Pay now or pay later

How to avoid state successor liability taxes in an acquisition **Interviewed by Elizabeth Grace Saunders**

Buyers beware: purchasing an existing company could include acquiring state tax liabilities from the former owner. Although most contracts give buyers the ability to sue for restitution of state taxes paid, it's best to take a proactive approach before the deal closes. After a sale, it may prove difficult to even find the previous owner, let alone recover damages.

"It's amazing that even sophisticated venture capitalists and investment bankers do not spend enough time during the due diligence process to review the potential state tax implications of a pending deal," says Mike Goral, principal, State and Local Tax Practice at Berenfeld, Spritzer, Shechter & Sheer. "In many cases, state tax liabilities can dramatically transform a profitable transaction into a money-losing endeavor."

Smart Business spoke with Goral about state tax issues in mergers and acquisitions transactions and how buyers can avoid successor liability for state taxes.

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What is successor liability?

Many states, including Florida, impose an obligation to ensure that prior-year state taxes are not avoided through ownership change. States often have statutory authority to seek prior-period taxes from either the seller or buyer of the company. Often, the buyer is the owner of the company at the time of a state audit. As a result, that owner gets stuck with the tax bill.

Some states have statutory authority to only impose successor liability for sales or use taxes, while other states have expanded their authority to include other business taxes. Therefore, it is imperative to perform a thorough review of any potential state tax obligation for multiple state business taxes before the transaction is completed.

In many cases, a company may be in compliance for taxes in its home state but has failed to file for state taxes in other states. Many factors can lead to this situation. For instance, people may not realize that state tax liabilities can be imposed in another state for commission-based independent contractors that market the company's product. Also, states can impose taxes when company employees attend local trade shows. Finally, some states impose taxes on certain services performed within their state.

Will the statute of limitations restrict the maximum amount of successor liability?

If the seller has been filing tax returns during the period covered by the statute of limitations, then the tax liability will be confined to only those years. In most states, this is the most recent three-year period. However, if no return has been filed for a given state, there is no limitation of liability.

Moreover, the state taxing authority will have the authority to go back to the first year business was conducted in the state and impose tax, interest and penalties for all prior years. The interest and penalty liabilities can, in some cases, exceed the underlying tax liability. If taxes have not been reported in multiple states, then the potential state tax liabilities can easily exceed the federal tax obligation that is often more carefully reviewed.

What steps can a potential seller or buyer take to avoid successor liability?

A potential seller of a business should perform a nexus study to determine if there are state tax liabilities outside the company's home state. A nexus study is an analysis to determine whether or not a company has exceeded some minimum threshold such as hiring independent contractors, attending trade shows, performing services or otherwise having some form of physical connection with the jurisdiction. Nexus thresholds are different for sales/use tax versus an income tax. This requires an independent analysis of nexus for the various taxes imposed by a state or local jurisdiction.

Performing a nexus study will demonstrate to potential buyers that the management team understands the importance of state tax compliance. This may also help the seller obtain offers closer to their asking price, since there are no contingent state tax liabilities.

Potential sellers or buyers of a company also can obtain a tax clearance certificate, or a similar document, from the state taxing authority. This document provides some assurance that taxes have been paid. States usually will hold the buyer harmless for any prior-period tax liability if they received a tax clearance certificate. Naturally, only those states where the company has been filing tax returns can produce a tax clearance certificate. If sufficient notice is given, a superficial audit can also be conducted in some states to provide greater assurances.

Potential buyers should include a thorough due diligence of the target company, including a state tax review. If contingent state tax liabilities are discovered, then they can negotiate with these states to mitigate the potential state tax liability. In many cases, penalties can be waived entirely and tax and interest can be negotiated for prior tax periods beyond the statute of limitations period. Absent such assurances, potential buyers should set aside funds in escrow until all contingent state tax liabilities have been extinguished.

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