

**IN THE SUPREME COURT OF MISSOURI**

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**No. SC87146**

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**EMERSON ELECTRIC CO., Appellant,**

**v.**

**DIRECTOR OF REVENUE, Respondent.**

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**ON PETITION FOR REVIEW  
FROM THE MISSOURI ADMINISTRATIVE HEARING COMMISSION  
THE HONORABLE KAREN A. WINN, COMMISSIONER**

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**APPELLANT'S REPLY BRIEF**

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## ARGUMENT

### INTRODUCTION

Emerson qualifies for an exemption from use tax on its purchases of a CAD system, a stereolithography machine (“SLA machine”), and a dynamometer<sup>1/</sup>. These machines are necessary to manufacture products Emerson’s customers have requested or ordered. If not for this equipment, either Emerson could not produce the products at all, or its production would be significantly more costly or time consuming (L.F. 161, 163, 165). Emerson operates this equipment in harmony with its production plants as a part of an integrated and synchronized system that meets the demands of the custom manufacturing market. In short, Emerson’s use of the CAD system, the SLA machine, and the dynamometer to design, test, and perfect custom ordered or co-development motors is an integral part of its manufacturing process.

The Director both misrepresents the facts regarding the activities at issue in this case and attempts to narrow the integrated plant doctrine this Court has established for

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<sup>1/</sup> The Director states that she denied one of Emerson’s refund claims on the grounds that it was untimely (Dir. Br. 9). Any suggestion, however, that the Commission upheld this determination is erroneous. The Commission found that on January 3, 2002, the Director consented to a one-year extension of the limitations period for Emerson’s refund claims (L.F. 165). The claim was filed on June 22, 2002, prior to the expiration of the extended limitations period. *Id.*

purposes of applying § 144.030.2(5)<sup>2/</sup> . While the Director states there is no dispute as to the facts of this case (Director’s Brief (“Dir. Br.”) 11), the Director fails to acknowledge or address facts related to Emerson’s customization production process (also referred to herein as “custom orders”) (Appellant’s Brief (“App. Br.”) 14-16; Tr. 84-85, L.F. 159-160). It is unclear whether the Director is simply ignoring the activities associated with the custom orders or collapsing the activities into activities related to co-development projects. The Director, however, also omits facts related to co-development projects.

The customization production process and co-development projects are two separate processes Emerson follows in manufacturing custom motors. Rather than viewing each of these processes as an integrated whole, as this Court’s decisions direct, the Director focuses on a narrow segment of Emerson’s activities related to its co-development projects. From this unduly constrained viewpoint, the Director argues that the machines in question are not exempt because they do not themselves produce the finished motors that are sold to Emerson’s customers (Dir. Br. 11, 14). The Director also erroneously asserts that Emerson’s use of the machines in a “remote location” has no causal relationship to the manufacture of a custom motor (Dir. Br. 18).

Finally, the Director misrepresents the purposes for which the machines at issue are used. Emerson used the CAD system, SLA machine, and dynamometer to design, test and perfect custom motors manufactured at the request of specific customers.

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<sup>2/</sup> Unless otherwise indicated, all statutory references are to the 2000 Revised Statutes of Missouri.

Contrary to the Director's assertions, Emerson does not engage in extensive design and testing work simply to create an elaborate sales pitch for its co-development and custom-order customers (Dir. Br. 14). Those customers come to Emerson for the purpose of purchasing specific products with precise specifications (Tr. 37, 84-85; L.F. 151, 159; Pet. Ex. 10; Pet. Ex. 23). By using the machines at issue, Emerson is able to meet these requirements, produce the product, and deliver it to the customer.

The Director advanced many of these same arguments in other cases this Court has considered. *See Floyd Charcoal Company, Inc. v. Director of Revenue*, 599 S.W.2d 173 (Mo. 1980); *Noranda Aluminum, Inc. v. Director of Revenue*, 599 S.W.2d 1 (Mo. 1980); *Concord Publishing House, Inc. v. Director of Revenue*, 916 S.W.2d 186 (Mo. banc 1996); *DST Systems, Inc. v. Director of Revenue*, 43 S.W.3d 799 (Mo. banc 2001); *Southwestern Bell Telephone Company v. Director of Revenue*, 182 S.W.3d 226 (Mo. banc 2005). As in those cases, this Court should reject the Director's arguments here.

**1. The Exemption Applies to Machinery that is an Integrated Part of Manufacturing, Even if the Machinery is Not Used to Transform Raw Materials into a Finished Product**

When a customer requests or orders a custom motor, Emerson uses the CAD system to design the motor (Tr. 88; Pet. Ex. 28), the SLA machine (in co-development projects) to produce a prototype for testing and perfecting the product's design (Tr. 29, 42-43; L.F. 161; Pet. Ex. 4), and the dynamometer to test motors and ensure that testing equipment at its plants is properly calibrated (Tr. 31, 91-92, 95; L.F. 162). As Emerson demonstrated in its opening brief, all of these functions constitute an integrated part of

the manufacturing process within the meaning of this Court's precedents (App. Br. 30-31). The machines are therefore exempt from Missouri use tax.

The Director's arguments to the contrary largely amount either to misstatements of the record or assertions in various forms of the "stricter view," which this Court has repeatedly rejected, that manufacturing exemptions must be limited to machinery which actually changes raw material into the finished product. *Floyd* at 176, 178 (rejecting this "stricter view"). For example, the Director misstates the record when he claims that the MTC equipment is "not necessary to the actual production of the products Emerson sold" (Dir. Br. 18). The record shows beyond dispute that the equipment is necessary; the equipment designs, tests, and perfects motors produced for specific customers; the equipment, therefore, materially advances production (App. Br. 30-31).

The Director also argues that, because the SLA machine produces a prototype not itself sold "for final use or consumption" (Dir. Br. 16), the machine cannot be exempt. This Court, however, has rejected the idea that a machine must turn raw material into a "finished product" to be exempt. *Floyd* at 178. If a machine operates harmoniously with admittedly exempt machines in an integrated and synchronized way, the machine is exempt. *Floyd* at 177. Here, a machine that produces prototypes for custom manufacturing is "integrated and synchronized" with those machines that rely on the prototypes to manufacture the final product.

This case is very similar to *Floyd* and *Noranda*. There this Court allowed the manufacturing exemption for machinery and equipment used prior to the transformation of raw materials into a finished product. The Director, in asserting that *Floyd* and

*Noranda* provide no support for Emerson’s position (Dir. Br. 20), reformulates the holding of *Floyd* and ignores the facts of *Noranda*. Under the Director’s view of *Floyd*, the relevant test is whether the machinery was “used between the point at which the raw materials for a particular product were gathered and the saleable product was completed” (Dir. Br. 20; *see also* Dir. Br. 18). *Floyd* articulated no such test. In *Noranda*, which was handed down on the same day as *Floyd*, this Court allowed the exemption for the following items, none of which was used “between the point at which the raw materials for a particular product were gathered and the saleable product was completed”:

(a) refractory brick and mortar used in the carbon anode baking furnace,

(b) the baking room crane used to move unbaked and baked carbon anodes in the baking furnaces,

\* \* \*

(e) the carbon anode conveyor system used in the baking room to convey and stock anodes prior to and after the baking process . . . .

*Noranda* at 2.

The taxpayer in *Noranda* used all of these items in its “bake room building” where it produced carbon anodes. The taxpayer’s business, however, was the production and sale of aluminum metal and aluminum products; it did not sell carbon anodes to its customers. The carbon anodes conducted electricity through pots of aluminum oxide which transformed the aluminum oxide to molten aluminum. The anodes did not become a part of the finished product. Instead, they were used for approximately 18 days and

then became useless. The “bake room building,” where the anodes were produced, was entirely separate from the “pot-room building” where the aluminum was manufactured.

As in the instant case, the Director in *Noranda* urged the Court to take a narrow view of the taxpayer’s activities, arguing that the items listed above were not ““used directly in the manufacturing of aluminum and related products”” but were instead ““used for the fabrication of products (anodes) which are in turn utilized in the manufacture of aluminum and therefore are not machinery and equipment used directly in a product which is intended to be sold for final use or consumption.”” *Noranda* at 3. Applying the reasoning of *Floyd*, this Court flatly rejected the approach the Director advocates and concluded:

When we apply the construction of the exemption provision which was approved and adopted in the *Floyd Charcoal* case, it is clear that the items designated and set forth above as (a), (b), [and] (e). . . are used in steps or operations that are essential to and comprise an integral part of Noranda’s manufacturing process, and are “used directly for manufacturing or fabricating a product” as that term is used in § 144.030 RSMo 1969.

*Noranda* at 4.

The Director advanced a nearly identical argument in *Concord* with respect to a “pagination system” that consisted of a network of computer equipment. The Director argued that “the computers directly produce a negative, not a newspaper, and because the negative is not the final product, [the taxpayers] do not qualify” for the manufacturing

exemption on their purchase of the computers. *Concord* at 191. In response to the Director’s argument, this Court explained:

In *Floyd* we rejected a contention similar to that made by the Director in this case. “To limit the exemption to those items of machinery or equipment which produce a change in the composition of raw materials involved in the manufacturing process would ignore the essential contribution of the devices required for such operation.”

*Concord* at 191-192 (quoting *Floyd* at 178).

Here, the Director again asserts that machinery is not exempt because it is used in processes that take place prior to the transformation of raw materials into a finished product. As in *Floyd*, *Noranda* and *Concord*, this Court should reject the Director’s constrained view of the manufacturing process.

## **2. The Exemption Applies to Machines that are Operated at a Location Separate From the Manufacturing Facilities But Causally Related to the Manufacturing Process**

In addition to distorting Emerson’s manufacturing activities, the Director contends that the machines at issue in this case cannot qualify for the exemption because they are used at a “remote” location and lack a “direct tie” to Emerson’s other manufacturing processes (Dir. Br. 18, 20, 21). The Director bases this argument, in part, on her view that the “purpose of the ‘integrated plant doctrine’ is to relieve the courts from parsing through equipment that is used in a *single plant* to determine which equipment is ‘used directly’ in manufacturing and which equipment is not” (Dir. Br. 23) (emphasis added).

The Director's contentions are without support. In *Concord*, this Court explained that:

physical distance alone is not determinative. We have previously permitted the exemption for equipment used in a different location from a manufacturing plant. *See Noranda*, 599 S.W.2d at 4 (exemption allowed for laboratory equipment located in a separate building). We have also recognized that portions of a newspaper may be produced in separate locations and by separate corporations, but still be considered part of one publication.

*Concord* at 192. This Court allowed the exemption for computer equipment in *Concord*, even though it was "physically separated from the printing press" where the papers were produced. *Concord* at 192-193. Likewise, this Court should reject the Director's argument here.

More fundamentally, the Director's argument fails because there is a "direct tie" between the functions the machines at issue perform and the manufacture of custom motors in Emerson's plants, in the sense that all of the machines operate as part of a synchronized and integrated process. Specifically, engineers at the MTC electronically transmit detailed drawings of the custom motor created on the CAD system to plant personnel (Tr. 72, 89; L.F. 158). These drawings show personnel how to manufacture the motor (Tr. 72). The drawings, therefore, guide the entire production process. Engineers at the MTC and personnel at the plant also use the prototypes the SLA machine produces to test Emerson's co-development products for fit and function at the early stages of

manufacturing (Tr. 42-43). This machine is necessary to refine the motor to meet customer specifications and to perfect the design the plant uses to manufacture the motor (Tr. 29, 67; L.F. 161). Finally, the dynamometer tests Emerson's motors (whether mass produced, custom-ordered or created through the co-development process) to insure they meet regulatory and customer specifications, as well as calibrates testing equipment at Emerson's plants (Tr. 31-32, 91-93, 95). The Director's arguments simply overlook these facts.

Allowing the exemption in the instant case serves the Court's purpose in adopting the integrated plant doctrine. Contrary to the Director's assertion, that purpose was to give effect to the legislature's desire to encourage the development of manufacturing in this state, to encourage businesses to produce products that "are subject to sales tax when sold," and to build the state's economy. *Floyd* at 177-178 (quoting *West Lake Quarry & Materials, Co. v. Schaffner*, 451 S.W.2d 140, 142 (Mo. 1970)); *Southwestern Bell* at 230. This Court recognized that "modern manufacturing facilities are designed to operate on an integrated basis." *Floyd* at 178.

Emerson's use of the machines at issue in this case exemplifies the operation of "modern manufacturing facilities" and technological advances. Machines like those at issue allow manufacturing companies to reduce errors and to add precision to their production capabilities. It is no longer necessary for a manufacturer to place all of its machinery in the same location. Emerson's engineers, based at the MTC, participate in the manufacturing process by using sophisticated machinery at a central location, as well as by traveling to the facility where the transformation of the raw materials occurs (Tr.

68, 70 -73, 89). Products assembled in one location can be easily transported for testing in another, where Emerson can analyze the results of the tests and make adjustments to the production process (Tr. 70-73; L.F. 163). Although Emerson's manufacturing functions are spread apart physically, the record in this case shows that they operate as a harmonious, integrated system that includes the machinery at issue. Allowing the exemption is in accord with this Court's precedent, which recognizes the modern manner of manufacturing.

### **3. The Exemption Applies to Design and Testing Activities Related to Specific Products Produced for Specific Customers**

As Emerson explained in its opening brief, the claim for exemption for the CAD system, SLA machine, and dynamometer rests solely on use of that machinery in the production of products specifically requested by and sold to customers (App. Br. 10). True, Emerson also engaged in the development of designs and concepts for new products for which Emerson had no specific customers, but those activities, innovation and platform design, are not at issue here (App. Br. at 11). The Director ignores these facts and incorrectly states that Emerson uses the machines at issue "before Emerson even knows whether it will actually manufacture production motors" (Dir. Br. 21-22). By ignoring the specific circumstances that support Emerson's claim, the Director erroneously concludes that, under Emerson's view, the manufacturing exemption applies to all research and development activities without any limitation (Dir. Br. 26). Emerson contends no such thing.

The Director also incorrectly asserts that Emerson uses the samples and designs created at the MTC for marketing to its customers (Dir. Br. 18, 22). The fact is, however, that with respect to custom orders and co-development projects, Emerson's activities do not begin until a customer has requested a specific product. In the customization production process, there is almost no uncertainty with respect to whether the customer will purchase the final product (L.F. 160). The customer initiates the process by placing a purchase order with Emerson (Tr. 84-85; L.F. 160). Emerson completes these projects in a short period of time (Tr. 85; L.F. 159). The engineers at the MTC draw the plans for the custom motor using the CAD System, not to market the product, but as an integral part of the customization production process. The production plants use these plans to produce the ordered motor (Tr. 87-89). The dynamometer is also sometimes used to test the custom-ordered motor (Tr. 94-95; L.F. 164).

Co-development is also custom manufacturing, but on a broader scale than the customization production process described above. Emerson enters into every one of its co-development projects with the full intention of producing and selling a product that meets the customer's specifications (Tr. 74). It follows, therefore, that when Emerson purchases machinery and equipment for use in a co-development project, it does so to use those items for the production of motors "intended to be sold." Section 144.030.2(5).

Certainly all "research and development" activities do not constitute manufacturing. Emerson makes no such contention. The development of product concepts and designs for which a company hopes to have customers is "research and development" in the experimental sense. It is not "manufacturing . . . a product intended

to be sold ultimately for final use or consumption.” Section 144.030.2(5). Conversely, when a manufacturer produces a specific product for a specific customer, as in this case, and where the design and testing activities are: (1) necessary to such production; (2) physically or causally connected to the finished product; and (3) operate harmoniously with admittedly exempt machinery to make an integrated and synchronized system, all of which are also true in this case, then the manufacturing exemption applies to these activities. *Floyd* at 177.

The Director points to § 144.030.2(33) and (37) as support for the contention that Emerson’s reading of § 144.030.2(5) is unduly broad (Dir. Br. 26). These exemptions expressly mention “research and development” and “research or experimentation.” Subdivisions (33) and (37) of § 144.030.2 create exemptions for “tangible personal property,” including property that is “purchased for use or consumption” in the development of prescription pharmaceuticals and in activities performed by life science companies, respectively.

These exemptions do not undermine Emerson’s claim. They are targeted at two discrete groups of taxpayers (pharmaceutical companies and life science companies) and provide these particular industries very broad exemptions that apply to nearly all their purchases of tangible personal property, not just machinery and equipment. In addition, neither exemption requires that the items be used to create products that are actually sold to a customer. These exemptions extend to research and development in the traditional experimental sense. These recently-enacted exemptions impose no limitation on the

well-settled interpretation of the manufacturing exemptions that have been part of Missouri's sales and use tax law for decades.

**4. The Director's Concession, and the Administrative Hearing Commission's Finding, that the Dynamometer Performs Exempt Functions Establishes That It is Not Subject to Use Tax**

The Director concedes that Emerson used the dynamometer in functions "similar to the functions performed by the laboratory in *Noranda*" (Dir. Br. 25). Nonetheless, the Director apparently believes that the Commission's finding that "such use . . . was incidental" is sufficient to sustain the denial of the exemption. *Id.* The Commission, however, erred as a matter of fact as Emerson showed in its opening brief (App. Br. 33-34). The Commission considered the use of the dynamometer for testing motors in mass production (L.F. 182). The record establishes, however, that Emerson used the dynamometer an additional fifteen percent of the time to test products ordered through the custom-order process (Tr. 94; L.F. 182). Emerson was engaged in the process of manufacturing the custom orders. *Id.* The plain language of § 144.030.2(5) places no threshold on the amount of use necessary to qualify for the exemption; the Director has offered no arguments to the contrary.

**CONCLUSION**

As demonstrated by the foregoing, and for the reasons explained in Appellant's opening brief, the decision of the Administrative Hearing Commission in this case is not authorized by law and creates a result that is clearly contrary to the reasonable expectations of the general assembly. Accordingly, the decision of the Commission

should be reversed and this Court should enter a decision: (1) granting the refunds requested with respect to Emerson's purchase of the CAD system and SLA machine; and (2) abating in full the assessment issued with respect to Emerson's purchase of the dynamometer.

Respectfully submitted,

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## **CERTIFICATE OF SERVICE AND COMPLIANCE**

I hereby certify that one true and accurate copy of the foregoing, as well as a labeled disk containing the same, were hand-delivered or mailed, first class, postage prepaid, this 7th day of August, 2006, to:

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I hereby further certify that the foregoing brief complies with Rule 55.03 and with the limitations contained in Rule 84.06(b), in that it contains 3,834 words.

I hereby further certify that the labeled disk, simultaneously filed with the hard copies of the briefs, has been scanned for viruses and is virus-free.