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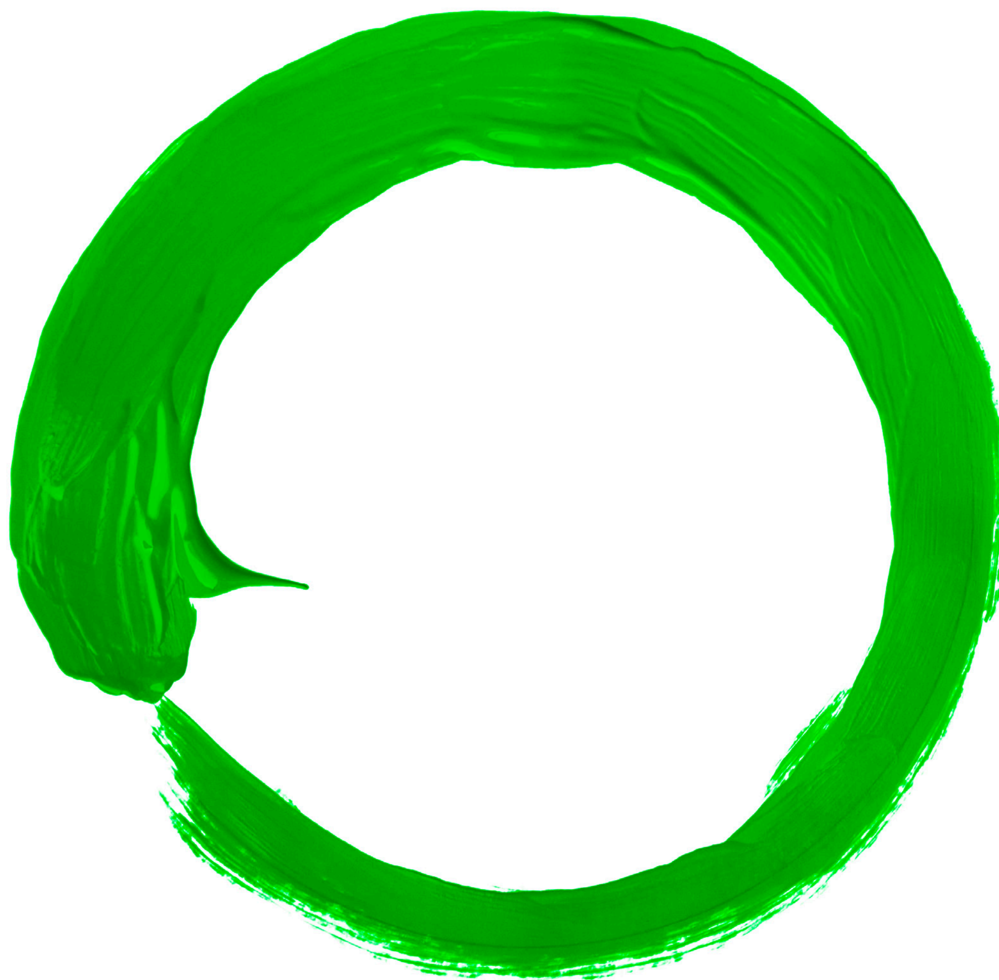

# Inside Deloitte

## State Mergers and Acquisitions, Part 2: Non-Income-Tax Types

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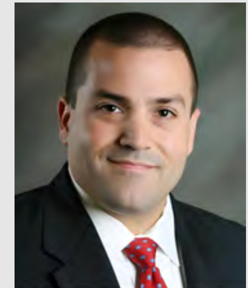

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In this installment of Inside Deloitte, the authors discuss various non-income tax types in the context of mergers and acquisitions along with potential considerations.

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The lack of uniformity across states in conjunction with increasing complexity has resulted in more emphasis on state taxes during due diligence.[1] In the state tax realm, the focus frequently shifts to various indirect taxes that are imposed on a gross basis, which means a potential exposure may exist regardless of whether a target reports overall losses for income tax purposes. Further, the bright-line nexus thresholds adopted for indirect taxes are in many instances lower and therefore easier to exceed as compared with the same type of standard adopted for income tax.[2] As a result, potential non-income-tax exposures identified during due diligence associated with a failure to file — despite triggering nexus — can quickly become material.

Correspondingly, indirect taxes necessarily play a crucial role in the valuation process during mergers and acquisitions, as these taxes represent an above-the-line adjustment that directly affects the quality of earnings and the corresponding valuation multiple, thereby influencing the overall financial assessment and deal structure. Potential exposure associated with indirect taxes

[1] Due diligence requires an examination of a company's multistate footprint and potential state tax exposure for various tax types. This article focuses exclusively on potential concerns for indirect taxes and does not address additional tax types.

[2] Following the Supreme Court's decision in *South Dakota v. Wayfair Inc.*, all states that impose a sales tax have adopted an economic nexus provision, which generally establishes taxable nexus with a state if there are over $100,000 or 200 sales into the state. *See* 585 U.S. 162 (2018). Consequently, a potential target may have established nexus for indirect tax purposes in all states where customers are located.



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also often carries an increased risk of successor liability as compared with state income taxes.[3] It is therefore paramount for both buyers and sellers to adequately evaluate the ineluctable implications of indirect taxes, which can significantly affect the overall cost and structure of a deal.

### A Double Click on Sales and Use Tax: Services and Digital Products

Although most companies are aware that sales and use tax is imposed on tangible personal property, the breadth of services potentially subject to tax (referred to as enumerated services) is frequently overlooked or a company's operations are oversimplified as only selling tangible personal property. For instance, several states levy sales tax on consulting services, along with data processing or information services.[4] Over the past decade, the types of companies providing technology offerings — often in conjunction with other goods or services — have continued to expand; nevertheless, unless a target undergoes a sales tax audit, the potential sales taxability of those services is frequently not considered until due diligence occurs.

For example, an issue that regularly arises during due diligence is whether a component of the services provided by a target constitutes data processing. While what constitutes data processing varies significantly among states, the term generally encompasses a service that involves turning raw data into something useful.[5] In the context of due diligence, uncertainty frequently exists when services provided by a target incorporate some aspect of data processing, or perhaps more colloquially, "use of a computer."[6]

> **Example:** X Corp. provides analytical services in which customer data are compiled and analyzed to provide recommendations to customers. Following that analysis, X Corp. provides a report to customers that summarizes the data provided. While the analytical services provided may constitute nontaxable professional services in some states, the summary report may be considered taxable data processing, particularly if it is separately desired by the customer.[7]

Similarly, a target may have failed to evaluate whether a digital product is more properly treated as either tangible personal property or service for sales tax purposes. The complexity associated with that determination often surfaces as part of due diligence, particularly given states' varied approaches to defining what constitutes a digital product.[8] Unfortunately, many states' sales tax definitions were adopted before most digital products existed, because advances in technology outpace state legislatures and tax authorities reacting to those developments in the marketplace, thereby creating more confusion in an already uncertain area. Informed potential buyers may not have an appetite to assume that uncertainty.

The sales tax classification of a technology offering is particularly crucial when evaluating a potential target with customers located in multiple states, which has become common for many companies. The M&A environment is fast-

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[3] *See further* Jacob Aguero, Tyler Greaves, and Grace Taylor, "State Mergers and Acquisitions, Part 1: Successor Liability," *Tax Notes State*, Apr. 8, 2024, p. 139.

[4] *See, e.g.*, Conn. Gen. Stat. section 12-407(a)(37)(J) (broadly subjecting to tax business analysis services or business management consulting services related to human resource management); *see further* S.D. Codified Laws section 10-45-4 (deems "engaging or continuing in the practice of any business in which a service is rendered" to be subject to sales tax in the state); *but see* N.Y. Tax Law section 1105(c)(1) (excluding from sales tax the furnishing of information deemed to be personal or individual in nature and that is not largely incorporated into end-use reports furnished to a purchaser).

[5] *See, e.g.*, N.M. Stat. Ann. section 7-9-46.1 (defining data processing services as "the processing or storage of information to compile and produce records of transactions for retrieval or use, including data entry, data retrieval, data searches and information compilation"); *see further* D.C. Code Mun. Regs. tit. 9, section 474.1 (defining data processing services as "the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information. It also includes word processing, payroll and business accounting, and computerized data and information storage and manipulation.").

[6] *See* Stephen W. Long and James M. Lucas, "How to Process Data Processing in Texas," *Tax Notes State*, May 13, 2024, p. 493.

[7] *See id.*

[8] *Compare* Conn. Gen. Stat. section 12-407 (defining digital goods to mean "audio works, visual works, audio-visual works, reading materials or ring tones, that are electronically accessed or transferred" and defining tangible personal property to include digital goods), *with* D.C. Code section 47-2001(d-1) (defining digital goods to include digital audio/audiovisual works, digital books, digital codes, digital applications and games, and otherwise taxable tangible personal property that is electronically or digitally delivered, streamed, or accessed).



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paced and competitive, meaning buyers are required to perform due diligence under an accelerated timeline. Given these dynamics, undertaking a multistate taxability study as part of due diligence is often impractical. To the extent that a target has not sufficiently evaluated the applicability of each state's tax framework on its product and service offerings, a material exposure may be identified and significantly affect the deal agreement (for example, purchase price or escrow agreement).

### Use of Commercial Tax Software

Tax impositions and rate changes may feel like a moving target, even for sophisticated companies, which necessitates regularly reassessing whether a service is taxable — along with the applicable tax rate. To the extent a target monitors sales tax developments manually, the likelihood for identifying a potential exposure during due diligence usually increases.

However, even if a target uses commercial tax software to assist with sales and use tax compliance, it is essential to understand the process used by the target, how long that process has been in place, and how recently the process was refreshed — particularly for a business whose operations have significantly changed. When mapping receipts into the software, has the target correctly classified its revenue streams for sales and use tax purposes? While many companies provide comparable products or services, arguably, no two companies — and no two revenue streams — are alike. A target's use of a custom tax code may demonstrate prudence or result in the need for a more detailed review as part of due diligence. Regardless of whether commercial tax software is used, formally documenting and regularly reassessing mapping and taxability can help streamline the due diligence process.

### Real Property Transfer Taxes

Another area of indirect tax that should be evaluated as part of due diligence is real property transfer tax. In addition to potential historical exposures, a merger or other change in control of a legal entity can trigger real estate transfer tax, similar to the outright sale of a company's real estate assets.

Generally, a real property transfer tax is imposed on documents (for example, deeds) that convey an interest in real property from one legal entity to another. Real property transfer taxes are typically levied on the recordation of a deed and based on the consideration paid for fair market value of the property, though meaningful differences concerning imposition and potential exemptions exist in each tax jurisdiction.

### Controlling Interest Transfer Taxes

Several states have expanded real property transfer taxes to include transfers of an ownership interest in a legal entity that directly or indirectly owns real property (commonly known as controlling interest transfer taxes).[9] Consequently, a transfer tax may be triggered as a result of a pretransaction restructuring or an acquisition even though no direct, deed-effected transfer of real property occurs. Further, many states may impose a controlling interest transfer tax to the extent a leasehold interest is indirectly transferred. Though generally limited to long-term leases, some states impose a transfer tax on leases entered into for shorter terms.[10]

What constitutes a transfer of a controlling interest varies, though it generally means transferring a specific percentage of (i) the voting stock or voting power of a corporation, or (ii) capital or profits interest in an unincorporated entity.[11] While the threshold is often 50 percent or more, some jurisdictions do not specify a threshold for change in control on entity

[9] Some states impose their controlling interest transfer taxes on transfers of ownership interests in any legal entity, while others limit the tax to entities engaged in a real estate business. *See, e.g.*, Pa. Cons. Stat. section 8101-C. Statutory definitions typically involve a minimum percentage threshold of total company assets consisting of real estate or total company gross receipts derived from real estate. *See id.* (defining a real estate company as "primarily engaged in the business of holding, selling or leasing real estate ninety percent or more of the ownership interest . . . and which (i) derives sixty percent or more of its annual gross receipts from the ownership or disposition of real estate; or (ii) holds real estate, the value of which comprises ninety percent or more of the value of its entire tangible asset holdings.").

[10] *Compare* Conn. Agencies Regs. section 12-494-1 (imposing transfer tax on leases for a "fixed period of 99 years or more"), *with* N.Y. Tax Law section 1401 (subjecting transfer of a leasehold interest to transfer tax regardless of the lease term).

[11] *See, e.g.*, 35 Ill. Comp. Stat. Ann. section 200/31-5 (defining controlling interest for transfer tax purposes as more than 50 percent of the FMV of all ownership or beneficial interests).



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transfers.[12] In some jurisdictions, a series of transfers are aggregated for controlling interest transfer tax purposes.[13]

**Example:** X Corp. owns real property in New York City. Company A owns 100 percent of the stock of X. On January 1, 2023, A sells 20 percent of X to B. On December 31, 2025, A sells 30 percent of X to C. Since A has transferred a controlling interest in real property within a three-year period, the transfer tax will apply to both sales made by A.[14]

Buyers should also maintain awareness of the potential transfer tax effects as a result of pre-close restructuring efforts involving multistep conveyances. In some jurisdictions, exemptions exist for transfers between related parties, though they are often narrowly construed.[15]

**Example:** X Corp. owns real property in New York City. Fifty percent of X is owned by A and 50 percent by B. Under a plan to be completed within 10 days, X is liquidated and its realty is distributed to A and B on January 1, 2024. The realty is then immediately conveyed to newly formed Y Partnership, in which A and B each take a 50 percent partnership interest. The two steps will be treated as a direct transfer of the realty from X to Y. The consideration for the realty (the partnership interests received by A and B) is presumed to be equal to the FMV of the realty conveyed.[16]

## Post-Close Compliance: Are You Ready for It?

In the heat of due diligence, post-close transfer tax filings are frequently overlooked, despite that these returns are generally required to be filed within a relatively short time frame following close.[17] Failure to fulfill post-closing compliance obligations can result in penalties, interest, and potential legal disputes. Further, some jurisdictions require both the grantor and grantee to sign the tax form as filed.[18] To ensure timely filings and payment of taxes due, both parties must clearly delineate and negotiate their responsibilities — either within the purchase agreement or otherwise as part of the transaction.

One such responsibility involves determining the tax base for computing transfer tax. Although not determinative, the failure to identify the real property's value in the purchase agreement may create ambiguity.[19] Following a transaction's close and the filing of transfer tax returns, tax jurisdictions may inquire as to the method used to determine the reported value. While occasionally based on FMV, a state or locality may also attempt to reassess the property's value post-transfer, which can lead to unforeseen costs to both parties.[20]

Because of these factors, obtaining an appraisal for the acquired real property assets near the closing date is typically a leading practice. For some interests in real property (for example, leasehold interests) or types of real property (for example, hotels), there are nuanced methods and

[12] *See*, *e.g.*, N.H. Rev. Stat. Ann. section 78-B:1-a(V), (VI) (defining taxable transfers to encompass "every contractual transfer of real estate, or any interest in real estate from a person or entity to another person or entity, *whether or not either person or entity is controlled directly or indirectly by the other person or entity in the transfer*") (emphasis added).

[13] *See* N.Y.C. Rules, tit. 19, section 23-02(2) (Controlling Interest — Aggregation).

[14] *See id.* at section 23-02(f)(4).

[15] These exemptions may apply to transfers between a parent and its subsidiary, or transfers resulting in a mere change in identity or form of ownership while the ultimate ownership of the real property remains unchanged.

[16] N.Y.C. Rules, tit. 19, section 23-03(f)(4).

[17] *See* 35 Ill. Comp. Stat. Ann. section 200/31-25 (requiring both buyer and seller to present transfer declaration to county recorder and pay tax within three days after the transfer); *see further* Fla. Admin. Code Ann. r. 12B-4.060(6) (controlling interest transfer tax form generally due on 20th day following taxable transaction); *see also* Minn. Stat. Ann. section 287.21 (transfer tax form must be filed within 30 days of the transaction that triggers the tax).

[18] *See*, *e.g.*, N.Y. Tax Law section 1409 (stating that "a joint return shall be filed by both the grantor and the grantee for each conveyance whether or not a tax is due thereon.").

[19] *See* N.J. Stat. section 54:15C-1 (assessing transfer taxes based on a percentage of the assessed value for property tax purposes); 72 Pa. Stat. Ann. section 8101-C (defining "value" in the context of transfer taxes for "transactions without consideration or for consideration less than the actual monetary worth of the real estate, a taxable lease . . . a leasehold or possessory interest, any exchange of properties, or the real estate of an acquired company, the actual monetary worth of the real estate determined by adjusting the assessed value of the real estate for local real estate tax purposes for the common level ratio of assessed values to market values of the taxing district as established by the State Tax Equalization Board, or a commensurate part of the assessment where the assessment includes other real estate.").

[20] *See S & A Property Investment Services LLC v. Garcia*, 360 So. 3d 432 (Fla. Dist. Ct. App. 2023), Case No. SC2023-0796 (petition for review denied Oct. 24, 2023) (holding transfer of real property to limited liability company held by grantors resulted in reassessment of FMV for real property tax purposes); *see further Prang v. Los Angeles County Assessment Appeals Board*, S266590; B298794; BS173698 (Cal. May 30, 2024) (holding transfer of real property from corporation to trust that owned all of the corporation's voting stock triggered a reassessment of properties).



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techniques to estimate the FMV for transfer tax purposes; therefore, an experienced appraiser should prepare a stand-alone valuation for the real property assets. Further, a purchase price allocation for financial reporting (that is, U.S. generally accepted accounting principles) should not be used for that analysis because there are regularly material differences between the accounting and tax guidance for valuation purposes.

### Gross Receipts Taxes: Part and Parcel to Due Diligence

States and localities frequently impose taxes based on a company's gross receipts attributable to a state, irrespective of a company's profitability. Consequently, gross receipts taxes can prove more burdensome for businesses with lower profit margins, as the tax applies to total revenue rather than profits. A gross receipts tax generally encompasses "a tax imposed on the total gross income (the total gross receipts) that a business receives from doing business."[21] The term used to identify this tax type varies across jurisdictions,[22] along with the mechanics of imposition.[23] Thus, the division of a target responsible for filing gross receipts tax returns is often not readily apparent (for example, income or non-income tax department, legal department) and may be inadvertently neglected.

Gross receipts taxes are often compounded as goods or services move through the production process, leading to multiple layers of taxation. This can increase the cost of products or services, which directly affects a target's overall profitability. The broader base and lower rates of gross receipts taxes can make them seem less significant, but their impact on business operations and economic activity can be substantial, especially for small and medium-size companies. Further, because gross receipts taxes are not based on or measured by net income, the protections provided under P.L. 86-272, which prohibits states from taxing specific business activities, do not apply.[24] Given the inapplicability of P.L. 86-272, a target with only minimal activities in a jurisdiction can be subject to a gross receipts tax filing.

There has also been an upsurge in local gross receipts taxes.[25] Unfortunately, many localities that impose gross receipts taxes do not offer a formal voluntary disclosure program. This absence can increase risk to businesses, particularly when past noncompliance issues are discovered as part of due diligence. In jurisdictions with voluntary disclosure programs, businesses can typically come forward to report previously undisclosed tax liabilities in exchange for a limited lookback period and potential abatement of penalties or interest.

Without these programs, however, there is no formal mechanism to limit the lookback period. This means that if a business discovers it has been underpaying gross receipts taxes, it could be liable for those taxes going back to when the liability first arose, potentially spanning many years. Further, without the opportunity for penalty relief offered by voluntary disclosure programs, businesses may face significant penalties and interest charges in addition to the original tax liability. This situation underscores the importance of accurate, proactive tax compliance and thorough due diligence to identify and address potential tax risks associated with gross receipts taxes.[26] ■

[21] *See* Matthew Bender, *Bender's State Taxation: Principles and Practice*, section 6.

[22] Examples include excise taxes, franchise taxes, gross proceeds taxes, gross business taxes, gross sales taxes, occupational taxes, privilege taxes, flat taxes, and amusement taxes.

[23] A few states identify certain taxes as gross receipts taxes — though these taxes are more akin to a sales tax or transactional tax. For instance, Hawaii's general excise tax is often referred to as a gross income tax because it is based on a company's total gross income derived from doing business in the state. *See* Haw. Rev. Stat. Ann. section 237-13; *see also* N.M. Stat. Ann. section 7-9-4 (imposition of New Mexico gross receipts tax).

[24] *See* P.L. 86-272, 73 Stat. 555.

[25] For example, although California does not have a state gross receipts tax, many of its local jurisdictions impose them. *See* L.A. Mun. Code (Cal.) section 21.03 (Los Angeles business tax); *see also* S.F. Bus. & Tax Regs. Code section 953 (San Francisco gross receipts tax).

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