ROBERTS & HOLLAND LLP

The Metropolitan Corporate Counsel *November 1, 2003*

State and Local Taxes Can Hold Unwelcome Surprises for Corporate M&A

By: Carolyn Joy Lee

Federalism is an interesting thing. On the one hand, it preserves considerable freedom to express local preferences and priorities free from the homogenizing influence of a centralized government. On the other hand, the diversity fostered within federalism can produce layers of complex and sometimes conflicting rules, which in turn can create considerable burdens and inefficiencies for multijurisdictional enterprises. The advent of the European Union, with its emphasis on establishing better economic coordination among member states, stands as a clear example of once independent governments making a choice to deemphasize local interests in favor of establishing a more efficient overall business environment. It is fair to say that state and local taxation within the United States often occupies the opposite end of the spectrum.

Our fifty states, and tens of thousands of subsidiary localities, impose a dazzling array of taxes, ranging from fairly simplistic ad valorem property taxes to sales and use taxes, excise taxes on specified transactions, products or industries, taxes on corporate capital, gross receipts taxes, estate and gift taxes, taxes and withholdings on pass-through entities, unemployment taxes, and of course corporate and personal net income taxes. State and local taxes (or "SALT") at times reflect profoundly local interests in benefiting local business or raising funds from local resources; at times reflect U.S. constitutional and legislative constraints on unmitigated federalism; and in a few cases reflect conscious efforts to coordinate policies among state taxing jurisdictions. Whatever the particulars, however, these taxes clearly can represent significant costs.

Why SALT Is a Real Concern

SALT takes on particular significance in corporate mergers and acquisitions, and for a number of reasons should merit close attention in planning and implementing these transactions. First, M&A often is new territory for the businesses involved, presenting structures, transactions, issues, and possibly even entire tax regimes that are not encountered in day-to-day business operations. Second, while the SALT treatment of a transaction will in many cases mirror its federal income tax treatment, this absolutely cannot be assumed. There are many significant ways in which SALT departs from federal income tax concepts, and these departures can represent sources of significant taxes, or opportunities for significant tax savings. Third, M&A transactions often involve the blending of businesses that have previously operated in different realms, either geographically or in terms of business lines. Because so much of SALT is influenced by territoriality, and can be further influenced by tax regimes developed to address the nuances of particular types of businesses, the blending of two corporate families can produce not only transactional tax issues, but also significant risks and/or opportunities for operations following the transaction. Fourth, the reality of modern business is that M&A transactions often

are followed by locational decisions involving the placement of future operations or headquarters. These decisions can be heavily influenced by state and local tax considerations, including the availability of localized development incentives. Finally, due diligence in the state and local area can be much more complex, and problematic, than that required for federal taxes. SALT due diligence often requires ascertaining not only where companies have filed and what positions they have taken in their returns, but also where they have not filed, or which entities or income they have not reported, and why not. And as proactive SALT planning has gained in popularity in recent years, getting a handle on potential exposures for unpaid or underpaid state and local taxes has become ever more important.

Diversity is the Rule

The SALT area is so diverse and complex as to defy summary. A few examples of the kinds of issues one encounters in corporate M&A provide useful illustrations of the variety, scope, and potential financial effects of the application of state and local taxes to these transactions. Looking first at something as basic as the local corporate income tax treatment of the transaction itself, one can find a variety of instances in which not even that conforms to the federal treatment. In New York, for example, the corporate franchise tax excludes from taxable income any gain derived from the sale of a more-than-fifty percent owned subsidiary, even where the gain is subject to federal income tax. New York likewise exempts interest and dividend income received from a subsidiary, but on the flip side denies corporate deductions for interest and other expenses attributed to subsidiary capital. In states that follow the Uniform Division of Income for Tax Purposes Act, nonbusiness income is taxable only in the state of commercial domicile, creating another kind of incentive -- to structure otherwise taxable dispositions, or to characterize the income, to avoid having business income apportionable to high-tax jurisdictions. (See, for example, the New Jersey Allied Signal case, 504 U.S. 768 (1992).)

At the individual taxpayer level the SALT treatment of transactions also can vary from the federal, and can be heavily influenced by the timing of entirely personal events. An individual who sells stock while resident in a high tax jurisdiction such as New York or California can incur significant state income taxes; and as the federal AMT creeps up to absorb an ever growing number of taxpayers the cost of this state income tax becomes increasingly expensive. The same person establishing residency and domicile in a no-tax state like Florida or Nevada will eliminate this tax cost from the transaction altogether.

Net operating losses also are an area in which the state tax treatment can differ from the federal, with potentially significant financial results. In many states, particularly during difficult budgetary times such as these, carrybacks of net operating losses are reduced or eliminated as states conclude they cannot afford to pay unexpected refunds of prior years' taxes. There also are numerous instances in which the configuration of entities following an M&A transaction can affect not just the availability of federal NOLs, but also, and perhaps differently, the availability of state and local NOLs as well.

Elections under Internal Revenue Code section 338(h)(10) also are a source of departure from the federal construct of a deemed asset sale to New Target. In many cases the states will adopt the same rules as the federal, but this is not universal, and particularly not so where S

corporations are involved. State tax reactions to a federal (h)(10) election can vary from pure conformity, to conformity with a corporate tax liability imposed on the deemed seller (and thus carried over to the deemed acquiror), or nonconformity and the attendant lack of an asset basis step-up for the "acquired" assets.

Combination is yet another source of SALT friction in M&A transactions. While the applicability of federal consolidated reporting is usually a relatively straightforward inquiry, the question of which entities are properly includible in a state combined reporting group is a source of endless controversy. These uncertainties can surface in the analysis of the M&A transaction itself, in terms of the SALT taxation of the transaction; they also can loom very large in the post-transaction planning phase, when it becomes necessary to identify the branches of the new family tree that will, or will not, be filing in new or existing combined groups.

Decoupling from Federal “Bonus” Depreciation

The recent and widespread state income tax decouplings from federal "bonus" depreciation are another example of the issues SALT creates for multistate businesses. States' decisions not to conform to the post-9/11 federal accelerated depreciation allowances can easily be understood in the light of the dire budgetary straights many states are currently traversing. However, the federal decision to incentivize business through deductions rather than credits, coupled with states' inabilities to match the federal tax incentives, has created numerous disconnects between the computation of the amounts of depreciation and gain that are reportable for federal as compared to state and local income tax purposes. These disconnects, which will remain relevant throughout the depreciable lives of the affected assets, can be particularly significant in carryover basis transactions that involve large amounts of bonus depreciation assets. In modeling future state tax exposures, these differences in federal and state basis need to be taken into account.

Down Into the SALT Mines

Moving from the relatively familiar world of corporate income taxes into the more peculiar domains of SALT, such as sales and use taxes, or stock or realty transfer taxes, one can encounter all manner of interesting problems. One might, for instance, identify a particular state or federal income tax problem that can be solved by transferring a business, or particular assets, from a corporate entity to a single-member limited liability company that is a disregarded entity for income tax purposes. Before making that transfer, however, it is necessary to consider whether moving those assets will trigger a sales tax, or a real estate transfer tax, and if so on what tax base. One also must evaluate the consequences of living with that disregarded entity on a going-forward basis, and whether, for example, intercompany charges for the provision of goods and services will attract sales taxes, or some other type of state or local transaction or excise tax.

Indeed whenever an income-tax disregarded entity is introduced into the mix, one must consider a separate checklist of the various ways in which the state tax treatment may or may not conform to the "nothingness" such entities connote in the federal realm. Whether the question is of the nexus of the owner to the states in which such entity does business, or involves the owner's treatment of the entity (or its assets) in calculating asset-based tax liabilities, or in computing its

apportionment factors, federally disregarded entities must be appreciated as potentially quite complicated presences in the SALT world.

In organizing one's thoughts around these issues, it is helpful to break the analysis down into three sets of three issues. The first is temporal -- investigate the past, in the form of due diligence; the present, through an evaluation of the taxation of the transaction itself; and the future, evaluating the SALT issues on a going forward basis. The second set of issues is locational. One needs to establish which jurisdictions are potentially relevant to the parties and the transaction; what kinds of taxes those jurisdictions impose; and how they work. The third set simply breaks the SALT world down into three substantive components: income taxes, including both corporate and personal; sales and use taxes; and "other," a category signifying the myriad varieties of revenue generators that might have an impact. Each of the three sets of issues, will in its turn, potentially affect the other sets of issues, creating a dynamic in which, for example, a prior year's decision regarding the proper nexus treatment of a existing corporation might impact the future income tax filing posture of a new member of the corporate family. It is not a simple undertaking, but this is what makes it interesting, and often financially important.