Sales Tax Corner

Sales Tax Implications of Intercompany Fees

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Navigating the complexities of sales tax is critical for businesses, especially when intercompany fees are involved. These fees, charged between two legal entities—usually by a foreign or domestic parent or management company—for providing administrative, financial, and operational services to its U.S. subsidiaries or affiliates, can trigger various sales tax implications, especially when they involve the sharing, transferring, or leasing of tangible personal property, including software and technology, or the sharing of employees when the subsidiary supervises and directs performance. They can be categorized in various ways, including as intercompany management fees, administrative fees, technology fees, or support fees.

Intercompany transactions can be subject to sales tax, and unlike in income tax regimes, are not eliminated in combined or consolidated filings. If not identified and properly addressed, businesses may find everyday expenses—such as back-office administration, management, employee payroll, internal equipment costs, or inventory management—are subject to sales taxes. Sales tax may apply even if no cash is exchanged between separate related legal entities.

This column highlights sales tax considerations related to intercompany fees by exploring key issues and common challenges and providing best practices for audit preparedness to minimize potential exposure.

Taxation of Intercompany Transactions

Sales tax consequences should be considered every time there is a transfer of tangible property or taxable services between two related legal entities, even if no consideration is exchanged. In analyzing whether a transaction is subject to tax, it should be reviewed without regard for the commonality of ownership between the separate legal entities.

Several states have provided sales tax guidance for transfers between related entities. For instance, Kansas provides that each transfer of tangible personal property or taxable services between separate legal entities for use or consumption—not for resale—is taxable. That is so even if the entities share common ownership and operations and business location and file consolidated income tax returns, and the transaction is not for consideration.[1] The state provides examples of transfers between separate legal entities that are subject to tax, unless an exemption applies:

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- Transfers between individuals and partnerships;
- Transfers between individuals and corporations;
- Transfers between individuals and unincorporated associations;
- Transfers between partnerships and corporations;
- Transfers between partnerships and unincorporated associations;
- Transfers between partnerships;
- Transfers between unincorporated associations and corporations; and
- Transfers between corporations, whether between sister corporations or a parent and subsidiary corporations.[2]

By way of another example, in April 2017, New York amended the tax law for transactions involving sales of tangible personal property between some related parties to eliminate a resale exclusion for such sales. The following sales of tangible personal property are considered retail sales subject to sales tax:

- Sales to a single-member limited liability company (SMLLC) or its subsidiary for resale to its member or owner, when the SMLLC or its subsidiary is disregarded as an entity separate from its owner for federal income tax purposes;
- Sales to a partnership for resale to one or more of its partners; or
- Sales to a trustee of a trust for resale to one or more beneficiaries of the trust.[3]

By the way of example, a SMLLC treated as a disregarded entity for federal income tax purposes purchases artwork in New York to lease it to its single member. The purchase of artwork by SMLLC does not qualify as a purchase for resale and is subject to tax. Further, the lease of the artwork to a single member would also be subject to sales tax. If the single member purchased the artwork directly without the additional transaction involving the SMLLC, the purchase would be subject to sales tax only once.[4]

Based on the New York guidance, companies that utilize disregarded SMLLC, partnerships, trusts, or their subsidiaries to purchase and resell or lease items to the parent or owner or member may not qualify as exempt sales for resale and may be subject to sales tax on original purchase, unless an exemption applies.

It is important to distinguish that an interdepartmental transfer within a single legal entity is not a sale subject to sales tax. However, use tax may be incurred if the company's employees take property out of inventory for their own use (for example, a pen manufacturer takes pens out of its inventory for use at the office).

Management Services

Some states impose sales tax on management services. For instance, in Connecticut, business analysis, business management, consulting, and human resource management services are subject to sales tax when they relate to a business's core activities, such as budgeting, strategic planning, hiring, or the sale of products or services.[5] The human resource management services include activities such as hiring, development, job-related training, compensation and management of personnel, employee relations, and design and implementation (but not ongoing administration) of employee benefit plans.[6]

Intercompany transactions can be subject to sales tax, and unlike in income tax regimes, are not eliminated in combined or consolidated filings. If not identified and properly addressed, businesses may find everyday expenses—such as back-office administration, management, employee payroll, internal equipment costs, or inventory management—are subject to sales taxes.

Connecticut excludes from taxable management services those services customarily rendered by attorneys, accountants, and actuaries when acting within the scope of their professions.[7] Marketing, investment, investment banking, insurance, and environmental consulting services[8] are also generally excluded, including when a service provider is acting in the capacity of a member of the service recipient's board of directors.[9] There is a limited exemption for services rendered between parent companies and 100% owned subsidiaries related to the management of industrial, commercial, or income-producing property, as well as flight instruction or chartering services by certified air carriers. However, for corporations engaged in the media business with their principal places of business in

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Connecticut, at least 80% ownership is required to qualify for this exemption.[10]

If properly documented on the invoice, the sales price of taxable managed services excludes separately stated compensation, fringe benefits, workers' compensation, and payroll taxes paid to employees performing such services.[11] A failure to show separately stated details on the invoice will cause sales tax to be imposed on the single bundled fee.

By comparison, New Mexico imposes sales tax on most services but allows a deduction for a business entity's receipts limited to administrative, managerial, accounting, and customer services that it performs for an affiliate on a cost basis.[12] It also allows the joint use or sharing of office machines and facilities on a cost basis.[13] However, if the affiliate pays its parent on a cost-plus basis for these services, as may be required by transfer pricing, such receipts cannot be deducted and are subject to tax.[14] Other services, such as legal and human resource services, fall outside the back-office support service and may be subject to sales tax. To qualify, the parent company must have equity ownership in an affiliate that represents at least 50% of its total voting power or that has a value of at least 50% of its total equity.[15]

Hawaii provides that charges for legal, accounting, managerial, and administrative services (including related overhead costs) furnished by one related entity to another, or interest on loans or advances to related entities, are not taxable. Related entities are generally those related through 80% common ownership and at least 80% of the total voting power.[16]

In contrast, South Dakota imposes a tax on all services and does not offer any exemptions for services provided to related entities.[17]

Technology Services

Subsidiaries often rely on the parent company's technology, such as hardware and software, for its everyday operations. For IT security, financing, or other business purposes, the parent company may purchase hardware such as computers, servers, or other expensive hardware and lease it to the subsidiary in exchange for a monthly or annual fee. Leasing of tangible personal property is subject to tax unless a state-specific exemption applies. For instance, when sales tax was paid on the initial purchase, Minnesota exempts from sales tax tangible personal property not made in the normal course of business of selling that kind of property and when the sale is between members of a controlled group as defined in the Code Sec. 1563.[18]

Alabama also has an exemption for intercompany leases of tangible personal property when a subsidiary is wholly owned by the parent and any sales tax due was previously paid.[19]

A parent may also provide its subsidiary with software it created or sublicense software it purchased. Intercompany sales or licensing of software may be subject to tax depending on the method to access the software. Approximately 35 U.S. states impose sales tax on electronically delivered software, such as an app downloaded onto a computer or phone; approximately half impose sales tax on software as a service (SaaS); and around 12 states impose sales tax on data processing.

There are several available exemptions. The multiple points of use (MPU) exemption allows businesses to allocate tax based on the proportionate use of software across jurisdictions. Available in jurisdictions including Massachusetts, New York, Pennsylvania, Utah, Washington, and the City of Chicago, MPU enables businesses to document that while the purchase of software licenses may occur in a taxable jurisdiction, the actual use of those licenses may take place in a jurisdiction where the offering may not be subject to tax or is taxed at a lower rate.

Several states also exempt from sales tax data processing services provided to related members. For instance, the District of Columbia exempts from sales tax data processing services that are provided by a member of an affiliated group of corporations to other corporate members of the group if the service is rendered has not been purchased with a certificate of resale or exemption by the corporation that provides the service, is rendered for the purpose of expense allocation, and is not for the profit of the corporation providing the service.[20]

Texas, which imposes sales tax on data processing services, exempts from sales tax charges for taxable services if the seller and purchaser are affiliated entities that are members of an affiliated group under Code Sec. 1504.[21] However, a seller of a taxable service or tangible personal property must pay sales or use tax on a purchase it transfers to an affiliated group member. The seller may not claim a sale for resale exemption on the purchase.[22]

Companies should carefully review their intercompany agreements to determine whether, in addition to providing back-office support and professional services—which are typically not subject to tax in most states—the parent is also licensing access to hardware or software for a single fee. Such bundling arrangements may make the entire fee subject to sales tax.

Sharing Employees

A parent company may lease its employees to a subsidiary temporarily to assist with operations or fulfill specific expertise needs at the direction or supervision of the subsidiary. Such arrangements are often documented in intercompany agreements in which a foreign parent receives payments for the use of its employees by the subsidiary without consideration for sales tax implications. States including Connecticut, New Mexico, Pennsylvania, and South Dakota impose sales tax on such leasing arrangements among separate but related legal entities.[23]

Pennsylvania recently issued administrative guidance indicating that sales tax can apply to such arrangements even with remote employees.[24] This means that if an employee located outside Pennsylvania performs a service that is delivered or used within the state, the service may still be subject to sales tax. Companies that rely on sharing employees should be aware of these potential, unanticipated sales tax costs.

In New York, when a parent company's employees perform maintenance services for a subsidiary and the parent charges the subsidiary for those services, the charge would be deemed a retail sale subject to sales tax. The employees performing the maintenance services are from the parent company's payroll and not employees of the subsidiary. Thus, the parent's charges to the subsidiary for the maintenance work performed by the parent's employees will be considered a retail sale subject to sales tax.[25]

Services provided by a related entity's employees must be carefully reviewed to determine the tax implications of the services being provided and that sales tax are properly remitted to the state. State tax auditors, especially in New York, examine intercompany fees in detail. If proper documentation is not provided to support the type of services or products being provided or purchased, New York is taking the position that these intercompany charges are subject to sales tax in its entirety.

Dodd-Frank Act Relief

Otherwise taxable sales between related separate entities may escape taxation under an exemption designed to mitigate unforeseen tax consequences under federal law. For instance, in New York, there is a sales and use tax exemption for some sales or services transactions between financial institutions and their subsidiaries arising as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Under the Act, specific financial institutions were required to create subsidiaries and then transfer property or services to them.

Tangible personal property or services otherwise subject to sales tax when sold to a related person are not subject to sales or use tax if the purchaser can show the required conditions have been met under the Dodd-Frank Act.[26]

This exemption will expire June 30, 2025, except for sales made, services rendered, or uses occurring pursuant to binding contracts entered into on or before June 30, 2025. In no case may the exemption apply after June 30, 2028. The New York State FY 2025 budget extended those expiration dates to June 30, 2027, and June 30, 2030, respectively.

Best Practices

Sales tax must be considered during the planning and implementation of intercompany agreements and transfer pricing discussions. Because each state—and sometimes locality in home rule states such as Colorado—has its own rules on the taxability of products and services, it is essential to review each state where related entities have nexus for the potential application of sales tax to intercompany products in services covered by the fees. It is recommended to separate and analyze the taxability of each component of the fee, which will help determine if any particular product or service when bundled together can result in the entire transaction being subject to tax.

Intercompany transactions should be considered during both the due diligence and post-acquisition phases. During due diligence, it is important to verify that no sales tax was charged for intercompany transactions and determine whether any analysis was performed to confirm that such transactions are not subject to tax or are covered by a state-specific exemption. Post-acquisition, it is crucial to evaluate the sales tax implications when the newly acquired entity receives tangible personal property or services under the new ownership.

In states such as Connecticut that impose a tax on management services, it is possible to reduce sales tax by tracking and separately detailing on the invoice taxable services, reimbursed costs, and nontaxable services. For companies aiming to minimize sales tax and avoid the applicability of bundling rules, it is imperative to maintain robust intercompany documentation. This includes issuing separately stated invoices for taxable

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business management services and nontaxable services (such as marketing or professional services), as well as separately stating the cost of employee benefits from service costs.

It is important to understand and document the ownership structure to claim exemptions from sales tax imposed on management services based on the parent's whole or partial ownership of the subsidiary to which such services are provided.

Intercompany fees that include licenses to software, SaaS, information services, and digital products, among other nontaxable administrative or professional services, may result in significant unintended liabilities because of the bundling rules. Thus, companies should know the taxability of such electronic products and, for contracting and invoicing purposes, either have them listed on the separate invoice or separately state them on the invoice to avoid application of bundling rules that would make the entire fee subject to tax. The MPU exemption should be used if software products are purchased in one state but used in another, which could result in the non-imposition of sales tax on such products or the imposition of taxation at a different—and sometimes—lower rate.

Companies should also research and consider other less commonly known exemptions, such as those under the Dodd-Frank Act, to see if their application may reduce the sales tax burden on intercompany transactions.

If sales tax is due on intercompany fees or to a portion of intercompany fee (for instance, for the use of software), it should be collected and remitted to the state. As part of the compliance process, the parent entity will need to register with the state and collect and remit sales tax. Alternatively, if the parent does not collect sales tax, the subsidiary should self-assess and remit use tax to the appropriate jurisdiction.

Companies with extensive intercompany transactions across multiple states should consider the benefits of automating their processes and implementing an indirect tax engine. Such a system can track taxability determinations and rates for over 12,000 taxing jurisdictions in the United States and simplify document retention for potential state and local audits.

Lastly, companies with intercompany transactions in states that impose taxes on gross receipts, such as Ohio and Washington, should consider if intercompany payments may also be subject to gross receipts taxes and if exemptions apply. These states may exempt from taxable receipts expenses that are passed through from the subsidiary to the management company if the management company is required to pay a third party.[27] Ohio also allows a group of two or more persons to elect to be a consolidated elected taxpayer, which in calculation of the state's commercial activity tax eliminates gross receipts among the affiliated entities on the consolidated return.[28]

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ENDNOTES

1. Kan. Admin. Regs. §92-19-72(b).
2. Kan. Admin. Regs. §92-19-72(c).
3. *See* Technical Memorandum TSB-M-17(4)S (Aug. 14, 2017).
4. *Id.*
5. Conn. Gen. Stat. §12-407(a)(37)(J).
6. Conn. Agencies Regs. 12-407(2)(i)(J)–1(i).
7. Conn. Agencies Regs. 12-407(2)(i)(J)–1(c)(3).
8. Conn. Gen. Stat. §12-407(a)(37)(J)(i).
9. Conn. Agencies Regs. 12-407(2)(i)(J), 1(c)(2), and 1(f)–(h).
10. Conn. Gen. Stat. §12-412(62).
11. Conn. Gen. Stat. §12-407(a)(8)(B)(vii).
12. NMSA 1978 §7-9-69(A).
13. *Id.*
14. N.M. Admin. Code 3.2.229.8(B). New Mexico provides for the following example: "D is a wholly owned subsidiary of C. C does the machine accounting for D for the actual cost of the accounting work plus ten percent. C may not deduct the receipts which it receives from D. The deduction is only for receipts from accounting services rendered on a nonprofit or cost basis."
15. NMSA 1978 §7-9-69(B).
16. Haw. Rev. Stat. §237-23.5(a).
17. S.D. Codified Laws §10-45-4; S.D. Codified Laws §10-45-4.1.
18. Minn. Stat. §297A.68, Subd. 25(a)(2).
19. Ala. Code §40-12-223(11).
20. D.C. Code Ann. §47-2001(n)(1)(N)(iii).
21. Tex. Admin. Code 3.331(c)(1).
22. Tex. Admin. Code 3.331(c)(4) and (5).
23. Conn. Gen. Stat. §12-407(a)(37)(C); N.M. Admin. Code §3.2.1.18(A); 72 P.S. §7201(k)(15); S.D. Codified Laws §10-45-4.
24. "Remote Help Supply Services," Pennsylvania Sales and Use Tax Bulletin 2021-03 (Sep. 16, 2021).
25. N.Y. Tax Law §§1105(c)(3) and (5).
26. N.Y. Tax Law §1115(jj).
27. Ohio Rev. Code Ann. §5751.01(F)(2)(l) (Gross receipts excludes "[p]roperty, money, and other amounts received or acquired by an agent on behalf of another in excess of the agent's commission, fee, or other remuneration"); Wash. Admin. Code 458-20-111 ("There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession").
28. Ohio Rev. Code Ann. §5751.011(A).

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