

Mergers and Acquisitions State and Local Tax Aspects

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PRELIMINARY CONSIDERATIONS

1. Get SALT people involved at the outset.
2. The application of state tax laws to corporate transactions is often unclear.
 - Many states do not have the equivalent of the Joint Committee on Taxation staff.
3. Corporations that file consolidated federal income tax returns often file separate returns in one or more states or file on a combined basis with different group members.
 - This can result in dramatic differences between the federal and state taxation of transactions.
 - It can also mean that the target has joint and several liability for taxes of other entities that are not involved in the transaction.

INCOME TAX ISSUES

- Nexus Issues
- Business v. nonbusiness income.
 - Asset acquisitions.
 - Stock acquisitions.
- 338(h)(10) transactions.
- Acquisitive reorganizations under section 368.
- Spin-offs and restructurings.
- Net operating loss carryovers in acquisitions.
- Ongoing planning.

INCOME TAX NEXUS BY ACQUISITION TARGET

- Acquiring target's assets located in a jurisdiction where acquirer is not taxable will often cause acquirer to become taxable in that jurisdiction.
- Acquiring target's stock may result in acquirer and target having to file state combined returns if engaged in a unitary business.
 - A unitary relationship may not be established immediately unless the corporations have a prior business relationship.
- Effect of acquisition on acquirer's income apportionment factors.
- Economic or attributional nexus.

BUSINESS v. NONBUSINESS INCOME

SIGNIFICANCE:

- Most states tax business income differently than nonbusiness income.
- Business income is typically apportioned among all the states in which a company does business under a formula (often based on a combination of the location of property, payroll, and sales, although use of sales-only formulas is increasing).
- Nonbusiness income is typically allocated to one state only.
 - The state of physical location, in case of tangible property.
 - The state of commercial domicile in case of good will and other intangible property.
- Corporations usually prefer gain on the sale of a business to be nonbusiness income, but this is not always the case.

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

- UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT (“UDITPA”):
 - Business income is: “Income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer’s regular trade or business operations.” Section 1(a).

BUSINESS v. NONBUSINESS

INCOME: ASSET SALES

Two tests for business income have been developed by the courts

All courts agree that gain on the sale of property (e.g., inventory) that is sold in the regular course of business produces business income, even if sold in bulk in an extraordinary transaction (the “transactional test”).

- The courts have divided on whether gain on the sale of property that is used to produce business income (e.g., a factory) is business income (the “functional test”).
- Cases holding that there is a functional test include Gannett Satellite Information Network Inc. v. Montana Dep’t of Rev., 348 Mont. 333 (2009); Welded Tube Co. v. Commonwealth, 101 Pa. Commw. 32, 515 A.2d 988 (1986).
- Cases holding that there is no functional test include Western National Gas Co. v. McDonald, 202 Kan. 98, 446 P.2d 781 (1968); McVean & Barlow, Inc. v. N.M. Bur. Of Rev., 88 N.M. 521, 543 P.2d 489 (1975).

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

Should there be a functional test?

YES: Tax Policy. The value of an asset that is used in the business is attributable to its ability to produce future business income and gain on its sale should be business income.

NO: Statutory Language. The statute says “and,” not “or.” Gain on the sale of an asset is nonbusiness income unless the disposition of the asset is a regular incident of the taxpayer's business.

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

LIQUIDATING SALES

- Some courts that follow the functional test have held that gain on the sale of business assets that would ordinarily be business income is nonbusiness income if the sale proceeds are distributed to the shareholders and not reinvested in the seller's business. See, e.g., Laurel Pipe Line Co. v. Comm'w of Pa., 537 Pa. 205, 642 A. 2d 472 (1994); Lenox, Inc. v. Tolson, 353 N.C. 659, 548 S.E.2d 513 (2001).
- The same principle may be applied to a corporation that is deemed to have sold its assets and liquidated under section 338(h)(10) of the Internal Revenue Code. See, e.g., Canteen Corp. v. Comm'w of Pa., 818 A.2d 594 (2003), aff'd, 854 A.2d 440 (Pa. Sup. Ct. 2004); ABB C-E Nuclear Power Inc. v. Mo. Dir. of Rev., 215 S.W.3d 85 (Mo. 2007).

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

LIQUIDATING SALES

- What is a liquidation?
 - A distribution of the sale proceeds to the shareholders?
 - The sale of a business? See Glatfelter Pulpwood Co. v. Comm’n of Pa, 19 A.3d 572 (Pa. Comm. Ct. 2011).
 - No liquidation when sale was of only some of the assets of a worldwide business and sale proceeds were not distributed to shareholder. Elan Pharmaceuticals, Inc. v. Director, Div. of Tax. (N.J. Tax Ct. 2014)
- Reinvestment of proceeds in a unitary business may prevent a “liquidation” for this purpose. Century Tel, Inc. v. Dep’t of Revenue (Ore. Tax Ct. 2010).

LIQUIDATING SALES

- Some courts have held that there is no liquidation exception to the functional test. Jim Beam Brands Co. v. Franchise Tax Bd., 34 Cal.3d 874 (2005); Crystal Communications, Inc. v. Oregon Dep't of Revenue, 353 Ore. 300, 297 P.3d 1256 (2013); First Data Corp. v. Arizona Department of Revenue, 233 Ariz. 405, 313 P.3d 548 (AZ. Ct. App. 2013); Harris Corp. v. Arizona Department of Revenue, 233 Ariz. 377, 313 P.3d 1143 (AZ. Ct. App. 2013).

BUSINESS v. NONBUSINESS INCOME: ASSET SALES

CONCLUSIONS.

- The law is unclear as to whether there is a functional test. Taxpayers should not hesitate to dispute department of revenue determinations.
- Taxpayers can take inconsistent positions in different states. Oracle Corp. v. Ore. Dep't of Rev. (Ore. Tax Ct. 2010).

BUSINESS v. NONBUSINESS INCOME: STOCK SALES

- Gains from the sale of a subsidiary's stock will generally be business income only if the parent and the subsidiary were engaged in a unitary business. Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992).
- The mere intent to create a unitary relationship does not convert a subsidiary's stock to a business asset if it is sold before the relationship is created. Calif. F.T.B. Legal Ruling No. 2012-01.

338(h)(10) TRANSACTIONS

- Under section 338(h)(10) of the Internal Revenue Code, a sale of the stock of a corporate subsidiary or an S corporation is treated as if the corporation had sold its assets and distributed the sale proceeds to its shareholders in liquidation. The actual sale of stock is ignored.
- The incident of tax is the deemed sale of the corporation's assets by the target corporation.
- The buyer and the seller must elect to have section 338(h)(10) apply.
- The provision's purpose is to allow the buyer of a corporation's stock to step up the basis of the corporation's assets to reflect the purchase price, as it would if it bought the assets directly.

338(h)(10) TRANSACTIONS

- The states generally follow section 338(h)(10) in that they allow the basis step-up of the target corporation's assets and otherwise respect the fiction of the deemed sale and liquidation.
- Whether 338(h)(10) treatment is available can affect pricing.
- California and Wisconsin allow taxpayers to elect into or out of section 338(h)(10) regardless of whether they elect it for federal tax purposes.
- Treatment of deemed sale proceeds in receipts factor can be an important issue.

338(h)(10) TRANSACTIONS

TRAP:

- In the typical 338(h)(10) transaction, the selling parent and the target file consolidated federal income tax returns and the target's gain on the deemed sale of its assets is taxed on the parent's return that includes the target.
- If the parent and the target file separate state returns, there is no mechanism for including the target's gain on the deemed sale of its assets on a parent tax return. The tax on the gain is a liability of the target and the economic burden of the tax will be borne by the buyer. Newell Window Furnishing, Inc. v. Comm'r of Rev., 311 S.W.3d 441 (Tenn. Ct. App. 2008).
- Solution: Reduce the purchase price to transfer the economic burden of the tax to the seller.

338(h)(10) TRANSACTIONS

- NYS Tax Reform Legislation: need to identify stock on the day of purchase as being held for investment for income from that stock to be tax-free investment income.
- Is the target treated as a new corporation for this purpose so that it must make a new identification on the closing date, even though it may have made a prior identification?

TAX-FREE REORGANIZATIONS

- State income taxes generally conform to the federal reorganization provisions and a transaction that is a tax-free reorganization under IRC section 368 will be tax-free for state income tax purposes.
- **WARNING:** a transaction that is not subject to federal, state, and local income taxes may be subject to state and local gross receipts, sales, and real property transfer taxes.

NYS INVESTMENT INCOME IDENTIFICATION

- NYS Tax Reform Legislation: need to identify stock on the day of purchase as being held for investment for income from that stock to be tax-free investment income.
- The acquiring corporation in a merger should make a new identification on the closing date. There is no authority suggesting that an identification made by the merged corporation carries over.

SPIN-OFFS AND RESTRUCTURINGS

- The distribution of the stock of a subsidiary corporation will generally be tax-free to the distributing parent and the parent's shareholders if the corporations are each engaged in an active business, there is a non-tax business purpose for the distribution, and the distribution is not a device to distribute the parent's earnings and profits. IRC section 355.
- The states generally follow the federal treatment of spin-offs. A spin-off that qualifies under section 355 will generally be tax-free for state income tax purposes.

SPIN-OFFS AND RESTRUCTURINGS

AREAS OF NONCONFORMITY WITH FEDERAL RULES

- New Hampshire does not follow the federal rule that qualification under the active business test is determined on an affiliated group (and not a separate corporation) basis because it conforms to the Internal Revenue Code as in effect before the effective date of IRC section 355(b)(3).
- California statute conformed to section 355(b)(3) as of January 1, 2010, but, because the bill of which it was a part was not adopted by the 2/3 vote required for tax increases, it may have been invalid. It is understood that the FTB was applying it as if it were in force. This has apparently been corrected by legislation enacted in 2015.

SPIN-OFFS AND RESTRUCTURINGS

- Internal restructurings typically involve asset transfers that can have tax consequences.
- The distribution of assets from a subsidiary corporation to a corporate shareholder can result in the recognition of gain to the subsidiary under I.R.C. section 311(b).
 - The gain may be deferred for federal tax purposes if the corporations are filing consolidated returns, but it will be taxed immediately for state tax purposes in states in which the corporations are filing separate state returns.
- Transfers within a corporate group may result in sales or other transfer taxes.

NET OPERATING LOSS CARRYOVERS

- The states often have special rules for net operating loss carryovers (NOLs) that do not track the federal rules.
- Taxpayers should not assume that NOLs that are available for federal tax purposes will be available for state tax purposes.

NET OPERATING LOSS CARRYOVERS

- States often have shorter carryforward periods than the federal 20-year period.
 - NOLs that are still available for federal tax purposes may have expired in one or more states.
 - NOLs may be suspended, sometimes for state budgetary reasons.
- Some states allow NOLs only to the extent that they are attributable to in-state activities.
- Use of NOLs may vary if state combined group is different from federal consolidated group.
- Apportionment of NOLs may vary, affecting availability of NOLs in different states.

NET OPERATING LOSS CARRYOVERS

- Some states do not have a provision allowing NOLs or unused credits to move from the target corporation to the buyer in a tax-free reorganization comparable to IRC section 381.
- In those states, the NOLs may be extinguished in the transaction. See A.H. Robins Co., Inc. v. Director, 182 N.J. 77 (2004).
- Case law in some states has held that the target's NOLs nevertheless survive the transaction if the buyer after the transaction continues the target's business that generated the NOLs, *See, e.g., Oliver's Laundry & Dry Cleaning Co. v. Ariz. State Tax Comm.*, 19 Ariz. App. 442, 508 P2d 107 (1973); Thermatool Corp. v. Dep't of Rev. Services, 43 Conn. Sup 260, 651 A2d 763 (1994).
- WARNING: This is a potential problem when a corporation with NOLs is reincorporated in another state by merging into a new "shell" corporation.

NET OPERATING LOSS CARRYOVERS

- Idaho statute: NOL passes in a merger but not in a “C” reorganization or in a section 332 liquidation.
- Idaho Decision 25749 (2014) incorrectly holds that a wholly-owned subsidiary’s NOLs do not pass to its parent when it merges into the parent, citing IRC section 382. The Commission’s mistakes: (1) section 382 does not apply to a merger of a subsidiary into a parent, and (2) section 382 limits the use of the NOL but does not prevent it from passing to the parent.

SALES TAX ISSUES

- “Sale” is broadly defined to include all transfers of title or possession of goods for consideration “unless otherwise excepted”. Consideration is considered both cash and the assumption of liabilities.
- Exceptions –Sales of businesses must be specifically exempted in order to escape the sales tax.
 - Not a transaction occurring in the ordinary course of business - Isolated, Casual or Occasional sales.
 - Reorganization Exemption specifically provided by statute.

SALES TAX ISSUES

- Sales Tax Exemptions for Transfers in Incorporations, Mergers, Acquisitions, & Liquidations
 - Strict compliance with statutory language and/or regulations is mandatory or the exemption will be forfeited.
 - State sales tax analysis must be done before structuring the transaction based solely on federal income tax consequences, or significant sales taxes could be due.

Sales Tax Problem Areas

- Creation of new subsidiaries and drop down assets with parent receiving consideration in the form of stock and securities in the subsidiaries. Tennessee held a taxable sale occurred. In D. Canalle & Co. (Tenn. Jan. 17, 1989).
- Some states exempt transfers in exchange for an equity interest that occurs “at the time of organization of the entity”. New York, New Jersey and Vermont.
 - Later transfers may be taxable. Noar Trucking C. Inc., v. State Tax Commission 138 A.D. 2d 869 (3d Dept. 1988).

Sales Tax Problem Areas

- Section 351 incorporation transactions may be subject to sales taxes, although many states have partial exemptions.
 - Liabilities that are assumed or taken subject to may be treated as cash that is not eligible for exemption. Beatrice Co. v. SBE, 6 Cal. 4th 767, 863 P.2d 683 (1993).
 - New York's exemption applies only to transfers upon the organization of the transferee corporation.
 - The economically meaningless issuance of new stock to a 100% shareholder can result in sales tax even though a capital contribution of unencumbered assets for no new stock would be exempt. Petition of Weichbrodt, N.Y.S. Tax App. Trib. (2002).
 - A transfer to a dormant "shell" corporation is taxable. P-H Fine Arts Ltd. v. N.Y.S. Tax App. Trib., 227 App. Div. 2d 683 (3d Dep't 1996); Petition of Mohonk Oil Co., Inc., Tax App. Trib. (2009).

Sales Tax Problem Areas

SMLLC

- Transfer assets to SMLLC followed by the sale of the SMLLC interest.
 - New York– no sales tax due.
 - Washington State and California – sales tax will be due.

Sec. 338(h)(10)

- Application of Sec. 338(h)(10) to Sales Tax. Generally, for sales tax purposes the deemed asset sale is not treated as an actual sale, and the sales tax normally would not apply.

BULK SALES/SUCCESSOR LIABILITY ISSUES

- In order to protect their tax revenues, most states have one or more bulk sale or successor liability provisions in their tax laws.
 - These provisions generally require the seller and/or purchaser of the assets of a business to notify the appropriate taxing authorities of the sale within a certain number of days before the transaction.
 - The purpose of the request is to either:
 1. obtain a clearance certificate from the authorities stating that the seller has no outstanding tax liabilities; or
 2. be instructed by the authorities as to the amount that should be withheld by the purchaser from the purchase price to cover the outstanding tax liabilities of the seller.

DUE DILIGENCE

- Develop check-list of SALT issues.
- Vary the check-list for industry-specific and company-specific issues.
- Watch out for aggressive tax planning strategies.
- Focus on key states if time and budget do not allow you to survey all states.

Other State Tax Issues

- Sec. 409A
- State Income Tax Withholding
- Employee v. Independent Contractor Classifications
- State Unemployment Taxes
 - “Successor Employer”
 - Experience Rating Transfers