

Sales Tax Considerations In an Asset Purchase

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Buying a business? The sale of a business is typically a frenetic time for both the seller and the purchaser. Both parties typically spend their time addressing long due diligence checklists, negotiating terms, and meeting with various professionals, including attorneys and accountants. For some reason, parties frequently overlook the sales tax implications that can arise when the transaction is structured as an asset sale (sometimes referred to as a bulk sale). In this scenario, the purchaser obtains only the seller's assets, rather than purchasing the seller's business as a going concern. That construction typically leads to two issues regarding state sales tax: Is sales tax due on any of the particular assets being purchased, and can the purchaser become liable for the seller's unpaid sales tax liability, if any? This article addresses these two issues. As with most of the articles written for this column, we'll take a general look at the issues from a multistate perspective, and then review the specific rules in force in New York state.

Taxability of an Asset Purchase

The first question that has to be addressed once the seller and purchaser agree to structure their transaction as an asset purchase is whether sales

tax is due on any of the assets that are being purchased. In most states, sales of intangible assets (such as goodwill, intellectual property, trademarks, and so on) are not subject to sales tax. However, all sales of tangible personal property are typically subject to tax unless a specific exemption applies. Because most asset purchases contain some tangible personal property, sales tax will apply unless the state provides an applicable exemption. So when tangible personal property is part of an asset sale, the parties have to determine whether an exemption covers the asset sale.

Because an asset sale is not a typical transaction for most businesses, the isolated or occasional sale exemption may apply.

Most states maintain an "occasional or isolated sales" exemption that can be applied to asset purchases. Those exemptions typically apply to transactions that do not regularly occur. For example, if a couple sells an old piece of furniture because they recently purchased a new living room set, the sale may be exempt from tax because the couple does not typically sell their furniture. Similarly, this exemption can be applied to asset sales because businesses are not typically in the business of selling their assets. Rather, they sell their inventory. Thus, because an asset sale is not a typical transaction for most businesses, the isolated or occasional sale exemption may apply. We include a chart detailing which states provide an isolated or occasional sale exemption (see next page).

Of the states that impose a general sales tax, only four — Colorado, New York, Oklahoma, and Wyoming — do not provide some form of an isolated or occasional sale exemption. It is important to note, however, that many of the states that allow the exemption impose requirements that may limit the

State	Isolated or Occasional Sale
Alabama	Exempt
Alaska	N/A
Arizona	Exempt
Arkansas	Exempt
California	Exempt
Colorado	Taxable
Connecticut	Exempt
Delaware	N/A
District of Columbia	Exempt
Florida	Exempt
Georgia	Exempt
Hawaii	Exempt
Idaho	Exempt
Illinois	Exempt
Indiana	Exempt
Iowa	Exempt
Kansas	Exempt
Kentucky	Exempt
Louisiana	Exempt
Maine	Exempt
Maryland	Exempt
Massachusetts	Exempt
Michigan	Exempt
Minnesota	Exempt
Missouri	Exempt
Mississippi	Exempt
Montana	N/A
Nebraska	Exempt
Nevada	Exempt
New Hampshire	N/A
New Jersey	Exempt
New Mexico	Exempt
New York	Taxable
North Carolina	Exempt
North Dakota	Exempt
Ohio	Exempt
Oklahoma	Taxable
Oregon	N/A
Pennsylvania	Exempt
Rhode Island	Exempt
South Carolina	Exempt
South Dakota	Exempt
Tennessee	Exempt
Texas	Exempt
Utah	Exempt
Vermont	Exempt
Virginia	Exempt
Washington	Exempt
West Virginia	Exempt
Wisconsin	Exempt
Wyoming	Taxable

exemption's applicability. For example, many states, such as California, Idaho, Kansas, Louisiana, Mississippi, and Pennsylvania, place restrictions on the exemption as applied to various vehicles.¹

Another issue arises regarding inventory. Most isolated or occasional sale exemptions specifically exclude inventory from the list of exempt assets. In most asset purchases, that does not create any sales tax liability because the purchaser typically purchases the inventory for resale to its customers. Thus, in most states, the inventory can be purchased tax free as a purchase for resale. However, occasionally inventories are not purchased for resale. Rather, the purchaser uses the inventory for some other purpose. In those instances, purchases of inventories in an asset sale can be subject to tax.

Finally, some states provide additional requirements that must be satisfied before the exemption can apply to the sale of a business. For example, in Idaho and Texas, to qualify for the exemption, the transaction must include "the entire operating assets of a business or of a separate division, branch, or identifiable segment of the business."² Thus, an occasional sale of one or two tangible assets by a business would not qualify for the exemption. The entire business, or an identifiable division, must be sold. So each state's exemption must be reviewed for particular requirements that must be satisfied. The chart indicates only whether the state maintains an occasional or isolated sale exemption on its books. It should not be read to mean that all asset sales in a particular state will be exempt from tax.

Moreover, as indicated in the chart, a few states do not provide an isolated or occasional sale exemption. New York is among that group. Thus, asset sales are typically subject to sales tax in New York.³ However, just because the state does not provide an isolated or occasional sale exemption does not mean that all the tangible assets will be subject to sales tax. Sellers and purchasers should investigate whether any other exemption could apply. As mentioned above, inventories can typically be purchased for resale. Also, New York provides an exemption for machinery and equipment used or consumed directly and predominantly in manufacturing or producing tangible personal property for sale.⁴ That exemption also extends to parts, tools, and supplies.

¹See Calif. Revenue and Taxation Code section 6367; Idaho Admin. Rules section 35.01.02.099; Kan. Stat. Ann. section 79-3606(1); La. Rev. Stat. Ann. section 47:303(B)(4); Miss. Admin. Code section 35.IV.3.02; Pa. Stat. Ann. 72 section 7204(1).

²Texas Tax Code Ann. section 151.304(b)(2); see also Idaho Admin. Rules section 35.01.02.099.

³See NYCRR 20 section 537.4(b).

⁴N.Y. Tax Law sections 1105-B and 1115(a)(12); NYCRR 20 section 528.13(a).

So if an asset purchase includes large machines used to make a tangible product for sale, that portion of the purchase price would be exempt from tax. Thus, a thorough review of New York's sales tax exemptions should be part of the due diligence performed by either the seller or purchaser in a New York asset purchase.

Sloppy construction of the asset purchase agreement could cause a mostly tax-exempt transaction to become completely subject to sales tax.

This also demonstrates the importance of separately listing the assets in the asset purchase agreement along with their corresponding portion of the purchase price. That allows the purchaser and seller to clearly determine what was paid for each asset. Failure to do so could cause taxable and exempt assets to be bundled together, making the entire purchase taxable.⁵ Thus, sloppy construction of the asset purchase agreement could cause a mostly tax-exempt transaction to become completely subject to sales tax.

Successor Liability and the Bulk Sale Rule

Most states maintain some sort of successor liability provision in their tax statutes. Those provisions allow the state taxing authority to collect the seller's outstanding sales tax liability from the purchaser in an asset sale if some requirements are not satisfied. Most states require that either the seller or the purchaser provide the state taxing authority with notice of the proposed asset sale. That affords the taxing authority the opportunity to review the seller's sales tax history and to collect any outstanding debts before the seller closes up shop. Those provisions are designed to prohibit sellers from selling their assets and absconding with the proceeds before satisfying their sales tax debts. And they protect purchasers from the sales tax liability of unscrupulous sellers. We include a review of the notice requirements that must be made in New York, though most states follow a similar approach.

A bulk sale is defined in New York as "any sale, transfer or assignment in bulk of any part or the whole of business assets, other than in the ordinary course of business, by a person required to collect tax."⁶ Note that a purchase or the transfer of con-

sideration is not required. Rather, successor liability can be imposed even in instances in which the assets are gifted. If a transaction satisfies the definition above, the purchaser may be held liable for the seller's outstanding sales tax liability up to the selling price of the assets or their fair market value, whichever is greater. This successor liability provision applies regardless of whether the assets purchased are tangible personal property (whether taxable or exempt), intangible property, or real property.⁷ In other words, even if the transaction is a nontaxable one, the bulk sale rule still applies.

To avoid successor liability, the purchaser must comply with the following notice requirements:

- The purchaser must notify the New York State Department of Taxation and Finance of the pending bulk sale transaction *at least 10 days before paying for or taking possession of any business assets*, whichever occurs first, by filing Form AU-196.10, "Notification of Sale, Transfer or Assignment in Bulk."⁸ The purchaser must send Form AU-196.10 by registered mail to the address on the form.
- Within five business days of receiving the bulk sale notification, the department must advise the purchaser whether it is possible that the seller has unpaid sales taxes. If the seller has unpaid sales taxes or is selected for additional review or audit, the department will issue the purchaser Form AU-196.2, "Notice of Claim to Purchaser." If the seller does not have any unpaid sales taxes and if an additional review or audit is not necessary, the department will issue the purchaser Form AU-197.1, "Purchaser's and/or Escrow Agent's Release-Bulk Sale."
- If the purchaser receives Form AU-197.1, the purchaser may pay the seller the full purchase price. The department will not hold the purchaser liable for any unpaid sales taxes, even if there are outstanding warrants or judgments.
- If the purchaser timely receives Form AU-196.2 (the Notice of Claim), it must not pay the seller until the department completes its review of the seller's sales tax account. If the seller releases the funds to the purchaser, the purchaser becomes liable for the seller's outstanding debt, up to the purchase price of the assets or their fair market value, whichever is greater. Within 90 days of the receipt of bulk sale notification, the department must notify the

⁷Publication 750, *A Guide to Sales Tax in New York*.

⁸Courts have held that a purchaser's failure to give notice of a bulk sale at least 10 days before the sale results in the seller's liability being transferred to the purchaser. See *Matter of Salh*, DTA 822113 (Mar. 10, 2011); *Matter of B and D Corp. of Lake George*, DTA 816349 (Jan. 20, 2000).

⁵Frequent readers of this column have seen the authors refer to this as New York's "cheeseboard rule." See NYCRR section 527.1.

⁶20 NYCRR section 537.1(a)(1).

purchaser (and the seller) of the actual amount of sales taxes due from the seller.⁹

Based on the information above, there are two deadlines that the department must meet in order to impose successor liability. These deadlines are designed to move the process along so that taxpayers do not hesitate to involve the Department of Taxation and Finance. The first deadline requires that the department respond to the bulk sales notice within five days of its receipt. The second deadline requires the department to determine the outstanding tax liability within 90 days of receiving the notice. Though there are special rules governing the application of those deadlines,¹⁰ if either deadline is not met, the department can be precluded from imposing successor liability on the purchaser for some or all of the seller's sales tax liability.

Practical Considerations

When buying a business, purchasers typically have two options available: They can either purchase the entity or purchase the assets. Back in law school, one of our old professors said that you have to be careful about purchasing an entity because you're purchasing it "warts and all." That meant that when buying an entity (for example, a stock purchase), the purchaser takes on all the entity's liability. Consequently, there are many reasons why buyers would choose an asset purchase over an entity purchase. But as the provisions detailed above indicate, asset sales can result in transferred liability as well. And even though New York's bulk sale notice rules have been on the books for years, purchasers still get caught footing the bill for a seller's unpaid sales tax debts.¹¹

In one recent New York case, a woman purchased the assets of her son's security business.¹² The assets consisted of some computers, filing cabinets, office supplies, and a customer list. The total cost of the assets was estimated to be \$12,250, though no purchase invoices, appraisals, or depreciation schedules were provided to substantiate this amount. Moreover, the assets were transferred though no contract was drawn up, no debt was assumed, and no money changed hands. Despite those facts, the Division of Tax Appeals determined that a sales tax debt of almost \$350,000 transferred from the son's

business to his mother's new business. The liability was not limited to the fair market value of the assets because the value of the assets was not definitively determined. And because sales tax is one of the few taxes that can be assessed personally against the owners of a business, the purchaser became personally liable for that massive debt. It will be interesting to see if this case will be appealed to New York's Tax Appeals Tribunal.

The Tax Appeals Tribunal, however, previously addressed a similar case. In *Matter of Llargo*, the taxpayer took over the operation of a restaurant from his mother.¹³ The taxpayer took a mortgage out on the real property that housed the restaurant to finance the purchase of his mother's interest in the property. Following his purchase of the building, the taxpayer began operating the restaurant using all the assets that his mother previously used when running the restaurant (that is, tables, chairs, ovens, freezers, menus, and so on). The taxpayer argued that no bulk purchase occurred because he did not pay for the restaurant's assets. Rather, he purchased only the real property that housed the restaurant. The administrative law judge disagreed and held him liable for the restaurant's sales tax debts incurred during the period that his mother operated the business. But this taxpayer got off light. The ALJ estimated that the fair market value of the business assets totaled \$50,000. So instead of being saddled with the full liability totaling approximately \$140,000, he got stuck with only about a third of it.

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Despite those horror stories, some purchasers purposely decide to forgo complying with New York's bulk sale notice requirements. Some purchasers make the business decision not to get the department involved because they are concerned about slowing down the deal — remember, a bulk sale notice may result in a full blown audit of the seller. Instead, they decide to incorporate provisions dealing with unpaid tax directly into the asset purchase agreement. For example, an agreement might contain indemnification provisions, stating that the seller remains liable for all tax liabilities incurred before the execution of the sale. Although those provisions may create a private right of action as between the seller and purchaser, the provisions do

⁹See N.Y. Tax Law section 1141(c); 20 NYCRR section 537.0 et seq. See also TSB-M-83(6)S, *Guidelines for Bulk Sales Transactions*; Publication 750, *A Guide to Sales Tax in New York*.

¹⁰See, e.g., 20 NYCRR sections 537.0(c)(3), 537.2(c), 537.3(c), 537.4(a)(2), 537.6(b), 537.6(d); Publication 750, *A Guide to Sales Tax in New York*, p. 45.

¹¹See *Matter of Salh*, DTA 822113 (Mar. 10, 2011).

¹²*Matter of Ultimat Security, Inc.*, DTA 822991 (Mar. 17, 2011).

¹³*Matter of Llargo of Lockport, Inc.*, DTA 521974 (July 9, 2009) *aff'd.* Aug. 23, 2010.

not insulate the purchaser from successor liability. Thus, those types of provisions are typically accompanied by an escrow fund that remains in place for several years following the sale. If the tax department seeks to assess the purchaser for a seller's tax liability, the purchaser will simply tap the escrow funds.

But this approach can suffer from two deficiencies. First, it can be costly and time-consuming to make an application to use escrow funds to pay a tax debt. What if the seller contests the application because it disagrees with the amount of tax assessed? Invariably, litigation ensues. Second, it can be difficult to know how much to escrow. Purchasers can estimate a potential sales tax liability using such information as the seller's deposits or sales reported per its tax returns. But that provides only a rough estimate at best. And sales tax liabilities can increase rapidly, especially considering that the department has the authority to estimate a taxpayer's liability in some circumstances. Remember, in one of the cases referenced above, assets estimated to be

worth about \$12,000 resulted in the transfer of a tax liability of almost \$350,000.

Conclusion

You know the old saying "Let the buyer beware?" Well, nowhere is that more true than in the case of an asset purchase. Though most buyers turn to asset purchases to limit successor liability, when it comes to sales taxes, they're not afforded much relief. Luckily, most states provide mechanisms for definitively determining a seller's sales tax liability before consummating the transaction. So buyers should take advantage. And sellers should be careful. Somewhere in the distance, a sales tax auditor is watching. ☆

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