Sales Tax Issues in Private Equity Acquisitions and Dispositions

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DHG Speakers

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About DHG

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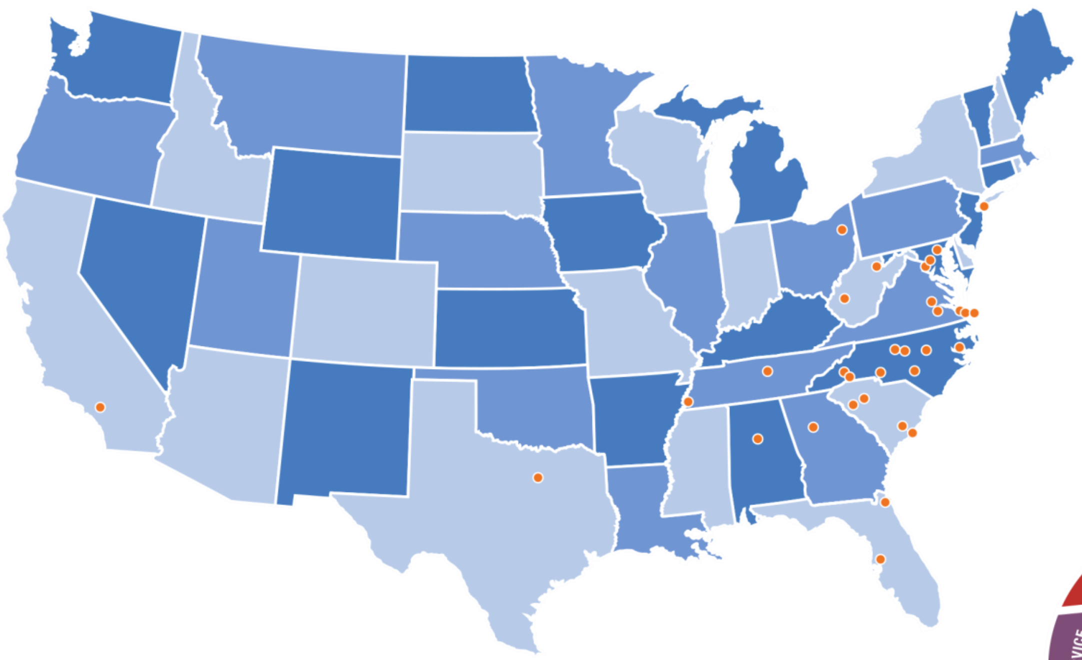
One of the top 20 largest accounting firms in the U.S. — **TOP 20**

States with resources serving clients across the U.S. and internationally — **13**

SEC / Public Audit Clients — **60+**



THERE WHEN IT COUNTS

- Experienced professionals who understand your industry
- Significant partner involvement
- Ongoing communication to avoid surprises
- Focused on business risks and their impact on your entity
- Accessible, responsive, hands-on style
- Customized service vs. one-size-fits-all approach
- Big Four alternative

Member of Praxity, an international alliance of independent accounting firms that offers multinational clients access to resources around the world.

DHG Private Equity Overview

NAVIGATING COMPLICATED MARKET TRANSACTIONS

DHG Private Equity offers a dedicated group of professionals across multiple service lines to provide private equity firms and their portfolio companies a full array of services to meet their demanding needs in a challenging market.

FUND

- Fund Formation
- Tax Planning & Structuring
- Audit of Fund
- Valuation Services

TRANSACTION ADVISORY

- Financial/Accounting Due Diligence
- Tax Due Diligence
- IT Due Diligence
- Operations & Human Resources Due Diligence

PORTFOLIO COMPANY

- Annual Audit
- Tax Planning & Compliance
- IT Audits & Assessments
- Valuation Services

EXIT STRATEGY

- Sell-Side Due Diligence
- Initial Public Offering
- Tax Structuring
- Carve-Out Assistance

COMPREHENSIVE SERVICES

We provide comprehensive services tailored to meet the unique needs of our private equity portfolio company clients. Our breadth of services and resources give us great strength to address a wide variety of financial and operational issues for our private equity portfolio company clients. Our professionals have solid industry knowledge plus a multi-disciplined approach to financial, accounting and operational solutions by offering coordinated comprehensive services and strategies.

Overview

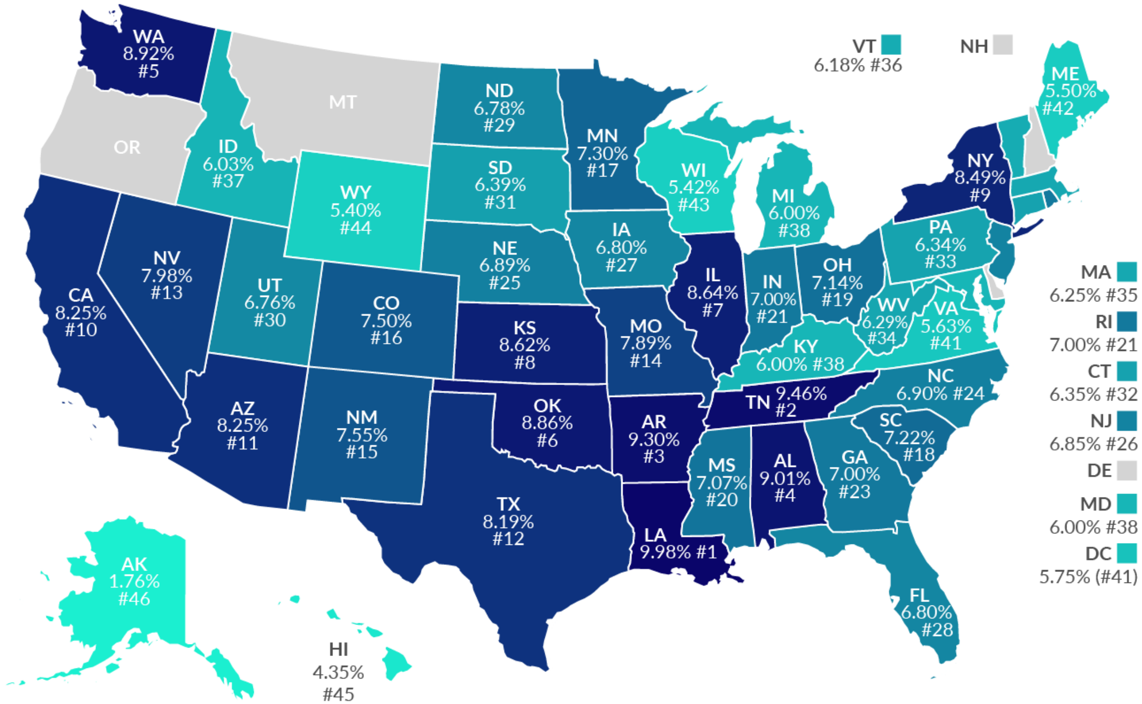
- The Realities & Constraints of Due Diligence
- Uncovering Sales Tax Exposure
- Remediating Exposure
- Post Transaction Best Practices

The Realities & Constraints of Due Diligence

What Has Been the Most Problematic Tax Issue?

Sales Tax

Combined State & Average Local Sales Tax Rates, Jan. 1 2017



Note: City, county and municipal rates vary. These rates are weighted by population to compute an average local tax rate. Three states levy mandatory, statewide, local add-on sales taxes at the state level: California (1%), Utah (1.25%), Virginia (1%), we include these in their state sales tax. The sales taxes in Hawaii, New Mexico and South Dakota have broad bases that include many services. Due to data limitations, table does not include sales taxes in local resort areas in Montana. Salem County is not subject to the statewide sales tax rate and collects a local rate of 3.4375%. New Jersey's average local score is represented as a negative.

Source: Sales Tax Clearinghouse, Tax Foundation calculations, State Revenue Department Websites

Why Is Sales Tax So Problematic in Private Equity Transactions?

- Sales tax is complex
- Sales tax is not well understood – particularly at the executive level
- Sales tax is disliked by everyone who doesn't work in that area
  - Sales tax is viewed as simple and mechanical and is often ignored or not given the attention it is due
- Sales tax can give rise to large tax liabilities

Due Diligence Context

- **Due diligence is often driven of a GAAP analysis – quality of earning**
- **Tax is a “bolt-on”**
- **Tax issues to consider in a M&A transaction:**
  - Income/franchise taxes
  - Gross receipts
  - Occupational and business license fees/taxes
  - Real estate transfer taxes
  - Employment taxes
  - Property taxes
  - Unclaimed Property
  - Business and Tax Incentives
  - Sales Tax

Due Diligence Review

Due diligence typically involves:

- Gathering of information
- Identify, quantify, evaluate and address risks
- Identify, quantify, evaluate and address opportunities (refunds, incentives, etc.)
- Work with deal team to address material issues and risks in the deal negotiations and in the deal documents
- Produce a summary document
  - Calculate exposure risk

Factors that Impact a Due Diligence Effort

- The form of the transaction
- Time/human resource constraints
- Business reasons/motivations for the transaction (*e.g.*, why is buyer acquiring the target or its assets?)
  - Cautious acquisition; or
  - “Damn the torpedoes”
- Size of transaction
- Sophistication of parties
- Prior transactions
- Nature of parties’ respective businesses
  - Internal controls
  - Thoroughness of compliance
- Risk exposure and tolerance level the parties

Important Things to Consider in Tax Due Diligence

- **Know the Form of the Transaction**
- **Understand the Business Operations of the Target**
  - Organizational and operational structure
  - Business activities
  - Locations of people and property
  - Industry specific issues
- **Nexus Evaluation**
  - Are filings adequate?
  - Other nexus creating activities
  - Visibility
    - Other state registrations
    - Website disclosures
    - Trucks & sales force

Keys Sales Tax Questions to Consider

- **Determine Filing Status**
  - Jurisdictions where returns are filed
  - Are returns filed and paid timely
  - Address responsibilities for filing returns for pre-closing, post-closing and straddle periods
  - Are tax determinations accurate
  - Are resale or exemption certificates in place and accessible
  - Are sales tax reserves maintained
  - Have nexus creating activities been identified/considered
- **Address Records Retention Policies and Issues**

Understanding the Economic Landscape – Audits / Refunds

- **Pending Audits**
  - Current, pending, and completed audits
  - Waivers issued and applicable statutes of limitations
  - How will pending audits be handled (record retention, information sharing, dispute resolution)?
  - Notice requirements between parties
- **Refund Claims**
  - How are they to be handled?
  - Who gets the money?
  - Notice requirements between the parties
  - Address decision-making process

Transactional Context: Who is on the Hook for What?

- **Pending Audits**
  - Current, pending and completed audits
  - Waivers issued and applicable statute of limitations
  - How will pending audits be handled (record retention, information, dispute resolution)
- **Refund Claims**
  - How are they to be handled
  - Who gets the money/bill?
  - Notice requirement between the parties
  - Decision making process
- **Written narrative of their sales tax policies**

Due Diligence Memorandum / Report

- **Components**
  - Executive summary
  - Business overview
  - Scope of review
    - What you reviewed and what you didn’t or couldn’t review
  - Assumptions utilized
  - Findings
  - Open issues
  - Exposure computations

Sales Tax Due Diligence Best Practices

- **Get Involved Early**
- **Stay Involved Throughout the Deal**
- **Transaction Documents**
  - Obtain copies of entire documents
  - Stay in the loop for all revised drafts
- **Add Value**
  - Don’t be the deal-killer
  - Be a deal facilitator

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Uncovering Sales Tax Exposure

Understanding When and How Sales Tax Liabilities Carryover

ASSET	VS.	STOCK
Buyer avoids liabilities: **Except for Sales Tax!**	**SUCCESSOR LIABILITIES**	Buyer is responsible
Buyer	**FAVORABLE FOR**	Seller
Buyer realizes	**TAX BENEFITS**	Seller realizes
Non-income tax items, generally	**DUE DILIGENCE FOCUS**	Income and Non-income tax items
Fair Market Value “Step Up”	**VALUATION**	Purchase Price + Expenses

Sales Tax Liabilities – Who is responsible?

- Typically, tax law imposes personal responsibility for payment of sales tax on certain **owners, officers, directors, employees, partners, or members** (together, *responsible persons*) of a business that has an outstanding sales tax liability.
  - Being personally liable means that your personal assets could be taken by the Tax Department to satisfy the sales tax liability of your business.
  - You may be held personally responsible:
    - Even if you have an employee or an accountant handle your sales tax matters.
    - Even though your business is a corporation or a limited liability company.

How Do You Uncover / Measure Sales Tax Exposure?

UNCOVER SALES TAX EXPOSURE	MEASURE SALES TAX EXPOSURE
• Know where you have sales tax nexus	• Know the number of states
• Know how "visible" that exposure is	• Know the non-filing look-back period
• Know your operating facts & the sales tax nexus standards	• Know how to remediate exposure in filing jurisdictions
• Taxable sales made without collecting sales tax	• **Understand state and local tax rates, penalty regimes, and interest rates**
• **Exempt sales without an exemption certificate or a resale**	• Use of statistical sampling

Tax collected and not remitted – you never want to be caught in that position. If you are be very quick and cautious as to how you resolve that issue!

Understanding Transaction Dynamics Between the Buyer and the Seller

BUYER	SALES TAX TENSION	SELLER
• Comfort around compliance process		• Do nothing
• Understand Exposure		• Hope the problem goes away
• Adequacy of Reserves		• Avoid an escrow
• Clear understanding of Nexus		• Mitigate indemnifications
• Reliability of taxability determinations for sales		• Participation in settling an audits which straddle the transaction date
• Adequacy of resale & exemption certificates		• Participation/approval of any remediation activities
• Remediation plan for any agreed upon exposure		

What is the Buyer Looking to Get?

- **Buyers want a thorough understanding of sales tax liabilities**
- **They want some documentary assurance as to the amount of any sales tax exposures**
- **Specifically:**
  - An understanding of any sales tax reserves
  - If there are no sales tax reserves they want to know why
  - Understand the scope of an enterprises sales tax nexus
  - Understand taxability determinations for sales
  - Clean and thorough resale and exemption certificate files
  - A fact-based exposure analysis
  - A plan for remediation or a dollar amount to escrow to be indemnified for

The Tension Between Buyer and Seller

- The buyer wants to be clear of all liabilities or require as escrow or an indemnifications
- The seller either wants to:
  - Reduce liability to avoid an escrow or mitigate indemnification terms; or
  - Do nothing and hope the problem goes away
- This is particularly true in middle-market companies
- **Sellers are typically initially in denial of sales tax exposures**

Indemnification & Escrow Agreements

- **Escrow agreements:**
- Typically contains a provision addressing termination of the agreement and payment of funds.
- This provision directs the payment from the escrow fund to the buyer or a third party for a valid and consented-to claim – read – potential sales tax exposures
- Additionally, language is typically included which clearly sets forth that on the termination date, the escrow agent will not release any portion of the fund in excess of any disputed claim not finally determined. The provision directs the escrow agent to continue to retain the "disputed" amount until a final determination has been reached.
- Indemnification agreements address contractual protection for the buyer for liabilities that are the responsibility of the seller that surface after the close of the sale.

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Remediating Exposure

Why Do Sales Tax Exposure Grow Quickly?

- What can lead to the fast growth of sales tax exposure?
  - Sales tax is transactional so the more transactions that are not properly analyzed the quicker sales tax exposure grows
  - How many state or local jurisdictions are at issue?
  - Understanding the non-fling look-back period (typically 7+ years)
  - Understanding the penalty regimes (typically 25%)
  - Understand the interest rate (typically 7% +/-)
  - The <u>reliable</u> presence of resale or exemption certificates

Remediation of Exposure

- Can the seller get a clearance letter?

- If the taxpayer is not registered in the state, it can enter into a voluntary disclosure agreement (VDA)?

- If exposure is small but continuous – register and file going forward.

- What if the client is registered to collect and remit tax in the state but nonetheless has exposure?

Asset Purchases: Is There an Exemption?

- **States call asset purchase exemptions different things:**
  - Bulk sales
  - Occasional sales
  - Casual sales
  - Other terms

- **How are asset sales typically taxed absent any exemptions?**
  - Inventory is exempt if a valid resale certificate is extended.
  - Vehicles will almost always be taxable on re-registration.
  - FF&E will generally be taxable.
  - Intangibles will generally not be taxable.

Asset Purchases: What Does a Clearance Letter Cover?

- **Questions to ask:**
  - What does the letter of clearance actually provide the purchaser?
    - Provides buyers absolution in states in which the seller was registered to collect and remit sales taxes.
  - What taxes are covered by a clearance letter?
  - What is the timing of getting a clearance letter?
  - Is the buyer required to escrow funds?
    - If so, under what terms?
    - If so, for what period?
  - If you are not registered – you cannot get a clearance letter!

Voluntary Disclosure Agreements (VDAs)

- **Analysis Issues**
  - Consider VDAs in jurisdictions where Target has nexus, but has not filed returns
  - Consider documentation necessary to file VDAs post-closing
  - Impact of VDAs on Acquirer/Acquiring Group and Target/Selling Group
- **Transaction Documents**
  - Address use of VDAs by Acquirer in transaction documents *(avoid surprises!)*

The Power of Voluntary Disclosure Agreements

- **VDAs gives the taxpayers:**
  - Limited look-back periods (typically to 3 to 4 years years)
  - Have penalties waived
  - Control the context/narrative under which disclosure/settlement is made to the state
- **Related VDA issues to consider?**
  - Under all VDA program the taxpayer has to come clean regarding all tax types in the state!
  - **You need to have sales data that is sales tax compliant for the required look-back periods**
  - You have to be prepared to fill out sales tax registration, nexus questionnaires, relate information and electronic registration/filing
  - **Once registered: Are you ready to file!**

Voluntary Disclosure Agreements (VDAs) in the Context of an M&A Transaction

- Is the VDA option available?
- Are their records to support the VDA?
  - Remember state VDA require the disclosure of all tax types
- Are the parties willing to meet the terms of a VDA?
- Who administers the process of completing the VDAs?
- What are the advantages of a VDA?
- What are the results of a VDA?

Post Transaction
Best Practices

Post Transaction Best Practices

- **Adoption of practices and procedures regarding:**
  - Managing business unit fixed asset purchases;
  - Supplies purchases / usages;
  - Customer set up;
  - Periodic nexus reviews (in what states does the business unit have nexus and therefore a collection and remittance obligation;
  - Tax determinations matrices (what is being sold and is it taxable in that state?);

Post Transaction Best Practices (Cont.)

- **Adoption of practices and procedures regarding:**
  - Establish the sale tax filing profile by entity including DREs!
  - Possible sales and use tax automation analysis including
    - Choosing software systems;
    - Financial statements reporting and journalizing transactions
    - Resale/exemption certificate management
  - **Consider outsourcing sales/use tax compliance**
  - Processes regarding establishing and managing financial statement reserves regarding sales taxes;
    - Formalizing financial statement reserves (ASC 450) for sales taxes

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Questions?

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