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Bankruptcy

A recent decision by the Texas Comptroller of Public Accounts provides some lessons in avoiding successor liability for unpaid taxes. In this instance, even though the purchaser did not directly pay the seller for the business, the comptroller upheld an auditor's assessment for unpaid sales and use taxes. In this article, the authors analyze the comptroller's decision for practical tips on sidestepping this common trap.

Texas Successor Liability: Avoiding Traps for the Unwary In Purchasing Certain Assets of Companies in Bankruptcy

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The Trap Is Sprung

In Texas, when a business owing Texas tax is purchased by another business, the purchaser is required to withhold an amount of the purchase price sufficient to pay the taxes due.¹ Failure to withhold makes the purchaser liable for the taxes, penalty, and interest owed by the seller up to the purchase price paid for the business.² If the purchaser receives a tax clearance certificate prior to the purchase, the obligation to

withhold terminates.³

In a recent decision, the Texas Comptroller of Public Accounts upheld an auditor's sales and use tax assessment, pursuant to the successor liability statute, against a purchaser even though the purchaser did not directly pay the seller, who was a debtor under federal bankruptcy protection, for the business.⁴

Facts

In March 2003, the purchaser contracted with the seller, which operated a restaurant in Texas, to buy all the goodwill, trade names, menus, recipes, as well as the spices, chemicals, foodstuffs, and alcoholic beverages remaining on the premises at the seller's location in Texas. Prior to the execution of the agreement, the seller had closed the restaurant, and the landlord took possession of the premises and its contents.

The purchase agreement provided that in order for the purchaser to get the employees to continue to work at the restaurant, the purchaser would pay the payroll amounts owed to the seller's employees with any sums remaining to be paid to the seller's creditors. That same day, the purchaser executed a lease for the premises with the landlord and reopened the restaurant under

¹ Tex. Tax Code Ann. §111.020(a).

² Tex. Tax Code Ann. §111.020(b).

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³ Tex. Tax Code Ann. §111.020(c).

⁴ Texas Comp. of Pub. Accts., Decision Hearing No. 43,810, STAR No. 200501045H (Jan. 24, 2005).

the same name used by the seller. At the time of its agreement with the seller, the purchaser did not request a tax clearance certificate from the comptroller.

In May 2003, the comptroller calculated but did not bill the seller for the audit period Jan. 1, 2001, through March 19, 2003, apparently because the seller filed for bankruptcy protection. On June 11, 2003, the purchaser was assessed, pursuant to the successor liability statute, for sales and use tax owed by the seller for the audit period.

Analysis

At the heart of the decision is the question of whether the purchaser acquired a business from the seller even though the seller was not operating the business at the time of the sale and the seller did not receive any payments under the purchase agreement.

The purchaser argued that it did not purchase a business since the seller had lost its lease, had its assets confiscated by the landlord, and had closed the restaurant. In addition, the purchaser argued that the seller received no payments from the purchaser. Rather, the purchaser paid the seller's employees and creditors.

In furtherance of its argument that it did not acquire a business, the purchaser cited Comptroller Decision No. 30,262, in which the comptroller held that the mere purchase of a trade name which was subsequently altered did not subject the purchaser to successor liability.⁵ Additionally, the purchaser cited Comptroller Decision No. 40,882, holding that the assumption of a lease, purchasing the primary items required to run a restaurant, along with the trade name, was sufficient for successor liability.⁶ The purchaser argued that it had purchased only the trade name and had not assumed the seller's lease for the premises and had not purchased the assets necessary to operate a restaurant.

In holding that the purchaser did acquire a business, the comptroller pointed to the purchase agreement which stated that the purchaser bought the trade name, goodwill, menus, recipes, etc. of the restaurant. Moreover, the comptroller stated that given the totality of the circumstances, including the fact that the purchaser operated under the same name with the same employees at the same location, the transaction was in effect a purchase of the business of the restaurant. The payments made to the employees and creditors, the comptroller determined, were consideration for the purchase of the business because they mitigated the seller's liabilities to the extent of the payments.

Finally, the comptroller held that since the purchaser did acquire the seller's business and since the pur-

⁵ Texas Comp. of Pub. Accts., Decision Hearing No. 30,262, STAR No. 9403080H (March 2, 1994).

⁶ Texas Comp. of Pub. Accts., Decision Hearing No. 40,882, STAR No. 200209636H (Sept. 20, 2002).

chaser did not request a tax clearance certificate at the time of its purchase, the purchaser was liable for the amount owed by the seller to the extent of the purchase price.

Trap Avoidance: How Not to Pay Twice For the Same Business

Given the comptroller's ever-expanding definition of what constitutes a business,⁷ the safest way for a buyer to avoid the successor liability trap is to request a tax clearance certificate from the comptroller before the purchase of a business, or the assets of a business, is completed. When the comptroller's office receives a request for the tax clearance, it has a maximum of 90 days to audit the seller's books and issue the certificate.⁸ If the certificate is not issued within the 90-day period, the buyer is released from any withholding obligation or liability.⁹

If a tax clearance certificate cannot be obtained, the buyer should carefully analyze the seller's state tax liabilities and withhold a sufficient amount from the purchase price to pay the potential tax liabilities. Although successor liability may not be contracted away and the comptroller may still take enforcement action against the buyer, if the seller objects to the withholding, the buyer should require the seller to agree to indemnify buyer or provide other security for any tax liability related to the seller's operation of the business.

If the seller is financially distressed and has sought or is contemplating seeking bankruptcy protection, the buyer should purchase the business or assets of the business from the bankruptcy trustee. Texas comptroller rules provide that sale of a business by a bankruptcy trustee is not a sale by the former owner, and the buyer will not incur successor liability.¹⁰

Conclusion

Acquiring a business, or the assets of a business, requires careful analysis of the costs relative to the return on the assets acquired. Paying the acquisition price twice rarely will lead to a profitable venture. By obtaining a tax clearance certificate from the comptroller prior to a purchase, buyers can avoid the Texas successor liabilities trap.

⁷ Tex. Regs. §3.7(d). A "business" may be sold if an owner sells: (1) a building, land, furniture, fixtures, inventory, and the right to use the seller's trade name; (2) all the capital assets of the business; (3) the name and goodwill of a business; (4) all the inventory of a business; or (5) the fixed assets and realty necessary to operate a similar business as the seller at the same location.

⁸ Tex. Tax Code Ann. §111.020(c).

⁹ Tex. Tax Code Ann. §111.020(d).

¹⁰ Tex. Regs. §3.7(h).