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Unknown Unknowns: State Tax Hazards In Transaction Planning

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In this article, Ben Carmel explores some of the problems entities might run into when not planning for state and local tax issues and how expert analysis in federal tax matters may be insufficient to plan for and reduce state and local liabilities.

"There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns — the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tends to be the difficult one."

— U.S. Secretary of Defense Donald Rumsfeld[1]

Experience reveals that transactions may be well into their structuring before an adviser is asked to carefully analyze tax considerations. Notably, this careful analysis often is limited to federal tax issues, with advisers explicitly or implicitly accepting responsibility for identifying state tax issues. Thus, one too often hears a comment from a federal adviser that he will contact a state tax expert "if he spots any state tax issues."

Respectfully, that refrain has no place in tax planning, as state taxes are not merely federal taxes writ small. As is shown below, state and local landmines can be hidden in unexpected places.[2] Serious missteps can occur because of the omission of expert state tax issue spotting and follow-up analyses — missteps that cannot be justified with state tax expertise so widely available.

A Classic Income Tax Scenario

Fact pattern. A business has been operating in a jurisdiction for many years. The business sells its operating assets, resulting in significant gain. Payment will be received over several years, and the business's federal tax advisers and management accepted (did not elect out of) installment sale treatment under IRC section 453, allowing for the spreading of income taxes over those years. For state income tax purposes, these same advisers and decision-makers conclude that because the business is no longer actively conducting affairs in a jurisdiction, it should file a final tax return with that jurisdiction.

Expected result. By filing a final return in a state, the business's installment gains reported federally in later periods will not be subject to income tax in that state.

[1] Defense Department news briefing, Feb. 12, 2002 (accessed Mar. 1, 2022).

[2] The transactions and tax reporting discussed in this article resulted in adverse, apparently unexpected, state and local tax consequences and demonstrate the need to obtain expert state tax guidance when planning a transaction. However, the cited decisions do not describe the tax planning conducted by the parties. Thus, it is beyond the scope of this article to critique the planning that occurred in any instance, and no critique is intended or implied.

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Actual result. By filing a final income tax return, the business accelerates the required reporting to the state of its installment income, causing it to owe income taxes in the state ahead of its federal reporting and, indeed, even before it receives the taxed payments.

The following are two recent instances of this scenario.

A. Gain on a Deemed Sale of Assets Under Section 338

In *Amarr*,[3] an S corporation operated throughout the United States. In November 2013 the S corporation and its shareholders entered into an agreement to sell all the S corporation's stock and to elect to treat the stock sale as an asset sale under section 338(h)(10). Payment was to occur in four annual installments, with the first installment being a fixed amount and the three subsequent installments being tied to growth in earnings before interest and taxes averaging at least 38.4 percent in the three years following the sale.

Under federal law, the 2013 stock sale and section 338(h)(10) election ended the S corporation's tax year. For that short period, the S corporation filed a California tax return that it marked as its final return. The California Franchise Tax Board audited the return and concluded that, because it was a final return, all the gain must be accelerated into that short period. The taxpayers paid the assessed tax and filed refund claims, which the FTB denied.

The California Office of Tax Appeals (OTA) sustained the FTB's denial of the refund claims. First, regarding the installment payment acceleration, the OTA cited Cal. Rev. and Tax Code section 24672(a), which state:

> Where a taxpayer reports income arising from the sale or other disposition of property as provided in this article, and the entire income therefrom has not been reported prior to the year that the taxpayer ceases to be subject to [California corporation franchise tax] or [California corporation income tax], the unreported income shall be included in the measure of the tax for the last year in which the taxpayer is subject to the [corporation franchise tax or corporation income tax].

The OTA rejected the taxpayers' claim that, although S corporation status was lost, the entity continued to exist as a C corporation. In doing so, the OTA cited Treasury reg. section 1.338(h)(10)-1(d)(4)(i) and stated that "when an IRC section 338(h)(10) election is made, the corporation is treated as if it sold its assets, liquidated, and ceased to exist." The OTA continued by referencing the well-known precept that "while a taxpayer is free to organize its affairs as it chooses, nevertheless, once having done so, it must accept the tax consequences of its choice, whether contemplated or not, and may not enjoy the benefit of some other route it might have chosen to follow but did not."[4] The OTA therefore agreed with the FTB that the entirety of the installment sale income had to be reported in the year that the S corporation ceased being subject to California's income and franchise taxes.[5]

B. Gain From Sale of Real Estate

1018 Morris Park[6] involved a taxpayer's liability for New York City's general corporation tax (GCT). The taxpayer was formed in 1993 and on that day purchased two parcels of real property in New York City. On November 17, 2009, it sold both of those parcels in an installment sale.[7] Two months later, on January 27, 2010, the taxpayer filed a GCT return for the period ending November 30, 2009, which it marked as its final return.

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[3] *Matter of Amarr Co. and Amarr Co. (C SGNF)*, 2022-OTA-041P (Cal. OTA Dec. 9, 2021, *nonprecedential*).

[4] Notably, the company operated nationwide with more than 90 percent of its sales outside of California. Therefore, it might have income acceleration issues in other jurisdictions as well.

[5] This led to a disagreement between the parties over the proper measure of the taxpayers' income. While this aspect of the decision is beyond the scope of this article, it involved the proper valuation of the installment sale in the year that the S corporation ceased to be subject to California taxes because the amounts of the three later payments were contingent on future results.

[6] *Matter of 1018 Morris Park Realty Inc.*, TAT(E) 14-4 (GC) (N.Y.C. Tax App. Trib. Aug. 7, 2017).

[7] While the number of years over which the installments were to be paid is not disclosed in either *1018 Morris Park* or in the administrative law judge determination from which it was appealed, the decisions note that installment payments were still being received in 2015. *Matter of 1018 Morris Park Realty Inc.*, TAT(H) 14-4(GC) (Dec. 5, 2016).

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The GCT return that was marked final reported the installment payment received in November 2009. This payment was 3 percent of the total installment payments to be received. The remaining 97 percent of the installment payments were to be made after the taxpayer terminated its New York City contacts and were not reported in later years as being subject to the GCT.

In November 2012 the New York City Department of Finance (DOF) assessed GCT against the taxpayer by taxing in tax year 2009 the other 97 percent of the installment gain. In 2013 the taxpayer filed an amended 2009 GCT return removing the "final" designation. In 2014 and 2015 the taxpayer had monthly deposits in an account in a bank located in the Bronx, but there is no indication that after 2009 it owned or leased property in New York City or maintained an office there. Moreover, despite the 2009 amended return and 2014 and 2015 bank activity, the taxpayer did not file GCT returns for 2010, 2011, or any later periods.

Administrative Code section 11-602.8(d) allows the commissioner of finance to disregard the taxpayer's method of accounting if that method results in an understatement of income subject to GCT. Moreover, state regulations applicable to the comparable state tax contain an example relating to a foreign corporation's gain on an installment sale and provides that, if the taxpayer concludes its New York activity in the year of an installment sale, all unreported gains on the sale must be accelerated into the year of the sale.[8] Further, the tribunal — citing letter rulings and other DOF guidance from the 1990s, 1980s, and 1970s — observed that "longstanding published statements of [DOF] policy also provide that the installment method of accounting should be disregarded when a corporation files a final return and ceases to do business in the City after selling its assets in an installment sale."

Finally, the taxpayer's assertion that its monthly bank deposits in 2014 and 2015 demonstrated that it was conducting business in the city in the years after the installment sale ran headlong into a DOF regulation stating precisely the opposite. That is, the regulation states that maintenance of cash balances with banks in New York City shall not cause a corporation to be deemed to be doing business there.[9] Therefore, without more, the deposits were insufficient to support the taxpayer's claim that it was conducting business in New York City. In sum, the taxpayer was left with the undesirable consequence of a final GCT return: All of its gain was accelerated into 2009.

Sales and Use Tax Scenarios

The possibilities for stepping on sales and use tax landmines are all but ubiquitous. Fundamentally, retailers must identify the most likely characterization of the goods or services they sell. Further, if what is being sold are services or digital goods, one must look deeper at the laws of the jurisdictions in which the services or digital goods are sold or used to determine taxability. Again, these are tasks requiring multistate expertise.

Secondarily, businesses selling their operating assets potentially generate significant sales tax liabilities, unless the sale qualifies for an occasional sale or other exemption. Unfortunately, the laws here vary greatly among the states, and it is easy to misread the controlling language in laws and regulations. Also, the actual application of potentially relevant exemptions can be generous or cramped depending on the interpretations of tax administrators.

The District of Columbia and Texas demonstrate the range of potential occasional sale treatments. District law provides an exemption for an occasional sale of operating assets by "a vendor who is not regularly engaged in the business of making sales at retail."[10] Thus, the exemption does not apply to "a sale of the entire operating assets of a business or of a separate division, branch, or identifiable segment of a business where the sale is by a vendor who is regularly engaged in the business of making sales at retail."[11]

[8] 20 NYCRR section 3-2.8, example 2.

[9] 19 RCNY section 11-04(c)(1).

[10] D.C. Code Ann. section 47-2005(7)(A).

[11] D.C. Muni. regs. 402.1(d).

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In contrast, Texas law generally exempts "the sale of the entire operating assets of a business or of a separate division, branch, or identifiable segment of a business."[12]

Other states allow nontaxable occasional treatments at a variety of intermediate points, which makes expert planning assistance necessary to qualify for these exemptions. For this, there might be no better example than the 2019 Wyoming Supreme Court decision in *Delcon Partners*.[13]

Wyoming law allows for nontaxable treatment of some retail sales of a business's assets as follows:

> "Sale" means any transfer of title or possession in this state for a consideration . . . but excluding an exchange or transfer of tangible personal property upon which the seller or lessor has directly or indirectly paid sales or use tax incidental to: . . .
>
> (N) The sale of a business entity when sold to a purchaser of all or not less than eighty percent (80 percent) of the value of all of the assets which are located in this state of the business entity when the purchaser continues to use the tangible personal property in the operation of an ongoing business entity in this state.[14]

Delcon purchased 100 percent of the target business's tangible assets located in Wyoming[15] and more than 80 percent of all its tangible assets.[16] Delcon, however, did not purchase the seller's cash or checking accounts (which were sitused to Wyoming), nor did it purchase the seller's accounts receivable (which were also apparently sitused to Wyoming).

Wyoming sales tax is not imposed on the sale of any of these intangibles, and all cash and cash equivalents would be expected to sell at 100 percent of their face amount (except for accounts receivable that presumably would be discounted because of the need to wait for payment and possibility of nonpayment). Therefore, it might have been presumed that purchasing cash and cash equivalents would be irrelevant to determining whether a purchase of tangible personal property was nontaxable under Wyoming law.

However, according to Wyoming's highest court, State Board of Equalization, and Department of Revenue, that presumption is incorrect. Read literally, the sales tax exemption can be understood as requiring consideration of sales or non-sales of intangibles sitused to Wyoming in evaluating the applicability of the exemption.

Applying section 39-15-101(a)(vii)(N), the court held that exemption from sales tax required the purchase of not less than 80 percent of "all of the assets which are located in" Wyoming — which in this case included the seller's cash and cash equivalents. The court stated that "section 39-15-101(a)(vii)(N) does not differentiate between tangible and intangible assets. We will not add that language in the guise of statutory interpretation" (citations omitted).[17]

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[12]Texas Tax Code Ann. section 151.304(b)(2).

[13]*Delcon Partners LLC v. Wyoming Department of Revenue*, 2019 WY 106 (Oct. 21, 2019) *aff'g Matter of the Appeal of Delcon Partners LLC from a Decision of the Department of Revenue*, 2018-30 (Wy. BOE Jan. 18, 2019).

[14]WY Stat. Ann. section 39-15-101(a)(vii)(N).

[15]The State Board of Equalization decision at para. 8 states: "The assets Delcon bought from Seller included 'equipment, vehicles, furniture, fixtures, leases and contracts, inventory, intellectual property, software, post-closing accounts receivable, and goodwill.' (*Id.* at para. 8). Seller owned other Wyoming assets (*all of which were intangible*) worth $3,010,602 that it did not sell to Delcon" (emphasis added).

[16]The State Board of Equalization at para. 14 decision states: "Delcon urges us to interpret Subparagraph (N) to require a purchase of 80 percent of a seller's *tangible personal property* rather than a purchase of 80 percent of a seller's *total Wyoming assets*" (emphasis in original).

[17]This article includes a discussion of *Delcon Partners* solely to demonstrate the hazards of state tax transaction planning. However, this does not indicate agreement with the Wyoming Supreme Court's analysis, which does not appear to take seriously the idea that limitations on the availability of tax categorizations must be relevant to the categorization or another legitimate state interest. Significantly, *Delcon Partners* contains no justification for why the Legislature would have desired this result. Rather, we apparently are expected to accept that the Legislature arbitrarily mandated the purchase of cash (an otherwise meaningless occurrence for sales tax purposes) so that a purchase of tangible assets can qualify for a sales tax exemption. Respectfully, this analysis is questionable. In contrast, other courts have required states to provide meaningful justifications for alleged statutory requirements when no such justifications are apparent. For an excellent example, see the Illinois Supreme Court's decision in *Searle Pharmaceuticals Inc. v. Department of Revenue*, 117 Ill. 2d 454 (1987), in which the court analyzed the state constitution's uniformity clause and rejected as arbitrary a proffered justification for a tax treatment: "There is no real and substantial difference between the two classes of corporations that is rationally related to the stated objective of reducing the number of amended returns that must be processed. The same objective could be achieved by denying corporations the right to carry the loss back based on any number of arbitrary considerations such as corporations having their offices in certain geographical areas, or corporations whose names start with certain letters of the alphabet."

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Will Federal Tax Planning Be Respected?

There appears to be a widespread misimpression that states and localities must respect a business's legitimate federal income tax planning. However, much to the contrary, subnational departments of revenue generally have a right to review income tax planning to determine whether it satisfies their jurisdiction's requirements. Here, two items bear noting.

First, because the members of a state income tax reporting group are seldom identical to the members of a federal consolidated group, states are on alert for affiliate tax planning that, in their opinion, improperly increases deductions sourced to the state or improperly decreases income sourced to the state. Separate reporting states are especially attuned to this possibility. Second, state tax reduction might be a satisfactory justification for federal income tax planning, but it generally is not a satisfactory justification for state tax planning — even if the taxpayer demonstrates that the state conducting an audit was not a target of the planning.

States and localities also may review — and might reject — federally permitted income tax reduction arrangements. For example, in a recent New York City administrative decision now on appeal, the city and taxpayer disputed the unincorporated business tax (UBT) consequences of a taxpayer's use of a federally recognized domestic international sales corporation (DISC).[18] In *Skidmore*, the taxpayer was a partnership subject to UBT. The taxpayer's partners established a DISC in conformity with federal law, and the relationships and activities involving the DISC apparently conformed to federal law.

Although the DISC had no employees, the taxpayer paid it some $17 million in commissions over two years for services the DISC was deemed by federal law to have performed. The administrative law judge said that "the parties agree that the DISC is a federally authorized fiction, in which payments are made for deemed services which are not actually performed." The DISC did not file any New York City tax returns.

The DOF disallowed deductions for almost all the taxpayer's commission payments to the DISC, asserting that under the UBT, deductions for payments to partners for services or the use of capital are capped at $10,000 per partner annually.[19]

At issue was whether the DISC should be treated as an entity distinct from its owners, each of whom was a partner in the taxpayer. If that distinction was respected, the taxpayer's payments to the DISC would not be subject to the limitation on the deductibility of payments to partners. But if payments to the DISC were treated as payments to its partners (that is, effectively ignoring the federal tax treatment of the DISC), the UBT's deductibility limitation would apply. The ALJ ruled in the DOF's favor, finding that the economic substance of payments to the DISC for deemed but not actual services was really a payment to the partners individually for their services or the use of their capital.

In language that supports this article's premise, the ALJ concluded:

> Petitioner uses [a case] to argue that "[i]n the absence of any such express modification, federal conformity requires that Petitioner be allowed the UBT deduction claimed in respect of the Commissions paid to S-DISC." (Petitioner's Surreply at p. 6.) . . . [That case] is not controlling here. Federal taxable income is the starting point for computing UBT taxable income. The issue here is whether there is a provision that requires the commissions to be added back in computing UBT. In this case, there is such a provision because, as explained above, when the economic substance is analyzed, the payments are to partners or for their benefit. [Citations omitted.]

Conclusion

State and local taxes involve issue spotting and follow-up analyses that require multistate expertise, which now is widely available. The business activity tax and transaction tax examples

[18] *Matter of the Petition of Skidmore, Owings & Merrill* LLP, TAT(H)17-21(UB) (July 30, 2021).

[19] NYC Admin. Code sections 11-507(3) and 11-509(a).

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presented are surrogates for the unnecessary issues encountered after the fact by state tax auditors and practitioners. Other areas of complexity that require state tax expertise include:

- knowing whether tax presence might be transferred from one affiliate to another;
- knowing whether in-state contacts might be accumulated among remote affiliates to create tax presence for all the affiliates, even though tax presence would not exist separately;
- understanding how affiliates will be treated in different states for business activities tax purposes;
- suggesting factor-planning possibilities;
- knowing whether transfers between affiliates will be subject to transaction taxes;
- suggesting transaction tweaks that can reduce sales tax exposures; and
- knowing whether acceptable federal tax planning will trigger state tax challenges.

The challenges presented by subnational taxation mean that federal tax advisers can no longer declare — without fear of triggering professional liability exposure — that "if I notice a state tax issue, I will request the assistance of a state tax expert." That approach makes no more sense than having a state tax planner make the claim about federal tax issues. These are separate areas of expertise, each of which requires expert attention. ■

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