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Archives of Treasury Update can be found on the website at **Michigan.gov/Treasury** *under the* ***Reports and Legal Resources*** *tab.*

Are Drone Services Taxable in Michigan?

Unmanned aerial vehicles, known colloquially as "drones," are rapidly becoming important and even indispensable tools in many industries. Drones are essentially small flying robots that can be controlled remotely, or even flown completely autonomously using software-controlled flight plans that are embedded in their navigation systems. Drones may be equipped with a range of cameras and sensors for capturing still images, video, thermal images, multispectral images (images that capture data within specific wavelength ranges across the electromagnetic spectrum), other types of data. Specialty drone service providers are now using drones to provide a wide range of services to many different industries. For example:

- Photographers and filmmakers use drones to capture high-quality aerial images of landscapes, sporting events, weddings, wildlife, and film and television subjects.

- Drones perform security surveillance in both residential and commercial settings, with live video feed sent directly to the home or business owner, or to a central monitoring facility.

- Drones perform agricultural surveys for farming operations, enabling the inexpensive collection of a large amount of useful data, including data regarding soil hydration, soil composition, and pest or other crop infestations.

- Drones perform building inspections, particularly of areas such as roofs, gutters, and chimneys, safely and inexpensively, enabling the building owner to locate existing problems or prevent future ones.

- Search and rescue organizations often use drones for aerial searches. Drones can be equipped to find missing persons by heat emissions as well as visually, and drones are also able to fly at night, reach remote areas that helicopters cannot, and even deliver emergency supplies.

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Recently Issued Guidance from Treasury

Revenue Administrative Bulletins

Updated RAB 2018-2,
Marihuana Provisioning Center Tax and Sales and Use Tax Treatment of Marihuana

Letter Rulings
2019-1 Eligibility for Sales and Use Tax exemption for property sold to contractors for affixation to, or construction of, nonprofit hospital.

Notices
Notice of Rescission of Obsolete Motor Fuel Tax Rules April 10, 2019

Notice of Discontinuance of 3.2 Gallon per Vehicle Standard Allowance for Automaker Fuel Tax Refund Claims May 2019

Revenue Administrative Bulletins (RAB) can be found on the website at **Michigan.gov/Treasury** *under the* ***Reports and Legal Resources*** *tab.*

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- Insurance companies use drones to perform inspections that would be costly or hazardous for humans to perform, such as inspections of large structures such as bridges, cell towers, pipelines, power lines, and wind turbines.

- Land surveyors use drones to acquire survey data from the air in a fraction of the time that would be required by a survey team on the ground. Specially equipped drones can also gather accurate, three-dimensional cartographic information for surveys used in archaeology, construction, mining, forestry management, and other industries.

- Drones provide disaster relief personnel with real-time video of areas affected by natural disasters such as flooding, hurricanes, tornadoes, and earthquakes that may make large areas too dangerous or even impossible to travel by land. Drones can also safely deliver food, medicine, and water to otherwise unreachable victims of such disasters.

With so many existing and potential commercial uses for drones, it is important that providers of drone services in Michigan understand how Michigan's sales and use taxes may apply to the sales of such services.

In general, Michigan sales and use taxes apply to the sale of tangible personal property, and not to the sale of services. By statute, however, certain specific services are subject to Michigan's use tax, including telecommunications services, the furnishing of hotel and motel accommodations, and certain laundering services. (MCL 205.93a.)

Considered by themselves, then, drone services are not subject to sales or use tax. However, it is possible – and very common – for a single sales transaction to involve a mixture of non-taxable services and taxable tangible personal property. Many, if not most, sales of drone services will likely include the sale of related tangible personal property. When such a single mixed sales transaction occurs, the service provider must determine the predominant nature of the transaction in order to determine whether the transaction is taxable. The entire transaction will be either fully taxable or fully non-taxable – an "all or nothing" result.

The test to be used for determining whether a mixed sales transaction is predominantly the sale of a non-taxable service or the sale of taxable tangible personal property was established by the Michigan Supreme Court in *Catalina Marketing Sales Corp v Michigan Dep't of Treasury*, 470 Mich 13 (2004). The *Catalina* court concluded that following six factors must be evaluated in order to determine whether a single mixed sales transaction is a service:

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- what the buyer sought as the object of the transaction;
- what the seller or service provider is in the business of doing;
- whether the goods were provided as a retail enterprise with a profit-making motive;
- whether the tangible goods were available for sale without the service;
- the extent to which the intangible services have contributed to the value of the physical item transferred; and
- any other factors relevant to the particular transaction.

While all of the above factors should be considered, the first factor – the object of the transaction – is the most important and bears the most weight. Another key factor is whether the tangible goods can be purchased without the service. Additionally, although not at issue in *Catalina*, the method of delivery of any related goods also bears on the taxability of the transaction. Goods provided digitally, such as through email, are not considered to be tangible personal property and are generally not subject to Michigan sales and use tax.

Focusing primarily on the two key *Catalina* factors noted above, following are a few examples of how some typical mixed transactions involving drone services might be analyzed to determine their taxability.

Example 1: A videographer uses a drone to capture aerial footage of a client's wedding ceremony, which takes place on a remote and picturesque Michigan lakeshore. The videographer performs additional services, such as editing the video footage and adding music. Ultimately, the client pays $1000 and receives a DVD containing the finished wedding video. The sale to the client is taxable. The buyer (the videographer's client) is seeking a professional wedding video; accordingly, the finished video, an item of tangible personal property, is the object of the transaction. Additionally, since the video is made entirely from the footage shot using the drone, it would be impossible for the videographer to make or sell the finished DVD without the related services.

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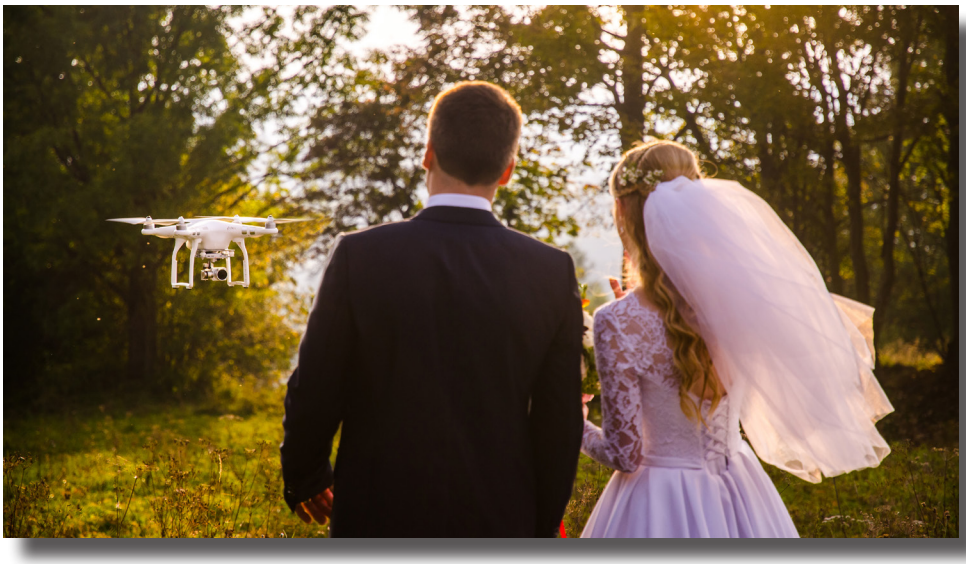

Treasury Rescinds Obsolete Motor Fuel Tax Rules

Effective February 27, 2019, Treasury rescinded the remaining rules issued under 1927 PA 150, the predecessor to the Motor Fuel Tax Act (MFTA), 2000 PA 403. These rules, listed below, have been rendered obsolete or are otherwise superseded by the MFTA:

- **Rule 207.1** (definitions)
- **Rule 207.2** (license application and fees)
- **Rule 207.3** (surety bond requirement for certain licensees)
- **Rule 207.4** (motor fuel tax reporting/payment obligations for various licensees)
- **Rule 207.7** (computed assessments for licensee failing to report motor fuel tax)
- **Rule 207.8** (reinstatement of a motor fuel tax license)
- **Rule 207.9** (3% deduction from gasoline tax to account for evaporation or loss)
- **Rule 207.10** (gasoline tax collection by wholesale distributors; tax held in trust)
- **Rule 207.11** (refunds of fuel tax on gasoline)
- **Rule 207.13** (authority of the Department to inspect books and records)
- **Rule 207.14** (gasoline returned to terminal storage)

Treasury previously announced this rescission through a Notice Issued April 10, 2019. These rules were formally rescinded by 2019 MR 4.

Tomra of N. America, Inc v Dep't of Treasury Update

Michigan Supreme Court grants Treasury's Applications for Leave to Appeal in case involving the scope of the sales and use tax industrial processing exemptions.

By Order issued March 27, 2019, the Michigan Supreme Court granted Treasury's Applications for Leave to Appeal the July 17, 2018, judgment of the Court of Appeals in the matter of *Tomra of N. America v Dep't of Treasury* (Docket Nos. 336871 and 337663).

These cases involve the application of the industrial processing exemptions, under MCL 205.54t and MCL 205.94o, to sales of reverse vending machines (bottle return machines) and the use of repair parts for those machines. For additional details regarding the Court of Appeals' decisions in this matter, please refer to p 11 of the September 2018 Treasury Update.

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Example 2: A large farming operation in Michigan contracts with a drone service company to conduct weekly agricultural surveys of its crops and farmland during the growing season, for an all-inclusive price. The drone is equipped with a camera and various sensors and, on a weekly basis, takes aerial photographs and collects data regarding soil hydration, soil composition, and possible pest issues. The drone service company immediately compiles the data gathered by the drone into a comprehensive report, which is emailed to the farmer each week. The service company also selects various representative photographs of the subject farmland, and emails the selected photography, as well. The farmer can view the reports and photographs on his computer or make hard copies by printing them out. The contractual transaction is non-taxable. Although the reports and photographs are the object of the transaction, and could not be sold absent the drone services, the items delivered in this case are not taxable tangible personal property, because they are delivered to the farmer via email in a digital format. If the drone service instead used FedEx to deliver printed photographs and a hard copy of the report to the farmer each week, the transaction would be fully taxable.

Example 3: A private search-and-rescue company in Michigan hires a drone service company to conduct aerial surveillance of a remote forested area in the Upper Peninsula. The drone operator provides a video monitor with a live feed, and search-and-rescue company personnel determine the parameters of the area to be searched by the drone. The personnel watch the video on the monitor in real time, as the footage is captured by the drone. When the injured missing person is finally located, the drone drops a small package of emergency supplies, and the search-and-rescue company arranges for the person to be taken out of the forest by helicopter and transported to the nearest hospital. Afterward, the drone service company prepares a surveillance report detailing the area searched and the outcome of the search. A hard copy of the report is mailed to the search-and-rescue company. The transaction is non-taxable. The report provided by the drone company is tangible personal property, and it may be helpful to the search-and-rescue company, but the report itself is not what was sought when the drone service company was hired. The object of the transaction was the use of the drone to conduct aerial surveillance that could be viewed, and utilized, in real time. The report is incidental to the provision of the drone services.

Audit Closing Agreements: An Alternative to Full Field Audits

Treasury now offers an alternative to full field audits during some cash-basis audits and may offer to close some audits without an extensive, time-consuming full field audit. Treasury auditors

will project the taxpayer's tax liability by comparing normative industry data to the taxpayer's preliminary audit data. Whether Treasury decides to offer a closing agreement depends on a variety of factors including the quality of the taxpayer's books and records and the size of its variance from normative data. If the taxpayer accepts the offer, it waives its appeal rights and the audit is closed without full field testing. If the taxpayer declines the offer, Treasury auditors will complete the full field audit and the taxpayer will retain all appeal rights.

Court of Appeals Upholds Denial of Refund in *North American Bancard v Dep't of Treasury*

In *North American Bancard Inc v Michigan Dep't of Treasury,* unpublished per curium decision of the Court of Appeals issued on February 28, 2019 (Docket No. 344211), the court affirmed the Michigan Tax Tribunal's denial of North American Bancard's (NAB) refund request by holding that processing terminals supplied by NAB to its customers were properly subject to use tax.

NAB is a credit card processor whose services allow merchants to accept and process credit and debit payments in retail transactions. NAB deploys card readers and processing terminals that operate in conjunction with NAB's processing software. These terminals are typically supplied free of charge to each merchant who contracts for NAB's services; however, NAB can also sell a terminal without a service agreement in place. The terminals generally become functional only after the merchant enters into a service agreement for NAB's services. All terminals are purchased and subsequently stored as inventory in Troy, Michigan. Prior to being deployed, NAB cannot distinguish between terminals that will be placed for free or sold. Even after being deployed, NAB cannot calculate revenue from terminals that were sold. After an audit, Treasury determined that NAB was the ultimate consumer of each terminal and, thus, subject to use tax at the time those terminals were purchased.

NAB principally challenged that determination on the basis that its terminal purchases were exempt purchases for resale because each terminal had the possibility to later be resold. However, the court noted that NAB did not submit any documentary evidence that such sales ever actually occurred. Rather, the evidence demonstrated that the sale of a terminal without a service agreement was unlikely because those terminals were generally inoperable without NAB's processing software. In this regard, because the transfer of a terminal was functionally tied to the execution of a service agreement, the terminal was incidental to the processing services provided by NAB under *Catalina Marketing Sales Corp v Michigan Department of Treasury,* 430 Mich 13 (2004). NAB was therefore held to be the ultimate consumer of the terminal under the Use Tax Act.

NAB further argued that terminals it shipped to merchants outside of Michigan were not subject to use tax in Michigan. The court held that the storage of terminals in Troy, Michigan was taxable insofar as Section 3(1) of the Use Tax Act levies a tax "for the privilege of using, storing, or consuming tangible personal property" in Michigan. Even though the terminals were later shipped to out-of-state merchants, NAB still "used" those terminals in Michigan when it relinquished control and delivered those terminals to a common carrier within the state. On this basis, the court determined that all terminals, even those later shipped out-of-state, were subject to use tax in Michigan.

The Court of Appeals Upholds Use Tax Assessment Due to Taxpayer's Lack of Sufficient Records

The Michigan Court of Appeals upheld Treasury's use tax assessment in *EBI-Detroit, Inc v Michigan Dep't of Treasury,* unpublished per curium decision of the Court of Appeals, issued March 7, 2019 (Docket No. 343932).

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Statement of Acquiescence/ Non-Acquiescence Regarding Certain Court Decisions

In each issue of the quarterly Treasury Update, Treasury will publish a list of final (unappealed), non-binding, adverse decisions issued by the Court of Appeals, the Court of Claims and the Michigan Tax Tribunal, and state its acquiescence or non-acquiescence with respect to each. The current quarterly list applying Treasury's acquiescence policy appears below. "Acquiescence" means that Treasury accepts the holding of the court in that case and will follow it in similar cases with the same controlling facts. However, "acquiescence" does not necessarily indicate Treasury's approval of the reasoning used by the court in that decision. "Non-acquiescence" means that Treasury disagrees with the holding of the court and will not follow the decision in similar matters involving other taxpayers.

ACQUIESCENCE:
No cases this quarter

NON-ACQUIESCENCE:
No cases this quarter

EBI, a general contractor, did not pay sales or use tax on tangible personal property (goods) that it reported on its federal tax returns as "cost of goods sold." Although EBI claimed that the goods reported on the return were exempt from sales or use tax, its books and records were insufficient to support an exemption. Treasury conducted an indirect audit and assessed use tax on those purchases for which the records were missing.

The court noted that it was "undisputed" that EBI did not remit any sales or use tax during the years at issue. Yet, the court also confirmed that EBI's federal returns and other records showed that EBI used or consumed goods subject to sales or use tax. Since EBI could not show that it was exempt from tax for the expenditures in question, the court upheld the assessment.

Hold the Phone – the Court of Appeals Finds Giveaway Items Taxable

The Court of Appeals recently issued its decision in *Emery Electronics, Inc v Dep't of Treasury*, unpublished per curium opinion of the Court of Appeals, issued February 12, 2019 (Docket No. 342250). During the tax periods at issue, Emery Electronics, Inc. (Emery) was "engaged in the business of selling cell-phone service contracts, cell phones, and related equipment." Emery purchased its inventory from a cellular phone service provider exempt from sales and use tax for purposes of resale. Under its contract with the service provider, Emery was permitted to set the sales price of phones and accessories. The contract further provided Emery would receive a commission for each service contract that it sold for the service provider. Exercising its right to set the price of cell phones Emery gave the phones away for $0 when the customer entered a service contract; Emery did not remit any use tax during the periods at issue.

Treasury conducted a use tax audit of Emery and assessed it for use tax on the phones it gave away to customers, based on the purchase price Emery paid for the given-away cell-phones. Emery challenged the assessment in the Court of Claims, which held in favor of Treasury; Emery appealed. On appeal, Emery argued that the Use Tax Act's definition of "purchase price" allows for a taxpayer to reduce the purchase price of property for purposes of use tax liability for "reimbursements" it receives for the sale of the property from a third-party. Treasury asserted that Emery purchased the phones exempt from tax and converted them to a taxable use by giving the property away. MCL 205.97(2). Further, Treasury argued that the Use Tax Act does not provide a reduction in the taxable purchase price of property based on third-party commissions.

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The court held in favor of Treasury, concluding that the payments from the service provider to Emery were commissions for the sale of service contracts that were not related to the amount Emery charged for the phones. Therefore, the court upheld the Court of Claims decision and found that Emery was properly assessed use tax on phones it gave away, because it had purchased them exempt for purposes of resale and converted them to a taxable use by giving them away.

Treasury Rescinds 3.2 Gallon per Vehicle Allowance for Motor Fuel Tax Refunds

Effective July1, 2019, Treasury will rescind its 3.2 gallon per vehicle standard allowance (safe harbor) relating to motor fuel tax refund claims based on the decision in *AutoAlliance Int'l, Inc v Dep't of Treasury,* 282 Mich App 492 (2009).

In *AutoAlliance*, the Michigan Court of Appeals held that the taxpayer (an automaker) was entitled to claim a refund for the motor fuel tax imposed by the Motor Fuel Tax Act on the 3.2 gallons of motor fuel that it placed into the fuel supply tank of each newly manufactured vehicle for export which was used for quality control, testing, and to ensure that the vehicles could be driven off transport carriers upon arrival at their out-of-state destinations.

As a result of that decision, Treasury instituted an administrative standard allowance (safe harbor) of 3.2 gallons per vehicle for *AutoAlliance*-based refund claims. This meant that as long as the taxpayer affirmed or otherwise demonstrated that each vehicle received at least 3.2 gallons of fuel, Treasury would not require the taxpayer to submit the fuel fill specification records that established, controlled, directed, or which would otherwise verify the actual fuel fill for each vehicle for which the refund is claimed for the first 3.2 gallons of fuel. Supporting fuel fill specification documentation were required only for claimed fuel fill amounts in excess of 3.2 gallons per vehicle.

In the years following the *AutoAlliance* decision, taxpayers have expressed concerns that Treasury's 3.2 -gallon standard allowance (safe harbor) is based on the particular attributes of the vehicles at issue in that case and does not reflect the attributes of the vehicles that are subject of their refund claims. In addition, the May 29, 2018, decision by the Michigan Court of Appeals in *Ford Motor Co v Dep't of Treasury* (Docket No. 338784) provides additional clarity as to the documentation that is required to support an *AutoAlliance*-based refund claim.
In consideration of these legal and factual developments, Treasury has discontinued its use of a 3.2 gallon per vehicle standard allowance (safe harbor).

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About *Treasury Update*

Treasury Update is a periodic publication of the Tax Policy Division of the Michigan Department of Treasury.

It is distributed for general information purposes only and discusses topics of broad applicability. It is not intended to constitute legal, tax or other advice. For information or advice regarding your specific tax situation, please contact your tax professional.

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Accordingly, *AutoAlliance*-based motor fuel tax refund claims for tax periods on or after July 1, 2019 must be supported by documentation that substantiates the actual fuel fill (e.g., gallons) per vehicle during the tax periods for which the refund is claimed.

For information regarding the documentation required to be filed by taxpayers to substantiate *AutoAlliance*-based motor fuel tax refund claims, please refer to Treasury's July 1, 2019 Notice which is available at: www.michigan.gov/taxes.

Pet Breeders Must Collect and Remit Sales Tax When Selling Animals as Pets

In recent years, the "backyard" breeding of dogs, cats, and other pets has become an increasingly popular activity, due in part to the continued trendiness of unusual and "designer" pet breeds as well as the relative ease of advertising such pets for sale using the internet. While some breeders may be driven by the possibility of big profits, many small breeders begin breeding activities because of their love for animals, considering their breeding operations to be nothing more than a fulfilling hobby. Perhaps for this reason, many pet breeders in Michigan do not realize that they are required to pay Michigan sales tax when they sell animals as pets. Treasury has become aware of this problem and is alerting taxpayers about their responsibilities under the law, so they can avoid potential sales tax liability in the future, as well as penalty and interest.

In Michigan, the sale of an animal as a pet is the sale of tangible personal property and such sales are subject to Michigan's 6% sales tax. Breeders who sell animals as pets – even if their sales are few or infrequent – are required to register with Treasury and obtain a sales tax license and timely pay the tax due on applicable sales. The requirement to pay sales tax applies to all sales of animals in Michigan unless a specific exemption applies.

Michigan law does not provide an exemption for "hobby" sales, or for sales below a certain minimum annual threshold. This means that nearly all breeders – including those who consider themselves "hobbyists" – are, for purposes of Michigan sales tax law, engaged in business and are required to pay sales tax. Michigan sales tax law broadly defines a "business" as any activity engaged in "with the object of gain, benefit, or advantage." (MCL 205.51(1)(e).) While a single isolated sale of an animal is not a "sale at retail" and therefore would not be subject to sales tax, anyone who advertises or offers tangible personal property (such as pets) for sale at any time and in any manner for the purpose of repeated sales is deemed to be regularly engaged in business, and their sales are not considered casual or isolated, even though they may be few or infrequent. (Sales Tax Rule 13; Michigan Admin Code, R 205.13.)

Under Michigan law, the sale of tangible personal property to a purchaser that intends to resell the property at retail is not a "sale at retail" that is subject to sales tax. Accordingly, sales tax is not generally owed on sales of animals by breeders to retail pet stores, or sales to other breeders who are in the business of breeding animals for sale. However, the taxpayer (the breeder making the initial sale) must document the exempt nature of the transaction by obtaining from the purchaser and retaining in its tax records a proper exemption claim, such as a completed and signed exemption certificate. (Treasury Form 3372, Michigan Sales and Use Tax Certificate of Exemption.) Note that the purchaser's sales tax license number must be included in the space provided on the exemption claim form.

Taxpayers can register for Michigan sales tax, and obtain more information, by visiting the Sales and Use Tax page on Treasury's website. This page contains links to, among other things, New Business Registration, the text of the Sales Tax Act and related administrative rules, Forms and Instructions, and Frequently Asked Questions regarding sales and use tax topics. Taxpayers needing additional information or who have a specific question regarding sales tax should call Treasury's Sales and Use Tax division at (517) 636-6925.