

**IN THE
SUPREME COURT OF MISSOURI**

No. SC 83859

SOUTHWESTERN BELL TELEPHONE COMPANY,

Appellant,

v.

DIRECTOR OF REVENUE,

Respondent.

**On Petition for Review from the
Missouri Administrative Hearing Commission
Hon. Willard C. Reine, Commissioner**

REPLY BRIEF OF APPELLANT

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POINT RELIED ON

THE ADMINISTRATIVE HEARING COMMISSION ERRED IN DENYING APPELLANT'S REFUND CLAIM BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT APPELLANT'S PURCHASES OF MACHINERY AND EQUIPMENT ARE EXEMPT FROM MISSOURI USE TAX UNDER SECTIONS 144.615(3) AND 144.030.2(4) AND (5) BECAUSE THE MACHINERY AND EQUIPMENT IS USED TO MANUFACTURE PRODUCTS WITHIN THE MEANING OF THOSE SECTIONS.

International Business Machines Corporation v. Director of Revenue,

958 S.W.2d 554 (Mo. banc 1997);

Bridge Data Co. v. Director of Revenue, 794 S.W.2d 204 (Mo. banc 1990);

DST Systems, Inc. v. Director of Revenue, 43 S.W.3d 799 (Mo. banc 2001).

ARGUMENT

THE ADMINISTRATIVE HEARING COMMISSION ERRED IN DENYING APPELLANT’S REFUND CLAIM BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT APPELLANT’S PURCHASES OF MACHINERY AND EQUIPMENT ARE EXEMPT FROM MISSOURI USE TAX UNDER SECTIONS 144.615(3) AND 144.030.2(4) AND (5) BECAUSE THE MACHINERY AND EQUIPMENT IS USED TO MANUFACTURE PRODUCTS WITHIN THE MEANING OF THOSE SECTIONS.

Introduction

It is undisputed that Bell’s basic and vertical telephone services are taxable services or tangible personal property, both of which are subject to sales tax in Missouri. As such, they are *products* within the meaning of the *manufacturing* exemptions, §§144.030.2(4) and (5) (“Manufacturing Exemptions”).¹ *International Business Machines Corporation v. Director of Revenue* (“*IBM*”), 958 S.W.2d 554, 557-58 (Mo. banc 1997) (“*the General Assembly intended that exemption [§144.030.2(5)] to apply to machinery and equipment that generates sales of tangible personal property or taxable services.*”),² citing with approval *Bridge Data Co. v. Director of Revenue*, 794 S.W2d 204, 206 (Mo. banc 1990) (“products” not limited to tangible personal property), *overruled* by *IBM* however on the issue of whether services must be taxable.

¹ All statutory citations are to the Revised Statutes of Missouri of 1986, unless otherwise noted.

Because this Court has concluded that taxable services are thus *manufactured products, id.*, the processes that create them are necessarily *manufacturing*. The Director's brief, like the Commission's decision, fails to address, much less resolves, the paradox that her underlying argument creates, namely, that under *IBM*, taxable services are products for purposes of the Manufacturing Exemptions, but that those products are not manufactured. Under *IBM* and *Bridge Data*, Bell's purchases of the machinery and equipment are exempt because that machinery and equipment "generates" the taxable services, and in some cases tangible personal property, that Bell sells.

The Director's principal authority is, oddly, one she admits is of "limited value" (Dir. Br. 23). That authority, *GTE Automated Electric v. Director of Revenue*, 780 S.W.2d 49 (Mo. banc 1989), is a decision that was expressly overruled by *IBM* and practically overruled by *Bridge Data*. The *GTE* decision held that telephone service was not a manufactured product because it was not tangible. Based on *GTE* and the Director's other authorities involving tangible products, the Director then argues that because the production of taxable services does not fit squarely within the discussion of the production of tangible products, Bell's processes must not be manufacturing (Dir. Br. 27-33).

Further, the Director misreads and misinterprets certain testimony of Bell's technical expert, Mr. William Deere (Dir. Br. 33-36), in her attempt to downplay Bell's creation of vertical services. Mr. Deere testified that each piece of equipment is used to produce Bell's basic and vertical services (Tr. 508-509). The Director then apparently assumes that because Bell's equipment at issue is not *solely* used to create vertical services, that equipment is not exempt even if generation of vertical services is

² Emphasis added here and throughout unless otherwise noted.

manufacturing. This argument is not supported by the manufacturing exemptions and was expressly rejected in *DST Systems, Inc. v. Director of Revenue*, 43 S.W.3d 799 (Mo. banc 2001).

The record firmly demonstrates that Bell used the Machinery & Equipment in an integrated telephone system for generating basic and vertical telephone products sold to customers. As noted in the Director's brief (Dir. Br. 12), the facts were established at a three-day hearing (and reflected by Bell's twenty-five page Statement of Facts in its opening brief) at which the Commission admitted nearly 40 exhibits. The Director does not dispute any of the facts set forth in Bell's Statement of Facts, but rather reinforces the description of some of the vertical services offered by Bell and described in the Commission's decision (Dir. Br. 6-9). And, as explained in Bell's opening brief, the Director's technical expert did not testify because, having heard Bell's expert's testimony, he concluded that the "technical information [was] very correct" (Tr. 682).

Rather than disputing the integrated nature of Bell's network, the Director is asking this Court to ignore that integrated plant by trying to convince this Court that it should not consider the numerous vertical services produced by the taxpayer. Thus, the Director argues that Bell's manufacturing is not "integrated" because it only provides basic service. As the record thoroughly demonstrates, Bell's integrated network was created and operates to produce both the basic and vertical services sold and subject to tax to its customers. This Court should reject the Director's attempts to otherwise characterize the integrated nature of Bell's operations as something else.

The sole issue before this Court is whether, based on the undisputed facts, Bell is entitled to a refund of Missouri use tax in the amount of \$601,404.46³ on its purchases of Machinery and Equipment during the same period that it collected and remitted \$11,011,655.48 in sales tax on its sales of basic and vertical services produced by that and other equipment.

As noted in Bell's opening brief, *Concord Publishing House, Inc. v. Director of Revenue*, 916 S.W.2d 186, 190 (Mo. banc 1996), distilled the elements of the Manufacturing Exemptions as follows:

Neither sales nor use tax is due on machinery and equipment (1) used directly for (2) manufacturing (3) a product which is intended to be sold ultimately for final use or consumption (4) if the machinery or equipment was purchased (a) to replace equipment by reason of design or product changes or (b) to expand existing manufacturing.

The Director does not dispute that the basic and vertical services constitute "products" sold for final consumption as the Director concedes that they are taxable services (Dir. Br. 16, n. 1).

Accordingly, all of those services are "products" under this Court's definition of the term in *IBM*.

Likewise, the Director does not dispute that the Machinery & Equipment was purchased to replace equipment by reason of design or product changes or to expand existing manufacturing (Dir. Br. 18-19).

³ The Director correctly notes that Bell's calculation of the refund claim should be reduced by several hundred dollars because Bell mistakenly included purchases that were recorded on "X" accounts and thus not eligible for exemption as capitalized equipment (L.F. 46) (Dir. Br. 29).

Instead, the Director presents her argument for denying Bell the Manufacturing Exemptions on three bases: (1) the generation of basic and vertical services does not constitute “manufacturing;” (2) if it does constitute manufacturing, not all of the Machinery and Equipment was “directly used” to manufacture the products; and (3) some of the Machinery & Equipment did not qualify as “machinery and equipment or materials and supplies solely required for the installation or construction of such machinery and equipment” within the meaning of the Manufacturing Exemptions. As explained below, none of these arguments is consistent with the language of the Manufacturing Exemptions or this Court’s interpretations thereof.

The Director also seeks to avoid Bell’s claim of exemption by arguing that unless redesigned products or services are sold during the tax period when the Machinery and Equipment is purchased, the purchases are not eligible for the Manufacturing Exemptions. Simply put, this argument is contrary to any common sense reading of the Manufacturing Exemptions, this Court’s decision in *Concord Publishing House v. Director of Revenue*, 916 S.W.2d 186, 194 (Mo. banc 1996), and the Commission’s own decision in *Hogan Transports, Inc. v. Director of Revenue*, Case Number 98-1305RV (Mo. Admin. Hrg. Comm. 1999).

Finally, the Director seeks to avoid Bell’s refund claim by asserting that a decision by this Court granting Bell’s refund would constitute an “unexpected decision” within the meaning of Section 143.903. As discussed below, this assertion is incorrect for two reasons. First, neither this Court, the Commission, nor any other court has decided whether the production of vertical services constitutes manufacturing. Second, any decision that the production of basic telephone service is “manufacturing” is not unexpected after this Court’s 1990 decision in *Bridge Data*.

A. Bell Manufactures Basic and Vertical Telephone Services

1. Production of Vertical Services Constitutes Manufacturing

This case squarely presents the question whether Bell, like DST, Concord, and IBM, is entitled to the Manufacturing Exemptions when it uses Machinery and Equipment to manipulate information and data to produce its products, in this case vertical services. The Director would have this Court virtually ignore the significant similarities between Bell's operations and the operations of DST, Concord, and IBM, and instead focuses solely on Bell's provision of basic telephone service. That is because the Director's primary authority is *GTE*, a case that addressed basic telephone service (although its holding was based upon a misconception of the term "product"), but did not address in any manner whatsoever the generation of vertical services.

Bell, in addition to using its integrated system to manufacture basic telephone services, uses its integrated system to manufacture vertical services. The Director's argument that the provision of vertical services does not constitute manufacturing requires this Court to ignore its own precedents since its decision in *Bridge Data*.

The vertical services that were addressed during the trial of this case are Bill Plus, Customer Billing Report, Detailed Billing Local Measure Services, CABS Bills on Floppy Disks, Caller ID, Anonymous Call Rejection, Auto Redial, Call Blocker, Call Forwarding, Selective Call Forwarding, Remote Access to Call Forwarding, Call Return, Call Trace, Call Waiting, Priority Call, Speed Call, and Three Way Calling (Exh. 31; Tr. 439-662). Each of these products involves the manipulation of information and data through use of Machinery and Equipment in the Bell system far beyond the simple transfer of analog signals that were considered in *GTE*.

The Director argues that Bell's Machinery and Equipment in this regard merely "repackages" information and data that Bell already collects, and modifies it into formats that customers can better use

(as evidenced by their willingness to pay a fee to receive the information in such a form). She argues that these processes are “not manufacturing under this Court’s definitions” (Dir. Br. 31). This statement is incorrect. As noted in Bell’s opening brief and elsewhere in this brief, in *Bridge Data* this Court held that organizing information through computer technology is manufacturing. There, the taxpayer “repackaged” financial data into formats that its customers could better use (as evidenced by their willingness to pay a fee to receive the information in such a form). Bell differs from *Bridge Data* only in that its generated services are taxable in Missouri while Bridge Data’s services were taxable only in other states.

Likewise, in *DST Systems, Inc. v. Director of Revenue*, 43 S.W.3d 799 (Mo. banc 2001), this Court concluded that the taxpayer’s use of mainframe computers and other equipment to “organize information” to create printed products was manufacturing. Also, in *Concord*, this Court relied on *Bridge Data* to conclude that the recording and processing of information was manufacturing. There, the Court found that the computers used to “lay out” a newspaper for printing were used in manufacturing: “[The Director] claims that gathering, storing, and arranging the information printed is not manufacturing. We Disagree.” This Court also concluded that the reporters’ laptop computers were exempt manufacturing equipment:

[T]he Director argues that even if the pagination system directly manufactures the newspaper, the laptop or portable computers were only used to take notes at an event, not to process the information and were therefore not necessary or integral to the pagination process. She argues they merely deliver the information to the editing computers and are not themselves involved in the editing process. We believe

equipment used to record information is part of the manufacturing process as well.

Recording is the first step in processing words into a newspaper.

Here, Bell uses certain input information and, by use of its sophisticated Machinery and Equipment, organizes this data into formats customers can better use (*e.g.*, converting electric impulses of the caller's phone number into letters for the caller's name and numbers for the caller's number to be displayed on the called person's Caller ID device).⁴ Whether those manipulation and organization functions are characterized as "repackaging" or not, those processes constitute manufacturing under this Court's precedents that address the processing of information.

The Director argues that the "vast majority" of Bell's vertical services merely allow customers to determine when, how or whether to have conversations (Dir. Br. 30). But nothing in *Bridge Data*, *IBM*, *Concord*, or *DST* makes the customer's use of the processed information relevant. The fact that Bell's customers find value in purchasing products based on processed information is evidenced by their willingness to pay additional amounts. What the customers do with the product is irrelevant. For all we know, many of Concord's customers did not read all of their newspapers.

The Director argues that under Bell's reasoning the Manufacturing Exemptions would thus apply to numerous other services including bank services (Dir. Br. 31). The Director never really explains

⁴ In her brief, the Director erroneously states that the information that accompanies a call to permit the use of Caller ID accompanies every call (Dir. Br. 30). The record demonstrates that electric impulses representing the name of the caller are retrieved from Bell's database and converted into signals that can be read as digits and letters on the receiving customer's Caller ID device only when the receiving caller has subscribed to that service (Tr. 402-405).

how the copying of a check constitutes the manipulation of information or how that is analogous to Bell's operations. Furthermore, the Director's argument in this regard ignores *IBM*. There, this Court specifically held that in order for a service to constitute a "product" for purposes of the Manufacturing Exemptions, the service must be taxable. Banking services (including the charge for copying a check) are not subject to Missouri sales tax. Therefore, purchases of machinery and equipment used to organize information as part of banking services are not eligible for the Manufacturing Exemptions.

Finally, the Director attempts to compare Bell's information organization operations to the repackaging of tangible products in *House of Lloyd v. Director of Revenue*, 824 S.W.2d 914 (Mo. banc 1992) (Dir. Br. 31-32). There, the taxpayer received products in shipping cartons, removed the products from the cartons, and inspected, repaired, sorted and repackaged the products for its customers. On these facts, this Court held that the taxpayer was not engaged in manufacturing or fabricating⁵ because the taxpayer's product was in its completed state when it was delivered to the taxpayer. *Id.* at 919. The *House of Lloyd* decision is not authoritative here. Bell's vertical services are not in the final state when Bell receives the inputs, usually electric impulses.

For example, with respect to Caller ID, Bell's input is the electronic pulses reflecting the dialed number of the calling party. Bell's Machinery & Equipment processes these signals, generates separate signals reflecting the caller's name from Bell's database, which is in no way input by the caller, and

⁵ Contrary to the Director's statement that "Bell has never argued that its provision of telecommunications service is fabricating" (Dir. Br. 18, n.2), Bell has consistently used the term "manufacturing" to include "fabricating," and thereby reserved such position. *See* Petitioner's Opening Brief to Commission at 28, n.3, a copy of which is attached as Appendix A.

transforms those electronic signals to a different format (*i.e.*, signals that will appear as letters and numerals displayed on a screen). The fact that the manipulated information is of an increased value is demonstrated by the customers' willingness to pay an additional fee for it. Likewise, with respect to the various Billing Services (Tr. 453-512), Bell takes its existing data and manipulates it into a different format, information summarizing calls and charges for example, that its customers find valuable. Some of those outputs are a combination of taxable services and tangible property like diskettes.

Based on the foregoing, it is obvious that operations of *Bridge Data*, *IBM*, *Concord*, and *DST*, and not *House of Lloyd*, are more analogous to Bell's operations in organizing information for the purpose of making its sales. Because Bell's product is not in its final state when Bell receives the inputs used in manufacturing the service, and because Bell uses its integrated system to manipulate data to provide its vertical services, this Court should hold that Bell manufactures each of the vertical services.

2. Production of Basic Telephone Service is Manufacturing

(a) *Bridge Data* Controls

In its opening brief, Bell noted that *Bridge Data* compels the conclusion that the production of basic telephone services constitutes "manufacturing" within the meaning of the Manufacturing Exemptions. The Director's brief does not address those parts of Bell's opening brief, but rather emphasizes two sentences of *Bridge Data* in an attempt to refute the obvious conclusion that the production of basic telephone service constitutes "manufacturing."

In *Bridge Data*, the taxpayer obtained financial data and converted it into sophisticated business information by taking "raw" financial information that it received from outside sources and converting this raw data into intangible formats usable by securities dealers. This Court stated:

We conclude that the manufacturing exemption should be allowed for the taxpayer's hardware used in collecting financial data and transmitting data to its customers. Here, what comes out of the system is clearly different from what went into it, in contrast to GTE, in which the telephone company purported to transmit, as accurately as possible, the voices of the participants, even though what one learned in theoretical physics might demonstrate that what came out was not really the same as what went in. The statute contains no explicit requirement that the product be "tangible" in order for the manufacturing exemption to apply. *The taxpayer makes use of complicated and expensive equipment in providing data to its customers. The recognition of the manufacturing exemption represents a reasonable adoption of the statutes to processes which were not known or hardly known, at the time they were enacted.*

Id. at 206. As noted in Bell's opening brief, and consistent with the construction of "manufacturing" in *Bridge Data*, Bell's production of basic telephone service "makes use of complicated and expensive equipment in providing [electrical impulses] to its customers[.]"

The Director does not dispute that in providing basic telephone service, Bell converts its customers' analog electrical impulses into digital electronic impulses and later converts the impulses into analog electrical impulses to provide effective telephone communications service. Instead, she relies entirely upon this Court's characterization of the conversion as "theoretical physics."⁶ In so doing, the

⁶ As a practical matter, the "theoretical" physics the Court referred to in *Bridge Data* was shown as fact in the record below (L.F. 23-24). Specifically, the process of converting analog to digital

Director seeks to freeze this Court's decisions based upon an understanding of technology more than a decade ago, and deprive the Court of the ability to review the record in this case. The definition of "manufacturing" necessarily evolves with technological evolution.

The Director's purported reliance on *Bridge Data* is further undermined by her failure to respond to Bell's comparison of its production of basic service to the production of a compact disk by a recording studio. In its opening brief, Bell noted that a recording studio captures sounds generated by artists and creates digital signals intended to "mirror" the actual sounds and burns them onto a compact disc. Similarly, Bell takes signals generated by its customers and creates digital signals intended to "mirror" the signals. The only difference between the two operations is that the recording studio's output is tangible, a distinction that is irrelevant under *IBM* since both products are taxable. Since the Director did not attempt to distinguish these two situations or suggest that a recording studio would not be entitled to the manufacturing exemption for purchases of machinery and equipment used in the

signals is called pulse amplitude modulation. First, the high and low frequencies of the analog signal are trimmed off because they cannot be heard well. The analog signals are then sampled 8,000 times per second and each sample is coded so that the samples can later be reconstructed to replicate the original analog sound because the human ear cannot hear digital signals as words and phrases. The process is completed by reproducing the digital signals, spaced one 125,000th of a second apart, to regenerate an analog signal that is like the original analog signal, but is, in fact, something different, a replication of it. The digital signal must in fact be regenerated or "reformated" numerous times (every 6,000 feet) throughout Bell's system because of the digital signal's tendency to degrade (Tr. 373-379, 412, 414).

manufacture of compact discs, one can assume that the Director concedes that she cannot legitimately rely upon *Bridge Data*.

(b) This Court's Other Manufacturing Decisions Do Not Support the Director's Argument

To support her position that the basic telephone service is not manufacturing, the Director traced this Court's manufacturing decisions. Contrary to the Director's arguments, however, those cases demonstrate that Bell's use of its integrated network constitutes manufacturing; the cases clearly do not support the Director's contentions.

In *West Lake Quarry & Material Company, Inc. v. Schaffner*, 451 S.W.2d 140 (Mo. 1970), this Court first addressed the definition of manufacturing. That taxpayer operated a quarry where it mined rock, and then used grinding equipment to pulverize the rock in various degrees to meet its customers' demands. The rock was not marketable immediately after it was blasted from the ground. The rock had to be coarsely ground to be used for dike purposes, and it had to be ground to a fine powder to be used as agricultural lime. The quarry had other customers requiring degrees of rock coarseness in between these two mentioned levels. *Id.* at 141.

This Court stated that the purpose of the manufacturing equipment exemption was to stimulate economic development by encouraging the production of products that are subject to tax. *Id.* at 142. It then determined that the grinding equipment qualified for the manufacturing exemption because:

[The quarry took] something practically unsuitable for any common use and change[d] it so as to adapt it to such common use We, therefore, hold that the machinery and

equipment used in processing and grinding the rock in various sizes for many different uses is exempt ... as used in manufacturing. *Id.* at 143.

Even though the fundamental nature of the product had not changed (*i.e.* rock was still rock), this Court held that the taxpayer's machinery and equipment qualified for the Manufacturing Exemptions.

Likewise, as noted in the Director's brief, in *Heidelberg Central, Inc. v. Director of Revenue*, 531 S.W.2d 752 (Mo. 1972), this Court held that the transformation of paper products into custom business forms, stationery, postcards and church bulletins constituted manufacturing, even though the fundamental nature of the product (*i.e.*, paper remaining paper) had not changed. The Court explained that producing "new and different articles from raw materials by the use of machinery, labor and skill... in forms suitable for new uses" constitutes manufacturing.

In *Wilson & Company, Inc. v. Director of Revenue*, 531 S.W.2d 752 (Mo. 1976), this Court reiterated its position that the fundamental nature of a product need not change in order to qualify for the Manufacturing Exemptions (conversion of live hogs into pork products suitable for human consumption constituted manufacturing even though "pork remained pork"). In *Jackson Excavating v. Administrative Hearing Commission*, 646 S.W.2d 48, 51 (Mo. 1983), this Court determined that water purification was manufacturing because the process caused "a substantial transformation in quality and adaptability ... [creating] an end product quite different from the original," even though water was still water. In *Galamet, Inc. v. Director of Revenue*, 915 S.W.2d 331 (Mo. banc 1996), this Court determined that shredding discarded scrap metal appliances constituted manufacturing because the steel shreds had new uses and values because the "deciding factor was whether the

process in question resulted in an end product different in quality and adaptability from the original” (citation omitted).

As is evident, none of these cases cited in the Director’s brief supports her interpretation of this Court’s decisions in *Bridge Data* (as discussed above) and *GTE*. Each case supports a holding that the production of basic telephone service constitutes manufacturing.

The Director also relies upon *GTE*. In *GTE*,⁷ a divided Court, over the objection of a sharply worded dissent, concluded that a telephone company was not entitled to the Manufacturing Exemptions for purchases used to produce basic local telephone service. The basis of the Court’s conclusion, acknowledged in the Director’s brief, was that the exemptions do not apply to services, but rather, only to tangible personal property. *Id.* at 51 (Dir. Br. 23). This Court stated “This conclusion disposes of appellant’s first point relied on[.]” *Id.*

Nonetheless, the Director seeks to rely on *dicta* in *GTE* to support her position that Bell does not manufacture basic local telephone service. The Director noted that the *GTE* majority concluded that the “telephone signal has no intrinsic value because the value” was really “a service, not an end in itself” and that because the human voice was the raw material and had broad common uses, the alteration of the human voice could not constitute manufacturing. *Id.*

⁷ The Director noted in her brief (Dir. Br. 22-23, n.3) that some of the vertical services were discussed in the Commission’s Findings of Fact in *GTE*. In fact, the only discussion of vertical services was a statement in the Statement of Facts. Neither the Commission nor this Court was asked, nor did either address the issue of whether the production of any vertical services constitutes manufacturing.

The Director cannot square her interpretation of the *GTE* dicta with this Court's decisions in *Bridge Data* and *IBM*. In *Bridge Data*, this Court rejected the conclusion of *GTE* that the exemptions did not apply to services, and that the manipulation of data constituted manufacturing. In *IBM* this Court made it clear that the definition of "products" in the Manufacturing Exemptions includes *all* taxable services. *IBM*, 958 S.W.2d 554 ("the General Assembly intended that exemption [§144.030.2(5)] to apply to machinery and equipment that generates sales of tangible personal property or taxable services.") There is no question that Bell manipulates the analog signal created by its customers (the human voice) in order to facilitate the use of this signal by its customers over long distances. Nor is there any question that Bell's services are taxable under §144.020.1(4).

Furthermore, the Director has not, and cannot, explain how taxable telephone service can, for purposes of the Manufacturing Exemptions, be a manufactured product (Bridge Data and IBM), but not be manufactured. For that matter, what taxable service will the Director agree can be manufactured? In effect, the Director would have this Court ignore *Bridge Data* and *IBM* and return the interpretation of the Manufacturing Exemptions to the standard set forth in *GTE*, namely that services cannot as a matter of law be manufactured. This Court rejected that interpretation in *Bridge Data* and *IBM*, and should also reject the Director's invitation in this case to freeze its interpretations of the Manufacturing Exemptions, especially in light of the consistent expansion of technology. Bell's production of basic telephone service by use of its integrated system constitutes manufacturing within the meaning of the Manufacturing Exemptions.

3. The Standard of Review Does Not Alter the Result

The Director argues that the standard of review should compel this Court to ignore its own precedents and affirm the Commission's decision. While the Director is correct that tax exemption statutes are to be construed against the taxpayer, this does not mean that the Court can or should decide all exemption cases against the taxpayer. In effectuating the legislature's intent, courts are to give exemption statutes a reasonable, natural and practical interpretation in light of modern circumstances. *Wetterau, Inc. v. Director of Revenue*, 843 S.W.2d 365 (Mo. banc 1992). The Director apparently takes issue with this statement of law (Dir. Br. 32-33), and concludes that Bell is asking this Court to rewrite §§144.030.2(4) and 144.030.2(5), when in fact, it is the Director that is asking this Court to narrow the sales tax exemptions set forth by the legislature and already construed by this Court.

The Director correctly notes that the legislature has amended the sales tax statutes addressing telephone service after this Court's decisions in *GTE* and *Bridge Data*, and did not enact legislation to overrule these decisions (Dir. Br. 27-28). However, this observation hampers, rather than helps, her arguments. Bell's production of basic and vertical services by manipulating data and providing those products to its customers in various forms and substantive materials that its customers find more useful (as evidenced by the fact that they willingly pay for such services) is analogous to the process used in *Bridge Data* that this Court concluded constituted "manufacturing" within the meaning of the Manufacturing Exemptions. In instances in which this Court has judicially construed the terms of a statute, the legislature's subsequent reenactment of the statute established the presumption that the legislature knew and adopted that construction. *Blue Springs Bowl v. Spradling*, 551 S.W.2d 596, 600-01 (Mo. banc 1977). The legislature's failure to statutorily overrule this Court's decision in *Bridge Data* demonstrates the legislature's acquiescence in that construction of the Manufacturing

Exemptions—that products include taxable services. Thus, by denying the Manufacturing Exemptions to Bell, it is the Director that seeks to “update the sales tax laws” *IBM*, 958 S.W.2d at 559.

Finally, the Director implies that Bell’s arguments would be contrary to the reasonable expectations of the legislature and the public (Dir. Br. 28). If the test is “reasonable expectations” of the legislature, a reading not entirely supported by §621.193 (pertaining to the exercise of discretion by the Commission), the expectations are reflected in the very legislation the legislature enacts. The enactments generally reflect policy decisions. In its opening brief (App. Br. 37), Bell noted that one of the policies of the Manufacturing Exemptions is to encourage the production of taxable products, thereby increasing State revenue. *IBM*, 958 S.W.2d at 558. Another policy is to prevent the pyramiding of sales tax inherent when tax is imposed on the machinery and equipment used to produce taxable products. *Floyd Charcoal Company, Inc. v. Director of Revenue*, 599 S.W.2d 173, 177 (Mo. banc 1980). As stated in Bell’s opening brief, both policies are furthered by applying the Manufacturing Exemptions to Bell’s purchases of Machinery & Equipment (Bell remitted nearly \$12,000,000 in sales tax for the Tax Period). Thus, in addition to being consistent with the language of the Manufacturing Exemptions, the application of the Manufacturing Exemptions to Bell are entirely consistent with the reasonable expectations of the legislature or the public. In sum, the Court need not “legislate” to find that the Machinery & Equipment is used to manufacture basic and vertical telephone services. The Court needs simply to apply the policies underlying the Manufacturing Exemptions to the realities of today’s world as reflected in the record of this case.

**B. The Machinery & Equipment is Used Directly to Manufacture
Bell’s Products**

In its opening brief, Bell noted that this Court’s adoption of the “integrated plant” theory of the Manufacturing Exemptions applies in this case, and Bell demonstrated that the Machinery & Equipment was directly used in manufacturing basic and vertical telephone services. The Director does not challenge the viability of the integrated plant decisions, but she argues that the integrated plant does not apply to Bell. None of her arguments is viable; each argument should be rejected.

First, the Director argues that Bell did not demonstrate that the Machinery & Equipment was used directly in manufacturing vertical services because the Commission “could not isolate any piece of equipment as a piece of equipment that provides a specific vertical service” (Dir. Br. 34). In this regard, the Director set out testimony of Bell’s expert, William Deere, who stated that some equipment in Bell’s integrated system would be in place without regard to the vertical services (Dir. Br. 34-36).

Beginning with the decision in *Floyd Charcoal Company v. Director of Revenue*, 599 S.W.2d 173, 178 (Mo. 1980), this Court consistently rejected like arguments. As stated in Bell’s opening brief, in *Floyd Charcoal*, the Director argued that the Manufacturing Exemptions could apply only to those items that could be identified as producing a change in the composition of materials to the extent that the operation could not be carried on without the machinery and equipment. *Id.* This Court flatly rejected this argument by adopting the integrated plant doctrine: if machinery and equipment constitutes an integral part of the business operation, it is “directly used” in manufacturing for purposes of the Manufacturing Exemption. This conclusion has been consistently reiterated by this Court. *See, e.g., Noranda Aluminum, Inc. v. Department of Revenue*, 599 S.W.2d 1 (Mo. 1980); *Concord Publishing House, Inc. v. Director of Revenue*, 916 S.W.2d 186, 190 (Mo. banc 1996). The issue is not whether a piece of equipment produces only the taxable product and nothing else; the question is whether the equipment produces a taxable product as demonstrated by the holding

of *DST*, where this Court rejected the Director's argument that computer equipment was not exempt because part of its output was not taxable tangible personal property. The Director's argument stands this Court's precedents on its head, and should be rejected.

This Court's recent decision in *Utilicorp United, Inc. v. Director of Revenue*, Case Number 83599 (Mo. banc 2001) provides no support for the Director's argument. In *Utilicorp*, this Court held that certain portions of the utilities' integrated plants were not engaged in manufacturing because the creation of their tangible product (electricity) was completed at the point of generation. *Id.* at 7, n.6. Specifically, the majority held "Nothing is added and nothing is subtracted in the transmission and distribution process." *Id.* at 10.

In this case, as opposed to the facts determined by the Court in *Utilicorp*, Bell's basic and vertical services are commenced at the customer's premise when the customer picks up the telephone, and such services are not complete until the services have been received by Bell's customer. Thus, every piece of Bell's integrated network is used to create Bell's tangible and intangible products.

The Director's other argument is that Machinery & Equipment should not be treated as "directly used" to manufacture the vertical services because the vertical services are "corollary" to another service. The Commission's conclusion, effectively "deconstructing" Bell's integrated network was made without the citation to any authority whatsoever, and Bell has located none in support of this conclusion. In effect, the Commission states that no piece of Machinery & Equipment may ever be used to produce two different items, one of which may be a taxable product, and one of which is not. This Court, in *DST*, reached a conclusion contrary to the Director's. There, this Court concluded that machinery and equipment was directly used in manufacturing even though the machinery and equipment was not exclusively used in producing taxable products. In this case, the Machinery & Equipment is

used exclusively to produce taxable products (basic and vertical telephone services). Thus, the Commission's treatment of certain services as "corollary" to other services is without basis in law and is, in fact, contrary to this Court's decisions.

Furthermore, the Director's arguments that "if this Court agrees with the Director that basic telephone service is not manufactured, but is inclined to consider the vertical services separately, Bell still cannot prevail" is incorrect. Just as the use of the mainframe computer and other equipment were used to create services that were not taxable products in *DST*, assuming *arguendo* that basic telephone service is not a manufactured product (an assumption that Bell vigorously refutes throughout its briefs), this fact does not affect the Machinery & Equipment used to manufacture vertical services. In short, the Director's arguments are erroneous.

C. Each Purchase of Machinery & Equipment Constitutes Machinery and Equipment or Materials and Supplies Solely Required for the Installation or Construction of Machinery and Equipment

In her brief, the Director notes that the Commission set forth several items of Machinery & Equipment for which the Commission questioned the application of the Manufacturing Exemptions (Dir. Br. 38-39) (L.F. 47). First, these items comprise a small part of Bell's claim. Second, they are either equipment or installation materials and supplies. As noted in Bell's initial brief, Mr. Deere provided lengthy testimony describing that all of the Machinery and Equipment were either machinery, equipment or material and supplies (Tr. 239-661). The Director, before the Commission, conceded that Mr. Deere's technical descriptions were "very correct" (Tr. 682). In her brief, the Director does not dispute any of this evidence (Dir. Br. 38-40). Therefore, her argument that any of the Machinery & Equipment does not qualify for the Manufacturing Exemptions is misplaced. Furthermore, assuming *arguendo*, that this Court questions the qualification of any of the Machinery and Equipment purchases, the record is sufficient to recalculate the refund (Exhs. 8, 9(a-e), 28-30).

D. The Manufacturing Exemptions Do Not Require Bell to Sell Every Possible Service To Be Created by the Machinery & Equipment When the Machinery & Equipment is Purchased

The Commission concluded that it could not consider four of the seventeen vertical services that the Machinery and Equipment were designed to manufacture because the four were not sold during the Tax Period (L.F. 45; Exh. 31). In her brief, the Director does not adopt the Commission's conclusion. Instead, the Director conceded that her similar argument before this Court was rejected in *Concord*

(Dir. Br. 40-41). In that case, this Court concluded that the “purpose of” the purchase was determinative, and that the Manufacturing Exemptions do not specify when the equipment be used. *Id.*

While conceding that the Manufacturing Exemptions must be interpreted in a commonsense fashion, the Director nonetheless states that consideration of the four vertical services not offered to customers during the Tax Period may not be considered in applying the Exemptions to Bell’s machinery and equipment. Her first argument is that this Court’s decision in *Concord* distinguished between “small” businesses and “large” businesses. Although she declined to define the distinction between “small” and “large” businesses, the Director presumes that the taxpayer in *Concord* as well as that in *Hogan Transports, Inc. v. Director of Revenue*, No. 98-1305RV (Mo. Admin. Hrg. Comm. 1999) (purchases of equipment prior to offering of services to public does not affect qualification for Manufacturing Exemptions) are “small,” while Bell is “large.” The Director’s distinction is without basis in §§144.030.2(4) and 144.030.2(5), and is inconsistent with this Court’s own language in *Concord*:

It is unreasonable to expect all businesses to pay for and make major production changes all in one tax year in order to qualify for the exemption. *Id.*

Furthermore, the record in this case demonstrates that Bell is not free to offer its services to the public immediately upon acquiring the capability of producing them. As stated in Bell’s opening brief, all services provided by Bell are subject to the prior approval of the Missouri Public Service Commission (“PSC”) (Tr. 502). Before seeking PSC approval, Bell must purchase any machinery and equipment necessary to produce the new product and test it using “friendly users” to identify and correct any bugs in the service. The equipment and machinery is then put into production and instruction manuals (Tr. 446-47). At that point, Bell would file a tariff with the PSC and participate in a series of hearings (Tr.

446-447). Thus, the time frame for the development of a new product through PSC approval can range from several months to several years (Tr. 447).

With respect to the four vertical services noted in the Director's brief that were not offered during the Tax Period, one of such services, Remote Access to Call Forwarding, was offered within a year (Exh. 31). Another, Caller ID was offered for sale in April of 1993 (Exh. 31). A third, CABS Bills on Floppy Disk, was offered two years after the Tax Period. The final such service, Anonymous Call Rejection, the service the Director focuses virtually exclusively upon in making her argument, was offered in 1999. However, as demonstrated by the record, Anonymous Call Rejection was planned along with many of Bell's other vertical services (Tr. 464-65). Bell's delay in offering this service was caused by concerns of the PSC that were not resolved until 1999 (Tr. 464-65).

In short, a reasonable and commonsense interpretation of the Manufacturing Exemptions, in light of the length of time necessary to implement new services requiring PSC approval, demonstrates that the Commission erred in refusing to consider the four vertical services that were not offered during the Tax Period. Therefore, this holding of the Commission should be reversed by this Court.⁸

E. A Decision Applying the Manufacturing Exemptions to the Machinery & Equipment Would Not be Unexpected Under §143.903

The Director argues that a decision applying the Manufacturing Exemptions to Bell's Machinery & Equipment would be unexpected within the meaning of §143.903. The argument is without merit.

⁸ Further, as noted above, the use of the Machinery & Equipment to produce the other thirteen vertical services as well as basic local telephone service would support the exemption on the purchase of the Machinery & Equipment under *DST*.

Section 143.903 provides that a refund is not due for any period prior to the issuance of an “unexpected decision.” In *Lloyd v. Director of Revenue*, 851 S.W.2d 519, 523 (Mo. banc 1993), this Court held that for a decision to be unexpected, it must:

- (1) overrule a prior case or invalidate a previous statute, regulation or policy of the director of revenue, *and*
- (2) not be reasonably foreseeable.

With respect to Bell’s vertical services, the Director does not even attempt to argue that a decision by this Court applying the Manufacturing Exemptions to Bell’s Machinery & Equipment used to manufacture vertical services would overrule a prior case or invalidate a previous statute, regulation or policy. Therefore, such a decision cannot, by definition, be an unexpected decision within the meaning of §143.903.

Furthermore, while a decision that applying the Manufacturing Exemptions to Bell’s Machinery & Equipment used to manufacture basic telephone services might arguably overrule *GTE*, there is no basis for stating that such a decision is unexpected. That is because any such decision would be eminently foreseeable. While *GTE* was not expressly overruled until this Court’s decision in *IBM*, as discussed above, this Court discarded the holding of *GTE* that a “product” must be in a tangible form in *Bridge Data* (decided nearly two years before the Tax Period). In *Bridge Data*, this Court held that the “use of complicated and expensive equipment” to provide services constitutes “manufacturing.” *Id.* at 794 S.W.2d at 206. Bell’s manufacturing process is not unlike the production of compact disks by a recording studio, an analogy the Director did not, and could not, address in her brief. In light of the fact that the recording studio’s activities are considered to be manufacturing, it cannot fairly be said that

a decision applying the Manufacturing Exemptions to Bell's Machinery & Equipment used to manufacture basic telephone service would be unforeseeable.

Thus, the Director's unexpected decision argument is contrary to Missouri law and cannot be used to avoid paying the refund on Bell's Machinery & Equipment which satisfies every element of the Manufacturing Exemptions.

CONCLUSION

Based on the foregoing, and for the reasons set forth in Bell's opening brief, this Court should reverse the Commission and remand with instructions to sustain Bell's refund claim.

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CERTIFICATE OF SERVICE

I hereby certify that two true and accurate copies of the foregoing, as well as a labeled disk containing the same, were mailed first class, postage prepaid or hand-delivered this 26th day of December 2001 to Deputy State Solicitor Alana Barragan-Scott, P.O. Box 899, Jefferson City, Missouri 65102.

CERTIFICATE REQUIRED BY SPECIAL RULE 1(C)

I hereby certify that the foregoing brief includes the information required by Supreme Court Rule 55.03 and complies with the limitations contained in Supreme Court Special Rule 1(b). The foregoing brief contains 7,585 words.

The undersigned further certifies that the disk simultaneously filed with the briefs filed with this Court under Supreme Court Rule 84.05(a) has been scanned for viruses and is virus-free.
