

Latest Developments in State and Local Tax Due Diligence for Private Equity

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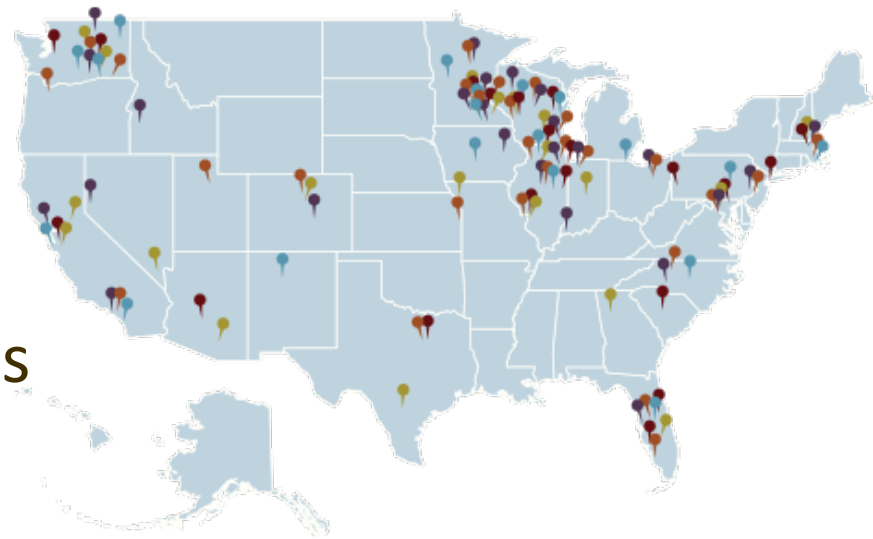
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Speaker Introductions

Andrew E. Finkle, CPA, JD, LL.M.

Principal, Philadelphia, PA



- Leads tax due diligence projects for private equity investor groups, venture capital funds and strategic buyers across various industries
- Provides transactional tax planning and structuring advice on domestic and cross-border mergers, acquisitions, restructurings, joint ventures, spin-offs, bankruptcies, and dispositions
- Develops tax models to help buyers identify the most tax effective structure, and to help sellers understand the tax consequences of alternative structures

Speaker Introductions

Daniel N. Kidney, CPA, JD

Director, Minneapolis, MN



- Leads CLA's State Income/Franchise Tax practice
- Works extensively in multiple areas of multistate tax planning, compliance, and controversy issues, regarding both corporate income and sales/use taxes
- Key focus areas include mergers and acquisitions, entity and transactional structuring, pass-through entity taxation, nexus analysis and voluntary disclosure agreements, audit defense and tax appeals, and ASC 740 (FAS 109) and ASC 740-10 (FIN 48) issues



Speaker Introductions

Rance Morton, CPA

Manager, Dallas, TX



- Leads CLA's Sales Tax Outsourcing practice
- Provides sales tax consulting services across the country covering various industries
- Examples of Rance's projects include buy-side and sell-side due diligence, sales tax refund and exposure reviews, voluntary disclosure agreement projects, sales tax research projects, nexus studies, and other state specific credit reviews

Agenda

- Successor Liability
- Historical Liabilities: Sales/Use Tax
- Historical Liabilities: Income/Franchise Tax
- State and Local Taxes on the Transaction
- Risk Mitigation Strategies
- Post-Acquisition Integration





Successor Liability

Successor Liability

- Stock Acquisitions: SALT liabilities stay w/ the target
 - Stock in a C corporation
 - Interest in a pass-through entity (S corp/partnership/LLC)
 - ◇ Income tax: generally limited to entity-level taxes on PTEs
- Asset Acquisitions
 - Exposures that generally remain with the target:
 - ◇ State income/franchise taxes (exceptions include Florida, Illinois, Michigan, Pennsylvania, South Carolina, and Texas)
 - Exposures generally transferred to the buyer:

Sales/use taxes

Gross receipts taxes

State unemployment insurance (SUI)

Property taxes (lien date driven)



Successor Liability (Continued)

- Is it really an asset acquisition?
- For federal and state income tax purposes, some sales are “deemed” to be asset sales
 - Stock sale with Sec. 338(h)(10) or Sec. 336(e) election
 - Sale of interests in a single member LLC (SMLLC)
- For sales/use tax purposes, there are no “deemed” asset sales
 - Sales/use taxes look at a transaction’s legal form
 - Sales of stock, partnership interests, and LLC interests are sales of ownership interests for sales tax successor liability purposes



Successor Liability (Continued)

- Asset acquisitions
 - Successor liability provisions are usually part of a state's sales/use tax laws
 - Some states impose successor liability only upon the purchase of “all or substantially all” of a target's assets; some also include sales of divisions
 - As a practical matter, states pursue the buyer for successor liability only if the target no longer operates in the state





Historical Liabilities: Sales and Use Tax

Overview of Sales and Use Taxes

- Tangible personal property (“TPP”)
 - Generally subject to tax unless exempt by statute
 - Personal property which may be seen, weighed, measured, felt or touched, or perceptible to the senses
- Real property
 - Generally not subject to tax
 - Land, buildings, fixtures, leasehold improvements
- Intangible property
 - Generally not subject to tax



Overview of Sales and Use Taxes (Continued)

- Services in general
 - Services are generally not subject to tax unless specifically enumerated by statute
 - Some states (such as Hawaii, New Mexico, South Dakota, and West Virginia) tax all services unless exempt by statute
- Services commonly taxed by many states
 - Information services
 - Data processing
 - Janitorial services
 - Security services
 - Software as a Service (SaaS)
 - Installation
 - Maintenance
 - Repairs



Sales and Use Tax Nexus

- Need to identify where target has a taxable presence
 - Physical presence standard (consider Wayfair case)
 - ◇ Employee travel including delivery in company owned trucks
 - ◇ Sale solicitation by employees or independent contractors
 - ◇ Installation/warranty work by employees or contractors
 - ◇ Consigned inventory
 - ◇ Click-through and affiliate nexus
 - Statute of limitations does not start if no return is filed
 - ◇ Penalty/interest for old years may exceed the tax liability
- Use tax “notice and reporting”
 - Eleven states impose reporting requirements
 - ◇ Significant penalties in Colorado and Washington State



Sales and Use Tax Common Missteps

- Nexus related issues (see prior slide)
- Not researching taxability when entering new states
- Assuming all services are not taxable
- Not realizing that services sold with tangible personal property can be taxable even if not normally taxable as stand-alone services
- Not paying any use tax
- Collecting sales tax when use tax is due (contractors)
- Use tax notice requirements!!!



Sales and Use Tax Common Missteps (Continued)

- Exemption Related Items
 - Not requesting resale or exemption certificates (or failing to maintain and refresh them)
 - Assuming government contracts are exempt
 - Assuming all equipment in a manufacturing facility is exempt
 - Not knowing the difference between an item being exempt by statute vs. the buyer claiming the exemption





Historical Liabilities: Income and Franchise Tax

Income Tax Nexus

- Need to identify where target has a taxable presence
- Physical presence standard (like sales/use tax)
- Public Law 86-272 (15 U.S.C. 381-385)
 - Only applies to solicitation of sales of TPP
 - Only protects against income taxes, not to franchise or gross receipts taxes
- “Bright line” economic nexus
 - Currently imposed by nine states
 - Threshold is usually in-state sales exceeding \$500k or 25% of total sales



Franchise and Gross Receipts Taxes

- Apply to most legal entities, including pass-throughs
- Franchise taxes
 - About half of the states impose them
 - Common calculation: net worth x apportionment x tax rate
 - Generally apply to corporations (C/S), not partnership/LLCs

- Gross receipts taxes

Washington B&O Tax	Nevada Commerce Tax
Ohio Commercial Activity Tax (CAT)	California LLC Fee
Texas Franchise Tax	Tennessee Business Tax

- Public Law 86-272 does not apply to these taxes



Significant Local Business Taxes

- Major cities in the following states:
 - California (e.g., Los Angeles and San Francisco)
 - Kentucky (e.g., Louisville, Lexington)
 - Michigan (e.g., Detroit, Grand Rapids)
 - Missouri (e.g., St. Louis and Kansas City)
 - New York (NYC unincorp. bus. tax, commercial rent tax)
 - Ohio (many, incl. Cleveland and Cincinnati)
 - Oregon (Portland and Multnomah County)
 - Pennsylvania (e.g., Pittsburgh, Philadelphia)
 - Virginia BPOL



Pass-Through Entity Issues

- Most states follow federal pass-through treatment
 - Composite individual income tax could be subject to successor liability
 - Nonresident withholding is always subject to successor liab
- Entity-level income taxes on most pass-throughs
 - DC, Illinois, New Hampshire, New York City, Tennessee
- Entity-level income taxes on S corporations
 - California, Louisiana, Massachusetts
- Some states require state-specific S corp elections
 - New York, New Jersey, Georgia, and (pre-2018) Alabama





Taxes Triggered by the Transaction

Sales/Use Taxes

- Sales tax does not apply to the sale of intangibles
 - Stock sales are sales of intangibles, not subject to sales tax
 - Asset sales may be subject to sales tax
 - “Deemed” asset sales (e.g., Sec. 338(h)(10), 336(e), sale of disregarded SMLLC interest) – treated as a sale of intangibles for sales tax
- Isolated/occasional sale exemptions
 - Certain states don’t provide them (e.g., CA, NY)
 - Certain property doesn’t qualify (motor vehicles, aircraft)



Sales/Use Taxes

- Valuation/allocation of purchase price
 - In an acquisition, this may be necessary; only the portion of the sales price allocated to TPP is taxable
- Please be aware that some transactions not involving cash can still be subject to sales and use taxes
 - The definition of “sale” for sales and use tax purposes includes consideration for the exchange of TPP or service
 - Examples of consideration could include the value of stock, the assumption of debt, the value of services rendered, or the value of TPP traded



Other Indirect Taxes

- Realty Transfer Tax (RTT)
 - Imposed by about 35 states on the consideration paid for real property; rates range from 0.1% to 5%
 - Generally paid by the seller when the new deed is filed
 - May apply to the sale of a controlling interest (50%+) of a company that owns realty (e.g., CA, CT, DC, NYS, NYC, WA)
 - ◇ Watch step transactions
 - Some jurisdictions impose RTT on the transfer of certain leases (e.g., CT, IL, NY, PA)
- Property Tax: Reassessment
 - California Prop. 13 limits annual increase in assessed value to 2% unless there is a “change in ownership”



Income/Franchise Taxes

- Apportionment
 - Some states require the proceeds from the sale of business assets to be included in the seller's apportionment factor
 - Potential for apportionment spike in a year when the target recognizes a large gain
- Section 382
 - Some, but not all, states apply Sec. 382 limitations to their states' net operating losses (NOLs)
 - While many state Sec 382 limits are determined after apportionment, some are not (e.g., Minnesota)





Risk Mitigation and Post-Acquisition Integration

General Strategies

- Indemnity Clauses
 - Requires a recognition event and contractual enforcement
 - Work well for risks that are hard to quantify
- Purchase Price Reductions
 - Protects buyer from future cash tax exposure
 - Highly contingent risks complicate negotiations
- Escrow
 - Offers protection for quantifiable risks
 - Often time-limited; don't extend as long as the SOL
- Transaction Restructuring
 - Often highly complex



Sales Tax: Bulk Sale Notifications

- Most states require sellers to notify them of any “bulk sale” of business assets
- Notification generally triggers an audit of the seller
- If not filed, states assert liability upon the buyer
- Many targets/buyers agree not to comply with “bulk sale” notification requirements, and instead choose to address responsibility for sales tax exposure contractually
- States do not care about indemnification clauses and will pursue the buyer and/or seller



Voluntary Disclosure Agreements (VDAs)

- All states offer VDA programs to companies with unmet filing obligations
- Two major benefits:
 - Limited look-back (vs. 7-8 year lookback as practical matter)
 - Penalty waiver
- Eligibility criteria:
 - No previous contact with the state about the tax type
- Income tax VDAs for pass-through entities generally affect all owners; communication is key
- Sales/use taxes can often be filed on a spreadsheet



Integration Considerations

- Sales taxes
 - Where does the new entity have nexus?
 - Registration of the new entity, withdrawal of the old entity
 - Return filing; new entity resource limits or systems issues?
 - Are new exemption certificates necessary?
- Income taxes
 - Does target give nexus to buyer in new states? If so, this may influence timing of VDAs filed for the target
- Property taxes
 - Property taxes have a lien date
 - APA should address who will pay and how to prorate



Questions?

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