Workshop L

Mergers & Acquisitions …
State Tax Planning, Traps and Recent Developments

Tuesday, January 26
3:00 p.m. to 4:00 p.m.
Biographical Information

Jeremy A. Hayden, Member, Frost Brown Todd LLC
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Jeremy A. Hayden is a Member of Frost Brown Todd, and he chairs the firm’s Privately Held Business group over its five-state footprint. Mr. Hayden formerly co-chaired the firm’s State and Local Tax Practice.

Mr. Hayden regularly represents private clients and governmental clients on state and local tax matters, including the litigation of significant tax controversies. Mr. Hayden also leads and assists clients with mergers, acquisitions, divestitures, and other sophisticated corporate and commercial transactions.

Mr. Hayden is an adjunct faculty member at the University of Cincinnati College of Law where he teaches State and Local Taxation. Mr. Hayden is also the lead author on the Ohio Commercial Activity Tax treatise for Thomson Reuter’s Checkpoint Catalyst.

Mr. Hayden received his J.D. from the University of Kentucky College of Law and his Masters in Taxation from the University of Cincinnati, magna cum laude. Mr. Hayden received the Young Professional Alumni Award from the University of Kentucky College of Law, and he has been recognized as a member of the 40 Under Forty by the Cincinnati Business Courier, an Ohio Super Lawyers® Rising Star by Thomson Reuters, and for inclusion in The Best Lawyers in America.

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Joel W. Pangborn serves as General Tax Counsel for CSX Transportation, Inc., which together with its affiliates, is one of the nation’s leading transportation companies, providing rail based transportation services including traditional rail services and the transport of intermodal containers and containers. As General Tax Counsel, Mr. Pangborn is responsible for ensuring CSX remains compliant with federal, state, and international tax laws. His duties include all aspects of tax planning and compliance, tax legislative analysis, and handling tax controversies for CSX. Mr. Pangborn has worked at CSX in various tax counsel roles for 26 years.

Immediately before joining CSX, Mr. Pangborn was employed by Trans World Airlines (1984-1988), most recently as Director- Tax Research and Planning. Prior to working at TWA, Mr. Pangborn engaged in the general practice of law.

Mr. Pangborn earned his LLM in Taxation from New York University School of Law (1985); his JD from Brooklyn Law School (1980); and BS in Economics and Business from Wagner College (1977).

Since 1996, Mr. Pangborn also has been teaching graduate tax courses at the University of North Florida, Coggin School of Business. In addition, Mr. Pangborn serves as a trustee of several not for profit organizations.

Cary D. Hines, Partner, BKD LLP
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Cary has more than seventeen years of public accounting experience in providing tax planning and compliance services to clients mainly in the manufacturing, distribution, and service industries. He has served a number of SEC registered clients, as well as numerous closely held clients, and has a strong background in C corporations, FAS 109, and pass-through entities. Cary has also served numerous clients with international operations. Cary has served as the BKD-Cincinnati office Tax Director since 2005 and is responsible for overseeing all aspects of the office tax practice to ensure quality and compliance with office, firm, industry, and taxing authority standards. Prior to entering public accounting, Cary spent several years in the banking and hi-tech industries. Cary is a member of the American Institute of Certified Public Accountants and Ohio Society of Certified Public Accountants. He has been an active member of the community previously serving as the Treasurer for the Kidney Foundation of Greater Cincinnati, the Treasurer for Miami County Children’s International Summer Villages, and periodically serving as a youth soccer coach. Cary is currently a board member of the Cincinnati Center for Respite Care, as well as the Chair of the Cincinnati BKD Foundation Cary received both his Bachelor of Science in Business Economics (1988) and his Master of Accountancy (1995) degrees from Miami University in Oxford, Ohio.
Mergers and Acquisitions
State Tax Aspects

PANELISTS:

- Jeremy A. Hayden  
  Frost Brown Todd LLC
- Cary Hines  
  BKD, LLP
- Joel W. Pangborn IV  
  CSX Transportation, Inc.

Presentation Overview

I. Successor Liability
II. Due Diligence
III. Agreement Terms
IV. Stock Transactions
V. Asset Transactions
VI. Mergers and Reorganizations
VII. Business / Nonbusiness Income
I. Successor Liability

A. Buyer’s Point of Emphasis – Determining Exposure for Taxes Prior to Closing

1. Stock/Merger vs. Asset Acquisition
2. Amount of Exposure (could be unlimited and include predecessors’ liabilities)
3. Rights to Challenge Successor Liability vs. Merit of Taxes Owed
4. Types of Taxes
I. Successor Liability

B. Minimizing Successor Liability - Start Early!!

1. Lien Searches
2. Tax Releases and Statements of Condition
3. Representations, Warranties & Covenants
4. Indemnities
5. Escrows and Holdbacks
6. Form a New Entity for the Purchase
7. Voluntary Disclosure Agreement
8. Cancel Vendor Licenses
9. Bulk Sales Act Notifications
II. Due Diligence

A. Overview

1. Broad – Encompasses all state and local taxes
   a. Keeping organized - start with Due Diligence Checklist
   b. Review and Analysis of Due Diligence Items
   c. Incorporate into Due Diligence Memo
   d. Sign and Close vs. Sign then Close Deal Structures

2. Fully Understand Business(es) Involved
   a. Goods or services
   b. Wholesaler or retailer
   c. Exempt or Government
   d. Industry type

3. Acquisition Structure
   a. Stock or Asset
   b. Taxable or Non-Taxable
II. Due Diligence

B. Tax Returns and Specific Taxes

1. Overview
   a. States in which the target is currently filing for all tax matters and reasons for filing in those jurisdictions
   b. How is the target’s business structured, and has it been appropriately reporting based on ownership and operational activities?
   c. Open tax years for target including extensions and waivers of SOL
II. Due Diligence

2. Income and Franchise Tax Matters

a. Allocation and appointment figures, whether the target has NOLs, depreciation adjustments, or state specific adjustments
   i. Specifically determine sourcing of services (cost of performance, customer’s address, market-based) of target
   ii. Determine states in which the target has payroll expenses and real or personal property
   iii. Goal is to minimize double taxation and maximize nowhere income

b. States in which the target files a separate return, a combined return, or a consolidated return
II. Due Diligence

3. Gross Receipts Taxes and Alternative Tax Structures
   a. Consider states such as Washington, Ohio, and Texas
   b. Subject to special industry taxes (e.g., financial institution, hospital franchise fee)

4. Sales and Use Tax Matters
   a. Review maintenance of exemption certificates
   b. Use tax assessments
   c. Whether Exemption will Apply to Transaction:
      i. Statutory Merger or Consolidation
      ii. Transfer to New Corporation
      iii. Isolated or Occasional Sale Exemption
      iv. Sales for Resale

5. Property Tax Matters
   a. Look at filings, exemptions and whether property has been understated or overstated in its assessment
II. Due Diligence

6. Payroll, Unemployment and Workers Compensation
   a. Analyze Worker Classification Issues
   b. Review withholding tax filings
   c. Review unemployment tax filings
   d. Although workers compensation is not a tax matter, certain aspects often may need to be reviewed by SALT practitioners.

7. Unclaimed Property.
   a. Often overlooked and exposure can be $$$
   b. Certain states (such as Delaware) have stepped-up enforcement

   a. Some states apply transaction based taxes (e.g., sales/use taxes) to equity sales involving passive companies whose assets include real property, boats, planes, motor vehicles, etc.
II. Due Diligence

C. Nexus

1. Analyze activities in states:
   a. Look for gaps in reporting and potential expansion of required filings
   b. Physical presence
   c. Employees or representatives working on behalf of Target to solicit sales
   d. Employees or representatives working on behalf of Target for activities beyond soliciting sales
   e. Client locations
   f. Any other affiliates, agents, etc. that may establish nexus for target (e.g., Amazon law)
   g. States in which Target is registered to do business
   h. States in which Target is registered for sales tax purposes
II. Due Diligence

D. Other Matters

1. Pending Audits, Appeals and Refund Claims

2. Incentives. State and local tax incentives applied for, denied or received

3. Reserves. Determine reserves for any state and local tax liabilities
III. Agreement Terms

A. Types of Taxes Addressed –

1. **Historic** – includes all prior taxes (should be broadly defined).
2. **Acquisition** – sales taxes attributable to transaction, payments for incremental taxes due to 338(h)(10) election, etc.
3. **Future** – filing responsibility for straddle periods, etc.
III. Agreement Terms

B. Representations and Warranties (the guarantees)
   - Addresses tax matters arising prior to closing (historic tax liabilities)
   - Seller is verifying that such tax matters are true and correct (e.g., all tax returns filed and taxes paid regardless of whether shown on a tax return or not, no ongoing audits)
   - Offers buyer further diligence and additional protection as risk shifts to Seller via contractual representations and warranties
   - May be subject to qualifiers (e.g., materiality, knowledge)
   - Seller should carefully review representations and warranties and schedule any exceptions
   - Address updates to schedules if sign then close transaction
   - Incorporate due diligence – (e.g., representation on tax attributes to be acquired)
III. Agreement Terms

C. Covenants

- **Types**: Negative (e.g., will not extend SOL, settle tax liabilities, or make any new tax elections without buyer’s consent) or Affirmative (e.g., seller to make all required tax filings)
- **Timing**: Pre-closing (if applicable) and post-closing
- **Taxes Covered**: May cover historic (between time of signing and closing), acquisition (e.g. buyer’s promise to pay incremental taxes associated with 338(h)(10) election), and future tax obligations

D. Contingencies, Indemnities, Escrows

- Provides remedies for compliance with representations, warranties, and covenants
- May overlap with representations and warranties
- Caps, deductibles, timing and other limitations on indemnities usually not applicable to tax matters
III. Agreement Terms

E. Other Tax Matters

- Responsibility for Tax Return Filings including Straddle Periods
- Ownership of Refunds, NOLs, and other Tax Attributes
- Special Elections (e.g., S corporation, 338(h)(10), etc.)
- Purchase Price Allocation (timing can be important)
- Withholding Provisions – could inadvertently require entire Purchase Price to be withheld
- Responsibility for Transfer Taxes
- Closing of Books for Income Taxes vs. Allocation for Net Worth Taxes
IV. Stock Transactions

A. Buyer’s Perspective

1. Combined and Consolidated Reporting
   a. Structural considerations

2. NOLs
   a. Limitations and treatment methodologies

3. Seller Financing - Deductibility of Interest
   a. Debt structure
   b. Intercompany charges
   c. Alternative Approach – Management Fee

4. 338(g) and 338(h)(10) Elections
IV. Stock Transactions

B. Seller’s Perspective

1. Gain
   a. Determination of amount
   b. Character of gain/(loss)

2. 338(h)(10) Election
   a. Use of offsetting NOL / Suspended loss
   b. Change in character of gain/(loss)
   c. Adjustments to consideration for incremental taxes (include gross-up?)

3. Loss
V. Asset Transactions

A. Buyer’s Perspective

1. Purchase Price Allocation
2. Nexus/Apportionment
   • Studies and Pro-forma planning
3. Tax Attribute Carryforwards
   • Transaction structure
V. Asset Transactions

B. Seller’s Perspective

1. Purchase Price Allocation
2. Determination of Gain/(Loss)
3. Character of Gain/(Loss)
4. Apportionment of Gain/(Loss)
VI. Mergers and Reorganizations

A. Most states follow federal treatment for income taxes

B. Same treatment does NOT necessarily apply to sales taxes
VII. Business / Nonbusiness Income

A. Business Income is Apportioned

- Normal apportionment methods – such as UDITPA property, payroll and sales factors
- Strong presumption in favor of business income
- Applicable only to assets that are part of the taxpayer’s unitary businesses (functional integration, centralized management, and economies of scale)
  - Careful though, as passive assets have been found to serve operational purpose rather than investment purpose.

B. Nonbusiness Income is Allocated

- Based on nature of property
  - Real property – situs of property
  - Tangible Personal Property – situs of property unless TP is not taxable in state, then to TP’s commercial domicile
  - Intangible – state of TP’s commercial domicile
VII. Business / Nonbusiness Income

C. Tests Based on UDITPA definition of business income:

1. **Transactional** – gain is business income and apportionable if the taxpayer regularly engages in transaction producing the gain.

   ✔ Whether sale was part of the taxpayer’s principal business activity
   ✔ Whether sales of similar property were common, even if not the taxpayer’s normal business activity
   ✔ Frequency of sales
   ✔ Whether sales proceeds are distributed in liquidation and not reinvested in the business
   ✔ Whether the sale was prompted by extraordinary circumstances
   ✔ Size of the transaction
VII. Business / Nonbusiness Income

2. **Functional** – gain is business income if the acquisition, management, and disposition of the property constitutes an integral part of the corporation’s regular trade or business operations

✓ Is this separate test applicable? Depends on the State.
  ▪ Argument against functional test is that the word “and” before the word “disposition” indicates that disposition (and not just use) of the property must be an integral part of the taxpayer’s business

✓ In response, some states have changed the “and” to an “or”

✓ Potential exception for liquidation of business

✓ In addition to asset transactions, has been held applicable to sale of a subsidiary’s stock and stock transactions in which a 338(h)(10) election is made.
VII. Business / Nonbusiness Income

D. Some States have repealed UDITPA definition in favor of broad Business Income Definitions

• All income that can be apportioned under within constitutional bounds
• Only income not derived from the conduct of a trade or business is non-business income

E. Lack of Uniformity can result in double taxation

• Business Income in one State and nonbusiness income in another State
• Similarly, taxpayer may not be required to use consistent treatment in every State
VII. Business / Nonbusiness Income

F. Ohio’s Treatment of Business Income.
   • Income is presumed to be business income.
   • Small Business Investor Income Deduction.
     ▪ HB 64
       ❖ Passed in 2015 to allow for 75% deduction of the first $250k for tax year 2015 and 100% deduction of the first $250k for tax year 2016.
       ❖ Upon initial enactment, it was unclear whether additional 25% up to $250k was subject to flat 3% rate or graduated rates.
       ❖ Legislative intent was for the graduated rates to apply.
     ▪ SB 208
       ❖ Tax correction bill to clarify that the remaining 25% will be taxed at the graduated tax rates and 3% flat rate on income greater than $250k.
       ❖ Signed into law by Governor Kasich on November 15, 2015.
VII. Business / Nonbusiness Income


1. Non-resident Taxpayer sold his majority ownership in a plumbing business for $27MM and challenged the special apportionment rules under R.C. 5747.212 via refund claim.

2. Rules require 20% or greater owner of qualifying entity to apportion gain on sale of interest based on apportionment factors for current year and prior two years.

3. Taxpayer argued that application of special allocation rules was unconstitutional.

4. BTA held it is without jurisdiction to hear constitutional challenges.

5. Taxpayer also alleged that ODT improperly calculated tax based on statutory misinterpretation. BTA disallowed argument because Taxpayer did not raise issue in his Notice of Appeal.
Questions?

- Thank you for your time today.

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