Merger and Acquisition Headaches: Transfer Taxes in the Purchase or Sale of a Business

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Overview

- In today's business environment, mergers and acquisitions are exceedingly common.
- These transactions can take many forms, so it is important to analyze each transaction specifically.
- The transfer tax consequences of such common activities differ and are often overlooked which can create significant problems for businesses.

Agenda

- For each general type of transaction, the following tax consequences will be examined:
  - Sales/Use Tax
  - Real Estate Transfer Tax/Recordation Taxes
  - Stock Transfer Tax
  - Non-Traditional Taxes
- The interaction of Bulk Sale Laws and Successor Liability will be examined.
- Finally, we will also explore the world of tax due diligence to illustrate how to safeguard against potential tax pitfalls.

Types of Reorganizations

	Taxable	Tax-free
Stock	Stock Purchase	Reorganization • Section 368(a)(1)(B)
	Section 338/336	Section 368(a)(2)
Asset	Asset Purchase • Subsidiary • Stand-alone	Reorganization • Section 351 • Section 368(a)(1)(A) • Section 368(a)(1)(C) • Section 368(a)(1)(D)

Common Types of Reorganizations

- Stock Acquisition
  - Acquisition of stock in a corporation or an interest in a flow-through entity (LLC or partnership)
  - Generally treated as a sale of an intangible for sales/use tax purposes
  - IRC § 338(h)(10) election: Acquire stock of a member of a federal consolidated or affiliated group or acquire stock of a S corporation
    - Also treated as a sale of an intangible for sales/use tax purposes despite differential income tax treatment

Common Types of Reorganizations

- Asset Acquisition
  – Generally treated as a sale of each underlying asset, leading to potential transfer tax consequences
- Bulk Sale Requirements
  – Jurisdictions may have enacted bulk sale rules that apply to sales of all or a large portion of a company's assets
- Successor Liability

Sales and Use Tax

- Generally, sales tax statutes are written and interpreted broadly to impose tax on transfers of property for consideration
- Essential inquiries to determine tax consequences for merger and acquisition activity:
  - Is there a sale or other transfer?
  - Is there consideration?
  - Is the property of the type subject to sales tax?
  - Do any relevant exemptions apply?

Sales and Use Taxes: Sale/Transfer

- Generally, “sale” or “transfer” is defined and interpreted very broadly
  - For example, Cal. Rev. & Tax Code 6006 defines “sale” to mean: “Any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration.”
- While this is generally straightforward, taxpayers should consider the following issues when analyzing a given transaction:
  - Transactions between affiliated entities can still constitute taxable sales.

Sales/Use Tax: Is there consideration?

- In theory, this is a simple concept
- However, be careful to understand the following:
  - Consideration need not be in money (e.g., transfer of property or cancellation of indebtedness)
  - Sales tax may even be due when transferring assets in exchange for stock, absent a special exemption
- This can be a difficult analysis for taxpayers and tax collectors alike and vary by state

Sales/Use Tax: Type of Property

- Focus on the structure of the transaction
  - Sale of Assets?
  - Sale of Stock?
  - Other?

- Traps for the unwary
  - Sales/Use tax generally only applies to transactions that can be characterized as a sale of assets rather than a transfer of stock
  - Evaluate each asset sold to determine if sales of that type of property are subject to tax in any given state

Sales/Use Tax: Exemptions

- If the transaction is generally subject to sales tax, does it qualify for an exemption?

- "Typical" Exemptions
  - Exemption for statutory mergers/consolidations
  - Exemption for corporate formations/liquidations
  - Exemption for capital contributions
  - Isolated/Casual Sale Exemption
  - Sale for Resale Exemption

- Exemptions will vary by state

Sales/Use Tax: Exemptions

- Merger/Consolidation Exemptions
  - Md. Code Ann. Tax-Gen. 11-209(c)(1): Exemption for a transfer of tangible personal property via a tax-free reorganization under I.R.C. 368(a)
- Formation/Liquidation Exemptions
  - N.Y. Tax Law 1101(b)(4)(iv)(A)(IV): Exemption of transfer of property to corporation upon its organization in exchange for stock
- Capital Contribution Exemptions
  - Mo. Rev. Stat. 144.011(4): Exemption for transfer of tangible personal property as a capital contribution

Sales/Use Tax: Exemptions

- Isolated/Casual Sale
  - In general, this exemption provides tax relief for sales that occur outside of the general course of business

- Isolated/Casual Sale statutes can vary in scope
  - Cal. Rev. & Tax Code: Occasional sale includes:
    - Sale of property not held or used by a seller in the course of activities for which he is required to hold a seller's permit…provided that the sale is not one of a series of sales sufficient in number scope and character to constitute an activity for which a seller's permit is required

Sales/Use Tax: Exemptions

- Isolated/Casual Sale
  - Tex. Tax. Code 151.304: Occasional sale includes the following:
    - One or two sales of taxable items at retail during a 12-month period by a person who does not habitually engage in such business
    - The sale of the entire operating assets of a business or separate division, branch, or identifiable segment of a business
- California vs. Texas
  - Potential difference in number of retail sales to disqualify occasional sale
  - Difference in whether an entire business' assets must be sold or whether a segment can be sold

Sales/Use Tax: Exemptions

- Resale Exemption
  - Resale exemptions generally exempt sales of tangible personal property for subsequent resale from sales tax to avoid multiple levels of taxation
  - Application to merger and acquisition activity
    - Helpful when certain activity or assets (e.g., inventory) are not covered by other exemptions, such as the casual sale exemption
- Planning Tip:
  - In general, the transferee of the assets must generally be registered as a dealer for sales/use tax purposes and provide the transferor with a valid resale certificate at the time of the sale.

Real Estate Transfer Tax

- Overview
  - While sales of real property are not subject to sales tax, such sales (or transfers of long-term leases) may be subject to a real estate transfer tax on the sale of real property
  - Generally, tax is owed based on the amount of the purchase price of the real estate
  - Tax can generally take two forms and some states may impose both
    - Tax on the transfer of the property
    - Tax on the recordation of the deed
  - Some states even tax the sale of ownership interests in a business that owns real property.

Real Estate Transfer Tax

- Examples
  - District of Columbia transfer tax:
    - Tax is imposed on the transferor for each transfer of real property at the time the deed is submitted for recordation. D.C. Code Ann. 47-903
    - Transferor is liable for the tax
  - District of Columbia recordation tax:
    - Tax is imposed on a deed (including a lease for a term of at least 30 years) when it is submitted for recordation. D.C. Code Ann. 42-1103
    - Parties are jointly and severally liable for the tax
- Be careful to understand both the base and imposition of tax in each jurisdiction where real property lies

Real Estate Transfer Tax

- While real estate transfer taxes and recordation taxes can apply to merger and acquisition activities, there may be exemptions available for such activity

- Exemptions will vary by state

Real Estate Transfer Tax

- "Controlling interest" transfer tax
  - Certain states have adopted statutes that apply real estate transfer taxes to transfers of interests in entities that own real estate.
  - Example: Washington Real Estate Excise Tax (REET)
    - REET applies to sale or purchase of 50% or more of an entity that owns real property in Washington
    - REET is measured by 100% value of the real property owned by the entity (note: measure often exceeds equity purchase price)
    - REET rate is commonly 1.78%, but ranges from 2.78% to 1.28% depending on the location of real property
    - E.g., LLC owns real property with FMV of $10M and $8M mortgage; A sells 50% of LLC to B for $1M; REET = $178K (1.78% of $10M—not $1M and not 50% of $10M)

Stock Transfer Tax

- Uncommon type of tax
- New York is the only state to have enacted a stock transfer tax
- Overview
  - Tax is imposed on sales or transfers of certificates of stock N.Y. Tax Law 270(1)
  - No general exemption for merger and acquisition activity
  - Absent any other relevant exemption, this tax will impact merger and acquisition activity in New York

Non-Traditional Taxes

- Most states have a sales/use tax and may have a real estate transfer tax
- Some states have imposed other non-traditional taxes either in lieu of, or in addition to, these transfer taxes
- Example: Washington Business & Occupation Tax
  - Sales of inventory are generally subject to B&O tax
  - Sales of other assets may qualify for casual or isolated sale exemption from B&O tax

Bulk Sale Requirements

- Many states have Bulk Sales Rules
- Generally applicable to asset sales
- Purchasing corporation is frequently required to file a notice with the relevant state's department of revenue
  - N.Y. Tax Law 1141(c) – When a person required to collect tax sells/transfers any part of the whole of his business assets, the transferee must notify the tax commission of the proposed sale at least 10 days before taking possession of the items
- Compliance can help avoid successor liability
- State-specific procedures for compliance can be complex

Bulk Sale Requirements

Advantage	Disadvantage
Avoidance of liability	Exposure
Adjustment to purchase price	Audit
Information (outstanding liability, future exposure, post-transaction planning)	Time constraints

Successor Liability

- Successor Liability
  - In addition to the Bulk Sale Requirements, many states impose some successor liability in connection with certain merger and acquisition activity
  - Taxpayers should be aware of these rules

Tax Due Diligence

- Every due diligence project is different
- Certain factors will affect a due diligence project
  - Time Constraints
  - Human Resources
  - Reasons for transaction
  - Size of transaction
  - Sophistical of parties
  - Nature of business
  - Tolerance for risk/exposure

Tax Due Diligence

- Primary due diligence goals
  - Gather all relevant tax information, including income, sales/use, real estate transfer tax, and unclaimed property information, as applicable
  - Identify and evaluate risks as well as potential opportunities within the deal structure
  - Work with all other stakeholders to address risks and opportunities uncovered as a result of information gathering.

Tax Due Diligence

- Potential Issues in Due Diligence
  - Are all relevant documents available for review?
  - Are all relevant filing obligations current?
  - Has the entity been operating with the appropriate nexus profile?
  - Does the industry affect the business' tax obligations in a specific way?
- After identifying specific issues, devise a plan in conjunction with the rest of the deal team to address these issues in context of the merger.

Tax Due Diligence

- Overview of steps to complete each diligence
  - Ask the basics:
    - Is it a stock deal or an asset deal?
    - Is the Target an S corporation, C corporation, LLC, partnership?
    - Is the Target a member of a consolidated group?
    - Is the Buyer open to an IRC § 338(h)(10) election?
    - Is the Target a public company or a privately held business?
  - Understand who the client is and the project scope
  - Review the Letter of Intent

Tax Due Diligence

- Overview of steps to complete each diligence (cont'd)
  - Scope of SALT due diligence may include:
    - Income/franchise tax
    - Sales/use tax
    - Gross receipts tax
    - Local business taxes
    - Employment/payroll tax
    - Real and personal property tax
    - Fuel taxes, utility taxes, and other miscellaneous taxes
    - Tax attributes, credits, abatements, benefits (PILOT)
    - Unclaimed property

Tax Due Diligence

Best Practices

- Communicate red flag issues as early as possible
- Conduct research when appropriate
- Compute exposure estimates, if any
- Communicate exposure issues to client
- Issue key findings
- Deliver complete due diligence report

Questions?