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State Tax Observations

Remember SALT Issues in M&A Due Diligence Situations

By Sandy Weinberg, JD, Principal

Buyers of businesses are often eager to get the deal done. But tax due diligence may be worth the wait. There can be a significant impact on the market value of a target company. State and Local Tax (SALT) issues, in particular, can sometimes be deal breakers.

Business owners seeking to sell their companies are also well advised to first consider undertaking a due diligence investigation of the company's taxes. A thoughtful evaluation of the SALT situation in advance of the sale can eliminate unwelcome surprises, improve the tax situation and make the sale process more manageable and efficient.

Tax due diligence is a comprehensive examination of the different types of taxes that may be imposed on a selling company (a.k.a. "the target"). The growing complexity of Federal, state, and local tax laws, aggressive enforcement by taxing authorities and the expansion of state tax nexus (i.e., a sufficient connection to a state to be subject to tax in the state) add risk to any purchase.

Transferee Liability

State tax issues abound. Transferee or successor liability must be considered whether the buyer is making a stock or an asset purchase. Generally, in a stock sale, historical SALT liabilities continue to the buyer after the transaction since the legal entity remains in existence and is responsible for its liabilities.

Asset purchases generally offer more protection for a buyer regarding historic risks than stock purchases. However, where asset purchases are concerned, most states have statutes allowing the states to pursue a seller's outstanding sales tax liability from the buyer.

To protect buyers, many states have bulk sale notification procedures where the buyer notifies the state of the potential purchase. On receipt of such notification, the state reviews the seller's sales tax account for any unpaid tax. If liability exists, the state may commence a collection action before the asset purchase is completed. The notification procedure protects the buyer from successor liability.

Sales and Use Tax Concerns

The most common state tax issues that need to be addressed in tax due diligence situations involve nexus (both sales and income tax), sales tax, income tax, payroll tax and unclaimed property.

A common sales tax error often detected is found in the area of software as a service (SAAS). SAAS is taxed differently (or not addressed at all) in many states, and the state laws are rapidly changing. Generally, the issue arises as to whether various transactions are subject to sales tax in various states.

A second area needing to be addressed is where the target has unknowingly established sales tax nexus in a state. This can occur where the company does not have an office or warehouse in a state, but has an employee or agent soliciting sales or attending trade shows for more than a few days each year.

Prior to the sale of the company, where nexus exists (for sales tax and other taxes), a voluntary disclosure agreement (VDA) should be considered. A VDA is an agreement between a taxpayer and a state where the taxpayer voluntarily comes forward (often through a representative on a no-name basis) to disclose back year tax liability. Generally, through the agreement, the taxpayer can limit the number of years for which taxes are owed, and penalties— and sometimes interest — are eliminated, thus reducing the tax exposure of that company and maintaining a strong negotiating position.

An additional troublesome sales tax area involves wholesalers and distributors, and the collection of resale certificates. Simply stated, if the wholesaler is not conscientious about collecting the certificates, sales tax exposure may result. Further, the buyer of such a company may have transferee liability.

Income Tax Issues

Few issues trip up taxpayers more than income tax nexus. Public Law 86-272 provides protection from income tax when a company is solely soliciting for the sale of goods in a state through sales representatives. However, taxpayers may not realize that the protection doesn't apply if a company's employees enter a state to perform other activities, such as making repairs, conducting training, installing machines or replacing damaged goods. For service companies, Public Law 86-272 does not apply, so once a company's employees enter a state to provide services, nexus is established. A service company can have factor presence nexus (economic nexus) even without setting foot in certain states. The greater number of states in which a company has income tax exposure, the more risk for the buyer of the company. And the tax could have been owed for years. A buyer should be aware of this exposure.

Further, state tax apportionment rules for service companies have recently become more complex, involving a market-based instead of a service-based approach, and unwittingly, companies up for sale have misapplied the new laws.

State tax treatment of S corporations varies and there is no uniform procedure for approving S corporation elections at the state level. Consequently, when purchasing the stock of an S corporation, the buyer must be aware that some states require a separate S corporation election and some may not extend the pass-through taxation advantages to them at all and, rather, treat them as C corporations.

For flow-through entities, in states where the entity has nexus, a withholding issue may exist with respect to nonresident shareholders or partners. To ensure tax compliance by such nonresidents, many states require the filing of composite tax returns or impose tax withholding obligations. A target S corporation or partnership may not be aware of these obligations, triggering additional tax exposure in these states.

Unclaimed Property Exposure

In the unclaimed property area, unused gift cards can result in exposure for the vendor issuing the gift cards. After a certain period of time has lapsed (referred to as the "dormancy period"), when the owner of a gift card cannot be located, a vendor who issues gift cards is generally required to "escheat" or submit the balance of the gift card to the appropriate state. When the escheat does not occur, potential exposure arises and this exposure is transferred to the buyer of that gift card vendor.

Employment Tax Exposure

With employment taxes, the independent contractor vs. employee misclassification continues to haunt many taxpayers, including sellers of businesses. Another area of employment tax concern occurs where a company has employees who travel to states other than their base state. If a selling company has this

issue and is not diligent in its compliance, there may be state payroll tax and unemployment insurance exposure.

Potential Tax Savings Opportunities

Not all state tax due diligence involves risk-aversion. Sometimes significant opportunities are revealed. Low hanging fruit usually involves tax credits that have not been identified. These can range from research credits to jobs credits to energy efficiency credits.

Be Mindful

Without proper due diligence, SALT issues can be the source of unexpected liabilities that could arise from an acquisition. If the target has not properly identified the potential exposure, the liability can be passed on to the acquiring business.

Contact Us

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