

Addressing Sales Tax Issues in Corporate Acquisitions

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In this edition of *In the Trenches*, Faber discusses sales and use taxation as it relates to sales of businesses. He writes that although sales and use taxes likely were not intended to apply to these transactions, they often do, and managing the disparate treatment across the states can create headaches for corporate tax managers.

Background

Most of the tax planning that is done in connection with purchases and sales of corporate businesses involves federal income tax issues. To the extent state and local tax aspects are addressed, the focus is usually on income tax issues. Sales taxes are often ignored. This can be a big mistake.

Sales and use taxes were probably not intended to apply to sales of businesses. The problem is that they often do apply, and this has created myriad problems for corporate tax managers. The sales tax was originally conceived of as a tax on retail sales. The concept of the retail sale in the context of sales and use taxation is intended to ensure that a tax will be imposed once, and only once, in the chain from the producer to the consumer. There should be no pyramiding of tax.¹

Although sales tax laws may have been intended to apply primarily to the classic retail sale — for example, a customer who buys a baseball bat at a sporting goods store — the typical sales tax statute applies to a greater array of transactions. The word “sale” is normally defined in the broadest possible terms, encompassing every transfer of title or possession of goods unless otherwise excepted, and the only exceptions to the broad definition are those specifically prescribed by the legislature. Thus, sales of businesses are exempted from the sales tax only if the legislature thinks to exempt them, and then only to the extent that it articulates the appropriate concept in the appropriate language. Legislatures have generally expressed a desire to exempt some or

all sales of businesses from the reach of the sales tax, but, as will be discussed in this article, they have often failed to achieve that result.

The scope of the problem is reduced to the extent that the sales of some assets of a business are exempt from sales tax because of the nature of the assets and not because the transaction involves the sale of a business. Inventory, for example, is typically exempt whether sold as part of the sale of a business or otherwise because the buyer plans to resell the inventory to its customers in the ordinary course of its business. Similarly, the sale of equipment used predominantly in producing tangible personal property for sale is normally exempt from the sales tax, as is the sale of intangible property and real estate. Thus, the problem generally involves sales of equipment not covered by the production exemption: furniture, supplies, and other items. Nevertheless, these items often have substantial value, and there have been many transactions in which the potential sales tax liability was significant.

The states have failed to apply the sales tax to corporate acquisitions consistently or coherently. Exceptions specifically designed for corporate acquisitions have been internally inconsistent and have not dealt with the whole universe of transactions. The result has been that economically similar, or even identical, transactions are often treated differently.

General Exemptions for Sales of Businesses

Some states have (or purport to have) a sales tax exemption for sales of businesses generally without regard to the form of the transaction or the nature of the consideration received. The rationale presumably is that a tax designed for retail sales should not apply to a sale of a business, which is not a transaction occurring in the ordinary course of business. Nevertheless, the exemptions usually do not go so far as to exempt all transactions not occurring in the ordinary course of business.

California exempts the sale of assets of a business activity when the product of the business is not taxable when sold in the ordinary course of business.² One can argue that the California State Legislature has it backward. If the theory behind a retail sales tax is that the tax should be imposed just

¹J.R. Hellerstein, “The Scope of the Taxable Sale Under Sales and Use Tax Acts: Sales as Distinguished From Services,” 11 *Tax L. Rev.* 261, 262-63 (1956).

²Cal. Rev. and Tax. Code section 6006.5(a).

once while the product is on its way to the ultimate consumer, it would be more logical to exempt the sale of assets of a business if the product of the business is taxable when sold to the ultimate consumer. Under the California scheme, a buyer of a business that manufactures a taxable product will have to pay a tax on the purchase of the business and charge a second tax when the business's products are sold to its customers. Because the cost of the business is presumably taken into account in setting the prices for the products, some pyramiding of tax will occur.

Illinois's exemption is broader. Sales of property are not taxed when the seller is not engaged in the business of selling the property that is sold.³ This exempts the sale of all of the business's assets except its inventory, and the sale of the inventory is covered by the exemption for sales of property that the buyer intends to resell. The application of this provision to property that is sold as a normal incident to the seller's business but that is not inventory (for example, demonstrators that are eventually sold) is unclear.

Texas has a more narrowly drafted exemption. The sales tax does not apply to the sale of "the entire operating assets" of a "business or of a separate division, branch, or identifiable segment of a business."⁴ It is unnecessary for all the assets of a corporation to be sold. A sale of a business or division — or even part of a business — can qualify for exemption even though the selling corporation retains other businesses. A separate unit will be found "if the income and expenses attributable to" it "can be separately ascertained from the books of account or record."⁵ This formulation suggests that the sale of a business operation that is part of a larger unitary business will not qualify for the exemption because the very nature of a unitary business is that separate accounting for income and expenses of one of its parts is not possible.

Any attempt to define concepts of this type will lead to interpretative problems. What are "operating assets"? The commissioner of public affairs has ruled that inventory is not an operating asset and that the failure of the inventory to be sold will not result in a loss of the exemption.⁶ How many of the business's assets must be sold to be of the entire operating assets? The word "entire" suggests that the sale must be of literally all the business's operating assets. Will the exemption be lost if a de minimis amount of assets is retained?

In one rather remarkable case, the exemption was held to be inapplicable when the parties intended to sell — and thought they were selling — all the seller's assets. However, the seller's list showed 38 items of equipment, and the buyer received only 35. No one could figure out what happened to the missing three items. Despite the obvious intent of the

parties, the exemption was denied.⁷ In another case, the exemption was not lost when a small amount of furniture, constituting 16 of 25,000 asset accounts and of insignificant value, was not transferred.⁸ Will the exemption be lost if some operating assets of the business are distributed to the selling corporation's shareholders before, and in contemplation of, the sale?⁹ Must all the assets be sold to one buyer in one transaction? If sales to several buyers can qualify, must they occur at the same time?

Exemptions for Mergers and Readjustments

Some states tax sales of businesses generally but have exemptions for statutory mergers and similar types of corporate readjustments. Here, too, the exemptions are often drafted in ways that produce surprising results. New Jersey, New York, and Vermont have narrowly drawn exemptions for a transfer to a corporation in a statutory merger or consolidation, but only if the transfer is in exchange for the acquiring corporation's stock.¹⁰

While the language of this exemption may appear broad, it actually applies to very few of the mergers that occur in the real world of corporate acquisitions. It is unusual for a target corporation to merge into the acquiring corporation in exchange for the acquiring corporation's stock. For corporate business reasons having nothing to do with the tax laws, it is much more common for an acquiring corporation to form a subsidiary and have the target corporation merge into the subsidiary in exchange for the subsidiary's parent corporation's stock. This avoids the need for the parent corporation, which is often publicly held, to hold a shareholders' meeting to authorize the merger (it technically is not a party to the merger although its stock is used as consideration), and the target company ends up as a subsidiary of the parent corporation, which is probably how the parent corporation would like it to fit in the parent's organizational chart. If properly structured, a merger of a target corporation into an acquiring corporation in exchange for the acquiring corporation's parent's stock is tax free under federal income tax laws.¹¹ Unfortunately, it is not exempt from sales tax in New Jersey, New York, or Vermont because although the transfer in the merger is to a corporation, it is not in exchange for its stock; it is in exchange for its parent's

⁷Decision of the Comptroller of Public Accounts, Hearing nos. 28,823 and 28,824 (Aug 25, 1992).

⁸Decision of the Comptroller of Public Accounts, Hearing No. 32,398 (Dec. 6, 1994).

⁹In an analogous area under federal income tax law, such a distribution will cause a transaction to fail to meet the requirements for tax-free treatment under those of the reorganization provisions that require a sale to be of substantially all of the seller's assets. *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605, *reh'g denied*, 305 U.S. 670 (1938).

¹⁰N.J. Rev. Stat. section 54:32B-2(e)(4)(B); N.Y. Tax Law section 1101(b)(4)(iv)(A)(I); Vt. Stat. Ann. section 9742(2).

¹¹IRC section 368(a)(2)(D).

³Ill. Retailers Occupation Tax section 1; reg. section 130.110(a).

⁴Tex. Tax Code Ann section 151.304(b)(2).

⁵Tex. Tax Code Ann section 151.304(c).

⁶Hearing No. 19,708 (Oct 6, 1986).

stock. While this statutory analysis might seem too technical, it is one that has been adopted by the New York State Department of Taxation and Finance and seems to be a correct reading of the literal language of the law.¹²

In many cases, the sales tax can be avoided by a simple restructuring of the transaction. Instead of merging the target into a subsidiary of the parent corporation, the parent corporation can merge its subsidiary into the target with the target surviving the merger and the target shareholders receiving the parent's stock in the transaction. This reversal of the transaction will also be tax free under the federal income tax laws,¹³ and because the target company's assets remain in the hands of the target and do not move to a new corporation, there is no transfer on which the sales tax can be imposed.¹⁴ This kind of restructuring saved several million dollars in sales taxes in one transaction this writer was involved in.

Transferring assets and assuming liabilities other than in a statutory merger is another way of selling a corporate business without incurring income tax. In this situation, the selling corporation receives stock of the acquiring company, which is then distributed to the seller's shareholders. This transaction can be used when a statutory merger or consolidation is not feasible. Such a transfer is economically similar to a merger in exchange for the acquiring corporation's stock, and, if it is properly structured, any gain realized by the corporate and individual parties to the transaction is not subject to federal income tax.¹⁵ Nevertheless, because this type of transfer is not literally a merger accomplished under the state merger statutes, it does not qualify for the sales tax exemption.¹⁶

The exemption applies only to the extent that the property is transferred in exchange for the buyer's stock. Therefore, if, as is normally the case, the target company's liabilities are assumed by the acquiring corporation in the merger, the transfer will not qualify for exemption to the extent that the consideration is deemed to be the assumption of the target's liabilities.

Example: If a target's assets consist entirely of tangible personal property worth \$1 million, it has liabilities of \$800,000, and it merges into the acquiring corporation in exchange for \$200,000 worth of the acquiring corporation's stock, the consideration for the property will be deemed to be \$200,000 of stock and \$800,000 of assumed liabilities, and barring a special allocation,

80 percent of the consideration received for the tangible personal property will be nonqualifying consideration and subject to the sales tax.

Similarly, the exemption does not apply to the extent that the consideration consists of cash or other property.

The exemption in New Jersey, New York, and Vermont is not linked to qualification as an income-tax-free reorganization under IRC section 368. For example, a merger for which the consideration is stock of the acquiring corporation may nevertheless fail to qualify for income tax exemption under the IRC if the target corporation's shareholders fail to maintain a sufficient continuity of proprietary interest through ownership of stock of the acquiring corporation or its parent, if the acquiring corporation fails to continue a significant portion of the target's business enterprise in a business after the transaction, or if there is not a proper business purpose for the transaction.¹⁷ Disqualification for income-tax-free treatment under any of these rules will not cause a loss of the sales tax exemption.

Maryland, on the other hand, has an exemption for all transfers of property in transactions that qualify as tax-free reorganizations under section 368 of the IRC.¹⁸ This exemption is considerably broader than the New Jersey, New York, and Vermont rule in some respects, yet it is narrower in others.

The Maryland exemption applies to transfers in exchange for stock of the parent of the acquiring corporation, as well as to transfers in exchange for stock of the acquiring corporation itself. It applies to non-merger transactions, and, as long as the transaction is generally exempt from federal income tax under section 368, it apparently applies even to the extent that cash or other nonqualifying property is received or target liabilities are assumed. On the other hand, because the Maryland exemption is directly linked to the federal income tax exemption, it will not apply if the transaction is disqualified from favorable federal income tax treatment because of a failure to meet the continuity of proprietary interest, continuity of business enterprise, or business purpose tests discussed above. In this respect, the exemption is narrower than the New Jersey, New York, and Vermont exemption.

Oklahoma exempts transfers in a reorganization, defined in this case as a statutory merger or consolidation or the acquisition of "substantially all of the properties of another corporation when the consideration is solely all or a part of the voting stock of the acquiring corporation."¹⁹ The second half of the definition is apparently intended to apply to non-merger transactions in which substantially all of the corporation's assets are transferred in exchange for voting stock of the acquiring corporation. These transactions are

¹²N.Y. Reg. section 526.6(d)(7).

¹³IRC section 368(a)(2)(E).

¹⁴There may be business and federal tax reasons why such a restructuring may not be possible in a particular case. For example, the requirements for federal tax-free treatment are more rigorous when the target survives the merger than they are when the buyer's subsidiary survives the merger.

¹⁵IRC section 368(a)(1)(C).

¹⁶N.Y. Reg. section 526.6(d)(6)(iv), *In re Bocard Indus. Inc.*, TSB-H-87 (128)S (Apr. 15, 1987).

¹⁷Treas. reg. section 1.368-1(b).

¹⁸Md. Code Ann. Tax-Gen section 11-209(c)(1)(i).

¹⁹Okla. Stat. section 1360(1)(a).

exempt from federal income tax under IRC section 368(a)(1)(C), but they would not qualify for exemption under the New Jersey, New York, or Vermont approach because they do not involve statutory mergers. The Oklahoma rule is narrower than the federal definition of C reorganizations in that a transfer in exchange for stock of the acquiring corporation's parent corporation will apparently not qualify for the sales tax exemption. The extent to which the general requirements of a C reorganization apply is unclear. For example, a distribution of assets to the target corporation shareholders in a tax-free spinoff before the transaction can cause a failure to meet the requirement that substantially all of the target's assets be transferred to the buyer for federal income tax purposes.²⁰ Will it also result in a loss of the Oklahoma sales tax exemption?

The context of the Oklahoma statute suggests that the solely voting stock requirement does not apply to statutory mergers but only applies to transfers of substantially all of the corporation's properties in a non-merger transaction. Nevertheless, it could be read the other way, and clarification would be helpful.

Does the "solely voting stock" requirement mean that the assumption of the target's liabilities by the buyer will destroy the exemption? It does not result in disqualification from C reorganization status under the federal income tax laws because there is a specific statutory provision that creates an exception for assumed liabilities. There is no similar exception in the Oklahoma sales tax statute, although it would certainly make sense to have one since in the business world it would be extraordinarily unusual for a corporation to agree to sell substantially all of its assets without its related liabilities being assumed as part of the same transaction.²¹

Although the Oklahoma statute describes transactions that are similar to those described in the tax-free reorganization provisions of section 368, it does not specifically refer to that section, unlike the Maryland statute. Therefore, the failure of a transaction to qualify for federal income tax relief under section 368 because it does not meet the continuity of proprietary interest or business enterprise test, the lack of a business purpose, or the failure to liquidate the target in the case of a C reorganization will apparently not cause a loss of the sales tax exemption. On the other hand, it is certainly possible that the Oklahoma courts will require continuity of interest and business enterprise in order to limit the statute to its intended scope, as the federal courts did when confronted with a similar bare-bones statute.²²

²⁰*Helvering*, 95 F.2d 732.

²¹The federal income tax laws also allow nonvoting stock consideration of up to 20 percent (reduced by assumed liabilities) to be received in a "C" reorganization. IRC section 368(a)(1)(C). The Oklahoma sales tax statute contains no such provision.

²²See, e.g., *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933).

Missouri has a broad exemption for any transfer of substantially all of a corporation's tangible personal property to another corporation in a statutory merger or consolidation.²³ There is no requirement relating to the consideration received. Thus, a corporation could transfer all of its tangible personal property to another corporation in a statutory merger in exchange solely for cash, and the exemption would seem to apply. There is no logic in this. If the sale of a business's assets for cash is subject to the sales tax (as it apparently is in Missouri unless the sale is incident to the liquidation or cessation of the taxpayer's business), there is no reason why an exemption should be obtained by the simple expedient of structuring the sale as a statutory merger instead of a sale. Nevertheless, the law is what it is, and there is no reason why taxpayers should not apply it literally. The Missouri courts may, however, limit the statute's application to situations in which stock of the buyer or its parent corporation constitutes a substantial part of the consideration in the transaction. The application of the "substantially all" test is unclear. What proportion of the target's assets must be transferred?²⁴

California exempts transfers under a statutory merger.²⁵ There is no requirement as to the nature of the consideration received, and the exemption literally would apply to a merger in which all of the consideration received was cash. Here again, the courts may impose a continuity of proprietary interest requirement, as the federal courts did in the income tax area. The exemption apparently applies when the consideration is stock of the buyer's parent corporation.

The California exemption is not available in the case of a transfer of all of the seller's assets in a non-merger transaction, even if all of the consideration received is buyer stock in a transaction that is a tax-free reorganization under section 368(a)(1)(C).²⁶

Transfers of Interests in Entities

Sales and use taxes generally apply only to sales of tangible personal property. The sale of a business accomplished through a sale of the stock of the corporation that runs the business will not be subject to sales taxation.

As discussed above, under section 338, the sale of 80 percent or more of a corporation's stock to a corporate buyer will be treated as a hypothetical sale of the target's assets for

²³Mo. Rev. Stat. section 144.011.1(1).

²⁴The IRS will issue a ruling that a transfer of at least 70 percent of a corporation's gross assets and 90 percent of its net assets (after reduction by liabilities) meets the "substantially all" tests of the tax-free reorganization provisions. The courts have been more lenient, suggesting that a transfer of substantially all of the corporation's active business assets will qualify even if they represent a relatively small part of the corporation's total assets. See, e.g., *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981).

²⁵Cal. Reg. section 1595(b)(3).

²⁶Cal. State Board of Equalization Ruling 395.2100 (May 12, 1988).

income tax purposes if the parties so elect. The price paid for that basis step-up is that the target recognizes gain on the deemed hypothetical sale of its assets. If the parties make a section 338(h)(10) election, the gain on the deemed asset sale is taxed to the selling parent corporation on its federal consolidated returns. A section 338 transaction is in fact a sale of corporate stock. The target corporation's assets remain owned by the target. The deemed asset sale under section 338 is a legal fiction intended to provide a rationale for giving the buyer a basis step-up reflecting its purchase price.

Those states that have addressed the question have uniformly held that a section 338 transaction is not subject to sales tax because no actual sale of the corporation's tangible personal property occurs.²⁷ In one New York case, the sales tax was held inapplicable when an asset sale was converted to a stock sale by having the target corporation drop the assets into a new corporation the stock of which was then sold to the buyer in a section 338(b)(10) transaction.²⁸ Although the income tax discussion in the opinion is somewhat confusing, the proper income tax analysis of the transaction is that the drop-down of the assets to a new corporation followed by an immediate sale of the new corporation's stock should be treated as a taxable transfer (it would not be tax free under IRC section 351 because the immediate and prearranged sale of the new corporation's stock would result in a failure to meet the control requirement). Further, the drop-down would produce a market value basis for the assets without regard to section 338. In any event, the drop-down of the assets to the new corporation in exchange for its stock was not subject to sales tax under New York law and the administrative law judge exempted the transfer. Would the result have been different had the buyer immediately liquidated the new corporation so that the net effect of the transactions would have been a sale of assets? If this technique is used, the seller should make sure that it is not a party to any agreement with the buyer in which the buyer indicates that it will liquidate the corporation. If the buyer does so the day after the acquisition but the seller is not a party to that transaction and has not agreed that it will be done, it is hard to say that the transactions together amounted to an asset sale, but the application of step transaction principles cannot be ruled out.

A variation on this theme could involve a transfer of the assets to be sold to a single-member limited liability company (SMLLC) followed by a sale of the SMLLC interest. The transfer of assets to an SMLLC in exchange for an SMLLC interest would normally not be subject to sales tax,

and the sale of the SMLLC interest, being one of intangible property, would also not be subject to sales tax. That the parties may elect to have the SMLLC disregarded for federal income tax purposes under the federal check-the-box regulations should not affect the viability of the SMLLC as a separate entity for sales tax purposes, although the law on this point is fragmentary.²⁹

States have taken different positions on the drop-down technique. The New York State Department of Taxation and Finance has approved it in several rulings, even when it appeared that the transactions were prearranged.³⁰ The writer has had one case in which the issue was identified by New York state auditors and briefed, and tax-free treatment was upheld. On the other hand, the technique has been rejected in California³¹ and Oklahoma.³²

The use of the drop-down of assets to a wholly owned corporation or LLC as a means of avoiding sales taxes has practical and legal limitations. For one thing, the laws in many states, while exempting drop-downs of assets in exchange for interests in the transferee, often impose tax if liabilities are assumed as part of the transfer. In most sales of businesses, liabilities will be assumed or taken subject to along with the assets being sold. Moreover, a corporation that buys a 100 percent interest in the stock of a new corporation or an LLC is acquiring all of the target entity's liabilities, known and unknown. Even if the assets being purchased have just been dropped down into the entity as part of the transaction, a careful buyer will want the purchase agreement to contain all the normal detailed protections against unknown liabilities that agreements for the sale of stock of corporations normally contain. Thus, it is unlikely that the drop-down technique will be used to convert routine sales of assets into sales-tax-free transfers. Nevertheless, in the sale of a business where the documentation will be complex regardless of whether the sale involves assets or an interest in an entity, consideration should be given to using an LLC or a new corporation to effect a transfer of assets in order to avoid sales tax liabilities, assuming that the buyer is willing to incur the added risk.

Conclusion

Purchases and sales of corporate businesses, even in so-called tax-free reorganizations, can result in substantial sales tax liabilities. Practitioners who ignore them in planning transactions do so at their peril. ☆

²⁷ See, e.g., Florida Department of Revenue, Technical Assistance Advisement 89A-054 (1989); and Virginia Department of Taxation, P.D. 94-106 (1994).

²⁸ *The TJX Companies Inc.*, New York State Division of Tax Appeals (1995), *aff'd on other grounds* (N.Y.S. Tax Appeals Tribunal 1997).

²⁹ See Faber "State and Local Tax Planning With Limited Liability Companies," *State Tax Notes*, Sept. 13, 1999, p. 677.

³⁰ TSB-A-98 (2)S; TSB-A-94(25)S; *TJX* (NYS Division of Tax Appeals 1995), *aff'd on other grounds* (NYS Tax Appeals Tribunal 1997).

³¹ Administrative Ruling SUTA series 395.0074.

³² Oklahoma Tax Commission Ruling I.D. No. T89 00153 (1991).