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Sales Tax Corner

Navigating Sales Tax in the Life Science Industry—Challenges and Solutions

By Ilya A. Lipin and Richard Salsano

The United States stands at the forefront of the life sciences industry, a sector that spans biotechnology, pharmaceuticals, biomedical technologies, life systems technologies, nutraceuticals, cosmeceuticals, and food processing. According to 2022 government data, foreign direct investment in the U.S. life science sector reached USD 656 billion and supported over 348,000 jobs.[1] Pharmaceutical manufacturing is nearing an all-time high, driven by an expanding drug pipeline and the onshoring of operations in response to supply chain disruptions caused by the coronavirus disease (COVID)-19 pandemic.[2] This industry is synonymous with innovation and technological breakthroughs. However, navigating the complexities of regulatory frameworks is crucial, particularly in understanding and complying with U.S. taxes, including state and local taxes.

Because of the need to purchase goods for facility build-outs, equipment, and testing inventory, sales tax could be the largest spend for life science companies. It is also the highest risk area for noncompliance due to broad nexus rules and multistate operations, challenges with correct product classifications for determining taxability, the use of technology to connect with customers and deliver products, and the timely collection of exemption certificates documenting exempt sales. Navigating sales tax compliance in the life science industry requires a strategic approach, leveraging technology, expertise, and best practices. This column delves into the sales and use tax challenges faced by life science companies and explores potential solutions to streamline compliance processes.

Nexus Considerations

Life science companies can establish nexus in a state through various means. A physical presence, such as employees, independent contractors, labs, offices, and inventory, can create nexus. For instance, using third-party clinical research organizations (CROs) for drug trials or to find new uses for marketed drugs can establish a nexus for a pharmaceutical company, especially if it retains ownership of the drugs being tested.[3] Many states consider retained ownership as creating a nexus in the state where the CRO operates.

Travel by employees or representatives across state lines—even without generating direct sales—can create nexus for tax purposes. For example, attending or participating

in conferences, trade shows, or seminars in a state can contribute to establishing a nexus. Likewise, the presence of employees or representatives involved in activities such as training sessions, product demonstrations, or networking events in a state may also be considered in determining nexus. The underlying rationale is that while those activities do not directly generate sales, they represent the company's interests and enhance the company's market presence in a state.

Sales tax nexus can also be established by eliciting sales that exceed economic thresholds (*e.g.*, $100,000 of sales or 200 separate transactions in the past or current year). All states that impose sales tax have economic nexus standards. It is crucial for life science companies to examine how states calculate sales thresholds when determining if they will meet those economic nexus standards. For example, some states, including Georgia, Illinois, and Michigan, base volume of sales on gross receipts, whereas others, including Florida, North Dakota, and Oklahoma, base it on taxable sales. The taxability of the product sold in relation to the measurement of the sales threshold means that a life science company's economic nexus could exist mostly in states that base their measurements on gross sales—that is, states that do not distinguish between taxable and nontaxable products in their threshold calculations.

For state income tax purposes, economic presence, exemplified by activities like the licensing of trademarks and patents or having sales over a bright-line threshold, can also establish a nexus. In addition, some states assert corporate income tax nexus when a corporation has a "substantial" or "significant" economic presence; others assert nexus to the "fullest extent of the U.S. Constitution."

Purchasing

Most states provide a sales tax exemption for purchases of equipment and other assets used in manufacturing and research and development (R&D) activities. Life science companies that want to use such exemptions need to understand their breadth and application, which varies by state, and document them in the event of future audits.

For example, North Carolina offers a sales and use tax exemption for purchases of equipment, attachments, or repair parts that meet the following criteria:

- The item is sold to a company mainly involved in R&D in the physical, engineering, and life science industries as classified under North American Industry Classification System (NAICS) industry group 54171;
- The company capitalizes the item for tax purposes according to the Internal Revenue Code; and
- The company uses the item in researching and developing tangible personal property.[4]

Utah has a notable tax exemption for construction materials used in the development of new or expanding facilities dedicated to life science R&D. To qualify for the exemption, the facility must be owned, leased, or rented by a life science establishment, and R&D must take place in at least 51 percent of its total area. The exemption requires that the construction materials be clearly identified, separated, and ultimately installed or converted to real property. The NAICS further defines eligibility for this exemption, with specific codes designated for qualifying life science establishments, including 33911, pertaining to medical equipment and supplies manufacturing; 334510, covering electromedical and electrotherapeutic apparatus manufacturing; and 334517, relating to irradiation apparatus manufacturing.[5]

Companies should also be aware of local tax obligations. The largest life science markets include San Francisco, Los Angeles, Philadelphia, and New York City, all of which impose taxes based on income and/or gross receipts.

Pennsylvania also provides a generous exemption for purchases of tangible personal property intended for predominant use—defined as more than 50 percent of the time—in manufacturing or R&D.[6]

By way of comparison, California provides only a partial exemption on the purchase or lease of qualified machinery and equipment primarily used in manufacturing and R&D. Under this exemption, eligible companies benefit from a reduced state tax rate of 3.3125 percent on qualifying purchases or leases up to $200 million in a calendar year but are subject to the district and local sales taxes at full rates.[7]

Unlike the Pennsylvania and Utah predominant use exemptions described above, Wisconsin requires purchases to be directly and exclusively used in the manufacturing process. Machinery that is not directly used in the manufacturing process does not qualify for the exemption. That rule applies even to items that play an indirect role in manufacturing processes. For instance, equipment used for cleaning, waste management, heating or air conditioning, communication, lighting, fire prevention,

research, development, storage, or transport are not exempt. Similarly, tools used for the repair or maintenance of machinery or the facility itself are taxable. A manufacturer must use the equipment solely to manufacture tangible personal property to the exclusion of all other uses. However, the exemption is not invalidated by an infrequent and sporadic use other than in manufacturing tangible personal property.[8]

By appropriately issuing an exemption certificate to the vendor before acquiring the equipment, companies can achieve immediate tax savings. Moreover, if the equipment is purchased and then used in a manner that qualifies for exemption, previously paid sales tax can be reclaimed *via* refund, provided the claim is filed within the applicable statute of limitations.

Finally, life science companies need to be aware of potential credits and incentives they may receive for creating new jobs, training, building new or upgrading existing facilities, or locating in special tax opportunity zones.

Exemptions similar to those for equipment can also apply to purchases of utilities (electricity, water, gas, *etc.*) used in qualifying manufacturing and R&D activities. To qualify for such exemptions, states may mandate that the company conduct a utility study to determine the percentage of exempt usage. Following this, the company can issue an exemption certificate to the utility provider, delineating taxable and nontaxable usage based on a reasonable method, including using the results of the utility study.

Companies should be cautious when purchasing products not used in manufacturing or R&D activities or for which they are not considered end-users. Items such as tangible property used for testing, cleaning supplies, and assets used outside the manufacturing area typically incur sales tax. If sales tax was not collected at the time of purchase, the company is responsible for timely self-assessing and remitting the corresponding use tax to the state.

Other areas of significant spend for life science companies typically include packaging materials, promotional materials and product samples, and subscriptions to market data and other information services used as part of clinical trials. All those categories present both challenges and opportunities.

Most states provide an exemption for purchases of material used to package goods intended for sale, so life science companies should ensure they are taking advantage of applicable exemptions at the time of purchase. For example, New Jersey exempts from sales tax wrapping, bags, labels, nonreturnable containers, and other wrapping supplies whose use is incidental to the delivery of any tangible personal property.[9]

Life science companies must understand and track where promotional materials and samples are being sent or used to accurately capture any sales and use tax that might be required. Free samples of non-prescription drugs and drugs for animal use are generally subject to tax in most states, and companies should track their use tax obligations.

Opportunities to allocate usage of market data subscriptions and software licenses add complexity to sales and use tax compliance. However, they can also lead to refund opportunities if the company originally paid sales tax to or accrued use tax in a single state on 100 percent of the total purchase. Approximately half of the U.S. states impose sales tax on software as a service (SaaS), and at least 12 states impose sales tax on data processing or information access services. If subscription services and software licenses are being used in states that do not impose tax on such services, life science companies may reduce their sales tax cost by issuing exemption documentation to their vendors showing on the invoice the location of their use instead of the ship-to or bill-to location, which may be in a state that would tax those services.

Sales and Taxability

On reaching the commercialization stage, a life sciences company should be concerned about the taxability of its products and services.

In general, prescription medicines developed for human consumption are exempt from tax in most states, except for Illinois, where they are taxed at a reduced rate. Over-the-counter medicines, however, are subject to tax in most states.

Life science companies also need to be aware of state and local gross receipts taxes and any special taxes such as the MinnesotaCare Tax, which includes a component of tax that applies to wholesale drug distributors selling into the state.

Items that can be classified as medical devices or prosthetics also carry unique rules that often depend on whether they are sold pursuant to prescriptions and

directly to patients/customers. State taxability rules in this area can be intricate and should be reviewed regularly.

Of particular note is how states view products that do not seem to reside anywhere in the existing categories of healthcare products covered by state sales tax laws. One such area comprises implantable surgical treatments that include some element of human tissue and are designed to promote healing and growth in affected areas. These products do not neatly fit within standardized tax categories, and companies are often left wondering whether their products can be considered drugs, medical devices, or prosthetic devices. Further, many states lack clear guidance in the form of rulings or case law to help taxpayers navigate this issue.

States that do offer guidance often require a taxpayer to understand the nature of the product in question and how it actually functions to ensure it fits within the state's view for inclusion in or exclusion from any available exemptions. For example, Missouri has published several letter rulings on human tissue-based products and whether they qualify for exemption as prosthetic devices in the state.[10] To qualify as a prosthetic device, a product must replace all or part of a bodily organ. A product that accommodates only the absence of an organ, is used to repair defects in existing organs, or supplements or aids impaired organ function is not a prosthetic device under Missouri's definition.

That view of prosthetic devices differs from those of member states that have adopted the definitions in the Streamlined Sales and Use Tax Agreement (SSUTA). Per the SSUTA, the term "prosthetic device" means a replacement, corrective, or supportive device worn on or in the body to artificially replace a missing portion of the body, prevent or correct physical deformity or malfunction, ***or*** support a weak or deformed portion of the body. One can see how the same human tissue-based product that did not qualify for exemption as a prosthetic device in Missouri could be deemed a prosthetic device in streamlined states.

To make this issue even more difficult for life sciences companies, the SSUTA gives member states the option to limit the application of the prosthetic device definition by requiring it be "dispensed pursuant to a prescription." This potentially creates additional barriers to exemption depending on how the product is sold and the state's interpretation of the law. In LR 2019-2, the Michigan Department of Treasury concluded that an implantable device that otherwise performed the function of a prosthetic device did not qualify for exemption as a prosthetic device because it was not dispensed in the transaction when sold to a medical facility that would use it in the performance of a medical service. If the device is sold directly to the patient pursuant to a prescription, it would be deemed dispensed and therefore exempt from sales tax as a prosthetic device in Michigan.

The animal health industry is booming globally, with an expected market size of $37.8[11] billion in 2023, but the sales and use tax landscape for the industry's products differ from that of their human counterparts. Medicated food additives, diagnostic testing kits, and vaccines and other injectables all carry potentially different tax results depending on the state. Drugs developed for pet consumption, including those sold pursuant to a prescription, are often subject to tax in many states, with some exceptions for food-producing livestock.

Other states are revising their tax laws to distinguish between products intended for human and non-human use. For example, Idaho recently amended its definition of the term "drug" for purposes of its sales and use tax exemption for prescriptions so that it does not include articles intended for use in the diagnosis, cure, mitigation, treatment, or prevention of disease in animals other than man.[12]

Similar to the human health industry, the customer in the animal health transaction can also affect taxability. Most states view veterinary practices as end users, rather than resellers, of products used in the performance of a medical service. However, if a product is sold to a distributor that then sells the product to a veterinary practice, the initial sale may be exempt as a sale for resale. Thus, life science companies should be aware of their customers and collect exemption certificates as required to document exempt sales.

With the life science industry's growing shift toward digitization, transactions involving software, digital products, and online subscriptions are on the rise. However, navigating the tax landscape for these intangible assets can be intricate, given the ever-evolving regulations and taxability rules. Thus, life science companies should be consistently thinking about their products and delivery models and ensure they charge and collect sales tax or accrue use tax as appropriate.

Solutions and Other State Tax Considerations

Life science companies should consider consulting with sales tax experts to understand their nexus profile and filing obligations and address intricate taxability concerns, product classification nuances, and potential exemption qualifications. Companies frequently face costly exposures or unintended expenditures when they do not engage

experienced U.S. tax professionals and advisors or when they lack robust internal controls for overseeing sales and use tax obligations.

Leveraging indirect tax compliance software or outsourcing this function can streamline the compliance process and mitigate the burden on the company. The use of compliance software can assist with automating sales tax calculations, provide real-time updates on rate and taxability changes, flag new states where activity may reach nexus thresholds, help collect exemption certificates and track their expirations, and generate reports for internal review and external audits.

Compliance software with real-time updates on taxability changes helps life science companies stay on top of the ever-changing sales and use tax landscape. One area of personal healthcare that has seen a significant amount of change in the last year from a sales tax perspective is the feminine hygiene products space. Over 10 states have recently amended their tax laws to exempt feminine hygiene products from sales tax, and there is legislation pending in North Carolina, Kentucky, Missouri, Wisconsin, Oklahoma, South Carolina, and West Virginia to do the same. Companies that lack automated tax decision software need to establish processes to monitor and implement relevant tax law changes to maintain compliance and avoid any unnecessary tax risk.

Periodic reviews and analyses of taxability, either on the sales or purchase side, can pinpoint opportunities for optimization and reduce potential risks. Significant savings can be realized before purchasing specific equipment and machinery by determining whether their use qualifies for sales tax exemptions under manufacturing or R&D categories. To claim exemptions, taxpayers must follow state-specific requirements and documentation procedures, which may include separately stating and identifying what materials and equipment were purchased and that the company's activities fit within a specific NAICS classification.

Expenditures on utilities such as electricity, gas, and water should also be reviewed. If sales or use tax was mistakenly paid, it might be recovered if the refund claim is submitted within the statute of limitations period specific to the state. For products that are consumed in trials, taken out of inventory for use, or are not covered by an exemption, it is important to monitor whether purchases were subject to tax or whether the company self-accrued and reported use taxes.

From an income tax perspective, a pre-revenue life science company should consider filing tax returns in jurisdictions where it has established a nexus to record and document losses. These documented losses can be invaluable in the future, offsetting taxable income once the company becomes profitable. Importantly, the company may lose the opportunity to carry forward net operating losses from previous years in states where it established nexus but failed to file a return. During the pre-commercialization and commercialization phases, it is crucial to review state-specific income tax sourcing methodologies to ensure that various revenue streams, such as licensing payments and drug sales, are correctly attributed to the appropriate state.

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Finally, life science companies need to be aware of potential credits and incentives they may receive for creating new jobs, training, building new or upgrading existing facilities, or locating in special tax opportunity zones.

ENDNOTES

1 U.S. Department of Commerce, "Foreign Direct Investment (FDI): Life Sciences, SelectUSA" (Mar. 7, 2024).

2 Newmark, "The National Life Science Market Overview" (midyear 2023).

3 *Genentech Inc. v. Comm'r*, ATB 2014-918-19 (Nov. 17, 2014).

4 N.C. Gen. Stat. §105-164.13(5g).

5 Utah State Tax Commission, "Sales and Use: Introduction: Application of Sales and Use Taxes: Guidance for Businesses," Publication 25 (Nov. 2017).

6 61 Pa. Code §§32.32; 41.9.

7 Cal. Rev. & Tax. Code §6377.1(a)(1); Cal. Code Regs. tit. 18, §1525.4; California SBOE Special Notice L-372 (Feb. 2014); California Tax Publication 541; *see* California Form CDTFA-230-M: Partial Exemption Certificate for Manufacturing and Research & Development Equipment.

8 Wis. Stat. §77.54(2); Wis. Stat. §77.54(6)(am)(1); Wis. Stat. §77.54(6)(am)(2); Wis. Stat. §77.54(30)(a)(6), Wis. Admin. Code Tax §11.40(2)(b); *see* Wisconsin Publication 203.

9 N.J. Rev. Stat. §54:32B-8.15; New Jersey Sales and Use Tax Bulletin SU-5.

10 *See* Missouri Letter Rulings No. LR-5446, LR-6884.

11 IMarc Group, "Animal Health Market Report by Animal Type (Commercial, Companion), Product Type (Pharmaceuticals, Biologicals, Medicinal Feed Additives, Diagnostics), and Region 2024-2032.

12 H.B. 527 amended Idaho Code §63-3622N and is effective July 1, 2024.

13 CBRE, "2023 U.S. Life Sciences Outlook, Rising Uncertainty Amid Burgeoning Scientific Discovery."