# NEXUS AND STATE TAX DUE DILIGENCE

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**CHAPTER 3**

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## I. Introduction

The basic premise for this paper is that more scrutiny is being put on (i) registration to do business requirements and (ii) state tax "nexus" standards than ever before. The *first* source of this scrutiny is state regulation. State budget crunches are causing state revenue departments to look harder at all of the businesses that they may be able to subject to state tax jurisdiction. Similarly, the Texas Secretary of State has stepped up enforcement of its fee and penalty authority against unregistered businesses.

For example, the Texas Secretary of State website has a "*late fee calculator*."[1] If you input data that a foreign corporation has been transacting business in Texas since Jan. 1, 2000 and should have been registered here over the last decade, the registration fee and late fees that would now be required to be paid in order to register in Texas total *$9,750*.[2] The stakes have obviously increased over days of not too long ago when foreign entities would in effect be granted amnesty for prior registration deficiencies.

In addition to regulatory concerns, a *second* major source of scrutiny is contractual in nature and can stem from opinion letter practice or merger and acquisition agreements. Acquisition agreements routinely contain representations and warranties that parties need to understand in the context of maturing state laws dealing the scope of long-arm state tax jurisdiction or "nexus."

For example, the following two seller representations are modified versions taken from one of the American Bar Association's Model Asset Purchase Agreements:

> "[Seller's representations and warranties]
>
> **Organization and Good Standing**. Schedule # contains a complete and accurate list of Seller's jurisdiction of incorporation and any other jurisdictions in which it is qualified to do business as a foreign corporation. Seller is a corporation duly organized, validly existing, and in good standing under the laws of its jurisdiction of incorporation, with full corporate power and authority to conduct its business as it is now being conducted, to own or use the properties and assets that it purports to own or use, and to perform all its obligations under the Seller Contracts. ***Seller is duly qualified to do business as a foreign corporation and is in good standing under the laws of each state or other jurisdiction in which either the ownership or use of the properties owned or used by it, or the nature of the activities conducted by it, requires such qualification***.[3]
>
> **Tax Returns Filed and Taxes Paid**. ***Seller has filed or caused to be filed on a timely basis all Tax Returns and all reports with respect to Taxes that are or were required to be filed pursuant to applicable Legal Requirements***. . . . No claim has ever been made or is expected to be made by any Governmental Body in a jurisdiction where Seller does not file Tax Returns that it is or may be subject to taxation by that jurisdiction. There are no Encumbrances on any of the Assets that arose in connection with any failure (or alleged failure) to pay any Tax, and Seller has no Knowledge of any basis for assertion of any claims attributable to Taxes which, if adversely determined, would result in any such Encumbrance.

Practitioners have to understand the legal standards behind these representations and counsel clients on whether they can accurately make them.

A *third* heightened source of scrutiny is coming from GAAP. The Financial Accounting Standards Board revised FIN 48 in 2006, and financial statement audits are now more likely to footnote any failures to file or comply

[1] http://www.sos.state.tx.us/corp/foreign_outofstate.shtml

[2] *See also* Tex. Bus. Org. Code §§ 9.052 & 9.054.

[3] Sample provision from an Asset Purchase Agreement adapted from a *Model Asset Purchase Agreement* published by the Mergers & Acquisitions Committee of the American Bar Association.

with foreign state tax regimes. A copy of FASB's Summary Interpretation of FIN 48 is copied at **Appendix 1** for reference.

## II. General Nexus Standards

### *A. Registration To Do Business*

Section 9.205 of the Texas Business Organizations Code provides the well-known list of safe harbor activities that do not constitute transacting business in Texas. The full list is set forth at **Appendix 2** for reference. The governance-by-negative-implication standard of this statute has always lead to good faith disagreement as to what activities require registration, and the Texas Secretary of State website has begun to be populated with more interpretation to fill in the gaps.

It should be safe to say that if a foreign corporation, limited liability company (herein "LLC") or limited partnership (herein "LP")[4] owns and operates tangible personal property or real property in Texas or has employees performing services on its behalf in Texas it will have to registration here. Beyond this basic scenario, additional analysis will be required.

One of the most common questions is the status of a foreign entity whose only contact with Texas is serving as (i) a general partner of an LP; (ii) a limited partner of an LP; or (iii) the manager of an LLC. On this point the Texas Secretary of State's frequently asked question section responds:

> "Does a foreign (including an out-of-state) filing entity that is a general partner of a Texas partnership or a manager of a Texas LLC have to register to transact business in Texas if the foreign entity has no other contact with the state of Texas?
>
> Texas Attorney General Opinion JM-7 holds that the act of being a general partner of a Texas partnership constitutes transacting business in Texas. This holding may extend to foreign entities that are managing members or managers of a Texas LLC. Accordingly, a foreign filing entity that is a general partner of a Texas LP or a managing member or manager of a Texas LLC may be required to register to transact business in Texas. Foreign entities should consult with their legal counsel to determine whether registration with the Texas secretary of state is required."

While it might be possible for an out-of-state entity serving as the manager of a Texas LLC to legitimately avoid TBOC registration, it is entirely possible that some active management will physically take place in Texas (i.e., contract signatures, bank account transaction authorizations, etc.). Take an analogous simple working example:

> Texas resident forms Colorado LLC to own and lease a condominium at a ski resort in Colorado. The Texas resident is the manager of the LLC. Texas resident uses the condominium for recreational purposes part of the year and leases it out part of the time to defray expenses. Texas resident is careful to travel to Colorado and sign all leases in Colorado. Rent checks are deposited in a bank in Colorado.
>
> ***Query*** whether the following activities trigger a registration requirement for the Colorado LLC in Texas: (i) prospective tenants call a Texas phone number or send

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[4] Not all types of legal entities are required to register. General partnerships, for example, are generally not required to register. See TBOC Sec. 9.001. FOREIGN ENTITIES REQUIRED TO REGISTER.

(a) To transact business in this state, a foreign entity must register under this chapter if the entity:

(1) is a foreign corporation, foreign limited partnership, foreign limited liability company, foreign business trust, foreign real estate investment trust, foreign cooperative, foreign public or private limited company, or another foreign entity, the formation of which, if formed in this state, would require the filing under Chapter 3 of a certificate of formation; or

(2) affords limited liability under the law of its jurisdiction of formation for any owner or member.

(b) A foreign entity described by Subsection (a) must maintain the entity's registration while transacting business in this state.

an email to Texas server to reserve the condominium; (ii) Texas resident LLC manager receives repair requests in Texas; or (iii) Texas resident LLC manager contracts with Colorado plumber to make a repair required under the lease. ***Contrast*** state tax nexus result (discussed below) with registration requirement.

### *B. Nexus For State Tax Purposes*

A full analysis of state tax "nexus" standards is beyond the scope of this paper, but the basics are important.[5] For starters, business law practitioners should know: (i) state tax jurisdiction over foreign businesses or "nexus" is almost always broader than the registration standards described above and enforced by the Texas Secretary of State; (ii) the consequences of noncompliance are usually greater; and (iii) the nexus standards for imposing income taxes on foreign businesses are slightly different than the threshold standards for requiring foreign businesses to collect and remit sales taxes on in-state sales.

#### 1. *Nexus for Texas Franchise Tax Purposes*

**Appendix 3** sets forth the Texas Comptroller's Rule 3.586 describing what constitutes "nexus" for Texas franchise tax purposes. In recent years the Comptroller's forensic ability to locate non-registered businesses that are conducting some form of commerce in Texas has grown significantly. The Texas Comptroller's Office has a separate division dedicated to this pursuit known as the Business Activity Research Team or "BART."

Unlike Section 9.251 of the TBOC, Rule 3.586 affirmatively lists activities that subject out-of-state businesses to Texas franchise tax jurisdiction and filing requirements. Certain of the provisions are of special note, either because they are common fact patterns or they are the subject of common misperception.

34 T.A.C. 3.586 (c)

(3) contracting: performance of a contract in Texas regardless of whether the taxable entity brings its own employees into the state, hires local labor, or ***subcontracts*** with another; . . .

(4) delivering: delivering into Texas items it has sold; . . .

(5) employees or representatives: having employees or representatives in Texas doing the business of the taxable entity

. . .

(16) services, including, but not limited to the following:

(A) providing any service in Texas, regardless of whether the employees, independent contractors, agents, or other representatives performing the services reside in Texas;

(B) maintaining or repairing property located in Texas whether under warranty or by separate contract;

(19) solicitation: having employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas, to promote or induce sales of the foreign taxable entity's goods or services.

[5] The limits on state tax jurisdiction are largely set by the due process clause and the interstate commerce clause of the US Constitution and by federal statutes based on the constitutional provisions. *See e.g., Complete Auto Transit vs. Brady*, 430 U.S. 274 (1977).

Comptroller's Rule 3.586 makes it clear that if a foreign business has any employees or independent contractors performing services, delivering goods, performing warranty work or soliciting sales in Texas the foreign entity needs to be filing franchise tax returns with the Texas Comptroller's Office.

Texas Courts are on board too. In *Gallend Henning Nopak, Inc. vs. Combs*[6] the Amarillo Court of Appeals held that the presence of a single employee in Texas whose primary job was to investigate, handle or assist in resolving customer complaints was not *diminimis* and was sufficient to support a nexus determination in favor of the Texas Comptroller of Public Accounts. State decisions on what constitutes nexus for state income or franchise tax purposes are coming out almost daily.[7]

2. *Leniency for Texas Trade Shows*

One carve out from the general nexus standard for franchise tax is found in Section 171.084 of the Texas Tax Code, which provides:

> (a) A corporation is exempted from the franchise tax if:
>
> (1) the only business activity conducted by or on behalf of the corporation in this state is related to the solicitation of orders conducted by representatives of the corporation who:
>
> (A) solicit orders of *personal property* to be sent outside this state for approval or rejection by the corporation and, if approved, to be filled by shipment or delivery from a point outside this state; . . . ; and
>
> (2) the solicitation of orders is conducted on an occasional basis at [certain] trade shows: . . .
>
> (b) For purposes of this section, the solicitation of orders is conducted on an occasional basis only if the solicitation is conducted ***during not more than five periods during the business period of the corporation to which a tax report applies and if no single period during which solicitation is conducted is longer than 120 hours.*** . . . (*emphasis added*)

The trade show statute is useful for trade show participants and also because it can help to demonstrate to skeptical clients the scope of the nexus standard that would otherwise apply, but for the statutory exemption. Solicitation of sales outside of the trade show context or for more than any one five-day period busts the exemption.

3. *Nexus For State Income Taxes and The Impact of Public Law 86-272*

The nexus standard for state income-based taxes is different than for non-income based business taxes and for sales tax collection. The distinction stems from the supremacy clause of the US Constitution and federal statutory law commonly referred to as Public Law 86-272.[8] The statute was passed by Congress in 1959 to prevent states from unduly burdening interstate commerce or otherwise prejudicing free trade among the states. The federal statute provides:

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[6] 317 S.W.3d 841 (Tex. App.—Amarillo, July 14, 2010)

[7] For example, on September 12, 2011, the Louisiana Court of Appeal, First Circuit held that the mere ownership of a limited partnership interest in a limited partnership that conducted business in Louisiana, by itself, did not subject the non-resident corporate limited partner to the Louisiana corporation franchise tax. *See* UTELCOM, Inc. and UCOM, Inc. v. Bridges, 2010-CA-0654 (La. App. 1 Cir. 09/12/11). The out-of-state foreign corporate partners did not engage in any business activities in Louisiana and had no physical or other presence in Louisiana and (1) were not registered to do business in Louisiana, (2) did not render any services in Louisiana, (3) did not have employees, independent contractors, agents, or other representatives in Louisiana, (4) did not buy, sell, or procure any services or property in Louisiana, and (5) did not maintain any bank accounts in Louisiana. They merely acted as holding companies for limited partnership interests as passive investors in an operating partnership which conducted business in Louisiana.

[8] 15 U.S.C. § 381.

> No State, or political subdivision thereof, shall have power to impose, . . . , a ***net income tax*** on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
>
> > (1) the ***solicitation of orders*** by such person, or his representative, in such State for sales of ***tangible personal property***, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; . . . (*emphasis added*)

Therefore, if an out-of-state company's only contact with a state is sending employees into the state to solicit orders for tangible personal property that have to be accepted at the home office, then the state may not impose a net income tax on the out-of-state business.[9] Note that Public Law 86-272 only restricts jurisdiction for *net income taxes* and it only protects activities with respect to sales of *tangible personal property*. The modern service economy and transactions dealing with intangibles were not on the agenda in 1959, and they are not protected. Likewise, franchise taxes that are not based on net income are not protected.

The Texas franchise tax makes an interesting case study in the application of Public Law 86-272. Section 27 of House Bill 3 from the 79th Texas Legislature[10] and the Texas Comptroller Rules[11] evidence clear intent that the Texas franchise ("margin") tax is not to be considered a tax based on net income and that it is not subject to the limitations of Public Law 86-272. As of the date of this publication, the issue of whether the Texas franchise tax is an income tax is pending before the Texas Supreme Court.[12]

4. *Nexus for State Sales and Use Tax Purposes*

A determination of when a foreign corporation should register in a state for sales tax collection purposes can create material liability exposure. Businesses that have nexus with Texas for sales tax purposes must collect and remit sales tax on sales of taxable items delivered to Texas residents. In one prominent dispute the Texas Comptroller's Office has made a $269 million audit assessment against Amazon for allegedly maintaining a place of business in Texas and failing to collect Texas sales tax on its Texas sales.[13] The case is ongoing and will revolve around nexus standards and presumably on whether an Irving distribution center is acting as an agent fulfilling orders on Amazon's behalf.

Texas Comptroller's Rule 3.286(a)(2) defines "engaged in business" in Texas for sales tax collection and permitting purposes as follows:

> (a) Definitions . . .
>
> (2) Engaged in business--A person is engaged in business in Texas if the person has nexus with the state as evidenced by, but not limited to, any of the following:
>
> (A) maintains, occupies, or uses, permanently or temporarily, directly or indirectly, or through an agent, by whatever name called, a kiosk, office, *place of distribution*, sales or sample room, warehouse or storage place, or other place where business is conducted;

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[9] Contrast the sales tax result where the existence of the sales personnel in the state (whether employee or independent contractor) would clearly trigger a sales tax collection responsibility.

[10] Act of May 2, 2006, 79th Leg., 3rd C.S. H.B. 3 (the revised franchise tax "is not an income tax")

[11] 34 T.A.C. § 3.586 (e) Public Law 86-272 (15 United States Code §§381 - 384) does not apply to the franchise tax.

[12] *Allcat Claims Service, L.P. and John Weakley vs. Susan Combs, et al*, Cause No. 11-0589 (Tex.) (*oral argument on jurisdiction set for October 24, 2011*).

[13] *See e.g. of news coverage,* http://www.texastribune.org/texas-taxes/2011-budget-shortfall/texas-comptroller-hunts-amazon-for-tax-money/

> (B) has any *representative*, *agent*, salesperson, canvasser, or solicitor who *operates in this state under the authority of the seller* to conduct business, *including* selling, *delivering*, or taking orders for taxable items; . . .
>
> (D) uses independent salespersons in direct sales of taxable items;
>
> (E) derives receipts from a rental or lease of tangible personal property that is located in this state or owns or uses tangible personal property that is located in this state, including a computer server or software;
>
> (F) allows a franchisee or licensee to operate under its trade name if the franchisee or licensee is required to collect Texas sales or use tax; or
>
> (G) conducts business in this state through employees, agents, or independent contractors.

The Comptroller's list of activities that trigger nexus for sales tax collection responsibilities all require a ***physical presence*** in the state. The physical presence standard is currently required under the US Supreme Court's interpretation of the interstate commerce clause.[14] Under current law, if an out-of-state retailer with no physical presence in Texas can take orders by phone or Internet and ship items to Texas addresses by common carrier, then it does not have to collect Texas sales tax from its Texas customers. The battle over trying to modify this standard has raged among state tax administrators, brick and mortar retailers, and Internet vendors for almost two decades, and the US Congress is beginning to get involved.[15]

## III. Nexus Due Diligence For Acquisition of a Business

### *A. Due Diligence Checklist*

A sample state tax due diligence checklist that might be presented to an acquisition target is copied at **Appendix 4**. Every transaction is different, so this checklist should be considered as merely a starting point. Its scope may be too broad in some areas and too narrow in others, but it should help to start the analysis and negotiations. The checklist provides questions to help determine if the target is doing business in states where it is not registered or if it is failing to file income tax or sales tax returns that it should be filing.

### *B. Successor Liability Statutes*

An important due diligence practice point that logically follows the potential for nexus oversight is successor liability for state taxes. Almost all states have successor liability statutes that impose certain pre-closing state tax liabilities on the buyer of a business. The Texas version of this concept is found at Section 111.020 of the Texas Tax Code and reads as follows:

> (a) If a person who is liable for the payment of an amount under this title sells the business or the stock of goods of the business or quits the business, the successor to the seller or the seller's assignee shall withhold an amount of the purchase price sufficient to pay the amount due until the seller provides a receipt from the comptroller showing that the amount has been paid or a certificate stating that no amount is due.
>
> (b) The purchaser of a business or stock of goods who fails to withhold an amount of the purchase price as required by this section is liable for the amount required to be withheld ***to the extent of the value of the purchase price***. . . .

[14] *Quill v. North Dakota*, 504 U.S. 298 (1992).

[15] See e.g., proposed "Main Street Fairness Act" designed to overturn the *Quill* decision for all states that join the Streamlined Sales and Use Tax Agreement. H.R. 5660 (July 1, 2010); http://www.streamlinedsalestax.org/index.php?page=faqs

The impact of Section 111.020 is that if a buyer acquires a "business" it can become liable to the State of Texas for up to the full amount it pays for the business (i.e., for a total outlay of double the purchase price, once to the seller and once to the State). The assumption of debt is counted in the total price paid as well as the fair market value of any assets paid in-kind. The determination of what constitutes a "business" is very fact specific, but the Comptroller's Rule 3.7 (d)[16] includes the following description:

> When determining if a "business" has been or will be sold, the comptroller will examine the transaction to determine what the parties to the transaction intended to buy and sell. The answer in each situation will depend on the type of business involved. A seller may have sold a "business" even when few assets were transferred. Depending on the type of business involved, a "business" may be sold if an owner sells:
>
> (1) a building, land, furniture, fixtures, inventory, and the right to use the seller's trade name; or
>
> (2) all the capital assets of a business; or
>
> (3) the name and goodwill of a business; or
>
> (4) all the inventory of a business; or
>
> (5) fixed assets and realty necessary to operate a similar business as the seller at the same location.

### *C. Tax Clearance Certificate Practice in Texas*

The buyer of a business can request a tax clearance certificate[17] from the Texas Comptroller of Public Accounts stating (i) the amounts that the seller owes to the State of Texas or if none (ii) releasing the buyer from liability that would otherwise extend under Section 111.020 of the Texas Tax Code. Such requests[18] typically result in a desk audit of the seller's sales tax, franchise tax, and other applicable state tax filing compliance history. Importantly, the Texas Comptroller has 90 days to respond to the request. If no clearance letter is issued within 90 days the buyer is generally released from the seller's state tax liabilities that accrue prior to closing. Note: the certificate is worthless if the parties close prior to the issuance of the clearance letter. In practice, the Texas Comptroller's office often responds to clearance letter requests inside 30 days.

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[16] 34 T.A.C. Section 3.7(d).

[17] *See* 34 T.A.C. Section 3.7(e); Tex. Tax Code Section 111.020(c) & (d) ("(c) The purchaser of a business may request that the comptroller issue a certificate stating that no tax is due or issue a statement of the amount required to be paid before a certificate may be issued. The comptroller shall issue the certificate or statement within 60 days after receiving the request or within 60 days after the day on which the records of the former owner of the business are made available for audit, whichever period expires later, but in either event the comptroller shall issue the certificate or statement within 90 days after the date of receiving the request. (d) If the comptroller fails to mail the certificate or statement within the applicable period provided by Subsection (c) of this section, the purchaser is released from the obligation to withhold the purchase price or pay the amount due.

[18] *See* http://www.window.state.tx.us/taxinfo/sales/faq_buy_sell.html

## Appendix 1

## FASB Summary of Interpretation No. 48
## Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109 (Issued 6/06)

**Summary**

This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

The evaluation of a tax position in accordance with this Interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one of the following:

1. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable
2. A reduction in a deferred tax asset or an increase in a deferred tax liability
3. Both (a) and (b).

An enterprise that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year or the operating cycle, if longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this Interpretation and its reported amount in the statement of financial position). This Interpretation does not change the classification requirements for deferred taxes.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in Statement 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this Interpretation.

**Reason for Issuing This Interpretation**

In principle, the validity of a tax position is a matter of tax law. It is not controversial to recognize the benefit of a tax position in an enterprise's financial statements when the degree of confidence is high that that tax position will be sustained upon examination by a taxing authority. However, in some cases, the law is subject to varied interpretation, and whether a tax position will ultimately be sustained may be uncertain. Statement 109 contains no specific guidance on how to address uncertainty in accounting for income tax assets and liabilities. As a result, diverse accounting practices have developed resulting in inconsistency in the criteria used to recognize, derecognize, and measure benefits related to income taxes. This diversity in practice has resulted in noncomparability in reporting income tax assets and liabilities.

**How This Interpretation Will Improve Financial Reporting**

This Interpretation will result in increased relevance and comparability in financial reporting of income taxes because all tax positions accounted for in accordance with Statement 109 will be evaluated for recognition, derecognition, and measurement using consistent criteria. Finally, the disclosure provisions of this Interpretation will provide more information about the uncertainty in income tax assets and liabilities.

**How the Conclusions in This Interpretation Relate to the Conceptual Framework**

In developing the recognition and measurement guidance of this Interpretation, the Board considered the qualitative characteristics discussed in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information.* Those characteristics emphasize that comparable information enables users to identify similarities in and differences between two sets of economic events. This Interpretation establishes a consistent threshold for recognizing current and deferred taxes.

When a position is taken in a tax return that reduces the amount of income taxes paid to a taxing authority, the enterprise realizes an immediate economic benefit. However, considerable time can elapse before the acceptability of that tax position is determined. This Interpretation requires the affirmative evaluation that it is more likely than not, based on the technical merits of a tax position, that an enterprise is entitled to economic benefits resulting from positions taken in income tax returns. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements.

**The Effective Date of This Interpretation**

This Interpretation is effective for fiscal years beginning after December 15, 2006. Earlier application of the provisions of this Interpretation is encouraged if the enterprise has not yet issued financial statements, including interim financial statements, in the period this Interpretation is adopted.

## Appendix 2

### Determining Whether Foreign Entity Must Register with the Texas Secretary of State to Transact Business in Texas

TBOC Sec. **9.001**(a) ("To transact business in this state, a foreign entity must register under this chapter if the entity: (1) is a foreign corporation, foreign limited partnership, foreign limited liability company, foreign business trust, foreign real estate investment trust, foreign cooperative, foreign public or private limited company, or another foreign entity, the formation of which, if formed in this state, would require the filing under Chapter 3 of a certificate of formation; or (2) affords limited liability under the law of its jurisdiction of formation for any owner or member.").

TBOC Sec. **9.001(b)** ("A foreign entity described by Subsection (a) must maintain the entity's registration while transacting business in this state.").

TBOC Sec. **9.251**. For purposes of this chapter, activities that do not constitute transaction of business in this state include:

(1) maintaining or defending an action or suit or an administrative or arbitration proceeding, or effecting the settlement of:

(A) such an action, suit, or proceeding; or

(B) a claim or dispute to which the entity is a party;

(2) holding a meeting of the entity's managerial officials, owners, or members or carrying on another activity concerning the entity's internal affairs;

(3) maintaining a bank account;

(4) maintaining an office or agency for:

(A) transferring, exchanging, or registering securities the entity issues; or

(B) appointing or maintaining a trustee or depositary related to the entity's securities;

(5) voting the interest of an entity the foreign entity has acquired;

(6) effecting a sale through an independent contractor;

(7) creating, as borrower or lender, or acquiring indebtedness or a mortgage or other security interest in real or personal property;

(8) securing or collecting a debt due the entity or enforcing a right in property that secures a debt due the entity;

(9) transacting business in interstate commerce;

(10) conducting an isolated transaction that:

(A) is completed within a period of 30 days; and

(B) is not in the course of a number of repeated, similar transactions;

(11) in a case that does not involve an activity that would constitute the transaction of business in this state if the activity were one of a foreign entity acting in its own right:

(A) exercising a power of executor or administrator of the estate of a nonresident decedent under ancillary letters issued by a court of this state; or

(B) exercising a power of a trustee under the will of a nonresident decedent, or under a trust created by one or more nonresidents of this state, or by one or more foreign entities;

(12) regarding a debt secured by a mortgage or lien on real or personal property in this state:

(A) acquiring the debt in a transaction outside this state or in interstate commerce;

(B) collecting or adjusting a principal or interest payment on the debt;

(C) enforcing or adjusting a right or property securing the debt;

(D) taking an action necessary to preserve and protect the interest of the mortgagee in the security; or

(E) engaging in any combination of transactions described by this subdivision;

(13) investing in or acquiring, in a transaction outside of this state, a royalty or other nonoperating mineral interest;

(14) executing a division order, contract of sale, or other instrument incidental to ownership of a nonoperating mineral interest; or

(15) owning, without more, real or personal property in this state.

TBOC Sec. **9.252** ("Other Activities The list provided by Section 9.251 is not exclusive of activities that do not constitute transacting business in this state for the purposes of this code.").

TBOC Sec. **9.054**(a) ("The secretary of state may collect from a foreign filing entity a late filing fee if the entity has transacted business in this state for more than 90 days without registering under this chapter. The secretary may condition the effectiveness of a registration after the 90-day period on the payment of the late filing fee.").

TBOC Sec. **9.054**(b) ("The amount of the late filing fee is an amount equal to the product of the amount of the registration fee for the foreign filing entity multiplied by the number of calendar years that the entity transacted business in this state without being registered. For purposes of computing the fee, a partial calendar year is counted as a full calendar year.")

## Appendix 3

## Nexus for Texas Franchise Tax Purposes

**Tex. Tax Code Ann. § 171.001**

"Tax Imposed (a) A franchise tax is imposed on each taxable entity that does business in this state or that is chartered or organized in this state. (b) The tax imposed under this chapter extends to the limits of the United States Constitution and the federal law adopted under the United States Constitution. (c) The tax imposed under this section or Section 171.0011 is not imposed on an entity if, during the period on which the report is based, the entity qualifies as a passive entity as defined by Section 171.0003."

**34 Tex. Admin. Code § 3.586 (2010)**

(a) Effective date. The provisions of this section apply to franchise tax reports originally due on or after January 1, 2008.

(b) A taxable entity is subject to franchise tax in this state when it has sufficient contact with this state to be taxed without violating the United States Constitution.

(c) Some specific activities which subject a taxable entity to Texas franchise tax include, but are not limited to, the following:

(1) advertising: entering Texas to purchase, place, or display advertising when the advertising is for the benefit of another and in the ordinary course of business (e.g., the foreign taxable entity makes signs and brings them into Texas, sets them up, and maintains them);

(2) consignments: having consigned goods in Texas;

(3) contracting: performance of a contract in Texas regardless of whether the taxable entity brings its own employees into the state, hires local labor, or subcontracts with another;

(4) delivering: delivering into Texas items it has sold;

(5) employees or representatives: having employees or representatives in Texas doing the business of the taxable entity;

(6) federal enclaves: doing business in any area within Texas, even if the area is leased by, owned by, ceded to, or under the control of the federal government;

(7) franchisors: entering into one or more contracts with persons, corporations, or other business entities located in Texas, by which:

(A) the franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by the franchisor; and

(B) the operation of a franchisee's business pursuant to such plan is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate.

(8) holding companies: maintaining a place of business in Texas or managing, directing, and/or performing services in Texas for subsidiaries or investee entities;

(9) inventory: having an inventory in Texas or having spot inventory for the convenient delivery to customers, even if the bulk of orders are filled from out of state;

(10) leasing: leasing tangible personal property which is used in Texas;

(11) loan production activities: soliciting sales contracts or loans, gathering financial data, making credit checks, collecting accounts, repossessing property or performing other financial activities in Texas through employees, independent contractors, or agents, regardless of whether they reside in Texas;

(12) partners:

(A) acting as a general partner in a general partnership which is doing business in Texas;

(B) acting as a general partner in a limited partnership which is doing business in Texas (a foreign taxable entity which is a limited partner in a limited partnership is not doing business in Texas, if that is the limited partner's only connection with Texas);

(13) place of business: maintaining a place of business in Texas;

(14) processing: assembling, processing, manufacturing, or storing goods in Texas;

(15) real estate: holding, acquiring, leasing, or disposing of any property located in Texas;

(16) services, including, but not limited to the following:

(A) providing any service in Texas, regardless of whether the employees, independent contractors, agents, or other representatives performing the services reside in Texas;

(B) maintaining or repairing property located in Texas whether under warranty or by separate contract;

(C) installing, erecting, or modifying property in Texas;

(D) conducting training classes, seminars or lectures in Texas;

(E) providing any kind of technical assistance in Texas, including, but not limited to, engineering services; or

(F) investigating, handling or otherwise assisting in resolving customer complaints in Texas.

(17) shipment: sending materials to Texas to be stored awaiting orders for their shipment;

(18) shows and performances: the staging of or participating in shows, theatrical performances, sporting events, or other events within Texas;

(19) solicitation: having employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas, to promote or induce sales of the foreign taxable entity's goods or services;

(20) telephone listing: having a telephone number that is answered in Texas; or

(21) transportation:

(A) carrying passengers or freight (any personal property including oil and gas transmitted by pipeline) from one point in Texas to another point within the state, if pickup and delivery, regardless of origination or ultimate destination, occurs within Texas; or

(B) having facilities and/or employees, independent contractors, agents, or other representatives in Texas, regardless of whether they reside in Texas:

(i) for storage, delivery, or shipment of goods;

(ii) for servicing, maintaining, or repair of vehicles, trailers, containers, and other equipment;

(iii) for coordinating and directing the transportation of passengers or freight; or

(iv) for doing any other business of the taxable entity.

(d) See §3.583 of this title (relating to Margin: Exemptions) for information concerning exemption for certain trade show participants under Tax Code, §171.084.

(e) Public Law 86-272 (15 United States Code §§381 - 384) does not apply to the franchise tax.

## Appendix 4

## SAMPLE
## State Tax Due Diligence Checklist for Acquisition Target

The below detailed document request is subject to amendment following a more detailed analysis and preliminary management discussions.

| | | Responsibility | Date Received |
|---|---|---|---|
| 1. | A list of state-conforming S elections for Target and its affiliates | | |
| 2. | A list of state-conforming Q-sub elections for Target and its affiliates | | |
| 3. | A list of any state-conforming Q-sub conversions to disregarded entity (LLC) for state law purposes for Target and its affiliates | | |
| 4. | An organization chart showing all Target entities and identifying ultimate individual owners | | |
| 5. | An chart breaking down assets/entities to be included in new venture and any assets/entities to be excluded | | |
| 6. | An chart scheduling the states (and NY City) in which Target or its affiliates holds titled motor vehicles and the approximate number/value in each state | | |
| 7. | An chart scheduling the states (and NY City) in which Target owns real estate and the approximate value in each such state (and NYC) | | |
| 8. | A list of the jurisdictions (state, local, etc.) where Target has submitted tax filings (income, sales & use, gross receipts, franchise, property etc.) during the prior reporting period and a separate list of all jurisdictions where Target has not submitted any type of tax filing but for which a claim has been made that tax filings should have been submitted. This information should include any "nexus" questionnaires or similar requests whereby a state is attempting to determine if the target entities are subject to tax in the state for the current period or for any prior period. | | |
| 9. | If different from #8 above, a list of jurisdictions (federal, state, local, foreign etc.) in which Target: 1) is registered or licensed to operate, 2) has employees that have entered the state for any reason during the previous four tax years, 3) has any independent contractors providing services on behalf of Target in the past four years; or 4) has or has had any real or personal property including inventory (owned or leased) during the previous four tax years | | |
| 10. | Please provide contact information for the primary law firms, accounting firms or other outside relationships that have material provided tax advice (oral or written) to Target (including addresses, telephone numbers and contact persons), in each case identifying the matter(s) with respect to which advice was given. | | |
| 11. | All tax legal opinions and technical memoranda, whether privileged or not, issued by any third-parties to Target (including related partnerships, if any) related to any state or local tax in the last five years. | | |
| 12. | A copy of all of the last-filed state and local tax returns for Target for:<br>i. Income/Franchise<br>ii. Sales & Use | | |
| 13. | Any information regarding state tax planning that is currently being utilized. This information would include any intercompany agreements (i.e. management service agreements, intercompany debt agreements, transfer pricing agreements) related to this planning | | |
| 14. | Sales/revenues, by state, for each of the last year. | | |

| | | Responsibility | Date Received |
|---|---|---|---|
| 15. | Brief description of Target procedures to 1) collect and remit sales tax and 2) self-assess use tax | | |
| 16. | Documents related to any type of current or historical state or local tax audits, appeals or court proceedings (whether resolved or unresolved) including:<br>statute of limitation waivers<br>i. All Exam documents and correspondence between target or its affiliates including partnerships<br>ii. notices of proposed adjustments<br>iii. state appeals documents and correspondence<br>iv. state protest letters<br>v. state closing agreements or similar documents<br>vi. court briefs, depositions, pleadings, interrogatories dealing with any state or local tax liability | | |
| 17. | List of any state tax amnesty and voluntary disclosure listing detailing the jurisdiction, the issues, the tax year(s), the status and the amount of tax, interest and penalty at issue | | |