Top Five State and Local Tax Issues to Consider When Buying the Assets of a Business

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Top Five State and Local Tax Issues to Consider When Buying the Assets of a Business

The failure to address such matters can take what looks like a good strategic decision and turn it into a poor investment.

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Depressed values during an economic downturn may motivate corporate decision-makers to acquire businesses in an effort to improve enterprise capability, market penetration, product mix, and the production process. While business strategies drive the decision to acquire a particular business, the form of the transaction drives a multitude of tax implications. When choosing to acquire the assets of a business, a number of state and local tax issues can significantly affect the overall acquisition cost. The following discussion examines the top five state and local tax issues to consider when acquiring the assets of a business. These issues are:

(1) The seller's unpaid taxes.
(2) Taxes triggered by the transaction.
(3) Credits and incentives.
(4) Income and franchise taxes.
(5) Sales and use tax processes.

(While some of these issues might arise also in the context a stock purchase that is treated as a deemed asset acquisition pursuant to IRC Section 338 , a discussion of the state and local tax issues associated with deemed asset acquisitions is beyond the scope of this article. For more on state aspects of that federal provision, see, e.g., Millar, "Does an IRC §338(h)(10) Election Produce Business or Nonbusiness Income?," 17 J. Multistate Tax'n 8 (July 2007).)

Unpaid Taxes of the Seller

One might assume, incorrectly, that by buying the assets of a business, the buyer is avoiding responsibility for any unpaid state taxes of that business. That assumption may prove costly, as it is common for states to impose successor liability for a business's unpaid taxes when a buyer acquires all or substantially all of the assets of the business. In some states, successor liability provisions apply when more than 50% of the assets are acquired. Historically, such provisions are included as part of a state's sales and use tax laws. Accordingly, these provisions often, though not always, were applied only to unpaid sales and use taxes of a seller. What might come as a surprise is that some states are amending their tax laws to include successor liability provisions with regard to any unpaid income taxes of the seller. Some other states are promulgating uniform tax provisions giving rise to successor liability for the seller's unpaid taxes of all types. As states face greater budget challenges during an economic downturn, they are more inclined to identify opportunities to enforce such provisions to collect unpaid taxes.

Successor liability may arise also in the context of asset acquisitions involving pass-through entities, such as S corporations and partnerships. Many states do not impose an entity-level income tax on a pass-through entity, instead subjecting the entity's owners to tax on their distributive shares of the entity's income. Nevertheless, the pass-through entity often has a reporting and remittance responsibility in the form of withholding with respect to state income tax. Many states require a pass-through entity to withhold tax on the distributive shares (or in some cases, e.g., California, on the actual distributions) of income with respect to the entity's nonresident owners. A buyer of the assets of such a pass-through entity should be aware that the buyer might be held liable for the seller's unpaid withholding liabilities. Moreover, some states do impose entity-level income taxes on pass-through entities, thus creating potential successor liability for those tax liabilities if unpaid by the seller.

State liens or injunctions. In seeking to recover a seller's unpaid taxes, states also have other means at their disposal that can significantly disrupt a buyer's ability to do business and result in the buyer's having to pay the seller's tax debt. Some states have provisions whereby the state can subject the target assets to a lien that cannot be removed until the seller's unpaid tax debt is satisfied. In order to remove the lien on assets it acquired, a buyer may find it easier to just remit the tax on the seller's behalf, even if the responsibility for the unpaid tax does not lie with the buyer. Also, a state may refuse to register the buyer for sales and use tax collection purposes until the seller's unpaid taxes are remitted.

And consider Florida's approach. That state has enacted legislation (H.B. 5801, 5/28/10; Laws 2010, ch. 166, §8, adding Fla. Stat. §213.758) giving the state's taxing authority the ability to seek an injunction denying the buyer the right to conduct business in the state until all the seller's taxes are paid (Fla. Stat. §213.758(4)(c)). Thus, while a buyer may not be legally liable for the seller's unpaid taxes, the buyer might find that it must pay that tax debt in order to conduct business.

Statutes of limitations. Generally, under their statutes of limitations, the states have between three and five years to assess a tax, depending on the particular jurisdiction. Some states extend the statute to six years under specified circumstances, such as when there is a significant understatement of income or an intent to evade tax. Moreover, if a tax return was not filed for a particular year or other tax period, the statute of limitations generally is unlimited and the state can assess tax at any time for that period.

Even if the tax exposure for failing to file is not significant on an annual basis, the combined exposure, along with applicable interest and penalties, for all tax years open under the statute can be significant. Thus, conducting a pre-closing examination of the seller's tax reporting practices and policies is warranted, in order for the buyer to understand the nature and magnitude of the seller's unpaid tax liabilities to which the buyer will succeed or, in some circumstances, will find itself having to remit in order to conduct business. With that understanding, the buyer then can determine how best to mitigate the risk of successor liability.

Mitigating successor liability. Frequently, by complying with certain requirements under a state's tax laws, a buyer may be able to limit liability for the seller's unpaid taxes. Many states' successor liability provisions include a requirement for notification to the state regarding a transaction involving the purchase of all or a significant portion of the assets of a business. Often referred to as a "bulk sale notification requirement," this type of provision typically requires a portion of the purchase price to be held in escrow while giving the state a period of time to audit the seller and determine if there are any outstanding tax liabilities, which then can be paid out of the escrowed funds. Compliance with bulk sale notification provisions, regardless of whether the state actually conducts an audit, can result in elimination of the buyer's successor liability for the seller's unpaid taxes.

The parties can always negotiate. Buyers and sellers do not always comply with these notification provisions. Sellers want to receive their sale proceeds as soon as possible. As a result, it is not uncommon that the contract of sale will have a "waiver of notification" clause.

With regard to negotiation, various approaches are available to mitigate the risk of successor liability. For example, the seller might be required to indemnify the buyer for tax assessments associated with periods prior to the sales transaction. A buyer might want to consider whether an indemnity clause will be enforceable, however, because a seller that subsequently goes out of business or moves to a new location might be difficult to locate. Such scenarios could make satisfaction of the indemnity obligation doubtful.

Alternatively, the buyer might require that the seller present, at the time of closing, tax clearance certificates from the states indicating that all taxes have been paid, or, if appropriate, enter into voluntary disclosure agreements under which the seller files any missing returns and pays the related taxes. Another option might be for the buyer to retain in escrow, for a specified period, an agreed-upon portion of the purchase price to cover future assessments against the seller for prior unpaid state taxes. Finally, a buyer might choose to demand an adjustment of the purchase price to better reflect the value of the acquisition by taking into account that the buyer might have to cover the seller's unknown unpaid tax liabilities.

Because state taxing authorities can hold a buyer responsible for the seller's unpaid taxes, the buyer would clearly be well advised to explore the potential for unpaid taxes on the part of seller and to understand the mechanisms the state taxing authorities employ to hold the buyer responsible. The buyer can mitigate any potential liability by requiring the seller to comply with the "notification and demand" statutes as provided for under state law. Where the seller has not complied with these provisions, the contract of sale should address this potential liability.

Taxes Triggered by the Transaction

The asset acquisition itself can trigger certain state and local taxes that are imposed on the transaction. The most common of these transaction taxes are the sales tax and the real estate transfer tax.

Sales tax. Most states impose a tax on sales of tangible personal property. Thus, the acquisition of the assets of a business generally will be subject to sales tax unless the sale qualifies for an exemption or exception. For example, all states that impose a sales tax provide an exemption for the purchase of property for resale, provided that the seller obtains a valid resale certificate from the buyer. Accordingly, a bulk sale of inventory generally will be exempt from sales tax as a purchase for resale by the buyer.

Some states also provide a sales tax exemption when tangible personal property is purchased for use in a specific activity, such as manufacturing, research and development, or pollution control. To claim such an exemption, the buyer generally must provide the seller with documentation attesting to the exempt use. The seller must retain the documentation so that it is available on audit for presentation to the state upon request.

Many states also provide a sales tax exemption for occasional or casual sales. While this exemption should be considered when all of a business's assets are sold, its application should be viewed with caution, as the definition of "occasional" or "casual" sale differs across the states. The statutory exemption may be limited based on the type of asset sold, the number of sales per year, the purchase price, and the number of different buyers per year. For example, a casual sale exemption generally does not apply to the sale of registered vehicles. And in some states, the exemption does not apply to assets used in a business for which the seller is a registered dealer (i.e., authorized to collect sales and use tax). Depending on the state and the particular assets involved, an acquisition not qualified under this exemption may trigger a significant sales tax liability.

Real estate transfer tax. An acquisition of assets consisting of real property might trigger real estate transfer taxes at the state, county, and/or local level. Generally, real estate transfer taxes are paid upon recording the deed reflecting the change in ownership. Depending upon the jurisdiction, the legal liability for the tax may fall on the seller or the buyer. Regardless of legal liability, however, buyers and sellers frequently determine responsibility for the real estate transfer taxes on their own when negotiating the sales contract.

Accounting for the tax liability. As indicated above, taxing jurisdictions that impose real estate transfer taxes vary as to whether the tax is the legal liability of the seller or the buyer. While sales taxes generally are imposed on the buyer, the funds usually are collected from the buyer and remitted to the state by the seller, although sometimes the buyer remits the tax directly to the state. An understanding, up front, of the nature and magnitude of any sales or real estate transfer taxes triggered by the transaction enables the buyer to plan for the taxes and, if appropriate, adjust the purchase price, negotiate a sharing of the responsibility for the tax, or restructure the sale.

Credits and Incentives

A buyer will need to understand the implications of the transaction on both statutory tax credits and negotiated credits and incentives. When the assets of a business are acquired, the statutory tax credits available for use in future tax periods typically remain with the selling entity and do not transfer to the buyer. In addition, credit recapture provisions often are triggered if an asset is disposed of prior to a required holding period, thereby requiring the seller to repay tax credits previously claimed and/or to lose unused credits it had earned. The seller might seek to negotiate reimbursement from the buyer for this cost.

Also, in some cases statutory credits typically available to a buyer upon the acquisition of an asset might not be available to the buyer if the seller had previously claimed the credit on its original acquisition of the asset. In that same vein, the buyer should consider the potential for the transfer of any credit and incentive agreements previously negotiated by the seller, as well as possible opportunities for the buyer to negotiate new credit and incentive agreements.

Based on the foregoing, seller-negotiated credit and incentive agreements should be evaluated to determine whether, in fact, they will survive the transaction and provide the buyer with benefits. Typically, these agreements are binding between the legal entity (e.g., the seller) that negotiated the agreement and the governing body or its political subdivision offering the incentives. The agreement may not apply to the new legal entity acquiring the assets. Thus, the buyer should review any such agreement to ascertain whether it contains provisions whereby it can be assigned or transferred. Moreover, if assignment or transfer is permitted, the agreement might require advance notification to and approval by the governing body. A buyer will want to make sure that those requirements are met in order to obtain benefits on a post-transaction basis. If the agreement does not provide for assignment or transfer, and thus will not afford the buyer post-transaction benefits, a determination of the resulting tax or other costs is warranted in order to properly value the assets being acquired. A buyer might seek to revise the purchase price if its taxes and/or other costs will increase dramatically from the taxes and costs currently incurred by the seller.

Before determining that a purchase price adjustment is warranted, however, a buyer should consider its ability to negotiate new credit and incentive agreements. The buyer may consider consolidating the newly acquired operation with that of another existing operation. A facility rationalization decision might be influenced by offers of credits and incentives from competing states. Similarly, the acquisition of business assets with the intention to continue their operation in the current location might also provide opportunities to negotiate credits and incentives. A buyer might consider additional investment in the newly acquired facility to upgrade or expand the operation, retain and train current employees, and/or create new jobs at the location. Nevertheless, such investments may not be desirable or viable but for an offer of credits and incentives from the state.

As indicated by the above analysis, a buyer would be wise to consider the potential credit recapture implications for which a seller might seek reimbursement, as well as the buyer's ability to obtain benefits under seller-negotiated agreements or under the buyer's own newly negotiated credit and incentive agreements. These considerations should be addressed early in the process to ensure compliance with any requirements under existing agreements, and to gain an understanding of the potential for benefits under new agreements. A complete understanding of the credit and incentive implications prior to negotiations can influence the buyer's perception of value of the business assets.

Income and Franchise Taxes

An understanding of the income/franchise tax implications of the acquisition can influence the buyer's decisions with respect to the purchase price, where to position the operation in the existing organizational structure, and how to fund the acquisition.

Whether the acquisition will increase or decrease the buyer's income/franchise tax liability on a post-transaction basis depends on several variables. Acquiring the new assets might give rise to an income/franchise tax filing obligation in states where the buyer had not previously been obligated to file returns. Also, the acquisition might affect income/franchise tax liabilities in states where, historically, the buyer has filed returns. A change in tax liability may result from the effect of the acquisition on a particular state's applicable reporting methodology, tax base, and/or specific computation of taxable income.

States differ, of course, with respect to their required reporting methodology. Some states require companies to file income tax returns on a separate-entity basis, while others require combined filings with affiliated entities all of which are engaged in a unitary business. Acquiring a new operation, whether in the form of an existing legal entity or through a newly established entity, can affect the state reporting methodology. Similarly, the acquisition might give the acquiring entity an opportunity to make or forgo elections that affect the reporting methodology; for example, an election to file on a water's-edge as opposed to a worldwide combined basis. The effect on the reporting methodology directly impacts the income/loss included in the income tax return.

Similarly, where in its existing structure the buyer positions the newly acquired operation also affects the income/loss included in its income tax return. For example, if the acquired operation is currently generating losses, the buyer might choose to place it within an existing entity that is generating income or in a disregarded entity (e.g., a single-member limited liability company) so that the losses may be used to offset income of the existing operations.

In addition to understanding the post-transaction filing obligations, reporting methodology, and effect on the filing entity's or group's income or loss, the acquisition's impact on each state's computation of taxable income is also of significance. A multistate business apportions its income among the various states with which it has tax nexus (i.e., a connection with a state that gives the state the right to impose its taxing jurisdiction). While apportionment methodologies vary by state, they generally employ one or more of the following three factors: property, payroll, and sales. Each factor is a ratio in which, generally, the numerator is the business's property, payroll, or sales in the state; and the denominator is the business's total property, payroll, or sales everywhere. Acquiring the assets of a business likely will affect the computation of each factor and the overall apportionment percentage computed for each applicable state. As noted above, whether an acquisition will result in an increase or decrease in the buyer's income tax liability depends on the acquisition's effect on state filing obligations, reporting methodologies, tax base, and apportionment of income across the states.

Factoring in the income tax effects when pricing the acquisition.

A buyer would be wise to create a model for the income/franchise tax implications in order to understand the anticipated post-transaction state income tax reporting profile. Doing so early in the process will permit the buyer to appropriately value and price the business assets, and to determine what entity to use for the acquisition and where to place the assets in the existing business structure. All these determinations, of course, should be made prior to completing negotiations and closing the deal.

Similarly, modeling the post-transaction tax reporting profile can influence a buyer's decision regarding the way to fund the acquisition. As an example, if one company (a holding company or finance entity) in a group obtains funding from a third-party lender and then contributes those funds to its sister company, which is acquiring the assets, the acquiring company likely will not receive a tax benefit from the holding company's interest expense deduction if it files returns in separate-entity states.

Alternatively, if the holding company *lends* the funds to the acquiring entity, the acquiring entity may be able to utilize the tax benefit of the interest deductions, depending on the rules in the states in which it files returns. In determining state taxable income, some states disallow deductions for interest paid to a related party unless one of several enumerated safe harbors is satisfied. These safe harbors can include, for example, interest paid to a related party that (1) ultimately pays the interest to a third-party lender outside the affiliated group, or (2) is subject to state tax on the interest income at an effective tax rate at least equal to some specified minimum. Another common safe harbor is for interest paid to a foreign (i.e., non-U.S.) related party in a nation that has a comprehensive income tax treaty with the U.S. Thus, an evaluation of the income tax implications in each applicable state can be useful in determining the buyer's approach to funding the acquisition.

Nonincome-based franchise taxes. In addition, franchise taxes based on measures other than income can also have implications in the choice of funding approaches. Franchise taxes are often based on the value of the taxable entity. And, as with income taxes, the computation of the franchise tax base is not uniform across the states. In addition to an entity's net worth, which typically is included in the franchise tax base, some states also include affiliate indebtedness. Thus, depending on the particular states involved, the choice to fund an asset acquisition with affiliate indebtedness may affect the measurement of the franchise tax base.

In summary, an understanding of the acquirer's post-transaction income and franchise tax reporting profile can influence the buyer's decision on funding the acquisition with related-party or third-party debt. Similarly, it can affect the decision as to the particular entity that will either obtain funds from third-party sources or fund the acquisition with existing resources.

Sales and Use Tax Processes

The acquisition of the assets of a business can have sales and use tax implications on a post-transaction basis with regard to not only the newly acquired operations, but also the buyer's existing businesses. That latter impact is often overlooked. Moreover, the changes that must be made to the buyer's processes as a result of the acquisition can be costly.

The acquisition of assets can create sales and use tax filing obligations in new jurisdictions for the buyer. In that situation, the buyer will need to register as a vendor and obtain a seller's permit in those jurisdictions so that it can properly and timely collect and remit taxes. Moreover, having to collect tax in the new jurisdictions might trigger an obligation for the buyer to collect tax not only from customers of the newly acquired operations but also from its existing business customers from whom it has not historically had to collect sales or use taxes.

In order to comply with applicable sales and use tax collection and remittance obligations, a buyer may need to upgrade its enterprise resource planning (ERP) system. At the time of invoicing, the ERP system, taking into account the items sold and the jurisdiction involved, must be capable of determining whether tax is due and, if so, the appropriate amount of tax to include on the invoice. It will require an analysis of whether the existing ERP system is capable of handling the increased number of jurisdictions and/or the change in product mix. Some additional investment may be required to program the existing system with the appropriate tax decision codes, based on the taxability of each of the products in each jurisdiction. In some instances, the existing system will not be sufficient to handle the magnitude of the changes arising from the acquisition, leading to a more significant investment in a system upgrade.

Similarly, the acquirer will need to assess its sales tax reporting process to determine whether that will require an upgrade. The assessment might reveal that the increased sales tax reporting obligations require a shift from a manual tax reporting process to an automated system. A buyer that already has an automated tax reporting system will, at a minimum, have to make program changes to enable it to: (1) access the appropriate information from the ERP system associated with the new filing jurisdictions and/or new products, and (2) properly report the tax for compliance purposes. In some cases, the buyer may determine that the existing automated system requires an upgrade to address the more-involved sales tax compliance burden.

Resale certificates. Another frequently overlooked aspect of an asset acquisition involves exemption certificate compliance and maintenance. Sales tax exemption certificates typically are issued to a vendor by the purchaser of otherwise taxable goods or services using "doing business as" names rather than an entity's legal name. Since the acquired operation will now be conducted under a new legal entity, the buyer of the business assets likely will have to issue new exemption certificates to vendors and may not be able rely on resale certificates customers issued to the former owner of the assets.

The need to obtain new sales tax exemption documentation might depend on several factors, including whether the business will continue to operate under the same business name as before the acquisition, as well as the applicable state requirements. In addition, if the asset acquisition has given rise to sales and use tax collection obligations in new states, the buyer might also need to collect sales tax exemption documentation from its own legacy customers in those states. Failure to obtain valid exemption certificate documentation might hinder the buyer's ability to support the exempt nature of a sale when subject to an audit. If a buyer does not have an exemption certificate compliance process, or its process has historically been manual, the new asset acquisition might warrant an investment in an automated exemption certificate management process.

The costs associated with system changes that may be necessary as a result of the asset acquisition can be significant. The possible need for such funding should be evaluated early in the process so that it can be taken into consideration when determining the buyer's anticipated return on investment.

Conclusion

The acquisition of the assets of a business can give rise to a variety of state and local tax issues. A thorough evaluation of those issues can make the difference when seeking to realize a desired rate of return on investment. Accordingly, all such issues should be carefully considered by the buyer prior to entering negotiations with the seller. The failure to address such matters can take what looks like a good strategic decision and turn it into a poor investment. **[]**

Sidebar

Practice Note: Taxes Triggered by the Transaction: Acquiring Assets vs. Stock

As discussed in the accompanying article, acquiring the assets of a business can have consequences with regard to various taxes triggered by the transaction. These can include sales taxes and real estate transfer taxes, for which a seller might seek to negotiate reimbursement.

Of course, the acquisition also can trigger income tax consequences to the seller. Income tax consequences arising from an asset transaction, however, will likely differ from such consequences arising from a stock transaction. Those differences may depend on the seller's business structure, its basis in the assets as compared with its basis in the stock, and other tax attributes.

While a comparative analysis of the tax implications of stock transactions versus asset transactions is beyond the scope of the accompanying article, it is nevertheless appropriate to note the possibility that the seller might seek compensation for its incremental income tax costs, if any, arising out of a buyer's desire for an asset transaction.

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