

Michigan – Equipment used to distribute and convert electricity qualifies for industrial processing sales and use tax exemption, appellate court invalidates Department rule

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UPDATE: On October 1, 2014, The Michigan Supreme Court granted a petition to appeal the January 9, 2014 decision by the Michigan Court of Appeals.

In brief

Purchases of machinery and equipment used to distribute and process electricity qualified for the state's industrial processing sales and use tax exemption. The Michigan Appellate Court found that a taxpayer's transmission and distribution equipment provided industrial processing because it changed the form and character of electricity by increasing and decreasing the electricity's voltage and by changing the electricity's current. The court held that a contrary regulation was invalid and unenforceable. [[*Detroit Edison Company v. Department of Treasury*](#), Mich. Ct. App. No. 309732 (1/9/14)]

In detail

Facts

During the tax period at issue, from January 1, 2003, to September 30, 2006, Detroit Edison Company (DTE) was an electric utility providing electricity to residential, commercial, and industrial customers. DTE produced and generated electricity at its generation plants, and transmitted and distributed electricity through its 'Electric System' (a network of machinery and equipment including substations,

transformers, towers, cables, and poles). The Electric System increased and decreased the electricity's voltage and changed an electricity's current as it left the generation plant. According to DTE: (1) the characteristics and quality of electricity continue to change throughout DTE's Electric System and (2) electricity is not usable by a consumer until it passes through the Electric System.

DTE claimed the industrial processing use tax exemption for purchases regarding its Electric System for the tax

period at issue. Following a 2009 audit, DTE paid the use tax under protest and filed suit with the Court of Claims, which ruled in DTE's favor. The Department appealed to the Michigan Appellate Court.

Industrial processing exemption – Changing and testing tangible personal property

Relevant portions of Michigan's sales and use tax exemption for industrial processing provide an exemption for:

"the activity of converting or conditioning tangible personal property *by changing* the form, composition, quality, combination, or character of the property for ultimate sale at retail . . . Industrial processing begins when tangible personal property begins movement from raw materials storage to begin industrial processing and ends when finished goods first come to rest in finished goods inventory storage." [emphasis added]

Additionally, the industrial processing exemption includes the activity of "inspection, quality control, or testing to determine whether particular units of materials or products or processes conform to specified parameters."

Electric System changes tangible personal property

For Michigan sales and use tax purposes, tangible personal property includes electricity. The court found that the terms "form, composition, quality, combination, or character" were sufficiently broad and expansive to encompass voltage and current changes as electricity passes through the Electric System.

Accordingly, the court held that DTE's Electric System converted or conditioned electricity "by changing the form, composition, quality, combination, or character of the property for ultimate sale." The court acknowledged that electricity was not a finished good in a form to be used by consumers until the electricity passed through DTE's Electric System.

Electric System also inspects, tests, and controls electricity

DTE asserted that its Electric System processed, monitored, tested, and maintained electricity and other equipment in the system. DTE

claimed that it was required to constantly monitor, test, and control its electricity and equipment in order to comply with state regulations. The Department offered no contrary argument to DTE's position and the court's decision did not include a detailed analysis of this issue. The court concluded that Michigan law provides that such testing and control activities qualify as industrial processing.

Machinery and equipment used for both distribution and industrial processing may qualify for the industrial processing exemption

Michigan provides that industrial processing does not include distribution activities. The Department argued that DTE's Electric System distributed electricity and therefore the system could not qualify for the industrial processing exemption.

The court disagreed, holding that DTE was entitled to the industrial processing exemption in full, despite the fact that its Electric System was used, in part, for a nonexempt purpose (i.e., distribution), because the machinery and equipment were concurrently used to also industrially process electricity.

Michigan regulation invalidated

Michigan regulation 205.115(4) provides, in part, that the "sale of tangible personal property consumed or used in the transmission or distribution of electricity . . . is taxable. Such transmission or distribution starts at the place where the product leaves the immediate premises from which it is manufactured."

The court recognized that this rule would clearly preclude the exemption sought by DTE. However, the court found that the rule is "invalid and unenforceable" because it conflicts with the court's interpretation of Michigan's industrial processing exemption statute.

The takeaway

Michigan now joins several other states in holding that the transmission and distribution system of an integrated utility performs manufacturing-like activities (pending any appeal by the Department). While this is a taxpayer victory, it remains to be seen whether the legislature will respond by amending the statute, as it has a past history of doing. While this case will directly impact taxpayers that transmit and distribute electricity in Michigan, it should also provide non-Michigan based taxpayers significant food for thought when contemplating a similar challenge in other states.

Let's talk

If you have any questions concerning the *Detroit Edison* decision, please contact:

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