

Going through a Business Organizational Change - What NOT to do and what TO do!

Taxpayers' Federation of Illinois

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Speakers

- ▶ Ron Cook,
- ▶ Plante Moran, PLLC
- ▶ ron.cook@plantemoran.com
- ▶ 312-351-1663



- ▶ Michela Petrosino
- ▶ Reed Smith
- ▶ mpetrosino@reedsmith.com
- ▶ 312-207-2815



- ▶ Diane Yetter,
- ▶ YETTER Tax
- ▶ diane@yettertax.com
- ▶ 312-701-1800 x2



Due Diligence

General Considerations

Target Footprint

- ▶ What is the mix of the target company's physical and economic footprint?
- ▶ What are the plans for post-acquisition? Any changes to the existing structure?
- ▶ What is the reach of sales? Does it include sales in the U.S. only, Canada, or globally?
- ▶ What are the considerations you will need to manage if dealing with a global acquisition? What is the impact to other departments or companies?

Due Diligence

- ▶ Due Diligence/Risk Analysis should be performed to evaluate whether there could be a significant liability transferred through the transaction.
- ▶ Both asset and stock transactions can result in the buyer absorbing pre-acquisition liability due to successor liability provisions.
- ▶ Indemnification for buyers may need to be sought through contract terms and potentially hold backs/escrow deposits.
- ▶ In other cases, resolution of the liability could be a requirement for closing the sale.

Due Diligence

- ▶ The due diligence review should be conducted prior to drafting the indemnification clauses and potentially before the final sales price is negotiated.
- ▶ Proceed with conservatism in the review while documenting all assumptions.

Due Diligence

Sales Tax Considerations

Considerations for Online and Remote Sellers

- ▶ Is the acquisition an online seller or remote seller entirely with no or limited physical presence?
- ▶ Is the acquisition a marketplace facilitator?
- ▶ If merged into an existing business, how does this change the dynamic of the business and its sales channels, registrations, nexus?
- ▶ Does the acquisition broaden the buyer's footprint?

Target Nexus Review

- ▶ Review registrations with state DORs to determine:
 - ▶ When nexus was established
 - ▶ When registration occurred
 - ▶ How the company registered (what type of registration)
 - ▶ Where existing sales tax compliance is current
 - ▶ Identify any outstanding returns at the time of the transaction
 - ▶ If any prior periods were resolved through audit or VDA

Target Nexus Review

- ▶ Obtain sales tax data for a determined period to evaluate transactions counts and sales dollars by state compared to economic nexus thresholds.
- ▶ Compare company and employee locations, inventory (including consigned) locations, tangible personal property, and real property locations to sales tax registrations.

Target Nexus Review

- ▶ Identify related entities to check for any affiliate nexus issues.
- ▶ Determine how products are delivered to customers and through which selling channels.
- ▶ Determine what services are performed and where.
- ▶ Consider the impact the nexus date will have on the existing buyer company upon transition if merged.

Due Diligence

Income/Franchise Tax Considerations

Income Tax

- ▶ Successor liability
 - ▶ Asset vs. equity acquisitions
 - ▶ Grossing-up buyer for tax differential
- ▶ Nexus
 - ▶ Economic nexus
 - ▶ PL 86-272
 - ▶ Web nexus
 - ▶ Physical presence
 - ▶ Working from home

Income Tax

- ▶ Filing methods
 - ▶ Combined vs. separate company
 - ▶ Unitary
 - ▶ Elections
- ▶ Modifications
 - ▶ Depreciation
 - ▶ Related party interest and royalties
 - ▶ IRC Section 163
 - ▶ GILTI, FDII
 - ▶ Nonbusiness/allocable income positions

Income Tax

- ▶ Apportionment
 - ▶ Sales factor sourcing
 - ▶ Market/customer benefit vs. costs of performance
 - ▶ Throwback
 - ▶ Partner's treatment of partnerships
 - ▶ Flowing-up or not flowing-up apportionment factors from underlying partnership
- ▶ Net operating losses
- ▶ Credits & incentives
 - ▶ Clawbacks
 - ▶ Transferability to buyer
- ▶ Audits and notices

Franchise Tax

- ▶ Nexus
 - ▶ No PL 86-272 protection
- ▶ Tax base
 - ▶ Owners' equity or exclusion of retained earnings
 - ▶ Additions to base
 - ▶ Investment in subsidiaries
 - ▶ Multiple bases (e.g., net worth, assets located in state)
- ▶ Apportionment factor
 - ▶ Often same as income but not always
- ▶ Audits and notices

Due Diligence

Payroll Tax Considerations

Payroll Taxes

- ▶ Withholding
 - ▶ Nexus
 - ▶ Tracking employee's work locations
 - ▶ Differing filing standards among states
- ▶ 1099 vs Employee Classification
- ▶ Unemployment
 - ▶ Determining where to pay
 - ▶ Change in employee work locations
- ▶ Audits and notices

Due Diligence

Unclaimed Property Considerations

Unclaimed Property

- ▶ Types of unclaimed property
 - ▶ Certain advanced payments
 - ▶ Uncashed vendor checks
 - ▶ Uncashed payroll checks
 - ▶ Customer overpayments or credits
- ▶ Determining proper state to file unclaimed property reports
 - ▶ State of the owner's last address or the state of the holder's incorporation/formation

Unclaimed Property

- ▶ Dormancy period
 - ▶ 3 - 5 years
- ▶ Interest and penalties
- ▶ Higher risk industries
 - ▶ Gift cards/certificates
 - ▶ Customer deposits
 - ▶ Advance/prepayments

Transaction Execution

General Considerations

Contractual Matters

- ▶ Resolving issues identified during due diligence
 - ▶ Nexus issues
 - ▶ Filing voluntary disclosures and who is responsible
 - ▶ Reviewing seller's tax returns for disposition treatment
- ▶ Methods of resolution
 - ▶ Standard indemnification clauses - definition of "tax"
 - ▶ Seller directly pays/resolves
 - ▶ Escrow funds
 - ▶ Duration of retention
 - ▶ Evaluation of release of funds
 - ▶ Purchase Price Adjustment

Contractual Matters

- ▶ Meeting deadlines pursuant to purchase agreement
 - ▶ Example: deadline for buyer to review returns and provide feedback to seller
- ▶ Texas may not follow federal short periods for income tax
 - ▶ Include party responsible for preparing return and manner of allocating taxes to pre and post acquisition periods

Transaction Execution

Income, Franchise and Transfer Taxes

Income Tax - Seller Treatment

- ▶ Asset sale
 - ▶ Allocate vs. apportion
 - ▶ Consider whether return positions are beneficial
 - ▶ Example: could be challenging to conclude, such as in the case of a partnership
 - ▶ Allocate
 - ▶ Treatment based on asset type (i.e., tangible vs. intangible)
 - ▶ Apportion
 - ▶ Sales factor treatment
 - ▶ Include gross proceeds or net gain
 - ▶ Sourcing - market/customer benefit vs. costs of performance
 - ▶ Exclude altogether
 - ▶ May depend on type of assets sold
 - ▶ Inventory; mobile property; intangibles

Income Tax - Seller Treatment

- ▶ Asset sale (cont.)
 - ▶ Basis differences (e.g., depreciation modifications)
 - ▶ Alternative apportionment
 - ▶ Installment note treatment
 - ▶ Most states follow federal treatment but not all
 - ▶ Pass-through entity tax elections

Income Tax - Seller Treatment

- ▶ Equity sale
 - ▶ Depends on seller and type of entity sold
 - ▶ Allocate vs. apportion
 - ▶ Allocate
 - ▶ Generally source gain from intangible assets to commercial domicile
 - ▶ Potential multiple commercial domiciles
 - ▶ Sale of partnership interests may be sourced using partnership's apportionment factors (e.g., sales factor of target partnership)

Income Tax - Seller Treatment

- ▶ Equity sale (cont.)
 - ▶ Apportion
 - ▶ Sales factor treatment
 - ▶ Include gross proceeds or net gain
 - ▶ Sourcing - market/customer benefit vs. costs of performance
 - ▶ Exclude altogether

Franchise Tax - Seller Treatment

- ▶ Equity sale
 - ▶ Prorate target's tax for short period in certain states
- ▶ Asset sale
 - ▶ Not allowed to prorate unless target entity dissolves

Income Tax - Buyer

▶ Income Tax

- ▶ Determining entity that will make acquisition
 - ▶ Review current structure to determine tax efficient structure
 - ▶ Model various scenarios
- ▶ Determine debt and equity structure
 - ▶ Identify most advantageous use of debt vs. equity
 - ▶ Income tax deduction of interest
 - ▶ Section 163
 - ▶ Related party addition issues
 - ▶ Equity increases net worth tax

Franchise Tax - Buyer

- ▶ Franchise tax
 - ▶ Entity type may impact liability
 - ▶ Many states do not impose franchise tax on partnerships
 - ▶ Equity vs. debt may impact tax base

Transfer Taxes - Contractual Matters

- ▶ Will sales tax and/or real estate transfer taxes apply to the proposed transaction/reorganization?
- ▶ Will buyer succeed these taxes based on the structure?
- ▶ Within the contract - confirm definitions:
 - ▶ What does the definition of “tax” include?
 - ▶ What does the definition of “transfer tax” include?
- ▶ If such taxes apply, how will they be treated by Buyer and Seller?
 - ▶ Split 50/50?
 - ▶ 100% by buyer v. seller?
 - ▶ What is beneficial to your client?

Transaction Execution

Sales Tax Implications

Sales Tax on the Transaction

- ▶ The first stage in any business reorganization is the determination of the type of transaction.
- ▶ Some transactions may incur a sales or use tax obligation on the transaction itself.
- ▶ Others will be exempt from tax but require an analysis of the target to determine the existing sales tax issues.
- ▶ Is it an asset (cash) transaction or a stock (equity) transaction?

Stock Transaction

- ▶ In a stock transaction, everything is being purchased (assets and liabilities), the entire company or division.
- ▶ In most situations, a stock transaction will be exempt from tax, as it is a purchase of an intangible.
- ▶ This generally also holds true if the transaction takes the character of an asset sale under a Section 338 election.

Asset Transaction

- ▶ In an asset transaction, you are handpicking the assets you want.
- ▶ In an asset transaction, you have to look at what the underlying pieces are. Are you purchasing:
 - ▶ Real estate?
 - ▶ Manufacturing equipment?
 - ▶ Inventory?
 - ▶ Intangibles?
- ▶ Each component of the transaction must be identified, classified and valued.

Asset Transaction

- ▶ If the transaction does not qualify as an exempt bulk sale under sales and use tax provisions, then the valuation and classifications determine the exempt and taxable portions.
- ▶ Allocation of sales price to real property and intangible is beneficial for sales tax but could have the opposite effect on income tax.

Asset Transaction

- ▶ In a taxable transaction, it is important to evaluate all possible exemptions that may apply:
 - ▶ Resale exemption
 - ▶ Manufacturing exemption
 - ▶ Pollution control exemption
 - ▶ Intangibles
- ▶ Documentation of the exemption should be provided to the selling company as soon as registration occurs.

Onboarding / Offboarding

The background features a white space on the left and a complex, abstract geometric pattern on the right. The pattern consists of overlapping, semi-transparent triangles and polygons in various shades of blue, ranging from light sky blue to deep navy blue. The shapes are layered, creating a sense of depth and movement.

Onboarding/Offboarding

Income and Franchise Tax

Income/Franchise Tax - Offboarding

- ▶ Determine post-acquisition nexus
 - ▶ Mark returns as final
 - ▶ States generally expect a return if filed in the past
 - ▶ Withdraw for income/franchise tax where required
- ▶ Determine impact to NOLs and adjust
 - ▶ Example: amount of NOL allocated to corporation that goes to buyer

Income/Franchise Tax - Offboarding

- ▶ Adjust tax accounts
 - ▶ Marginal tax rates change due to apportionment changes
 - ▶ Revise gross cumulative temporary differences
 - ▶ Adjust valuation allowances
 - ▶ Determine if tax accounting policies and procedures need updating
- ▶ Determine when and how much sales funds to distribute
 - ▶ Keep money to cover tax and other expenses, including state taxes

Income/Franchise Tax - Onboarding

- ▶ Establish integration plan
- ▶ Identify nexus and impact on state filings
 - ▶ Use due diligence findings and expand analysis if necessary
- ▶ Determine filing methods
 - ▶ Determining if/when acquired entity or assets is unitary
 - ▶ Making elections in elective combined/consolidated filing states
 - ▶ Electing water's-edge in combined filing states
 - ▶ Making state S corporation election
- ▶ Work with seller to transfer credits

Income Tax - Onboarding

- ▶ Determine whether limitations exist on tax attributes, such as IRC Sec. 382
- ▶ Register for income tax where required
- ▶ Update state tax filing calendar
- ▶ Incorporate acquisition into tax accounting procedures
 - ▶ Determine state tax accounts
 - ▶ Determine if tax accounting procedures and policies need updating
 - ▶ Establish tax sharing agreement

Registrations - Onboarding/Offboarding

- ▶ Who is responsible for opening/closing registrations with state and local government agencies?
 - ▶ Stock vs Asset and responsibility for accounts
- ▶ Specific tax types/areas of concern with unique rules
 - ▶ Notice of sales, purchase, transfer of business (bulk sale notifications)
 - ▶ Payroll tax - is notification optional/mandatory in respective state (experience rating)

Registrations - Onboarding Activities

- ▶ Document the following:
 - ▶ Bank accounts to fund sales tax return payments
 - ▶ Within tax engines and within state accounts if tax accounts are retained
 - ▶ New officers and responsible party information to list on registrations
 - ▶ Key for POA in future
 - ▶ Authorized signers
 - ▶ Secure Power of Attorney authorization as part of the closing package.
 - ▶ Before accounts are closed and with the listed authorized signer

Onboarding Considerations for the Buyer

- ▶ Evaluate the seller's exemption certificate management process and establish or update the new process for vendors and customers.
 - ▶ Issue new exemption certificates to vendors for purchases for resale or exempt use needs.
 - ▶ Request new exemption certificates from customers for sales.
 - ▶ Mark customers exempt in the new system.
 - ▶ Create ongoing customer maintenance.
 - ▶ Establish an exemption certificate management process.

Onboarding/Offboarding

Systems Integration Issues

Onboarding Considerations for the Buyer

- ▶ Onboarding or transitioning sales tax system considerations
 - ▶ What selling systems and tax systems are being used?
 - ▶ Migration from seller's systems to buyer's systems?
 - ▶ Who is responsible for cancelling contracts with the prior selling system, tax engine and compliance providers (if applicable)?
 - ▶ Who is responsible for migration?
 - ▶ How will sales tax returns be filed?
 - ▶ Will filing frequencies change for any returns?
 - ▶ Are returns moving between SST and non-SST status?

Onboarding Activities

- ▶ How will sales tax returns be filed upon transition?
 - ▶ What about Quarterly and Monthly returns if transition occurs mid-quarter or mid-month?
 - ▶ Semi-annual, annual and reconciliation returns
 - ▶ Will data be migrated to a different tax engine for prior periods that haven't been filed yet?

Onboarding Activities

- ▶ Request access to all selling accounts for the earliest possible time even prior to acquisition.
 - ▶ Evaluate systems and sales tax settings in each.
 - ▶ Review how systems interact with the tax calculation and returns package or process.
 - ▶ Identify what is being done manually and what can be automated.
 - ▶ Review customer mapping and exemptions in both the selling systems and tax engine.
 - ▶ Review product mapping and exemptions in both the selling systems and tax engine.
 - ▶ Determine changes to taxability and impact on customers.

Onboarding Considerations for the Buyer

- ▶ Have a compliance plan that includes the prior entity shutdown steps for sales tax.
 - ▶ Consider the timing of the transition and its impact.
 - ▶ Determine who is the responsible party for closing out the prior company's sales tax registrations if necessary.
 - ▶ Acquire the necessary data from the selling company during transition while access is still available.
 - ▶ Schedule final returns, expire/inactivate returns, and deregister with the taxing authorities.

Q&A