Transaction Tax Challenges in Mergers and Acquisitions
Identifying Reserves, Preserving Credits and Incentives, Maintaining Post-Integration Documents

TUESDAY, DECEMBER 4, 2018, 1:00-2:50 pm Eastern

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TRANSACTION TAX CHALLENGES IN MERGERS AND ACQUISITIONS

STRAFFORD WEBINARS
DECEMBER 4, 2018
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AGENDA

- Identifying sales/use tax implications and challenges
- Understanding the various types of transaction taxes, such as stock transfer and documentary transfer/issuance taxes
- Identifying, describing and evaluating for sufficiency any reserves the target company has made for sales and use and other transaction tax liabilities
- Due diligence for transaction taxes
- Identifying potential real property transfer tax issues
MERGERS & ACQUISITIONS GENERALLY

- Structure of the transaction has sales/use tax implications.
  - Statutory mergers or consolidations
  - Transfers of TPP for equity interest
  - Transfers to new corporations for equity interest
  - Stock-for-stock acquisitions
  - Recapitalizations
  - Change in form or identity
  - Capital contributions
  - Corporate liquidations

- Jurisdictions will vary:
  - One jurisdiction may impose tax on certain tangible personal property transferred as part of an M&A transaction while another jurisdiction may offer an exemption.

- Nexus may be created in additional jurisdictions as the result of an M&A transaction.
“Sale” is broadly defined to include all transfers of title or possession of goods for consideration “unless otherwise excepted.”

Consideration includes both cash and the assumption of liabilities.
## MERGERS & ACQUISITIONS TRANSACTION TYPES

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<tr>
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<th>Asset Sale</th>
<th>Stock Sale</th>
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<tr>
<td><strong>Nontaxable</strong></td>
<td>Type A</td>
<td>Type B Reverse Triangular Merger § 351</td>
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<td>Type D § 351</td>
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<tr>
<td><strong>Taxable</strong></td>
<td>§ 1060 § 338</td>
<td>Direct Stock Purchase Reverse Cash Merger § 338</td>
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**Notes:**
- **Type A:** Taxable
- **Type B:** Reverse triangular merger
- **Type C:** Nontaxable
- **Type D:** Nontaxable
- **Section 351:** Nontaxable
- **Section 1060:** Taxable
- **Section 338:** Taxable
POTENTIAL M&A EXEMPTIONS

- If the transaction is potentially subject to tax, look to exemptions that may apply.
- Generally, transfers of TPP between and among affiliated entities could trigger sales and use tax implications.
- Remember: Every transfer of TPP potentially is subject to sales or use tax, unless a specific statutory exclusion or exemption applies!
Certain types of assets are exempt from sales tax even if sold as part of a business sale:

- Inventory – usually exempt as a “sale for resale;”
- Equipment – usually exempt if used predominately in producing tangible personal property (i.e., the manufacturing, machinery and equipment exemption);
- Intangible property – normally not subject to sales/use tax;
- Real estate – normally not subject to sales/use tax; and
- Stock acquisitions – normally not subject to sales/use tax.
EXCLUSIONS AND EXEMPTIONS

- Sales tax exemptions for transfers in incorporations, mergers, acquisitions, and liquidations
  - Strict compliance with statutory language and/or regulations is required or the exemption will be forfeited.
  - State sales tax analysis should be done before structuring the transaction based solely on federal income tax consequences, or significant sales taxes could be due.

- General sales/use tax exclusions/exemptions
  - Isolated/occasional/casual sale
  - Sale for resale
  - Manufacturing machinery and equipment
POTENTIAL PROBLEM AREAS

- Equipment, furniture, supplies, etc. (TPP) not covered by specific exemptions could be subject to sales tax.

- Titled property (i.e., motor vehicles, aircraft, and watercraft) may create special problems depending on how the states govern those items.

- Reclassification of “intangibles” to TPP. For example, a California court has held that drawings, designs, manuals and procedures used in manufacturing were TPP subject to sales tax. *Navistar Int’l Transp.*, 884 P.2d 108 (Cal. 1994).

- Very narrow statutory definitions create interpretative problems:
  - For example, Texas exempts the sale of “the entire operating assets,” but it is unclear what constitutes an “operating asset” or what is meant by “entire assets”.

Statutory merger exemptions

Exemptions for transfers of property in exchange for an equity interest at the time of organization

- Create a new subsidiary and drop down assets with the parent receiving consideration in the form of stock and securities.

Incorporation transaction exemptions

- Assumption of liabilities can be treated as cash that is not eligible for exemption.

Timing can make or break a transaction

- For example, if an exemption is available for transfers upon the organization of a transferee corporation, later transfers (even a later step in a series of transfers upon organization) may not qualify.
Bulk Sales

- Many states have bulk sale notification provisions
- These notification provisions require that the seller and/or purchaser of the assets of a business notify the appropriate taxing authorities within a certain number of days
- Purpose of bulk sale requests are to either:
  - (1) obtain a tax clearance certificate stating that the seller has no outstanding tax liabilities, or
  - (2) be instructed by the taxing authorities as to the amount that should be withheld by the purchaser from the purchase price to cover the outstanding tax liabilities of the seller.
- The purchaser becomes personally liable for the tax obligations of the seller if the bulk sale provisions are not complied with.
Successor Liability

- Even where bulk sale notifications are not required, several states impose successor liability for sales/use taxes when an acquiring entity purchases all or substantially all of a selling entity's assets.
- Potential tax liabilities should be negotiated when discussing the purchase price.
- Again, the type of transaction may determine whether a successor is liable (asset sale versus stock sale).
WHAT IS FAS 5?

- Financial Accounting Standard No. 5
- FAS 5 is referred as the original FASB pronouncement
- FAS 5 required the loss of contingency must be disclosed, only if the loss is assessed or estimated
  - Assessed and estimated are not specifically defined (i.e: there is a 65% to 75% or greater likelihood that the contingency will occur)
A contingency is defined as the existing condition or a situation, or even a set of situations involving improbability as to possible loss or gain to an enterprise, which most likely will occur more than once or in future events.
LIABILITIES

- Liability is a known obligation
  - Subsidiary taxes tend to be liabilities rather than contingencies
  - Subsidiary taxes are not contingencies if the laws of the taxing jurisdiction clearly apply to the transaction(s)
Ensure all sales and use tax contingencies required by FAS 5 are accumulated and entirely documented.

Estimating the contingency can be challenging.
A substantial portion of transaction taxes are often ignored or not considered in their entirety due to external auditors not questioning the accurate questions.

Businesses must ensure sales & use tax is required by FAS 5 for fully documented.

It is important to know what contingencies need to be disclosed.
HOW FAS 5 AFFECTS SALES TAX?

- Must review all the agreements, which the party will be held responsible for any taxes due
- It may affect the estimated contingency
COMMON CONTINGENCY AREAS

- Nexus Positions
  - Change in business activities and areas
  - Return filings and exposure of unregistered jurisdictions
  - Employees, plant, equipment, now economic impact
- Tax Base
  - What should be included in taxable sales price
- New product and services introduced into business
- Change in tax laws, additional exemptions
- In-process and upcoming audits and refund claims
A contingency may exist that needs to be disclosed for FAS 5 purposes

Sales/use tax compliance must be considered

Ensure the company is in compliance with and regularly filing with various sales/use tax reports

Obvious contingencies must be considered before moving forward
FAS 5 FACTORS

- Customer obligations
- Penalties and Interest
- External auditors
- Estimate by state or legal entity
CUSTOMER OBLIGATIONS

- Must consider the customer compulsions when quantifying
- Contact the customer, if self assessed
  - Collect sales tax on taxable sales
  - Paid tax as a tax assessment
  - Resale or exemption certificate
DETERMINING RISK

- Should review all business operations and business activities
- Review the dollars for exposure in jurisdictions
- With new business/acquisitions, review of financials and business operations to determine risk
- Set up appropriate reserves
PENALTY AND INTEREST

- Most states impose penalty/interest
- Extra costs must be encompassed when estimating contingency
- How do you qualify to not pay interest and penalty?
  - Participate in a Voluntary Disclosure Program
  - Amnesty Programs
  - Abatements/Waivers
EXTERNAL AUDITORS

- Have proper documents on file to support your accrual
- It may take several months before hearing back from auditors, after reviewing the documentation provided
- Performed a sample to the auditors? Ensure the documents are valid and accurate
When providing a sample, ensure the following below steps are followed:

- Be prepared to identify the amount of the exposure by state
- Properly account the financial statements and update the logs periodically
- Deliberate using total accounts payable data to apply to the error rate to analyzing the exposure
ESTIMATION PRACTICES

- Review existing Reserve
- Division/Entity/Category
- State-by-State
- Choose the best period for most accurate estimation
DUE DILIGENCE

- Know your business! Due diligence checklist should vary based on the specific industry and company issues
- An assessment of any legal, financial, and business risks
- Where time and budget are tight, focus on key states
- It is appropriate and recommended for both parties to a transaction to perform their due diligence, whether the transaction involves a purchase, sale, or merger
- Important to understand the nature of the businesses involved and the details of the transactions including the types of assets being transferred
DUE DILIGENCE

- Business overview
  - Obtain business background (e.g., SEC filings, audited financial statements, contracts, list of locations, etc.)
  - Get an organizational chart!

- Acquisition structure and transaction issues
  - Understand the proposed transaction

- Nexus evaluation
  - Where have returns for various taxes been filed? Where should they have been filed?
    - Property, payroll, sales, registrations, etc.
DUE DILIGENCE

- **Sales/Use Tax**
  - Obtain sales/use tax return filings and sales/use tax audit history for state and local level sales/use tax
  - Identify open audits, refund claims, waivers, etc.
  - Reserve documentation
  - Policies and procedures for sales/use taxes
  - Discuss products and taxability
  - Consider “testing” sales, purchases, capital assets, and leasing transactions
REAL PROPERTY TRANSFER TAXES
REAL PROPERTY TRANSFER TAXES - OVERVIEW

- Generally imposed on the recording of a deed, lease or other instrument.
- Imposed in 37 states plus the District of Columbia.
- Also known as Real Estate Transfer Tax, Documentary Stamp Tax, Document Recording Tax, or Deed Transfer Tax.
- Sales tax exemptions do not apply.
- May apply to transfer of a controlling interest in an entity owning real property.
- Special rules for minerals / timber / other property rights.
Oregon does not impose a statewide RPTT and localities are prohibited from doing so, with the exception of Washington County, which imposes a tax that is grandfathered in under the state law.
Transfers of a controlling interest in an entity holding real property may create a real property transfer tax liability.

Unlike with sales tax, a stock sale may trigger a liability.

E.g., Washington State imposes its real estate excise tax on a transfer of a controlling interest in any entity owning real property within the state. Wash. Rev. Code § 82.45.010(2)(a).

Controlling interest provisions vary from state to state regarding the types of entities and transactions that may trigger a liability.

However, a number of states do not have any controlling interest provisions.

Issues regarding valuation of real property in controlling interest transfers.


New York law refers to the amount of consideration paid, but in the case of a sale of a controlling interest consideration is defined as “the fair market value of the real property or interest therein.” N.Y. Tax Law § 1401(d)(iii).
Certain states have controlling interest provisions that apply only to certain real estate entities.

- D.C.'s controlling interest tax applies to sale of a controlling interest in an entity that derives more than 50% of receipts from ownership in real property or holds real property with a value comprising at least 80% of tangible asset holdings. D.C. Code Ann. § 42-1102.02.

- Illinois taxes transfers of controlling interests of “real estate entities”.
  - “Exists or acts substantially for the purpose of holding directly or indirectly title to or beneficial interest in real property.” Ill. Comp. Stat. 200/31-5.
  - Rebuttable presumption if entity owns real property with fair market value greater than 75% of total fair market value of all the entity’s assets. Ill. Comp. Stat. 200/31-5.

- Michigan’s controlling interest provisions apply to a transfer of a “real estate company” which is defined as an entity that owns real property comprising 90% or more of the fair market value of its assets. Mi. Comp. Laws § 207.523.

- Other states have special rules regarding conduit entities used to transfer real property. E.g., Florida (“conduit entities”), Minnesota (“designated transfers”).
No transfer of controlling interest
- Delaware – exception for transfers where at least 80% overlap of beneficial ownership prior and post-transfer. Del. Code Ann. 30 § 5401(7)(c).

Mere change in form of ownership
- New York – exemption for “mere change of identity or form of ownership or organization where there is no change in beneficial ownership.” N.Y. Tax Law § 1405(b)(6).

Mergers, Consolidations, and Reorganizations
- Florida – while not explicit in the statute, the Department has taken the position that property transferred pursuant to merger laws is transferred by operation of law and therefore not subject to the Documentary Stamp Tax. Fl. Tech. Advis. No. 16B4-002 (Aug. 24, 2016).
- Illinois – exemption for transfers that are made “pursuant to mergers, consolidations or transfers or sales of substantially all of a corporation’s assets under plans of reorganization under the Federal Internal Revenue Code or Title 11 of the Federal Bankruptcy Act.” Ill. Comp. Stat. 200/31-45(i).
Step-transaction doctrine may be used to subject a series of transactions to tax.


- A 2018 New York Tax Appeals Tribunal decision regarding the application of the New York State real estate transfer tax to this transaction refused to address the step-transaction doctrine and instead found the transactions taxable by deferring to the Department’s interpretation as set forth in a regulation regarding the aggregation of transactions. In re GKK 2 Herald LLC, No. 826402 (N.Y.Tax.App.Trib. May 10, 2018).
REAL PROPERTY TRANSFER TAXES – OTHER CONSIDERATIONS

- Careful attention must be paid to the form of legal entity owning the real property.
  - Although South Carolina does not have any controlling interest provisions as part of its deed recording fee laws, the sale of a single-member LLC owning South Carolina real property will be treated as a sale of the underlying assets and therefore subject to the deed recording fee.

- Local tax considerations – rates can often be higher than the state rate.

- Transfers of certain real property interests, such as mineral rights or timber property may be subject to special rules.
  - States with no generally applicable real estate transfer tax may impose a tax on such transfers of title to mineral rights or other similar property interests, i.e. Mississippi’s mineral documentary tax.
Questions?

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