TAXING THE DEAL:

STATE AND LOCAL TAX ISSUES IN TELECOM M&A TRANSACTIONS

MARCH 10, 2016

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I. Background

- Significant M&A activity involving telecommunications service providers and cloud-based service providers
- Excessive state and local taxes imposed upon telecommunications service providers
- Tax uncertainty – in many cases, taxing statutes and regulations have not changed to reflect new technologies
- State and local tax audit adjustments by revenue hungry state taxing authorities are increasingly common
- Wide disparity in level of state and local tax compliance
- Potential increased customer churn if, following acquisition, buyer increases taxes imposed upon or passed-through to customers

II. Types of Acquisitions

- Acquisitions may take two basic forms – stock and asset.
  - A buyer may also acquire membership interests in a limited liability company (an “LLC”) that is treated as a partnership or disregarded entity for federal income tax purposes.
- Both stock and asset deals may be structured as taxable, tax-free, or partially taxable for federal income tax purposes.
  - State income tax treatment typically follows federal income tax treatment.

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Taxable Stock Deals

- If the target is a corporation, a taxable stock deal will generally take the form of a purchase of target stock for cash and/or debt.
- Sellers typically prefer stock deals, for a number of reasons, including:
  - Avoidance of double level of tax;
  - Qualification for preferential capital gain rates; and
  - Subject to the indemnification provisions of the acquisition agreement, sellers could shift more of target's liabilities to the buyer.
- Buyers typically prefer asset deals for a number of reasons, including:
  - The buyer could avoid responsibility (direct or indirect) for undisclosed liabilities of the target, subject to certain exceptions; and
  - The buyer could obtain a stepped-up tax basis with respect to the target's assets.

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Taxable Stock Deals with a Section 338(h)(10) Election

- In the case of an eligible stock sale, where the buyer and seller jointly make an election under Section 338(h)(10) of the Internal Revenue Code of 1986, as amended (the "Code"), the sale would be treated as an asset sale rather than a stock sale for federal income tax purposes.
- In a transaction eligible for a Section 338(h)(10) election (involving a premium purchase price above book value), a buyer will often request that the Section 338(h)(10) election be made in order to obtain a stepped-up tax basis in the target's assets.
- The requirements for a Section 338(h)(10) election include:
  - The target must either be an S corporation or a corporation that is a member (but not the parent) of an affiliated group of corporations that files a consolidated federal income tax return;
  - The buyer must also be a corporation;
  - The buyer must purchase 80% or more of the target corporation's stock within a 12-month acquisition period; and
  - Both the buyer and the seller (or all of the sellers where the target is an S corporation) must jointly file the election.

Taxable Stock Deals with a Section 338(h)(10) Election

- When asked to participate in the Section 338(h)(10) election, a seller will often demand to be compensated for any additional tax cost resulting from the election.

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STATE TAX ISSUES

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Issues Presented by Different Services

Telecommunications:

- Telecommunications services are generally considered to be a form of service by state and local taxing authorities, but do not resemble most other types of services. Telecommunications service providers typically have customers in many states, but unlike traditional service providers, they often do not have property or personnel in states in which they have customers.
- The unique nature of telecommunications services raises two fundamental issues:
  - **Nexus**: The minimum contact required under the federal Constitution for a state to have the jurisdiction to tax a person. Whether the nexus standard for state income taxes is the same as the nexus standard for state sales and use taxes is a hotly debated topic.
  - **Apportionment**: The measurement of the revenue or income that is subject to tax in a particular state. The apportionment rules for state income taxes generally differ from the apportionment rules for state sales and use taxes and gross receipts taxes.
- The expansion of a telecommunications service provider's customer base into new states could potentially outpace the provider's state and local tax compliance capability.

Difficulty of Categorizing Cloud-Based Services for Tax Purposes:

- Cloud-based services are difficult to characterize for tax purposes. In general, state and local tax laws do not contain provisions that specifically address the tax treatment of such services. Service providers may contend that because tax laws do not specifically address such services, they should not be taxable. State and local taxing authorities might however contend that cloud-based services should be classified as more traditional types of service for which the tax treatment is known.
- Certain SaaS applications, such as web-based teleconferencing services, provide functionality comparable to that provided by traditional telecommunications services. The tax issues that arise in connection with such services can be similar to the ones that arise in connection with telecommunications services. For example, SaaS with telecommunications functionality can potentially generate nexus and apportionment issues. Below, we will discuss in greater detail issues presented by SaaS services that provide telecommunications functionality.

Nexus

- In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the U.S. Supreme Court held that a taxpayer may be subject to a state tax if the tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." Of the four requirements identified in Complete Auto Transit, the one that is most frequently an issue in the case of telecommunications services is the substantial nexus requirement.
- In *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), the U.S. Supreme Court held that under the Commerce Clause of the U.S. Constitution, a state may not impose a sales and use tax collection obligation on a taxpayer unless the taxpayer has a physical presence in the state.

Sales and Use Tax Nexus

General Operation of Sales and Use Taxes:

- Sales and use taxes are generally imposed on sales of tangible personal property and taxable services, which usually include telecommunications services. Providers of taxable services are typically obligated to collect sales taxes from their customers and remit them to the state.

General Principles of Sales and Use Tax Nexus:

- As noted above, a pre-requisite for substantial nexus with a state, and therefore the state's ability to require a service provider to collect and remit sales or use taxes, is physical presence in the state.

Sales and Use Tax Nexus

- Physical presence may be triggered by the presence of a service provider's owned or leased property within a state. The presence of a service provider's server, fiber, or other telecommunications equipment in a state may be sufficient physical presence to create substantial nexus.
- Physical presence may also be triggered by the presence of a service provider's personnel within the state.
  - The personnel need not be permanently based in the state. Even occasional visits by sales personnel to customers may represent enough physical presence to create substantial nexus.
  - The presence of an employee who works from home in a state may also create substantial nexus in the state, and the filing of an employment tax return (or any other tax return) with a particular state can potentially cause the state to conclude that the employer has substantial nexus with the state.

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Sales and Use Tax Nexus

- Personnel whose presence in a state may trigger substantial nexus may also include independent contractors
- Some states have become creative in finding physical presence. New York, for example, has enacted a so-called Amazon statute, pursuant to which a seller based outside New York is presumed to be soliciting business through an independent contractor or other representative if:
  - The seller enters into an agreement with a resident of the state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on a website or otherwise, to the seller; and
  - The cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of $10,000 during the preceding four quarterly periods ending on the last day of February, May, August, and November.
- Certain jurisdictions take the position that substantial nexus may be created if a taxpayer's affiliate is physically located in the state.

Application to Telecommunications:

- Telecommunications carriers often provide telecommunications services in states in which they do not own or lease equipment or other property. If the carrier has no personnel in such a state, then the carrier might be able to argue that it has no substantial nexus with the state and therefore it has no obligation to collect and remit that state's sales and use taxes.
- If a carrier has no property in a state, but its employees or independent contractors are physically present in the state, even on an intermittent basis, then the state could take the position that the carrier has substantial nexus with the state.
- Kansas has taken the position, in an administrative ruling, that telecommunications service providers may be obligated to collect sales tax from Kansas customers even if the service provider has no physical presence in the state other than providing services in the state. It remains to be seen whether Kansas' position would withstand Constitutional scrutiny. It also remains to be seen whether other states would follow Kansas.

Application to Cloud Services:

- Cloud-based services should generally be subject to a nexus analysis similar to that applicable to telecommunications services.
- Cloud-based service providers may have substantial nexus with a state if they own or lease property within the state (e.g., servers).
- Cloud-based service providers may also have substantial nexus with a state if they have in-state personnel, including sales representatives, independent contractors, and personnel who work from home in the state.

Income Tax Nexus

- As a practical matter, the standard for finding state income tax nexus may be lower than the standard for finding sales and use tax nexus.
  - Several states have taken the position that the Supreme Court's Quill decision applies only for sales and use tax purposes, and that physical presence is not essential to finding substantial nexus for state and local income tax purposes.

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Economic Nexus

- Recently, a number of states have adopted an economic nexus standard for finding substantial nexus based upon economic presence rather than physical presence, for income tax purposes.
- Economic nexus states have adopted different formulations of the economic presence test. Several economic nexus states have adopted a bright-line test for economic presence that treats any nonresident as having economic nexus with the state if its revenue from the state during the tax year equals or exceeds a specified threshold amount (typically, $250,000 to $500,000).

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Sales and Use Tax Apportionment

General Rule for Telecommunications Services:

- Telecommunications services billed on a per-call basis are generally apportioned according to the rule of Goldberg v. Sweet, 488 U.S. 252 (1989), in which the Supreme Court ruled that where a telephone call crosses state lines, generally only one state has the jurisdiction to tax the call. The state with the jurisdiction to tax the call is the state in which two of the following three factors are located: (1) the origination point of the call, (2) the termination point of the call, and (3) the "service address" of the call. (Some jurisdictions might use a customer's "billing address" in lieu of, or in addition to, its service address as the third factor.) Because the state with the jurisdiction to tax a telephone call is determined based upon the location of two out of three factors, the Supreme Court's rule is often referred to as the "Goldberg v. Sweet 2 out of 3 rule."
- Private line services are generally taxed based upon the location of "channel termination points," i.e., the points at which the line may be accessed by the customer. Revenue from private line services is apportioned between states based upon the proportion of channel termination points located in each state.

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Sales and Use Tax Apportionment

- The apportionment of revenue from conference-bridging services, or cloud-based services that resemble conference-bridging services, is less uniform.
  - A number of states are parties to the Streamlined Sales and Use Tax Agreement (the "SSUTA"), which is intended to be a uniform law. In states that are parties to the SSUTA, revenue from conference-bridging services is typically sourced to the customer's "place of primary use," which is typically the customer's business address.
  - A few states have different rules. Some states have attempted to apply the Goldberg v. Sweet 2 out of 3 rule to conference bridging services. In the case of a conference bridging service, identification of the origination point, termination point, and service address can potentially be subject to different rules in different states.

Application of Apportionment Rules to Cloud-Based Services:

- Cloud-based services that offer conference bridging capability may potentially be apportioned like traditional conference bridging services – e.g., based upon the user's primary place of use or based upon an application of the 2 out of 3 rule.
- In some jurisdictions, application of the 2 out of 3 rule to a cloud-based service with conferencing bridging capability might cause revenue from cloud-based services to be apportioned to the customer's address.
- In other jurisdictions, however, application of the 2 out of 3 rule might cause revenue to be apportioned to the location of the bridging equipment. Florida, for example, has ruled that where bridging equipment is located outside of Florida, and where the Florida customer pays for connections to the bridging equipment, the service has both an origination point and a termination point outside of Florida, such that the service is not sourced to Florida.

Income Tax Apportionment

- Apportionment rules for state income tax purposes are generally different from the apportionment rules for state sales and use tax purposes.
- Historically, most states used a three-factor apportionment formula, based on a weighted average of property, payroll, and sales located in a state.
- A recent trend has been a shift to single-factor apportionment, based solely on sales sourced to a state.
- The manner in which sales are sourced for income tax purposes can vary.
    - Historically, revenue from the provision of services was sourced to the state in which the services were physically performed.

Income Tax Apportionment

- Most states that have adopted economic nexus standards have also adopted so-called market apportionment rules. Under market apportionment, service revenue is attributed to the state where the customer receives the benefit of the service. Many service providers, however, reside in states that still apportion service revenue to the state where the services are physically rendered. The inconsistency in apportionment rules may cause some income to be taxed by two different states, often without the benefit of a credit from either state.

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Bundling

- Telecommunications services and other services are frequently “bundled.” For example:
  - Local service might be bundled with long-distance service.
  - A traditional voice service might be bundled with directory assistance, three-way calling, a listing in a telephone directory, and other services that are not necessarily the delivery of pure voice services.
  - A cloud-based information management service might be bundled with an IP-based voice service.
- For sales and use tax purposes, if a taxable service is bundled with non-taxable services, all of the bundled services may be considered to be taxable.
  - A service provider might thus increase its potential sales and use tax exposure by bundling a taxable service with a non-taxable service.

Bundling

- In some states, there are limited exceptions to the general bundling rule. For example:
  - Under the SSUTA, a service provider may generally disaggregate a bundled telecommunications service for sales and use tax purposes if it "can identify by reasonable and verifiable standards such portion from its books and records that are kept in the regular course of business for other purposes, including, but not limited to, non-tax purposes."
  - The SSUTA includes a "true object" test. Where one service is provided that is essential to the use or receipt of a second service and the first service is provided exclusively in connection with the second service and the true object of the transaction is the second service, then the services are not considered to be bundled.
  - The SSUTA also contains a de minimis test, under which a taxable product is not considered to be bundled with a non-taxable product if the purchase price or sales price of the taxable product is 10% or less of the total purchase price or sales price, as the case may be.

Gross Receipts Taxes

- Some states impose a gross receipts tax (in addition to or in lieu of a sales and use tax) on telecommunications services. In certain states, the gross receipts tax may be referred to as a telecommunications excise tax.
- Gross receipts taxes, unlike sales and use taxes, are typically imposed on the service provider, rather than on the end-user. Some states permit telecommunications service providers to pass through all or a portion of gross receipts taxes to their customers.

Gross Receipts Taxes

- Gross receipts taxes may be imposed upon a broad range of services, as illustrated by the 2015 Pennsylvania Supreme Court decision in Verizon Pennsylvania, Inc. v. Commonwealth of Pennsylvania.
  - The Pennsylvania taxing statute provides that its gross receipts tax ("GRT") is imposed on "[t]elegraph or telephone messages transmitted wholly within this state and telegraph or telephone messages transmitted in interstate commerce where such messages originate or terminate in this state and the charges for such messages are billed to a service address in this state." The essential language, "telephone messages transmitted," has been incorporated in the statute since 1929.
  - Verizon argued that the Pennsylvania GRT should not apply to charges for installation, directory assistance, repairs, and similar services.
  - The Pennsylvania Supreme Court disagreed with Verizon and held that while the services described above were not literally "telegraph or telephone messages transmitted," they were, nevertheless, subject to the GRT.

THE ACQUISITION PROCESS

Due Diligence

- Questions that a buyer should raise during the due diligence process:
  - Whether the target is filing income tax returns and has paid required income taxes in all states in which, for state income tax purposes, it has nexus and to which it has income apportioned.
  - Whether the target is filing sales and use tax returns and remitting sales and use taxes in all states in which, for state sales and use tax purposes, it has nexus and to which it has income apportioned. Sub-issues include:
    - Whether the target has correctly identified those services that are potentially taxable for each state in which it potentially has substantial nexus.
    - Whether a target that is relying on a resale exemption for sales to resellers has obtained necessary exemption certificates from resellers.
  - Whether the target is filing gross receipts tax returns and paying gross receipts taxes in all states in which, for state gross receipts tax purposes, it has nexus and to which it has income apportioned.

Due Diligence

- Due diligence steps to take:
  - Ask questions regarding the scope of the target's activities, to identify states with which the target has nexus:
    - In what states does the target own or lease tangible personal property or real property?
    - What states have been visited by target personnel (including independent contractors) in the course of their duties?
    - With which states has the target filed employment tax returns?
    - Does the target have any relationships with third parties that might potentially be viewed as agents of the target, and in what states are such third parties located?

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Due Diligence

- Ask for documents showing the extent of the target's tax compliance:
  - Copies of bills sent to the target's customers for each service offered by the target and for each state in which a customer is located. The bills should show what sales taxes have been collected and when.
    - Be alert for indications that the target has only recently begun to comply with its tax reporting obligations in jurisdictions outside of its home state. A target that has been put up for sale might have only just begun to fully comply with its tax reporting obligations.
  - Samples of sales and use tax returns for each state for each period during which the statute of limitations on assessment has not expired.
  - Copies of all federal income tax returns for each period for which the statute of limitations for assessment has not yet expired.
  - Copies of all income tax returns for each state for each period for which the statute of limitations for assessment has not yet expired.
  - If no tax return has been filed for a particular jurisdiction, the statute of limitations will generally not have begun to run, so the target could have exposure for all periods for which it has not filed a tax return.

Negotiating the Agreement

Representations and Warranties:

- In addition to typical representations and warranties related to federal tax issues, a buyer of a telecommunications service provider or a cloud-based service provider should seek certain state-specific representations and warranties including:
  - No claim has ever been made by an authority in a jurisdiction where target or any of its subsidiaries does not file tax returns that target or any of its subsidiaries is or may be subject to taxation by that jurisdiction.
  - Target and each of its subsidiaries have collected and remitted to the appropriate taxing authority all taxes payable with respect to services provided to its customers.
- A seller might propose a representation that the target has paid all of its taxes. Such a representation would arguably not be broad enough to cover taxes that the target was obligated to collect from other persons (e.g., sales and use taxes).

Indemnities

- Indemnification provisions in acquisition agreements typically indemnify buyers for pre-closing taxes of the seller or target.
- If the target had a sales and use tax collection obligation, care should be taken to ensure that the indemnification provision is broad enough to cover taxes of customers collected by the target, and not merely the target's own taxes.

Escrow

- The buyer would generally prefer to have an escrow, to partially secure seller's tax indemnity obligations. The buyer would typically argue that the escrow should not be the sole source of tax indemnity payments (assuming the target is privately held), while a seller would typically argue that the escrow should be the sole source of tax indemnity payments.
- Query whether the escrow funds would be distributed prior to expiration of the statute of limitations applicable with respect to state and local tax claims.

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Bulk Sales Act

- Several states have statutes that require a seller or buyer to notify the state's taxing authority several days (for example, ten days in New York) in advance of a sale of the seller's assets outside the ordinary course of business. The notification requirement, which is typically referred to as a "bulk sale" notification requirement, gives the state an opportunity to collect unpaid sales and use taxes out of the sales proceeds. If the state is not notified in a timely fashion, then the buyer becomes liable for the seller's unpaid sales and use tax liabilities in connection with an asset purchase.
- As a practical matter, it can be difficult to comply with a bulk sales notification requirement, and it is customary for buyers and sellers to waive this requirement. Buyers instead typically rely on indemnification provisions in the acquisition agreement.
- If there is a concern regarding the seller's creditworthiness, then compliance with bulk sales notification requirements should be considered.

Voluntary Disclosure

- During the due diligence process, or after closing, a buyer may discover that the target has not fully complied with its tax reporting or payment obligations.
- States frequently offer "voluntary disclosure" programs, pursuant to which taxpayers may voluntarily come forward and disclose unreported tax obligations in exchange for the waiver or reduction of potential penalties, and in some cases, a limited "look back" period (typically three or four years).
    - Once a buyer has completed its acquisition, it may wish to make a voluntary disclosure of unpaid tax liabilities, to avoid penalties and to "cap" its liability with respect to unpaid tax obligations of the target. (Note the absence of a statute of limitations if target did not file tax returns.)

Voluntary Disclosure

- Because acquisition agreements typically require a seller to indemnify a buyer for pre-closing tax liabilities (including penalties and interest), in certain cases, a seller may demand that the buyer agree to refrain from making a voluntary disclosure (or demand that indemnification be contingent on the buyer not making a voluntary disclosure).
  - In some cases, a seller might attempt to include in the acquisition agreement broad language precluding indemnification if the claim arises as the result of buyer's actions.

Transfer Taxes

- Transfer taxes may be incurred in connection with a sale of assets (including a deemed sale of assets arising in a transaction involving a Section 338(h)(10) election). Such taxes may include sales and use taxes and real property transfer taxes.
  - There is often an "occasional" or "casual" sale exemption from sales and use taxes where an entire business is acquired. Some states severely limit this exemption, however. New York, for example, generally does not offer an occasional or casual sale exemption. Some states, California for example, limit the exemption to a certain number of sales per year.
  - To the extent that inventory is transferred, a sale for resale exemption may apply, but to qualify for this exemption, the buyer is typically obligated to provide a resale certificate (including, in many instances, its state vendor registration number).
  - The acquisition agreement should contain a provision requiring the buyer and seller(s) to cooperate in obtaining any available exemptions with respect to transfer taxes.

Section 338(h)(10) Election

- If a Section 338(h)(10) election is contemplated, and if the seller is compensated for additional taxes it must pay as a result of the election, the acquisition agreement should contain detailed provisions regarding the manner in which the Section 338(h)(10) payment is calculated. If the relevant provisions are not clear, there can be a serious disagreement regarding the calculation of the Section 338(h)(10) payment.

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