 106. Rule 106 states:

> A transfer of capital assets to or by a business is deemed not taxable to the extent the transfer is accomplished through an adjustment of the beneficial interest in the business. The following examples are instances when the tax will not apply.
>
> (1) Transfers of capital assets between a corporation and a wholly-owned subsidiary, or between wholly-owned subsidiaries of the same corporation.
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> (2) Transfers of capital assets by an individual or by a partnership to a corporation, or by a corporation to another corporation in exchange for capital stock therein.

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[2]Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

> (3) Transfers of capital assets by a corporation to its stockholders in exchange for surrender of capital stock.
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> (4) Transfers of capital assets pursuant to a reorganization under 26 USC Section 368 of the Internal Revenue Code, when capital gain or ordinary income is not realized.
>
> (5) Transfers of capital assets to a partnership or joint venture in exchange for an interest in the partnership or joint venture; or by a partnership or joint venture to its members in exchange for a proportional reduction of the transferee's interest in the partnership or joint venture.
>
> (6) Transfer of an interest in a partnership by one partner to another; and transfers of interests in a partnership to third parties, when one or more of the original partners continues as a partner, or owner.
>
> The burden is upon the taxpayer to establish the facts concerning the adjustment of the beneficial interest in the business when exemption is claimed. (Emphasis added.)

The taxpayers argue that the six examples are representative of the types of transactions that are exempt from taxation. Thus, if they are able to show that their transaction is similar to the examples, they should be entitled to the benefit of the exemption. Specifically, the taxpayers argue that the exemption is available because the transaction between Taxpayer 1 and Taxpayer 2 is similar to a corporate reorganization. (Example 4.)[3]

[1] It is the law in this state that the taxing authority may not impose taxes based on the step transaction theory[4]. Estep v.

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[3] The taxpayers contend that they received erroneous advice concerning the ramification to the Subchapter S election. If they had not received the erroneous advice, they could have accomplished the same result by forming a subsidiary and then immediately spinning off the subsidiary. This transaction, they claim, would have been exempt from taxation in Washington. Alternatively, they argue that the transaction was in fact a "D" reorganization.

[4] The court specifically rejected the Kimbell-Diamond Rule which is based on Kimbell-Diamond Milling Co. v. Commissioner of Internal Rev., 14 TC 74, aff'd per curiam, 187 F.2d 718, cert. den. 342 U.S. 827 (1951).

King County, 66 Wn.2d 76, 401 P.2d 332 (1965)[5], Det. No. 87-212, 3 WTD 259 (1987). Estep involved the acquisition of real property. The real property was held by a corporation. The transaction was structured as a purchase of the stock of the corporation followed by the liquidation of the corporation. King County claimed that the transaction, when viewed as a whole, was the purchase of real property subject to the real estate excise tax. The state supreme court held, in Estep, at 80.[6]

> Adoption of the rule [step transaction] would write into Washington law a provision not voiced by the legislature and would make suspect every conveyance of real property by a corporate liquidating trustee. It would involve the county and the courts in a search for subjective intents, motives, and purposes every time a transfer of stock is followed by a transfer of real property in corporate dissolution. Any change in the application of the statutes and ordinance must be legislative.

We note that the taxpayers' argument is that the subjective intent and motives of the shareholders was to have a tax-free reorganization. This argument is in direct conflict with the court's basis for rejecting the step transaction doctrine.
It can be argued that the rule in Estep applies only to real estate transactions. However, the state tax system is based on taxation of transactions. Det. No. 91-128, 11 WTD 327 (1991). The issues in this case are based on a particular transaction. It is unimportant whether either taxpayer realized a gain or loss as a result of the activity. Rather, the issue is whether there was business activity. RCW 82.04.070. If in fact the activity is "business", then the business and occupation tax applies. RCW 82.04.220. The term "business" is broadly construed. Budget Rent-A-Car, Inc. v. Department of Rev., 81 Wn.2d 171, 500 P.2d 764 (1972).

The reasoning stated by the court in Estep is equally applicable to all excise taxes. We find that the step transaction rule does not apply to the excise taxes of Washington.

Additionally, we find that the transaction between the taxpayers was not a reorganization. The reason for this finding is that

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[5] The taxpayers were given the opportunity to respond to Estep at the hearing. The response dated November 19, 1993, has been received and considered.

[6] We note that the legislature has extended the real estate excise tax to corporate acquisitions.

Taxpayer 1 never received any stock of Taxpayer 2. Rather, it received relief from liabilities and a promise to pay full value. The transaction between Taxpayer 1 and Taxpayer 2 is properly characterized as a sale. There was a transfer of tangible personal property for valuable consideration.

2. Casual and Isolated Sale.

[2] The Audit Division assessed business and occupation taxes on the sales of Taxpayer 1's inventory, but not on the sale of the capital assets. Taxpayer 1 believes that it is inconsistent to tax part of the transaction while exempting the remainder.

RCW 82.04.220 states:

> There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

RCW 82.04.150 defines engaging in business as:

> commencing, conducting, or continuing in business and also the exercise of corporate or franchise powers as well as liquidating a business when the liquidators thereof hold themselves out to the public as conducting such business. (Emphasis added.)

The emphasized language clearly implies that some activities are outside the scope of the business and occupation tax. Casual and isolated sales are defined as "a sale made by a person who is not engaged in the business of selling the type of property involved." RCW 82.04.040. We find that casual and isolated sales are the transactions the legislature sought to exclude from the business and occupation tax. Taxpayer 1 was not in the business of selling its capital assets.[7] Thus, the sale of the capital assets to Taxpayer 2 was a casual and isolated sale and exempt from the business and occupation tax. However, Rule 106 states:

> Furthermore, persons who hold themselves out to the public as making sales at retail or wholesale are deemed to be engaged in the business of selling, and sales made by them of the type of property which they hold themselves out as

[7] These included, for example, sales booths, motor vehicles, and office furniture.

> selling, are not casual or isolated sales even though such sales are not made frequently.

As we stated in Det. No. 90-83, 9 WTD 149 (1990):

> Prior to the liquidation of the business, the taxpayer was engaged in the business of selling the type of property that was taxed by the auditor. Therefore under RCW 82.04.040 and Rule 106 the sale of that inventory, even though part of the liquidation of the business, is not a casual or isolated sale. As such it is fully subject to Washington B&O taxes. The taxpayer's petition is denied on this issue.

RCW 82.08.0251 states:

> The tax levied by RCW 82.08.020 shall not apply to casual and isolated sales of property or service, unless made by a person who is engaged in a business activity taxable under chapters 82.04 or 82.16 RCW: Provided, That the exemption provided by this section shall not be construed as providing any exemption from the tax imposed by chapter 82.12 RCW.

Thus, even though the sale of the capital assets to Taxpayer 2 was exempt from the business and occupation tax, Taxpayer 1 was required to collect the retail sales tax. RCW 82.08.050 states:

> In case any seller fails to collect the tax herein imposed or having collected the tax, fails to pay it to the department in the manner prescribed by this chapter, whether such failure is the result of his or her own acts or the result of acts or conditions beyond his or her control, he or she shall, nevertheless, be personally liable to the state for the amount of the tax.

Thus, the assessment of the retail sales tax against Taxpayer 1 is correct. However, if Taxpayer 1 pays the tax, it will have a cause of action against Taxpayer 2 for that tax. Likewise, the Department has the authority to collect the tax directly from Taxpayer 2. Thus, the assessment is correct in that regard as well. However, the Department may only collect the retail sales tax once. Therefore, as stated in both audit reports, the Department will adjust each assessment to the extent the other pays the tax.

We note that the tax assessment against Taxpayer 1 correctly distinguished between the sale of capital assets as casual and isolated sales and the sale of inventory which is not casual and isolated.

DECISION AND DISPOSITION:

The taxpayers' petitions are denied.

DATED this 24th day of November, 1993.