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October 18, 2000

Honorable Rick Auerbach  
Los Angeles County Assessor  
500 West Temple Street  
Los Angeles, CA 90012-2770

Attn: Ms. \_\_\_\_\_, Property Assessment Specialist

In re: Corporate Stock Acquisition of \_\_\_\_\_ and \_\_\_\_\_ – Date of Transfer and Application of Presumption in Rule 2.

Dear Ms. \_\_\_\_\_:

This is in response to your August 15, 2000 letter to Mr. Timothy Boyer, requesting our opinion regarding the application of Revenue and Taxation Code Section 64 (c) to the acquisition by \_\_\_\_\_ (hereinafter “Petroleum” or “Purchaser”) of all of the capital stock of \_\_\_\_\_, Inc., (“Seller”) and \_\_\_\_\_ Company (hereinafter “Company”).

Specifically, you wish to know (1) the appropriate date for identifying the change in ownership, and (2) whether the purchase price presumption in Rule 2(b) is applicable. For the reasons hereinafter explained, the answer to your first question is October 1, 1999; the answer to the second question is no.

1. What is the appropriate date for recognizing the change in ownership – the closing date described in the Stock Purchase Agreement – or the post-closing date when all conditions subsequent have been executed?

Answer: October 1, 1999, the “Effective Time,” consistent with the date identified by the transferee in the Change in Ownership Statement, assuming all of the Company’s issued and outstanding capital stock effectively transferred to Purchaser on that date.

Rule 462.260(a)(2) provides that in sales transactions, “Where the transfer is accomplished by an *unrecorded document*, the date of the transfer document shall be rebuttably presumed to be the date of ownership change. This presumption may be rebutted by evidence proving a different date to be the date all parties’ instructions have been met in escrow, or the date the agreement of the parties became specifically enforceable.”

The Stock Purchase Agreement (hereinafter "Agreement") is an unrecorded document, with the meaning of Rule 462.260(a)(2), and was entered into on November 15, 1999, between Seller, Company, and Petroleum. Several dates are identified in the Agreement as the date on which the transfer would occur, in addition to the date of the Agreement: (1) the "Closing Date" (September 30, 1999), (2) the "Effective Time" (October 1, 1999), and (3) the Interim Period," - commencing with the Effective Time and ending with the Closing Date. As explained below, the date on which the Agreement was specifically enforceable was the date of that all of the voting stock of Company effectively transferred to Purchaser, that is, the "Effective Time."

The "Closing Date" and the "Effective Time" are both described in Section 2.2 of the Agreement as follows:

"Section 2.2 Closing. Subject to the satisfaction or waiver of the conditions set forth in Article X hereof, the Closing shall take place at the end of the month after such satisfaction or waiver of conditions [the "Conditions Precedent to Closing" in Article X], provided however, that Seller has had sufficient time to prepare the closing statements, at the offices of [Company], at 10:00 a.m. Pacific Time (the 'Closing Date'), *but effective as of the Effective Time or at such other time or place as may be mutually agreed upon in writing by the Seller and the Purchaser.*"

The "Effective Time" is specifically defined in Section 1.1, as "October 1, 1999, at 12:01 a.m. Pacific Daylight Time." It is time that the purchaser's September 30<sup>th</sup> acquisition of all stock, as well as the real property and account balances, is deemed to have taken effect as agreed upon by the parties in Section 7A.1 of the Agreement - pursuant to Internal Revenue Code Section 338(h)(10).

The third date is the "Interim Period," described in Section 1.1 as the "period commencing with the Effective Time and ending with the Closing Date." This period is the allowable time period - within a year before *or after* the acquisition date - for the purchaser to take a carryover basis of the acquired assets, within the parameters of IRC Section 338. The end of the "Interim Period" therefore (September 30, 2000), would be the last possible date that Closing could occur, if it had not previously closed.

Although the Agreement allows for two *possible* "closing dates," the *actual* "closing date" is the date that all of Company's stock transferred to Purchaser. The fact that the "closing date" represents the date of the sale of the stock is expressed in Section 2.1 as follows: "Subject to the terms, provisions, and conditions of this Agreement, the Seller hereby grants, sells, assigns and conveys, to have and to hold forever, to the Purchaser on the Closing Date, and the Purchaser agrees to purchase and accept from Seller on the Closing Date, all right, title and interest in and to the Company Shares."

The main reason for these varying dates in the Agreement is the structuring of this transaction as a *stock acquisition* under IRC Section 338, including a Section 338(h)(10) "election" cited in Section 7A1.1. The purchaser of a corporate business frequently prefers buying the selling

corporation's stock, rather than its assets, because it is generally simpler and avoids interruption of the existing contractual and business relationships of the selling corporation. In contrast, the primary benefit to a purchaser for buying the *assets* rather than the stock, is that the purchaser could obtain a "step-up" cost basis for the assets. (IRC Section 1012.) The advantage of an IRC Section 338 *stock acquisition* is that a purchaser can have the convenience of a stock purchase together with the tax benefits of an asset purchase – by "electing" to treat the stock as an asset. The following description in BNA No. 788, *Tax Management Portfolios*, "Stock Purchases Treated as Asset Acquisitions – Section 338," page A-1, is analogous to the transaction in the Agreement:

"...a corporation that purchases 80% of the stock of a target corporation within a 12-month period can irrevocably elect to treat the stock purchase as an asset acquisition. If the election is made, the target (selling) corporation is treated as if it sold all of its assets at the close of the first day that the purchaser has acquired 80% of the target's stock, i.e., the acquisition date." The target is then treated as a new corporation (new target) that purchases, on the day after the acquisition date, old target's assets at a price that reflects the price paid for the target's stock plus target's liabilities and other adjustments. New target is required to allocate the deemed purchase price among its assets according to a 'prescribed residual method.' Old target's attributes are extinguished and new target starts with a clean slate."

In addition, if the seller and the purchaser make an election under Section 338(h)(10), they can treat the stock sale as a sale of the assets (giving the purchaser the benefit of the asset basis step-up) - followed by a liquidation of old target (seller). There is a single tax liability from the deemed sale of the assets for the seller's account, which may be offset when the gain realized from the seller's stock is greater than the assets, or where the seller has tax loss carryovers. The purchasing corporation may make a joint Section 338(h)(10) election with the selling corporation only if it has made a "*qualified stock purchase*" of the selling corporation.

Several timing requirements are inherent in the procedures necessary for making a qualified stock purchase. A "*qualified stock purchase*" occurs on the first day that the purchasing corporation has purchased, in one or more transfers during the "12-month acquisition period," at least 80% stock (by vote and value)<sup>1</sup> of the selling corporation's stock. The "*12-month period acquisition period*" is the 12-month period beginning on the date of the first purchase of the seller's stock (in the qualified stock purchase). While the first day on which there is a qualified stock purchase is the *beginning "acquisition date,"* the *closing "acquisition date"* is the date of the *deemed sale* ("sale date") of the seller's assets (i.e., the date that 80% of the stock has transferred). The *closing acquisition date*, that is, the deemed sale date, is also the *deemed liquidation date* of seller's old target. The effect of a Section 338(h)(10) election is that the purchasing corporation is *deemed* to have made the purchase on the day following or immediately after the closing acquisition date, sometimes called the "*effective date.*"

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<sup>1</sup> To be eligible as a qualified stock purchase, the purchasing corporation meets the 80% vote and value test if it possesses at least 80% of the total voting power and at least 80% of the fair market value of the stock of the selling corporation.

For property tax purposes, the foregoing procedures, absent express agreement provisions to the contrary, lead to the conclusion that the date of a change in control under Section 64(c) occurs *on the effective date*, since that is the date the purchasing corporation is deemed to have effectively purchased 80% of the selling corporation's stock. Although more than 50% of the voting shares *could* transferred prior to the effective date, the purchasing corporation is not deemed to beneficially own them until after the closing acquisition date, i.e., the *actual* Closing Date in the Agreement here.

The Agreement here appears to be consistent with the requirements of IRC Section 338 et seq. Although the Agreement was executed on November 15, 1999, the Seller and Purchaser, structured this transaction as a *qualified stock purchase* deemed to have occurred on the *closing acquisition date*, "Closing Date," and effective the following day (12:01 a.m., October 1, 1999), the *effective date*, "Effective Time;" since October 1, 1999, is the date reported on the Change in Ownership Statement that 100% of Company's stock transferred to Purchaser. The "Interim Period" in the Agreement is the *12-month period acquisition period* beginning on the Effective Time (October 1, 1999) following the September 30th purchase of the Seller's stock. This interpretation is supported by express language in several provisions of the Agreement.

Section 2.5 requires the Seller to deliver to Purchaser all certificates representing the company's shares at Closing, and Purchaser to wire transfer the Closing Payment to an account designated by Seller on the Closing Date. As confirmed by Section 5.5, 100% of the shares of [Company] transferred to Purchaser on the Closing Date.

Section 2.6 specifies:

Cash Contributions and Withdrawals. As a convenience to the Seller, Purchaser will not restrict Seller's actions regarding the cash management policy of the Company during the Interim Period. Accordingly, the Seller shall deliver to Purchaser on or prior to the third Business Day immediately preceding Closing a statement (the "Cash Statement") setting forth the Seller's preliminary determination of Seller's Cash Contributions to Company and Cash Withdrawals from Company during the Interim Period (including interest thereon calculated as provided in this Section 2.6). The Cash Statement shall be in substantially the same form as the sample calculation contained on Exhibit 2.6 hereof. Prior to Closing, the Seller shall convert to or contribute to the Company as equity capital the amount of Total Intercompany/Interdivision Balance set forth on the Balance Sheet as of September 30, 1999, that forms part of the Financial Statements attached on Schedule 5.6 hereof, and such conversion or contribution shall not be treated as a Cash Contribution or Cash Withdrawal.

In Section 2.8, Seller and Purchaser state that all "Long Beach Unit costs, expenses, capital and taxes reported subsequent to the Effective Time will be deemed to have occurred" immediately after the Effective Time, regardless of when they actually occurred.

In Section 3.5, record title to and beneficial ownership of the Seller's shares transfer on the Closing Date. And in Section 5.15, Company's Ownership of the Long Beach Unit will be held free and clear of any encumbrance as of the Effective Time, as follows:

Section 5.15 Company Ownership. Schedule 5.15 attached contains a listing of Company's Long Beach Unit Ownership Interest, Working Interest Percentage, Share of Oil Net Profit, Share of Gas Revenue and a breakdown of Company's share of the State of California's Incremental Net Profits from Tract 1 and Tract 2 (collectively the "Company's Ownership Interests"), and the Company's Ownership Interests were held by the Company or [Company], as the case may be, as of the Effective Time, free and clear of any Lien or Encumbrance except that the Townlot Interests identified on Schedule 7.9 were held by the Seller. The Company's Ownership Interests will be held by the Company or [Company], as the case may be, on the Closing Date subject only to such changes therein as may arise in the ordinary course of business of the Company or [Company] in compliance with Section 7.2, free and clear of any Lien to Encumbrance.

With regard to responsibility for taxes, Sections 5.9 and 7A.8 indicate that all tax liabilities of the Seller for the 1999 tax year were paid through September 30, 1999, with the remainder allocated to the Purchaser, as follows:

Section 5.9 Tax Matters. Except as shown on Schedule 5.9 and only as to federal and state income or franchise, property and production Taxes, Seller and Company represent and warrant, respectively, as the case may be that:

- a. the Seller or its Affiliate has timely filed, or has caused the Company to have timely filed, all Tax Returns of the Company or [Company] required by applicable Law to be filed on or prior to the Closing Date, such Tax Returns were correct and complete in all material respects and such Taxes shown as due and payable thereon have been timely paid;
- b. adequate accruals or provisions for Tax liabilities (except for deferred, franchise and income Taxes) have been recorded on the Balance Sheet as of September 30, 1999, attached as Schedule 5.6.

Section 7A.8 Interim Period and Pre-Effective Time Allocation. With respect to Taxes of the Company or [Company] paid during the Interim Period or for a taxable period beginning on or before and ending after the Closing Date, such taxes shall be allocated between the Seller and the Purchase as follows:

- a. in the case of federal and state income or franchise Taxes, the amount of such Taxes subject to this allocation shall be the amount shown on each of the separate company federal income tax returns for the Company and [Company] or the amount of California franchise tax computed on a separate company basis for the Company and [Company], (i) the amount of such Taxes for the tax year 1999 allocable to the Seller shall be the

amount of such tax multiplied by a fraction, the numerator of which is the pretax income of the Company and [Company] for the period January 1, 1999, through September 30, 1999, and the denominator of which is the pretax income of the Company and [Company] for the period January 1, 1999, through December 31, 1999, and the remaining amount of such Taxes shall be allocated to the Purchaser, and (ii) for the tax year 2000 all federal and state income and franchise Taxes shall be allocated to the Purchaser. For purposes of this Section 7A.8, pretax income shall mean pretax income as reflected in the financial statements of the Company and [Company].

- b. in the case of all other Taxes not described in Section 7A.8(a), such Taxes shall be allocated on a per diem basis and the Seller shall be liable for all such Taxes up to the Effective Time.

Based on the foregoing provisions authorized by IRC Section 338 et seq., the Agreement became specifically enforceable on the Effective Time, that is, at 12:01 a.m. on October 1, 1999, when 100% of Company's stock transferred to Purchaser. Verification that the Effective Time is date of the transfer is also found on the Change in Ownership Statement (BOE-502A) filed by Petroleum, which states that the actual transfer date – for purposes of Purchaser's acquisition - was October 1, 1999.

The fact that there are conditions subsequent in the Agreement, such as required written consents from government entities like the State Lands Commission and the City of Long Beach (per Article X), does not mean that the stock and accounts did not transfer on the Effective Time. Likewise, the fact that the Seller was not required to obtain formal approval from its Board of Directors until November 19, 1999 after the Effective Time, and that the Agreement was executed after the Effective Time, does not mean the transfer failed to occur on October 1, 1999. As stated in Rule 462.260(a)(2) above, where the parties structure their transaction pursuant to a written agreement and the date of the transfer is the date set forth in that agreement, the agreement becomes specifically enforceable on the date that the conditions authorizing the transfer are met. Conditions subsequent to the transfer will only effect the activation of relevant penalty or breach provisions in the Agreement, but do not relate back to the date of the transfer to prevent its execution.

2. Is the purchase price presumption in Rule 2 (b) applicable in determining the value upon Petroleum's acquisition?

No.

In order to take advantage of the Rule 2(b) presumption,<sup>2</sup> it must first be established that the sale satisfied the stated preconditions.<sup>3</sup> One of the preconditions is that the purchase

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<sup>2</sup> The presumption in Rule 2(b) provides, "When valuing real property (as described in paragraph (a)) as the result of a change in ownership . . . for consideration, it shall be rebuttably presumed that the consideration valued in money, whether paid in money or otherwise, is the full cash value of the property. The presumption shall shift the burden of proving value by a preponderance of the evidence to

consideration must not have included any taxable possessory interest. A second precondition is that the purchase consideration must not have included shares of stock. These preconditions are specifically set forth in Rule 2(c) as follows:

- (c) The presumption provided in this Section shall not apply to:
  - (1) The transfer of any taxable possessory interest.
  - (2) The transfer of real property when the consideration is in whole, or in part, in the form of ownership interests in a legal entity (e.g., shares of stock) or the change in ownership occurs as the result of the acquisition of ownership interests in a legal entity. (Emphasis added.)
  - (3) The transfer of real property when the information prescribed in the change in ownership statement is not timely provided.

Based on the information reported on the Change in Ownership Statement, Petroleum's purchase was accomplished through its acquisition of 100% of Company's stock. The Agreement itself is structured as a "stock purchase agreement," and sets forth in Article II, the details of Petroleum's purchase of all of Company's common stock. Furthermore, data already available to the county indicates that the Company's property consists of hundreds of wells, the locations of which result in taxable possessory interests located on government owned lands.

Consequently, Rule 2(b) does not apply because the purchase price in this case did, in fact, include a stock acquisition (100% of Company's shares), and did include the transfer of taxable possessory interests. Since the preconditions were not satisfied, the requirements for invoking the Rule 2(b) presumption have not been met.

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the party seeking to overcome the presumption. The presumption may be rebutted by evidence that the full cash value of the property is significantly more or less than the total cash equivalent of the consideration paid for the property ...".

<sup>3</sup> The presumption set forth in Revenue and Taxation Code Section 110(b) and Rule 2 is conditional. In other words, in order for the taxpayer to raise this presumption, the existence of certain preliminary conditions must first be shown. (See Witkin, 1 California Evidence, 3<sup>rd</sup> Ed. (BW, San Francisco, 1986).) The conditions that give rise to the presumption are: (1) the real property must have been exposed for sale in the open market with a reasonable time for the seller to find a purchaser; (2) the real property must have been transferred for cash or its equivalent (as opposed to familial affection, etc.); (3) the terms and conditions of sale must have been entered into under "prevailing market conditions;" (4) the parties must have had knowledge of the uses to which the property may be put; (5) the parties must both have been seeking to maximize their gains; (6) the parties must not have been in a position to take advantage of the exigencies of the other; (7) the transferred real property must not have consisted of a taxable possessory interest; (8) the consideration for the transfer of the real property must not have consisted in whole or in part of ownership interests in a legal entity (e.g., shares of stock); (9) the information prescribed in the change in ownership statement must have been timely provided; and (10) if a single transaction results in a change in ownership of more than one parcel of real property, the purchase price must be allocated among those parcels and any other transferred assets based on the relative fair market value of each. (See Rule 2.)

Honorable Rick Auerbach

October 18, 2000

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The views expressed in this letter are only advisory in nature. They represent the analysis of the legal staff of the Board based on present law and the facts set forth herein, and are not binding on any person or public entity.

Very truly yours,

/s/ Kristine E. Cazadd

Kristine E. Cazadd  
Senior Tax Counsel

KEC:tr

prop/prec/corporat/00/09kec

cc: Mr. Dick Johnson, MIC:63  
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