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Sales Tax Planning of Organizations, Acquisitions, Reorganizations and Dissolutions

By Barry Leibowicz

There is an essential disconnect between the income and sales tax rules that govern corporate and partnership organizations, reorganizations and dissolutions. Whether this difference causes enormous hardship or confers a great benefit often depends simply on whether it is adequately considered in the planning process.

From inception, every business is confronted with questions of business form and transactional structure. The initial question of which business form best suits the current and projected nature of the business must be dealt with before any experience with the business operations is available for guidance. Once the initial form is selected, questions continue throughout the life of the enterprise as to how the business will be capitalized, assets acquired and disposed of, owners added or removed, reorganizations accomplished, and, eventually, how the business will be terminated.

A major factor in answering all of these questions is the tax effect of competing organizational and transactional forms. Generally, business tax advisors are well versed in the pros and cons of the various business forms and transactions from the federal income tax perspective. If business operations are to be conducted in a state such as New York, the income tax rules essentially parallel those of the federal tax for these transactions. As a result there is usually consistency in tax planning from both the federal and state income tax perspective. Quite predictably, the focus of business tax planning for entity choice, formation, operation, acquisition and dissolution is often exclusively concerned with income tax consequences. In many instances, sales tax issues are given short shrift in the decision-making process, if they are considered at all. This inattention can, however, be very costly.

Unlike state and local income taxes, which generally "piggyback" on the federal rules, there is a core disconnect between the income tax rules and those of the sales tax. In New York, the state sales tax was adopted in 1965, modeled after a 1934 New York City sales tax. As such, the tax, and its basic underpinnings, stems from an entirely different root than that of the federal, state and local income taxes. The sales tax, and its sibling, the use tax, are seemingly clear-cut and simplistic. However, in interpretation and administration, the sales and use taxes are among the most complex and arcane in existence today. An entirely different set of criteria applies to the sales and use tax definition than for other taxes. A person who is subject to the sales tax, and deemed a resident for purposes of that tax, may not be deemed a resident for income tax purposes. Transactions which are recognized under the income tax may not be recognized for sales and use purposes, or vice versa. In many respects, the New York State and local sales taxes are more complex than the equivalent state, local or federal income taxes in application and administration. Without doubt, the results of a transaction for sales and use tax purposes are more difficult to predict than under the income tax.

Much of the language of the income and sales taxes appears similar, adding to the peril which results from inattention. It is not safe to assume that transactions optimized for income tax benefits will be best suited for sales tax purposes, as there is a significant danger that taxes will have to be paid which could have been substantially reduced or avoided. This article seeks to point out important areas of concern both in sales and use tax consequences of entity selection and in transactional planning for reorganizations and acquisitions. By highlighting the divergence between income and sales tax rules in New York State, this article will hopefully encourage planning that takes these differences into account, thereby minimizing the overall tax burden.

The New York sales and use tax is broader in scope than many other sales taxes since it covers a wide range of services, as well as transfers of property. Under New York law, a sale occurs whenever there is a transfer of title, possession or both for consideration or for the rendering of any service which the statute enumerates as subject to tax.[1] Sales would include barter, rental, leasing and license to use or consume, whether conditional or otherwise, and includes any agreement to transfer title or possession or both of tangible personal property, as well as any redemption of reward credit for merchandise. A use is defined as the "exercise of any right or power over tangible personal property . . . by the purchaser thereof."[2] Sales are broadly construed,[3] and there is a presumption of taxability for any sale or use.[4] However, exclusions from the taxable transactions enumerated in New York Tax Law § 1105 are broadly construed, with the benefit of the doubt being given to the taxpayer.[5]

In contrast to the taxpayer-friendly interpretations mandated for exclusions, the exemptions as set forth in Tax Law § 1115 are strictly construed and narrowly interpreted in a manner favoring the state.[6]

It is the interaction of the broad definition of sale and use,[7] the limitation of the tax to tangible property only,[8] and a unique exemption for corporate and partnership transactions that give rise to the immense danger of creating sales tax liabilities in the course of these transactions. However, a corollary also applies. The differences in income and sales tax treatment present significant potential to reduce or eliminate sales taxes otherwise payable on reorganization and acquisition transactions.

Section 1105(a) of the Tax Law imposes a sales tax on the receipts of every retail sale of tangible personal property, unless otherwise excluded. However, various transfers between partners and partnerships and between corporations and stockholders are excluded from the definition of "retail sale" under New York law. The rationale for the exclusion is that, while the form of ownership of the property is changed, there is a continuity of interest in the property transferred.[9] As a result, otherwise taxable property will be exempt if obtained in the course of a statutory exempt transaction. The transactions which qualify for the exemption are:[10]

A. The transfer of property to a corporation, solely in consideration for the issuance of its stock, pursuant to a merger or consolidation effected under the law of New York or any other jurisdiction.

B. The distribution of property by a corporation to its stockholders as a liquidating dividend.

C. The distribution of property by a partnership to its partners in whole or partial liquidation.

D. The transfer of property to a corporation upon its organization in consideration for the issuance of its stock.

E. The contribution of property to a partnership in consideration for a partnership interest therein.

For purposes of the exemptions of Tax Law § 1101(b)(4), a limited liability company is given the same status tax treatment as a partnership.[11]

A review of the statutory scheme set forth in Tax Law § 1101 makes clear that, while it appears similar to the non-recognition provisions of the Internal Revenue Code for entity creation and reorganization, there are sufficient differences to require careful planning to satisfy both sets of criteria. The problem is compounded by a strict adherence to form over substance by the New York State Department of Taxation and Finance and the courts in determining the application of the transactional exemptions. Generally controlling is the form chosen by the taxpayer. Unfortunately, the fact that the taxpayer could have chosen a different form which would have had different tax consequences does not convert a taxable transaction into a nontaxable one.[12] This is in marked contrast to the income tax statutes' well established elevation of substance over form. That rule has been well accepted for more than 70 years and is a basic tenet of income tax transactional planning. As stated by the United States Supreme Court, "in tax law, we should remember, substance, rather than form, determines tax consequences."[13]

No case could make the dangers of ignoring form more apparent than that in *In re R.E. Weichbrodt, Inc.*,[14] which was decided by the Division of Tax Appeals in 2002. In *Weichbrodt*, a sole proprietor transferred the assets of a sole proprietorship, which owned four McDonald's restaurants, to his existing wholly owned corporation.[15] The Tax Department successfully argued that the form of the transaction did not strictly fall within any of the provisions of Tax Law § 1101(b)(4)(iv) and was taxable.[16] Under the Internal Revenue Code (IRC) § 351, this transaction would qualify for nonrecognition for income tax purposes.[17] The closest corresponding provision of the Tax Law for sales taxes, § 1101(b)(4)(iv)(D), limits the exemption of property for stock transfers to the original organization of the corporation.[18] Additionally, the taxpayer did not qualify for the sales tax exemption for contributions to capital at times other than a corporation's organization. The New York State Tax Law definition of contribution to capital requires that the transfer occur "without the issuance of stock or other consideration."[19] The Administrative Law Judge (ALJ) found in *Weichbrodt* that, "without question, title and possession of the assets . . . owned by the sole proprietorship were transferred to the Corporation . . . in exchange for stock."[20]

The ALJ rejected the argument that the "shares of stock received by Weichbrodt lacked economic or financial value"[21] because he was already the sole owner of the corporation. In doing so the ALJ accepted a long, well established history of elevating form over substance in sales tax cases by finding:[22]

> It is well-established that the transfer of assets from a sole proprietorship to a corporation in exchange for stock, where both entities are wholly owned by the same individual, constitutes a sale subject to sales tax. (*In re Sunny Vending Co. v. State Tax Comm'n*, 101 A.D.2d 666, 475 N.Y.S.2d 896; *see also, In re P-H Fine Arts Ltd. v. N. Y. State Tax Appeals Tribunal*, 227 A.D.2d 683, 642 N.Y.S.2d 232 (artwork transferred by a company to an existing corporation, both owned by the same individual, in

exchange for 10 shares of stock, is a sale as defined in Tax Law § 1101(b)(4)). In Sunny Vending, the petitioners were a sole proprietorship and a corporation wholly owned by the sole proprietorship. All of the assets of the sole proprietorship were transferred to the corporation in exchange for 100 additional shares of common stock issued to the sole proprietor, and the books and records of both entities were adjusted to reflect the transfer. The court held that this transaction was reasonably deemed by the State Tax Commission to be a sale within the meaning of Tax Law § 1101(b)(4). The Court noted that "the broad and inclusive language of the taxing statute clearly expresses an intent to encompass most transactions involving the transfer or use of commodities in the business world" (*Sunny Vending Co. v. State Tax Comm'n*, quoting *Albany Calcium Light Co. v. State Tax Comm'n*, 55 A.D.2d 502, 504, 391 N.Y.S.2d 201, rev'd on other grounds 44 N.Y.2d 986, 408 N.Y.S.2d 333). There, as here, the petitioners argued that there was no consideration for the transfer and, therefore, no sale because "the individual received nothing of value since he owned 100% of the corporate stock both before and after the transfer." Petitioners' argument is essentially the same. In light of the longstanding precedent of Sunny Vending, it is meritless.

Had Weichbrodt simply contributed the assets to his wholly owned corporation without taking any additional stock back, the transaction clearly would have been exempt as a contribution to capital. Thus, where trucks obtained by the liquidation of a partnership were subsequently transferred to an existing corporation as a contribution to capital, the transaction was exempt as long as the entries on the books of the corporation documented the acquisition of the trucks as a legitimate contribution to capital. Such a transfer would be without consideration and therefore not a retail sale.[23] The taxable difference between *Weichbrodt* and the non-taxable result in other instances was simply whether the corporation issued meaningless stock.

While blind adherence to form can produce the kind of horrific and inequitable consequences demonstrated by the *Weichbrodt* case, it can also present significant opportunities for tax savings when incorporated into the tax planning process. Literal interpretation of the statutes permits predictable tax planning based on the mechanics, rather than substance, of the organization, reorganization or acquisition of an entity. Moreover, literal interpretation of the statutes would prevent the uncertainty that potential application of judicial tax avoidance doctrines, such as substance over form, step transaction doctrine and business purpose doctrine, bring to the process.

The New York courts have historically validated the use of form-based step transactions to manipulate the sales tax effect of a transaction without regard to its economic substance. If the form fits the exemption, neither "substance over form" nor "step transaction doctrine" will be imposed to change it.

In *In re TJX Companies*,[24] the taxpayer desired to sell all of the assets of its Zayre department stores to Ames. It accomplished the transfer in multiple steps, the first of which was to transfer its Zayre business assets to several wholly owned subsidiaries.[25] In an immediate second step, all of the stock of the newly formed subsidiaries was then sold to Ames, thus completing the transaction.[26]

Although the contribution of assets to an 80-percent-owned subsidiary generally permits non-recognition of gain for federal income tax purposes under IRC § 351,[27] Zayre's capitalization of its subsidiaries did not qualify because of the immediate sale. In addition, the parties subsequently made a timely election under IRC § 338(h)(10)[28] with respect to this stock sale to recognize gain or loss on the transfer as a virtual sale of assets.

Although federal law and doctrine recognized all of the gains without regard to the form, New York—in contrast—permitted the transaction to enjoy tax-free status. Under New York Regulations § 526.6(d)(8)(11),[29] property transferred to a corporation as a contribution of capital where no stock is received in return is not a retail sale. It then follows that if there is no retail sale, there can be no sales tax due on the transaction. In form, then, the first transaction was an exempt contribution to capital of a corporation. There is no equivalent for an IRC § 338(h)(10) elective-deemed sale in the sales and use tax, and the income tax election is ignored. The New York court rejected an attempt by the Division of Taxation to ignore the form and impose sales tax based on the substance of the transaction, but the Division of Taxation was unsuccessful. Since the transaction was structured as a contribution of capital as provided by New York Regulations § 526.6(d)(8)(11), it was not a retail sale and therefore exempt from sales tax.[30] Likewise, there was no tax due on the second step of the transaction since it involved the sale of an intangible, i.e., the stock of the newly formed subsidiaries which held the original Zayre's assets. Neither "sub-

stance over form" nor "step transaction doctrine" was applicable to disturb the literal conclusion that the transactions qualified for exemption.

Merger or Consolidation

Qualification for exemption under the first of the four transactional exemptions set forth in Tax Law § 1101(b)(4)(iv) requires the transfer of property to a corporation, solely in consideration for the issuance of its stock, pursuant to a merger or consolidation effected under the law of New York or any other jurisdiction.[31]

Under § 910 of the N. Y. Business Corporation Law, a "merger or consolidation" is defined as:[32]

> (a) Two or more domestic corporations may, as provided in this chapter: Merge into a single corporation which shall be one of the constituent corporations; or Consolidate into a single corporation which shall be a new corporation to be formed pursuant to the consolidation . . .
> (c) One or more domestic corporations and one or more other business entities, or one or more foreign corporations and one or more other business entities may as provided by any other applicable statute and this chapter:
> (1) Merge into a single domestic or foreign corporation or other business entity, which shall be one of the constituent entities; or
> (2) Consolidate into a single domestic or foreign corporation or other business entity, which shall be a new domestic or foreign corporation or other business entity to be formed pursuant to the consolidation.

A merger thus occurs when Corporation A is merged into Corporation B, and a consolidation occurs when Corporations A and B are consolidated into Corporation C.[33] It need not be a New York State merger or consolidation to qualify. Mergers and consolidations meet the definition of the New York exemption if they qualify under IRC § 368(a)(1)(A) or meet the requirements of the law of the state, District of Columbia or territory pursuant to which it was effected. Thus, when A and B Corporation merge into A under the N. Y. Business Corporation Law, or the law of any other U.S. jurisdiction, and include within the merger transfers of tangible personal property, none of the merger property is subject to the sales or use tax.

In interpreting and implementing the sales tax merger and consolidation exemption, the Tax Department and the New York courts have, true to form, refused to "read into the statute an exemption not expressly stated." In *Prospect Dairy, Inc. v. Tully*,[34] a parent corporation transferred all of the assets of one of its divisions, Handy, to its subsidiary, Prospect Dairy, in return for stock in the subsidiary. The transaction did not have any economic or practical effect on the parent's investment in the subsidiary, and was the substantial, if not procedural, equivalent of a New York exempt transaction.[35] Had Enterprise incorporated Handy and then merged it into Prospect Dairy, the transaction would have been exempt from sales tax. Dairy alleged that since it could have simply altered the form of the transaction to literally comply with the statutory language without affecting its substance, it should thereby qualify for exemption.[36] Dairy asserted that the availability of a qualifying form of the transaction which would essentially achieve the same result was indicative of the Legislature's intent not to tax transactions of similar effect.[37] In rejecting the "substance over form" argument the court stated:[38]

> Initially, Dairy's contention that the subject transaction was not a sale is without merit, since a sale is any transfer or exchange of title for a consideration (Tax Law, § 1101(b)(5)), and the stock or securities of the purchasing corporation is clearly consideration. Dairy and Enterprises have chosen for their business objectives to maintain two separate corporate identities. There is no proper basis for ignoring those separate entities so as to hold that sales by one to the other do not constitute "sales" within the meaning of the Tax Law merely because in this case it might benefit the corporations to do so.

Acknowledging that Dairy could quite simply have adopted a form that would qualify for the exemption, the Court found it irrelevant, in that the form would control without regard to the substance or equities of the transaction:[39]

> Dairy's primary contention is that the sale should not be taxable because it was similar in nature to transactions which are statutorily exempted from taxation. Under subparagraph (D) of clause (ii) of paragraph 4 of subdivision (b) of section 1101, the transfer of property to a corporation upon its organization in exchange for stock is nontaxable; similarly, under subparagraph (A) of said paragraph and subdivision, the transfer of property in exchange for

> stock pursuant to a corporate merger or consolidation is exempt. The essence of Dairy's position is that the sale here achieved the same result as could have been accomplished by incorporating Handy and then merging it into Dairy, wherefore it should be concluded that the Legislature did not intend to impose the tax on such a sale.
>
> The Tax Commission rejected this contention, and we concur. The corporations chose not to follow procedures which would have exempted the transaction from the sales tax, and the construction by the Tax Commission refusing to read into the statute an exemption not expressly stated is not unreasonable and must be upheld. (Cf. Matter of Howard v. Wyman, 28 N Y 2d 434, 438.) Had those steps been followed, there would have been somewhat different consequences regarding stock transfers at the very least so as to distinguish such transactions from a sale. Presumably, additional stock transfer taxes would have become due (Tax Law, art. 12). Thus, the distinction is one of substance and not merely of form. Dairy and its parent, however, chose to effectuate a direct sale, and the tax consequences thereof cannot be avoided.

Had Dairy properly considered and planned for the sales tax consequences of its transaction, it most certainly could have avoided the sales tax completely by simply transferring the Handy Division assets into a newly formed corporation. It could have converted the tangible and taxable business assets transferred into the intangible stock of a new subsidiary. Immediately thereafter it could have merged the new subsidiary into its existing subsidiary in another tax-exempt transaction. While the federal income tax authorities would not respect the multiple steps of this transaction and treat it as its substance rather than form dictates, a taxpayer could be assured that this form would avoid any sales tax on the transaction in New York.

In similar fashion, an acquiring corporation desiring to purchase all of the assets of another target corporation could avoid all sales tax simply by first purchasing its stock and subsequently merging the corporation into itself. Stock is an intangible, rather than tangible, personal property. Accordingly, since Acquiring Company is merely purchasing an intangible and not tangible personal property, pursuant to §§ 1101(b)(4) and 1105(a) of the Tax Law and § 526.8(c) of the Sales and Use Tax Regulations, the purchase by the Acquiring Company of 100 percent of the stock of the target is not subject to State and local sales and use taxes. In addition, pursuant to § 1101(b)(4) of the Tax Law and § 526.6(d) of the Sales and Use Tax Regulations, the merger of the Target into the Acquiring Company solely in exchange for the stock of the Acquiring Company and in accordance with the laws of New York State is not deemed to be a result of the sale of tangible personal property. Therefore, pursuant to § 1105(a) of the Tax Law and § 526.6(d) of the Sales and Use Tax Regulations, such merger is not subject to state and local sales and use taxes.[40]

Although qualifying as a merger or consolidation can be accomplished under IRC § 368(a)(1)(A), no such benefit is available under IRC § 368(a)(1)(C). A reorganization under IRC § 368(a)(1)(C) would normally involve the transfer of substantially all the assets of the Target Corporation for stock of the Acquiring Corporation as in Diagram 1 below.

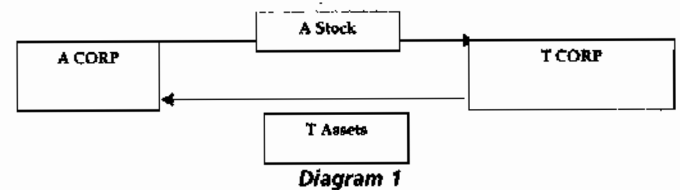

Diagram 1

Reorganizations defined in IRC § 368(a)(1)(C) are specifically excluded from the definition of a merger or consolidation for New York Sales Tax purposes.[41] Thus, the acquisition of business assets of the transferor in exchange for shares of voting stock of the acquiring corporation is subject to the sales tax.[42] The above transaction is taxable because it does not take place at the organization of the recipient corporation or in any statutory merger or consolidation under state law.[43]

However, because of New York's form-driven approach to qualification for exemption, a mere change in the form of the transaction will qualify it as sales-tax-free.

Step 1

Target forms Temp Corp in a sales-tax-free transaction because it qualifies as a transfer at the time of the organization of a corporation solely for its stock.

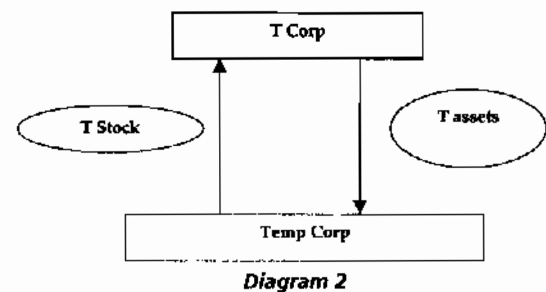

Diagram 2

Step 2

A Corp acquires Temp Corp Stock from Target in a tax-free "B" reorganization, which is exempt from New York State Sales Tax because the stock exchanged is intangible property.

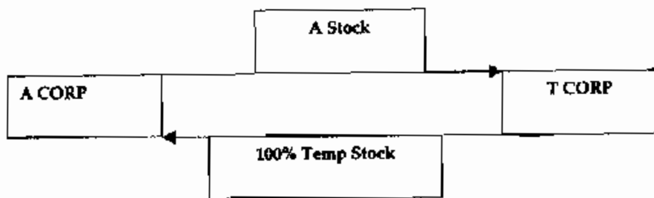

Diagram 3

Step 3

A Corp completely liquidates the newly formed Temp Corp and receives the Target assets in the process. The transaction is sales-tax-free because distribution to the corporate parent is in liquidation and therefore exempt.

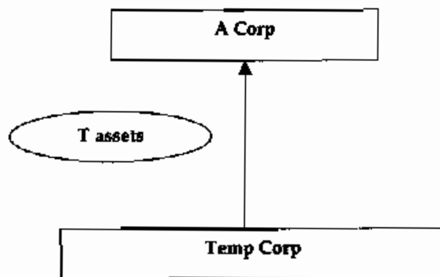

Diagram 4

Final Status

The final status of the transaction is the same as it would have been in an IRC § 368(a)(1)(C) reorganization except that there will be no sales tax imposed. In fact, for federal tax purposes, step transaction doctrine would require it to be treated as a "C" reorganization. The IRS would ignore the multiple steps and tax the transaction according to its substance. New York State, on the other hand, would respect the form and the tax-exempt treatment derived from it.

Diagram 5

Liquidating Dividend

A distribution of property from a corporation, partnership or LLC that is in the nature of a complete or partial liquidation is not a retail sale and is therefore exempt from tax.[44] A parent corporation can thus absorb the assets of a subsidiary through a complete liquidation of the subsidiary without incurring any sales tax obligation on the transfer of assets.[45] The sole requirement is that the liquidating dividend must be declared in accordance with the law of the state of incorporation. However, even though the transaction is exempt from taxation, it still constitutes a bulk sale requiring notice to the Department of Taxation.

This exemption was critical to Felix Industries when it wished to acquire all of the assets of its wholly owned subsidiary, C & F Equipment Company.[46] C & F Equipment Company held title to construction equipment used solely by Felix Industries. Felix Industries was able to absorb the assets of C & F Equipment Company without incurring a sales or use tax liability on the transfer since it met the liquidating corporate exemption of Tax Law § 1101(b)(4)(iii)(B).[47] Had the assets been held by a third party, they could have been conveyed tax-free on the organization of a holding company, followed by a sale of the stock to the acquiring corporation, and subsequently acquired tax-free in the liquidation of the holding company, as in the diagram above.

Compliance with local law for corporate liquidation is a requirement, but an immediate formal dissolution is not. In *In re Daniel Leary*,[48] a professional architecture corporation redeemed the stock of its shareholder for an automobile which it owned pursuant to a declaration of redemption, and wound up its business affairs. It did not file its certificate of dissolution with the Secretary of State, however, for two years.[49] In determining that the distribution of the vehicle was a liquidating dividend under Tax Law § 1101(b)(4)(iii)(B), the Tax Commission held that the date on which the corporation is formally dissolved under state law is not the determinative factor, stating that:[50]

> In determining whether a corporation has been completely liquidated the inquiry is not whether the corporation was formally dissolved under state law, but whether the corporation intended to and actually did wind up its affairs, gather its resources, settle its liabilities, cease engaging in business activity, and distribute its remaining assets to its shareholders. The absence of a formal written plan to liquidate is not conclusive of the issue if there exists in fact an intention to liquidate and those in control of the corporation entertain such intention.

In re John R. Sorrenti[51] stands in marked contrast to the successful tax-exempt liquidation presented by the Leary case. In *Sorrenti,* the corporation once again redeemed the shareholder's stock for a company car.[52] However, in this instance the transfer was not a liquidating dividend, but rather a retail sale subject to sales

tax. In *Sorrenti*, there was no evidence that the corporation discontinued its business activities.[53] The only change that was made to the certificate of incorporation was to change the corporation's name to Perry B. Goldstein Architect. The corporation merely continued operating under a new corporate name.[54]

In *In re Duracast Contracting*,[55] an agreement was carefully crafted to reflect the distribution of all of a corporation's assets to its shareholders in the form of a sale to produce personal income tax benefits for the shareholders. The property was then contributed to a new corporation owned by the same shareholders.[56] One can only guess whether or not the sales tax consequences of characterizing this complete liquidation as a sale were considered. However, in choosing this form, the transaction failed to qualify for the exemption under Tax Law § 1101(b)(4)(iii)(B), and sales tax was imposed.[57]

Transfers Upon Formation of a Business Entity

Under Tax Law § 1105, sales tax is due on all retail sales of tangible personal property.[58] The receipt of stock in a corporation meets the definition of a sale at the fair market value of the stock received. However, when property is transferred to a corporation upon its organization in return for stock in the newly formed corporation, the transfer is exempted from the definition of retail sale under Tax Law § 1101(b)(4), and, as such, the transaction is exempt from sales tax. Unlike IRC § 351, the exemption from sales tax for transfers to a corporation in return for its stock does not require 80 percent control. In fact, any ownership interest will do, but regardless of the extent of control, the transfer must be on the initial formation of the corporation to qualify. Since there is an exchange of the stock for the assets, the transaction would be a taxable sale at any time other than its formation. A corporation is said to begin its existence at the time the articles of incorporation are filed with the Secretary of State. Transfers made to the corporation at this time, or within a reasonable time, while the corporation is still in the process of organizing its business, are exempt under Tax Law § 1101(b)(4)(iii)(D).[59]

Transfers made to a dormant corporation which is being activated are not eligible for the exclusion. The term "dormant corporation" has been defined as "[a]n inactive but legal corporation which is capable of being activated, but is presently not operating."[60]

A corporation which is in the process of organizing itself and obtaining the necessary authorities from the time of its incorporation until the time the assets were transferred cannot be said to be inactive or dormant. Where the assets were transferred as soon as the law allowed, it was deemed to be on the initial organization despite some assets being transferred as many as 21 months after incorporation.[61] Thus, in *K-B Transport Inc.*,[62] the key was the transfer taking place as part of the initial organization of the business operations of the enterprise, without regard to the necessary delay caused by regulatory requirements.

Despite the flexible position demonstrated in the ruling in *K-B Transport, Inc.*, great care must be taken not to delay transfers outside the limited window created by the initial organization of the corporation. *Noar Trucking v. State Tax Commission*[63] is an example of a multi-stage corporate reorganization that fell outside the organization window and resulted in the imposition of sales tax on a portion of the assets transferred. Noar Trucking was incorporated in February 1980 to protect its sister corporation, Armmart, from liability for accidents relating to its beer delivery routes.[64] Armmart was to transfer all of its trucks to Noar Trucking in return for stock in Noar.[65] In order to avoid paying duplicate registration fees on the trucks, Armmart only transferred some of its trucks, worth $14,000, in 1980, and the remainder of its fleet, worth $120,000, was transferred the following year.[66] The Court held that only the transfers made during 1980 fell within Tax Law § 1101(b)(4)(iii)(D) and were exempt from sales tax.[67] The court recognized "the economic realities of petitioner's 1980 activities and transactions," citing *In re Nat'l Elevator Ind. v. N. Y. State Tax Comm'n*,[68] and concluded that the 1981 transfers, some 10 to 21 months thereafter, were too late for entitlement to the corporate organizational exemption. This was despite the fact that Noar chose to defer going through the technical formalities of physically issuing stock certificates and holding an organizational meeting until after the transfer of all trucks had been completed. As a result, the transfers made in 1981 were not made upon the corporation's organization, and therefore were subject to sales tax.[69]

Taxpayers are free to tailor the transactional structure of their transfers to comply with the exemption statute and therefore avoid the tax that would be imposed on a more direct exchange. In *In re Binghamton Burial Vault Co, Inc.*,[70] Binghamton transferred the assets of one of its divisions to a newly formed corporation in return for stock in the newly formed corporation. The stock was then distributed to the shareholders of the Binghamton Burial Vault Company.[71] Since the transfer was made upon the organization of the corporation in exchange for stock, the transfer of property was exempt from sales tax under Tax Law § 1104(b)(4).[72]

Step transaction doctrine is used regularly by the IRS to recharacterize multi-step transactions according to their economic substance, rather than form, to prevent tax avoidance. However, that is not the rule for sales tax purposes. The New York State Department of

Taxation regularly accepts the form of multi-step transactions, which segregate and transfer the property to temporary holding corporations, as determinative of their tax effect. These transactions are designed for the express purpose of qualifying the transaction for the corporate organizational exemptions. For example, in an advisory opinion rendered to *Nomura Securities*,[73] multiple corporate transfers were made to separate and transfer certain assets free of sales tax. NSC was a Japanese company that owned 100 percent of the stock of NSI, a Delaware corporation that developed computer systems to be used in NSI's securities trading business.[74] NSI had two groups of assets: Group I, which was the computer software and hardware of the trading business, and Group II, which was all of the furniture and equipment used in the ordinary course of business.[75] Group I and Group II assets were located in New York.

NSC in transaction 1 formed a new United States corporation, USHC, in exchange for 100 percent of the stock of USHC, and contributed the NSI stock to the capital of USHC.[76] In transaction 2, NSI distributed to USHC only that portion of Group I assets consisting of computer hardware and operating systems and all of the Group II assets.[77] Thereafter, in transaction 3, USHC formed a United States subsidiary, hereinafter referred to as U.S. Sub, and contributed the Group I assets received from NSI to the capital of U.S. Sub solely in exchange for 100 percent of the common stock of U.S. Sub.[78] NSI then sold the remaining assets in Group I (i.e., customized computer software) by transferring the copyright for such assets to U.S. Sub at the fair market value.[79] Also transferred with the copyright were the intellectual property rights (intangible technological know-how) and other proprietary rights in the software (collectively the "Customized Computer Software").[80]

Transaction 1 was an exchange of stock for stock, which is a transaction that is not a sale as defined in § 526.7 of the Sales and Use Tax Regulations, and thus is not subject to the tax imposed under § 1105(a) of the Tax Law. In transaction 2, if the entries on the books of USHC document the acquisition of the assets as a legitimate contribution to capital, such transaction will not be subject to the tax imposed under § 1105(a) of the Tax Law because the transfer is not a retail sale in accordance with the meaning and intent of § 526.6(d)(8)(ii) of the Sales and Use Tax Regulations. Transaction 3, in which USHC upon forming its subsidiary will exchange assets for stock, is a transfer that is not subject to the tax imposed under § 1105(a) of the Tax Law because it is not a retail sale in accordance with the meaning and intent of § 526.6(d)(1)(iv) of the Sales and Use Tax Regulations. The sale of the software as described by Petitioner met the criteria set forth in Technical Services Bureau Bulletin 1978-1(S) and was therefore exempt since it was not a sale of tangible personal property.

In these multi-step transactions, tangible personal property is converted to intangible corporate stock through an exempt contribution to capital of a newly organized corporation. This step is exempt under Tax Law § 1101(b)(4)(iii)(D) as occurring upon corporate organization. The stock in the corporation can then be sold or exchanged since the stock is an exempt intangible asset. Following the sale of the stock, the corporate shell can be liquidated tax-free under Tax Law § 1101(b)(4)(iii)(B). While the IRS will typically disregard these multiple steps, for sales tax purposes New York State will not.

To the extent any consideration other than stock is received upon the organization of a corporation, the transaction is a taxable sale to the extent of the other consideration. However, the assumption of liabilities in the nature of security interests on the property transferred will not cause the transaction to be taxed.[81]

In *In re Tops Inc.*,[82] there was a transfer of assets to a newly formed corporation, WFI, five weeks after it had been incorporated, in exchange for stock in WFI and the assumption of various general corporate liabilities of Tops. The Division of Tax Appeals held that five weeks was within a reasonable time of the corporation's organization, making the transfer exempt from sales tax, and exempted the consideration in the form of stock from taxation.[83] Nonetheless, it found the assumption of the general liabilities represented "other consideration" than the stock and was taxable.[84]

Contributions to partnerships, and therefore LLCs, can be made tax-free at any time, not just at the time of organization. New York does not deem a partnership to be a legal entity which is separate and apart from the individuals who comprise it.[85] As a result, contributions of assets to a partnership are always exempt, whether on or after its initial formation.[86]

The transfer of the assets and liabilities of an ongoing business to a partnership in exchange for a partnership interest is not a taxable event. Nor does the treatment of a contribution in exchange for a partnership interest change merely because, as part of the business transferred, liabilities, as well as assets, pass to the partnership. A person who transfers property, including liabilities, to a partnership in exchange for a partnership interest is not relieved of the liabilities when they are assumed by the partnership and is therefore not treated as if the assumption is a "payment" for his assets.[87]

Joint ventures are partnerships organized for a limited time and purpose.[88] In *In re Great Lakes-Dunbar-Rochester*,[89] the use by a joint venture of property

owned by the joint venturers, and the payment of "reimbursements" for the use of the equipment by the joint venturers, did not constitute rentals subject to tax. The joint venturers that owned the equipment never gave up possession, dominion and control.[90] The use of the equipment in the joint venture project was subject to continued possession and control by the members of the joint venture.[91] There was no fixed rent to be paid, nor any guarantee that the members could retain reimbursements for the equipment.[92] Thus, the transaction was not a sale and was therefore not taxable.[93] In circumstances in which a fixed rental was paid to corporate joint venturers in another joint venture for the use of their equipment, the transaction was taxable as a rental.[94]

Conclusion: The Form Is Critical and Dispositive in Most Instances

As can be seen from the prior discussion, under New York's Sales and Use Tax Laws, transactions with equivalent outcomes and economics can have widely differing results. The difference between a tax on the transfer of millions of dollars in assets and complete exemption from the tax can often rest on the form or order the transaction took, without regard to its essential economics. In general, neither step transaction doctrine nor substance over form arguments will be applied in the context of qualification for sales tax exemptions. This focus on form is a great trap for those whose focus on the income tax consequences distracts them from sales tax issues. Conversely, a focus on form is of great benefit to those who carefully plan the transaction in the context of the corporate transaction exemption. With prudent planning and heeding the guidance of case law, much can be done to minimize the sales tax impact of corporate organizations, reorganizations, acquisitions, dispositions and liquidations.

Endnotes

1. *See* N.Y. Tax Law § 1101(b)(5); N.Y. Comp. Codes R. & Regs. tit. 20, § 526.7(d).
2. N.Y. Tax Law § 1101(b)(7). *See also* N.Y. Tax Law § 1110.
3. *Albany Calcium Light Co., Inc. v. State Tax Comm'n*, 55 A.D.2d 502 (3d Dep't 1977); *see also In re Tenneco, Inc.*, TSB-H-86 (86)S (N.Y.S. Tax Comm'n 1986); *In re Tops, Inc.*, 1991 N.Y. Tax LEXIS 623 (N.Y.S. Tax App. Trib. 1989); Op. No. S840130A, TSB-A-85 (40)S (N.Y.S. Tax Comm'n 1985).
4. N.Y. Tax Law § 132(c); N.Y. Comp. Codes R. & Regs. tit. 20, § 532.4.
5. *King v. State Tax Comm'n*, 70 A.D.2d 447, 451, 421 N.Y.S.2d 668, 671 (3d Dep't 1979).
6. *Delta Sonic Car Wash Sys., Inc. v. Chu*, 142 A.D.2d 828, 828, 530 N.Y.S.2d 341, 342 (3d Dep't 1988).
7. N.Y. Tax Law § 1101(a)(5) includes the right to reproduce computer software as a taxable sale.
8. N.Y. Tax Law § 1101(a)(6) describes computer software as tangible property: "such term shall also include pre-written computer software whether sold as part of a package, as a separate component, or otherwise, and regardless of the medium by means of which such software is conveyed to a purchaser."
9. *See* N.Y. Tax Law § 1101(b)(4); N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6.
10. N.Y. Tax Law §1101(b)(4)(iv).
11. N.Y. Tax Law § 1101(a) states that,"when used in this article the term person includes an individual, partnership, limited liability company, society, association, joint stock company, corporation, estate, receiver, trustee, assignee, referee, and any other person acting in a fiduciary or representative capacity, whether appointed by a court or otherwise, and any combination of the foregoing."
12. *In re Chanry Communications, Ltd.*, TSB-D-91(12)S (N.Y.S. Tax App. Trib. 1991), citing *Sverdlow v. Bates*, 283 A.D. 487, 490, 129 N.Y.S.2d 88, 91 (3d Dep't 1954).
13. *Comm'n v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *see also Cottage Sav Ass'n v. Comm'n*, 499 U.S. 554 (1991); *Gregory v. Helvering*, 293 U.S. 465, 469–70 (1935); *Shoenberg v. Comm'n*, 77 F.2d 446, 449 (8th Cir. 1935), *cert. denied*, (1935).
14. *In re Weichbrodt*, Nos. 817950 & 817951 (N.Y.S. Div. of Tax App. 2002).
15. *Id.*
16. *Id.*
17. I.R.C § 351.
18. N.Y. Tax Law § 1101(b)(4)(iv)(D).
19. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6(8)(ii) states: "The transfer of property to a corporation, as contribution to capital, at a time other than its organization, without the issuance of stock or other consideration, is not a retail sale."
20. *In re Weichbrodt*, Nos. 817950 & 817951 (N.Y.S. Div. of Tax App. 2002).
21. *Id.*
22. *Id.*
23. *See* Op. No. S840404b, TSB-A-85 (27)S (N.Y.S Tax Comm'n 1985).
24. *In re TJX Companies, Inc.*, No. 812048, TSB-D-97 (6)S (N.Y.S. Tax App. Trib. 1997).
25. *Id.*
26. *Id.*
27. I.R.C. § 351.
28. I.R.C. § 338(h)(10).
29. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(8)(11).
30. *Id.*
31. N.Y. Tax Law § 1101(b)(4)(iv).
32. N.Y. Bus. Corp. Law § 910.
33. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6.
34. *Prospect Dairy, Inc. v. Tully*, 53 A.D.2d 755, 384 N.Y.S.2d. 264 (3d Dep't 1976).
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*

39. *Id.*

40. *See* Op. No. S971209e, TSB-A-94(25)S (N.Y.S. Dep't of Taxation & Fin. 1998).

41. N. Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(6)(iv). *See also* IRC § 368(a)(1)(C).

42. *See In re Boccard Indus. Inc.*, TSB-H-87(128)S (N.Y.S. Tax Comm'n 1987), citing N. Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(6)(iv).

43. *See In re Spartan Motors, Ltd.*, TSB-H-84(61)S (N.Y. S Tax Comm'n 1984).

44. N.Y. Tax Law § 1101(b)(4)(ii).

45. *See*, Op. No. S880811a, TSB-A-88 (52)S (N.Y.S. Dep't of Taxation & Fin. 1988).

46. Op. No. S880811a, TSB-A-88 (52)S (N.Y.S. Dep't of Taxation & Fin. 1988).

47. *Id.*

48. *In re Daniel Leary*, TSB-H-87 (130)S (N.Y.S. Tax Comm'n 1987). *See also* N.Y. Tax Law § 1101(b)(4)(iii)(B).

49. *In re Daniel Leary*, TSB-H-87 (130)S (N.Y.S. Tax Comm'n 1987).

50. *Id.*

51. *In re Sorrenti*, 1988 N.Y. Tax LEXIS 196 (N.Y. Div. of Tax App. 1988).

52. *Id.*

53. *Id.*

54. *Id.*

55. *In re Duracast Contracting*, TSB-H-81(57)S (N.Y.S. Tax Comm'n 1981).

56. *Id.*

57. *Id.*

58. N.Y. Tax Law § 1105.

59. *In re Tops, Inc.*, 1991 N.Y. Tax LEXIS 623 (N.Y. Div. of Tax App. 1991).

60. *In re K-B Transport Inc.*, 1988 N.Y. Tax LEXIS 354 (N.Y. Div. of Tax App. 1988).

61. *Id.*

62. *Id.*

63. *Nour Trucking v. State Tax Comm'n*, 139 A.D.2d 869, 527 N.Y.S.2d 597 (3d Dep't 1988).

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. 49 N.Y.2d 538, 548 (1980).

69. *Id.*

70. Op. No. S881114a, TSB-A-89(4)S (N.Y.S. Comm'r of Taxation & Fin. 1989).

71. *Id.*

72. *Id.*

73. Op. No. S890324B, TSB-A-90(1)S (N.Y.S. Tax Comm'r 1989).

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.*

79. *Id.*

80. *Id.*

81. N.Y. Comp. Codes R. & Regs. tit. 20, § 526.6(d)(5).

82. *In re Tops, Inc.*, 1991 N.Y. Tax LEXIS 623 (N.Y.S. Tax App. Trib. 1989).

83. *Id.*

84. *Id.*

85. *Walker & Bailey v. We Try Harder Inc.*, 123 A.D.2d 256, 257, 506 N.Y.S. 2d 163 (1st Dep't 1986).

86. N.Y. Tax Law § 1101(b)(4)(iii)(E).

87. *In re Beautiful Visions Co.*, Nos. 810495, 810496, 810497, 810498 & 810499 (N.Y. Div. of Tax App. 1994).

88. *Dogan & Sado & Dogan, Inc. v Harbert Const. Corp.*, 507 F. Supp 254, 258 (S.D.N.Y. 1980); 16 N.Y. Jur. 2d, § 1578.

89. *In re Great Lakes-Dunbar-Rochester v. State Tax Comm'n*, 102 A.D.2d 1, 477 N.Y.S.2d 461 (3d Dep't 1984).

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. Op. No. S971020a, TSB-A-98(4)S (N.Y.S. Dep't of Taxation & Fin. 1998).

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