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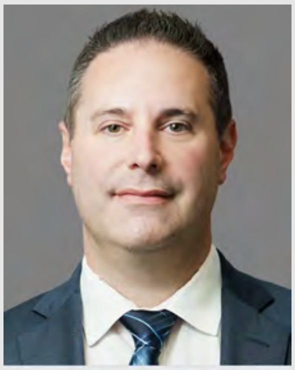

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Louis Mancini is a managing director at Alvarez and Marsal Tax and LLC in New York where he is part of the global transaction tax practice specializing in state and local tax with an expertise in mergers and acquisitions.

In this article, Mancini highlights some of the key state corporate income tax considerations following the acquisition of a business and addresses transfer tax considerations when acquiring a business.

Last year was a record-setting year for merger and acquisition activity — volume reached $5.9 trillion for the first time ever, according to Dealogic. M&A activity started off strong in 2022, but it remains to be seen how the year will close given the economic and geopolitical uncertainty. That said, when private equity sponsors make bolt-on acquisitions to existing portfolio companies or corporate buyers expand operations through acquisitions, it is prudent to consider how these acquisitions may affect a company's post-closing state and local tax footprint, compliance obligations, and tax liabilities.

Given the broad scope of state tax considerations that may become entangled with a business acquisition, it is important to consult with a SALT adviser before an acquisition and assess potential tax planning opportunities early in the process. This article highlights some of the key state corporate income tax considerations following the acquisition of a business and includes commentary on transfer tax considerations when acquiring a business.

Could an Acquisition of a Business Affect a Corporate Buyer's State and Local Effective Income Tax Rate?

A corporation's effective tax rate (ETR) is generally the percent of its income that it pays in taxes. From a state and local income tax perspective, it could be thought of as the rate at which its pretax income is taxed. Several factors may affect a corporation's state and local ETR, including the jurisdictions where the corporation has nexus and files an income tax return, the statutory income tax rate in those jurisdictions, and the corporation's apportionment factor and taxable income sourced to jurisdictions where it files an income tax return. Depending on the state operations of an acquired business and how these operations are integrated as part of a buyer's corporate structure, the post-closing state ETR of a corporate buyer may change. Close consideration of these factors, as discussed below, may help a buyer determine how to optimally integrate an acquired business and assess potential planning opportunities to minimize adverse effect to its post-closing state and local ETR.

Nexus. A threshold question for any corporation is assessing the states where it must file a tax return and pay income tax. A state has jurisdiction to tax a corporation only if the corporation's contacts with the state are sufficient to create nexus. Several factors, both physical and economic in nature, should be considered when assessing nexus.

Following an acquisition of a business, an initial consideration is whether the acquired business may create nexus and therefore require a buyer to file an income tax return in additional jurisdictions. This nexus analysis may be affected by how the acquired business is integrated into the buyer's corporate structure. If the acquired business is held as a division of a corporate buyer, either through a single-member limited liability company that is treated as a disregarded entity or directly as part of and commingled with its assets, then the activities (for example, property, payroll, sales, travels, and so forth) of the acquired business should likely create nexus for a corporate buyer. An important consideration is whether the acquired business operates in states where the corporate buyer had not historically operated; after closing, the corporate buyer may have nexus in additional states, thus expanding its filing profile because of the acquisition. Conversely, if the acquired business is a C corporation that will continue to operate in this form after closing, the buyer should generally not have nexus in additional states merely from owning corporate stock of a C corporation. However, if the entities enter related-party transactions (that is, use of intangibles, trademarks, and so forth) or act as an agent on behalf of each other, consideration should be given to whether these activities create nexus, such as under the principles of agency or economic nexus.

Public Law 86-272. In 1959 Congress enacted P.L. 86-272 to provide multistate corporations with a limited safe harbor from the imposition of state income taxes. P.L. 86-272 prohibits a state from imposing a net income tax on a corporation if the corporation's only in-state activity is the solicitation of orders of tangible personal property if the orders are sent for approval and shipped from out-of-state locations. Following the acquisition of a business that is held as a division of a corporation that claimed P.L. 86-272 protection, consideration should be given to whether the consolidated operations that include the acquired business exceed the statutorily protected activities and thus create income tax nexus in states where the corporate buyer previously claimed P.L. 86-272 protection.

Filing method. Many states require corporations engaged in a unitary business to file a combined or consolidated income tax return and determine taxable income on a combined or consolidated basis. Also, some states may permit taxpayers to elect to file a consolidated income tax return subject to meeting requirements. Filing combined or consolidated state income tax returns may provide for some benefits, such as when one affiliate has losses that can be offset against the income generated by other affiliates. It may also provide for the elimination of some intercorporate dividends and transactions, and the deferral of gains on some intercompany transactions.

Since the acquisition of a C corporation by a corporate buyer may either form a new consolidated group of corporations or be an addition of a member to an existing consolidated group, consideration should be given to whether the acquired corporation is required to file on a combined basis, or if it would be advantageous to elect to file on a consolidated basis, with its corporate buyer and affiliates on a post-closing basis.

Determining whether affiliated corporations operate a unitary business depends on facts and circumstances that courts have developed over several years. Some key factors include (1) unity of ownership (generally having 50 percent or more ownership); (2) unity of operation (generally evidenced by functions being carried out by a corporation on behalf of the group of corporations, such as centralized human resources, legal, procurement, finance/accounting, and so forth); and (3) unity of use (generally evidenced by having common executives and centralized management that makes key policy decisions, intercompany flow of services and goods provided among the members of the group, and so forth).

As it relates to an acquisition of a business, some states have provided guidance in tax statutes, regulations, and notices that address a unitary business. Some states have a rebuttable presumption of a unitary business upon acquisition, such as Texas.[1] However, other states provide that the determination of a unitary business on acquisition is based on the

[1] *See* Tex. Admin. Code 3.590(b)(6)(C) (providing that there is a presumption of a unitary relationship for the first reporting period when a taxable entity acquires another entity).

facts and circumstances, such as Connecticut.[2] Overall, the lack of consistency among the states presents complexity and makes it important to perform a close review of the applicable tax authority following the acquisition of a business to ascertain the required and optimal filing method.

Apportionment. To determine the amount of modified federal taxable income that is subject to state income tax, states apply an apportionment factor or percentage that is commonly based on the relative amounts of property, payroll, and/or sales that the corporation has in each taxing state. Acquiring a business may affect a buyer's apportionment factors, depending on the post-closing structure. For instance, when a corporate buyer acquires the assets of a business that will be held as a division, the acquired business's property, payroll, and sales will be considered in conjunction with the buyer's factors to compute its apportionment percentages. Conversely, when a corporate buyer acquires the stock of a C corporation that will remain in that legal form after closing, any effect to apportionment should likely be limited to combined and consolidated states where the corporate buyer and acquired corporation are members of the same combined/consolidated reporting group.

Overall, it is prudent to consider the aforementioned factors when acquiring a business to assess any potential impact to a corporate buyer's state ETR and whether any potential tax planning opportunities may exist.

Could an Acquisition of a Corporation With State NOL Carryforwards Result in a Limit on the Use of Its State NOLs Post-Closing?

Following the acquisition of a corporation with state net operating loss carryforwards, the use of the carryforwards may become subject to a limit for post-closing tax years if the applicable states conform to IRC section 382, which limits the use of federal NOL carryforwards following an ownership change, or if the states have enacted a state-level "change in ownership" limitation in the absence of such conformity.

For state tax purposes, two common questions encountered by taxpayers regarding section 382 are determining state conformity, or lack thereof, and determining how to compute this limitation if a state conforms to section 382 or has its own state-level limitation.

Limited states provide specific guidance addressing conformity to section 382 and how to compute this limitation. An example of a state that provides specific guidance on conformity to section 382 is Alabama. Alabama explicitly conforms to section 382 by statute.[3] Under Alabama tax regulation,[4] the state provides guidance for how taxpayers compute the state-level NOL limitation by specifically stating that the federal limitation must be apportioned to Alabama using the Alabama apportionment factor of the loss corporation for the reporting period including the ownership change. The regulations provide an example to help illustrate how the computation is done in Alabama:

> Loss Corporation L experiences an ownership change that triggers an IRC section 382 limitation. The annual federal limitation is $10. For the reporting period including the ownership change Loss Corporation L's Alabama apportionment factor is twenty percent (20 percent). The federal limitation of $10 must be apportioned to Alabama using Loss Corporation L's Alabama apportionment factor of 20%, creating an Alabama limitation of $2.

Overall, following an acquisition of a corporation with state NOL carryforwards, it is important to analyze whether any state NOL carryforwards may become limited post-transaction in conjunction with any federal section 382 analysis.

Don't Forget About Transfer Taxes

Many states and localities impose a real estate transfer tax on the direct sale of real property,

[2] *See* Connecticut Special Notice SN 2016(1) (providing that when a change in the direct or indirect ownership of a company causes it to be commonly owned with other companies, it shall be presumed that the company is not engaged in a unitary business with the other commonly owned companies during the income year in which ownership change occurred).

[3] *See* Ala. Code section 40-18-35.1(6).

[4] *See* Ala. Admin. Code section 810-3-1.1-.01(4).

which should be evaluated when acquiring the assets of a business that includes real property. Also, a select group of those jurisdictions have enacted legislation that extends the imposition of a real estate transfer tax on the acquisition of a controlling interest in a legal entity that holds a real property interest in the jurisdiction. As such, the acquisition of stock of a corporation may trigger a transfer tax, commonly referred to as a controlling interest transfer tax, upon meeting the requirements for imposition of the tax.

The imposition of a controlling interest transfer tax varies by jurisdiction but commonly entails the following factors:

1. how the jurisdiction defines a change in "controlling interest" (that is, more than 50 percent or another percentage threshold);
2. how the jurisdiction defines a "real property interest" (that is, ownership of real property or real property leasehold interests, such as long-term leases, leasehold improvements, below-market-value leasehold interests, and so forth); and
3. whether the jurisdiction limits the imposition of the tax to those entities that are "real estate entities" (that is, those entities that primarily exist to hold real property and whose fair market value of the real property accounts for over a percentage of its total assets).

One of the states that impose a controlling interest transfer tax is New York, which imposes a controlling interest transfer tax, in relevant part, when there is a transfer or acquisition of a controlling interest in a corporation (that is, 50 percent or more of the voting stock of a corporation) that holds an interest in New York real property (that is, owned real property, leasehold improvements, leasehold interests, and so forth).[5] Also, the tax could apply when an acquirer may buy interests in a business over a period of time, since New York aggregates separate transfers made by a person, or group of persons acting in concert, occurring within a three-year period to determine whether there has been a change in controlling interest.[6] While the tax is imposed on the grantor under the tax statute, the grantor and grantee shall have joint and several liability for the tax.[7]

When a business acquisition is structured as a direct conveyance of assets that includes tangible property, it is critical to assess whether the conveyance may give rise to any sales tax. Sales tax is generally imposed on the conveyance of the sale of tangible personal property, but many states provide exemptions that may mitigate a portion of, or all, sales tax on the conveyance of tangible property, depending on the scope of the exemptions. For instance, many states provide an occasional or casual sale exemption, the scope of which varies by state but commonly entails the sale of substantially all the assets of a business and/or the sale of assets not sold in the ordinary course of business (that is, fixed assets).

States have enacted statutes and regulations and issued court decisions, rulings, publications, and other forms of guidance that warrant review to assess whether a transaction may qualify for an occasional sale exemption. However, even in states where a transaction may be exempt as an occasional sale, the conveyance of motor vehicles is often excluded and subject to tax. This exclusion could result in a meaningful amount of sales tax if the assets of a business that is being acquired have a large and valuable fleet of motor vehicles. And in states that do not provide an occasional sale exemption, or where the scope is narrow and not applicable, consideration should be given to other potential exemptions, such as exemptions provided for the sale of manufacturing machinery and equipment, or the sale of inventory as a sale for resale. Such exemptions may require a buyer to furnish the seller with the applicable exemption certificate.

Overall, while transfer tax may be imposed on the buyer and/or seller, depending on the applicable jurisdiction's tax law, some jurisdictions impose joint and several liability on both parties to a transaction. Thus, it is prudent that the parties on both sides of a transaction

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[5] *See* N.Y. Tax Law sections 1401(e) and 1402; N.Y. Comp. Codes R. & Regs. tit. 20, sections 575.1 and 575.6; New York Department of Taxation & Finance Publication, No. 576 (June 1, 2008); and New York Tax Bulletin RE-885 (Nov. 18, 2011).

[6] *See* N.Y. Comp. Codes R. & Regs. tit. 20, section 575.6.

[7] *See* N.Y. Tax Law section 1404.

ensure compliance with any transfer tax obligations. Moreover, buyers and sellers may consider having provisions in the purchase agreement address which party will bear the transfer tax liability and prepare any required tax filings.

Closing Thoughts

Overall, there are several SALT considerations that buyers may encounter when acquiring a business. Evaluating these considerations early in the process should help a buyer better prepare for any effect to its post-closing SALT compliance obligations and liabilities and assess whether there are any potential tax planning opportunities. ■