

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 96-221
)	
...)	Registration No. . . .
)	
...)	Registration No. . . .
)	Assessment of Successorship

- [1] RULE 216; RCW 82.04.180 AND 82.32.140. -- SUCCESSORSHIP -- ELEMENTS. The five elements of a statutorily defined successor are: (1) The successor must acquire from a taxpayer; (2) who is selling out, exchanging, or disposing of a business; (3) in bulk and not in the ordinary course of business; (4) by sale or conveyance; (5) a major part of the materials, supplies, merchandise, inventory, fixtures, or equipment of the delinquent taxpayer.
- [2] RULE 216; RCW 82.04.180 AND 82.32.140. -- SUCCESSORSHIP -- "STEP TRANSACTION DOCTRINE". The Department may not collapse steps of a transaction to determine successorship. For example, the fact that a lessor repossesses property and immediately leases the property to a third party may not be treated as the acquisition of property from the previous lessee.
- [3] RULE 216; RCW 82.04.180 AND 82.32.140. -- SUCCESSORSHIP -- ELEMENTS -- OPERATION OF A SIMILAR BUSINESS. Whether a person operates a business similar to that of the alleged predecessor is irrelevant to a determination of successorship.
- [4] RULE 216; RCW 82.04.180 AND 82.32.140. -- SUCCESSORSHIP -- "MAJOR PART OF THE MATERIALS, SUPPLIES, INVENTORY, FIXTURES, OR EQUIPMENT." The element of successorship requiring the acquisition of a "major part of the materials, supplies, inventory, fixtures, or equipment" refers to the tangible personal property of the alleged predecessor and does not include intangible property.

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 protest Assessments of Successorship Liability relating to their respective operation of restaurants formerly operated by one corporation.¹

FACTS:

Coffman, A.L.J. -- The predecessor corporation (the predecessor) operated two restaurant/nightclubs² in Washington under a common tradename.

The predecessor filed for protection under the U.S. Bankruptcy Code, Chapter 11, in April 1995. During the period the bankruptcy was active, the predecessor continued to operate but failed to remit taxes due to the Department of Revenue (Department) and the Internal Revenue Service (IRS). The bankruptcy action was dismissed in December 1995, pursuant to a motion filed by the IRS.

Restaurant 1.

In June 1986, the predecessor entered into a commercial lease of the building, fixtures, equipment, and inventory used in its operation of Restaurant 1. The lease provided:

Tenant hereby grants to Landlord a lien on and security interest in all property of Tenant now or hereafter placed in or upon the Premises, and such property shall be and remain subject to such lien and security interest of Landlord for the payment of all Rent and the performance of all other obligations of Tenant hereunder. This lien and security interest shall be in addition to any Landlord's lien provided by law. This lease shall constitute a security agreement under the Uniform Commercial Code of the State of Washington (UCC), so that Landlord shall have and may enforce a security interest in all property of Tenant now or hereafter placed in or on the Premises, including without limitation all trade fixtures, machinery, equipment, furniture, furnishings, and other articles of personal property now or hereafter placed in or upon the Premises by the Tenant. Tenant shall execute as debtor such financing statement or statements as landlord may now or hereafter reasonably request so that such security interest or interests may be protected pursuant to the UCC. Landlord may at its election at any time file a copy of this lease as a financing statement. Landlord as secured party shall be entitled to all rights and remedies afforded a secured party under the UCC.

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

² For the sake of convenience we refer to these businesses collectively as "the restaurants."

(Emphasis added.) In November 1995, after a default, the lessor peacefully repossessed all of the leased assets of Restaurant 1 and immediately leased them to Taxpayer 1. Taxpayer 1 is 100% owned by a son of the predecessor's president. The predecessor also gratuitously granted to Taxpayer 1 the right to use its tradename.

Taxpayer 1 continued the operations of Restaurant 1 as if there were no change of ownership. Therefore, the customers of Restaurant 1 were unaware of the change of ownership.

Restaurant 2.

The predecessor had a similar relationship with the lessor³ of the building, fixtures, equipment, and inventory used to operate Restaurant 2. However, the lessor of Restaurant 2 required the predecessor to execute a separate security agreement covering all property owned or used by the predecessor on the premises of Restaurant 2.

In November 1995, the lessor peacefully repossessed all of the assets used in the operation of Restaurant 2 and immediately leased them to Taxpayer 2. Taxpayer 2 is 100% owned by another son of the president. The predecessor also gratuitously granted to Taxpayer 2 the right to use its tradename.

Taxpayer 2 continued the operations of Restaurant 2 as if there were no change of ownership. Therefore, the customers of Restaurant 2 were unaware of the change of ownership.

The lease entered into by Taxpayer 2 includes the following provision:

28. Contents of Building Located on Premises. Prior to the execution of this lease, the premises were leased to [predecessor], in accordance with the provisions of a Standard Industrial/Commercial Single-Tenant Lease-Net dated . . . , 1992 (the [ABC] Lease). Lessor holds a first priority security interest in all of the contents of the building located on the premises as collateral security for the repayment of a note executed by [ABC] and for the payment of all other amounts due under the [ABC] Lease. Lessor and Lessee agree that the execution of this Lease shall not relieve any of the parties to the [ABC] Lease of any obligations thereunder, except to the extent of rent actually paid to Lessor by Lessee under this Lease, which shall be allowed as a setoff against the payments falling due on the [ABC] Lease on or after

In May 1996, the lessor of Restaurant 2 mailed to Taxpayer 2 a notice of strict foreclosure of the assets formerly used by the predecessor in Restaurant 2.

³ The lessors of Restaurants 1 and 2 were unrelated.

The Department issued an Assessment of Successorship Liability individually to both Taxpayers 1 and 2. Due to the similarity of issues and facts, the taxpayers consented to our hearing their respective appeals together and issuing a joint determination.

ISSUE:

Does a secured party's peaceful repossession of property from a debtor and immediate lease of that property to a new corporation, which operates a business similar to the debtor, constitute a sufficient connection between the debtor and the new corporation to impose successorship on the new corporation under RCW 82.04.180 and 82.32.140?

DISCUSSION:

If a taxpayer quits, sells out, or otherwise ceases to operate a business, the taxpayer must pay its excise taxes within 10 days of the closure of the business. If the taxes are not paid within those 10 days, any successor to the taxpayer is personally liable for the delinquent taxes. To the extent that the successor pays the delinquent taxes, the payments are treated as payments to the delinquent taxpayer.⁴

RCW 82.32.020 states that the statutory definition of successor shall apply to chapter 82.32 RCW. Therefore, successorship liability applies only if the person assessed is a successor under the statutory definition.

Successor is defined in RCW 82.04.180 as:

"Successor" means any person to whom a taxpayer quitting, selling out, exchanging, or disposing of a business sells or otherwise conveys, directly or indirectly, in bulk and not in the ordinary course of the taxpayer's business, a major part of the materials, supplies, merchandise, inventory, fixtures, or equipment of the taxpayer. Any person obligated to fulfill the terms of a contract shall be deemed a successor to any contractor defaulting in the performance of any contract as to which such person is a surety or guarantor.

[1] This definition has five elements: (1) The successor must acquire from a taxpayer; (2) who is selling out, exchanging, or disposing of a business; (3) in bulk and not in the ordinary course of business; (4) by sale or conveyance; (5) a major part of the materials, supplies, merchandise, inventory, fixtures, or equipment of the delinquent taxpayer.

All five of these elements must be present before an assessment of successorship liability will be sustained.

⁴ RCW 82.32.180.

The respective lessors of Restaurants 1 and 2 did not acquire the assets of the predecessor by sale or conveyance. They already owned the property by virtue of the security interests they held and the lease agreements.⁵

[2] The fact that the lessors leased the same property to the taxpayers, immediately after repossessing it, is not equivalent to the taxpayers acquiring the property from the predecessor. To reach that conclusion, we would have to treat the repossession, followed by the lease, as merely a transfer of the predecessor's lease. Stated another way, we would have to impose the "step transaction doctrine" on the process used by the lessors and predecessors. We may not do so.⁶

[3] Likewise, the elements of a successor do not include operating a similar business or continuing the operation of the former business. Therefore, how the alleged successor operates its business is irrelevant to the finding of successorship.

[4] Taxing statutes are construed against the application of the tax.⁷ The successorship liability statute must be construed as a taxing statute. Before a person can be treated as successor, he must acquire "a major part of the materials, supplies, inventory, fixtures, or equipment." The listed items are all tangible personal property used in the business. None of the intangible assets of a business are listed. Therefore, we find that the predecessor's tangible personal property is the only property which is of concern in a successorship assessment.

The taxpayers acquired only the right to use the predecessor's tradename. The predecessor did not transfer any other assets to the taxpayers. As a result, the taxpayers are not successors of the predecessor.

DECISION AND DISPOSITION:

The taxpayers' petitions are granted. The assessments of successorship liability are cancelled.

DATED this 22nd day of November, 1996.

⁵ Palmer v. Department of Rev., 82 Wa. App. 367, 917 P.2d 1120 (1996).

⁶ Under federal income tax law, the concept of a "step transaction" may apply here. However, Washington does not recognize that doctrine and must treat transactions as they occur. Estep v. King County, 66 Wn. 2d 76, 401 P.2d 332 (1965); Det. No. 87-212, 3 WTD 259 (1987); Det. No. 92-345, 12 WTD 501 (1992); and Det. No. 93-303, 14 WTD 54 (1993).

⁷ Department of Rev. v. Hoppe, 82 Wn. 2d 549, 512 P.2d 1094 (1973).