taxanalysts a view from the front line

State and Local Tax Implications of Reorganizing Business Enterprises

by Craig B. Fields and Philip M. Tatarowicz

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The Marketplace and Its Challenges

This is the first installment in a series that will examine state and local tax (SALT) questions implicated by the purchase, sale, and reorganization of business enterprises. The goal of the series is to share tax knowledge ranging from broad discussions of topical themes to detailed analyses and critiques of current merger and acquisition (M&A) controversies and developments.

One area in which sustained M&A activity is predicted for 2012 involves tax-free spinoffs by companies trying to create value for their shareholders.[1] This is good news because it suggests that as economic growth and global commerce continue to heal from the traumas wrought by the Great Recession, overall M&A activity should pick up in 2012 and into 2013.

Entity restructurings are one of management's key tools for expanding, contracting, and addressing environmental effects on a business's current operating model. To pass tax muster, restructurings generally must not be principally undertaken to save taxes. Tax authorities dictate that in most situations a business purpose other than principally saving taxes be reflected by a restructuring.

The business purposes that continue to drive restructurings are varied. For instance, business exigencies still arising from the global financial crisis and its effect on the business environment are driving many decision-makers to take actions to deal with market turbulence, declining market capitalizations and asset valuations, and the changing landscape of competitors. Included are current and ongoing internal restructurings designed to reduce financial exposures and operational costs, improve efficiencies and productivity through better resource allocation models and processes, and prepare for other volatilities.

Other drivers of restructurings include recently enacted financial, legal, and regulatory demands (for example, increased transparency and internal controls) that prompt restructurings to reduce compliance risks and better manage capital. Frequently, organizational changes are designed to improve treasury, finance, and other general administrative functions, such as through the use of shared services, outsourcing arrangements, and other global supply chain strategies. It is through these ongoing restructurings that business enterprises better position themselves to take advantage of growing opportunities.

SALT specialists trained to work on restructurings help their clients by evaluating the tax implications of various opportunities and thereby aiding management in meeting its strategic goals. By their very nature, restructurings raise several complex technical matters, including identifying and implementing tax-effective organizational models; preserving and maximizing the value of tax attributes;

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[1] *See, e.g.*, Anupreeta Das et al., "Deals & Deal Makers: M&A Faces a Tough 2012, but Spinoffs Could Do Well," *The Wall Street Journal*, Jan. 3, 2012 ("Many deal makers said companies will try to find creative ways to increase value for shareholders, such as spinning off businesses in a tax-free manner. Spinoffs were popular in 2011, and it's a trend deal makers expect will continue"). *See also,* Anupreeta Das et al., "Europe's Woes Even Damped M&A: Players Say Global Uncertainty Kept — and Will Keep — Deal Making in Check; Tough Regulatory Scrutiny Not Helping," *The Wall Street Journal*, Jan. 3, 2012.

handling administrative and judicial controversies; providing filing and compliance risk management; assisting in the identification and safeguarding of needed data; advising or handling tax refund claims and exposures; advising on entity simplification and management; and identifying strategic alternatives that will inform post-transaction ownership, supply chain models, capital structures, and related elections.

The forms in which multijurisdictional business enterprises (MBEs) operate today have evolved significantly from the days when they operated primarily through corporate form. Mixtures of corporations, limited liability companies, disregarded entities, partnerships, trusts, and dual resident hybrids, and others dominate the landscape of global enterprises. Although this article will distinguish when necessary among those types of entities when tax consequences do differ, for ease of reference when providing general observations, this article will use the umbrella term of MBEs, rather than listing each type of potential entity. Also, the umbrella terms "restructurings" or "mergers and acquisitions" will be used when generally referring to activities that may include the buying, selling, and reorganizing of business enterprises.

The Challenge Facing SALT M&A Specialists

Depending on the size and complexity of the deal, the workload facing the SALT M&A specialist can be considerably greater than that facing the federal tax specialist. To illustrate, consider a restructuring limited to U.S. operations. Typically, the federal tax specialist will predominantly be focused on income tax questions. Thus, one body of law — the Internal Revenue Code — is informed by relevant legislative, executive, and judicial guidance, as well as, perhaps, common practices for which guidance is not available or dispositive. By contrast, the SALT specialist's role will be defined by many things, including the number of states, taxes paid to each state, and entities making up the parties to the transaction.

To illustrate, assume that two unrelated corporate entities and their owners want to combine operations through a tax-free, stock-for-stock exchange — a B reorganization. Assume further that each of those two entities operates in 10 states and has shareholders residing in 10 states, and that none of the sets of 10 states overlap, so collectively, the two entities and the two sets of shareholders are located in 40 (2 x 2 x 10) different states. (Getting the picture? Imagine if this example included global operations conducted through hundreds of country-specific or multinational enterprises.)

For the federal income tax (FIT) specialist, the analysis will be relatively straightforward, primarily requiring a review and determination that the restructuring meets the requirements of IRC section 368(a)(1)(B),[2] which defines the conditions that must exist for the transaction to qualify as a (B type) tax-free, stock-for-stock exchange.[3] What of the SALT specialist? Typically, in these types of scenarios, after verifying the scope of the engagement and the level of associated SALT effect that management deems cost beneficial or, inversely, the level of SALT costs that management will declare a deal killer, the SALT specialist will need to gather and analyze the facts and circumstances by tax and jurisdiction.

For illustration purposes only, let's assume that all questions (in the "real" world, unlikely) are deemed material. In that situation, the SALT specialist must consider the tax laws of 40 different states (not to mention their local taxing jurisdictions), compared with the FIT specialist, who generally has to consider the laws of only one jurisdiction. Also, unlike the single corporate income tax analyzed by the FIT specialist, the SALT specialist must analyze many taxes and fees. Although too numerous to list herein, collectively there are dozens of different levies imposed by the states according to the industries in which the corporations operate.

Unlike the federal government, which derives most of its tax revenue from the income tax, state governments generate a relatively small percentage of their tax revenue from income taxes. To illustrate, let's assume further that only these five more broadly applied taxes apply to the restructuring: income, sales and use, property, unemployment, and the ubiquitous transfer taxes.

If one were to stop here, at least theoretically, and exclude from the count such things as local taxes, there would be 40 states with five tax questions each to be considered for a sum of 200 discrete questions. Of course, such a simplistic model can be misleading because of what it doesn't include — matters such as local levies; other state level taxes, like gross receipts taxes, that can be significant in states such as Washington and Ohio; pre- and post-transactional matters, for example, the unitary implications of the restructuring to the two entities' shareholders and other enterprises they may own; and the all-important need to investigate available statutory or

[2]Unless otherwise stated, all references to the code and to the IRC are to the Internal Revenue Code of 1986 as amended, and all references to regulations are to the regulations promulgated thereunder. All section references are to sections of the code or regulations.

[3]Section 368(a)(1)(B) states: "The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)."

negotiable tax and nontax incentives that can spring from decisions to retain or expand operations in a given jurisdiction.

The common FIT colloquialism of a 'tax-free' transaction does not exist in the SALT world.

As one considers the above, it quickly becomes clear that the common FIT colloquialism of a "tax-free" transaction does not exist in the SALT world. When one looks at the collective U.S. SALT laws, it is virtually imponderable to think of anything other than the most simplistic of transactions — involving genre not germane to this writing — that could possibly skate through the myriad nonuniform taxes and fees that exist today. Frequently, the good news is that with proper planning, these levies can be managed to acceptable levels, instead of becoming deal killers. Even better news is that a restructuring event can frequently open new strategies to consider and can qualify for various tax and nontax incentives to help finance its costs.

Factors Influencing the Demand for (and Supply of) SALT M&A Specialists

Already noted are the predictions that there will be a growing number of restructurings as the economy continues to recover. These predictions raise the question, will taxpayers demand the services of SALT specialists? And will the current supply of SALT M&A specialists meet demand?

As for demand, it is our experience that large and sophisticated MBEs do seek and incorporate the advice of SALT M&A specialists when restructuring. However, there is a significant gap between the demands at this level and what exists among smaller and less sophisticated MBEs. Why? Unfortunately, in large part, for the same reasons that existed when one of the authors last published an article in this area nearly some three decades ago:[4] The cost-benefit of considering the myriad and specialized SALT rules and questions that apply to restructurings, and the many tax and nontax questions that have to be coordinated and resolved (often sequentially) within tight and inflexible timelines. Also, management may mistakenly believe that the federal tax M&A specialist can adequately evaluate the related questions that may be implicated at the subnational level.

We have worked on hundreds of restructurings implicating thousands of SALT technical questions, and one thing is clear: Given the complexity and volume of tax laws that exist among the different nations and their subnational taxing authorities, no one person knows it all. Unlike bowling, golf, or any other sort of single-person activity, the area of complex transactional planning is a team sport. The more complex and voluminous the questions, the greater the depth of the team required if administrative efficiencies and the maximization of tax savings are among the goals.

In addition to complexity, other reasons SALT specialists are often not invited to the planning process include the mistaken belief that FIT costs and risks always overshadow SALT costs and risks; the incorrect assumption of a greater likelihood of less scrutiny by subnational taxing authorities because they lack technical understanding; management's need or desire to maintain secrecy; and restrictive timelines that would not allow most SALT specialists sufficient time to act once other business and legal needs are identified and resolved. For management and their legal, financial, and operational advisers, successfully juggling those competing realities is not for the faint of heart and, certainly, not for the novice. Business decisions frequently have to be made that weigh other opportunities; triage often is the norm, not the exception.

Although businesses' federal M&A specialists almost always can work on their questions without consulting a SALT specialist, the opposite is frequently untrue, at least for corporate income tax cases. Because states piggyback on federal taxable income either before or after special deductions, a SALT M&A specialist must typically have a working familiarity with federal M&A laws, as well as access to a deep subject-matter federal M&A specialist. Accordingly, unless a SALT M&A specialist is also a FIT M&A specialist (almost an oxymoron because of the volume of laws in both spheres), there has to be close consultations between the FIT and SALT M&A specialists, so one can inform the other and they can collaborate on identifying options that result in the least tax cost and burden to the taxpayer.

M&A work is generally fast paced. M&A specialists must move quickly to provide the level of services required within the compressed time frames that frequently accompany work in this area. Quickly and efficiently addressing questions in this area and meeting the time-sensitive needs of taxpayers involved in a merger or acquisition also requires individuals with deep subject-matter expertise and seasoned professional judgment that comes only from experiential learning.

Summary

This article represents the first installment in a series by Morrison & Foerster LLP. The series will explore SALT questions implicated by restructurings. This first installment examined select aspects

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[4]*See* Philip M. Tatarowicz, *Buying, Selling and Reorganizing Corporations*, New York University Institute on State and Local Taxation and Conference on Property Taxation (1984).

of the dynamics of the SALT M&A marketplace and the challenges that they present to SALT specialists and those who employ them.

Before taking on the more analytical subject matter — dives that will become the hallmark of this series — the next installment will further establish a foundation by proffering general observations. It will provide an overview of select matters that taxpayers undergoing an M&A transaction should consider when facing a restructuring. These general considerations include jurisdiction to tax; timely compliance with filing obligations; and optional and mandatory accounting methods, periods, and income calculations. The next installment also will provide an overview of the more frequently encountered state and local taxes and compliance questions implicated by restructurings. Included in that overview will be a discussion of income taxes, ad valorem taxes, sales and use taxes, unemployment taxes, and transfer taxes.

We plan to reserve the potential universe of entity forms and SALT restructuring questions for future analysis and comment. For example, in addition to looking at questions generally applicable to manufacturing and mercantile entities, future installments as needed will look at specialized enterprises (for example, real estate investment trusts, regulated investment companies, and co-ops) and the special questions they present.

Although this series is primarily targeted to those responsible for avoiding SALT traps and managing state and local taxes and fees implicated by mergers and acquisitions, future installments will inform international, federal, state, and local tax practitioners through a comparative laws format. For instance, future installments will present illustrative disconnects between the IRC and SALT laws regarding taxable transactions, tax-free reorganizations, contributions, liquidations, elective recognition of gain by target corporation, the carryover of tax attributes, dividends received and their permitted deductions, and gains recognized on distribution of appreciated property. Sprinkled among those discussions and included in future installments will be discussions of current SALT restructuring controversies and an analysis of federal tax planning techniques and the questions they raise.

Readers with requests for future subjects are encouraged to contact the authors or any other member of the Morrison & Foerster LLP SALT practice whose names and contact information can be found under "People" at http://www.mofo.com/state-local-tax-services/. It is our intention to allow sufficient flexibility in the release of future installments to provide periodic inclusion of reader-driven requests and breaking environmental changes that affect this dynamic and technically challenging area of the law. ✰

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