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This Week in State Tax (TWIST)

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Maryland: State Supreme Court upholds treatment of certain electrical transmission and distribution equipment as being involved in 'processing'

The Supreme Court of Maryland partially resolved a long-running controversy between the Comptroller and a public utility company involving the sales and use tax treatment of equipment used in transmitting and distributing electricity to customers. The Court affirmed the Appellate Court of Maryland determination that certain of the taxpayer's transmission and distribution equipment was exempt from sales and use tax as it was used directly and predominantly in a production activity. The Supreme Court also upheld the appellate court determination that the taxpayer was entitled to interest on any timely refund. There was also an issue of the appropriate statute of limitations (not addressed further here) on which the high court reversed and remanded the case to the appellate court to consider the taxpayer's arguments centered on the defense of equitable estoppel.

The procedural history of the case is extensive. In 2006, the taxpayer informed the Maryland Comptroller that it believed most of its transmission and distribution equipment qualified for the state production activity exemption. Maryland law exempts from sales and use tax the purchase of tangible personal property used "directly and predominantly" in a "production activity," which is further defined to include "assembling, manufacturing, processing, or refining tangible personal property for resale." The taxpayer argued that much of the equipment used to transmit and deliver electricity subjects the electricity to a series of actions intended to deliver electricity most efficiently at usable voltages to its customers and therefore constitutes "processing" for purposes of the production activity exemption.

The Comptroller commenced an audit, during which the taxpayer also sought a refund of certain tax payments it had erroneously made. The Comptroller denied both the refund request and the assessment challenge based on the view that the exemption did not apply to the transmission and distribution equipment. On appeal, the Maryland Tax Court, followed by the Circuit Court for Baltimore County, affirmed the Comptroller.

The taxpayer then sought its first review by the appellate court which held that some of the taxpayer's equipment should qualify for the production activity exemption as there was definitely processing of the electricity going on, thereby requiring a remand to the Tax Court. On remand, the Tax Court determined that conductor, substation, and transformer equipment qualified as being used directly and predominantly in processing electricity because they were continually involved in changing the form and characteristics of the electricity to ensure delivery to the customer in a useable form. It denied the exemption for other items, including foundation support structures and electric meters used to measure customer usage. It was on remand to the Tax Court that the statute of limitations issues was first raised by the Comptroller. The Comptroller appealed to the Circuit Court of Anne Arundel County next, which affirmed the Tax Court on the applicability of the exemption but reversed on the issue of the

Comptroller's statute of limitations defense. That occasioned a second trip to the appellate court which upheld the Tax Court and circuit court determinations on the equipment exemption issue but reversed the circuit court on the statute of limitations issue.

In the present appeal to the Supreme Court of Maryland, the Court upheld the Tax Court's exemption determinations, concluding that the taxpayer's transmission and distribution system "subjects the electricity to a series of actions designed for the specific objective of delivering, over long distances, electricity generated out of State, to Maryland customers at a voltage suitable for their use. Such equipment is, therefore, used for 'processing' and, as such, performs a 'production activity'" under state law. The Court also found that the Tax Court had relied on the "directly and predominantly" standard found in the state's regulations and that the Tax Court's findings were supported by substantial evidence.

For more information on *Comptroller of Maryland v. The Potomac Edison Company*, please contact Glenn Todd.