

THE POTOMAC EDISON COMPANY

*

IN THE

*

vs.

MARYLAND TAX COURT

*

COMPTROLLER OF THE TREASURY

*

No. 12-SU-OO-0644 & 0645

*

MEMORANDUM AND ORDER

This matter is before the Court after its original decision was appealed and then reversed and remanded back with instructions by the Court of Special Appeals. Potomac Edison Company ("Potomac Edison"), Petitioner, filed a claim for refund of sales and use taxes it paid between 2003 and 2007 with respect to processing equipment it had purchased for use in transmitting and delivering electricity to its customers in Maryland. Potomac Edison claims that the equipment it purchased was using "production activity" as "assembling, manufacturing, processing, or refining tangible personal property for resale," and further provides that electricity is tangible personal property for purposes of the production activity exemption. The Maryland Comptroller of the Treasury ("the Comptroller") contends that the processing of electricity in Potomac Edison transmission and distribution system does not qualify as a production activity.

The Court of Special Appeals ruled that the Potomac Edison processing activities were performed within the statutory definition of "production activity." The equipment purchased by Potomac Edison for use directly and predominantly in a "production activity" is exempt from sales and use tax. Maryland Code (1988, 2016 Repl. Vol.), Tax General Article ("TG"), §11-101(f). The Court of Special Appeals further found that there was no genuine dispute that some degree of processing was required between the point at which Potomac Edison received the electricity from the generating plant and the point of delivery to its

residential and commercial customers. Consequently, on remand, the principal issue remaining before this Court is which equipment was used “directly and predominantly” in “processing” the electricity Potomac Edison Company sold. Any consideration of which equipment is exempt from taxation requires a consideration of the following relevant statutes and Comptroller regulations:

Maryland Tax Gen. §11-210(b). Machinery for Manufacturing and Research

The sales and use tax does not apply to a sale of:

- (1) tangible personal property **used directly and predominantly in a production activity** at any stage of operation **on the production activity site** from the handling of raw material or components to the movement of the finished product, **if the tangible personal property is not installed so that it becomes real property;**
- (3) **a foundation to support other machinery or equipment** or an item required to conform to an air or water pollution law and **normally considered part of real property.**

Maryland Tax Gen. §11-101(f)(1). Definitions

“Production activity” means:

- (i) except for processing food or a beverage by a retail food vendor, assembling, manufacturing, **processing**, or refining **tangible personal property** for resale;

Code of Maryland Regulation (“COMAR”) 03.06.01.32-2. Tangible Personal Property

Used in a Production Activity

B. In this regulation, the following terms have the meanings indicated:

- (2) “Used directly and predominantly in a production activity” means the:

(a) Use of the property is integral and essential to the production activity, occurs where the production activity is carried on, and occurs during the production activity; and

(b) Property used both in production activities and administrative, managerial, sales, or any other operational or nonoperational activities is used more than 50 percent of the time directly in production activities.

COMAR 03.06.01.19. Real Property Construction, Improvement, Alteration, and

Repair

C. Determination of Material as Real Property.

(3) ...Machinery used in a production activity retains its character as tangible personal property without regard to the method or permanency of its annexation to real property. Farm equipment, a foundation in support of machinery and equipment used in a production activity and any machinery, device, or equipment which is required for conformance with air or water pollution laws or regulations retain their character as tangible personal property.

Potomac Edison claims that its transmission and distribution system, with over 1,000 miles in transmission lines and approximately 10,000 miles in distribution lines, is one massive production activity site spanning the point where electricity is first purchased on Potomac Edison's transmission lines to the point the electricity enters the customer home. The electricity production begins in a power plant and through a synthesized process continues the

transmission and distribution system up to and including the customer's meter. It contends that every single component of its system is used directly and predominantly in a production activity, and it seeks a refund for taxes paid on the equipment in its system, and a reduction of the assessment issued against it for the period from August 2003 through July 2007.

The Court shall review the numerous pieces of disputed equipment in five categories:

1. Conductor - equipment such as the utility wire and electrical components, as well as related protective devices which carry voltage.
2. Distribution - equipment such as electric meters which measure and provide performance data and quality control on voltage for the step-down transformer.
3. Foundation Support Structures - items such as the clamps, bolts, brackets, cross-arms, pole mounts and pad mounts which support the equipment.
4. Substation - machinery and equipment that change voltage, as well as other essential and integral items.
5. Transformer - machinery and equipment, such as overhead or distribution transformers, as well as pad mount ground transformers, that change voltage, as well as other essential and integral items.

The Court agrees with the Petitioner that conductor equipment produce and continually process the required current through conductor wires and cables by stripping, or harnessing, electrons from the atoms in which they reside and directing them to move in an organized, unified manner. The Petitioners' expert witness explained that the aluminum and copper wires and cables are used as conductors because these metals readily donate and

receive electrons. The electrons cause the atoms to change from neutral to positive ions and the cumulative effect of the electrons' movement in the conductor is an electric current.

The conductors are vital, interactive parts of the process by which electricity is produced. Thus, absent the conductors and the current that Potomac Edison Company produces in them, electricity in the form that consumers use could not be produced and would not exist. The Court finds that the conductor equipment is exempt.

The Court also finds that the transformer and substation equipment are also exempt. This equipment produces and constantly processes the voltage of the electricity that customers purchase and consume. Electricity leaves a power plant with a voltage of roughly 20,000 volts and has no practical use for consumers and cannot be sold. The finished product that customers use in their homes and businesses varies based upon customer needs. Commercial customers generally require electricity at a higher voltage than residential customers that must have a voltage of just 120 to 240 volts. Potomac Edison uses a series of transformers, substations, and other related equipment to continually process the physical composition of the electricity by increasing (stepping up) and decreasing (stepping down) its voltage. The processing of electricity takes place through transformers and substations by allowing the electrons to migrate through the system in order to process and reduce their high voltage to lower voltage. The result of the voltage reduction process is useable level of voltages for commercial or residential use such as 120/140 volts.

However, the Court finds that the distribution equipment and foundation support structure are not exempt from taxation. The distribution equipment which consists mainly of electric meters are necessary to measure the amount of electricity used by the customer. They do not change or process electric power and thus are not used in the production activity. The "support structures" category includes items such as cross arms, clamps, bolts, brackets,

pole mounts, pad mounts, poles, and other structures provide physical support for the system. This equipment does not transform, substantially or otherwise, electric power.

Potomac Edison's conductor equipment, substation equipment and transformer equipment are used directly and predominantly in "processing" electricity—not the delivery of electricity. This holding is consistent with the Court of Special Appeals' holding in *Potomac Edison Company v. Comptroller*, No. 1645, Sept. Term 2016, 2019 WL 1897463, at *9 (April 29, 2019).

The conductors do not simply "deliver" electricity the way a conveyor belt or truck might deliver another product. To the contrary, electricity is processed and generated and produced from the beginning of the transmission and distribution system to the customer's light bulb. The conductors and transformers in the transmission and distribution system – not the power plant – are the very source of the electrons that migrate through the customer's load.

Furthermore, Potomac Edison uses a series of transformers, substations, and other related equipment to continually process the physical composition of the electricity by increasing (stepping up) and decreasing (stepping down) its voltage. Potomac Edison directly and predominantly processes the electrons in its transmission and distribution system in a step-up transformer; this allows the electrons to migrate efficiently over long distances. As electrons migrate through the transmission and distribution system, their high voltage must eventually be further processed and reduced to connect to lower voltage power lines. This voltage reduction occurs in transformers at Potomac Edison's substations.

For the reasons stated herein, Potomac Edison Company's conductor equipment, substation equipment and transformer equipment are exempt from sales and use tax pursuant to Tax Gen. §11-210(b) and the corresponding Comptroller regulations.

However, the distribution equipment and foundation support structure are not exempt from sales and use tax.

The Court additionally finds that the Comptroller is estopped from asserting that the Extension of Limitations Agreement does not apply to Potomac Edison's refund claim at issue. Bill Cole, the Comptroller's auditor, represented that the Extension of Limitations Agreement extended Potomac Edison's ability to file a refund claim. Potomac Edison reasonably relied on Mr. Cole's representations, as those representations followed the Comptroller's policy at the time for allowing valid refund claims under executed statute of limitations waivers by both parties. Thus, the Comptroller is estopped from asserting that Potomac Edison's refund claim does not cover the full period at issue, extended by the Extension of Limitations Agreement.

The Court next finds that Potomac Edison is entitled to interest under Tax Gen. § 13-603. The tax paid was not paid as a result of Potomac Edison's own error or mistake. Rather, Potomac Edison was following Comptroller policy to pay tax on the categories of equipment based on the Comptroller's misreading and interpretations of the appropriate statutory exemptions.

Therefore, the Court concludes that Potomac Edison is entitled to a refund in the amount of \$2,420,163.20 plus credit interest up to the date of issuance of the refund by the Comptroller. In so holding, the Court adopts the calculations of Potomac Edison. Specifically, Potomac Edison demonstrated at the trial that it is entitled to a refund relating to its conductor equipment in the amount of \$1,149,488.10; relating to its substation equipment in the amount of \$636,646.07; and relating to its transformer equipment in the amount of \$634,029.03. In total, Potomac Edison is entitled to a refund in the amount of \$2,420,163.20 before credit interest.

With respect to Potomac Edison's Petition for Redetermination of the Comptroller's Audit, Potomac Edison's tax assessment should be reduced by \$1,198,119.14 based on the calculations set forth in Potomac Edison's Trial Exhibit 20 for the exempt categories of items. The resulting amended audit tax assessment is \$559,743.04, and the Comptroller should calculate interest due on that balance up to and through the date of Potomac Edison's audit tax payment. Considering Potomac Edison paid the total tax assessment of \$1,757,872 on or around May 6, 2011, once the amended tax assessment and interest due amounts are applied to Potomac Edison's audit payment, Potomac Edison will be owed a refund plus credit interest calculated forty-five days from May 6, 2011, of the amount of the audit overpayment through the date of issuance of the refund.

Potomac Edison is entitled to a refund and assessment reductions of sales and use tax overpayments. Accordingly,

1. The assessment shall be amended,
2. The prior audit payment shall be applied to the amended assessment, with any additional balance plus credit interest being refunded, and
3. The sales and use tax erroneously paid to the Comptroller shall be refunded, and interest shall be applied to the amount of sale and use tax refunded to Potomac Edison Company based on the refund claim.

Date Issued: March 17, 2022

CC: Alexander T. Mitchel, Esq.
Michael W. Fox, Esq.

CERTIFIED TRUE COPY
TEST: John T. Hearn, Clerk

NOTICE: You have the right of appeal from the above Order to the Circuit Court of any County or Baltimore City, wherein the property or subject of the assessment may be situated. The Petition for Judicial Review **MUST** be filed in the proper Court within thirty (30) days from the date of the above Order of the Maryland Tax Court. Please refer to Rule 7-200 et seq. of the Maryland Rules of Court, which can be found in most public libraries.