

**CROSBY GUENZEL LLP**

FEDERAL TRUST BUILDING  
134 SOUTH 13<sup>TH</sup> STREET, SUITE 400  
LINCOLN, NEBRASKA 68508  
TELEPHONE: (402) 434-7300  
FACSIMILE: (402) 434-7303

WRITER'S E-MAIL: SGS@CROSBYLAWFIRM.COM  
WRITER'S DIRECT DIAL NO. (402) 434-7324

WILLIAM D. KUESTER  
STEVEN G. SEGLIN  
ROCKY C. WEBER  
DAVID A. JARECKE  
WILLIAM R. KUTILEK  
RICHARD L. RICE  
THOMAS E. JEFFERS  
JEFFREY A. GAERTIG

ROBERT C. GUENZEL (RETIRED)  
THEODORE L. KESSNER (RETIRED)

ROBERT B. CROSBY (1911-2000)  
THOMAS R. PANSING (1917-1973)  
DONN E. DAVIS (1929-1998)

December 9, 2004

Jay Holmquist  
General Manager  
Nebraska Rural Electric Association  
Box 82048, 800 So. 13<sup>th</sup> Street  
Lincoln, NE 68501

Re: Application of state sales tax to lease payments by PPDs to Municipalities

Dear Jay:

**QUESTION PRESENTED**

You have asked whether lease payments made by a public power district ("PPD") to a Municipality for the use and operation of such Municipality's electric system are subject to state sales tax.

**INTRODUCTION**

In order to analyze this question, there exist two inter-related transactions, which need to be examined in order to fully understand the question.

The first transaction involves the question of the recovery of the lease payment from the customers of the PPD. This recovery may occur in one of two ways. The first way is for the PPD to recover the lease payment as an overall expense of doing business. This would occur by increasing the rate to all electric customers which results in the recovery of the expense being included in the gross charge for electric service to all customers ("bundled charge"). The second way is for a PPD to separately charge its customers within such Municipality for recovery of the lease payment by including it as a line item charge on each customer's monthly statement ("unbundled charge").

The second transaction involves the question of whether the lease payment made to a Municipality for the right to use the Municipality's electric system, is subject to sales tax. This question comes to the forefront if the unbundled charge to customers within the Municipality is not subject to sales tax.

### **BRIEF ANSWER**

With respect to the recovery of the lease payment from its customers, if a PPD bundles its charge for the lease payment in its rate, it is subject to state sales tax on the gross receipts for electric service. Although it is not entirely clear, if a PPD unbundles its charge for the lease payment, a meritorious argument can be made that the unbundled charge is not subject to sales tax. In that event, no sales tax whatsoever would be paid on either of the inter-related transactions referred to in the Introduction.

With respect to whether the lease payment in the underlying transaction between a PPD and a Municipality is subject to sales tax, although it is not entirely clear, a PPD may be subject to a sales tax on this transaction, if it avoids paying sales tax on the unbundled charge to electric customers residing within the Municipality.

### **ANALYSIS**

#### **I. SALES TAX**

A state sales tax is imposed upon the gross receipts from all sales of tangible personal property sold at retail in this state, including the gross receipts of every person engaged as a public utility. *Neb. Rev. Stat.* §§ 77-2703(1) and 77-2701.02 (Reissue 2003).<sup>1</sup> Section 77-2703(1)(a) further provides that the sales tax is to be collected by the retailer from the consumer and remitted to the State as a debt owed by the retailer.<sup>2</sup> Gross receipts is defined as "the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers valued in money whether received in money or otherwise . . ." *Neb. Rev. Stat.* § 77-2701.16 (Reissue 2003).

A PPD is a "retailer"<sup>3</sup> for the purpose of § 77-2703 and is required to collect the state sales tax from the consumer upon the sale of "tangible personal property," which includes electricity,<sup>4</sup> unless the PPD elects to pay the sales tax and not collect it from the consumer.

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<sup>1</sup> Note: Upon approval by a majority of the voters, any Nebraska county or incorporated Municipality may impose a Local Option Sales and Use Tax at a rate of either 0.5%, 1%, or 1.5% which is applicable to the identical transactions subject to the state sales and use tax and added thereon. *See NEB. REV. STAT.* §§ 77-27,142 *et seq.*

<sup>2</sup> Section 77-2703(1)(b) allows a public utility to pay the sales tax without collecting it back from the consumer.

<sup>3</sup> *See NEB. REV. STAT.* §§ 77-2701.32 (defining "retailer" as "seller"), 77-2701.36 (defining "seller" as a "person"), and 77-2701.25 (defining "person" as "any, city, county, district, or other political subdivision of this state of any agency thereof.")

<sup>4</sup> *See NEB. REV. STAT.* § 77-2701.39.

In addition, beginning January 1, 2004, the rental arrangement between a PPD and a Municipality is a “lease” as the term is defined under *Neb. Rev. Stat. § 77-2701.18* (Reissue 2003). Moreover, a Municipality is a retailer with respect to the lease with the PPD, which may subject the lease payment by a PPD to a Municipality to a sales tax. (See footnote 3 above). Furthermore, a Municipality is engaged in the business of leasing in this State if it is “deriving rentals from a lease of property in this state (as a) retailer.” *Neb. Rev. Stat. § 77-2701.13* (Reissue 2003). Business is defined as “any activity engaged in by any person or caused to be engaged in by him or her with the object of gain, benefit, or advantage, either direct or indirect.” *Neb. Rev. Stat. § 77-2701.07* (Reissue 2003). These definitions are broad enough to include the underlying lease between the PPD and the Municipality, which may subject the transaction between a PPD and a Municipality to sales tax at the time payments are made.

The first question presented above of whether the recovery from a PPD’s customer of lease payments made by a PPD to a Municipality are subject to state sales tax hinges upon the statutory interpretation of the term “gross receipts.” Under *Neb. Rev. Stat. § 77-2701.16(7)*, “gross receipts” means “the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers.” “Gross receipts” of every person engaged as a public utility is further defined as:

*In the furnishing of gas, electricity, sewer, and water service, the gross income received from the furnishing of such services upon billings or statements rendered to consumers for such utility services; ...*

*Neb. Rev. Stat. § 77-2701.18(8)(c)* (Reissue 2003). (Emphasis added.)

The Nebraska Department of Revenue provides additional guidance on this issue under its sales and use tax rules and regulations, which define “gross receipts” as “the total amount of the sale or lease or rental price of retail sales by retailers, valued in money, whether received in money or otherwise.” 316 *Neb. Admin. R. & Regs.* 1-007.01 (2003). “Gross receipts,” among other things, include, “[t]he gross revenue received from furnishing gas, electricity, sewer and water service.” *Id.* at 1-007.01C. Gross receipts also includes “the gross revenue received from the sale, lease, rental, installation, application, repair, or maintenance of tangible personal property . . .” *Id.* at 1-007.01 F.

A PPD is required to impose and collect sales tax upon the recovery from its customers of the lease payments made by a PPD to a Municipality, if such recovery is included in the “gross receipts” of a PPD. As explained above, gross receipts of a public utility are those derived from the gross income from furnishing electric service. See *Neb. Rev. Stat. § 77-2701.16(8)(c)*, *supra*. It should also be noted that gross receipts includes gross revenues from the lease or rental of tangible personal property. See *Neb. Rev. Stat. § 77-2701.16(7)*.

It is clear that a PPD is required to collect and pay sales tax on the bundled charge to its customers for electric service as such charge is included in the rate and is aggregated with the gross receipts for electric service. This conclusion is also supported by *Neb. Rev. Stat. § 77-2703.04(c)* (Reissue 2003) which is applicable to mobile telephone service and analogous to electric service, as follows:

If charges for mobile telecommunications service that are not subject to the [sales] tax are aggregated with and not separately stated on the bill from charges that are subject to the tax, the total charge to the customer shall be subject to tax unless the home service provider can reasonably separate charges not subject to tax using the records of the home service provider that are kept in the regular course of business.

It is not completely clear, however, whether the unbundled charge on the customer's bill for the recovery of the lease payment is subject to sales tax. The Department of Revenue may argue that the unbundled charge to the customer is subject to the state sales tax because the furnishing of electric service cannot take place without the underlying lease of a Municipality's electric system. In other words, the lease enables a PPD to furnish the electric service, thereby subjecting the unbundled charge to sales tax.

On the other hand, a PPD may argue that the unbundled charge to customers has no direct connection with the furnishing of electric service. The gross receipts that a PPD derives from furnishing electric service is separated on the bill and does not include the unbundled charge to the customer. This argument is supported by the ordinary meaning of the word "furnish." The Nebraska Supreme Court, in *American Family Ins. Group v. Hemenway*, 254 Neb. 134, 143 (1998) (citing *Webster's Encyclopedic Unabridged Dictionary of the English Language* 575 (1994)), stated that "the ordinary meaning of the word 'furnish' is to 'provide or supply.'" Collecting an unbundled charge from a customer to recover a lease payment for the rental of a Municipality's electric system has no causal connection to the actual provision of electric service. In addition to *Neb. Rev. Stat. § 77-2703.04(c)* (Reissue 2003) cited above, a 1999 Revenue Ruling issued by the Nebraska Department of Revenue ("Department") provides further supports for this argument.

In *Revenue Ruling 1-99-1* (1999), the Department provided regulatory guidance on whether the Nebraska Universal Service Fund (NUSF) surcharge, which is added to a telephone customer's bill as a line item charge, should be included in the gross receipts of a retailer providing telecommunication services within Nebraska, thereby subjecting the surcharge to sales tax. The Department explained that, "[t]he NUSF surcharge is imposed on intrastate telecommunication services billed to retail end-users. It is required to be separately stated on the customer's bill. It is remitted by the vendor to the Public Service Commission and becomes a part of the Universal Service Fund." *Id.* The Department ruled that the NUSF surcharge assessed against certain retail end-user revenues is not included in gross receipts subject to sales tax. This ruling was based on the similarity of the NUSF surcharge to the Nebraska 911 surcharge and the Nebraska surcharge for the hearing impaired, which are also surcharges on a customers bill. *Id.* According to the Department, "[l]ike these surcharges, [the NUSF surcharge]

is not subject to Nebraska sales tax and is not a part of the taxable gross receipts of a vendor providing telecommunication services.” *Id.*

The unbundled charge for the recovery of the lease payment to a PPD’s customers is similar to the line item surcharge for NUSF, Emergency 911, and the surcharge for the hearing impaired. This is the case, even though the recovery of the lease payment is not required to be separately stated on a customer’s bill, as are these telephone users charges. The telephone user charges are not necessary for the provision of telephone service, just as the unbundled charge for the recovery of the lease payment is not necessary for the provision of electric service. Telephone service and electric service can be provisioned without these charges.

A PPD, therefore, has a meritorious argument that the unbundled charge for the lease payment on a PPD’s customer statement should not be subject to state sales tax.

This argument, however, may in turn subject the underlying lease transaction between a PPD and a Municipality to further scrutiny. This may be the case, because the unbundling of the recovery of the lease payment charge to a customer may make it possible for a PPD to avoid altogether the payment of any sales tax on the inter-related transactions.

In this instance where no sales tax has been paid, the underlying lease transaction between the PPD and a Municipality may be subject to sales tax because a Municipality is a retailer who by definition is engaged in the business of leasing tangible property. Accordingly, the lease payment made by a PPD to the Municipality fits within the definition of gross receipts and may subject the lease payment to the collection of sales tax from a PPD.

For those PPD’s that bundle the recovery of the lease payment in the rate, and thereby collect a sales tax on the recovery of the lease payment, this billing practice results in the payment of sales tax on the inter-related transactions. It would seem unreasonable for the Department of Revenue to take the position that two sales taxes are due on the inter-related transactions (one from the customer and one from the PPD). However, if the unbundled charge to the customer is not subject to sales tax, then no sales tax would be paid on the inter-related transactions, which may subject a PPD to a sales tax at the time that the rental payment is made by a PPD to a Municipality.

### CONCLUSION

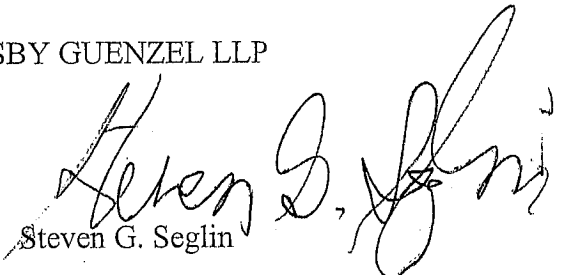
Based upon the foregoing authorities and analysis, it is clear that a bundled charge for electric service to a PPD’s customers, which includes the recovery of the lease payment made by a PPD to a Municipality, subjects the entire charge for electric service to sales tax. Although it is not entirely clear whether an unbundled charge is subject to sales tax, a meritorious argument can be made that it is not, based on the fact that the unbundled charge is not necessary to the furnishing of electric service and the finding by the Department of Revenue, in an analogous situation, that telephone user surcharges are not subject to sales tax.

With respect to whether a sales tax is due from a PPD on the underlying rental of the electric system from a Municipality at the time that a lease payment is made, it appears that such a tax may be due if no sales tax whatsoever is paid on the inter-related transactions due to unbundling the recovery of the lease payment. Consequently, it appears that the safest course for a PPD to follow is to bundle the recovery of the lease payment in the rates, which thereby subjects such recovery to a sales tax along with the charge for electric service. If a PPD has already unbundled the charge, then a PPD may collect sales tax from the customer on the unbundled charge which may avoid a subsequent inquiry or audit from the Department of Revenue and a resulting claim that sales tax should have been paid by a PPD on the underlying lease transaction with a Municipality at the time that the lease payment or payments were made.

Very truly yours,

CROSBY GUENZEL LLP

By

  
Steven G. Seglin

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