Legal Entity Restructuring: State Tax Implications
Analyzing Liquidation and Conversion Options to Achieve Tax Benefits

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Legal Entity Restructuring: State Tax Implications Webinar

Nov. 18, 2010

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Today’s Program

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NEXUS CONSIDERATIONS IN ENTITY ACQUISITION/FORMATION
Issue

- When will the in-state activities of an out-of-state business be sufficient for a state to impose taxes on the out-of-state business?
  - I.e., does the business have sufficient nexus to be subject to state income tax and/or sales/use tax collection?
  - Nexus is a "connection," the threshold requirement for state taxation under the Due Process Clause and the Commerce Clauses.
Focus On Corporate Mergers, Acquisitions And Reorganizations

- Corporate mergers and acquisitions or reorganizations that result in the acquisition of business entities or assets
  - What has been acquired?
  - Where are those entities and assets situated?
  - In what states does the acquirer now have nexus as a result of the entities or assets acquired?
Due Process Clause: Low Nexus Standard

- Requires only “some definite link” or “minimum connection” between the state and the transaction. *Miller Bros. Co. v. Maryland.*

- Economic exploitation of an in-state market is sufficient link or connection. *Quill Corp. v. North Dakota.*
  - Physical Presence in the taxing state is not required under the Due Process Clause.
Complete Auto Transit, Inc. v. Brady. Tax on interstate commerce allowed under the Commerce Clause only if:

- Substantial nexus
- Fair apportionment
- No discrimination
- Tax is fairly related to services provided by the taxing state
Quill Corp. v. North Dakota

- Physical Presence required for use tax collection obligation under the Commerce Clause

Does Quill’s physical presence standard apply outside the context of sales and use tax?

- Most recent state courts have said NO.
- The U.S. Supreme Court has denied certiorari in a number of cases that would have resolved this question.
The nexus standard differs for income tax and sales/use tax.

- Sales/use tax = **Physical presence** required
- Income tax = Current trend is that physical presence is not required (although it would be sufficient)
  - Intangible nexus without physical presence is enough.
Income Tax Nexus: P.L. 86-272

- U.S. Supreme Court:
  - Mere presence of traveling salesman in-state is sufficient nexus for state to impose its income tax on sales made to in-state customers
Congress reacts!

- Enacts P.L. 86-272
- “No state or political subdivision thereof, shall have power to impose ... a net income tax on the income derived within such state by any person from interstate commerce if the only business activities within such state by or on behalf of such a person during the taxable year are ...
... the solicitation of orders by such person, or his representative, in such state for sales of tangible personal property, which orders are sent outside the state for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside of the state.”
Examples of protected activities
- Soliciting by any form of advertising
- Soliciting by an in-state sales representative
- Carrying sample or promotional materials for display only
- Passing orders, inquiries and complaints on to the home office
- Owning or leasing personal property used in a sales representative’s home office
Examples of unprotected activities

- Making repairs or providing maintenance services
- Installing products
- Training or seminars for persons other than sales representatives
- Approving or accepting orders
- In-state collection action
- Maintaining an in-state physical location (other than a sales representative’s home office)
Notable limitations

- Does not apply to sales of intangibles or services
  - Only protects solicitation of sales of tangible personal property
- Thus, states are not precluded by P.L. 86-272 from taxing income from intangibles.
  - Must look to constitutional limitations
- Applies only to “net income” taxes and not to gross receipts taxes
Income Tax: Intangible Nexus

- **Background**
  - Parent company forms a subsidiary to hold trademarks
  - Subsidiary is generally domiciled in a state that taxes royalties very favorably or not at all (such as Delaware or Nevada)
  - Subsidiary has no physical presence in any other state
Income Tax Nexus: Intangible Nexus (Cont.)

- Background (Cont.)
  - Subsidiary licenses trademarks to parent or other affiliates and receives royalties.
  - Parent takes an income tax deduction for the business expense of licensing trademarks.
  - Goal of structure: Reduce or eliminate state income taxes by creating large royalty deductions paid to an out-of-state affiliate with no physical presence in the taxing state.
Courts have rejected this structure applying several theories, including finding nexus through the in-state use of intangibles (i.e. **intangible nexus**).

The “Geoffrey cases”

- Standard intangible holding company structure holding “Toys R Us” trademarks
- Courts held:
  - *Quill’s* physical presence test does not apply to state income tax.
  - In-state presence of intangible property satisfies “substantial nexus” requirement when the taxpayer derives income in-state from the property (trademarks) used in the state.
  - Thus, a state may tax out-of-state intangible holding company’s income.
Courts across the country have followed the *Geoffrey* cases.

U.S. Supreme Court has denied *certiorari* in these cases.
Income Tax Nexus: Intangible Nexus (Cont.)

- Intangible nexus cases include:
  - South Carolina: *Geoffrey Inc. v. S.C. Tax Comm’n*
  - Oklahoma: *Geoffrey Inc. v. Okla. Tax Comm’n*
  - Massachusetts: *Geoffrey Inc. v. Comm’n of Revenue*
  - Louisiana: *Dep’t of Revenue v. Gap (Apparel), Inc*
  - North Carolina: *A&F Trademark, Inc. v. Tolson*
  - New Jersey: *Lanco, Inc. v. Director, Division of Taxation*
  - Maryland: *The Classics Chicago, Inc. v. Comptroller of the Treasury*
  - New Mexico: *Kmart Corp. v. Taxation and Revenue Dep’t of the State of New Mexico*
Income Tax Nexus: Substantial Economic Presence

- Some courts have found substantial nexus because of an out-of-state business’ substantial economic presence.
Credit card cases
- Out-of-state banks with no physical presence in state
- Marketed to in-state customers
- Issued and serviced credit cards to customers in-state
Credit card cases (Cont.)

- Most courts held:
  - Physical presence is not required for income tax nexus.
  - Substantial economic presence is sufficient when the out-of-state company solicits business in the state and derives substantial income from in-state customers.
- U.S. Supreme Court denied *certiorari* in these cases.
Credit card cases include:

- West Virginia: *Tax Comm’r of State of W. Va. V. MBNA America Bank*
- Massachusetts: *Capital One Bank v. Comm’r of Revenue*
- Indiana: *MBNA America Bank v. Ind. Dep’t of Revenue*
Income Tax Nexus: Summary

- After restructuring, is there physical presence in a state?
  - If so, would P.L. 86-272 protect you from income tax in the state?

- Has the acquisition of trademarks or other intangibles created intangible nexus?

- Do the newly acquired assets or entities create nexus through their substantial economic presence in a state?
Sales/ Use Tax Nexus

- Under *Quill*, nexus for sales/use tax collection purposes requires *actual physical presence* in the taxing state.
  - Interesting development: The Streamlined Sales Tax Governing Board is considering initiating litigation to challenge *Quill’s* physical presence standard.

- How much physical presence is required?
  - Any physical presence? Rejected in *National Geographic*
  - “More than the slightest physical presence”? Adopted in *Quill*
  - Fact-based inquiry
Sales/ Use Tax Nexus (Cont.)

- Nexus-creating physical presence may include:
  - In-state employees
  - In-state independent contractors
  - In-state deliveries
  - Trade shows (maybe; states have come out differently depending on the extent of activities)
Sales/ Use Tax Nexus (Cont.)

- Frequency and duration of in-state physical presence
  - 76 in-state visits per year = Sufficient nexus
    - *In re: Orvis Co., Inc. v. Tax Appeals Tribunal of N.Y.*
  - 13-14 in-state visits per year = Sufficient nexus
    - *Vermont Info. Processing, Inc. v. Tax Appeals Tribunal of N.Y.*
  - 28 in-state visits per year = Sufficient nexus
    - *Care Computer Sys., Inc. v. Ariz. Dep’t of Revenue*
  - Average 6 ½ trips per year = Sufficient nexus (gross receipts tax)
    - *Baker & Taylor, Inc. v. Kawafuchi*
  - Less than 3 in-state visits per year = No nexus
    - *In re: Appeal of Intercard, Inc.*
There is no bright-line quantitative test for nexus!

- Nexus depends on all the facts and circumstances.
What about nexus though ownership of property in-state?

- Must exceed an opaque *de minimis* threshold. See *Quill* (presence of floppy discs in-state was not enough)
- Rental of personal property within the state is sufficient. *Wabash Power Eqpt. Co. v. Lindsey*
- Sufficient nexus existed in part due to taxpayer’s ownership of a warehouse and apartment in state. *In re Krystallos, Inc*
Sales/ Use Tax Nexus: Agency Nexus

- An out-of-state vendor with no physical presence can establish nexus through an in-state “agent” acting on its behalf.”
  - Under Supreme Court case law, the “agent” does not need to be a common law agent or an exclusive agent. *Scripto, Inc.*

- Operative inquiry: Does the in-state party help the out-of-state vendor establish and maintain a market for its products in the taxing state? Tyler *Pipe.*
Sales/ Use Tax Nexus: Agency Nexus (Cont.)

- School book club cases
  - Teachers pass out order forms to students, collect money, assemble and submit orders, and distribute books (sent by the seller via common carrier).
  - Teachers occasionally earn bonus points, which they can use to acquire globes, maps or other educational materials for the classroom.
  - California and Kansas: *Nexus*; teachers are agents of book sellers
  - Michigan, Arkansas, Ohio and Connecticut: *No nexus*; teachers are consumers, not agents of the seller.
Sales/ Use Tax Nexus: Agency Nexus (Cont.)

- Personalized delivery – *Furnitureland South*
  - North Carolina furniture seller advertised over the Internet but had no physical presence in Maryland.
  - Used third-party carriers to deliver furniture into Maryland
  - Carrier advertised for the furniture company on its trucks, collected price, set up furniture, did minor repairs or picked up furniture for repair in North Carolina.
  - Nexus established through carrier
Dell Computer maintenance cases (*Dell Catalog Sales*)

- Online/catalog computer vendor contracts with a nationwide service company to repair computers in purchasers’ homes; the service contract is sold to the purchase at the time of purchase.
- **Nexus**: Louisiana and New Mexico
- **No nexus**: Connecticut
Affiliate nexus: A “unitary” theory in which an out-of-state vendor is subject to sales/use tax, because a related entity (parent, sibling or subsidiary) has physical presence in the state.

- No court has upheld nexus based solely on affiliation.
- Rather, nexus has been found when the in-state affiliate acts as an agent of the out-of-state vendor.
Affiliate nexus cases

- **Border’s Online** (California)
  - Online bookseller advertised on its Web site that its customers could return books at in-state retail outlets.
  - Retail outlets effectuated the policy and would not accept returns from other online booksellers.
  - In-state retail stores encouraged customers to shop online, and its receipts advertised the Web address.
  - **Nexus found**: Retail store acted as “agent” of online affiliate.

- Compare with **Barnesandnoble.com** – California court found no nexus.
  - No agency relationship when in-state affiliate merely placed online affiliate’s coupons in shopping bags.
Affiliate nexus cases (Cont.)

- *St. Tammany Parish v. Barnesandnoble.com*
  - In-state book retailer offered membership program and gift cards that included an online vendor.
  - In-state store instituted a policy to accept returns from the online vendor (but also accepted returns from all other vendors).
  - When the retailer did not have books in stock, it would often have the online entity ship the book directly to in-state customers.
  - **No nexus**
Sales/ Use Tax Nexus: Affiliate Nexus (Cont.)

“Amazon laws”
- Many states are enacting laws to define nexus to include certain types of online affiliates (“click-through” nexus).

New York Senate Bill 6807, effective April 23, 2008
- Creates rebuttable presumption that a remote seller has nexus if:
  - Remote seller has an agreement with an in-state third party that directly or indirectly refers customers to the remote vendor (including through Web site links — “click-through”).
  - The in-state party receives compensation.
  - The remote seller has at least $10,000 in sales for the previous four quarters.
- Hotly contested and litigated by Amazon.com and Overstock.com
- New York Sup. Ct App. Div. held that the Amazon statute is not facially unconstitutional and remanded to determine whether as applied it is unconstitutional (Nov. 4, 2010).
Colorado HB 1193

- Presumes nexus if remote vendor is part of a “controlled group” as defined by IRC § 1563(a), and a component member has physical presence in Colorado
- Remote vendors without nexus must:
  - Notify customers that use tax is due to the state; $5 penalty for each failure
  - Provide each Colorado customer (by Jan 31) and the Department of Revenue (by March 1) with an annual account statement for each customer; $10 penalty for each failure
Sales/ Use Tax Nexus: Summary

- Does the acquirer now have a responsibility to collect sales/use tax on sales into a destination state?
TAX IMPLICATIONS TO CONSIDER IN RESTRUCTURING ENTITIES
Overview

- Stock transactions: Seller’s and buyer’s perspectives

- Asset transactions: Seller’s and buyer’s perspectives
State Conformity To Internal Revenue Code

- State conformity to IRC and computation of state taxable income
- State income tax treatment generally conforms to federal treatment.
  - But, some states have gross receipts-based taxes divorced from typical federal income tax concepts (e.g., MI, OH, TX, WA).
Stock Transactions: Seller’s Perspective

Basic Conformity Issues

• For the seller, the gain recognized from a transaction for state income tax purposes generally conforms to the gain at the federal level.

• But, taxpayers should be aware of non-conforming recognition of gain at the state level.
  – Separate-return states (e.g., IRC § 311(b))
  – Depreciation decoupling
Stock Transactions: Seller’s Perspective

Gain-Sourcing Issues

- Allocation vs. apportionment
  - Transactional test vs. functional test
Stock Transactions: Seller’s Perspective

Sect. 338(h)(10) Elections

- Most states conform to the federal tax treatment of a Sect. 338(h)(10) election by conforming to the federal tax base.

- But:
  - Mississippi does not conform (see Miss. Code Ann 27-7-9(j)(5)).
  - If a corporation or other entity makes an IRC § 338 election, or other similar election under which the aggregate basis in assets is increased on the tax records of the taxpayer, then a similar election must also be made for Mississippi purposes, but the gain must be recognized by the corporation in which the increase in basis of the assets occurs. The corporation or other entity is allowed to increase its basis by the amount of gain recognized. An aggregate write-down of assets is not allowed. The parent corporation shall recognize the gain on the disposition of its stock.
While most states adopt Sect. 338(h)(10) treatment, be wary of certain exceptions.

- California (Cal. Rev. & Tax. Code § 23051.5) and Wisconsin (Wis. Department of Revenue Tax Release (4/1/91)) allow taxpayers to opt out for state purposes or to make a state-only election.
Stock Transactions: Seller’s Perspective
Sect. 338(h)(10) Liquidation Exception

- Liquidation exception
  - Many states treat gains from a Sect. 338(h)(10) transaction as non-business income, based on an application of the functional test.
    - E.g., *ABB C-E Nuclear Power, Inc. v. Mo. Dir. of Revenue*, 215 S.W.3d 85 (Mo. 2007)
  - However, at least two states – New Mexico and Ohio – specifically define business income to include liquidation gains.
  - And, many others treat gains from transaction involving a Sect. 338(h)(10) election as apportionable business income.
    - E.g., CA – *Jim Beam Brands Co. v. Franchise Tax Bd.*, 34 Cal. Rptr. 3d 874 (Cal. Ct. App. 2005)
Stock Transactions: Seller’s Perspective
Other Sect. 338(h)(10) Considerations

• Does the seller apportion its receipts based on the gain from the sale or the gross proceeds of the transaction?

• Practical pointer: Be mindful of making a Sect. 338(h)(10) election when selling shareholders may not be subject to state tax on a direct stock sale.
  – E.g., because the shareholder is an individual residing in Florida or another tax-free jurisdiction.
An asset transaction creates an opportunity to allocate the purchase price to assets situated in states with the most advantageous tax situations.

– No duty of consistency in multi-state reporting (Oracle Corp. v. Oregon Dep’t of Revenue, No. TC-MD 070762C (Ore. Tax Ct. Feb. 11, 2010))

However, there may be tension between the interests of the buyer and those of the seller, because of (a) sales tax concerns, and/or (b) buyer’s own tax situation.
Generally, states conform to federal law (i.e., buyer receives stepped-up basis of the purchase price of the stock).

But, common exceptions include:
- Carryover of tax attributes, including NOLs (IRC § 381)
- Limitations on use of NOLs (IRC § 382)
• Under IRC §172, a federal taxpayer can carry NOLs:
  – Back to the previous two years, except for tax years ending in 2001 and 2002 which pursuant to the Job Creation and Worker Assistance Act of 2002 may be carried back five years.
  – Forward for the next 20 years.
• The most frequently encountered difference between state and federal NOL periods is the disallowance of NOL carrybacks. More than half of the states permit carryforwards only.

*Examples:* Florida law provides that NOLs may be carried forward only. See Fla. Stat. §220.13.

- In the last decade, Illinois, Iowa, Kentucky, Maine and North Dakota – among others – eliminated carrybacks.
Stock Transactions: Buyer’s Perspective
Net Operating Losses (Cont.)

• Limitations may be made either by dollar amount or by percentage of the amount of NOL that may be deducted.

  *Example:* Pennsylvania imposes an annual NOL deduction limitation, as the greater of 12.5% of taxable income or $3 million (72 Pa. Stat. §7401(3)).

• Caps on NOL carrybacks.

  *Example:* Utah limits carrybacks to $1 million.

• Temporary limits on carryforwards.

  *Example:* New Jersey limited carryforwards to 50% of entire net income for 2004 and 2005.

• Some states temporarily suspend the NOL deduction in years of tight budgets.

• Even in states that follow the federal carryback/carryforward provisions, a corporation’s NOL deduction may vary for federal and state tax purposes. Many states do not permit an NOL deduction for a loss that was incurred while a taxpayer was not doing business (i.e., subject to tax) in the state or because the NOL arose before the state began imposing the tax. See, e.g., Ga. Code § 48-7-21(b); Miss. Reg. 506.
The computation of state NOL deductions is complicated by the allocation of non-business income and the apportionment of business income.

- Some states require that the NOL be carried forward from the loss year after allocation and apportionment. These states provide that the NOL deduction should be applied in the carryover year after allocation and apportionment. This permits only the loss attributable to that state to be carried over against income from that state. In determining the amount of NOLs in states that compute NOLs on a post-apportionment basis, a state may use the apportionment factor in the year the loss is generated or the apportionment factor in the year the loss is utilized.

- Other states, however, allow the NOL computation to be made before apportionment and permit the deduction to be applied in the carryforward year before apportionment.
Some states:
- Permit an affiliated group of corporations to file a consolidated state return if the requirements of the IRC and state law are satisfied. Even if consolidated returns are filed at both the federal and state levels, the calculation of the NOL deduction for federal and state purposes may differ.
- May require NOLs to be tracked on a separate-company basis, even in the context of a combined or consolidated filing
  - E.g., California requires members of a combined group to compute NOLs using their individual apportionment factors.
- Some states also add their own restrictions on the use of NOLs generated in separate return filing years (SRLY issues).
  - E.g., Massachusetts (830 CMR 63.32B.2(8))
• Combined reporting may be elective or required by a state. States that provide for combined reporting differ on how the NOL computation is made. For example:
  – In California, members of a unitary group may combine taxable income and losses in the current year, but must compute the NOL carryover and the utilization of the carryover on a separate company basis. Cal. Rev. & Tax Code § 25108. This segregates the NOLs of each member of a group and prevents the offset of one member’s loss carryover against the future income of another member.
  – In Illinois, members of a unitary group filing an Illinois combined report determine the NOL deduction and carryover as if the group were one taxpayer. Ill. Admin. Code §100.2340.
A majority of states conform to IRC §§ 381 and 382, including:
- California (Cal. Rev. & Tax Code § 24451)
- Florida (Fla. Stat. § 220.13)
- New York (N.Y. Tax Law § 208.9), and
- Ohio (Ohio Rev. Code § 5733.053)

A number of states do not follow the current federal rules.  
*Examples:* Tennessee NOLs do not survive a merger, unless successor was a shell prior to merger (Tenn. Code. Ann. § 67-4-2006(c)).

North Carolina (continuity of business enterprise): Pre-merger losses may be offset against post-merger profits only to the extent that the group of assets that generated the pre-merger losses is now profitable (N.C. Reg. § 17:05C.1507).
In a transaction where the buyer borrows funds for the purpose of an acquisition, a mismatch may result in separate-filing states where the buyer has deductible interest expenses while the newly-acquired subsidiary produces operating income.

- In a consolidated or combined filing, there is no problem; but, in a separate state, buyer might choose to “push down” the debt by way of:
  - Loan to the subsidiary
  - Having the subsidiary agree to assume the debt
  - Management fee structure
As part of any transaction (asset or stock), the buyer should examine the pre-existing state income tax liabilities of the seller.

- More of a concern in stock transactions, but some states (e.g., IL, PA) permit income tax liabilities of seller to travel to the buyer even in an asset transaction
- Also note that in a merger, the assets of the acquirer may become subject to the liabilities of the acquired assets
Conversions/Re-Domestications

• Many states will permit the conversion of an entity into another entity type.
  – E.g., taxpayers often convert wholly-owned corporations into LLCs that are disregarded for federal and (generally) state income tax purposes.
    • This structure should have no federal income tax consequences but may have state tax consequences such as a loss of NOL carryovers.

• Similarly, many states permit a simple re-domestication to incorporate in another state.

• However, not all states have such provisions, and not all states with conversion/re-domestication provisions apply them equally to all entity types.
  – E.g., NY permits corporations to convert into other entities but does not have a similar conversion provision for LLCs.
  – These differences often may not have income tax consequences (the inability to re-domesticate an LLC can be worked around by merging the LLC into an LLC formed in another state). But, such a structure may have additional sales tax consequences that would not have arisen in a more efficient structure.
  – Accordingly, parties should pay careful attention to the state of formation, as state law peculiarities may have consequences when a structure needs to be unwound.
Tax Implications Of Restructuring Entities: Other Taxes

- Sales & use taxes
  - Nexus implications
  - Sales & use tax on the restructuring transaction

- Real estate transfer taxes

- Real property tax implications
Sales & Use Tax: Nexus Implications

- Higher nexus standard than for corporate income tax
  - Physical presence required (*National Bellas Hess*, *Quill*)
  - But beware: P.L. 86-272 not applicable

- Where is “target” entity registered?

- Where should “target” entity be registered?

- Voluntary disclosure opportunities
Sales & Use Taxes: General Rules

- **Every** transfer of tangible personal property (TPP) potentially is subject to sales or use tax, unless a specific statutory exclusion or exemption applies/

- State and local sales/use tax aspects of a entity restructuring transactions generally do not follow federal or state income tax treatment.
Sales & Use Taxes: Four Key Questions

- Is there a “sale” or other “transfer”?
- Is there consideration for the “sale” or “transfer”?
- Is the property transferred of a type that is subject to sales/use tax (e.g., TPP)?
- Are there any exclusions or exemptions that apply?
Is There A “Sale” Or Other “Transfer”?

- “Sale” is generally defined very broadly/

- Can’t overlook transfers among affiliated entities

- Consider a routine “drop down” of assets from a parent to a wholly-owned subsidiary
Single-Entity Conversions

- Don’t fit neatly into the category of an asset transfer or a stock transfer

- Generally, treated as an “F” reorganization, for income tax purposes

- Should be treated as a non-event for sales tax purposes, because there is no “sale” or “other transfer” and no consideration
Sales & Use Taxes: Consideration

- “Consideration” may be broadly interpreted
- Be aware of transfers among affiliates
- Assumption of liabilities could create “consideration”
- Consider *Beatrice Co. v. SBE*, 863 P.2d 683 (1993)
Sales & Use Taxes: Transfer Of Taxable Property

- How does the state define TPP, for sales tax purposes?
  - Custom or customized software
  - Blueprints, customer lists
  - Fixtures

- Keys
  - Identify types of property being transferred
  - Identify and evaluate sales/use tax issues
  - Consider alternative structures

- Transfers of stock, partnership interests and LLC interests generally are not subject to sales/use taxes (no transfer of TPP).
### Sales & Use Taxes: Transfer Of Taxable Property (Cont.)

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Sales & Use Taxes: Exclusions And Exemptions

- Vary from state to state
- General sales/use tax exclusions/exemptions
  - Isolated/occasional/casual sale exclusion/exemption
  - Manufacturing machinery and equipment exclusions/exemptions
  - Sale-for-resale exclusions/exemptions
- Specific exclusions/exemptions for business restructuring transactions
Sales & Use Taxes: Isolated Or Occasional Sales

- Vary from state to state
  - Broad vs. narrow application

- Examples
  - Broad (Illinois - 35 ILCS 120/1)
  - Narrow (Calif. Rev. and Tax Code §6006.5; N.Y. Tax Law §1115(a)(18); N.Y. Regs. §528.19)
Sales & Use Taxes: Sale For Resale

- Available in all sales/use tax jurisdictions

- General characteristics
  - Applicable to inventory-type property
  - Requires resale certificate from buyer
  - Potential administrative burdens with resale certificates
Sales & Use Taxes: Transaction-Specific Exemptions

- Transfers to new corporations for equity interest
  - Examples: Missouri, Georgia, New York, New Jersey, Vermont, Maryland, Oklahoma and Texas
  - Be aware of possible temporal restrictions
  - E.g., California
    - Blanket exemption for transfers of TPP to controlled transferee corporations that are newly organized in start-up situations, and a more limited exemption for later transfers
Sales & Use Taxes: Transaction-Specific Exemptions (Cont.)

- Transfers of TPP for equity interest and “Boot”
  - Some states exempt transaction regardless of the consideration transferor of TPP receives
    - Ex: Illinois, Georgia, Texas and Oklahoma
  - Maryland
    - Exempts the entire transfer of TPP as long as the transferor “principally” receives stock in exchange for the transfer. Tax General Art. §11-209(c)(1)(ii).
  - New York, New Jersey and Vermont impose sales tax on the “boot” only
  - California
    - Sales tax on “boot”
    - Beware of assumed liabilities. See, e.g., Beatrice Co. v. State Bd. of Equal., 6 Cal. 4th 767 (Cal. 1993)
Sales & Use Taxes: Transaction-Specific Exemptions (Cont.)

- Statutory mergers or consolidations
  - Beware of specific statutory definitions of tax-free reorganizations in Internal Revenue Code vs. state and local sales/use tax statutes
  - CA, NY and Iowa have specific exemptions for statutory mergers/consolidations
  - Some states exempt from sales taxes any transactions that are tax-free for income tax purposes, under any of the provisions of I.R.C. §368.
    - Ex: Washington, Hawaii and Maryland
Sales & Use Taxes: Transaction-Specific Exemptions (Cont.)

- Corporate liquidations
  - Many states (e.g., NY, CA and OK) have exemptions for corporate liquidations.
  - Some liquidation exemptions exclude inventory.
  - Other exemptions/exclusions might apply in other states.
  - Is there consideration in a complete liquidation? (see Cal. Rev. and Tax. Code section 6006; Sales Tax Counsel Ruling 395.2280; Calif. Sales and Use Tax Reg. Sec. 1595(b)(5))

- Capital contributions
  - Some states exempt, but not always clearly
  - Is there any “consideration” if no new stock is issued and no assumption of debt?
Other Taxes

- Real estate transfer tax
  - Beware of “indirect” transfers of real property
  - Beware of transfers of long-term leasehold interests

- Real property tax
  - Asset sale may trigger a new assessment
  - Change in ownership may cause loss of grandfathered valuation (e.g., CA Proposition 13)
Michael Jacobs, Reed Smith

STATE TAX CLEARANCE REQUIREMENTS WITH RESTRUCTURING
State Tax Clearance Requirements: In General

- More than two-thirds of the states have bulk sale laws, tax clearance letter procedures and/or escrow provisions.
- Generally apply to sales or transfers of substantially all of the assets of a business.
- Tax clearance may also be required to liquidate an entity under state corporate law or to withdraw an entity’s qualification to do business in a state.
- Failure to comply with tax clearance procedures could subject the buyer to transferee liability for the seller’s unpaid taxes, penalties and/or interest (Note: Different states have different limits on the potential exposure for a buyer. BUYER BEWARE!).
- Compliance may avoid transferee liability.
- Buyer and seller generally have different perspectives on compliance.
- Timing is critical.
State Bulk Sales Laws

- General procedures
  - Notify state taxing authority prior to transaction (statutory period)
  - Buyer withholds from purchase price until clearance from state DOR
  - Expect that the DOR will audit
  - Seller files final sales and use tax return shortly after sale
## State Bulk Sales Laws: Pros And Cons Of Compliance

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tr>
<td>Avoidance of liability</td>
<td>Exposure</td>
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<tr>
<td>Adjustment to purchase price</td>
<td>Audit</td>
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<td>Information (outstanding liability, future exposure, post-transaction planning)</td>
<td>Time constraints</td>
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Protection For Purchasers Outside Of State Bulk Sales Laws

- Contractual indemnities
  - Address tax liabilities and refunds in the transaction documents
  - Use of escrow or purchase price hold-back
- Due diligence
- Other ways to protect parties
  - Surety bond
  - Insurance policy