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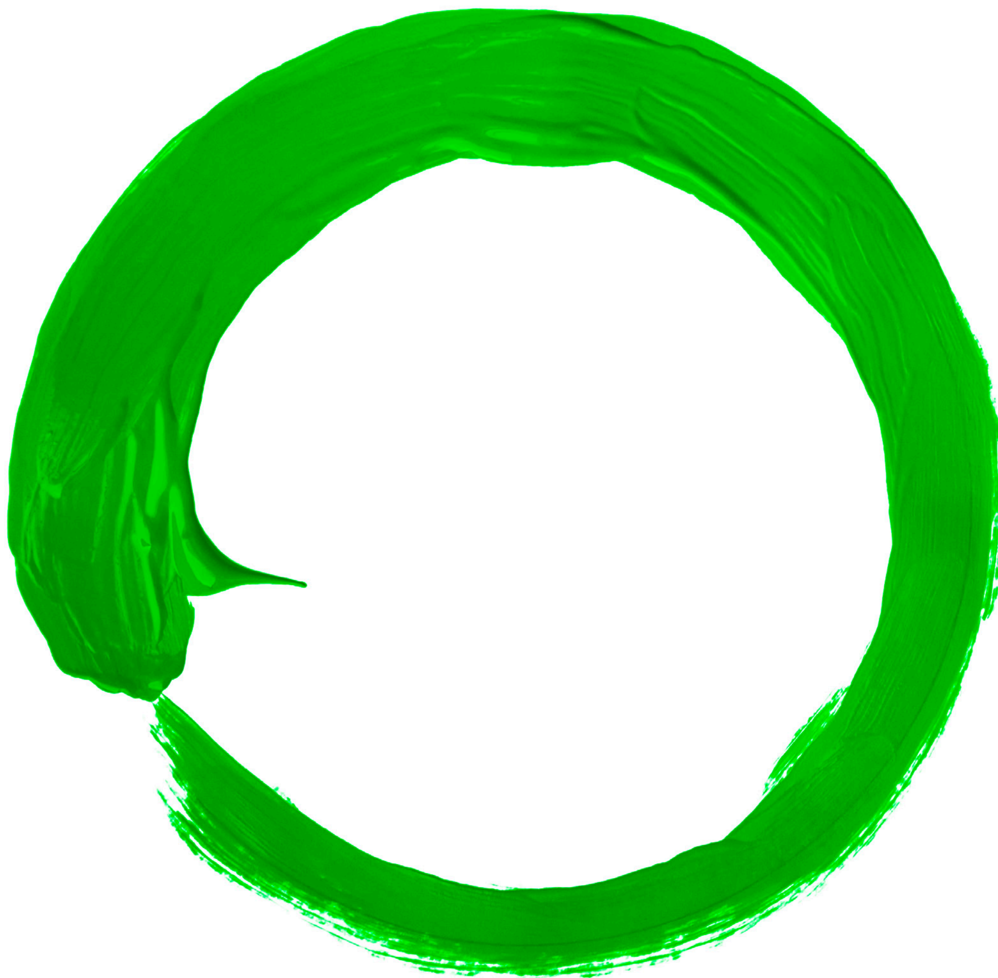

Inside Deloitte

State Mergers and Acquisitions, Part 1: Successor Liability

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State Mergers and Acquisitions, Part 1: Successor Liability

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In this installment of Inside Deloitte, the authors discuss successor liability for state income taxes in the context of mergers and acquisitions and how some state tax statutes apply.

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In the ever-evolving landscape of mergers and acquisitions, the intricate dance of state tax continues to play a pivotal role. This article marks the inception of a comprehensive series that delves into the multifaceted world of state M&A, which will unravel complexities and shed light on the potential state tax implications.

This inaugural article serves as a gateway into the nuances of state M&A, setting the stage to understand the reason state tax matters as part of due diligence. By the series's conclusion, readers will have an opportunity to gain a better understanding of how to approach state tax more effectively as part of an overall hunt for value in an increasingly challenging market. Join us on this intellectual adventure as we navigate through the fascinating landscape of state M&A, which begins with successor liability.[1]

Acquisition Structuring

Business acquisitions may fundamentally be structured as either (1) an acquisition of the assets of a company or line of business (asset purchase), or (2) a transfer of corporate stock, partnership interest, or a membership interest (stock purchase).[2] In an asset purchase, the seller generally recognizes a gain equal to the difference between the adjusted basis of the assets transferred and the purchase price, while the buyer acquires the assets with a basis equal to fair market value, referred to as a "step up" in basis.[3] Consequently, the buyer may receive the benefit of additional depreciation deductions, thereby reducing potential future taxes. From a tax perspective, one of the primary differences to a

[1]Various tax types may result in successor liability for a buyer in the context of an asset sale. This article focuses exclusively on potential concerns for state income or franchise taxes; as such, additional tax types and potential successor liability concerns are not addressed.

[2]Note that there are multiple methods of structuring the sale of a corporate business as a tax-free transaction for the seller, including — but not limited to — a statutory merger (IRC section 368(a)(1)(A)), stock-for-stock acquisition (IRC section 368(a)(1)(B)), and stock-for-asset acquisition (IRC section 368(a)(1)(C)). The specific conditions and potential consequences of these transactions are beyond the scope of this article.

[3]*See* IRC section 1001(a) (specifying that "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . . for determining gain"); *see further* IRC sections 1011, 1012(a) (explaining "basis of property shall be the cost of such property, except as otherwise provided").

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buyer when entering into a stock purchase, as compared with purchasing the assets directly, is that the assets retain their adjusted basis and holding periods.[4]

In addition to numerous tax considerations, buyers may also prefer an asset purchase to potentially avoid the assumption of some tax and nontax liabilities. Unlike a stock purchase, in which the buyer retains all liabilities and obligations of the purchased entity, both known and unknown, the buyer in an asset purchase has the ability to identify which liabilities it will contractually assume.

State Income Tax Successor Liability — The Worst Thing That's Ever Been Mine?

When acquiring a business's assets, most parties are aware that the buyer may be held responsible for any pre-transaction sales and use tax liabilities. However, buyers often overlook the possibility that a buyer in several instances may inherit state income tax liabilities generated before the transaction. This common misconception may be caused by the fact that although the IRS can hold an asset transferee liable for unpaid federal income tax in some instances (for example, fraudulent conveyance), in most cases the buyer of assets can reasonably expect to not be responsible for the seller's federal income tax liabilities.[5] In contrast, successor liability for state income tax purposes applies more broadly and generally does not require a finding of fraud to be implicated.

Before purchasing all or substantially all of a business's assets, buyers should acknowledge the risk that state tax authorities may hold the new owners liable for state income tax liabilities generated before the transaction. From a practical perspective, the parties to a transaction may negotiate including a tax indemnification provision in the purchase agreement, in which the seller agrees to indemnify the buyer for tax liabilities established before the transaction. However, contractual protection will not limit a state tax authority's ability to hold a buyer liable under state law.[6] Various state statutory provisions (such as bulk-sale procedures) and common law doctrines (such as de facto merger) may result in a buyer being held liable for the seller's liabilities that the buyer did not contractually agree to assume.[7] Further, states have means at their disposal to recover a seller's unpaid state income taxes, including subjecting the purchased assets to a lien.[8]

Bulk-Sale Procedures as Applied To State Income Taxes

Many buyers are aware that for sales and use tax purposes, when a business sells, transfers, or assigns the assets outside the ordinary course of business, most states require the buyer, the seller, or both parties to follow specific procedures (bulk-sale procedures). These procedures may include:

- providing notice to the relevant state tax authority of the transaction details;
- requesting a tax clearance certificate; or
- withholding money from the purchase price for any unpaid taxes.[9]

A key function of the bulk-sale procedures is to protect a buyer from inheriting any tax liabilities from a seller of business assets. Most states that impose bulk-sale procedures have the authority to impose successor liability against the buyer for the seller's outstanding sales and use tax liabilities (typically limited to the purchase price of the

[4] *Id.*

[5] For example, the IRC provides a mechanism for the IRS to assert at law or in equity liability against a transferee. *See* section 6901. Liability may be asserted by the federal government in this context if, for example, there are facts to support a finding of fraud. *See id.* However, the IRC otherwise only provides for liabilities generally imposed under state law. *See* section 6901(a); *see further Feldman v. Commissioner*, 779 F.3d 448 (7th Cir. 2015) (concluding that the buyer must be "liable for the [target company's] debts under some provision of state law").

[6] *See A. Gadley Enterprises Inc. v. Department of Labor and Industry*, 135 A.3d 1131 (Pa. Commw. Ct. 2016) (explaining circumstances of transaction do not absolve purchaser from compliance with bulk-sale procedures and that "purchasers, like all other Pennsylvanians, are presumed to know the law") (internal quotes omitted).

[7] *See e.g., Tri-Financial Corp. v. Department of Revenue*, 495 P.2d 690 (Wash. Ct. App. 1972) (explaining that successor liability is a "rational means of collecting taxes which might otherwise be uncollectable").

[8] *See, e.g.*, Mass. Gen. Laws ch. 62C, section 51.

[9] The bulk-sale procedure should not be conflated with the sales tax exemption available in most states, which is often referred to as a bulk-sale or occasional sale exemption for sales tax purposes. *See, e.g.*, Idaho Admin. Code r. 35.01.02.099. While both concepts should be considered in the context of an asset sale, the bulk-sale procedures affect prior liabilities whereas the bulk-sale exemption involves the taxability of the assets transferred.

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business) if the bulk-sale notification procedures are not strictly followed.[10] Each state's laws are unique and the bulk-sale notification procedures can vary significantly from state to state; in some states, if the procedures are not followed (whether those specific to sales and use tax or income tax), the state is authorized to impose successor liability for state income taxes and other taxes.[11]

New Jersey

Under statutory law, when there is a sale, transfer, or assignment in bulk of any part — or the whole — of a business's assets, the purchaser is required to notify the Division of Taxation of the proposed sale and the price at least 10 days before taking possession of the property to be sold.[12] Within 10 days of receiving the notice, the division is required to notify the purchaser whether a possible claim for state taxes exists and include the amount of the state's claim.[13] But if a purchaser fails to give the required notice to the agency, it will be subject to a first priority right and lien for "any such taxes theretofore or thereafter determined to be due from the seller" and "shall be personally liable for the payment to the State of any such taxes theretofore or thereafter determined to be due."[14]

Pennsylvania

When a business sells or transfers in bulk 51 percent or more of its assets, Pennsylvania statutory law requires the seller to provide the Department of Revenue 10 days' notice of the sale before the transaction closes.[15] After providing that notice, the seller is required to present the buyer with a clearance certificate from the DOR, which indicates that all state tax reports have been filed and all state taxes paid to the state.[16] However, to the extent the buyer fails to obtain this certificate from the seller, the buyer is liable to the state for all unpaid taxes owed by the seller, regardless of whether the taxes have been settled, assessed, or determined at the time of sale.[17] Pennsylvania courts have also explicitly upheld the imposition of successor liability for corporate income tax under the state's bulk-sale procedures when notice was not provided and a clearance certificate was not properly obtained.[18]

Successor Liability Beyond Bulk-Sale Procedures

In some states, successor liability provisions may exist beyond bulk-sale procedures or sales-tax-specific provisions and the state may attempt to impose successor liability for all unpaid income taxes following an asset acquisition. In these states, a buyer may incorrectly assume that by purchasing the assets of the business directly, it is avoiding responsibility for unpaid state income taxes.[19]

Massachusetts

When a buyer purchases all or substantially all of a business's assets, a lien attaches to the purchased assets by operation of Massachusetts law unless a waiver of the lien is obtained.[20] To obtain a waiver, Massachusetts statutory law

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[10] *But see* Wash. Rev. Code sections 82.32.140(2), (3) (buyer liable for total amount of tax whereby any payment exceeding the purchase price is an obligation of the seller to the buyer).

[11] *Compare* Fla. Stat. sections 213.758(4), (5) (stating transferee "is liable for any unpaid tax" unless certificate of compliance from the Florida Department of Revenue is provided), *with* Hawaii Rev. Stat. section 237-43(c) (stating that absent "the required report of the bulk sale or transfer . . . the purchaser shall be personally liable to pay . . . the amount of all taxes, penalties, and interest . . . for taxes administered by the department"), *and* Mich. Comp. Laws section 205.27a ("If the purchaser or succeeding purchasers of a business . . . fail to comply with the escrow requirements of this subsection, the purchaser is personally liable for the payment of the taxes, interest, and penalties accrued and unpaid by the business of the former owner"), *and* Minn. Stat. section 270C.57(2)(b) ("If the successor fails to give the notice required [to the commissioner], the successor is liable for any unpaid taxes, interest, and penalties due from the transferring business to the extent of the purchase price"), *and* Or. Rev. Stat. section 314.310 ("When a taxpayer ceases to exist or is no longer subject to the jurisdiction of this state . . . being indebted for taxes upon or measured by net income, the transferee of the money or property of the taxpayer shall be liable for any such tax or deficiency in tax, including penalties and interest, imposed by law on the taxpayer and accruing or accrued upon the date of transfer, to the extent of the amount of money or value of the property received by the transferee"), *and* W.Va. Code section 11-10-11(f)(2), *but see* N.Y. Bus. Corp. Law ch. 4, section 906(3) (broad successor liability applicable only upon the filing of a certificate of merger by the New York Department of State).

[12] N.J. Stat. section 54:50-38(a).

[13] *Id.*; *see also* N.J. Div. of Tax'n, TB-60(R), "Tax: Bulk Sales, Transfers, or Assignments Tax Compliance" (Oct. 21, 2010).

[14] N.J. Stat. section 54:50-38(c).

[15] 72 Pa. Stat. section 1403(a).

[16] *Id.*; *see also* Pennsylvania Form REV-181, Application for Tax Clearance Certificate.

[17] *Id.*

[18] *See Department of Revenue v. Qwest Transmission Inc.*, 765 A.2d 818 (Pa. Commw. Ct. 2000) (holding that because required bulk clearance certificate was not obtained, the surviving corporation became liable for unpaid taxes of the predecessor and merged corporation).

[19] *See also* S.C. Code section12-54-124 (explaining that a lien will be imposed on the transferred assets for unpaid state taxes when most of the assets of a business are sold).

[20] Mass. Gen. Laws ch. 62C, section 51.

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requires that the DOR must be notified of the proposed transaction at least five days before the sale or transfer and that the buyer must identify the purchase price, terms, and location of the assets and agree to pay all taxes owed.[21] To the extent the waiver is not obtained, a lien attaches to the assets to satisfy any unpaid corporate income taxes.[22]

Texas

Similar to several of the states discussed earlier, Texas provides a mechanism to limit successor liability by either obtaining a certificate (or similar receipt or statement) of no tax due from the Comptroller of Public Accounts.[23] Generally, the transferred liability cannot exceed the purchase price of the business; however, the comptroller has the authority to claim the purchase price was not equal to FMV and, therefore, transfer the entire liability to the buyer.[24]

Notably, the comptroller may claim successor liability exists even if only a few (as compared with "substantially all") of a target's assets were transferred.[25]

Texas has also adopted an extremely broad "jeopardy determination" successor liability provision that appears to allow the state to transfer an outstanding tax liability to any party.[26] There is no requirement to demonstrate that a purchase of the business occurred or that the transfer was fraudulent.

Finally, Texas regulatory law provides that "the members of a combined group shall be jointly and severally liable for the combined tax reported on the combined report and any interest and penalty."[27] For Texas franchise tax purposes, the legal formation of an entity determines its filing responsibility — not an entity's treatment for federal income tax purposes.[28] Thus, each taxable entity that is organized or doing business in Texas is subject to the tax, even if it is treated as a disregarded entity for federal purposes. As a result, the imposition of joint and several liability for Texas group members often has broader implications as compared with federal income tax; specifically, although acquiring a disregarded entity for federal income tax purposes may be treated as an acquisition of assets, Texas would generally treat the transaction as an acquisition of the disregarded entity's stock — which, again, would result in joint and several liability even to the extent that only some disregarded entities within the Texas combined group are acquired.[29]

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[21] *Id.*

[22] Note that Massachusetts statutory law provides the state with a mechanism to satisfy a corporation's unpaid income taxes by imposing a lien that arises by operation of law. *See id.* A similar process exists in Massachusetts for other tax types, including sales and use taxes. *See* Mass. Gen. Law ch. 62C, section 44.

[23] *See* Tex. Tax Code Ann. section 111.020(a) ("If a person who is liable for . . . an amount under this title sells the business or the stock of goods of the business or quits the business, the successor to the seller or the seller's assignee shall withhold an amount of the purchase price sufficient to pay the amount due until the seller provides a receipt from the comptroller showing that the amount has been paid or a certificate stating that no amount is due.").

[24] *See* Tex. Tax Code Ann. section 111.020(f) (stating that obtaining a certificate of no tax due from the comptroller "is not a defense to an assessment of tax liability under Section 111.024 [*i.e.*, in the context of a "fraudulent transfer"] if: (1) the amount withheld from the purchase price is not sufficient to fully satisfy the liability of the seller of the business or stock of goods; and (2) the purchase price paid to the seller for the business or stock of goods is not reasonably equivalent to the value of the business or stock of goods."); *see further* Tex. Tax Code Ann. section 111.024(b) ("A transfer of a business or the assets of a business is considered to be a fraudulent transfer . . . if the taxpayer made the transfer or undertook the transaction . . . without receiving a reasonably equivalent value in exchange for the business or business assets subject to the transfer or transaction.").

[25] *See* 34 Tex. Admin. Code section 3.7 (defining what constitutes a purchase of a business and explaining that "a seller may have sold a 'business' even when few assets were transferred").

[26] Tex. Tax Code Ann. section 111.022 ("If the comptroller believes that the collection of a tax required to be paid to the state or the amount due for a tax period is jeopardized by delay, the comptroller shall issue a determination stating the amount and that the tax collection is in jeopardy.").

[27] *See* 34 Tex. Admin. Code section 3.590(g).

[28] *See generally* 34 Tex. Admin. Code section 3.581 (Taxable and Nontaxable Entities).

[29] Although this article focuses on successor liability in the context of asset acquisitions, some transactions may involve acquiring the stock of an entity that has historically filed within a consolidated or unitary combined group for state tax purposes. Despite not acquiring the entire consolidated or combined group, it should be acknowledged that joint and several liability for each group member may apply. *See, e.g.*, Or. Rev. Stat. section 317A.113 (for purposes of the Oregon corporate activity tax: "All members of a unitary group during the tax year or periods for which additional tax, penalty or interest is owed are jointly and severally liable for such amounts. Although the reporting person shall be assessed for the liability, amounts due may be collected by assessment against any member of the unitary group or pursued against any member of the unitary group"); *see further* Wis. Stat. Ann. section 71.255 ("The members of a combined group shall be jointly and severally liable for costs, penalties, interests, and taxes associated with the combined report.").

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Potential Applicability of Equitable Common Law Doctrines

Absent a statutory or regulatory exception, successor liability may be imposed on an asset sale based on an equitable doctrine. Many states have extended successor liability to buyers through various common-law doctrines based on the relationship between the successor and the transferor, including the mere continuation doctrine and de facto merger doctrine. Although the doctrines are occasionally applied interchangeably, many states focus more heavily on specific factors for purposes of considering whether each theory applies. Determinations as to whether a mere continuation or de facto merger has occurred is a fact-intensive inquiry relying on an overall sense of equity and fairness, which may be difficult to demonstrate in some instances.[30]

Mere Continuation Doctrine

Under the mere continuation doctrine, a successor may be determined to be so similar to a predecessor that it is reasonable to conclude there has been no change in identity between the two companies, even if the predecessor dissolved and the buyer in no way represents itself as the successor to the business.[31] Some states only apply the mere continuation doctrine to the extent assets are transferred for less than adequate consideration, while some jurisdictions have focused primarily on whether a buyer was provided notice of the liability before sale.[32]

De Facto Merger Doctrine

When an asset purchase resembles a merger, many states will treat the purchasing company as if it were the survivor of a merger, referred to as a "de facto" merger (that is, merger "in fact"). Successor liability after a de facto merger is the same as if a statutory merger occurred. Most courts consider the following factors when analyzing whether a de facto merger occurred:

- continuity of ownership or continuity of shareholders;
- continuity of the enterprise, including management, personnel, physical location, aspects, and the general business operation;
- cessation of the seller's ordinary business, along with dissolution as soon as practically and legally possible; and
- assumption by the successor of liabilities ordinarily necessary for uninterrupted continuation of the predecessor's business.[33]

While it's by no means typical to apply equitable common-law doctrines in the context of state income taxes, buyers should be aware that these principles further expand a tax authority's ability to impose successor liability.[34]

Mitigating the Risk of Successor Liability

The states discussed here are not the only jurisdictions with the authority to hold a purchaser of assets liable for income tax liabilities incurred by a seller. A purchaser of assets may be able to mitigate the risk of being held liable for the seller's unpaid income taxes by strictly following a state's bulk-sale procedures or obtaining a waiver of a lien. However, complying with these provisions can vary significantly by state and become

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[30] For purposes of this article, the types of scenarios that may invoke the state equitable doctrines discussed in the context of acquisitions (*i.e.*, pre-transaction restructuring) will not be covered.

[31] Federal courts have historically referred to the concept of substantial continuity as opposed to mere continuation. The federal test generally focuses on whether there is a continuation of the corporate entity of the selling entity as opposed to whether there is a continuation of the seller's business activities. *See, e.g., Mickowski v. Visi-Trak Worldwide LLC*, 415 F.3d 501 (6th Cir. 2005) (distinguishing the federal substantial continuity successor liability doctrine with Ohio's mere continuation doctrine).

[32] *Katzir's Floor & Home Design Inc. v. M-MLS.com*, 394 F.3d 1143 (9th Cir. 2004) (applying California law and explaining "inadequate consideration is an 'essential ingredient' to a finding that one entity is a mere continuation of another"); *see further Lewis v. Blackman Plumbing Supply LLC*, 51 F. Supp. 3d 289 (S.D.N.Y. 2014) (applying New York law and stating that notice of the claim before acquisition is critical to any finding of successor liability).

[33] Some factors have been viewed as more important by courts when evaluating the de facto merger theory (as compared with mere continuation), including whether the acquiring company paid with its own stock instead of cash, and whether a significant number of additional obligations were assumed. *See, e.g., Sedbrook v. Zimmerman Design Group*, 526 N.W.2d 758 (Wis. Ct. App. 1994) (buyer's assumption of liabilities was "necessary to the uninterrupted continuation of the business"); *see also Fox v. Sunmaster Products*, 821 P.2d 502 (Wash. Ct. App. 1991) (explaining that "usually the seller's shareholders acquire shares in the purchaser corporation in exchange for their stock, rather than selling for cash" when describing de facto merger).

[34] As recently as January 5, a state court issued an opinion applying the common law doctrine of de facto merger, though in relation to state unemployment compensation taxes. *See Four Seasons Logging LLC v. Department of Labor and Industry*, No. 347 C.D. 2022 (Pa. Commw. Ct. Jan. 5, 2024).

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burdensome when a target business operates in multiple states. Further, the timeline for obtaining a certificate or complying with bulk-sale procedures (for example, notice in advance of the transaction) may not be viable in some instances.[35]

Buyers should also consider factual circumstances that may affect the likelihood of successor liability issues. Does the transaction involve acquiring only a portion of the seller's existing assets, and if so, does the seller intend to continue its business in a state and file returns? And does the seller intend to terminate its tax presence in a state where the purchased assets were located, or is the seller no longer operational as a result of the transaction?

Buyers should be aware of each state's obligations and the potential risk of inheriting income tax liabilities — both known and unknown — in the states where the target business operates. The parties to a transaction can also negotiate contractual protections to mitigate the risk of successor liability. Specifically, a buyer may require the seller to provide an indemnity for any unpaid federal and state taxes and withhold a percentage of the purchase price in escrow to cover potentially unpaid taxes.[36] ■

[35] *See e.g.*, 35 Ill. Comp. Stat. 5/902(d) (stating "the purchaser . . . shall, no later than *10 business days* before the sale or transfer, file a notice of sale or transfer of business assets with the Department . . . if the purchaser or transferee fails to file the above described notice of sale with the Department within the prescribed time, the purchaser or transferee shall be personally liable to the Department for the amount owed hereunder by the seller or transferor but unpaid, up to the amount of the reasonable value of the property acquired by the purchaser or transferee"), *and* R.I. Gen. Laws section 44-11-29(a) ("The sale or transfer of . . . the assets of an entity . . . shall be fraudulent and void as against the state unless the . . . entity . . . at least *five (5) business days* before the sale or transfer, notifies the tax administrator of the proposed sale or transfer . . . by requesting a letter of good standing from the tax division.").

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