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State Tax Alert

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Illinois Supreme Court Closes the Circuit and Zaps Two Tax Codes

On February 20, 2009, the Illinois Supreme Court ruled that for purposes of the Investment Tax Credit ("ITC") against the Illinois Personal Property Replacement Income Tax,[1] a sale of electricity is a sale of tangible personal property. The case involved a public utility's claim that it was engaged in the occupation of "retailing" when making sales of electricity. *Exelon Corporation v. Department of Revenue*, Ill. S.Ct. No. 105582 (Slip.Op. Feb. 20, 2009), ___ Ill. 2d ___ (2009). The ITC is a .5 percent credit that may be applied against the Replacement Income Tax by taxpayers engaged in retailing, manufacturing, or mining of coal or fluorite. The credit is allowed for qualified property, which is tangible, depreciable, and acquired by purchase, and with a useful life of at least four years when placed in service in Illinois. The court's decision has important implications for purposes of both Illinois income tax and Illinois sales and use tax.

The court treated its own 52-year-old holding in *Farrand Coal Co.* that electricity is not tangible personal property for Illinois sales and use tax purposes as "*obiter dicta*," not binding as precedent. The majority perceived the real issue in *Farrand Coal* to be whether coal used in electricity production was consumed in the power generation process, and thus was tangible personal property, whereas the dissent perceived the issue to be (we believe correctly) whether electricity was tangible personal property such that coal consumed to generate it was purchased for resale and thus could be exempt from sales and use tax. However, approaching the issue of whether *Farrand Coal* was *stare decisis* (settled binding precedent) as a matter of law, the majority applied *de novo* review (unhampered by lower court or administrative rulings) and was therefore free to hold, for the first time, that it could "now join the several courts that have held in varying contexts that electricity constitutes 'tangible personal property.'"[2] Consequently, the court held that Exelon's Commonwealth Edison subsidiary was properly engaged in the occupation of "retailing" when making sales of electricity, and so it qualified to claim the ITC.

By not treating *Farrand Coal* as *stare decisis* on the question of whether electricity is tangible personal property for purposes of the ITC, the majority's decision does not technically represent a "change" in the law—after all, according to the majority, *Farrand Coal* did not need to be overruled because its dicta was not determinative judicial *dicta*, but rather it was surplus *obiter dicta* that was misperceived as its holding for the past 52 years for purposes of *both* the Illinois sales and use tax and the Illinois income tax laws. Nonetheless, the court's decision raises some intriguing income tax issues, including whether:

- The production of electricity qualifies as "manufacturing" for ITC purposes. There are older cases holding electricity production and distribution is a service, but these predate deregulation and did not factor in that electricity would be held to be tangible personal property.
- The sale of electricity nevertheless remains the sale of a service for income tax apportionment purposes. The legislature has specifically provided for apportionment of utility service income as apportionment of a sale other than tangible personal property, but this decision does provide occasion to ponder whether that should remain the appropriate treatment (a sale of service need not be devoid of a tangible personal property component).
- There are other types of sales of services or personal property heretofore deemed intangible that ought now be characterized as the sale (or manufacture) of tangible personal property, such that the service providers can be characterized as engaged in the occupation of "retailing" or "manufacturing" for purposes of the ITC.

Largely becaue of *Farrand Coal* and earlier decisions, Illinois has not taxed electricity sales under the sales and use tax laws, unlike many other states. There is a highly structured and specific Illinois tax scheme in the Public Utility and the Electricity Excise Tax laws governing the sale and purchase of electricity. Classifying electricity as tangible personal property should not lead automatically to

the conclusion that the sales and use tax laws apply to the sale and purchase of electricity, not only because of the specificity of the tax structure already in place, but also because of the existing precedents characterizing the sale of electricity as a sale of service. However, some sales and use tax issues may need to be reconsidered as a result of the *Exelon* decision, including whether:

- Generation of electricity should qualify as a "manufacturing process" for purposes of the sales and use tax "manufacturing machinery and equipment" (MME) exemption.
- Wind power turbine generators qualify for the MME, so that they (and possibly other qualifying machinery and equipment) can be tax exempt even if not installed within an Enterprise Zone, as most are now.
- Raw materials for electricity-generation qualify for the resale exemption as their energy is now included in the electricity produced (this *was* the issue in *Farrand Coal Co.*, as the *Exelon* dissent correctly notes).

It is premature to speculate on these and other such issues until the Department of Revenue's response to the *Exelon* decision is known. The state has 21 days from the date of the ruling to request a rehearing; otherwise, the mandate will issue to the lower court no earlier than 35 days. Should a rehearing not be requested, or should such a request be denied, the case will be remanded to the Department of Revenue to grant the ITC claim. Of course, legislative options remain open to all interested parties, as the spring session is just getting underway.

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[1] 35 ILCS 5/201(e)

[2] 35 ILCS 5/201(e)

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