

Salt trends

A PwC state and local tax publication

September 2012



- Managing the dynamic taxability and tax rate environment in the utility industry is a challenging task, especially for entities operating in multiple jurisdictions.
- In the power and utility industry, certain key areas are being heavily audited. In particular, there is an increase in audit activity with respect to repairs and maintenance, construction contracts, and software and related services.
- As facilities are repaired, expanded, remodelled, or newly constructed, the indirect tax rules regarding construction contracts vary widely and are often complex.
- Some utilities are starting to recognize that new technology can potentially qualify for property tax exemptions, thus lowering above the line operating costs.

Re-energizing state taxes in the utilities industry

In a world of economic uncertainty and state budget deficits, taxpayers are facing increased pressure from both the financial and tax side of the house. Different industries have been adjusting to this increase in pressure in unique ways. This article provides above the line tax tips to taxpayers in the utilities industry that can help face these challenges head on.

Improve your indirect tax processes

In today's economic environment, state budgets are being stretched and revenue agencies are tasked with finding revenue to make up these shortfalls. These shortfalls are typically made up via expansions to the base or increases in the tax rate. While a single rate change or taxability change in a single state may be simple enough to track, managing this same information across multiple jurisdictions is a challenging task.

In the utility industry, the power supply itself, as well as additional fuel surcharges, delivery/infrastructure charges, and public utility fees may have differing taxability across jurisdictions. Outside of the underlying taxability determination, rate changes occur frequently across jurisdictions, with over 400 rate changes occurring nationwide in

2011. New taxes regularly pop up targeted at utility providers and users.

Managing the dynamic taxability and tax rate environment is a challenging task, especially for entities operating in multiple jurisdictions. For retail electricity providers, the task may be more daunting considering the thousands of individual customer addresses and their corresponding tax jurisdictions. Many large organizations increasingly rely on indirect tax software to remove some uncertainty around these issues. Most tax software providers provide monthly or quarterly updates to their software rate packages to account for fluctuations in tax rates. Many software providers also provide as part of their maintenance packages similar taxability decision updates to reflect changes in taxability across jurisdictions. The utility of these updates is largely dependent on the level

of integration of the software and the degree to which any tax decisions rely on pre-populated and maintained tax decisions.

Using a software package and updating it in a timely manner provides a greater control over tax rate changes and taxability adjustments than relying on mailed notices from the state revenue agencies. Many times these hard copy notices may not arrive at the tax department in a timely fashion, and as a result, tax rate changes or taxability adjustments are not implemented when necessary, leaving potential liabilities as a result.

Similar to the billing and collection of sales and pass through taxes, many companies also employ a third party software platform to assist in making use tax determinations. With thousands of accounts payable invoices potentially processed on a weekly basis, it is difficult to train accounts payable staff to review and make accurate tax determinations on invoices coming into the company. This becomes more difficult in decentralized operations, with accounts payable/purchasing staff located in multiple geographic locations. Commercially available software products for use taxes function similar to the sales tax software (many in fact have both modules), provide customizable tax determination rules and allow for updated tax rates across jurisdictions. An automated tax decision system allows for better control over prevailing exemptions (e.g. exempting equipment in certain cost centers) while still providing assurance with regard to use tax accruals on purchases not qualifying for exemption.

Watch your tax base

To further complicate matters, the expanding alternative energy market is providing a unique set of challenges to both utility providers and state revenue agencies; in particular, the increasing acceptance of 'net metering'.

Net metering allows reductions to billings based on alternative energy generated by the individual consumer through the use of solar power, wind, or fuel cells. The challenge of net metering from an indirect tax perspective, is determining the base on which the tax should be calculated. If a customer consumes \$100 of electricity in a month, but through a solar panel generates a \$25 credit for electricity returned to the grid, the taxable base could be either \$100 or \$75. While most states exclude 'discounts' from the tax base, it is unclear from state policy perspectives whether this credit qualifies as a discount. These issues may become more prevalent as consumers look to supplement their existing utility supply with alternative sources.

Manage your audits (not the other way around)

Throughout the US, state and local taxing agencies are challenging taxpayers resulting in increased indirect tax assessments on taxpayers. Mounting state deficits and departmental budget cuts are spurring state tax departments to shift headcount to bolster audit staff. State tax departments are providing new audit staff with less training and support and encouraging such less experienced auditors to elevate audit decisions typically made in the field. As a result, the audit process has become more burdensome and more contentious.

Matters once handled at the field audit level are now being elevated to a more experienced supervisory auditor and sometimes even appeals. Clearly, the state tax departments are trying to do more with less, resulting in increased frustrations on the part of taxpayers. Status quo with respect to state tax indirect audits is a thing of the past.

In the power and utility industry, certain key areas are being heavily audited. In particular, there is an increase in audit activity with respect to repairs and maintenance, construction contracts, and software and related services.

Repair and maintenance expenses continue to be hot audit areas with uncertainty in many states between repairs versus capital improvements. Key questions focus on the interplay between tangible personal property and real property and when repairs to or additions of tangible personal property are considered improvements to real property. For example, in New Jersey, capital improvement means an installation of tangible personal property which increases the capital value or useful life of the real property (land or buildings). The item installed must be permanently attached to the real property.¹ What is considered permanently attached to real property is often subject to debate. Given the uncertainty in this area, it is important to document the components of the repair/improvement, detailing labor versus material costs, and available exemptions.

¹ New Jersey Regulation 18:24-5.7.

As with repairs and maintenance, understanding the provisions of the construction contract and detailing the component costs can significantly impact audit assessments. Third party construction contracts can be particularly challenging since amounts billed to the customer are often lump-sum progress billings. Therefore, the preservation of contracts is critical to understand the nature of the work, provide a listing of major material purchases, and title passing provisions. For example, in California, auditors are increasingly focusing on title passage provisions of tangible personal property purchased or facilitated by the contractor to convert what would historically be considered a sales tax transaction to a use tax obligation. Due to the importance of this topic, it is discussed in more detail later in this article.

The use of software and related services in the power and utility industry continues to expand with emerging technologies such as smart meters and other remote controlled data retrieval devices. As state tax laws play catch up to changes in technology, the taxability of computer software and related services continues to evolve. Key issues relating to the taxation of software involve the method of delivery used when purchasing software, whether software is prewritten versus custom software, and subsequent optional or mandatory maintenance or repair contracts for the underlying software. For companies operating in multiple states, the issues are compounded by needing to not only

identify the taxability in the jurisdiction in which the software is purchased, but also the jurisdictions where the software is used. Issues arise when trying to determine the appropriate taxing jurisdiction. For example, in *7-Eleven Inc. v. Combs*, the Texas Comptroller argued that the true purpose of the purchase of financial software was not to resell to franchises but rather to automate all out of state third party franchises for the benefit of the parent company in Texas and therefore the entire purchase price of the software should be sourced to Texas.²

Take advantage of exemptions when possible

While sales tax collection responsibility is a significant concern for retail electricity providers, the power generation business has significant challenges of its own. With few exceptions, purchases of tangible personal property and select services not intended for resale are subject to sales/use tax. In instances where vendors do not charge sales tax (perhaps due to lack of nexus with a particular jurisdiction), it is the purchaser's responsibility to accrue and remit use tax on the transaction.

However, many jurisdictions provide sales/use tax exemptions for machinery and equipment used in a manufacturing operation, including the generation of electricity. While state revenue agencies are seeking ways to raise revenue, companies are likewise looking for ways to reduce costs. Proper application of available exemptions is important to ensure that companies capture the

statutorily afforded exemptions and do not place themselves in a competitive disadvantage compared to companies that more diligently capture those exemptions.

Exemptions can be moving targets, since states provide exemptions for manufacturing equipment, but do not necessarily define where that process begins or ends and what specific pieces of equipment qualify from one type of manufacturing operation to the next. Understanding the manufacturing process from an operational standpoint is critical for a tax department to fully understand the types of equipment used and the applicability of the exemptions to these equipment purchases.

Capitalize on your construction contracts

Large facility operators find complexity in the varying rules across the states regarding construction contracts. As facilities are repaired, expanded, remodeled, or newly constructed, the indirect tax rules regarding construction contracts vary widely and are often complex. Contract structure (e.g. lump-sum versus separated contract), may impact the overall taxability of the contract. Additionally, in states like Texas, the contract structure may negatively impact the availability of a manufacturing exemption for incorporated materials. The type of contract may impact the taxability. In states like New York, the taxability of a contract may be dependent upon the classification as a capital improvement or as routine maintenance. Making this determination up front with the project teams could result in tax savings for

² *7-Eleven Inc. v. Combs*, Texas Court of Appeals 03-08-00212-CV (4/22/2010).

companies undertaking capital projects. The dollar value typically involved in large construction contracts often makes the additional front-end due diligence worth the investment.

Document your loss contingencies

The combination of sales tax collection responsibilities and use tax liabilities on purchases provides a number of avenues for risk and potential tax liabilities to arise. In recent years, regulatory agencies and auditors have placed more attention on reserves for contingent liabilities. With this increasing scrutiny by external parties, it is becoming more important for corporate tax departments to understand the possibility for liabilities in the indirect tax area. Increased regulation has focused on uncertain tax positions in income tax filings, and corporate tax departments have appropriately allocated resources to that effort. However, an exposure draft issued by FASB in 2010 hinted at the possibility that similar disclosures may soon be required for indirect taxes as well.

Indirect tax has not always been a focus area when reviewing loss contingencies. In many instances, the contingency is put in place when an audit workpaper is issued. However, with increasing scrutiny in this area, companies may begin looking in more detail at the full range of possible loss contingencies in the indirect tax area. This should include a review of current audit inventory as well as a review of large liability jurisdictions to at least validate that significant liabilities are not expected on future audits.

Identify embedded software to lower property tax liabilities

Although advanced technology is not new to the utility industry, the passage of the American Recovery and Reinvestment Act of 2009 sparked a renewed interest in smart grid technologies and with over \$3B of Smart Grid Investment Grants awarded, many companies have made and continue to make significant investments in smart grid equipment and technology. Some utilities are starting to recognize that this new technology can potentially qualify for property tax exemption, thus lowering above the line operating costs.

Drawing on a recent California Court of Appeals case, *Cardinal Health 301, Inc. v. County of Orange*³, utilities have begun reviewing their property tax base for exemptions. In *Cardinal Health*, the taxpayer argued that its Pyxis MedStation 2000 was a series of stand-up medicine storage cabinets with a built-in computer, 99% of whose value is proprietary computer software systems. In California, as well as many other states, 'application' software, as distinct from 'basic operational' software, is exempt from personal property taxes.⁴ The taxpayer argued, and the court agreed, that the value of the 'embedded' software (i.e. the application software) should be exempt from tax.

Utilities are now arguing that embedded software in a smart meter should be exempt from property tax.

A comprehensive smart grid program entails the installation of a large number of smart meters. A large utility, for example, will install approximately 10 million meters as part of its program. Other programs are smaller, such as one with 4.5 million meters. Although the cost of a single meter may not be significant from a property tax perspective, when the number of meters is in the millions, the potential for savings is significant.

The main difference between a smart meter and a traditional analog meter is the advanced technology within a smart meter. Both devices measure a customer's usage of power. However a smart meter contains advanced technology and software allowing it to perform additional functions. This software comprises a portion of the value of a smart meter and may qualify for exemption. Many states exempt some variation of intangible property, software in general or application software from personal property tax. The value of the exemption depends on the state and often whether or not a taxpayer is centrally assessed. (Most states centrally assess utilities, but not all.) The challenge is proving what portion of the value of the property is exempt as embedded software. An engineering study may need to be done to analyze and support the exempt value.

³ *Cardinal Health 301, Inc. v. County of Orange*, California Court of Appeals, 167 Cal. App. 4th 219 (9/30/2008)

⁴ Cal. Rev. & Tax Code §§ 995, 995.2.

Of course, these exemptions apply to more than just smart meters. A smart grid program typically involves purchases of advanced technology housed at the utility itself. Parts of this equipment likely qualify as well. Moreover, portions of the traditional utility infrastructure potentially qualify—SCADA systems, relays, remote switch actuator, capacity bank control, etc. Thus, savings opportunities may exist in many fixed asset areas.

Summary

Utilities, both rate-regulated and non-regulated, continue to face pressure to reduce operating costs. From a tax perspective, it is challenging environment where states are facing budget deficits and maintain and increasing their audit activity. Nevertheless, there are ways to help reduce above the line taxes in the utility industry. Due to the large volume of transactions in the utility space, basic process improvements can impact the amount of tax going out the door, either through payments to vendors, direct payments to states, or on audit. Pursuing exemptions, both for sales and use tax as well as property tax, can also reap significant rewards. While in the past this type of attention and focus has been given to federal and state income tax, experience shows that given the same level of attention, indirect taxes can become a wealth of tax savings opportunities.

Let's talk

For more information on this topic, please contact one of the following:

Jim Manley
Managing Director
Detroit, Michigan
(313) 394-6518
james.r.manley@us.pwc.com

Jeff Lemmons
Director
Houston, Texas
(713) 356-5796
jeff.lemmons@us.pwc.com

Mary Crane
Manager
San Francisco, California
(415) 498-5025
mary.crane@us.pwc.com

pwc.com/us/tax

This document is provided by PricewaterhouseCoopers LLP for general guidance only, and does not constitute the provision of legal advice, accounting services, investment advice, or professional consulting of any kind. The information provided herein should not be used as a substitute for consultation with professional tax, accounting, legal, or other competent advisors. Before making any decision or taking any action, you should consult a professional advisor who has been provided with all pertinent facts relevant to your particular situation. The information is provided 'as is', with no assurance or guarantee of completeness, accuracy, or timeliness of the information, and without warranty of any kind, express or implied, including but not limited to warranties of performance, merchantability, and fitness for a particular purpose.

Solicitation

© 2012 PricewaterhouseCoopers LLP. All rights reserved. PwC refers to the United States member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details. This document is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.