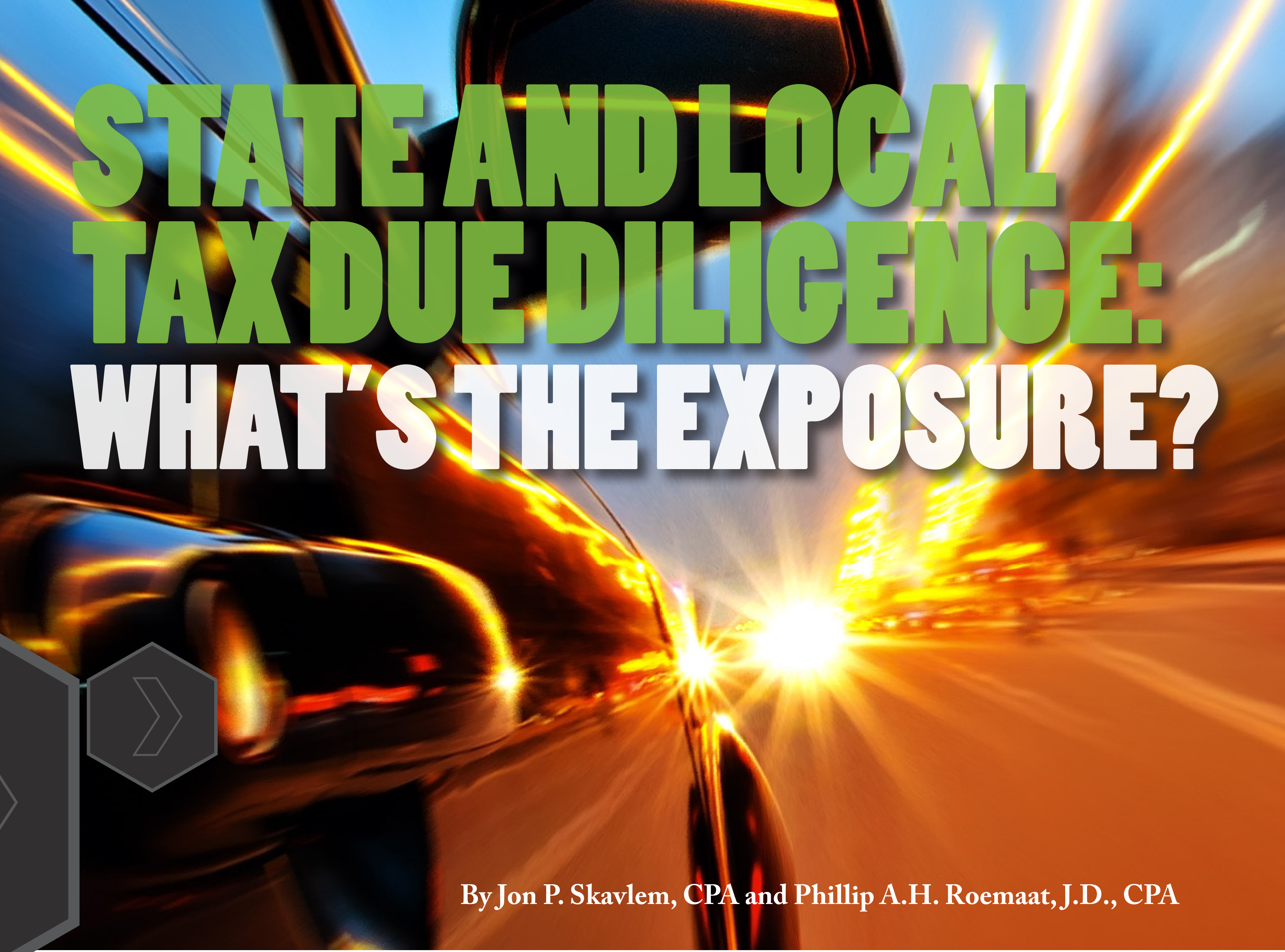
STATE AND LOCAL TAX DUE DILIGENCE: WHAT'S THE EXPOSURE?



By Jon P. Skavlem, CPA and Phillip A.H. Roemaat, J.D., CPA

As the U.S. economy continues to recover from the last recession, the pace of business acquisitions, mergers, recapitalizations and venture capital transactions has accelerated. Globally and in the U.S., initial public offering activity in the first half of 2013 was more than double the first half of 2012. Private equity investors have been especially busy. A necessary outgrowth of this has been an increased demand for tax due diligence work on the part of CPA firms and corporate tax departments.

A key area of tax due diligence investigations involves state and local taxes income, franchise, sales and use, withholding, unclaimed property and other levies. It is no secret that state and local budgets were rocked by the recession. In an effort to close fiscal deficits, they passed aggressive new tax laws and ramped up enforcement efforts, initiating more nexus actions, bringing technology to audits, and adding new staff. [1]

As the owners of a company contemplate selling, the historical state and local tax filings and activities will be a focus of a sophisticated buyer. In the

[1] Katz, "State Insecurity," CFO Magazine (April 2011), www.cfo.com/magazine (click on "View Back Issues").

past, the potential buyer focused primarily on the entity's federal return positions. With the advent of FIN 48 (now ACS 740), it became clear that state and local tax exposures often exceeded federal exposures. Professional due diligence teams now routinely inquire about such issues as sales and income tax nexus, combined reporting, pass-through entity taxes and compliance with unclaimed property laws.

It's important for both the buyer and seller to understand all material state and local filing positions before concluding a sale. If a substantial liability is identified, it can threaten the viability of the deal or drastically reduce the sale price. Given that the price is often pegged to a multiple of earnings, changing the earnings to reflect unrecorded taxes that would otherwise be assumed by the buyer can have a substantial impact. If the deal is cancelled, the buyer and seller are both at a loss given the amount of professional fees incurred during due diligence and negotiations.

During the sale process, sell-side risk identification of state and local tax issues should commence well in advance of sale, typically six to 12 months before engaging investment bankers, attorneys and other key professionals. For the buyer, a due diligence team normally reviews the historical prior year state and local filing positions after a letter of intent (or a similar document) and nondisclosure agreement are executed.

It should not be assumed that state and local tax exposures can be side-stepped by the buyer if the deal is structured as an asset purchase. Sales and use tax and withholding taxes are treated as successor liabilities in many states. They can be pursued against either the buyer or the seller unless a tax clearance certificate is obtained or similar procedure is followed.

Another way to deal with this risk is to carefully craft the buy-sell agreement's tax representations and warranties such that the seller continues to have responsibility to pay prior state and local tax obligations. In most states but not all, past income and franchise tax liabilities remain with the entity if the buyer acquires an ownership interest, e.g. stock acquisition.

To help mitigate risks for both the buyer and the seller, the agreement may include baskets and caps. Baskets provide a minimum amount before the purchaser can recoup funds from the seller for the tax liabilities it assumed. Caps define the maximum amount that a buyer would have to return to the seller for its exposure. Additionally, an escrow fund may be provided so that the tax claims of a purchaser will be satisfied after the transaction closes. However, the due diligence and negotiation processes are not exact and amounts put in escrow for potential state and local tax exposures may prove inadequate or the terms of the warranty period too short.

State and local tax: Areas of risk

State and local tax exposures can be many in number and varied in nature. This article is the first of two articles. This article focuses on tax due diligence generally and how it relates to state income and franchise taxes. The second article, which will appear in the January/February 2014 *On Balance*, will highlight sales and use taxes and ways to remediate state and local tax exposure that might affect a pending transaction.

Income, franchise, and gross receipts taxes

When assessing a company's state and local tax risk, income, franchise, and gross receipts taxes are the conventional starting point. Due diligence efforts should focus on where the company's activities are versus what states and localities it files returns in. The operational territory of employees and location of the company's property is a good first indicator of where the company should be filing. For companies that sell tangible personal property, e.g., retailers, manufacturers, distributors, etc., Public Law 86-272 can provide protection, although limited in nature, from income taxes nexus.[2] An emerging jurisdictional concept among states is that of "economic nexus."

Under this concept, a taxpayer is deemed to be doing business in a state based on the amount of economic activity, e.g. sales, it has within a state even if the taxpayer lacks traditional measures of nexus such as physical presence.[3] Businesses dealing in intangibles, e.g. software, or providing services, are particularly exposed to economic nexus risk. State and local tax due diligence should focus on states like California, Colorado and Connecticut if investigation reveals activity but no returns have been filed.

Multistate apportionment can also entail state tax exposure risk. Sales factor sourcing rules for service and intangibles companies are complex. Failure to understand when to apply the cost-of-performance approach, e.g., proportionate method and the plurality method[4] versus benefits derived[5] can lead to material income, franchise and other business entity tax liabilities.

While income taxes often create state and local tax exposure, a number of states impose taxes based on the corporation's net worth[6] or the value of its capital stock.[7] Other taxes that can come into play include gross receipts taxes, like Washington's Business and Occupation Tax[8], Ohio's Commercial Activities Tax[9], the Texas Franchise Tax[10] and the now defunct Michigan Business Tax, which imposed both an income and a gross receipts tax.[11] Since these are not income taxes, they generally have different nexus thresholds and can create liabilities even if the company posts a net loss for the year.

A growing number of states, including California, Illinois, Michigan, Massachusetts, Minnesota, New York, Texas and Wisconsin, require corporations that conduct a "unitary business" to file a combined return. In some cases, combination on a worldwide basis is necessary in the absence of a proper election to exclude foreign affiliates. Proper due diligence requires a target company's filing position be examined to determine if a return should have filed on a combined basis and if so, what entities were includible under state law.

Do not overlook local tax filings in the due diligence process. Many municipalities have income or other business entity taxes that can be material. New York City, Philadelphia, Louisville and various communities in Ohio impose such taxes.

If available, the target's tax calendar of due dates provides a convenient roadmap for someone outside the company to understand where it files and due dates to be aware of. Reviewing on-going and prior year audits can bring other state exposures to light. Organizing these documents in advance of a buy-sell transaction (both in a paper and electronic format) is recommended.

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[2] Interstate Income Law, 15 U.S.C. §381 through §384 (known to state and local tax practitioners as P.L. 86-272), [3] See Cal. Rev. & Tax § 23101
[4] Compare, N.C. Gen. Stat. § 105-130.4(l)(3) and Tex. Tax Code Ann. §171.103(a)(2) with Cal. Rev. & Tax § 25136 for taxable years beginning prior Jan. 1, 2013 and 72 Pa. Stat. Ann.§ 7401(3)(2)(a)(17), [5] See, e.g. Wis. Stat. § 71.25(9)(dh)(1); 18-125 ME Code R. § 801.05E(1); Cal. Rev. & Tax § 25136 for taxable years beginning after January 1, 2013, [6] Ga. Code Ann. § 48-13-72, [7] Pa. Stat. Ann. § 7602, [8] Wash. Rev. Code § 82.04.220 a, [9] Ohio Rev. Code § 5751.02, [10] Tex. Tax Code. Ann § 171.001, [11] Mich. Comp. Laws Ann. §§ 208.1201, 208.1203