

[Free Newsletter Sign Up](#)

Tax Insights & Commentary

Voluntary Disclosures Prove a Useful Tool in Tax Liability Talks

Nov. 21, 2022, 3:45 AM

A voluntary disclosure agreement can be beneficial to both sides in a merger and acquisition transaction. By stressing the extent to which the parties are aligned, a buyer and a seller may be able to negotiate more efficiently to mitigate overall tax liabilities, according to Sidley Austin's Katharine A. Funkhouser, Tara M. Lancaster, and Richard M. Silverman.

Think you know everything about the global tax deal? Take our quiz.

In an M&A transaction, the buyer and seller must determine how best to address any unknown or unresolved state tax exposure due to failure to file returns and pay taxes in jurisdictions in which the business has a nexus. This issue has become more pervasive in the wake of the US Supreme Court's decision in *South Dakota v. Wayfair* permitting states to impose sales tax on businesses with no physical presence in the jurisdiction.

Remediating state tax exposure through a voluntary disclosure agreement can be a desirable path, because a VDA typically limits the look-back period to three to five years and reduces or eliminates penalties for the look-back period. This Insight discusses how parties approach VDAs in connection with mergers and acquisitions.

Overview of VDA Process

The VDA process is fairly straightforward. Third-party advisers can engage with a tax authority anonymously during most or all of the negotiation phase, or a client may engage with state tax authorities directly. The client then enters into a non-negotiable agreement provided by the tax authority and files the appropriate tax returns for the relevant period(s).

Seller and Buyer Alignment

A seller with pre-closing tax indemnity obligations often will hesitate to seek a VDA. A seller may be concerned that a buyer will be too willing to concede tax liability issues due to the buyer's economic indifference to resolving a VDA. In practice, however, a buyer's acceptance of extensive nexuses would lead to higher post-closing operating costs in the form of increased tax liabilities. Additionally, if a seller is or becomes uncreditworthy, the buyer will have no avenue for recovery and will have to make VDA payments itself.

A seller may view the VDA process as increasing its tax indemnity obligation. This view is often mistaken. If a buyer intends to begin filing tax returns in a state, a seller's failure to previously file required tax returns there will become apparent. A VDA is a cost-effective solution to limiting the seller's exposure to compounding unpaid taxes, penalties, and interest. Ultimately, a buyer and a seller should be aligned regarding a VDA process, even where a seller has given a pre-closing tax indemnity.

VDA Mechanics in a Purchase Agreement

In the absence of a specific provision governing VDAs, the VDA process typically is governed by the amendment of tax returns provision in a purchase agreement. A buyer concerned about unresolved state tax liability should negotiate the amendments provision with care in the absence of a VDA provision.

VDA provisions in a purchase agreement should cover who controls the process; what role, if any, the counterparty has; and the interplay between VDA-related payments and the indemnity provisions.

Common Areas of Negotiation

Initiation: A buyer will ask for the ability to initiate VDA proceedings in its sole discretion, while a seller will want to negotiate for consent rights over initiating a VDA proceeding. Although this provision in a purchase agreement is highly negotiated, both sides ultimately are aligned and should be amenable to VDAs for the reasons discussed above.

Control: Negotiations over control of the VDA process are typically the most contentious. The VDA process is inherently backward-looking. As such, a seller will view the proceedings as predominately a seller issue—especially because the seller will bear the tax burden and potentially third-party advisory costs of the process. A buyer, on the other hand, will want to fully control the processes because it typically owns the company at the time the VDA is consummated. At minimum, a seller typically will ask to review and comment on all VDA filings. A creditworthy seller may be able to require the buyer to incorporate the seller's reasonable comments into the VDA filings or obtain a consent right.

Duration and timing: A seller often wants finality and certainty with respect to its historic tax obligations. Accordingly, a seller will negotiate to limit the duration of the VDA process. Third-party advisers familiar with the VDA process in a specific jurisdiction can advise on what is a realistic timeframe. Because a VDA typically does not reduce interest owed, all parties should want to begin the process as soon as possible. Sometimes the process begins prior to closing a deal. This is often an efficient path forward but makes the determination as to who should control the process more nuanced.

Indemnification provisions: Often a seller will seek to cap its liability by setting a total dollar limit or indemnifying only certain jurisdictions. When negotiating a cap (and generally the scope of the indemnification), a buyer should attempt to ensure that the cap covers third-party expenses incurred in connection with obtaining the VDA. These costs can be as large as the amount due to the state taxing authority as part of the agreement.

In addition, the creditworthiness of the seller should not be overlooked. For example, the seller may be comprised of individuals or a private equity fund towards the end of its lifecycle. An escrow is often appropriate for VDA-related liability; the liability will be known within a relatively short amount of time (compared with federal income tax audit risk, for example), and the amount of liability and third-party costs can be estimated. Because this indemnity could be outstanding longer than a general purchase agreement indemnity, and because the amount is more predictable in nature than a general indemnity, the parties should consider a separate VDA-related escrow.

Role of Due Diligence

Tax due diligence informs the VDA process. Diligence will allow the parties to estimate potential unpaid state tax liability, which may be used to determine what cap, if any, is appropriate, whether the cap should be imposed on a state-by-state basis, and the amount of any escrow. A buyer also should confirm whether states identified in diligence reflect all state tax exposures or whether there are other state tax exposures (whether or not material) that have not been listed. If a voluntary disclosure significantly understates tax liability, it may render the agreement non-binding and allow the state to look back to all prior periods.

Conclusion

Although heavily negotiated in purchase agreements, a VDA is beneficial to both buyers and sellers. By stressing the extent to which parties are aligned, a buyer and a seller may be able to negotiate more efficiently to mitigate overall tax liabilities.

This article does not necessarily reflect the opinion of Bloomberg Industry Group, Inc., the publisher of Bloomberg Law and Bloomberg Tax, or its owners.

Author Information

Katharine A. Funkhouser is a senior managing associate at Sidley Austin LLP. She advises clients on a wide range of federal income tax planning matters.

Tara M. Lancaster is a partner at Sidley Austin LLP. She represents private equity sponsors and corporate clients on federal income tax matters covering a broad range of international and domestic transactions.

Richard M. Silverman is a partner at Sidley Austin LLP. His practice principally focuses on tax issues arising in structured finance and securitization transactions, as well as bankruptcy and restructuring matters.

We'd love to hear your smart, original take: Write for Us

Law Firms

Sidley Austin

Topics

failure to pay tax
tax penalties
state tax
failure to file returns
indemnification
negotiated acquisitions
collection of tax

© 2022 Bloomberg Industry Group, Inc. All Rights Reserved