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PA TAX LAW NEWS

WHEN DO ELECTRICITY GENERATION ACTIVITIES QUALIFY AS "MANUFACTURING" FOR PA SALES AND USE TAX PURPOSES? *By Sharon R. Paxton*

The Pennsylvania Department of Revenue has issued a series of rulings that machinery and equipment used in the generation of electricity qualify for the Sales and Use Tax manufacturing exclusion. *See* Ruling No. SUT-10-001 (April 7, 2010) (machinery, equipment, parts and supplies for a solar energy facility, for which the electricity output will be transferred to a public utility through a high voltage transmission system, qualifies for the manufacturing exclusion); Ruling No. SUT-03-032 (July 1, 2003, reissued July 2, 2008) (machinery, equipment, parts and supplies used to generate electricity through "combined cycle technology," using generators driven by both fuel-fired combustion and steam turbines, qualifies for the manufacturing exclusion); Ruling No. SUT-00-190 (December 12, 2000, reissued October 7, 2008) (production of electricity through the use of wind turbines qualifies as manufacturing). These rulings are based on the Department's determination that the production of electricity constitutes the "manufacture of tangible personal property" because the sales tax statute defines "tangible personal property" to include "electricity for non-residential use." *See* 72 P.S. § 7201(m).

The Department of Revenue recently issued Sales and Use Tax Bulletin 2010-01 (July 28, 2010), which is intended to further "clarify when a person's activities rise to the level of being engaged in the business of manufacturing electricity," in order to be eligible to claim the manufacturing exclusion on the purchase of equipment, machinery, parts and supplies used directly in the generation operations. The Bulletin states five requirements for being engaged in the "business" of manufacturing electricity, which are similar to the requirements for eligibility to claim the in-house printing exemption (e.g., conducting the activities in a distinct location, providing separate accounting or interdepartmental billing, and conducting electricity production activities that are "of sufficient size, scope and character that they could be conducted on a commercially viable basis separate and distinct from any other business activities").

The Bulletin specifically states that (1) back-up or emergency generators and (2) residential electric systems such as solar panels/photovoltaic systems and windmills (regardless of whether some of the electricity is sold) do not qualify for the manufacturing exclusion.

The Bulletin also provides information on the manner in which an exemption certificate should be completed by a construction contractor when claiming exemption for property that will be transferred to an electricity producer for use directly in manufacturing electricity. Based on the content of this Bulletin, contractors have been put on notice that the manufacturing exclusion does not apply when they purchase property for installation as part of a residential electric generation system.

The sales tax statute explicitly requires that manufacturing activities be "engaged in as a business" in order to qualify for exclusion. *See* 72 P.S. § 7201(c). It is questionable, however, whether every requirement stated in Bulletin 2010-01 must be satisfied in order to meet the statutory prerequisite that electricity production activities be "engaged in as a business." It is well established that the manufacturing exclusion applies to machinery and equipment used to manufacture tangible personal property for "use" by the manufacturer as well as to manufacture property for resale to

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others. If your company utilizes equipment to produce electricity for use in its other business operations, but does not satisfy all of the requirements set forth in the Bulletin, you may still have a viable claim to the manufacturing exclusion.

Although it has been the Department of Revenue's longstanding position that the production of electricity constitutes "manufacturing" for Sales and Use Tax purposes, no Pennsylvania court has yet addressed the issue. The tax statute limits the manufacturing exclusion to machinery and equipment used in the manufacture of "tangible personal property." *See* 72 P.S. § 7201(k)(8)(A). The production of electricity does not fall within the "traditional" concept of manufacturing tangible personal property (i.e., having tangible material as a starting point and a continuity of existence of the material into the final product), and the Commonwealth Court has refused to extend the exclusion to the production of certain other "services" included within the statutory definition of "tangible personal property." *See Bell Atlantic Mobile Systems, Inc. v. Commonwealth*, 799 A.2d 902 (Pa. Cmwlth. 2002), *aff'd per curiam*, 845 A.2d 762 (Pa. 2004) (holding that production of cellular telecommunications services does not qualify as "manufacturing" even though such services were then included within the statutory definition of "tangible personal property"). While the Department has consistently ruled that electricity production qualifies for the sales tax manufacturing exclusion, a letter ruling technically may be relied upon only by the particular taxpayer that obtained the ruling, based upon the facts supplied. *See* 61 Pa. Code § 3.3. Therefore, given the lack of direct guidance by statute or court decision, and the fact that the methods of producing electricity are continually evolving, we recommend that companies obtain a private letter ruling from the Department to confirm that their electricity production activities qualify for the manufacturing exclusion prior to constructing new facilities or expending significant sums on equipment for operating facilities. ■

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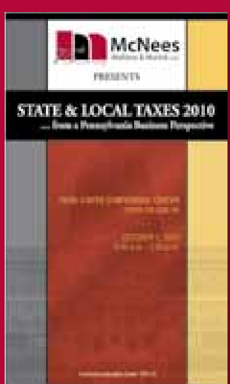

Two Seminar Dates and Locations

STATE & LOCAL TAX SEMINARS - YOU'RE INVITED!

The McNees SALT Group will be presenting a full-day seminar titled **"State and Local Taxes 2010 … from a Pennsylvania Business Perspective"** on Friday, October 1st at the Penn Stater Conference Center in State College and Friday, November 5th at Eden Resort and Suites in Lancaster.

The morning program will feature a series of panel discussions covering recent developments and current issues in PA Sales & Use Tax, PA Corporate Taxes, Unclaimed Property, PA Fuel Taxes, Local Taxes and Real Estate Taxes. The AM program also will focus on proposed federal legislation potentially impacting state taxation, Pennsylvania's prospective natural gas severance tax, and tax increase options most likely to be considered in next year's budget deliberations.

The afternoon program will offer a series of state tax skills sessions covering "Local Taxes on Pennsylvania Businesses," "What Every Business Needs to Know About Their Abandoned and Unclaimed Property Reporting Obligations," "PA Fuel Tax Tips," "PA Sales Tax on Services" and a State Tax "Nexus" primer.

The full-day program will qualify for 8.0 CPE credits. Business owners, managers and tax personnel, as well as independent accounting professionals, are invited to attend. The cost is $99.00 per person and includes a buffet lunch. More information and a registration form may be accessed from the main page of McNees' website (www.mwn.com), by clicking the "Newsroom" tab and selecting "Events."

PA REINSTATES VOLUNTARY COMPLIANCE PROGRAM *By James L. Fritz*

The Pennsylvania Department of Revenue has reinstated its voluntary disclosure program, which had been suspended during the Commonwealth's recent tax amnesty. Program guidelines are the same as before the amnesty, except that the 5 percent amnesty nonparticipation penalty mandated by the amnesty legislation will not be waived.

Under Pennsylvania's Voluntary Disclosure Program, taxpayers who have outstanding Pennsylvania tax liabilities and are as yet unknown to the Department may come forward and qualify for a limited look-back period as well as general penalty abatement (excepting the 5% amnesty penalty).

The limited look-back period for non-corporate taxes is three years plus the current year. Taxes in this category include sales and use tax, employer withholding tax and personal income tax. In the case of trust fund taxes (collected sales tax and withheld personal income tax), there is no limited look-back period but general penalty abatement may be obtained.

A look-back period of five years plus the current year applies to corporate taxes. These include gross receipts tax, corporate net income tax, franchise tax, etc.

Corporate taxes of foreign and domestic corporations registered with the Pennsylvania Department of State and Revenue Department are not eligible for the Voluntary Disclosure Program. But, the non-corporate tax liabilities of those companies will qualify where the company is not registered for the non-corporate tax.

Participants in the Voluntary Disclosure Program must waive their right to appeal any taxes submitted under the program. Generally, we initiate a voluntary disclosure case by contacting the Department on a "blind" basis to obtain a "case number." We then compile certain information and submit it to the Department, again on a "blind" basis. If the voluntary disclosure submission is accepted, the Department provides a standard Voluntary Disclosure Agreement for taxpayer execution. After the Agreement is signed by all parties, returns and tax payments due for the applicable look-back period are submitted.

Some companies which do not qualify for Pennsylvania's Voluntary Disclosure Program because they are already known to the Department may still have options available to seek partial relief. Of course, if there is a legal question as to whether tax is owed, one or more tax returns may be filed to precipitate an assessment that can be appealed - sometimes we have been able to use a single tax return as a vehicle to initiate a "test case" to give us an opportunity to negotiate a settlement on an issue affecting several tax years. If a company has already been assessed and failed to file a timely appeal, we may be able to pursue a collections compromise based on doubt as to liability or on inability to pay.

The bottom line is that if your company thinks back taxes may be owed to Pennsylvania (or another state, for that matter), we may be able to save your company some money, and probably some serious aggravation, by pursuing the appropriate course to resolve your tax exposure. ■

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JIM FRITZ SELECTED FOR INCLUSION IN "*THE BEST LAWYERS IN AMERICA*"

Jim Fritz again has been selected for inclusion in *The Best Lawyers in America*, in the category of Tax law. According to the publisher, selection to the 2011 edition of *Best Lawyers* was based on an exhaustive and rigorous peer-review survey in which more than 39,000 leading attorneys cast almost 3.1 million votes on the legal abilities of other lawyers in their practice areas. Jim has been with McNees Wallace & Nurick LLC since 1987 and serves as the chair of the McNees State and Local Tax group. His practice focuses on resolving Pennsylvania state and local tax controversies at the audit level, through administrative appeals and by court appeals. ■

COMMONWEALTH COURT ADDRESSES CALCULATION OF INSURANCE COMPANY RETALIATORY CHARGES

The Commonwealth Court has ruled that the Pennsylvania Department of Revenue may not ignore New Jersey's statute capping a foreign insurer's taxable premiums at 12.5% of worldwide premiums when determining what amount, if any, of Pennsylvania Retaliatory Charges must be paid by a New Jersey insurance company doing business in Pennsylvania. Calculation of the retaliatory charge requires more than simply a comparison of New Jersey and Pennsylvania premium tax rates. The Department must determine what amount of tax would be paid to New Jersey by a Pennsylvania insurance company doing the same amount of business in New Jersey that the New Jersey insurance company has done in Pennsylvania. *Selective Way Insurance Co. v. Commonwealth*, No. 429 F.R. 2008 (June 30, 2010). ■

NATURAL GAS SEVERANCE TAX PROPOSALS

By Randy L. Varner

Act 46 of 2010, more commonly known as Pennsylvania's 2010-2011 budget bill, contained a commitment by the General Assembly to pass a natural gas severance tax by October 1, 2010, with an effective date of no later than January 1, 2011. This article will provide a brief summary of things to watch for as the General Assembly "makes the sausage" this month. Severance taxes throughout the United States are generally based on the volume of gas extracted, the value of gas extracted, or a combination of the two. In the case of a tax based on the volume of gas extracted, there is a flat rate in terms of cents per thousand cubic feet (MCF). The gas is simply metered through the well as it is extracted. The problem with the volume method is that it does not take into account the value of the gas being extracted. For instance, when gas prices are very high, the taxing jurisdiction will not share in the increased revenues. Conversely, when gas prices are very low, the tax may be a severe impediment to extracting the gas at all.

The alternative is to tax the value of gas extracted "at the wellhead," which means before any deductions are made for transportation and distribution costs. The downside of this type of tax is that it is difficult to forecast for state budgeting purposes. It is also more difficult to enforce the tax, because sales and prices must be monitored and audited, rather than simply reading a volume meter at the wellhead.

A balance would be to enact a "hybrid" tax that takes into account both volume and value. A hybrid tax spreads the risk by imposing a tax on the volume extracted, as well as a tax on the value of gas extracted. The hybrid method allows budget makers some certainty, doesn't overly burden producers when prices are low, and allows the state to benefit when prices are high.

Governor Rendell proposed a hybrid tax based upon the West Virginia model. Several other bills in the General Assembly also propose to impose tax on a hybrid method. All but one of the pending bills impose a tax of 5 percent at the wellhead and an additional 4.7 cents per MCF extracted—the same rate imposed by West Virginia. One bill in the House is more aggressive in its imposition, using 8 percent at the wellhead and 8 cents per MCF extracted as its formula.

Several volume-based bills also have been introduced and vary from imposing 25 cents per MCF extracted to a high of 35 cents per MCF extracted. All of these bills contain provisions allowing the state to benefit when prices are high by adjusting the rate based on pricing determined by the New York Mercantile Exchange.

Various exemptions have been proposed. Most of the bills that have been introduced contain a "Stripper Well" exemption which would exempt wells producing less than 60,000 cubic feet per day from tax. Another common exemption is for shallow wells, which typify most of the "pre-Marcellus Shale" wells. Finally, the producers have been arguing for a phase-in period which would allow them to recapture some development costs before becoming subject to tax.

The pending bills also vary somewhat in how the revenues from the tax would be used. Potential recipients include the General Fund, local governments and the Game Commission, among others. How the Commonwealth decides to use the revenue is likely to be just as contentious as the fight over what form the tax is to take. We will provide a summary of whatever passes in a future newsletter. ■

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