



# MULTISTATE TAX REPORT



April 24, 2009

Reproduced with permission from Tax Management Multistate Tax, Vol. 16, Issue 4, 04/24/2009. Copyright © 2009 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

## Tax Base

In this troubled economy, some of the old assumptions about taxation of loss companies are no longer valid. Even companies that lose money may owe significant state and local taxes. If businesses are unable to pay these taxes, the burden may be imputed to officers, directors, affiliates, or successors-in-interest. That burden is often far greater than expected, thanks to recent state efforts to expand the scope of their taxes. In this article, authors Charolette Noel and Carolyn Joy Lee, of Jones Day, provide an overview of some common tax traps awaiting unwary taxpayers.

## Troubled Times for State and Local Taxes: How Unexpected Obligations Arise for Loss Companies, Officers, and Directors

By CHAROLETTE NOEL AND CAROLYN JOY LEE

### INTRODUCTION

*Charolette Noel is a tax partner in the Dallas office of Jones Day and the adjunct professor of State and Local Taxation at Southern Methodist University Dedman School of Law. Carolyn Joy Lee is a tax partner in the New York office of Jones Day. Ms. Noel can be reached at [cfnoel@jonesday.com](mailto:cfnoel@jonesday.com), and Ms. Lee can be reached at [cjlee@jonesday.com](mailto:cjlee@jonesday.com). The views set forth in this article are the personal views of the authors and do not necessarily reflect the opinions of Jones Day or any organization with which the authors are associated.*

State and local taxes seem to be taking on a more prominent role in these troubling economic times. The change results, in part, from recent state legislative and judicial actions that have increased the scope of state and local taxes. Companies with significant federal income tax losses, even those that are insolvent, regularly have significant state and local tax liabilities. As such liabilities may, in certain situations, be imputed to officers, directors, affiliates, or other third-parties, increased attention to state and local tax is warranted.

This article explains why some of the old assumptions about taxation of loss companies are no longer valid, if they ever were. It provides examples of how

and when officers, directors, affiliates, and other third parties may succeed to the state and local tax liabilities of a distressed company that may be unable to pay its taxes directly. Businesses in distress—and companies and individuals interacting with them—are cautioned to avoid taking on unnecessary state and local taxes, a task made much more difficult as states have moved aggressively to expand the reach of their tax laws.

Failing to plan for state and local taxes when buying, selling, restructuring, or winding down a money-losing operation, or when foreclosing on out-of-state collateral, can result in various unexpected tax obligations. For example, an acquirer of a distressed business may succeed to certain pre-transfer tax obligations of the business. Restructuring of the company's debt may trigger income from cancellation of indebtedness, even between related parties that are consolidated for federal income tax purposes. These are just a few reasons to include state and local tax diligence in the assessment of risk when dealing with a distressed business. Because most businesses today have customers and/or affiliates in multiple states, a multistate evaluation is usually needed.

## TAX LIABILITIES OF LOSS COMPANIES

Generally, loss companies have no federal or state income tax liabilities, though some may owe income taxes for cancellation of indebtedness income. However, at the state and local levels, most loss companies will be liable for a variety of taxes, such as sales and use taxes, real estate transfer taxes, motor vehicle transfer taxes, miscellaneous excise taxes, gross receipts taxes, ad valorem property taxes, and various franchise, privilege and occupation taxes. The number, scope, and rates of these taxes have increased as states have struggled to fill budget gaps. Unlike the federal government, states cannot print money, and many states have balanced budget requirements that limit their borrowing options. Hence, a recent crop of state and local tax initiatives impose and expand on non-income based taxes and create even more complexity for taxpayers, even in loss situations.

The picture is even further complicated by the fact that, in recent years, states have enacted more alternative minimum taxes, imposed more withholding obligations, created new combined reporting and payment obligations for affiliated businesses, subjected more services and intangible transactions to traditional transfer taxes, asserted broader jurisdiction over out-of-state taxpayers, increased tax rates, reduced the availability of deductions (including net operating loss carryforwards), and expanded tax responsibility to more ancillary parties.

For many companies (and their officers) now is a good time to rethink assumptions about state and local taxation, particularly assumptions that loss companies should not owe much tax, intercompany transactions should not trigger tax, out-of-state vendors should not be subject to tax, officers and affiliates should not be guarantors of a corporation's tax, and state taxable income should not exceed federal taxable income. Relying on these assumptions can be costly, for none of them are universally true.

## Trend to Expand Non-Income Based Taxes

For years, states have been under increasing pressure to find new revenue sources to fund budget shortfalls and to avoid unpopular budget cuts. As new business models and strained economic times have cut into income tax revenues and property tax values, the tax trend has moved away from reliance primarily on income taxes or property taxes. Some states have replaced a portion of their income, net worth, and property taxes with broad-based gross receipt taxes. And because even entities operating at a net loss may have a gross receipts tax liability, gross receipts taxes are especially attractive to governments in a recession.

Some might argue that gross-receipts-based taxes are also attractive to states because they permit maximum exportation of state and local taxes by attributing a large portion of the local tax base to out-of-state sales activities. Others will argue that gross receipts taxes are regressive, hurt small businesses, and are often discriminatory or unfairly apportioned to nonresidents. Gross receipts taxes are sometimes considered good for in-state business; they allow states to provide incentives for in-state headquarters, jobs, and investment because in-state payroll and property factors have limited effect on the taxpayer's liability.

Interestingly, gross receipts taxes arose during the Great Depression in response to budget shortfalls. They are generally imposed at a low tax rate and are apportioned like an income tax, using receipts as the single apportionment factor. In contrast to income taxes, however, gross receipts taxes have few, if any, deductions for the costs of doing business. Thus, in bad economic times, these taxes provide an attractive taxing scheme because the revenue stream is more predictable than that of an income tax, which ebbs and flows more broadly with business and economic cycles.

From a tax compliance and collection perspective, gross receipts taxes are generally considered more efficient than sales taxes because they are levied on the seller's gross sales and are payable by the seller, rather than the buyer. Traditional sales taxes are consumption taxes typically imposed on numerous, less sophisticated purchasers, or on sellers who may have limited nexus with the taxing jurisdiction. Moreover, gross receipts taxes are typically imposed in addition to the state's sales tax, not as a substitute.

Traditional gross receipts taxes, such as Washington's business and occupation tax (B&O tax),<sup>1</sup> Delaware's business and occupational license tax,<sup>2</sup> and Hawaii's general excise tax,<sup>3</sup> have been in existence for a number of years.<sup>4</sup> The rates often vary by business classification, and few deductions are allowed.

<sup>1</sup> Washington's B&O tax is imposed on every person for the privilege of engaging in business activities. See Wash. Rev. Code §82.04.220.

<sup>2</sup> Delaware's license tax is imposed on contractors, manufacturers, retailers, and wholesalers, including pass-through entities. See Del. Code Ann. tit. 30, §§1601, 1621, 2101 to 2911.

<sup>3</sup> Hawaii's general excise tax is broadly imposed on any person engaging in any trade or business activity, occupation, or calling. See Haw. Rev. Stat. §237-13.

<sup>4</sup> A more complete list of locations that have gross receipts taxes is published by the Washington Department of Revenue. See Wash. Excise Tax Advisory No. 543.04.1930 (Sept. 30, 1994).

Most gross receipts taxes enacted more recently are similar to the Washington B&O tax in that they are broadly imposed on most business activities, in lieu of a state income tax, and in addition to the state's sales and use tax. Such taxes include the Ohio commercial activity tax (CAT), the Texas gross margin tax, and the Michigan modified gross receipts tax.

The Ohio CAT, which will be fully phased in by 2010, applies to all types of businesses (e.g., manufacturers, service providers, and retailers) and to most types of entities, individuals, or combinations thereof.<sup>5</sup> The tax is imposed at 0.26 percent for gross receipts over \$1 million that are attributable to Ohio.

The Texas gross margin tax generally applies to all entities other than general partnerships that are solely owned by individuals. The gross margin tax is imposed at a 1 percent rate (0.5 percent for entities engaged primarily in retail or wholesale). The tax is based on the lesser of (a) 70 percent of a business's total gross receipts, or (b) total gross receipts minus either:

- cost of goods sold, or
- compensation (with a cap of \$300,000 per payee).

Effective Jan. 1, 2008, Michigan enacted the new Michigan business tax, which is, essentially, in part a business income tax and, in part a modified gross receipts tax (GRT). The GRT portion of the tax is generally levied on every person or unitary business group with nexus in Michigan at a tax rate of 0.80 percent. The tax base is the taxpayer's gross receipts less "purchases from other firms," which includes acquired inventory, depreciable assets, and materials and supplies.

Like the Texas gross margin tax, the Michigan GRT permits limited exclusions, including some that were carried over from the former Michigan single business tax (a value-added tax) and other exclusions that are industry-specific. The two-part Michigan business tax appears to be a political tradeoff of added complexity for a broader tax base.

These new gross receipts taxes may trigger unexpected taxes on loss companies. If a company makes sales—even at a loss—gross receipts taxes will create tax liabilities, and these liabilities can fall to the officers and directors.<sup>6</sup> Because the taxes have not been on the books long, they may be traps for the unwary. Officers responsible for tax compliance of distressed businesses should take particular care to identify and pay all responsible officer taxes.

## Sales Tax Rates Increasing

Recent opinion polls show that the country is essentially split regarding whether taxes should be increased or lowered in the current economy.<sup>7</sup> More commonly, states have increased sales tax rates as a quick budgetary fix, in some cases with specific voter approval. In 2008, sales tax rates were raised in Indiana, Iowa, Minnesota, North Carolina, Utah, and other states. In Colorado, while the state Legislature eliminated the aggregate tax rate cap on state and local sales taxes, the voters, at least initially, rejected state sales tax increases.

<sup>5</sup> Ohio Rev. Code Ann. §5751.01(A).

<sup>6</sup> See Mich. Comp. Laws §205.27a(5).

<sup>7</sup> See Meg Shreve, *New Analysis: Opinion Polls Show the Public Is of Two Minds on Taxes*, 2008 TNT 214-1 (Nov. 4, 2008).

Some states, however, have lowered rates (for specific items or industries) or enacted new sales tax exemptions. For example, Louisiana lowered its sales tax rate on natural gas and electric power. And Alaska voters approved a temporary local sales tax exemption for purchases of groceries—so groceries will be taxed in Alaska's Kenai Peninsula only during the tourist season.

Generally, the scope and rate of other transfer taxes have increased as well. Historically, these taxes typically did not apply to transfers of intangible interests, such as stock. Now, several states impose transfer taxes when sufficient ownership interests are transferred to cause a change in control of the business. The change of control provisions may result in, among other things, real estate and lease transfer taxes, invalidated tax incentives and abatement agreements, and increased taxable value for annual ad valorem taxes.

The trends for sales taxes bear watching because in most states responsible officers and directors of the business have personal liability for sales taxes. Sales taxes are generally considered to be collected and held in trust by the retail seller for the benefit of the state and local taxing jurisdictions. The personal liability of the officers applies even when the retail seller is in bankruptcy and not permitted to make payments for obligations incurred before bankruptcy.

## State Privilege Taxes Continue After Dissolution

In some states, it can be difficult to wind down operations, particularly if taxes remain outstanding. Dissolving a corporation does not necessarily prevent the business, or its officers and directors, from incurring additional income or franchise taxes in the various states where the company is qualified to do business. Some states require entities to file final tax returns and pay all corresponding taxes before the entity is permitted to withdraw from the state. Failure to properly withdraw continues to subject the business to additional income, franchise, or alternative minimum taxes.

If the wind down activities continue after the loss company has lost its corporate privileges, subsequent taxes and other business liabilities may be imposed directly on the company's remaining officers and directors.<sup>8</sup> If a loss company has income from cancellation of indebtedness in the wind down process, before the company withdraws from doing business, it may be difficult to determine where and how such income should be sourced for state and local tax purposes. Thus, as regular business operations cease, it is usually beneficial to file final returns promptly and to withdraw from as many jurisdictions as possible.

## States Increase Assertions of Taxable Nexus

Even healthy businesses are struggling to deal with expanding tax exposure based on assertions of economic and affiliate nexus. Under these precepts, courts in some states now permit taxation of income that most taxpayers had previously considered to be earned out of state. To have taxing jurisdiction, a state must have

<sup>8</sup> See, e.g., Cal. Rev. & Tax. Code §6829; Cal. Code Regs. tit. 18, §§1702.5 and 1702.6; Tex. Tax Code Ann. §§171.252, 171.255.



“substantial nexus” with the taxpayer and the transactions it seeks to tax. A state may have the “minimum contacts” with the person, property, or transaction for due process under the U.S. Constitution, and yet lack “substantial nexus” required by the Commerce Clause.<sup>9</sup> At least historically, the substantial nexus requirement for sales taxes required some sort of physical presence in the taxing state because mere “economic presence” was insufficient.<sup>10</sup> State tax administrators have, however, continued to push the limits of nexus, often finding that economic nexus is sufficient outside of the sales tax context.<sup>11</sup>

Judicial decisions have increasingly permitted state and local taxation based on economic nexus, and state legislatures are increasingly adopting corresponding legislation. One of the first states to attempt to legislate “economic nexus” was Ohio with regard to the CAT.<sup>12</sup> Since then, other states have enacted similar legislation:

- New York enacted legislation in 2008 asserting nexus to impose its bank income tax on credit card companies with New York customers. Where credit card transactions produce more than \$1 million in receipts from customers with a New York mailing address or from transactions with New York merchants, the out-of-state credit card company is required to file under Article 32, on a separate company basis.<sup>13</sup>

- On Feb. 19, 2009, Wisconsin enacted S.B. 62, which adopts various corporate income tax changes, including combined reporting, the “economic substance” doctrine, and an economic nexus standard, as well as sales tax changes (effective dates vary by provision).

- On Feb. 20, 2009, California enacted S.B.X3 15, which includes provisions adopting an economic nexus standard for “doing business” in California, market-based sourcing of sales, the *Finnigan* approach to assigning combined group receipts to California, and corporate elections to use single sales factor apportionment (effective dates vary by provision).

In a similar vein, on April 9, 2008, the New York Legislature enacted an “Amazon Tax,” so-called because of its direct impact on Amazon.com and other Internet retailers.<sup>14</sup> The new law creates a presumption of nexus for sales tax purposes for any seller that:

- enters into agreements with New York residents for web site referrals or links;
- pays commissions or fees for such referrals based on sales; and

<sup>9</sup> See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

<sup>10</sup> *Id.*

<sup>11</sup> See, e.g., *Capital One Bank v. Massachusetts Comr. of Rev.*, 899 N.E.2d 76 (Mass. 2009); *West Virginia Tax Comr. v. MBNA America Bank*, 640 S.E.2d 226 (W. Va. 2006).

<sup>12</sup> See Ohio Rev. Code Ann. §§5751.01(H), and -(I); Ohio Tax Inf. Rel. No. CAT 2005-02 (Sept. 1, 2005).

<sup>13</sup> N.Y. Tax Law § 1451(c).

<sup>14</sup> N.Y. Tax Law § 1101(b)(8)(vi). Shortly after the New York legislation passed, the New York Department of Taxation and Finance issued TSB-M-08(3)S (May 8, 2008), in which the department sought to clarify the application of the presumption through explanation and example. On June 30, 2008, the department issued a second memorandum, TSB-M-08(3.1)S, designed to provide additional information as to how sellers can rebut the new nexus presumption. The memorandum sets forth the specific steps that Internet sellers must take in order to properly rebut the presumption of nexus based on web site-linking arrangements.

- had total gross receipts from sales of at least \$10,000 during the preceding four quarterly periods.

New York tax officials have informally stated that the presumption does not apply if the sole contribution of the New York sales representative is a web-based click-through.

A number of states have followed New York’s lead and have proposed legislation adopting similar nexus provisions. Bills have been introduced in California (A.B. 178 and A.B.X3 27),<sup>15</sup> Connecticut (S.B. 806),<sup>16</sup> Hawaii (H.B. 1405),<sup>17</sup> Maryland (S.B. 1071), Minnesota (S.F. 282/H.F. 401), and Tennessee (S.B. 1741).<sup>18</sup>

The new laws are problematic because it is increasingly difficult to gauge the extent of a company’s tax liabilities. If the business is not aware of the tax obligation, it certainly will not have been paid. For most taxes, if no return is filed, the statute of limitations on collection never runs. Obviously, this is particularly troubling for taxes that may be imposed on officers, directors, affiliates, and successors.

For businesses operating in multiple states, the rules for allocating or apportioning taxes between states are increasingly subjective and tilted against out-of-state businesses that have the burden to submit to taxation or prove discrimination or unfair apportionment, usually without recourse for costs of the legal challenges.

## WHY STATE TAXABLE INCOME MAY EXCEED FEDERAL

### States Have Decoupled From Federal Rules

As the economy has softened and state corporate tax revenues have declined, many states have sought to protect their tax bases by departing or decoupling from federal stimulus depreciation rules. The tax benefits enacted by the federal government can be a detriment to the tax base for state and local governments.

For example, beginning in 2002,<sup>19</sup> with the enactment of I.R.C. § 168(k), businesses were allowed for federal income tax purposes to claim additional first-year “bonus depreciation” equal to 30 percent of the adjusted basis of qualified property. Subsequent amendments increased the federal first-year bonus depreciation to 50 percent of the adjusted basis of qualifying property and extended the time period during which

<sup>15</sup> A.B.X3 27 would change the definition of “retailer engaged in business in this state” to include any retailer that has any third party operating in California under its authority for the purpose of servicing or repairing any tangible personal property.

<sup>16</sup> The bill applies when the affiliate relationships generate more than \$5,000 in sales annually.

<sup>17</sup> H.B. 1405 would have amended the definition of “engaging in business” to include any person who enters into an agreement with residents of the state where the person pays a commission for referral of potential customers. The bill has been amended to substitute Streamlined Sales Tax conformity language.

<sup>18</sup> The nexus threshold would be \$2,000 of sales resulting from such referrals.

<sup>19</sup> See Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147 (March 9, 2002).

qualifying property could be acquired and placed in service.<sup>20</sup>

In 2008, Congress again amended I.R.C. §168(k) with the passage of the Economic Stimulus Act of 2008.<sup>21</sup> The Economic Stimulus Act allows businesses to claim additional first-year depreciation equal to 50 percent of the cost of a qualified asset acquired and placed into service during 2008. Property for which bonus depreciation may be claimed is generally the same as under previous bonus depreciation rules (e.g., purchased computer software, water utility property, and qualified leasehold improvement property). The additional first-year depreciation for qualifying passenger cars is increased as well, by \$8,000.

The Economic Stimulus Act also increases the dollar limitations for the election to expense depreciable business assets under I.R.C. §179. Effective for tax years beginning after Dec. 31, 2007, the aggregate cost that may be expensed under §179 is increased to \$250,000. The phase-out threshold for 2008 is increased to \$800,000.

These federal stimulus initiatives, if followed at the state level, could cost cash-strapped states millions, if not billions, in lost tax revenue. As a result, many states have decoupled, in whole or in part, from the federal bonus depreciation rules, in an attempt to shield the states' tax bases from erosion. If economic pressures don't subside, more states may decouple from the federal depreciation stimulus initiatives. A number of states, including Alabama, California, Connecticut, Florida, Iowa, Maryland, New Jersey, and New York, have already indicated that they will not follow all the changes included in the Economic Stimulus Act of 2008.

### States Limit or Prohibit NOL Carryforwards and Tax Credits

Generally, for federal tax purposes, net operating losses (NOLs) may be carried back (currently five years) or forward (currently 20 years) pursuant to I.R.C. §172. In addition, I.R.C. §381 specifies the circumstances in which NOLs will survive corporate acquisitions (e.g., a reorganization), and I.R.C. §382 imposes limitations on the use of NOLs following an "ownership change" (generally 50 percent).

Many states have NOL rules that differ from the federal tax NOL rules. The differences are becoming more prevalent as states take action to limit NOL carrybacks and carryforwards. For example, New York does not allow carrybacks (beyond \$10,000),<sup>22</sup> California recently suspended NOL carryforward deductions,<sup>23</sup> and Pennsylvania has imposed limitations on the amount allowed as an NOL carryforward.<sup>24</sup> Examples of other state NOL limitations include entity-specific NOL limitations (e.g., no §381), classification-specific NOL limitations (e.g., a New York taxpayer cannot use an Article 9-A NOL in an Article 32 year), or disallowance of NOLs from a nonnexus/nonfiling year.

<sup>20</sup> See Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27 (May 28, 2003).

<sup>21</sup> Pub. L. No. 110-185 (Feb. 13, 2008).

<sup>22</sup> N.Y. Tax Law §208(9)(f)(5); N.Y.C. Admin. Code §11-602(8). New York City's Banking Corporation Tax does not allow NOLs at all. N.Y.C. Admin. Code §11-641(b)(3).

<sup>23</sup> L. 2008, A. 1452, effective Sept. 30, 2008.

<sup>24</sup> Pa. Stat. Ann. 72 §7401(3)(4)(c)(1).

State efforts to limit or suspend tax benefits go beyond NOLs. Some states are suspending state tax credits. For example, the Missouri Legislature is currently considering S.B. 121, which, if enacted, would institute a two-year moratorium on all state tax credits, effective August 28, 2009.

## WHEN A LOSS COMPANY'S TAX IS BORNE BY OTHER PARTIES

One of the most troubling elements of state taxation is the many circumstances in which officers, directors, successors, or other parties can be held liable for an entity's tax obligations.<sup>25</sup> On a personal level, this can turn a business recession into an individual's downright tax disaster, because personal liability for entity taxes often is not limited to officers who withhold but don't pay over trust fund taxes. Officer and director liability can also extend to the company's self-reporting of use, income, gross receipts, and other state and local taxes.

### Officer and Director Liability

"Responsible person" liability is a derivative liability, meaning that when a corporation fails to pay certain taxes, a responsible person may be held personally liable for such nonpayment. Responsible person liability is usually limited to trust fund-type taxes, which generally include withholding taxes, unemployment compensation taxes, sales taxes, and certain other excise taxes. However, some taxing jurisdictions also extend responsible person liability to non-trust fund taxes. These derivative liabilities can also include interest and penalties.

At the state level, the potential liability for officers, directors, and other responsible persons generally falls into three categories:

- responsible person liability for officers and/or directors of collected but unremitted wage-withholding, employment, sales, and excise taxes;<sup>26</sup>
- personal liability for non-trust fund taxes;<sup>27</sup> and
- debt and tax liability for failure to maintain corporate charters and authority to do business.<sup>28</sup>

While collection of pre-existing entity taxes of a company in bankruptcy is generally prohibited by the automatic stay, that protection may not apply to the compa-

<sup>25</sup> See, e.g., "Caught In The Web," announcement of the Maryland Comptroller of the Treasury identifying 25 businesses and respective officers asserted responsible for the state's largest unresolved business tax liabilities. [http://compnet.comp.state.md.us/Compliance\\_Division/Collections/General\\_Collections\\_Information/Caught\\_in\\_the\\_Web.shtml](http://compnet.comp.state.md.us/Compliance_Division/Collections/General_Collections_Information/Caught_in_the_Web.shtml).

<sup>26</sup> See, e.g., Ga. Code Ann. §48-2-52; 35 ILCS 735/3-7(a); Ind. Code §6-2.5-9-3; Md. Code Ann., Tax-Gen. §10-906(d); Tenn. Code Ann. §67-1-1443.

<sup>27</sup> See, e.g., Ky. Rev. Stat. Ann. §139.185; Mich. Comp. Laws §205.27a(5) (imposes personal liability on responsible persons for the corporation's failure to file required tax returns or to pay tax due); Minn. Stat. §270C.56; Ohio Rev. Code Ann. §5739.33 (responsible person liability extends to use taxes in addition to sales taxes); S.D. Codified Laws §10-45-55; see also Chicago, Ill., Mun. Code §3-4-270 (imposes responsible person liability for all Chicago taxes).

<sup>28</sup> See, e.g., Cal. Rev. & Tax. Code §6829; Cal. Code Regs. tit. 18, §§1702.5 and 1702.6; Tex. Tax Code Ann. §§171.252 and 171.255.

ny's responsible officers.<sup>29</sup> Generally, responsible person liability will survive the dissolution of a business entity.<sup>30</sup>

## Affiliate Liability

Another feature of state taxation is the exposure of "combined" affiliates for the taxes of the group. In cases of corporate combined reporting groups, states commonly impose joint and several liability on all members of the group for the combined tax liability of the group.<sup>31</sup> This is in many respects similar to the federal consolidated return rules,<sup>32</sup> with one important difference. While it is a fairly straightforward task to ascertain whether a federal group exists and to identify the corporations it includes, state combination standards vary and can be fact-driven. For example, New York state now premises combination on the existence of substantial intercompany transactions;<sup>33</sup> New York City premises combination on the existence of distortion in intercompany pricing;<sup>34</sup> many states have historically limited combination to entities with nexus (although that rule is changing, as is the concept of nexus),<sup>35</sup> and a number of states have special rules for entities doing business overseas.<sup>36</sup> And, of course, with certain exceptions in elective states,<sup>37</sup> combination usually requires a unitary business.<sup>38</sup>

Texas offers a glimpse of an even more dramatic departure from traditional federal concepts. Texas requires combination of all entities, including most business partnerships, that are part of an affiliated group engaged in a unitary business. The control threshold for determining whether affiliated businesses are part of the Texas unitary group is "more than 50 percent" of the direct or indirect ownership of the entity's voting stock, capital, profits, membership interests, or beneficial interest in the partnership, association, trust, or other entity.<sup>39</sup> As a result, two partnerships with a 50.1 percent common owner can be combined, if unitary, and thereby indirectly expose the third-party partners to the tax burdens of the entire unitary group, at least to the extent of their investment in the unitary member.

Partnerships present another area in which it is increasingly easy to get tripped up. Managers, and especially general partners, must take care to identify and

comply with taxes imposed on pass-through entities,<sup>40</sup> as well as their obligations to withhold,<sup>41</sup> pay estimated taxes,<sup>42</sup> and/or file composite returns<sup>43</sup> for their partners and shareholders.

## Successor-in-Interest (or 'Bulk Sale') Liability

Purchasers of distressed businesses should be on particular alert to avoid successor taxation. Most states impose successor liability on purchasers of at least 50 percent of the business assets of a company.<sup>44</sup> Such purchases, which are outside the seller's ordinary course of business, are considered "bulk sales," and often are the state's last chance to collect taxes owed before the seller leaves the jurisdiction. A "bulk sale" does not always require the sale of a majority of the seller's assets. Successor liability for bulk sales may also be imposed on a lesser purchase if the buyer acquires the seller's stock of goods (*i.e.*, inventory).<sup>45</sup> In some states, the exact percentage of inventory that triggers successor tax liability is somewhat uncertain.<sup>46</sup> Typically, the states' successor liability statutes apply only to the sales tax owed by the seller.<sup>47</sup> The liability may be limited to the outstanding tax or may also include penalties and interest.

A number of states also expand the purchaser's potential liability to include business taxes beyond sales taxes.<sup>48</sup> Some states require separate filings to release the buyer from the seller's liability with respect to unemployment insurance and withholding taxes.<sup>49</sup> Although most states limit a buyer's successor liability to the purchase price (inclusive of liabilities assumed or taken subject to),<sup>50</sup> some will seek to collect the entire liability, without any limitations.<sup>51</sup> And, of course, multiple states may make claims, so the limitation can be more theoretical than protective.

Generally, to limit successor liability purchasers and/or sellers must follow the state's requirement to give bulk sale notice to the state (or obtain a tax clearance certificate), or the purchaser must withhold from the purchase price an amount sufficient to cover the outstanding tax liability of the seller. These rules generally require notifying the state in advance of the sale,<sup>52</sup> which can often prove cumbersome.

<sup>29</sup> See *Stackpoole v. Michigan Dept. of Treas.*, 486 N.W.2d 322 (Mich. Ct. App. 1992).

<sup>30</sup> See, *e.g.*, S.D. Codified Laws § 10-45-55.

<sup>31</sup> See, *e.g.*, Ind. Code § 6-5.5-6-1; Ky. Rev. Stat. Ann. § 141.200; Tex. Tax Code Ann. § 171.1014(i); 86 Ill. Admin. Code 100.5250(a).

<sup>32</sup> U.S. Treas. Regs. § 1.1502-6.

<sup>33</sup> N.Y. Tax Law § 211(4)(a).

<sup>34</sup> N.Y.C. Admin. Code § 11-605(4); N.Y. Rev. Code § 11-9.

<sup>35</sup> See, *e.g.*, Ark. Code Ann. § 26-51-805; Conn. Gen. Stat. § 12-223a.

<sup>36</sup> See, *e.g.*, Mich. Comp. Laws Ann. §§ 208.1109(5)(c); see also California H.B. 1178 (pending), which provides that corporations making a water's-edge election must take into account the income and apportionment factors of foreign affiliates located in tax havens.

<sup>37</sup> See, *e.g.*, Ala. Code § 40-18-39(c); Fla. Stat. Ann. § 220.131; Mo. Rev. Stat. § 143.431.3.

<sup>38</sup> See, *e.g.*, 35 ILCS 5/502(e); Mich. Comp. Laws Ann. §§ 208.1117(5), -(6), 208.1201(4), and 208.1203(3); 20 N.Y.C.R.R. § 6-2.29(b); Cal. Code Regs. § 25110.

<sup>39</sup> Tex. Tax. Code Ann. § 171.0001(8).

<sup>40</sup> See, *e.g.*, Ala. Code § 40-14A-22; Tex. Tax Code Ann. § 171.0002(a); N.Y.C. Admin. Code. § 11-503(a).

<sup>41</sup> See, *e.g.*, Cal. Code Regs. § 18662-1.

<sup>42</sup> See, *e.g.*, N.Y. Tax Law § 658(c)(4).

<sup>43</sup> See, *e.g.*, Mich. Comp. Laws Ann. § 206.315; Va. Code Ann. § 58.1-395.

<sup>44</sup> See, *e.g.*, Ariz. Rev. Stat. Ann. § 42.1110; Ala. Code § 40-23-25; Cal. Rev. & Tax. Code § 6811; Conn. Gen. Stat. § 12-424(1).

<sup>45</sup> *Id.*

<sup>46</sup> See Tex. Comp. of Pub. Accts., Decision No. 12,822 (1988).

<sup>47</sup> See, *e.g.*, Md. Code Ann. Tax-Gen. § 13-802; N.Y. Tax Law § 1141(c); N.C. Gen. Stat. § 105-164.38.

<sup>48</sup> See, *e.g.*, Haw. Rev. Stat. § 237-43; N.J. Rev. Stat. § 54-50-38; Pa. Stat. Ann. 72 § 1403.

<sup>49</sup> See, *e.g.*, Cal. Unemp. Ins. Code § 1732.

<sup>50</sup> See, *e.g.*, Cal. Rev. & Tax. Code § 6812; Ga. Code Ann. § 48-8-46; Ky. Rev. Stat. Ann. § 139.680.

<sup>51</sup> See, *e.g.*, Ariz. Rev. Stat. Ann. § 42-1110; La. Rev. Stat. Ann. § 47:308

<sup>52</sup> See *New Ashiya Japanese Cuisine (NY) Inc.*, Dkt. No. 822030 (N.Y. Div. Tax App. March 5, 2009).



When purchasing assets from a distressed business, the buyer should take extra care to address successor liability taxes. For sales in bankruptcy, particular attention should be given to the language in the court's order permitting the sale. U.S. Bankr. Code §363 should permit the sale of assets free and clear of all tax liens. Purchasers should be aware, however, that under a recent U.S. Supreme Court holding, transfer taxes for transfers prior to the effective date of a bankruptcy plan of reorganization are not protected under the Bankruptcy Code.<sup>53</sup>

Purchases from distressed entities raise not only concerns of successor liability, but also limitations on transfer of tax incentives. For example, such transfers may breach a tax abatement or incentive agreement, thereby requiring recapture of abated tax or revaluation and increased tax on the abated property or transac-

---

<sup>53</sup> *Florida Dept. of Rev. v. Piccadilly Cafeterias Inc.*, 554 U.S. \_\_\_, 128 S.Ct. 232 (2008).

tions. Where there are material tax abatements or incentives, a careful review of the state and local tax implications of a transaction is often necessary to derive accurate liability and cash flow projections.

## CONCLUSION

For those unprepared, this recession can be downright depressing when it comes to state and local taxation of distressed businesses. Whether you are restructuring debt or an entire business; buying, selling, or winding up a business; or simply associated with a distressed business, take care to consider the state and local tax exposure and the options for avoiding unnecessary tax liability. Recent and numerous legislative and judicial actions often render old assumptions about state and local taxation no longer valid. Business entities with sales representatives or economic presence in multiple states require multistate tax analysis. The rules of the road, assumptions of economics, and exposures for state and local taxation have changed. Be prepared.