

# **Sales Tax Implications of Product Prototypes**

## Background

North Carolina imposes sales tax at the combined general state and local rate of 7% (except in Mecklenburg County where a combined 7.5% rate applies) on items of tangible personal property sold at retail. In the context of research and development activities, businesses purchasing tangible inputs to the R&D process typically pay 7% or 7.5% sales tax on R&D supplies and other tangible inputs to the research and development process.

In contrast to purchases of tangible personalty, North Carolina does not generally impose sales tax on services. Therefore, businesses that enter into research agreements that do not involve the production of tangible personalty do not typically pay sales tax on the cost of such services.

## Issue

A potentially troublesome aspect of sales taxation in the context of the research and development activities arises in connection with the production of product prototypes as an incidental aspect of research and development service agreements. Specifically, although service agreements as a rule are not subject to sales tax, prototypes produced pursuant to such agreements are items of tangible personalty that may be taxable at the general sales tax rate, depending on circumstances. Issues arising in the context of prototypes include (i) whether the prototype is an incidental product of the service agreement, and (ii) if the prototype is not incidental to the underlying service agreement, the value attributable to the prototype for sales tax purposes.

## Discussion

The North Carolina Department of Revenue advises NCBIO that its analysis of prototype taxation issues is heavily fact dependent. The Department therefore has issued no general guidance on the issue of prototype taxation.

In an effort to help its members in addressing this issue, NCBIO has met with representatives of the Departments Sales and Use Tax Division for the purpose of learning more about the Division's procedures for analyzing prototype taxation issues as well as particular facts or circumstances that the Division considers in determining the tax status of prototypes produced as a part of a research and development service arrangement.

## Factors and Analysis

The Department advises NCBIO of three factors considered in its analysis: (i) the nature of the prototype, (ii) the quantity of prototypes produced, and (iii) the purposes for which the prototypes are used.

*Nature of Prototypes.* Prototypes are more likely to be subject to sales tax if they are fully or partially functional. Non-functioning prototype made primarily to illustrate the physical or other characteristics of an item are less likely to be subject to sales tax.

*Number of Prototypes Produced.* The larger the quantity of prototypes produced, the more likely the prototypes are to be considered taxable.

*Use of Prototypes.* Prototypes used for testing purposes are more likely to be taxed than prototypes that are provided merely to illustrate physical characteristics or other properties.

#### Guidance for Specific Transactions

The Sales Tax Division is available to discuss the sales tax ramifications of pending research and development service agreements involving prototypes. Taxpayers are encouraged to contact the Division for guidance with respect to specific facts and circumstances. Inquiries should be directed to

Mr. Andy Sabol, Director  
Sales and Use Tax Division  
North Carolina Department of Revenue  
Post Office Box 871  
Raleigh, North Carolina, 27604-0871  
Telephone: (919) 733-2151

In addition to consultations, the Division will issue Private Letter Rulings if warranted by circumstances.

For more information, contact Sam Taylor (919) 281-8960 or by e-mail at [staylor@ncbioscience.org](mailto:staylor@ncbioscience.org).