

## PA Supreme Court Rejects "Sheetz Test" for Sales Tax Purposes

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In a consolidated decision issued on December 21, 2011, the Pennsylvania Supreme Court reversed the Commonwealth Court's 2009 decisions in *Northeastern Pennsylvania Imaging Center v. Commonwealth* and *Medical Associates of the Lehigh Valley, P.C. v. Commonwealth*, which had held that MRIs and other medical scanning systems installed in the taxpayers' imaging centers became part of the "real estate" under the *Sheetz* test discussed below, so that the taxpayers were entitled to a refund of sales tax paid on their purchase and lease of installed scanning systems. The Supreme Court held that the scanning systems retained their identity as tangible personal property after installation, but remanded the cases to the Commonwealth Court for consideration of the taxpayers' argument that the Department of Revenue's denial of their refund claims violated the Uniformity Clause of the Pennsylvania Constitution because the Department had granted refunds to other similarly situated taxpayers. The Commonwealth Court did not address the Uniformity Clause issue because it had ruled in favor of the taxpayers on the merits.

More significant than the particular ruling in this case was the Supreme Court's holding that the "test" enunciated in *Commonwealth v. Beck Electric Construction, Inc.*, 403 A.2d 553 (Pa. 1979), rather than the standard enunciated by the Commonwealth Court in *In re Appeal of Sheetz*, 657 A.2d 1011 (Pa. Cmwith. 1995), *appeal denied*, 666 A.2d 1060 (Pa. 1995), applies for purposes of determining whether property that is attached to real estate becomes a permanent part of the real estate for sales and use tax purposes. This "realty-personalty" analysis determines whether a contract with a non-exempt entity for the sale and installation of property constitutes a "construction contract" (in which case the installed property is "used" by, and taxable to, the installer) or a sale of tangible personal property (in which case the installer claims the resale exclusion when purchasing the property and collects any applicable sales tax from the purchaser).

While the sales tax consequences of contracts with non-exempt entities depend on whether the property being installed becomes part of the real estate, neither the Sales and Use Tax statute nor the Department of Revenue's regulations define the term "real estate." The Department's regulation at 61 Pa. Code § 31.11 lists items that are presumed to become a permanent part of the real estate upon installation and items that are presumed to remain "tangible personal property," but that regulation contains no explicit test for determining whether an item becomes part of the real estate. Since the term "real estate" is not defined by statute or regulation, the parties in *Northeastern* and *Medical Associates* took the position that the common law doctrine of fixtures, as delineated in the *Sheetz* case, represented the proper standard.

In *Sheetz*, the Commonwealth Court articulated a three-factor test for determining whether items become part of the real estate for property tax purposes. Under the *Sheetz* test, in determining whether items that are affixed to real estate, but can be removed without material injury to themselves or to the real estate, are realty or personalty, the following three factors must be considered: (1) the manner in which the item is physically attached or installed, (2) the extent to which the item is essential to the permanent use of a building or other improvement, and (3) the objective intention of the parties. The Supreme Court rejected

use of the *Sheetz* test for sales and use tax purposes on the basis that *Sheetz* was a real estate tax case, which involved a different tax statute, and there is apposite Supreme Court precedent (“*Beck*”) which addresses the issue of whether a contractor is a “user” of goods or a “vendor” entitled to claim the “resale” exclusion.

The *Beck* test has been characterized by the courts as involving a determination as to whether property is “easily” removable without damage to itself or to the surrounding real estate. The Supreme Court did not establish an independent “realty-personalty” test in *Beck*, however, but simply construed the Department of Revenue’s regulations in effect at the time. While both the *Sheetz* and *Beck* tests require a consideration of the method of attachment to the real estate, the *Sheetz* test also takes into account whether an item is an integral part of the real estate, as it is currently being used. By way of contrast, some of the items that were held to remain tangible personal property in *Beck* were integral parts of the electrical systems of the buildings in which they were installed.

The Supreme Court purportedly relied on *Beck* to conclude that the medical scanning systems in these cases did not become part of the real estate after they were installed in the imaging centers. Nevertheless, the Court did not analyze the ease with which the scanning systems could be removed from the imaging centers or whether such removal would damage the real estate. Rather, after stating that the *Beck* test applied, the Court analyzed the character of the medical scanning systems by simply comparing those systems to other items listed in the Department’s regulation that are found “in a medical setting.” The Court essentially determined that the scanning systems remained tangible personal property because they were “more like x-ray equipment than a nurses’ station.”

Based on the Court’s analysis in the *Northeastern* and *Medical Associates* cases, the tax treatment of items affixed to real estate remains unclear in the context of contracts with non-exempt entities. For example, the Court relied almost exclusively on its interpretation of the Department’s regulation to conclude that the scanning systems remained tangible personal property. It is not clear, therefore, whether the *Beck* “test” involves anything more than an evaluation of the lists of presumptions in the Department of Revenue’s regulation at 61 Pa. Code § 31.11. The presumptions listed in the Department’s regulation apply “in the absence of satisfactory evidence to the contrary,” but the Court has not articulated what evidence would be required to overcome these presumptions. To the extent the Court’s decision stands for the proposition that any item that can be removed and replaced remains tangible personal property under the *Beck* test, then many items that are presumed to become part of the real estate under the Department’s regulation, and under letter rulings issued by the Department, would presumably remain tangible personal property under the Court’s analysis.

The taxpayers filed Applications for Reconsideration with the Supreme Court in early January, requesting, among other things, that the Court reconsider and clarify the parameters of the *Beck* test and the interrelationship of that test with the Department’s regulations. As of the time this article was written, the Court had not yet acted on the Applications for Reconsideration.

Contractors and other taxpayers will need to carefully evaluate their tax compliance procedures in light of this decision. For advice concerning the tax implications of the Supreme Court’s decision on contracts for

the sale and installation of items affixed to real property, please contact [Sharon Paxton](#) or another member of the McNees State and Local Tax group.

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