



Volume 12 Number 12

December 2005

State Tax Return

Beware Of Hidden Taxes – North Carolina Imposes Use Tax On Intercompany Purchases

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The North Carolina Tax Review Board has affirmed the holding of the Secretary of Revenue requiring a land surveying company to pay use tax on purchases from its affiliates even though the surveying company sells nontaxable services.¹ In the wake of Sarbanes-Oxley and IRS Circular 230, this decision highlights the complexity tax professionals face in determining what "hidden" tax liabilities might be lurking within intercompany transactions between complex organizations.

Facts

The taxpayer in this case, EarthData, is a single-member limited liability company that is likely disregarded for federal income tax purposes. EarthData surveys land and provides aerial topographical mapping services to customers throughout the United States. In the course of providing these services, EarthData purchases undeveloped aerial photography film, geo-referenced imaging data (such as on contact prints, negatives, and diapositives), and scanning information tapes and compact disks from subcontractors, including affiliates of EarthData.

True Object Test

The North Carolina Department of Revenue assessed use tax against EarthData on its purchases from subcontractors, including its affiliates. EarthData contested the assessment, arguing that the land surveying process was a nontaxable professional service and any purchases from subcontractors were also for nontaxable services. EarthData argued that any tangible personal property provided by the subcontractors was incidental to the services rendered and thus, the "true object" of the transaction was not the transfer of tangible personal property.

The Tax Review Board rejected EarthData's argument finding that the "true object" of the transaction was the acquisition of the contact prints, negatives, diapositives, tapes and compact disks that EarthData needed to provide its nontaxable topographical services. Because the true object was determined to be the tangible personal property

¹ See *EarthData International of North Carolina, LLC*, TRB Decision No. 451 (September 4, 2004) (released June 1, 2005).

itself – not the provision of a service – the purchases were subject to North Carolina use tax.

Affiliate Transactions

EarthData also argued that the transactions between the affiliate companies did not constitute a taxable event and thus, the intercompany purchases were not subject to tax. The Tax Review Board rejected this argument holding that transactions between EarthData and its sister limited liability companies were taxable transactions.

Although unclear from the Tax Review Board decision, it is likely that EarthData, and its sister limited liability companies from whom the intercompany purchases were made were both disregarded for federal and North Carolina income tax purposes. As disregarded entities, any intercompany transactions would have been disregarded for income tax purposes, thus creating the false impression that they would be disregarded for sales tax purposes as well. However, like many states, North Carolina follows the federal entity classification rules for income tax purposes only, and respects the legal form for purposes of sales and use tax.

Commentary

The Tax Review Board's decision provides an excellent example of the unexpected tax consequences that can occur through otherwise conventional intercompany transactions. EarthData's intercompany purchases were unassuming for two primary reasons: (1) the land surveying services themselves were nontaxable professional services, thus lulling the taxpayer into believing the subcontracting of such services would also be exempt from tax; and (2) the affiliate structure was likely disregarded for income tax purposes, creating an illusion that the intercompany transactions would be disregarded for all tax purposes.

Adding to the confusion is the fact that the affiliates may have paid sales tax on the tangible personal property (i.e., the negatives, data tapes or compact disks) when purchased. If so, double taxation occurred and could be avoided on future sales only through the provision of a resale certificate on the original purchase of tangible personal property by the affiliate. By providing a resale certificate, the affiliate would no longer have an obligation to pay sales tax on the purchase and instead the obligation would shift to EarthData.

While addressing the double taxation concerns, the provision of a resale certificate could have its own negative consequences. To provide a valid resale certificate the affiliate may need to concede nexus and register for tax in North Carolina, thus creating an additional administrative burden in the future. Conceding nexus may also result in an additional financial burden because the affiliate would be required to collect and remit tax on all North Carolina sales, not just those made to EarthData.

Another adverse consequence is the potential increase in the tax base to include the value of the services or intangible elements. The amount charged to EarthData by its affiliates included an intangible or service component, in addition to the tangible

personal property. The Department assessed use tax on the entire amount based on the finding that the "true object" of the transaction was the sale of tangible personal property, thereby imposing tax on the mark up for services as well as the transfer of tangible personal property. To avoid paying tax on this otherwise nontaxable service component in the future, the value of taxable tangible personal property would need to be stated separately from any other nontaxable amounts, creating an additional administrative burden.

This increased administrative and financial burden left EarthData in a likely unexpected predicament that many other taxpayers have faced, or will face in the future. The fact that affiliate sales may be subject to tax is often ignored, particularly when sales are for resale. However, where the ultimate item being sold is a nontaxable service, a resale exemption will not apply and taxpayers may incur unanticipated tax obligations on intercompany transactions. Further complexity and confusion may exist for transactions between disregarded entities where the extent and details surrounding such intercompany transactions are not easily determined. To avoid any unexpected surprises, taxpayers should carefully review intercompany transactions from not only an income tax perspective, but a sales tax perspective as well.

Statutory Amendment

Fortunately, this predicament was solved, at least for purposes of EarthData, through the enactment of legislation in 2004. Effective October 1, 2004, Article 5 of Chapter 105 of the General Statutes of North Carolina was amended to add a provision that "[s]ales to a professional land surveyor of tangible personal property on which custom aerial survey data is stored in digital form or is depicted in graphic form are exempt from sales and use tax."² According to the new provision, EarthData's subcontracted sales, whether affiliate or otherwise, are not subject to tax.■



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² N.C. Gen. Stat. § 105-196.13(53).