

Pennsylvania Tax

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Pennsylvania Supreme Court Reverses Its Previous Decisions Regarding the Public Utility Exclusion from Sales and Use Tax

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SUMMARY

By opinion issued August 21, 2002, the Pennsylvania Supreme Court changed the standard for determining when a public utility qualifies for an exclusion from Pennsylvania sales and use tax. The Supreme Court's decision in *City of Philadelphia v. Commonwealth of Pennsylvania*, 803 A.2d 1262 (2002), overruled its previous determinations, and held that the public utility sales and use tax exclusion is available for the construction of facilities to be "predominantly" rather than "exclusively" used for public utility service.

The City of Philadelphia claimed a public utility exclusion for property purchased and used to build a taxiway, a tunnel and a baggage claim facility at the Philadelphia International Airport. These facilities were available for use by common carriers and nonpublic utilities. The Pennsylvania Commonwealth Court, applying the holdings of prior Supreme Court decisions, found that the public utility exclusion was not available to the City of Philadelphia because the uses for which these facilities were put were not exclusively for public utility services. On appeal, the Supreme Court reversed the Commonwealth Court and expressly overruled its prior decisions. It held that the public utility exclusion was available because the record demonstrated that these facilities would be predominantly used by a public utility.

The Tax Reform Code of 1971 provides for an exclusion from the Pennsylvania sales and use tax to provide for "the purchase and use of tangible personal property and services predominantly and directly used in producing, delivering or rendering public utility service, or

constructing, repairing and maintaining facilities used directly in producing, delivering or rendering public utility service." 72 P.S. § 7201(k)(8)(C) and (o)(4)(B)(ii); 61 Pa. Code § 32.34. Prior to *City of Philadelphia*, the Supreme Court interpreted this language to provide for a public utility exclusion only where the constructed facilities were to be "exclusively" used by public utilities. See *Commonwealth v. Erie Excavating and Grading Company*, 248 A.2d 191 (Pa. 1968) and *Commonwealth v. Public Constructors, Inc.*, 248 A.2d 29 (Pa. 1968). This well-established case law provided guidance for the Pennsylvania courts for over twenty-one years, but was often regarded by many practitioners as in conflict with the relevant statutory language.

The issue before the Pennsylvania Supreme Court in *Erie Excavating* was focused upon whether the exclusion was available to a contractor who constructed a roadbed to be used exclusively by a public utility pursuant to a contract with a nonpublic utility entity. When examining that issue, the Supreme Court noted that where a facility is designed for use in a public utility service, and,

was contracted to be constructed *solely* for use in a public utility service, and the contractual commitment by and among the interested parties lent reasonable certainty to the ultimate use of the facility to the purposes for which it was designed and constructed

the public utility service of the public utility exclusion applies. 248 A.2d at 193 (emphasis in original). Thus, if a contractor was constructing a facility that was to be used *solely* as a public utility service, the contractor could claim the public utility exclusion from sales and use tax

for purposes of those items or services rendered in conjunction with that construction activity.

In *Public Constructors*, an opinion dated the same day, the Supreme Court evaluated whether materials used in the construction of runways for two airports qualified for the public utility exclusion. The Supreme Court held that because the airports, and their runways, were not used *exclusively* by common carriers, which are considered to be public utilities, the public utility exclusion did not apply. In doing so, the Supreme Court stated that the objective of allowing an exclusion from tax for public utilities would only be fulfilled where the facility was “used exclusively by the public utility.” 248 A.2d at 31.

To overrule this clear precedent, in the *City of Philadelphia*, the Supreme Court returned to the language of the relevant statutory provisions. In the Tax Reform Code, the General Assembly defined sale at retail, in relevant part, as follows:

it shall be presumed that such tangible personal property or services are utilized for purposes constituting a ‘sale at retail’ and subject to tax *unless the user thereof proves to the Department that the **predominant purposes** for which such tangible personal property or services are utilized do not constitute a ‘sale at retail.’*

72 P.S. § 7201(k)(9) (emphasis added). Similarly, where tangible personal property or services are utilized for purposes constituting a use,

it shall be presumed that such property or services are utilized for purposes constituting a ‘sale at retail’ and subject to tax *unless the user thereof proves to the Department that the **predominant purposes** for which such property or services are utilized do not constitute a sale at retail.*

72 P.S. § 7201(o)(5) (emphasis added). According to that language, if a taxpayer can demonstrate that the

predominant purpose of the property or services is excluded from the definition of sale at retail, that property or services is not subject to sales and use tax.

Interpreting this language in conjunction with the express exclusion applicable to public utilities, 72 P.S. § 7201(k)(8)(C) and (o)(4)(B)(ii), the Supreme Court expressly overruled its prior holdings and held that:

A sale or use of tangible personal property is taxable unless the taxpayer demonstrates that the *predominant purpose* of the sale or use is excluded.

This decision expands the application of this exclusion. When beginning a construction project, a public utility should take care to not only properly allocate the construction costs associated with the use of the facility for public utility versus non-utility purposes, but should also allocate the projected use of the constructed facilities between non-utility use and utility use. If the latter allocation demonstrates that the facility would be predominantly used for public utility purposes, the costs of the construction could be excluded from sales and use tax.

If a contractor or public utility has made a payment of sales and use tax within 3 years prior to the date of this decision, or has received an assessment within 3 years prior to the date of this decision, that entity may file a petition for refund with the Pennsylvania Department of Revenue. The petition must be filed within 3 years from the date of that payment or assessment.

FOR FURTHER INFORMATION

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