State and Local Tax Aspects of Corporate Acquisitions

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Background

Historically, the state and local tax aspects of corporate acquisitions received little or no attention from tax lawyers or other professional advisors, at least prior to the closing of the acquisition. This is much less true today. Experienced tax professionals appreciate that state and local tax burdens may be very significant—indeed, they can often be more significant than federal tax burdens.[1] In addition, the multi-jurisdictional nature of state and local taxes provides for an unusual number of opportunities and pitfalls in the context of corporate transactions. These opportunities and pitfalls can be observed not only in the context of acquisitions, but also in the context of other corporate transactions, such as corporate organizations, spin-offs, split-offs and split-ups, and corporate liquidations.

The purpose of this article is to identify and address the state and local tax issues most commonly encountered in corporate acquisitions. Income tax issues will be discussed first, followed by sales/use tax considerations, real property transfer taxes and other types of taxes.

Income Taxes

General Principles

Relationship to Federal Income Tax

All states that impose corporate income taxes are tied directly or indirectly to the federal income tax. Almost all states use federal taxable income as the starting point for computing state taxable income, though a few states adopt mirror provisions with language that closely tracks the Internal Revenue Code ("the Code"). The states that use federal taxable income as their starting point—often referred to as "conformity states"—typically follow federal tax principles and interpretative authorities. This is particularly true in states that have specifically incorporated by reference the provisions of the Code.[2] Although "mirror code states" are more clearly permitted to interpret independently their own code language, even if that language is identical to federal Code language, they are nonetheless inevitably influenced by analogous or comparable federal authorities and doctrines. Finally, it must be observed that even though conformity states start with federal taxable income, they invariably enact modifications and, in some cases, these modifications can be relevant in the context of an acquisition.

Multistate Division of Income

Gains or losses recognized as a result of a sale of a multistate business must be distributed or assigned among the various jurisdictions that are entitled to tax the seller. With rare exception, states do not adhere to pure separate accounting principles. In other words, states do not attempt to determine precisely how much gain is directly attributable to their jurisdiction under pure accounting theory. Instead, states generally divide income into two types—business income and nonbusiness income. Some states do not use the terms "business income" and "nonbusiness income," but simply provide that certain types of income are allocable to a particular jurisdiction, and all other types of income are apportioned based on the taxpayer's activities in each state.[3]

Nonbusiness income, which generally includes passive investment income such as interest, dividends, rents, royalties and capital gain from the sale

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of property, is assigned to a particular jurisdiction. All other income is considered business income, which is apportioned among states by a formula mechanism—typically based on some combination of three factors: property, payroll and sales (receipts). Many of these apportionment formulas are based on, or reflect, the apportionment formula adopted by the Uniform Division of Income for Tax Purposes Act (UDITPA). The UDITPA formula apportions the business income of a corporation to a particular state based on the average of the following "factors" for that state:

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- The **property factor,** which is generally equal to the ratio of the average value of real and tangible personal property owned or rented and used by the corporation in that state to the average value of real and tangible personal property owned or rented and used by the corporation in its entire business
- The **payroll factor,** which is generally equal to the ratio of all salaries, wages, commissions and other compensation paid by the corporation in that state for personal services performed by employees in connection with the trade or business of the corporation to all salaries, wages, commissions and other compensation paid by the corporation for personal services performed by employees in connection with the entire trade or business of the corporation
- The **gross receipts factor,** which is generally equal to the ratio of the corporation's gross receipts from business done within that state to its total gross receipts from business done everywhere[4]

The differing treatment of nonbusiness and business income is based on the general belief that nonbusiness income is produced by specific property located in a particular state, and thus should be assigned to that state. For example, gain from the sale of property is produced by the property being sold, and thus should be assigned to the state in which the property is located. Similarly, rental income is produced by the property being leased, and therefore should be assigned to the state where that property is located. The same principle applies to intangible property, but since such property has no physical location, it is generally deemed to be located in the commercial domicile of the business on the basis that this is the most likely location where the activities producing such property take place. On the other hand, business income is produced by all of the activities of the business, and thus a portion of such income should be assigned to each jurisdiction in which the business conducts activities. State apportionment formulas are therefore an attempt to approximate roughly the portion of the business that is conducted in each state.

States are free to adopt their own apportionment formulae, and they vary significantly not only by state, but also by industry and type of business. About 20 states (including California, New Jersey and North Carolina) now double-weight the sales factor (as compared to the other two factors) for purposes of determining the amount of business income apportioned to the state. In addition, a number of states have recently switched (or are in the process of switching) to an apportionment formula based entirely on the sales factor. For example, Illinois, Iowa, Missouri, Nebraska, Oregon and Texas have already adopted a single-factor apportionment formula based on sales. Georgia, Minnesota, New York and Wisconsin are currently in the process of phasing in a single-factor gross receipts formula, and (except in Minnesota) the single-factor formula will be fully phased in for tax years beginning after 2007.

The inconsistencies among state apportionment formulas can give rise to both opportunities for income assigned to no jurisdiction (*i.e.*, "nowhere income") as well as risks of "double taxation." The Supreme Court has pronounced repeatedly that the risk to taxpayers of multiple taxation in and of itself is not unconstitutional.[5] Neither is the risk to states of having nowhere income.

Unitary Business Principle

Although states have been granted great latitude in adopting and applying apportionment formulae to multistate business income, the classification of income as business income subject to apportionment has a constitutional dimension. More specifically, a state is constitutionally precluded from taxing

income wholly attributable to another jurisdiction, even on an apportioned basis.[6] Consequently, even though a state is permitted to tax an apportioned amount of a company's multistate business income, not all of a company's income necessarily constitutes multistate business income, and rules have been devised to help distinguish such income from other income. The allocation rules for nonbusiness income can be viewed fairly as an application of this constitutional principle.[7]

However, it is important to note that not all states agree with the distinction between business and nonbusiness income, and, as a result, some take the position that all the income of a taxpayer is subject to apportionment.[8] Other states recognize the concept of allocation, but provide that if the taxpayer is only subject to tax in their state, all of the taxpayer's income is allocable to that state.[9] Similarly, still other states have adopted "throwback" or "throwout" rules, which essentially permit them to increase the amount of business income apportioned to their state if the taxpayer makes sales to a state where it is not subject to tax.[10] It is questionable whether these sorts of deviations from the typical allocation and apportionment scheme are consistent with the constitutional restrictions on taxing interstate businesses as established by the U.S. Supreme Court.[11]

The principle used to determine the contours of a single business whose income is subject to a single apportionment computation is called the unitary business principle; put differently, a state may only apportion income of a "unitary business."[12] There is no universally accepted definition of what constitutes a "unitary business" among the states. However, the U.S. Supreme Court has referred to a unitary business as one that exhibits "contributions to income resulting from functional integration, centralization of management, and economies of scale."[13] In addition, a number of courts have adopted a more specific three-part test for establishing unity, which requires the following:

- Unity of ownership (typically, a state will require a minimum threshold, such as 50-percent common ownership, to treat affiliated entities as unitary)
- Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions
- Unity of use in its centralized executive force and general system of operation[14]

A single unitary business may be conducted by a single corporate entity or by a group of affiliated corporations. Where the unitary business is conducted by a group of affiliated corporations, some states apply the unitary business principle to the entire group, and thus apply the formulary apportionment method to the business income of all members of the group. Other states—often referred to as "separate entity" or "separate return" states—apply the formulary apportionment method to the business income of each separate entity in a multi-corporate unitary group.

Combination and Consolidation

States that apply the unitary business principle to groups of affiliated corporations are sometimes known as unitary (or combined reporting) states. These states currently include Alaska, Arizona, California, Colorado, Hawaii, Illinois, Kansas, Maine, Minnesota, Montana, Nebraska, New Hampshire, North Dakota and Utah. These states require the company or companies that are doing business in their jurisdiction to file combined reports that include the income and apportionment factors of the entire unitary business across the affiliated group.[15] The resulting tax liability, however, is assigned only to the entities that are actually doing business in the state. It is in this way that combined reports are legally distinguishable from consolidated returns under which each included member of the consolidated group is severally liable for the entire tax liability.[16]

Another important distinction is that state consolidated returns normally require apportionment to be applied on a separate company basis before the netting or consolidation occurs, whereas combined reports require netting or combination prior to a single apportionment application for the entire unitary business.[17] In addition, although intercompany transactions are almost always eliminated for purposes of preparing combined reports, states differ as to whether such transactions will be eliminated for purposes of filing consolidated returns. Finally, the filing of a consolidated return—unlike the filing of a combined report—is generally not predicated upon the existence of a unitary business. State rules regarding the requirements for filing consolidated returns vary widely, but most states require that a federal consolidated return be filed and that each member of the affiliated group consent to the filing. In addition, some states per-

mit a state consolidated return to be filed only if a certain portion of the affiliated group's income is derived from sources in that state.[18]

Once it is established that a state consolidated return may be filed, states differ as to which members of the affiliated group may be included in the state consolidated return. Some states provide that the same members that are included in the federal return must also be included in the state return.[19] Other states require that only those members of the affiliated group that are subject to the state's income tax may be included in the state consolidated return [20]

Taxable Transactions

Seller's Perspective

In a taxable stock or asset acquisition, the seller's computation of gain usually follows or resembles the federal computation. This is because states generally conform to the purchase price allocation rules under Code Sec. 1060, and thus the seller's "amount realized" for state income tax purposes will usually be the same as for federal income tax purposes.

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However, taxpayers should be particularly aware of potential nonconforming basis issues. Sometimes, these issues arise where a state does not permit the filing of consolidated returns. For example, under Reg. §1.1502-32, a parent's basis in its subsidiary stock is adjusted to reflect the subsidiary's income and loss, distributions and certain other items. These adjustments are made because the parent and subsidiary are treated as the same taxpayer under the federal consolidated return regulations; thus, if these adjustments are not made, the consolidated group could either be subject to double taxation (*e.g.*, first, when the subsidiary recognizes income and second, when the parent sells the subsidiary's stock) or receive a double deduction. However, where a taxpayer files state tax returns on a separate entity basis, no adjustments would need to be made.

Nonconforming basis problems may also be caused by different depreciation rules for state and federal income tax purposes. For example, California has generally not adopted the accelerated cost recovery system (ACRS) or modified ACRS depreciation rules under the Code, and instead applies rules similar to the pre-1981 federal depreciation rules.[21] Other states may generally conform to the federal depreciation rules, but have specific carve-outs for certain types of property.[22] An asset's basis for state income tax purposes may differ from its basis for federal income tax purposes for other reasons as well. For example, the asset may have been acquired pursuant to an acquisition that was tax-free for federal purposes, but taxable for state purposes (thus triggering a basis step-up for state, but not federal, purposes). State tax incentives or credits can also affect an asset's state tax basis without affecting its federal tax basis.

In addition to determining the amount of gain for state income tax purposes, the seller must also determine to which states the gain is sourced. In an acquisition, the seller's gain will either be allocable to a particular state or included in the taxpayer's business income that is subject to formulary apportionment depending on state law as informed by the constitutional principles discussed above. Notably, because the amount of the seller's gain may differ depending upon the laws of the state to which it is sourced, the sourcing of the gain will, as a practical matter, need to be determined prior to the computation of the gain itself.

The sourcing of gain to a particular state will depend upon whether the gain is triggered in a stock or asset sale. Gain from the sale of stock is generally viewed as nonbusiness income that is allocable to the state in which the "*situs*" of the stock is located—typically, the commercial domicile of the seller unless the stock has obtained a special business *situs* elsewhere.[23] Thus, if the seller is located in a no-tax jurisdiction (such as Delaware or Nevada), the seller will usually prefer a stock sale to an asset sale. However, the sale of stock of a subsidiary may produce business income where there is a high degree of operational integration between the parent and the subsidiary, or possibly if the stock was held by the parent as part of its overall strategic business plan.[24]

In an asset sale, the determination of whether the gain is regarded as apportionable business income or allocable nonbusiness income will often turn on whether the jurisdiction at issue has adopted only the "transactional test" or both the transactional test and the "functional test." Under the transactional test, gain is treated as business income if the taxpayer regularly engages in the

type of transaction producing the gain, even if the assets were not used to generate business income. In contrast, under the functional test, gain is treated as business income if the assets were used to generate business income, even if their sale is not a regular incident of the business.[25]

Accordingly, in states that apply the functional test, gain from the sale of business assets will ordinarily be treated as business income, whereas in states that apply only the transactional test, such gain will typically be classified as nonbusiness income allocable to the location of the assets being sold. An increasing majority of state revenue departments has taken the position that the functional test is appropriate and applicable under state law.[26] However, a number of state courts continue to follow only the transactional test.[27]

Despite these general principles, several courts have suggested that a full or partial liquidation of a business interest may not constitute business income under either the transactional test or the functional test. This result appears to be entirely consistent with the transactional test because a liquidation is not considered a "regular" or "ordinary" business transaction.[28] However, it is somewhat more difficult to understand this result under the functional test because that test merely requires that gain be derived from the sale of business assets, and a transfer of assets in liquidation represents either the equivalent of or at least a very close variation of the sale of business assets. Indeed, this was the conclusion reached by the California Court of Appeal in *Jim Beam Brands Co. v. Franchise Tax Board*,[29] which held that a corporation's gain from the sale of stock of a wholly owned unitary subsidiary was business income because the acquisition, management and disposition of the subsidiary's stock were integral parts of the corporation's unitary business under the functional test. The *Jim Beam* court thus rejected the "liquidation exception" because it focuses on the nature of the transaction rather than the relationship between the property sold and the taxpayer's regular trade or business operations, which is the focus of the functional test.

Nonetheless, courts in several other states—including Illinois, Pennsylvania and North Carolina—have shown a willingness to view liquidations as by nature a nonbusiness activity even under the functional test.[30] These courts appear to place liquidations in a separate category from other asset dispositions, essentially reasoning that a liquidation is not in furtherance of a unitary business but rather is a means of business cessation. However, each of these states has subsequently amended its definition of "business income" to mean "all income that may be treated as apportionable business income under the Constitution of the United States."[31] Under this broader definition, it would appear somewhat more difficult for a taxpayer to argue successfully that income from a liquidation is nonbusiness income—indeed, these amendments may have been intended to override the decisions upholding the liquidation exception in these states. Other states, such as New Mexico and Ohio, have taken a slightly more direct approach, by specifically defining "business income" to include income from the liquidation of a business.[32] Despite this apparent trend toward categorizing liquidation gains as business income, courts in some states still take the view that these gains constitute nonbusiness income.[33]

Due to the varying state rules regarding apportionment and allocation, it is possible for gain in either a stock or asset sale to be less than fully taxed at the state level. This possibility can be enhanced by careful planning, including the following techniques:

- **Gain on asset sale is allocable (or apportioned) to another state.** A seller of business assets should take the position in as many states as possible that the gain resulting from the asset sale is entirely allocable to another jurisdiction. For example, if a multistate corporation sells a Georgia manufacturing facility, it should carefully examine whether it can take the position in states other than Georgia that the gain is nonbusiness income allocable to Georgia (in Georgia, the corporation would take the position that the gain is apportionable business income so that only a portion of the gain would be taxed in Georgia). For the reasons discussed above, this will be much easier to accomplish in states that apply only the transactional test for the purpose of defining business income. Alternatively, one might be able to argue that although the gain represents apportionable business income, it is attributable to a different unitary business than the business being conducted in that state. The success achieved by asserting these strategies in other states will have no bearing on the Georgia tax liability be-

cause, like all other states, Georgia will apply its rules independently. In this case, Georgia would probably not seek to treat the gain as nonbusiness income allocable to Georgia since Georgia uses the functional test approach.[34] Notably, this same phenomenon can whipsaw taxpayers if the facility being sold is located in a state that employs only the transactional test, because the state is in a better position to seek allocation of the entire gain to that jurisdiction (even though many other states would seek to tax an apportioned share of the same gain).

- **Use of passive investment companies.** A popular tax planning technique involves the placement of intangible assets, such as stock, receivables, trademarks, *etc.*, into a passive investment company (PIC) located in a tax haven jurisdiction—most notably Delaware, Nevada and various unitary states. In most cases, companies contribute these assets in a Code Sec. 351 transaction to the PIC where they can earn royalties, dividends or other passive income on a tax-free basis for state income tax purposes. It is important to recognize that gain realized from the sale of these assets also can escape taxation at the state level by virtue of this arrangement. Consequently, a company considering selling stock in a subsidiary or even assets that include various intangibles should strongly consider contributing those assets to a PIC prior to sale. Careful attention must be paid to effectuating such contributions sufficiently prior to a sale in order to avoid assignment of income problems or disqualification under Code Sec. 351. While the general efficacy of PICs is beyond the scope of this article, it should be noted that these vehicles usually will have no benefit where the parent is located in a combined unitary state due to the fact that the PIC typically will be part of the parent's unitary group. In addition, many nonunitary states are endeavoring to combat these arrangements by requiring that expenses paid to PICs be added back into income. However, these add-back statutes often apply only to interest and royalties and not to gains from the sale of assets. In any event, proper documentation and general attention to detail is vital to the success of these tax planning vehicles.

Buyer's Perspective

The treatment of the buyer in a stock or asset acquisition for state income tax purposes will ordinarily follow the federal rules due to general state conformity with the Code. In particular, the buyer will generally receive a basis step-up under state law as under federal law. In addition, in an asset acquisition, because purchase price allocation rules under Code Sec. 1060 inform the computation of "federal taxable income" and because most states use federal taxable income as their computational starting point, the Code Sec. 1060 rules will typically apply at the state level.

However, state rules regarding the carryover of tax attributes (such as net operating losses[35]) often differ from the federal rules under Code Secs. 269, 382, 383 and 384. Some states also do not apply the federal separate return limitation year (SRLY) rules, even where the state permits the filing of state consolidated returns. These state law deviations may sometimes work to the taxpayer's advantage, as an NOL that is limited for federal income tax purposes may not be similarly limited for state income tax purposes. For example, some states do not impose Code Sec. 382–type limitations on NOLs where there is a change of ownership of the company.[36] However, some states apply even more restrictive limitations on the use of tax attributes than the federal rules. For example, California does not permit NOL carrybacks at all.[37] In addition, Georgia takes the position that the Georgia Code Sec. 382–type limitation must be computed on a separate entity basis even if a state consolidated return is filed, thereby preventing consolidated NOLs from being used by any member of the consolidated group other than the member that actually incurred the losses. Georgia also rejects the federal "overlap rule" and thus applies the SRLY rules even in situations where there has been a change of ownership under Code Sec. 382.[38]

In addition, it is not uncommon for states to have different carryforward and carryback periods for NOLs than are allowed under federal law, which currently permits NOLs to be carried forward for up to 20 years and back for up to two years. Several states, for example, still have the 15-year carryforward/three-year carryback provisions previously allowed under federal law. Special state tax attributes, such as state incentives or credits, have no federal counterpart and thus any potential carryover limitations will be governed solely by state law.

Notwithstanding these general principles, a buyer may be able to use certain planning techniques to reduce or eliminate state income taxes in a merger or acquisition. A few of the more common techniques are discussed below.

- **Location of acquisition indebtedness.** When a buyer borrows funds for the purpose of acquiring a company, the debt may produce deductible interest expenses for the buyer while the newly acquired subsidiary is producing operating income. Consolidation solves the obvious mismatch at the federal level, but the mismatch can continue for state tax purposes where the state does not permit consolidated or combined reporting.[39] Companies often try to solve this state level mismatch by "pushing down" the acquisition indebtedness to the subsidiary by way of accounting entries. Sometimes these accounting entries are supported by legal documentation pursuant to which the subsidiary agrees to assume the debt of its parent. Many states routinely disallow these "pushdown" techniques under the theory that no corporation would accept the debt of another corporation on an arm's-length basis for no consideration. One potential solution to this problem is for the subsidiary to distribute an interest-bearing note to its parent, allowing the subsidiary to make deductible interest payments to offset its income. However, if the mismatch cannot be avoided for whatever reason, the buyer may wish to consider moving certain employees and assets associated with administrative and other services to the parent, thereby allowing the parent to charge a service fee to the subsidiary that will produce income and deductions in the appropriate entities in order to mitigate the mismatch. Understandably, state revenue agencies often take issue with these remedial techniques, and proper supporting legal documentation is advisable in connection with any mismatch remedy.
- **Formation of PICs.** In the context of any purchase that includes passive intangible assets, such as stock or trademarks, the purchaser should consider using a PIC that is incorporated in a no-tax or unitary state to acquire these assets.[40] This is true even if operating assets are also being acquired. There is no reason affiliated companies cannot acquire the desired assets, with the PIC accepting certain identified intangible assets and the other "operating company" accepting all other assets. Ideally, this arrangement should involve brother/sister corporations rather than a parent/subsidiary in order to achieve the business purpose of most effectively insulating each company's assets from the liabilities of the other company. Because states often attack PICs on the basis that they lack either economic substance or a valid business purpose, careful attention should be paid both to the operation of the company and to the legal documentation used in setting it up. For example, the PIC should have its own office space and employees and should conduct regular meetings of its board of directors. In addition, any licensing or royalty fees paid to the PIC must of course be calculated at arm's length. The legal documentation may include employment agreements, administrative services agreements, licensing agreements and loan agreements, as well as other more standard documentation such as the PIC's bylaws, articles of incorporation and board resolutions. In addition, both the PIC and the operating company should enter into separate asset purchase agreements if possible with separate closing statements and separate payments. As noted above, a number of jurisdictions—including Alabama, Arkansas, Connecticut, the District of Columbia, Georgia, Illinois, Kentucky, Maryland, Massachusetts, Mississippi, New Jersey, New York, North Carolina, Oregon, South Carolina, Tennessee and Virginia—have begun to challenge the use of PICs by enacting "add-back" statutes that effectively deny deductions for expenses paid to these companies by related parties.[41] A state may also attempt to disallow the state tax benefits of a PIC either by arguing that the company has nexus with that state (based on either an "economic presence" or agency theory) or by requiring the parent and the PIC to file combined reports.[42] In addition, the tax benefit of using a PIC to acquire and hold an

> In any corporate merger or acquisition, there are a myriad of state tax issues that must be considered.

intangible asset must be weighed against any foregone amortization deduction that would have been available to the operating entity had it acquired the asset itself. Although the comparative computation is fairly simple, it must be performed in order to evaluate properly whether a net benefit would exist and, if so, whether it would be sufficient to justify the maintenance cost of a separate corporation.

- **Jurisdictional implications.** Corporations often carefully plan their activities in order to limit the number of states in which they must file income tax returns. In general, federal P.L. 86-272[43] prohibits a state from taxing the income of an out-of-state corporation that limits its in-state presence or activities to "solicitation of orders" for sales of tangible personal property (and activities ancillary thereto), provided that such orders are sent outside the state for approval and the goods are delivered from outside the state.[44] Thus, because of the protection afforded by P.L. 86-272 (as well as under state statutory and judicial authorities limiting the state's taxing jurisdiction), corporations may have sales in a number of states in which they need not file income tax returns. These sales can serve to dilute the apportionment formula's receipts factor and thereby reduce state income tax liabilities in those states in which the corporation is filing. Acquiring any assets or employees located in jurisdictions where the purchaser has previously not been required to file could result in new and unanticipated filing obligations and liabilities in these states. For example, a large and profitable multistate widget manufacturing business that has not been required to file in Wisconsin might acquire a troubled Wisconsin production facility that is not expected to turn a profit for a few years. If some part of the purchaser's net profit is apportioned to Wisconsin, the tax consequences of acquiring the production facility can be quite serious, particularly if Wisconsin has been a significant market state for the purchaser. One possible antidote to this problem would be for the purchaser to restructure its operations so that one marginally profitable corporation conducts the manufacturing operation and a very profitable 100-percent affiliate conducts the sales operation. In nonunitary states, such as Wisconsin, the profits earned by the sales affiliate could continue to be protected from taxation by virtue of P.L. 86-272 notwithstanding the nonprotected manufacturing activities now conducted by a separate company. However, because most states have adopted Code Sec. 482–type provisions requiring arm's-length pricing, it is essential that intercompany transactions include arm's-length terms and proper documentation. In particular, valuation studies that support pricing decisions can be critical elements in surviving an audit or prevailing in court.
- **Purchase price allocation.** As discussed above, apportionable business income is usually not taxed 100 percent at the state level due to the varying apportionment methodologies adopted by different states, and the apportionment of some income to states in which the business is not subject to tax. As a result, in an asset acquisition, the purchase price should be allocated, to the extent appropriate, to business assets rather than to nonbusiness assets that produce gain 100 percent allocable to a state that imposes a significant income tax. Of course, the opposite strategy would be true if the nonbusiness assets are located in a tax-haven state (*e.g.*, stock owned by a Delaware passive investment company).

Special Considerations in Code Sec. 338 Transactions

Sometimes, the parties to an acquisition may wish to structure it as a stock sale rather than an asset sale for nontax reasons (*e.g.*, a stock sale is generally easier to structure mechanically), but may wish to have the transaction treated as an asset sale for tax purposes (*e.g.*, so that the buyer will receive a stepped-up basis in the purchased assets).[45] In order to achieve this goal, the parties may consider making an election under Code Sec. 338(h)(10).

Generally, a Code Sec. 338(h)(10) election is permitted where:

- there is a taxable purchase of at least 80 percent of the target's stock;
- either the seller is a corporation owning at least 80 percent of the target's stock or the target is an S corporation;
- the buyer is a corporation unrelated to the seller;
- the target is a U.S. corporation; and

- the election is made by both the buyer and seller.

Under Code Sec. 338(h)(10), the stock sale is treated as if the target had sold its assets in a taxable transaction and liquidated tax-free into its parent under Code Sec. 332 (or to its subchapter S shareholders). The sale of the target's stock is disregarded for federal income tax purposes. Thus, the only tax that is imposed is on a deemed sale by the target subsidiary of its assets.[46]

Almost all states now generally respect federal Code Sec. 338(h)(10) elections.[47] However, not all states do so explicitly; many conform simply by calculating state taxable income based on federal taxable income. On the other hand, several states do impose special rules in Code Sec. 338(h)(10) transactions. For example, some states—such as California and Wisconsin—permit the parties to make (or not make) a Code Sec. 338(h)(10) election for state tax purposes regardless of whether an election is made for federal tax purposes.[48] Notably, California also requires that both the buyer and the seller be California "taxpayers" (*i.e.*, either qualified to do business in California or actually doing business in California) in order to make the election.[49] Other states provide that the effect of a Code Sec. 338(h)(10) election differs slightly from the federal treatment. For example, Ohio provides that the target retains its NOL carryforwards and other tax attributes despite the deemed asset sale.[50] As noted above, states also differ as to whether the gain from the deemed asset sale is treated as apportionable business income, allocable nonbusiness income or some combination of the two.[51]

Careful attention must be paid to the responsibility for the tax liability on a deemed asset sale under Code Sec. 338(h)(10). Under federal regulations, where the selling parent and the target subsidiary are part of a federal consolidated group, the deemed asset sale is considered to occur prior to deconsolidation; therefore, the tax liability for the gain is attributable to the seller rather than the purchaser. If state returns are filed on a separate company basis, however, some states may assert that the income tax liability resulting from the deemed sale continues to be the liability of the target subsidiary that is now owned by the purchaser *via* the stock purchase.[52] Well-informed buyers should reduce the purchase price to take into account this risk or otherwise address the matter contractually.

Tax-Free Transactions

Reorganizations, Divisions and Liquidations

Because most states directly or indirectly use federal taxable income as their computational starting point, and because the federal reorganization provisions inform the computation of federal taxable income, states will generally respect the tax-free treatment of reorganizations under Code Sec. 368 and related provisions. Similarly, most states follow the federal rules for tax-free divisions under Code Sec. 355 (*i.e.*, spin-offs, split-offs and split-ups) and tax-free liquidations under Code Sec. 332. However, it should be noted that, in a tax-free division, the state tax characteristics of the business may change significantly. For example, if a division of a corporation is spun-off into a separate entity, the original corporation may lose nexus with certain states; its apportionment factors may also change substantially.

However, states have adopted various approaches to the succession of NOL carryovers and other tax attributes following a reorganization. Some states, either through express provision or by their general adoption of federal taxable income as the starting point for their tax base, generally follow the federal rules provided in Code Secs. 381, 382, 383 and 384 (and under the federal consolidated return regulations). Other states employ their own rules or otherwise limit the carryover. For example, a Tennessee regulation indicates that the surviving party to a reorganization may not claim the NOL carryovers of a predecessor.[53]

Any special state tax attributes, such as state incentive credits, should be examined separately in order to determine any potential carryover limitations in the context of a tax-free reorganization or liquidation.

Like-Kind Exchanges

Almost every state now follows the federal treatment of like-kind exchanges under Code Sec. 1031. However, a few states have adopted different rules, which can potentially result in double taxation. For example, Mississippi requires that both the relinquished property and the replacement property be located in Mississippi in order to qualify for nonrecognition.[54] Thus, if Mississippi property is exchanged for like property in another state, and the replacement property is subsequently sold for

cash, Mississippi will impose tax on the initial exchange and the other state will tax the subsequent sale (while ignoring the basis step-up triggered for Mississippi tax purposes on the initial sale).

Similarly, the California Franchise Tax Board takes the position that, if the replacement property in a like-kind exchange is located in another state, any deferred gain in the transaction will be sourced to California and must be recognized upon the subsequent disposition of the replacement property.[55] Thus, because the state in which the replacement property is located will attempt to tax the entire amount of the gain from the sale of that property, a portion of the gain (*i.e.*, the deferred amount) will be subject to double tax. However, it is not entirely clear whether the FTB applies the same treatment to corporate taxpayers (as the publication containing this rule technically applies only to personal income taxes). In any event, there does not appear to be any statutory or regulatory authority that supports the FTB's position. Notably, Oregon has adopted a similar rule, also apparently without statutory or regulatory authority. However, in the case of Oregon, it is clear that the revenue authorities take the position that the sourcing rule applies to corporate taxpayers.[56]

It should be noted that the constitutionality of these types of limitations for like-kind exchanges—which appear facially to discriminate against interstate commerce—is highly questionable.

Real Estate Withholding Taxes

Some states (including, most notably, California) have adopted "baby FIRPTA" (or "mini-FIRPTA") statutes that require purchasers to withhold a portion of the purchase price attributed to the transfer by a nonresident of real estate located in that state.[57] Typically, these requirements are mechanically more relaxed than the federal FIRPTA requirements under Code Sec. 1445 insomuch as they can be avoided by seller certifications without revenue department rulings. In addition, state "baby FIRPTA" statutes often have a much more narrow application than their federal counterpart—in particular, they generally apply only to direct transfers of real estate and not to transfers of interests in real property holding companies (which can trigger withholding at the federal level). However, California is a notable exception, as it has adopted the broader federal definition of "real property interest" for this purpose.

Pre-Existing State Income Tax Liabilities of Target

In any acquisition, it is important for the buyer to determine whether, and the extent to which, it may become subject to any pre-existing income tax liabilities of either the acquired company (in the case of a merger or stock acquisition) or the seller (in the case of an asset acquisition).

Stock Acquisitions and Mergers

In a stock acquisition, any pre-existing state income tax liabilities of the target corporation will continue to remain liabilities of that corporation notwithstanding the change of ownership. Similarly, in a merger, any such liabilities of the target will continue in the surviving corporation by operation of law (whether the merger is performed as a forward or reverse merger). However, unlike in a stock acquisition, a merger can also expose the assets of the acquirer to the state income tax liabilities of the acquired target corporation.

Asset Acquisitions

A few states (*e.g.*, Illinois and Pennsylvania) apparently have the statutory authority to hold a purchaser liable for the state income tax liabilities of a seller of substantially all the assets of a business.[58] This type of "successor liability," common for trust fund taxes such as sales taxes and withholding taxes, is highly unusual for state income taxes. Thus, in most cases, an asset acquisition will not subject the buyer to any pre-existing state income tax liabilities of the seller.

Protection Strategies

There are a number of protection strategies that a buyer can (and often should) use in an acquisition in order to minimize the likelihood of unexpectedly incurring any of the target's pre-existing income tax liabilities.

The most important of these is that the purchase agreement should include an appropriate tax representation and indemnification by the seller. The issues surrounding these provisions resemble those applicable in the federal context, with a couple of exceptions. First, it is often assumed incorrectly that in an asset purchase, a representation with respect to tax liens is sufficient. Due to the possibility of a state successor liability statute, a broader tax representation is often desirable.

Second, it is worth emphasizing that it may be more common for corporate taxpayers to employ creative and somewhat risky tax planning strategies at the state level than at the federal level. Consequently, potential exposure at the state level is often more likely. It is thus important not only for the tax representation to be sufficiently broad, but the indemnification should operate for a period at least as long as the applicable statute of limitations. Furthermore, any indemnification limitations in the form of baskets or caps should be closely scrutinized to determine if they are acceptable in light of this risk.

In some cases, a seller's indemnity may not provide the buyer with the necessary comfort (either due to limitations on the indemnity or concerns regarding the seller's reliability). In these cases, the buyer may request some other form of security, such as a holdback or deferred payment of a portion of the purchase price. Where no such security is available, however, there is no substitute for a thorough due diligence investigation of the target and/or the seller. Conversely, where the buyer is adequately protected by a broad (and reliable) indemnity and/or other forms of security, the importance of a due diligence investigation is reduced.

The buyer may also request a letter from a state indicating the current outstanding income tax liability of the target. Some states may agree to provide these letters, but they generally will not be binding on the revenue agency in the event a greater tax liability is ultimately determined to exist. Thus, they are usually of little comfort to prospective buyers. However, in the rare situation where a state imposes successor liability on the buyer in an asset acquisition, the state will usually permit the buyer to request a binding letter (often referred to as a tax clearance certificate) regarding the amount of the liability.

Sales and Use Taxes

General Application

All states (as well as the District of Columbia) other than Alaska, Delaware, Montana, Oregon and New Hampshire impose sales taxes on the sale of tangible personal property. Where the sale is made by an out-of-state seller, the state's "use" tax, rather than its sales tax, will generally apply.

The sale of intangible property is not subject to sales tax; thus, sales of stock or interests in partnerships or LLCs generally will not trigger sales taxes even if the LLC is disregarded as a separate entity for income tax purposes. However, a few states may treat an LLC that is disregarded for income tax purposes as also being disregarded for sales tax purposes.[59] Hence, in these states, the sale of a membership interest in the LLC will be treated as a sale of the LLC's assets, thereby potentially triggering sales tax.

Sales taxes may potentially apply to both asset acquisitions and corporate mergers, which are generally recognized as conveyances of assets by operation of law. In either case, the tangible personal property that is transferred generally falls into two categories: (1) inventory; and (2) furniture, machinery and equipment. Often, states provide exemptions for transfers of property in either category pursuant to the sale of a business.

Inventory

Almost all states provide an exemption from the sales tax where the property is being purchased "for resale." The sale of inventory in the context of the sale of a business is therefore almost always treated as nontaxable because the business' purchaser will typically be buying the business' inventory for the purpose of reselling it.

Notwithstanding the generally exempt nature of the transfer, careful attention must be paid to documentation. Most states presume that any sale is taxable unless a valid resale certificate is secured by the seller; if the seller fails to collect a certificate from the buyer, the seller will have the burden of proving the resale nature of the transaction on audit.[60] However, a handful of states provide that if the seller does not collect and retain a valid resale certificate covering the inventory at the time of the sale, the seller is absolutely precluded from relying on the resale exemption.[61] Furthermore, a few states will not regard a certificate as valid if the purchaser was not a registered dealer at the time of the sale.[62] In the context of an acquisition, this is not unusual because acquiring companies are often created specifically for the transaction and therefore would have not conducted any business activities (or registered) prior to the acquisition. For these reasons, a diligent seller should make the provision of valid resale certificates (in all states in which the seller has inventory) a closing condition in any asset purchase agreement.

Furniture, Machinery and Equipment

Although resale exemptions do not apply to non-inventory items, such as furniture, machinery and equipment, many states provide exemptions that could cover these items. The precise scope of any potentially applicable exemption should be closely examined in any transaction, as the scope of these exemptions varies widely among states, and the exemptions typically include carve-outs for specific types of assets.

Many states provide that casual, isolated or occasional sales of tangible personal property are not subject to sales tax. Often, this exemption will apply to the sale of a business. For example, Tennessee—like many states—exempts sales of tangible personal property that are not normally sold by a dealer and that have been used by the dealer prior to sale, provided that such property was not purchased using a resale certificate.[63] However, the breadth of this type of exemption can vary considerably from state to state. Some states impose time limitations—*e.g.*, in Georgia the sale must be pursuant to a liquidation completed within a 30-day period unless consent is given by the Department of Revenue for a longer period.[64] In other states, the exemption will apply only if the seller is selling all (or substantially all) of its assets. This test might be applied on an entity, division or location basis. For example, Texas has an exemption for sales involving a complete segment of a business as determined by whether the profit or loss attributable to the assets being sold can be determined from the seller's financial records.[65] Some states exempt casual sales by regulation only, relying on a statutory definition of "retail sale," "business" or another term. These states often limit the exemption to infrequent sales (*e.g.*, fewer than three in a year).[66] Finally, many states exclude certain types of property—in particular, inventory and motor vehicles (including aircraft)—from the casual sales exemption.[67]

A number of states also have exemptions that apply to specific types of business reorganizations. Occasionally, as in Minnesota, these exemptions apply to the same extent that the transaction is exempt from income tax.[68] More often, though, these exemptions will differ from those applicable for income tax purposes, and may apply only in very limited circumstances. For example, Oklahoma's exemption applies to an 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, or of its parent or subsidiary corporation."[69] By contrast, Georgia's reorganization-type exemption applies only "when the owners, partners, or stockholders of the business being reorganized maintain the same proportionate interest or share in the newly formed business reorganization" and thus covers a transfer from a parent to a wholly owned subsidiary, but not a transfer to a 99-percent–owned subsidiary.[70] A few states—such as California—provide specific exemptions for mergers, even though they may not have a general reorganization-type exemption.[71]

Finally, in order to provide incentives and avoid multiple taxation, many states offer fairly broad sales tax exemptions for machinery and equipment used in manufacturing. Although the breadth and nature of these exemptions vary considerably, they should be carefully examined if a casual sale or reorganization-type exemption is not available.

Liability for Sales Taxes Triggered by Merger or Asset Acquisition

In some states, the sales tax is considered a vendor levy, and liability is imposed on the retailer for the "privilege" of engaging in business as a retailer or on the privilege of selling.[72] In these states, the law usually permits (but does not require) the seller to collect the tax from the purchaser.[73] In other states, liability is legally imposed on the consumer, but the seller is required to collect the tax; if the seller fails to collect, it becomes secondarily liable for the tax. In yet other states, the statute may be unclear whether the tax liability is imposed on the seller or the buyer.[74]

In jurisdictions where the tax is imposed exclusively on the seller, the seller may have limited legal recourse against the purchaser if the seller fails to collect the tax from the purchaser at the time of the sale. In states that impose a payment obligation on the purchaser, practical impediments often prevent a seller from collecting the tax after a transaction is closed.

Allocating Responsibility Between Buyer and Seller

In general, nothing prevents a purchaser and seller from allocating contractual liability for any sales tax in connection with a corporate acquisi-

tion. Although such contractual provisions will not prevent a revenue agency from proceeding against either party, assuming it has the statutory authority to do so, it is generally accepted that as between each other the contracting parties will be bound by their agreement. The allocation of contractual responsibility for sales taxes imposed on the transaction thus can be very important. In this connection, it is worth noting that it is not unusual for one party to accept responsibility for such matters under the mistaken assumption that few such taxes would apply. Also, given the concerns regarding the collection of these taxes as noted above, it is good practice for the seller to collect the tax from the purchaser at closing, absent an express provision to the contrary in the acquisition agreement.

Planning Techniques to Reduce or Eliminate Sales Taxes

Certain planning techniques may sometimes be used to reduce or eliminate sales taxes in an asset acquisition. A few of these techniques are discussed below.

Use of Single-Member LLCs

One common planning technique is for the seller to contribute the assets to a newly formed single-member LLC (that is disregarded for income tax purposes) and then sell the interest in the LLC to the buyer, rather than sell the assets directly. Most states provide exemptions for contributions to wholly owned LLCs and will treat the subsequent sale as a nontaxable sale of intangible assets.

However, as mentioned above, a few states conform to the federal entity classification rules for all tax purposes, including sales taxes; in those states, the sale of an interest in a single-member LLC that is disregarded for income tax purposes would be treated as a sale of the assets held by the LLC.[75] It is also possible that a state could attack this structure under the step transaction or a similar doctrine. However, the step transaction doctrine is rarely applied in the sales/use tax context.[76]

Use of Code Sec. 338(h)(10)

A seller and buyer who desire to perform an asset transaction for income tax purposes, but who also want to avoid sales taxes that would be triggered by such a transaction, can often accomplish their goals by performing a stock acquisition subject to an election under Code Sec. 338(h)(10). This should be true even if (1) the sale is preceded by an asset contribution to a new target company pursuant to Code Sec. 351 (assuming a sales tax exemption applies to the contribution) the stock of which will be sold to the purchaser; or (2) the stock purchase is followed by an upstream merger of the target into the purchasing corporation under Code Sec. 332 (again, assuming a sales tax exemption applies to the merger). In each case, the deemed asset sale under Code Sec. 338 should be ignored for purposes of the sales tax because there is no actual sale or transfer of assets.[77]

Purchase Price Allocation

If an acquisition is subject to a significant amount of sales taxes, it is generally advantageous, from a sales tax perspective, to allocate the purchase price away from taxable assets (*e.g.*, toward intangible assets or perhaps machinery and equipment that might qualify for a targeted exemption) in order to reduce the tax liability on the transaction. Obviously, not only must any purchase price allocation be supportable, but it should also be consistent with the allocation performed for income tax purposes. The allocation preferences for income tax purposes are often in tension with the sales tax allocation preferences (*e.g.*, for income tax purposes, it is generally desirable to allocate purchase price towards quickly depreciable assets), and both should be taken into account during the allocation process.

Buyer's Liability for Pre-Existing Sales/Use Tax Liabilities of the Seller or Target Company

A purchaser of a business may become responsible, as a result of the acquisition, of pre-existing sales or use tax liabilities of the seller or target company.

Stock Acquisitions and Mergers

In the case of a stock acquisition, the pre-existing sales and use tax liabilities of a target corporation continue to be contained within that corporation notwithstanding any change of stock ownership. Similarly, in a merger, pre-existing sales and use tax liabilities of the merging corporation will continue in the surviving corporation by operation of law, regardless of how the merger

is structured. Unlike a stock acquisition, however, a merger can also expose the assets of the acquiror to the sales and use tax liabilities of the acquired target corporation.

Asset Acquisitions

In the case of an asset acquisition, most states have enacted statutes (referred to as "successor liability" or "bulk sales" statutes) that specifically provide that the purchaser may—in certain circumstances—become liable for the pre-existing sales and use tax liabilities of the seller.[78] Because many companies that make multi-state sales take fairly aggressive positions with respect to their sales and use tax responsibilities, it is not unusual for successor liability exposures to be quite substantial. However, usually the state successor liability statutes will not hold the purchaser liable for any taxes owed that exceed the consideration paid in the transaction.

Successor liability statutes sometimes require the purchaser to provide an advance notification to the revenue department of the impending acquisition (sometimes called a "bulk sales notice"). The revenue department will then determine the amount of any sales/use tax, interest and penalties due prior to the sale and require the buyer to withhold a portion of the purchase price sufficient to cover the outstanding liability. If the buyer fails either to provide the notice or withhold the amount due, then the buyer becomes liable for such amount. Many states, however, dispense with the notification requirement and simply provide that the buyer succeeds to the sales/use tax liabilities of the seller unless the buyer withholds an amount from the purchase price sufficient to satisfy any sales/use tax liability of the seller.[79]

Frequently, it is impractical for buyers to comply with these requirements. In such cases, the asset purchase agreement should include an appropriate tax representation and indemnification from the seller.[80] Bearing in mind the often aggressive position taken by sellers with respect to sales and use tax responsibilities, any indemnification limitations in the form of baskets or caps should be carefully evaluated. If the buyer determines that an indemnification is insufficient to protect its interests (*e.g.*, due to the financial instability of the seller) and other forms of security are not available, the buyer may request as a condition to closing that the seller obtain a letter or certificate from the applicable state revenue departments either confirming that no taxes are due or expressing the amount of taxes due and outstanding. Many states specifically provide for the issuance of these "tax clearance certificates" and permit the buyer to rely on these letters even if subsequent audits prove the letters to be incorrect.[81] In most states, requesting these letters usually does not result in a field audit of the seller but simply a cursory examination of the seller's returns and payments.[82] Although requiring tax clearance letters can be very useful to a purchaser, it is not a panacea—if a seller has been taking aggressive "non-reporting" positions, for example, there is usually no practical prospect of obtaining such letters.

Real Estate Transfer Taxes

Introduction

Approximately two-thirds of the states (and many counties and cities) impose transfer taxes on the conveyance of real estate located in their jurisdiction.[83] Some jurisdictions apply the tax to the entire value (or consideration) of the real estate transferred, whereas other jurisdictions permit the tax base to be reduced by the amount of any pre-existing mortgage surviving the conveyance.[84] In the latter situation, these taxes can often be avoided (at least in transfers among affiliated entities) by encumbering the property immediately prior to the transfer and then removing the encumbrance shortly thereafter.

Most states impose the transfer tax only on direct transfers of real estate; accordingly, transfers of interests in entities (including real estate holding companies) are generally not subject to tax. However, a growing number of states, including Illinois, Maryland and New York, now tax transfers of controlling interests in certain entities holding real estate.[85] These rules often contain limitations that make them inapplicable in the vast majority of cases. For example, in Illinois, in order to trigger the tax, the entity must exist or act "substantially for the purpose of holding directly or indirectly title to or beneficial interest in real property."[86]

In most states, real estate transfer taxes are imposed only on transfers of fee interests.[87] However, a few states do tax transfers or assignments of certain leasehold interests.[88] In such cases, the tax is typically based on the consideration or fair market

value of the lease—*i.e.*, the gross value reduced by the present value of the remaining rental payments required to be made under the lease.

Liability

Some jurisdictions provide that the liability for any real estate transfer taxes is the sole responsibility of either the buyer or seller. Other states split the liability equally among the buyer and seller. Still others provide that the buyer and seller are jointly and severally liable for the tax.[89] Although buyers and sellers may generally allocate responsibility for the tax pursuant to the asset purchase agreement, states are not typically bound by such agreements.

Exemption for Mergers and Reorganizations

Many states provide an exemption from the real estate transfer tax for conveyances that are incident to a merger.[90] However, some states, such as Florida, only exempt transfers by merger if a deed is not executed or recorded.[91] A number of states also exempt certain other types of reorganizations—particularly where there is not a change in beneficial ownership of the real property—from real estate transfer taxes.

Planning Techniques

In general, the same types of planning techniques discussed above for sales/use taxes can often also be used to reduce or eliminate real estate transfer taxes. However, it should be noted that many states have begun taxing realty transfers using single-member LLCs either by applying the tax to transfers of controlling interests in entities holding real estate, or by applying the step-transaction doctrine.[92] In addition, states often provide more limited exemptions for drop-downs to LLCs in the real estate transfer tax context than in the sales/use tax context.[93]

Other Taxes

A merger or acquisition may also raise a number of other state tax issues. Some of the more common issues are discussed briefly below.

Property Taxes

The transaction agreement should take into account or provide for property tax responsibilities. Typically, the buyer and seller will prorate annual property taxes based on the date of the merger of acquisition. However, the payment mechanics should be specifically provided for, particularly in asset transactions. In addition, the property will generally remain subject to any pre-existing liens on the property notwithstanding the transfer of ownership. As a result, even though the buyer will not become personally liable for these debts, the buyer will clearly want to ensure that any such liabilities have been paid by the seller prior to the acquisition.

It should also be noted that acquisitions, particularly asset acquisitions, generally trigger revaluations for property tax purposes. In some states (most notably California), revaluation of real property is required upon any change of ownership, even in the case of a stock sale.[94]

Capital Stock/Franchise Taxes

Some states impose capital stock or franchise taxes on the corporation's net worth or its authorized or outstanding capital stock. Obviously, mergers and acquisitions will frequently affect (sometimes significantly) the amounts of these taxes that are due.

Intangible Recording Taxes

A few states impose taxes on the recording of certain security interests.[95] These taxes are generally triggered only in asset acquisitions. The asset purchase agreement should assign responsibility for these taxes between the buyer and seller. Where the instrument secures property located in more than one state, the amount of the tax is typically based on the value of the property located in the taxing state.[96] In some cases, these taxes can be eliminated by the use of guaranty arrangements involving affiliates.[97]

Wage Withholding Taxes

A number of states have successor liability rules for state payroll withholding taxes similar to those often applicable to sales/use taxes discussed above. Thus, the purchaser should ensure that the seller's tax representation and indemnification in the acquisition agreement covers this potential liability. A due diligence investigation of the seller's potential tax liability is also highly recommended, particularly in industries where

taxpayers often take aggressive tax positions regarding the classification for workers as independent contractors for withholding purposes and Code Sec. 530[98] relief is unavailable.[99]

Unemployment Taxes

Unemployment tax rates are generally based on the extent to which a business's former employees claim unemployment benefits. In an acquisition, if the target company has an unfavorable unemployment tax rate, sometimes the acquisition can be planned such that the acquiror's rate is applied to the acquired business. Conversely, if the target has a favorable rate, it may be possible in some cases to structure the acquisition such that the acquirer qualifies as a "successor employer" and thus inherits the target's rate. However, by qualifying as a "successor employer," the acquirer also typically becomes liable for any unemployment tax liability owed by the target; hence, it is important to weigh both the benefits and burdens of becoming a successor employer in any particular case.

Unclaimed Property Liabilities

Unclaimed property liabilities, though not "taxes," are increasingly becoming the responsibility of state tax practitioners. Every state (as well as the District of Columbia) has now adopted custodial unclaimed (or abandoned) property laws that require holders of property that is "presumed abandoned" to report and remit such property to the state. The state then holds the property on behalf of the true owner, who may reclaim it from the state at any time. Property subject to these laws generally includes unclaimed wages, customer/vendor credits, accounts payable, deposits, dividends, interest and most other types of intangible property held, issued or owing in the ordinary course of the holder's business. Such property is "presumed abandoned" after it has remained unclaimed for a certain period of time. The period of presumed abandonment varies depending on the particular type of property at issue. Most types of property have either a three- or five-year period, although unclaimed wages (which generally become presumed abandoned after one year) are a notable exception.

In a stock acquisition, any pre-existing unclaimed property liabilities of the target will continue to remain liabilities of the target following the acquisition. Similarly, in a merger, any unclaimed property liabilities of the target will be assumed by the acquirer by operation of law.

Unclaimed property liabilities will also be transferred in an acquisition of all of the assets and liabilities of a business, unless they are specifically excluded. Sellers should be aware, however, that even if the acquiring company agrees to assume the unclaimed property liabilities of the seller, a state may not respect the parties' agreement and could still attempt to hold the seller liable for any amounts that became "presumed abandoned" under the state's unclaimed property laws prior to the acquisition. Conversely, even if the acquirer specifically does not assume any unclaimed property liabilities in the transaction, a state may nonetheless attempt to treat the acquirer as a "successor holder" liable for these obligations—particularly if the acquirer purchased all of the assets of the business and assumed the original liabilities of the seller that gave rise to the unclaimed property liabilities in the first place.[100] Because of these uncertainties, an indemnity is often recommended to ensure that the parties' expectations of liability are met.

Finally, it should be noted that a merger or acquisition may change the state to which unclaimed property liabilities are reportable. In general, unclaimed property must be reported to the state in which the last known address of the owner of the property is located (as set forth on the holder's books and records).[101] But if the holder does not have a record of the last known address of the owner, the property is reportable to the state of the holder's legal domicile (*i.e.*, its state of incorporation).[102] Hence, if the latter rule applies and the holder's legal domicile changes as a result of a merger or acquisition, the state to which the property is reportable will also be affected. However, this rule applies only to property that becomes "presumed abandoned" *after* the date of the merger or acquisition. If the property was already "presumed abandoned" under the laws of the state of incorporation of the predecessor corporation prior to the acquisition, then that state's interest in the property has already vested, and the merger or acquisition will not eliminate the holder's obligation to report and remit the property to that state.

Conclusion

In any corporate merger or acquisition, there are a myriad of state tax issues that must be considered. From the income tax perspective, many states deviate from the federal rules either in minor ways (*e.g.*, subtle differences in depreciation rules) or major ways (*e.g.*, not permitting affiliated groups to file consolidated returns). These differences can give rise both to potential traps for taxpayers and to opportunities to minimize or even eliminate state taxes through careful tax planning. The varying state rules regarding the allocation and apportionment of income also present significant opportunities for tax arbitrage. In addition, sales/use and real estate transfer taxes can often be entirely avoided either by restructuring the acquisition or simply qualifying for a statutory exemption. Finally, taxpayers should also consider the potential impact of (and the possibility of reducing) other types of taxes, including property, unemployment, intangible, wage withholding and capital stock/franchise taxes, as well as unclaimed property liabilities, in any acquisition.

ENDNOTES

[1] A March 2006 study prepared by Ernst & Young's Quantitative Economics and Statistics group, in conjunction with the Council on State Taxation, found that businesses paid approximately half a trillion dollars of state and local taxes in 2005, which is almost five times the amount of state and local taxes businesses were paying in 1980. *See* Robert Cline, et al., *Total State and Local Business,* TAXES, Mar. 2006. In addition, on average, state and local taxes generally account for approximately 45 percent of a company's total tax expense. *See www.ey.com/global/content.nsf/US/Tax_-_State_&_Local_Tax_Services_-_Overview.*

[2] States that incorporate the Code by reference into their tax codes generally incorporate either the entire Code or certain provisions of the Code, and do so either as of a particular date or on a continuing basis. *Compare, e.g.,* Cal. Rev. & Tax. Code §§23051.5, 24601 (generally incorporating certain provisions of the Code, as amended as of January 1, 2005) and Neb. Rev. Stat. §77-2714 (incorporating the Code, as well as federal income tax rules and regulations, as in effect at any time during the tax year). *But see* N.H. Rev. Stat. Ann. §77-A:1(XX) (incorporating the Code as in effect on December 31, 2000, but specifically not incorporating the rules, regulations, forms and procedures of the IRS).

[3] *See, e.g.,* Ga. Code Ann. §48-7-31(c) and (d).

[4] *See* Unif. Div. of Income for Tax Purposes Act §§9, 10, 13, 15, 7A Pt.1 U.L.A. 147, 147 (2002).

[5] *See, e.g., Moorman Mfg. Co. v. Bair,* 437 US 267 (1978).

[6] *Allied-Signal, Inc. v. Director,* 504 US 768 (1992).

[7] The principle that states are permitted to tax an apportioned part of a business' income only to the extent the business is a unitary business appears to be generally compatible with the business/nonbusiness distinction discussed above.

[8] *See, e.g.,* Conn. Gen. Stat. §12-218; Conn. Ruling No. 2003-3 (July 13, 2003).

[9] *See, e.g.,* Mass. Gen. Laws, ch. 63, §§38(j), 42.

[10] About 20 states have adopted a throwback rule. This rule generally provides that if a taxpayer makes an interstate sale that originates in the taxing state and the taxpayer is not taxable in the state in which the purchaser is located (*e.g.,* because the taxpayer lacks nexus with that state), the sale is "thrown back" (*i.e.,* it is treated as being attributable) to the state of origin for apportionment purposes. By contrast, a "throwout" rule generally provides that if a taxpayer makes an interstate sale and the taxpayer is not taxable in the state in which the purchaser is located, the sales are "thrown out" of (*i.e.,* not included in) the numerator and the denominator for purposes of calculating the taxpayer's gross receipts factor in the state of origin. The throwout rule is less common than the throwback rule and has been adopted only by a handful of states.

[11] *See Mobil Oil Corp. v. Comm'r of Taxes of Vt.,* 445 US 425, 438 (1980); *Standard Oil Co. v. Peck,* 342 US 382 (1952); *Moorman Manufacturing Co. v. Bair, Director of Revenue of Iowa,* 437 US 267 (1978).

[12] *See Mobil Oil Corp. v. Comm'r of Taxes of Vt.,* 445 US 425, 439 (1980) ("the linchpin of apportionability in the field of state income taxation is the unitary-business principle").

[13] *Id.,* at 438.

[14] *See, e.g., Butler Bros. v. McColgan,* 111 P.2d 334 (Cal. 1941), *aff'd,* 315 US 501 (1942).

[15] Some states—including Idaho, Indiana, Massachusetts, Michigan, Mississippi, New Mexico, New York, Ohio and Virginia—do not normally require a taxpayer conducting a unitary business to file a combined report, but may permit or require the taxpayer to do so under certain circumstances.

[16] Notwithstanding this legal distinction, some states use the terms "combination" and "consolidation" incorrectly.

[17] This difference probably has a constitutional dimension insomuch as (1) separate company apportionments would seem to be incompatible with a combination predicated on a single unitary business, and (2) a single apportionment would seem to be impermissible without a showing of a single unitary business.

[18] *See, e.g.,* Mo. Rev. Stat. §143.431.3; 12 C.S.R. 10-2.045 (requiring at least 50 percent of the affiliated group's income be derived from Missouri sources).

[19] *See, e.g.,* Fla. Stat. §220.131(1).

[20] *See, e.g.,* Iowa Code §§422.37(2), 422.32(1); Iowa Reg., r. 701 53.15(1)(a); Ga. Reg. Sec. 560-7-3-.13(2)(b).

[21] *See* Cal. Rev. & Tax. Code §24349.

[22] For example, in Georgia, the bonus depreciation deductions allowed under Code Sec. 168(k) must be added back to federal taxable income for purposes of computing taxable income. *See* O.C.G.A. Sec. 48-1-2(14). *See also* N.C. Gen. Stat. §105-130.5(a)(15) (requiring a full or partial add-back for bonus depreciation for tax years before 2005).

[23] *See ASARCO, Inc. v. Idaho State Tax Comm'n,* 458 US 307, 330 (1982); *Nabisco Brands, Inc. & Affiliates v. Dep't of Revenue,* No. TC-MD 010109A, 2003 WL 21246425 (Or. Tax Magis. Div. Apr. 3, 2003) (finding that gains from sale of foreign subsidiaries were nonbusiness income where parent and subsidiary lacked integration and centralization of management common to a unitary business).

[24] *See Allied-Signal, Inc. v. Director, Div. of Tax'n,* 504 US 768 (1992).

[25] We are not aware of any court that has adopted *only* the functional test. This is

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probably because these tests were derived from the individual state statutes defining "business income" for apportionment purposes, and those statutes are often based on the UDITPA definition of "business income," which provides that:

> Income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Unif. Div. of Income for Tax Purposes Act §1(a), 7A Pt.1 U.L.A. 147, 147 (2002). This first clause in this definition clearly suggests a transactional test, and thus the issue is generally whether states interpret the second clause in this definition to also encompass the functional test.

By contrast, the Multistate Tax Commission regulations adopt a presumption in favor of business income and include the functional test:

> Gain or loss from the sale, exchange or other disposition of real or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in ... the taxpayer's trade or business.

Multistate Tax Comm'n Allocation & Apportionment Regulations §IV.1.(c)(2), available at *www.mtc.gov/uniform/alloc_and_apport percent20regs. pdf.* Some courts, such as the Alabama Supreme Court in Ex Parte Uniroyal Tire Company, 779 So.2d 227 (Ala. 2000), have suggested that the functional test is "so broad that it essentially renders nugatory the transactional test."

[26] *See, e.g., Texaco-Cities Serv. Pipeline Co. v. McGaw,* 695 N.E.2d 481 (Ill. 1998); *Dist. of Columbia v. Pierce Assocs., Inc.,* 462 A.2d 1129 (D.C. 1983); *IPCO Corp. v. Collins,* No. C-97364 (Super. Ct. Fulton Co., Ga. May 13, 1988); *Lenox, Inc. v. Offerman,* 538 S.E.2d 203 (N.C. Ct. App. 2000) *aff'd,* 548 S.E.2d 513 (N.C. 2001); *Texaco-Cities Serv. Pipeline Co. v. McGaw,* 695 N.E.2d 481 (Ill. 1998); *Jim Beam Brands Co. v. Franchise Tax Bd.,* 34 Cal. Rptr. 3d 874 (Cal. Ct. App. 2005).

[27] *See, e.g., Atlantic Richfield Co. v. State,* 601 P.2d 628 (Colo. 1979); *Tipperary Corp. v. N.M. Bureau of Revenue,* 595 P.2d 1212 (N.M. Ct. App. 1979).

[28] *See, e.g., Hoechst Celanese Corp. v. Franchise Tax Bd.,* 22 P.3d 324, 337 (Cal. 2001); *Associated P'ship I, Inc. v. Huddleston,* 889 S.W.2d 190 (Tenn. 1994).

[29] 34 Cal. Rptr. 3d 874 (Cal. Ct. App. 2005).

[30] *See, e.g., Lenox, Inc. v. Offerman,* 538 S.E.2d 203 (N.C. Ct. App. 2000) *aff'd,* 548 S.E.2d 513 (N.C. 2001) (partial liquidation); *Laurel Pipe Line Co. v. Commonwealth,* 642 A.2d 472 (Pa. 1994) (partial liquidation); *Texaco-Cities Serv. Pipeline Co. v. McGaw,* 695 N.E.2d 481 (Ill. 1998) (finding business income under the functional test for the sale of pipelines, but implicitly suggesting that a true liquidation, *i.e.,* the cessation of a business interest accompanied by final shareholder distributions, might still result in nonbusiness income); *Nat'l Holdings Inc. v. Zehnder,* No. 98-CH-443 (Ill. Cir. Ct. Jan. 11, 2006). Two Illinois cases have recently extended this principle, logically, to deemed liquidations under Code Sec. 338(h)(10). *See Blessing/White, Inc. v. Zehnder,* 768 N.E.2d 332 (Ill. App. Ct. 2002) (finding gains realized to be nonbusiness income in a sale of assets presumably governed by Code Sec. 338(h)(10)); *Am. States Ins. Co. v. Hamer,* 816 N.E.2d 659 (Ill. App. Ct. 2004) (same). In contrast, both North Carolina and Pennsylvania have promulgated regulations that purport to characterize all gain from Code Sec. 338(h)(10) liquidation as "business income." Directive CD-02-3, N.C. Dep't of Revenue (May 31, 2002); 61 Pa. Code §153.81(d)(1). However, in *Canteen Corp. v. Commonwealth,* 854 A.2d 440 (Pa. 2004), *aff'g,* 818 A.2d 594 (Pa. Commw. Ct. 2003), the Pennsylvania Supreme Court upheld the Pennsylvania Commonwealth Court's holding that Code Sec. 338(h)(10) gain must be characterized as nonbusiness income despite the provisions of 61 Pa. Code §153.81(d)(1). The Commonwealth Court stated:

> It remains generally true that such a regulation has the force of law. Teledyne Columbia-Summerill Carnegie v. Unemployment Comp. Bd. of Review, 160 Pa. Cmwlth. 17, 634 A.2d 665, 668 (1993). Moreover, we recognize that such a regulation can be of great value in providing taxpayers a clear interpretation of statutory language upon which they can rely in planning their business affairs. However, in the present case, the application of the regulation conflicts with our Supreme Court's interpretation of the underlying statute in Laurel Pipe Line. Because a regulation must be consistent with the statute under which it is promulgated, the regulation is not lawfully applied to the present case.

818 A. 2d at 599-600.

[31] 35 Ill. Comp. Stat. Ann. 5/1501(a)(1) (applicable for tax years beginning on or after July 30, 2004); N.C. Gen. Stat. Ann. §105-130.4(a)(1); 72 Pa. Cons. Stat. §7401(3)2(a)(1)(A).

[32] N.M. Stat. Ann. §7-4-2(A); Ohio Rev. Code Ann. §5747.01(B).

[33] *See, e.g., ABB C-E Nuclear Power, Inc. v. Dir. of Revenue, Mo. Admin. Hearing Comm'n,* No. 04-0189RI (June 23, 2005) (holding that the taxpayer's gain from a deemed sale of assets under Code Sec. 338(h)(10) is nonbusiness income and not apportionable to Missouri); *Nadler v. Commissioner,* 2006 Minn. Tax LEXIS 12 (Apr. 21, 2006) (same). Neither Missouri nor Minnesota has amended its definition of "business income" to override these results.

[34] *IPCO Corp. v. Collins,* No. C-97364 (Super. Ct. Fulton County, Ga. May 13, 1988).

[35] In most states, federal NOL deductions are added back and state NOL deductions are subtracted from the state tax base in computing state taxable income. *See, e.g.,* Ga. Comp. R. & Regs. 560-7-3-.06(3); Fla. Stat. Ann. §220.13(1)(b)(1); Fla. Admin. Code Ann. r. 12C-1.013(13). State NOL deductions are generally computed to reflect the apportioned or allocated losses attributable to the state for the years generating the losses.

[36] *See, e.g.,* Conn. Ruling 93-23 (Nov. 23, 1993).

[37] Cal. Rev. & Tax. Code §24416(d).

[38] For a detailed analysis of Georgia's limitations on the use of NOLs in the context of consolidated returns, *see* Ethan D. Millar, *Imperfect State Conformity to Code Sec. 382: Georgia's Unorthodox Approach,* 39 STATE TAX NOTES (TA) 719 (Mar. 6, 2006).

[39] If the acquisition was structured as an asset purchase rather than stock purchase, then the mismatch can be avoided by making sure that the entity actually acquiring the assets incurs the debt. However, if this is not possible, then the loan proceeds should be loaned by the borrowing entity to the acquiring entity, in order to produce interest expense deductions that can be used to offset the income generated by the acquiring entity.

[40] A buyer could also form the PIC after the purchase, and contribute the acquired intangibles at that time. However, states are generally more likely to respect these vehicles when they are created as part of an arm's-length acquisition.

[41] *See, e.g.,* Ala. Code §40-18-35(b); Conn. Gen. Stat. §12-218c; D.C. Code §47-1803.03(b)(7); O.C.G.A.

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§§48-7-21(b)(10), 48-7-28.3(b); Ky. Rev. Stat. §§141.205(2), 141.205(4); Mass. Gen. L. Ch. 63, §31I; Md. Code Ann. §10-306.1(b); Miss. Code Ann. §27-7-17(2); N.J. Rev. Stat. §54:10A-4.4; N.Y. Tax Law §208(9)(o); Ohio Rev. Code Ann. §5733.042; Tenn. Code Ann. §67-4-2006(b)(1)(L).

[42] *See* note 16, *supra*.

[43] 73 Stat. 555 (1959) (codified at 15 U.S.C.A. §381).

[44] *See also Wis. Dep't. of Revenue v. William Wrigley, Jr., Co.*, 505 US 214 (1992).

[45] Other times, a seller may prefer a stock sale to an asset acquisition because the latter may result in a double tax on the seller and its shareholders, if the selling corporation is liquidated as part of the transaction and the liquidation does not qualify for nontax treatment under Code Sec. 332.

[46] Code Sec. 338(h)(10) elections should be distinguished from so-called straight Code Sec. 338 elections. In a "straight" Code Sec. 338 election, the target is treated as having sold its assets to itself, resulting in tax on any gain from the deemed asset sale and a basis step-up in its assets. However, unlike in a Code Sec. 338(h)(10) election, the seller is also taxed on any gain recognized on its sale of the target stock. Because of this double tax, straight Code Sec. 338 elections are relatively uncommon.

[47] *See, e.g.*, Ala. Code §40-18-8(j); Ala Admin. Code §810-3-8-.13; Ala. Rev. Rul. 94-005 (June 14, 1994); Ariz. Corporate Tax Ruling CTR 98-2, (July 23, 1998); Ark. Code Ann. §26-51-413; Conn. Admin. Releases, Ruling 89-46); Conn. Ruling 2003-3 (July 14, 2003); Ga. Code Ann. §48-7-21(b)(7); Idaho State Tax Commission Decision No. 18340 (June 7, 2005); Ill. Priv. Ltr. Ruls. 89-0306 and 89-0222; Mich. Rev. Admin. Bull. 1994-12 (Oct. 21, 1994); N.J. Reg. §§18:7-5.8 and 18:7-11.15; W. Va. Dep't of Tax'n & Revenue Tech. Assistance Advisory 95-003 (May 15, 1995). *But see* Miss. Reg. 801 (treats a Code Sec. 338(h)(10) election the same as a straight Code Sec. 338 election and taxes both the target (on the deemed sale of assets) and the seller (on the actual sale of stock), but permits the seller to offset its gain on the stock sale by the amount of any taxes paid by the target).

[48] *See* Wis. Tax Release, Dep't of Revenue (Apr. 1991); Cal. Rev. & Tax. Code §§24451, 23051.5(e); Cal. Franchise Tax Bd. Information Letter (Oct. 28, 2003). However, if the target is an S corporation, the parties cannot make a Code Sec. 338 election for California income tax purposes unless an election has also been made for federal tax purposes. Cal. Rev. & Tax. Code §23806(b).

[49] Cal. Rev. & Tax. Code §§24451, 23051.5(e); Cal. Franchise Tax Bd. Information Letter (Oct. 28, 2003).

[50] *See* Corporate Franchise Tax Information Release CFT 2004-02 (June 17, 2004). Texas appears to have taken a similar position. *See* Texas Letter No. 9909262L (Sept. 21, 1999).

[51] *See* note 34, *supra*. *See* also Fla. Reg., r. 12C-1.0511 and 12C-1.013 (allocation or apportionment determined on an asset-by-asset basis); Ind. Letter of Findings No. 98-0523 (Apr. 1, 2006) and 03-0166 (July 1, 2006) (gain is business income subject to apportionment).

[52] *See* Reg. §1.338(h)(10)-1(e)(1) (effectively allocating the liability to the purchaser in a nonconsolidated return situation).

[53] Tenn. Comp. R. & Regs. 1320-6-1-.21(2)(d). *See also Golf Digest/Tennis, Inc. v. Dubno*, 525 A.2d 106 (Conn. 1987) (interpreting the applicable Connecticut statute to generally not permit the carryover of NOLs in a merger).

[54] *See* 48-030-001 Miss. Code R. §203. For tax years beginning prior to 2004, Georgia also required that the replacement property be located in Georgia in order to qualify for nonrecognition. *See* former Ga. Code Ann. §48-7-21(b)(5); Ga. Comp R. & Regs. §560-7-3.06.

[55] *See* Cal. Franchise Tax Bd. Publ'n. 1100 (Apr. 2005).

[56] *See* Instructions to 2004 Forms 20 and 20-I (Or. Corp. Excise/Income Tax Returns).

[57] *See, e.g.*, Cal. Rev. & Tax Code §18662(e); Ga. Code Ann. §48-7-128(b); Colo. Rev. Stat. §39-22-604.5; Haw. Rev. Stat. §235-68; R.I. Gen. Laws §44-30-71.3; S.C. Code §12-8-580; Vt. Stat. Ann. §5847.

[58] 25 Ill. Comp. Stat. 5/902(d); 72 Pa. Cons. Stat. §1403.

[59] *See*, e.g., Ala. Code §10-12-8 (following the check-the-box treatment of LLCs for all state tax purposes except for the business privilege/corporate shares tax).

[60] *See, e.g.*, Ga. Code Ann. §48-8-38.

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[61] *See, e.g., Scholastic Serv. Org., Inc. v. Commonwealth,* 721 A.2d 74 (Pa. Cmwlth. Ct. 1998) (vendor was subject to sales tax when it failed to obtain a resale certificate from the purchaser).

[62] *See, e.g.,* Fla. Admin. Code Ann. r. 12A-1.038 (stating that a resale certificate is not valid unless the purchaser is registered with the Department of Revenue at the time of sale).

[63] Tenn. Code Ann. §67-1-102(1); Tenn. Comp. R. & Regs. 1320-5-1-.09.

[64] Ga. Comp. R. & Regs. §560-12-1-.07.

[65] Tex. Tax Code Ann. §151.304. Compare Ga. Comp. R. & Regs. §560-12-1-.07 (casual sale exemption applies only to business liquidations that involve all the assets by reference to a location test).

[66] It is sometimes difficult to reconcile these limitations perfectly, which are probably intended only to distinguish vendors who should be registered and have collection responsibilities from truly occasional sellers, with regulations that appear to exempt most sales of business assets. *See, e.g.,* Fla. Admin. Code Ann. r. 12A-1.037.

[67] *See, e.g.,* Tenn. Code Ann. §67-6-102(1).

[68] Minn. Stat. §297A.25(12)(b). Colorado and Maryland also generally exempt reorganizations qualifying under Code Sec. 368. *See* Colo. Rev. Stat. §39-26-102(10)(h); Md. Code Ann. 11-209(c)(1)(i).

[69] Okla. Stat., tit. 68, §1360(A)(1).

[70] O.C.G.A. §48-8-3(21).

[71] *See, e.g.,* Cal. Code Regs. tit. 18, §1595(b)(3). These exemptions may be based on the somewhat antiquated view that a merger is not a conveyance of assets by operation of law, but instead is a combination of two entities such that the extinguished entity's assets are treated as having been "subsumed by" rather than transferred to the survivor. *See also* Okla. Stat., tit. 68, §1360(A)(1) (exempting statutory mergers and consolidations).

[72] *See, e.g.,* Wis. Stat. Ann. §77.52(1); Cal. Rev. & Tax Code §6051.

[73] *See, e.g.,* Ala. Code §40-23-26.

[74] *See, e.g.,* Okla. Admin. Code §706: 65-7-6.

[75] *See, e.g.,* Ala. Code §10-12-8 (following the check-the-box treatment of LLCs for all state tax purposes except for the business privilege/corporate shares tax).

[76] *But see Shuwa Invs. Corp. v. County of Los Angeles,* 2 Cal. Rptr. 2d 783, 796 (Cal. Ct. App. 1991) (relying heavily on federal case law discussions of the step transaction doctrine to disregard the taxpayer's transaction structure for property tax revaluation purposes so that the court could respect "the intent and spirit of the Revenue and Taxation Code"); Cal. Sales & Use Tax Ann. 395.0074 (June 30, 1995), 395.1840 (July 28, 1986) and 395.1935 (Aug. 21, 1991) (using the step transaction doctrine if the taxpayer's motivation was to avoid sales/use taxes).

[77] Some states specifically acknowledge this treatment. *See, e.g.,* Cal. Code Regs. tit. 18, §1595(a)(6); Fla. Dep't. of Revenue, Tech. Assistance Advisement No. 89A-054 (Oct. 19, 1989); Va. Dep't of Tax'n, P.D. Nos. 04-213 (Dec. 8, 2004), 94-106 (Apr. 8, 1994); Wis. Tax Release, Dep't of Revenue (Apr. 1991); *In re TJX Cos.,* DTA No. 812048, N.Y. St. Tax Rep. (CCH) ¶402-246, *aff'd,* DTA No. 812048, 1997 N.Y. Tax Lexis 78 (Feb. 13, 1997). However, even in states that do not specifically recognize this treatment, it is likely that the state would nevertheless ignore the deemed asset sale and follow the actual form of the transaction.

[78] *See, e.g.,* N.Y. Tax Law §1141(c); Tenn. Code Ann. §67-6-513; Va. Code Ann. §58.1-629; Md. Code Ann. §§11-505 and 13-802.

[79] *See, e.g.,* Va. Code Ann. §58.1-629.

[80] Although it is always advisable for buyers to perform due diligence in any substantial asset acquisition, it will often be impossible as a practical matter to determine conclusively that the seller does not have any potential sales/use tax exposure. Thus, buyers should not rely solely on their own due diligence investigations to protect themselves against potential sales/use tax liabilities.

[81] *See, e.g.,* Ga. Code Ann §48-8-46; Tenn. Code Ann. §67-6-513.

[82] Florida is a notable exception, however.

[83] For example, Georgia imposes a real estate transfer tax at the rate of $0.10 per $100 of consideration or value. Ga. Code Ann. §48-6-1. Tennessee imposes a recording tax at the rate of $0.37 per $100. Tenn. Code Ann. §67-4-409. Florida's rate is $0.70 per $100. Fla. Stat. Ann. §201.02.

[84] Ga. Code Ann. §48-6-1; Fla. Stat. Ann. §201.02.

[85] 35 Ill. Comp. Stat. 200/31-10; Md. Code Ann., Tax-Prop. §13-202; N.Y. Tax Law §1401(e).

[86] 35 Ill. Comp. Stat. 200/31-5.

[87] *See, e.g.,* Ga. Code Ann. §48-6-2(a)(4).

[88] *See, e.g.,* 72 Pa. Cons. Stat. §§8101-C, 8102-C (imposed on mineral and similar interests only); N.Y. Tax Law §1401(d).

[89] *See* Ga. Code Ann. §48-6-3 (the person who executes the deed or other instrument, or the person for whose use or benefit it is executed, is liable for the transfer tax).

[90] *See, e.g.,* Tenn. Code Ann. §67-4-409(e).

[91] Fla. Stat. Ann. §607.11101 (amended in 2000 explicitly to permit transfers of title to real estate incident to merger without execution or recordation of a deed). Although most states have sufficient statutory and regulatory guidance, some states (*e.g.,* Georgia) continue to rely on exemptions provided in the former federal Documentary Stamp Tax Act. In this connection, it is worth noting that many state transfer tax regimes are closely patterned after the old federal act, and were originally intended to piggy-back the federal levy. For example, while most states with transfer taxes would tax a conveyance of realty incident to a Code Sec. 351 contribution, many such states would exempt a distribution of such property to a shareholder pursuant to a corporation liquidation. The disparate treatment between a contribution upon incorporation and a distribution upon liquidation can be traced to regulations under the old federal act.

[92] *See, e.g.,* Va. Code Ann. §58.1-811(10), (11) (transfer between a company and its majority owner is taxable if the transfer is "a precursor to a transfer of control of the assets of the company to avoid recordation taxes").

[93] *See, e.g.,* Ga. Code Ann. §48-6-2 (providing an exemption only for transfers between an individual and a related entity, and not to transfers between two related entities).

[94] Cal. Rev. & Tax Code §62.

[95] *See* Ga. Code Ann. §48-6-61 (tax imposed on recording of long-term notes secured by real estate).

[96] *See* Ga. Code Ann. §48-6-69(b); Ga. Comp. R. & Regs. §560-11-8-.07.

[97] *See* Ga. Code Ann. §48-6-65(a); Ga. Comp. R. & Regs. §§560-11-8-.04, 560-11-8-.14.

[98] Act Sec. 530 of the Revenue Act of 1978 (P.L. 95-600), 92 Stat. 2763, 2885 (1978).

[99] Act Sec. 530 generally provides relief from withholding taxes if (1) the employer did not treat an individual as an employee for any period, (2) the employer had a reasonable basis for not treating the individual as an employee, and (3) none of the employer's federal tax returns (including information returns) treat the individual as employee.

[100] The U.S. Supreme Court has established that the "holder" of unclaimed property required to report and remit it to the state is the person that is legally obligated to pay or deliver the property at issue under the applicable state law—or, to put it another way, the holder is the person who could successfully be sued by the owner for return of the property. *Delaware v. New York,* 507 US 490 (1993). Nevertheless, state definitions of the term vary, and many states provide that the holder may include both (1) the person in possession of the unclaimed property and (2) the person that is obligated to pay or deliver the unclaimed property to its owner.

[101] *See Texas v. New Jersey,* 379 US 674 (1965); *Pennsylvania v. New York,* 407 US 206 (1972); *Delaware v. New York,* 507 US 490 (1993).

[102] *Id.*