Illinois Supreme Court Ruling Raises Questions Regarding Sourcing Regulations and Sales Tax Rules

In *Exelon Corp. v. Dep’t of Rev.*, Docket No. 105582, 2009 III. LEXIS 188 (Ill. Feb. 20, 2009), a divided Illinois Supreme Court held that electricity is tangible personal property for purposes of Sec. 201 of the Illinois Income Tax Act. *Exelon* represents a change in the State’s longstanding position regarding the treatment of electricity for state income tax purposes. Nationally, states are split regarding whether sales of electricity are sales of tangible personal property, sales of intangible property, or sales of a service. In some cases, states have conflicting positions depending on the type of tax at issue.

**Background**

Exelon Corporation challenged the Illinois Department of Revenue’s denial of its claims for replacement tax credits for investments in “qualified property” under 35 ILCS 5/201(e). The Circuit Court and the Appellate Court agreed with the Department’s denial of the credits. The dispute in this case centered around whether the taxpayer engaged in “retailing” under 35 ILCS 5/201(e). For a taxpayer to be engaged in retailing, it must sell tangible personal property. The Department took the position that the taxpayer was not engaged in retailing because the taxpayer sold electricity and electricity is not tangible personal property.

The Income Tax Act does not define “tangible personal property.” The debate thus centered around whether, under existing case law, electricity was tangible. The lower courts agreed with the Department’s contention that “the classification of electricity as intangible property” had already been conclusively determined in *Farrand Coal Co. v. Halpin*, 140 N.E.2d 698 (1957). However, the Illinois Supreme Court held that *Farrand Coal* was not dispositive because the court’s discussion in that case as to whether electricity was tangible personal property was simply an aside (obiter dicta) and not necessary to the holding in *Farrand Coal*. Thus, the Illinois Supreme Court undertook its own analysis as to whether electricity met the dictionary definition of “tangible.”

**Sutherland Observation:** The court’s detailed discussion of the scope and role of obiter dicta in judicial decision making illustrates that courts are not bound by stare decisis simply because an issue was discussed in a previous case. Before determining that an earlier discussion of an issue is binding authority, the Illinois Supreme Court’s decision provides that a court must first determine if the discussion is an extension of an opinion on a point in the case which is deliberately passed on by the court as not necessary to the disposition of that case or an expression of the court which is “uttered as an aside.”

**Is Electricity Tangible Personal Property?**

The Illinois Supreme Court ruled that, based on the dictionary definition of “tangible” and the modern scientific understanding of electricity, electricity is tangible. The court found expert testimony stating that electricity “can be sensed (felt, tasted, seen, and heard), measured, weighed, and stored…” to be

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1 *Exelon Corp. v. Dep’t of Rev.*, 376 Ill. App. 3d 918 (2007).
2 See *Exelon Corp. v. Dep’t of Rev.*, 376 Ill. App. 3d 918, 922 - 923 (2007).
persuasive. Noting advances in the scientific community’s understanding of electron theory of electricity, the court accepted the expert’s position.

**Sutherland Observation:** The classification of electricity as tangible personal property for purposes of the Illinois income tax has ramifications not only for credit eligibility but also for nexus and Illinois apportionment calculations.

As of December 31, 2008, Illinois changed its sourcing rules for its corporate income tax apportionment formula. Receipts from the sale of most services are in the state if the services are received in the state. The legislation required the Department to adopt rules defining where utility services are received. Early this year, the Illinois Department of Revenue issued a proposed rule for the “Sale, Transmission and Delivery of Electricity.” Because both the Department’s authority and its regulations are premised on electricity not being tangible personal property, the *Exelon* decision may affect the applicability of the proposed regulations as currently drafted. This is particularly true for the wholesale sale of electricity. The statute mandates that sales of tangible personal property be sourced to the state in which the property is shipped or delivered. The proposed regulations, however, source receipts from the wholesale sale of electricity based on the location of the customer’s office that entered the transaction, the customer’s billing address, or based on an independent system operator load ratio. Other provisions of the proposed regulation, such as the sourcing of receipts from transmission services, should remain unaffected because the purchase of electricity is not directly involved.

The classification of electricity as tangible personal property also raises nexus and P.L. 86-272 questions. Illinois has generally noted that merely holding title to electricity in the state did not create nexus. Similarly, selling electricity in the state was not protected by P.L. 86-272. The *Exelon* opinion may reverse both of these positions because electricity is now tangible personal property.

### Other Jurisdictions

The *Exelon* court notes that its decision is consistent with other state court decisions in California, Rhode Island, Florida and Alabama that have expressly held in varying contexts that electricity is tangible personal property. Other states that have (in the absence of legislative pronouncements) judicially determined electricity to be tangible for tax purposes include: Tennessee and Arizona.

Though the court aligns itself with other states treating electricity as tangible personal property, there are states that treat the sale of electricity as a sale other than a sale of tangible personal property (e.g., a service or intangible) for purposes of state income and/or sales taxes. For example, the Massachusetts Appellate Tax Board ruled electricity is not tangible personal property when sourcing receipts for the sales factor of the Massachusetts apportionment formula. *EUA Ocean State Corp., et al. v. Comm’r of Revenue*, Mass. App. Tax Bd., Nos. C258405-406, C258424-425; C258882-883; C259158-159; C259653; C262566-568 (April 24, 2006). For sales tax purposes, the Indiana Tax Court ruled that electricity was not tangible personal property for application of the sale for resale exemption. *Mynsberge v. Dep’t of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999).

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4. Id. at 23.
Sutherland Observation: In General Information Letters, the Illinois Department of Revenue has consistently taken the position that electricity is not tangible personal property for purposes of Illinois Retailers’ Occupation (Sales) Tax. It is not clear whether Exelon will affect the Department’s treatment of electricity for purposes of the Retailers’ Occupation Tax. If the Department follows Exelon for the Retailers’ Occupation Tax, this creates opportunities for claiming the machinery and equipment exemption to the Illinois sales tax available under 35 ILCS 120/2-5. The exemption applies to the gross receipts of “[m]achinery and equipment that will be used by the purchaser… primarily in the process of manufacturing or assembling tangible personal property…” 35 ILCS 120/2-5(14) (emphasis added). Taxpayers should consider filing sales tax refund claims for tax paid on purchases of machinery and equipment used to manufacture electricity. Note, however, that at least one state—California—has decisions that treat electricity as tangible personal property for one type of tax but not for the other. Interestingly, these California decisions treat electricity as not tangible personal property for purposes of its franchise/income tax but are tangible personal property for purposes of its sales tax.

If you have any questions regarding this Legal Alert, or the services we provide, please feel free to contact the attorneys listed below or the Sutherland attorney with whom you regularly work.

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