June 2009

State Tax Return

Volume 16 Number 2

Holding Back the State Tax Tide: Exelon's Victory in Illinois Proves That It Pays to Fight

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States are under mounting pressure to increase revenues in the wake of the financial crisis and resulting slowdown in economic activity. A recent Rockefeller Institute report shows a 16 percent decline in personal income tax collections, the steepest decline since 2002.[1] Other revenue sources are off as well. Corporate income tax collections are also down by 16 percent, and sales and use taxes have fallen by 8 percent. At the same time, the demands on the states' social service systems are expanding. With job losses come losses in private health insurance coverage and increasing Medicaid and Medicare burdens. The revenue situation is not expected to improve in the near term. In fact, the Rockefeller study expects a sharper decline in collections.

Many states had taken an aggressive posture toward corporate taxpayers even before the mortgage derivative meltdown. New York and other states have moved to expand their respective definitions of "nexus" in an effort to broaden their reach to out-of-state taxpayers. And taxing authorities across the country are revisiting formally settled interpretations of their governing laws in hopes of finding additional revenues. Taxpayers, meanwhile, are girding themselves for the inevitable audits and administrative battles that will follow. Ultimately, taxpayers are likely to find the administrative process less receptive to reason than they once were and for that reason should prepare themselves for litigation in the state courts. One recent case from Illinois shows that the state courts are still amenable to the taxpayer.

[1] http://www.rockinst.org/newsroom/news_releases/2009/2009-05-13-state_tax_collections_plummet.aspx.

Exelon Corporation is the nation's largest electric and gas utility. In 1996, Unicom, an entity later merged into Exelon, filed a return and paid a substantial "personal property tax replacement income tax" imposed by section 201(c) of the Illinois Income Tax Act. Later, Unicom timely filed an amended return claiming approximately $15 million in offsetting investment tax credits under the same section, which allows such credits to, among others, "retailers." The Department of Revenue denied the credit, reasoning that the statute defined "retailing" as "the sale of tangible personal property or services rendered in conjunction with the sale of tangible consumer goods or commodities." Unicom filed an administrative protest and failed in its argument that electricity qualified as "tangible personal property." Following its succession, Exelon timely challenged the administrative determination in the Illinois appellate courts.

The court of appeals found language in a 1957 Illinois Supreme Court decision to foreclose any argument over whether electricity is tangible. That case, *Farrand Coal Co. v. Halpin*, 10 Ill. 2d 507 (1957), dealt with a coal producer's attempt to avoid a sales tax on the coal it sold to an electric utility on the theory that it was effectively selling energy for resale. In the process of rejecting the argument that the coal company was selling energy rather than coal, the court's opinion also rejected the assertion that "energy," as coal or electricity, had a distinct, tangible quality apart from the material from which it was produced. Relying on this language, the court of appeals affirmed.

Undeterred by an unbroken string of losses, Exelon sought review in the Illinois Supreme Court. The supreme court reversed, finding its discussion of the nature of electricity in *Farrand* to be dictum. Free of the stare decisis burden, the court had little difficulty siding with Exelon on the merits. While the court agreed that, lacking a statutory definition, *Farrand* had properly turned to *Webster's Dictionary* in defining the word "tangible" as something "corporeal" or "capable of being touched," the court agreed with the expert opinion tendered in the administrative process confirming that electricity has a physical corporeal property.

The Illinois Supreme Court's decision is important for several reasons. First, and most directly, the opinion's acceptance of electricity as a tangible commodity for state tax purposes adds Illinois to the growing rank of state courts of last resort that have so held under a variety of statutory settings, including California, Arizona, Alabama, Florida, Tennessee, and Rhode Island.[2] But perhaps just as important is the example Exelon has set here. By pressing the issue to the Illinois Supreme Court, it has claimed a backwards-looking tax credit, brought Illinois law into line with the law in other states, and established a potentially important precedent.

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[2] *Curry v. Alabama Power Co.*, 8 So. 2d 521, 526 (1942); *Tucson Electric Power Co. v. Arizona Dep't of Rev.*, 822 P.2d 498 (Ariz. App. 1991); *Searles Valley Minerals Operations, Inc. v. State Bd. of Equal.*, 72 Cal. Rptr. 3d 857, 862 (2008); *Narragansett Elec. Co. v. Carbone*, 898 A.2d 87, 97-98 (R.I. 2006); *Davis v. Gulf Power Corp.*, 799 So. 2d 298, 300 (Fla. App. 2001); *Texas Eastern Trans. Corp. v. Benson*, 480 S.W. 2d 905, 908 (Tenn. 1972). *But see Mynsberge v. Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999).

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