

The Maryland Comptroller Dragged Kicking and Screaming into the 21st Century

—by Harry D. Shapiro and Seth Groman

Introduction

Until recently it was not clear whether companies operating in Maryland whose work involves geospatial data collection and analysis for mapping were engaged in a non-taxable production activity or a service. The distinction between the two classifications is significant as it affects sales and use tax treatment. Companies engaged in production activities must collect sales and use tax on the sale of the final product to their customers but are not required to pay sales and use tax on purchases of equipment, software, and services used to produce their product. Companies that perform services are not required to collect sales and use tax from customers but must pay sales and use taxes on all purchases occurring during the course of performing the service. The Comptroller's recent dismissal of his appeal in *Comptroller v. EDA, LLC et. al.* finally settles this issue in favor of companies.

Background

The ED Companies consist of three single member LLCs—EDA, LLC (“EDA”), EDM, LLC (“EDM”), and Leasing, LLC (“Leasing”)—that collectively produce spatially accurate map products and geospatial data reports in multiple forms. EDA collects the data that is used to produce the ultimate product for clients, while EDM formats and processes the data to meet clients' specific needs before delivering the final product. Leasing leases equipment, including aircraft, photographic sensors, software, hardware, etc. to EDA and EDM, necessary for them to perform the production activities.

After EDM contracts with a client to produce the desired product, it subcontracts with EDA to collect the initial data. EDA utilizes a fleet of aircraft that collect this data through the use (in the early years) of conventional film-based aerial photography, and more recently, a highly advanced laser system called LIDAR. After the audit period, photography using state-of-the-art digital cameras was used. To ensure the accuracy of the data, the aircraft is also outfitted with global positioning system (GPS) and inertial measurement unit (IMU) equipment that very accurately measures the position and orientation of the plane during data collection.

The conventional photography uses a traditional camera that takes aerial photographs recorded on film, which is developed by a third party which then returns the developed negatives to EDA. EDA's LIDAR system is an airborne sensor that creates three-dimensional terrain models with a high level of vertical accuracy and resolution. The LIDAR system emits thousands of laser pulses per second that reflect off the earth's surface, including trees, buildings, and other structures as the plane traverses the pre-planned route. By measuring the position and altitude of the sensor, the orientation of the sensor, and the time for return of each laser pulse, EDM can produce a digital model of the terrain.

After completing its flight, EDA performs a minimal amount of processing and quality control of the data to make sure it meets client specifications, including complete coverage of the project area. EDA then delivers to EDM the processed aerial photography film or a hard drive containing the LIDAR data, and the GPS and IMU data. At this point, such raw data are not in a format that EDM's customers can utilize. EDM then processes the data into spatially accurate map products. After a number of quality control checks and peer reviews, EDM produces a written report that contains the data in an organized format that is delivered to the client along with a CD-ROM containing the data.

Customers can download the data, allowing it to be used for the intended purpose. For example, federal, state, and local governments use this to determine the existence of flood plains within specific geographic boundaries. In this case the ED Companies' customers were, with few exceptions, federal, state, and local governments, which meant that the Comptroller would not collect any sales and use tax because governments are not subject to the sales and use tax if the ED Companies were engaged in a production activity. Unfortunately, this drove the Comptroller to take the unsupportable position that the ED Companies were providing a service.

In *Comptroller v. EDA, LLC, et al.*, the taxpayer and Comptroller disagreed as to whether the activities of the taxpayers in producing spatially accurate maps was a production activity or a nontaxable service. The Comptroller initially assessed the ED Companies in 2003 for sales and use taxes relating to purchases of equipment, including the aircraft, hardware, various photographic sensors, software, and services used to produce the final products. The ED Companies appealed to the Maryland Tax Court but, on the eve of the hearing date, the Comptroller issued revised work papers which amounted to a new assessment. The major change from the initial assessment was the change in his position that LIDAR should not be treated the same way as conventional photography because LIDAR, unlike conventional photography, does not produce an image. As a result, the Tax Court remanded the case so that the ED Companies could pursue their administrative remedies. The Comptroller affirmed the assessments after an informal hearing, and the ED Companies appealed to the Tax Court once again.

The Tax Court finally held a trial on June 8-9, 2005. At the end of the hearing and after closing arguments and a recess, Judge Silberg announced his decision that the final product produced by the ED Companies was tangible personal property and reversed the Comptroller's assessments. The Comptroller appealed the decision to the Circuit Court for Anne Arundel County. Following oral argument, Judge Caroom agreed with the Tax Court's ruling that the mapping products could be tangible personal property but remanded the case for the Tax

Court to explain in more detail why the taxpayers were engaged in a production activity versus performing a service. On remand, the Tax Court affirmed its prior holdings on remand in a short written opinion indicating that the Comptroller had not been very helpful and did not address the issue except to suggest that the LIDAR sensor did not produce an image. Whereas, the ED Companies' fact and expert witnesses provided credible evidence that they produced a product for sale and was not engaged in a service. The Comptroller appealed to the Circuit Court for a second time.

Following the filing of additional memoranda, the Circuit Court affirmed the Tax Court decision on January 25, 2008, finding that, "a reasonable mind reasonably could have reached the factual conclusion the agency reached." The Comptroller appealed the decision to the Court of Special Appeals; however, after declining to file a reply to the ED Companies' brief, it voluntarily dismissed its appeal on December 4, 2008, with the effect that it acquiesced in the Tax Court's ruling.

By consenting to the Tax Court's ruling, the Comptroller recognizes that the ED Companies, as well as any other company engaged in work that involves data production and analysis providing a physical product to its customers, are engaged in a production activity rather than providing a service.

ED Companies' Arguments

The fact that the final product of the ED Companies' effort was tangible personal property was clear from the start. The Maryland Code of Regulation recognizes that conventional photography is tangible personal property, and despite arguments from the Comptroller otherwise, expert testimony at the Tax Court trial demonstrated that the product of the LIDAR sensor is no different than a developed negative produced by conventional photography for sales and use tax purposes. Moreover, the same expert witness explained that the most recent Edition of the American Society for Photogrammetry and Remote Sensing's (ASPRS) *Manual of Photogrammetry* (the "Bible" of the ED Companies' industry) refers to the work produced by the ED Companies as products rather than services. Finally, the deliverables wanted most by clients of the ED Companies was the CD-ROM containing the processed data. It is fatuous to contend that this product was not tangible personal property that resulted from a production activity.

The record strongly supported that the ED Companies were engaged in a production activity as it substantially transformed the conventional photographic negatives and LIDAR data. Under Section 1-101(f)(1)(i) of the Code of Maryland Tax—General Article, a production activity involves, "assembling, manufacturing, processing, or refining tangible personal property for resale." The Maryland Court of Appeals clarified this definition in *Comptroller v. Disclosure, Inc.*, 340 Md. 675 (1995), when it ruled that the conversion of paper documents into electronic format followed by burning the files to a CD-ROM was substan-

tial enough of a transformation to qualify as manufacturing, and thus a production activity. The activities performed by EDA and EDM result in an even greater transformation than occurred in *Disclosure*. Rather than simply scanning documents into electronic form, EDM processes the data it receives from EDA and makes changes to it so that it conforms to the needs of the ultimate customer. The argument that this is a production activity is strengthened further by the fact that the data received by EDM is unusable by the customer until it is processed. As in *Disclosure*, the Tax Court and Circuit Court determined that the production activity began with EDA and continued with EDM that produced the CD-ROM, the final product.

Comptroller's Arguments

While it is clear that the ED Companies' activities qualify as a production activity under the Maryland Code, it is even clearer that they were not a service. The Comptroller argued that the creation of a custom product is always a service based on a footnote in *Disclosure* (340 Md. at 686) explaining that "clerical, literary, or intellectual" labor by a company was not manufacturing, and thus not a production activity. However, this analysis ignores the rest of the case cited in the footnote which requires one to examine the entire work performed by a company to determine if it engages in manufacturing.

If the Comptroller's interpretation that any taxpayer who performs clerical, intellectual, or literary labor is incapable of engaging in manufacturing, then the entire economic base of the country would be turned on its head. Under the Comptroller's analysis, companies that produce a product from the design stage through the assembly of a final product, such as Ford Motor Company and General Motors, would not be considered engaged in manufacturing because of the clerical and intellectual labor that is involved in the design and engineering of the vehicles.

Moreover, the following activities that result in custom products have always been viewed as a production activity: (1) the craftsman who builds a cabinet, desk, table, and chairs or a breakfront; (2) the seamstress who sews specially designed draperies; (3) the tailor who makes a suit of clothes; (4) the artist who paints using oils, watercolors, or pastels to produce a one-of-a-kind work of art; (5) the sale by a carver of a one-of-a-kind duck or bird; and (6) the sculptor of the one-of-a-kind object.

The Comptroller also supported his argument that the creation of custom products must always be treated as services by citing *Comptroller v. Equitable Trust Company*, 296 Md. 459 (1983). In *Equitable*, the Maryland Court of Appeals considered the sales and use tax treatment of sales of "canned" computer programs as opposed to custom software. Though the case contained a discussion regarding the tax treatment of custom programs, the Anne Arundel Circuit Court correctly recognized that such a discussion was *dicta*. *Equitable* is a case concern-

ing the sales and use tax treatment of “canned” software programs, nothing should be read into the decision regarding the treatment of custom software let alone all custom products. In *Equitable*, it was noted (296 Md. at 480) that half the states treated custom software as taxable for sales and use tax purposes.

The Comptroller’s central argument was that the products produced by EDA and EDM should receive the same tax treatment as custom computer programs because they are both custom products. This argument is fatally flawed because the tax treatment of custom software in Maryland is prescribed by a statute. The Maryland General Assembly’s decision to codify the sales and use tax treatment of custom software, as stated in the legislative history of the statute, reflects a policy decision intended to attract high-tech businesses to the state by precluding a future change in the Comptroller’s administrative policy that currently exempted it from sales and use taxation. To state that the ED Companies’ products should be treated the same way as custom software would require the Court to legislate a new exemption. Such a policy decision is best left, as both the Tax Court and Circuit Court noted, to the Maryland General Assembly.

The work performed by the ED Companies was a service, contended the Comptroller, because EDA’s and EDM’s employees were highly skilled professionals. Testimony from the presidents of EDA and EDM demonstrated that employees of each company were not engineers or professionals, and in fact many employees did not even hold a college degree. The employees were technicians who, in some cases, received a few weeks of in-house training followed by over-the-shoulder instruction and received compensation in the low \$30,000s to a maximum in the \$40,000s.

The Comptroller found support for its position in the First Edition of the *ASPRS Manual of Photogrammetry*, published in 1944. The 1944 Manual concluded that the mapping products

were the result of a service because they were performed by engineers. However, by the 1990s, as a result of technological advances, technicians were capable of performing the work previously done by engineers. This is reflected in the most recent edition of the *ASPRS Manual of Photogrammetry* which classifies the items delivered by the ED Companies as products rather than services. The Carolina Distinguished Professor, Dr. John R. Jensen, testified that the employees performing these activities were not professionals or highly skilled any more than factory workers operating technical machinery on the assembly line.

Finally, the Comptroller attempted to draw comparisons to California’s tax treatment of custom maps. This analogy was ineffective as the Comptroller failed to provide a single reason for Maryland to follow California’s lead, nor did the Comptroller point to any similarity between California and Maryland sales and use tax law. Moreover, the Comptroller’s argument was based on an annotation to the California Administrative Code, which is not binding on taxpayers or the State, and was based on decisions issued in the 1950s and early 1970s.

Conclusion

The Comptroller’s voluntary dismissal of his appeal demonstrates Maryland’s acquiescence in the Tax Court’s holding that the activities performed by the ED Companies are production activities and not services. Companies such as the ED Companies, whose activities involve data collection and analysis with a final tangible product provided to their customers, need not pay sales and use tax on purchases of equipment, including aircraft, photographic sensors, computers, software, and services used to produce their product, or on intermediate transfers to other companies participating in various stages of the production process. Any sales or use tax is owed on the sale of the product to the customer which may be exempt, as was the case with the ED Companies.

USB drives are a Flash

Sneaker-net—that’s what they used to call carrying a floppy disk between computers to transfer files. And the highest capacity floppy was 1.44 **Megabytes**. In the last couple of years, sneaker-net has resurfaced using USB flash drives. My first held 16 megabytes. Now 16 **gigabyte** drives are affordable, 1 and 2 gigabyte drives cost less than \$10. And they are handy for more than transferring files. Back up those critical files each day and carry the drive home with you. Carry important documents, such as scanned images of your passport, medical records, etc. separately from your computer. Even if it gets lost or stolen, you have what you need.

My favorite new flash drive is a 4 gigabyte A-Data PD15. It’s about as thick as a credit card and half the size of regu-

lar flash drives (think the same size as the key fob versions of your office supply or grocery store loyalty card). It lives in my wallet and is available anywhere I might need my data, or someone has a file that they want to open. One problem with the A-Data PD15, it’s not really meant to live in a wallet. The SuperTalent Pico C is a bit thicker, but has a metal case to protect it. And it still fits in a wallet, but with a bulge. [Gregg Marshall, CPMR, CSP, can be reached by e-mail at gmarshall@reconnection.com, or visit his website at <http://www.reconnection.com>.]

