Navigating the Complex State & Local Tax M&A Landscape

May 9, 2024

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Disclaimer

1. Presentation is intended to make participants aware of tax issues that may apply to their business.

2. Information presented herein is not intended to be tax advice.

3. Please consult with a qualified practitioner for tax advice related to specific transactions.

Agenda

- Key Objectives of the Due Diligence Process
- SALT-Specific Considerations
- Tax Clearance, Successor Liability, and Other Post-Deal Considerations

Key Objectives of the Due Diligence Process

Deal Structure: Asset v. Stock Sale

1. Does the Business "Survive"

- In an asset sale, the buyer acquires specific assets and liabilities of the target company, while in a stock sale, the buyer purchases ownership interests in the target company. The survival of the business after the transaction can have significant tax implications, as it may impact the continuity of tax attributes such as net operating losses (NOLs), credits, and tax basis.
- Deemed asset sale (e.g., I.R.C. 338 election)

2. "Quit the Business" Language in Many State Statutes May Carry Unique Tax Consequences

- State tax laws may have consequences for a business ceasing operations or substantially reducing its activities within the state.
- Designed to prevent businesses from avoiding state tax liabilities by simply ceasing operations in the state or changing corporate form.
- Income/Franchise, Sales Tax, Property Tax.

Key Objectives of the Due Diligence Process

Deal Structure: Asset v. Stock Sale

3. Tax Treatment May Differ Between Tax Types

- **a) Corporate income tax v. PTE v. Individual:** Apportion v. allocation of gain, sourcing tests, rates.
  - **Asset Sale**: seller typically recognizes gain or loss on sale of each asset. May result in different tax consequences for assets with built-in gains/losses
  - **Stock Sale**: target company's shareholders may benefit from preferential tax treatment for LTCG
  - **Purchase Price Allocation** between tangible assets, intangible assets, and goodwill has tax implications
    - Depreciation/Amortization Deductions
    - Taxable Income

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Key Objectives of the Due Diligence Process

Deal Structure: Asset v. Stock Sale

3. **Tax Treatment May Differ Between Tax Types**
   a) **Sales/Use/Other Tax Considerations:**
      a) **Stock Sale – Successor Liability**: buyer "step into the shoes" of the seller with respect to unpaid sales/use taxes
      b) **Asset Sale:** asset sales may trigger sales tax liability for buyer unless exemption applies
         - **Casual Sale Exemption:** exemption for occasional infrequent sales of TPP by individuals who are not "in the business" of selling such property (i.e., non-inventory assets)
            - **Scope may differ by state**: e.g., Indiana: casual sales exempt, except for sales of motor vehicles and rental property. 45 IAC 2.2-1-1(c).
         - **Sale of Inventory:** buyer can purchase inventory of the seller for resale
      c) **Title Transfer – Motor Vehicles:** buyer will need to retitle the vehicle / pay associated taxes / fees
         - **Exemptions:** e.g., Massachusetts – transfer of motor vehicle to/from business entity in acquisition or reorg exempt from sales tax. 830 CMR 64H.25.1(8)(g).
         - **Responsible Party for Payment of Taxes / Fees**: e.g., Kentucky – if vehicle transferred before property tax on vehicle has been paid, owner of vehicle on Jan 1 will receive tax bill. KRS 134.805(5)(b)

Key Objectives of the Due Diligence Process

Understanding the Target’s Business Activities

1. **Company Footprint**

   a) Physical Operations
   - Where are the target company's manufacturing facilities, distribution centers, stores, offices, and other fixed assets, whether owned or leased?

   b) Sales or Service personnel
   - Determine where the target company has sales or service personnel, which may create nexus for income tax, sales tax, and other state taxes.

   c) Remote Employees
   - Consider the presence of remote employees working from home offices in various states and the nexus implications for state income tax and wage withholding and reporting.

Key Objectives of the Due Diligence Process

Understanding Business Activities of the Target

d) Locations of Customers

- Use the geographic distribution of the target company's customers to assess potential sales tax obligations and nexus considerations.

e) Economic Nexus / Factor Presence

- What is the sales threshold, and did the target exceed them?
- What sales are included in the threshold? Some states exclude exempt sales.

f) Deliveries

- Assess delivery (frequency and volume) within and across state lines, which can trigger nexus for sales tax and other taxes.
- Also assess *means* of delivery –by common carrier or by company’s own vehicles/personnel

Key Objectives of the Due Diligence Process

Understanding Business Activities of the Target

3. **Product Offering**
   - Analyze target company's product offering, including tangible property, intangible property, services, and digital products, to determine the taxability and sourcing rules applicable to each type of transaction.

4. **Tangible Property**
   - Review the sale and distribution process for tangible goods and the potential sales tax implications, including sourcing rules for interstate transactions.

5. **Services (Importance of Classifying Service Type)**
   - Different types of services may be subject to different tax treatment under state and local tax laws.
   - Crucial to accurately classify the services to determine their taxability / potential exemptions and applicable tax rates.

Key Objectives of the Due Diligence Process

Understanding Business Activities of the Target

6. **Sourcing of services**
    - The sourcing rules for services can vary between states and impact the allocation of sales tax revenue between jurisdictions.
    - *Apportionment for Income Tax Purposes*:
        - Proper classification of service types will determine apportionment rules.
        - Market-based sourcing v. cost of performance.

7. **Mixed transactions**
    - Identify transactions that involve a combination of tangible goods, services, and digital products to determine the appropriate tax treatment and allocation of revenue for state tax purposes.
    - Some states may only tax the portion of the transaction related to TPP, while other states may determine that the transaction is either fully taxable or exempt based on the "true object" of the transaction

SALT-Specific Considerations

Tax Due Diligence

1. **Opportunity to Uncover Issues Beyond QoE**

2. **Successor Liability – SALT liabilities that may attach to buyer regardless of deal structure**

3. **Understand materiality on both buy- and sell-side**

4. **Transaction amount:**
5. How will SALT liabilities affect the purchase price?
    - Holdbacks or Indemnifications?

6. **Timing for completion of diligence, close**

7. **Willingness of parties to take on risk**

SALT-Specific Considerations

Entity Level Taxes

1. **Income (corporate)**
   - Historical liabilities and compliance levels
   - Apportionment, nexus, filing positions (e.g., P.L. 86-272)
   - Significant transactions
   - Net Operating Losses (NOLs) and Credits
2. **Pass-Through Entity income taxes** (e.g., S corp income tax in CA, LA, TN; elective PTETs)
3. **Franchise tax (e.g., AL, GA, LA, NC, SC, TN):** not subject to P.L. 86-272
4. **Gross Receipts (e.g., CA LLC fee, KY, OH, WA, TX, TN, OR):** not subject to P.L. 86-272
   - Nexus Thresholds; Industry-Specific Exemptions; Calculation Methodology
5. **Employment Taxes:** employer taxes and employee withholding
   - prepared in-house or service provider?
   - Withholding taxes, unemployment insurance, and other employer-related taxes (incl. local).
   - Worker Classification
   - Tax Credits and Incentives

SALT-Specific Considerations

Entity Level Taxes

- **Local Entity Level Taxes**
  - Net income taxes (e.g., NYC, OH, KY, MI, St. Louis, Philly, Portland OR)
  - Gross receipts taxes (e.g., WV, CA, WA B&O, SC, TN, VA)
  - Income tax withholding (e.g., OH, KY, MI, PA, Kansas City)
  - These taxes go by different names, e.g., occupational license/tax, business license tax, business privilege tax, and business earnings tax.
  - Who administers the tax? State, city, county, private third-party contractor

SALT-Specific Considerations

Indirect Taxes

1. Sales/Use

- **Compliance**, including the collection, remittance, and reporting of sales tax on taxable transactions.
- **Single or Separate Filing**? Single return for both SUT (MI, CO, MN), or separate filings (OH, NC, AZ)
- **Economic Nexus**
- **Product Taxability**
  - **Taxability of services**
    - E.g., HI, NM (gross receipts); WV (sales tax)
    - Other states subject only certain services to sales tax (e.g., OH – janitorial services)
- **Exemption Certificates**

2. Property Tax

- Assessment Practices
- Exemptions and Abatements: Personal Property Reporting

3. Tax Incentives

- Investment Credits
- Research and Development Credits

SALT-Specific Considerations

Indirect Taxes

4. Quasi "Taxes" and Fees

- **Business Licenses/Fees that may impact tax analysis**
  - **Secretary of State registrations**
  - **Franchise and Trademark Registrations**
  - **Industry-Specific**
    - Restaurants – Alcohol Permits / Food Business Operator Licenses
    - Environmental Permitting (Exempt Facilities / Pollution Control Permits; Hazardous Waste Permits)
    - Construction – Contractor Licensing– some states require a certified contractor to be listed as an officer or hold a qualifying position within a contracting business
    - Manufacturing – varies by industry, but e.g., FDA establishment registration for pharma companies; food safety permits for food manufacturers

- **State-Specific Quasi Taxes:**
  - E.g., Colorado Retail Delivery Fee

SALT-Specific Considerations

Indirect Taxes

4. **Quasi "Taxes" and Fees**
    - **Unclaimed Property**
        - Govern the handling of financial assets or tangible property that has been abandoned by its rightful owner.
        - Common to see low compliance and lack of understanding
        - Penalties for failing to make unclaimed property filings
    - **Real Estate Transfer Taxes**
        - Imposed on the transfer of real property, typically upon filing of a deed
        - 37 states and DC impose in some form
        - Responsible party varies by state; some states impose on seller (PA, NY, CT); others on buyer (NJ, MD, DC)
        - May also apply to certain leases (CT, NY, DC)

SALT-Specific Considerations

Pre-Due Diligence (Sell Side)

1. **Perform state tax review to uncover any issues and create a game plan to clean up liabilities**

    - **Prospective compliance**

    - **Voluntary disclosure/Amnesty filings**
        - Nearly every state has some form of a Voluntary Disclosure program but eligibility and terms vary
        - Mitigate exposure for past non-compliance (e.g., cut off old years, penalty waiver)

    - **Document non-filing positions, establish return positions**

    - **Secure exemption documentation (sales tax)**
        - Ensure that the target company has proper documentation to support any claimed exemptions from sales tax liabilities, such as resale certificates or exemption certificates.
        - If exemption certificates have not been collected, the buyer and seller may need to come to an agreement on how to handle the potential liability (indemnity provisions; purchase price reductions/escrow holdback)

SALT-Specific Considerations

Pre-Due Diligence (Sell Side)

2. **Gather records and documentation regarding filing history**
    - Compile all relevant records, documentation, and filings.
    - Make it organized and readily accessible for review by potential buyers.
    - Include copies of state tax returns, payment confirmations, correspondence with tax authorities, audit reports, and any other relevant documents that provide insight into the target company's state tax affairs.

3. **Update internal tax policies and procedures**
    - Review and update the target company's internal tax policies, procedures, and controls to align with current best practices and regulatory requirements.
    - Ensure that tax policies are clear, comprehensive, and effectively communicated to relevant stakeholders within the organization.
    - Implement measures to enhance tax compliance, risk management, and governance processes, including periodic reviews and updates to reflect changes in tax laws and regulations.
    - Consider engaging tax advisors or consultants to provide guidance on optimizing tax policies and procedures and addressing any specific challenges or opportunities identified during the pre-due diligence process.

SALT-Specific Considerations

Pre-Due Diligence (Buy Side)

1. **Understand target's industry and unique tax implications that may result**
    - Identify industry-specific tax regulations, incentives, credits, and deductions.
    - Manufacturing / agricultural sales tax exemptions; pollution control facilities.

2. **Define materiality threshold for tax-related issues**
    - Establish a materiality threshold for identifying issues that could impact the success or viability of the deal.
    - Document the materiality threshold and decision-making process to ensure transparency and accountability throughout the pre-due diligence phase and subsequent stages of the transaction.

3. **Compile initial info request**
    - Develop a detailed request for essential documents, financial records, and tax filings.
    - Tailor the request to address specific areas of interest, such as corporate tax returns, financial statements, exemption documentation, sales reports and sales tax filings, tax provisions, and any tax-related correspondence with regulatory authorities.

SALT-Specific Considerations

Example Info Request:

- Sales / Use Tax returns for last X Years
- Sales by State for last X years
- Fixed Asset Listing
- Trial Balance
- General Ledger
- Use Tax Accruals
- Exemption Certificate Sampling and Process for Collecting / Issuing
- Individuals responsible for filing [tax type] returns
- Notices issued by states where filing
- Apportionment workpapers for X years by state
- Payroll by State
- Property Listing by State (real / personal)
- Rent Expense by State
- List of Services provided, including sample contracts
- Listing of Employees and Independent Contractors by State for last X years
- Details pertaining to any corporate structure transactions for last X years
- Real and Personal Property Tax Returns for Last X Years
- Listing of any real estate owned – location, date acquired, cost basis.
- Unclaimed Property Reports for Last X years
- Name of payroll processor / indicate if payroll is completed in-house.
- Forms 1099 filed for X years
- Confirm unemployment compensation reports are paid / filed.
- Confirm workers compensation reports are paid / filed.
- Listing of any state or local tax incentives awarded / received.
- Copies of last X years of personal property tax returns filed and a listing of states where tangible personal property is located.
- Any state and local tax incentives or credits
- Correspondence and findings regarding any tax audits for the past X Years
- Copies opinion letters, correspondence and memoranda or studies prepared by the Company /subsidiary / representatives regarding significant tax exposure items

SALT-Specific Considerations

During Due Diligence (Sell Side)

1. **Be responsive.** Many issues can be resolved by providing detailed tax filings and associated backup.

2. **Review due diligence report and refute findings where possible**

   a. **Taxability of product/service offering**
      - Clarify any exemptions, exclusions, or special tax treatment that may apply to specific product or service offerings.
      - Address any facts or assumptions that may be incorrect.
      - Provide evidence to support the target company's tax positions, including prior studies/reports.

   b. **Nexus determinations**
      - Provide documentation and legal arguments to support the target company's nexus determinations, including evidence of physical presence (or lack thereof), economic nexus (or lack thereof – e.g., exempt sales). Nexus study?
      - Collaborate with buy-side to resolve any discrepancies, uncertainties, or factual issues.

SALT-Specific Considerations

During Due Diligence (Buy Side)

1. **Review Tax Filings of Target and Identify Gaps**
    - Conduct a comprehensive review of the target company's historical tax filings, including federal, state, and local tax returns, to identify any inconsistencies, errors, or omissions.
    - Verify that all required tax returns have been timely filed.
    - Identify any gaps or discrepancies in the tax filings that may indicate potential areas of tax exposure or non-compliance.

2. **Quantify Exposure by Tax Type and Year (including Estimates for Interest and Penalty)**
    - Quantify the exposure by tax type (e.g., income tax, sales tax, payroll tax) and year.
    - Estimate accrued interest and penalties that may apply to outstanding tax liabilities.
    - Consider the impact of any unresolved tax disputes, pending audits, or contingent liabilities on the overall tax exposure and potential financial impact on the transaction.

Tax Clearance, Successor Liability, and Other Post-Deal Considerations

Post-Due Diligence Considerations

1. Successor Liability

- When could the buyer inherit certain tax obligations or liabilities of the target company (e.g., unpaid sales and use, employment, income taxes, SUI)
- How to address successor liability (e.g., provisions in purchase agreement, tax clearance certificates, VDAs, etc.)

2. Tax Clearance Certificates

- Request these from tax authorities to confirm that all outstanding tax liabilities of the target have been satisfied.
- Can be difficult and time-consuming to obtain, especially if there are unresolved tax issues
- The target company may first need to file missing returns or resolve outstanding issues before obtaining clearance.
- **Note**: A Tax Clearance Certificate does not necessarily mean all outstanding tax liabilities have been resolved – it only means the State is not aware of any additional liabilities. Due diligence may expose additional liabilities.

Tax Clearance, Successor Liability, and Other Post-Deal Considerations

Determine Next Steps

1. **Indemnification provision / Escrow account**
   - Often are limited in scope or time.
2. **Purchase Price Reduction**
   - Adjust the purchase price to account for any tax liabilities or risks identified during due diligence.
3. **Reps and Warranties Insurance**
   - Consider obtaining RWI to protect against financial losses arising from breaches of reps and warranties by seller in the purchase agreement. R&W insurance can be used to:
     - **Mitigate Risk**
     - **Enhance Deal Certainty**
     - **Facilitate Negotiations**
     - **Preserve Relationship**
4. **VDAs** – Whose responsibility and cost?
5. **Refunds** for pre-close periods – Whose responsibility, cost, and control?

Tax Clearance, Successor Liability, and Other Post-Deal Considerations

Acquisition Tax Filings

1. **Real Estate Transfer Taxes**
   a. **Tax Rates / Calculation:** Vary by jurisdiction; flat rate v. graduated scale
   b. **Exemptions / Exclusions:** Some states provide exemptions; e.g., transfers for nominal consideration
   c. **Recording Requirements:** Must be paid and recorded with proper government authority before legally complete
   d. **Seller v. Buyer Responsibility:** Responsible party (buyer v. seller) varies by jurisdiction

Tax Clearance, Successor Liability, and Other Post-Deal Considerations

Acquisition Tax Filings

2. **Bulk Sales Laws:** Apply to the sale of a significant portion of a business's inventory or assets outside the ordinary course of business
   a. **Scope:** Typically apply to sales of inventory, equipment, fixtures or other TPP; threshold varies by jurisdiction
   b. **Notice Requirements:** Sellers generally must provide advance notice to creditors with claims
   c. **Creditor's Rights:** Creditors can assert claims during notice period
   d. **Exemptions / Exceptions:** Some states provides exemptions; e.g., sales to secured creditors
   e. **Enforcement / Penalties:** invalidation of sale, liability of damages to credits, penalties
3. **Sales Tax:** Register for sales tax permits in relevant jurisdictions; ensure compliance with sales tax collection and remittance requirements.
4. **Short Period / Final Income Tax Returns**: File returns for target to report income up to date of acquisition.

Questions?

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