As headline figures like EBIDTA and revenue growth command deal partners’ attention, lurking behind a target company’s financial statement is a risk that has the potential to throw their forecasting models into whack.

Sales and use tax is an area of risk not always given great attention by private equity dealmakers, but tax experts warn that the small- and medium-sized businesses scouted by private equity buyers in the mid-market arena often contain hidden tax liabilities that can damage a deal years after the acquisition papers are signed.

One of those experts, John Wozniczka, spoke with pfm about sales and use tax to provide a sense for the risk it presents to private equity fund managers and why it may deserve more consideration during due diligence.

“Every transaction we get involved in, there’s invariably some sort of sales and use tax issue that the private equity group may face and in some cases don’t give it the attention that it may deserve,” says Wozniczka, a state and local tax specialist at McGladrey, the assurance, tax and consulting firm.

It’s not that fund managers are unaware that sales and use tax is a tax liability when purchasing a company – they accept that small businesses typically don’t have the in-house resources to effectively monitor interstate tax obligations – but that the level of tax risk they’re accepting can often be much higher than what they imagine, Wozniczka continues.

“Some private equity buyers say ‘We have a purchase agreement that indemnifies us for unpaid taxes prior to the acquisition,’ but that may provide limited relief the longer it takes to resolve the issue or come into compliance,” says Wozniczka.

He explains that a business with potential sales and use tax liability, which can easily run into the hundreds of thousands of dollars or even millions depending on the company size, is “an ongoing risk until the problem is addressed.” A business may have escaped a state tax authority’s attention pre-acquisition only to become subject to an audit after the deal is completed.

And if it is discovered that the portfolio company failed to collect and remit sales and use tax in a certain state, the tax authority can look back a number of years (prior to the acquisition) when assessing tax liability. The tax authority can also assess tax for periods post-acquisition for which the company is not indemnified if the issue is has not been resolved. In this event, claiming indemnification is far from simple, and further assumes that the seller has the financial capacity to honor the indemnification agreement.

Scarier still, 15 to 20 years ago, state and local tax authorities were generally more forgiving “or at least willing to work with you” if they discovered a company had unpaid sales and use tax during an audit, says Wozniczka.

“Today municipalities and state governments are more desperate for revenue. Audits have become much more aggressive, resulting in auditors interpreting the laws more liberally in favor of the state,” says Wozniczka.

“Even in a simple asset transaction where inventory is transferred, not getting the proper exemption documentation (i.e., a resale certificate) at the time of transaction can expose the company to a potential sales tax liability.”

As an example, he mentions a company selling inventory to a customer...
who intends to resell the item at a profit. Under normal circumstances, the company isn’t exposed to sales tax provided that the customer signs and provides a resale exemption document, “which used to be easy to verify, but now auditors are demanding they are written in the proper form, properly completed, and timely accepted. If any of these are items are overlooked, a state can use that to nullify the document,” warns Wozniczka.

“In an asset transaction, a lot of states have different processes to limit the successor liability risk, but what we’ve seen is that most companies don’t follow the necessary steps to protect themselves” Wozniczka continues. Moreover, indemnification agreements do not provide any relief in case of a trust tax (i.e., sales tax) deficiency. A state can pursue the liability against the seller or the buyer if proper state specific procedures are not followed. “So don’t assume that there is no risk when you buy assets,” says Wozniczka.

Lastly, if a company has established “nexus” in a state – meaning they have a physical presence there, such as a sales office, an employee representative, or other activities – but has not registered and filed a sales tax return with the state, the statute of limitations does not apply and a state can go back to the first day that nexus was established and impose additional tax, penalties, and interest, warns Wozniczka.

Accordingly, sales and use tax is a secondary concern that really deserves to be a priority area during due diligence, urges Wozniczka. But what does that mean exactly?

**Playing it safe**

For starters, it means having sales and use tax in mind when screening investments, begins Wozniczka, who says certain sectors deserve more attention than others.

“For example, service companies and software companies can have a higher risk of nexus because of the required out of state travel or customer contact which could result in a tax collection responsibility in multiple states. More generally, companies with interstate operations that skirt the line of establishing nexus are high-risk targets. Wozniczka says that the rules determining nexus are open to interpretation and vary state by state. In some cases, a company interpreting those rules can get it wrong, leading management to incorrectly assume that they are exempt from filing requirements when in fact they are not.

A best practice is to kick up tax due diligence in the acquisition process, he continues. Typically sales and use tax is a consideration only discussed deep into the dealmaking process. “But I think it’s good for it to be occurring, at least in part, more upfront so you allow the tax professionals more time to understand the business and their compliance requirements,” says Wozniczka. “The deal team tends to want the tax-side of things done quickly and later in the process, but that means not always having the company’s tax information as soon as possible.”

To that end, Wozniczka recommends tax advisors be included during initial meetings between deal partners and target company managers. “When the transaction team is being introduced to the company, they will typically walk through the back-office to examine how the company does business and maintains its books and records. If we’re part of that initial kick-off team, from an efficiency standpoint, we can begin scoping out sales and use tax liability concerns from the start.”

Moreover it presents Wozniczka and his team an early opportunity to identify and quantify the risks and provide technical views and practical solutions. That additional time may be used to better work through the issues and review more data if necessary. “Many CFOs may think that their companies have no material tax issues. However, it’s important to ask relevant questions to determine if their companies’ sales and use tax compliance procedures and documents are adequate. A good understanding of the companies’ business will help determine the right questions to ask. In some instances, target company management will ask their tax provider to field such questions on their behalf, which Wozniczka says is not as beneficial as talking to the companies’ personnel.

“From my experiences, the tax provider isn’t normally the person or entity responsible for managing the company’s sales and use tax liabilities. They may provide income tax compliance and audit services, but generally are not familiar with transaction level taxes such as sales and use taxes.

As Wozniczka explains, sales and tax liability is a hidden risk that can be unearthed with enough due diligence and planning. “It’s just a matter of giving the issue enough priority.”