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DealThink: As Always – State Taxes Lurk as a Trap
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You are general counsel of a publicly traded medical device company that has begun the diligence process on your company's target, a publicly held x-ray and CT scan component manufacturer. The target is a Delaware corporation based in California, with additional manufacturing facilities in Utah a Kentucky; within the past three years, it has sold two mothballed manufacturing facilities. It sends salespeople to 15 different states, but due to its Internet presence, it ships components worldwide. also provides support services for its component parts within the continental U.S.

The tax partner at your company's outside counsel has assisted you with the following tax-related diligence questions.

In what states should the target have been paying taxes if it has operations in only 3 states, is incorporated in Delaware, ships worldwide and sends sales people to 15 states?

The Key Issue is Nexus. When a company has nexus with a state, it generally has one or more tax obligations in that state. Nexus can arise from a variety of different factors, including the place of incorporation or a place where a company is doing business. Nexus also arises in states where a company sends salespersons or provides support services with respect to its products – though it depends on how the support services are provided. Some general rules for when a company has ne with a state are:

- *Nexus arises automatically in the state of formation or a state in which a company has registered or qualified to do business*. The target, as a Delaware corporation, has nexus with Delaware.
- *Nexus arises in states in which a company has offices, facilities, assets, and/or employees*. The target has nexus with California, Utah, and Kentucky - which are the three states where it has offices and/or facilities. The target also had nexus in the states where the two previously-owned mothballed manufacturing facilities were located. With respect to these two states, a question wil present regarding how to deal with this contingent liability. The answer will, in part, depend on th form of the transaction chosen by the parties.
- *Nexus generally arises when a company sends salespersons into a state*. Sending a salesperson into state gives rise to nexus and allows the state to impose its tax regime over the company. Howeve federal law prohibits the states from imposing net income taxes if a company's only activity in the state is selling tangible personal property that (i) is solicited by salespersons, (ii) is sent outside o the state for approval or rejection, and (iii) if approved, is filled outside the state by shipment or delivery into the state via common carrier. Depending on the activities of the target's salesperson the 15 states may be unable to impose a net income tax on the target. Additional information will needed to make a definitive determination. However, those states could impose all other applicab state taxes on the target.
- *Nexus generally does not arise when a company sells goods over the Internet.* Sales made through th Internet do not give rise to nexus, unless such sales are accompanied by other company-related indicia of nexus within the state where the goods are sold.
- *Nexus will arise if a company provides "in state" supports services for its products*. If a company provides "in state" support services for its products, it will create nexus for state tax purposes. In

most states, this will include services provided by a third party that is paid for by the company sell the goods. Additional diligence would be necessary to determine the nature of the target's suppo services to determine if nexus would exist.

What happens if the diligence uncovers that the target has not been paying properly its state taxes?

Avoiding Successor Liability. Assuming that the target has tax obligations in 21 states (the state c incorporation, the 3 states where it has facilities, the 2 states where it previously had facilities, and 15 states where its salespersons operate) and is only paying tax in three states, the next issue is h your company, as purchaser, avoids being liable for the unpaid taxes of the target. The answer depends in part on the type of transaction.

Asset Purchases. If your company is purchasing the assets of the target (versus its stock), almost all states impose successor liability despite the fact that the purchaser is not acquiring the entity, but o the entity's assets. Generally, successor liability can be avoided by obtaining a tax clearance certifica from each state (or a "certificate of no tax due") which if granted prevents the state from asserting liability against the company for the target's unpaid taxes. But be aware that in the process of requesting this state tax clearance, the state could assert that the target has unpaid tax liability in which case the purchaser is required to withhold and pay over to the state these unpaid tax liabilitie In other states, the procedure involves filing a bulk sales notice where the seller and purchaser noti the state of the impending purchase and provide certain documentation relating to the transaction. There are often strict time periods in which requests for tax clearance or bulk sale filings must be ma If the requisite certificate or filing is not made within the correct time period, the purchaser likely will have successor liability for the target's unpaid state taxes.

Stock Purchases and Mergers. If your company is purchasing the stock of the target or merging with t target, your company will inherit all of the entity's liabilities, including tax obligations. In general, purchasers in such a situation protect themselves through contractual provisions in the stock purcha agreement (i.e., escrows, representations and warranties, etc.).

In addition, the target currently gets a tax break because it built its newest plant in a depressed economic area in Kentucky. Could it lose that tax break in the event of a change of control?

Potential Loss of Tax Break. State and local laws and ordinances determine whether a change of control would result in the target losing its tax break in Kentucky. Additional diligence will be necessa to determine whether the tax break will either flow to your company, as the transferee, or be lost.

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