SC98007

IN THE SUPREME COURT OF MISSOURI

DIRECTOR OF REVENUE,

Appellant,

v.

DREYER ELECTRIC COMPANY,

Respondent.

From the Administrative Hearing Commission
The Honorable Renee T. Slusher

APPELLANT'S BRIEF

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JURISDICTIONAL STATEMENT

The decision by the Administrative Hearing Commission (AHC) is a final decision. Because that decision involves construction of the revenue laws, this Court has exclusive appellate jurisdiction. Mo. Const. art. V, § 3.

INTRODUCTION

Dreyer Electric Company (Dreyer) challenged the Director of Revenue's denial of its refund claim for sales tax collected on parts used in an electrical system Dreyer installed for B&B Timber Company (B&B). The AHC ruled that the assessment was improper and Dreyer was entitled to a sales-tax refund of $6,336.61 because the claimed parts were "replacement equipment" that were "used directly in the manufacturing process." (L.F. 14-23). The Director seeks review of the AHC's decision granting Dreyer a refund on the sales tax paid on the items used in the electrical system. The parties' central issue is whether the disputed items constitute "replacement machinery, equipment, or parts" that are "used directly in" the manufacturing of B&B's products.

B&B is a sawmill that produces flooring material, railroad ties, pallet material, and other timber products. [1] (Tr. 8). B&B engages in manufacturing and utilizes multiple pieces of machinery, equipment, and parts to make products, which are intended to be sold ultimately for final use.[2] Several pieces of this machinery run on electricity. (Tr. 13-14, 24, 48). Following a fire, B&B

[1] Neither party disputes that B&B engages in manufacturing when it renders graded logs into flooring material, railroad ties, pallet material, or other timber products that are intended to be sold wholesale.

[2] This equipment includes a debarker to remove the bark from the logs, transfer chain rollers used to move the logs from the debarker to the saws, head saws, a grinder, a wood chipper, and other equipment. (Tr. 13-14).

installed a new electrical system in Building A, where its manufacturing process takes place. (Tr. 9, 27). The electrical system includes components that are necessary to operate the manufacturing machines, but the electrical system also includes parts that have the sole purpose of powering the lights, heating, and other electrical outlets in Building A. (Tr. 10-11, 31-32, 36-37). Dreyer sought an exemption from sales tax for the sale of every item used in the new electrical system, including the light bulbs, heater, and electrical outlets that are not used in its manufacturing process. (Tr. 13-14, Ex. 2.). The AHC granted Dreyer's claim for a sales-tax refund on all of the disputed items. (L.F. 14-23). This decision was overbroad and expanded the manufacturing exemption to items that are not directly used in manufacturing.

STATEMENT OF FACTS

On April 28, 2016, someone set fire to B&B Timber Company in Marble Hill, Missouri. (Tr. 11). As a result, B&B rebuilt the structure housing its production line (Building A), replaced the entire electrical system inside Building A, and replaced the manufacturing machinery inside of Building A. (Tr. 12-13, 27). This machinery included a debarker, head saws, edgers, transfer chain rollers, a grinder, a chipper, blowers, transfer chains, and a conveyor (collectively, the "manufacturing machinery"). (Tr. 14). This equipment, along with the lights to the building, and heating, is powered by electricity. (Tr. 10-11, 24, 31, 52). B&B hired Dreyer to install the new electrical system within Building A. (Tr. 13). Parts of this electrical system were specifically used because of the electric company's requirements. (Tr. 16). These parts include soft starters which slowly draw power from the electrical grid when starting the manufacturing machinery so that other customers do not experience a disruption in service, a 1,200 Amp disconnect service which includes a series of circuit breakers that will stop the flow of electricity to different motors in the event of a malfunction, and a NEMA overload relay that automatically stops the equipment if it overheats.[3] (Tr. 14-24). Dreyer also

[3] Other disputed items that Dreyer sought a sales tax exemption for were wires, washers, connectors, disconnectors, tape, conduits, couplings, ground rods, cables, and many other items listed in Exhibit 2. (Tr. 13-14).

installed a H2009B-3 heating element which provides heat to the facility, as well as wires and parts used in the lighting system and for electric outlets throughout the building. (Tr. 31, 52, Ex. 2). The manufacturing machines are not plugged into these outlets, and the outlets are not used for any permanent purpose. (Tr. 31-32).

The disputed items do not directly touch, grind, chip, or saw the wood processed by B&B and they are not used up in the manufacturing process. (Tr. 35-37). They are "support items," some of which are necessary to transfer electricity to the motors contained within the manufacturing machinery. (Tr. 13-14, 22-24).

After Dreyer installed the new electrical system in Building A, B&B provided Dreyer with a sales-tax-exemption certificate that stated under exempted products or services purchased: "electrical panels, starters, wiring, motors, support materials, etc."[4] (Tr. 38). On May 12, 2017, Dreyer submitted a refund claim for $6,336.61 to the Director on B&B's behalf for the sales tax it collected from B&B for the sale of the disputed items described in Exhibit 2. (Ex. 1 p. 1). Dreyer's claims were for the tax periods from July 1, 2016 to December 31, 2016. (Ex. 1 p. 1). On June 22, 2017, the Director denied Dreyer's

[4] Respondent Ex. C, p. 2.

claim, stating that the "items do not qualify under the manufacturing exemption." (Ex. A).

Dreyer filed a petition with the AHC, alleging that it was entitled to a refund for the sales tax paid to the Director for the disputed items. (L.F. 1-2). The Director answered, and the AHC held a hearing on April 23, 2018. (Tr. 1).

At the hearing, Barry Booth, the owner of B&B, testified that B&B manufactures logs into wholesale items such as flooring, railroad ties, and pallet material. (Tr. 8). He stated that the disputed items were not "directly used" in the manufacturing process, but that the items were instead "support items" and opined that all of the items were necessary to transmit power to the manufacturing equipment. (Tr. 36-37). He also admitted that the disputed items included items purchased for the lighting system, heating system, and electric outlets that were not used in the manufacturing process. (Tr. 48-50).

Keith Lincoln testified that he was the head electrician for Dreyer and that he designed B&B's new electric system. (Tr. 43-44, 50). He testified that parts of the installed system were necessary for the motors inside the manufacturing equipment to run. (Tr. 44-47). He further stated that the circuit breakers (or disconnects) were required under the electric code and necessary for the operation of the equipment, but did not explain how they were necessary to power or operate the equipment. (Tr. 46). He explained that the soft starters were required by the electric company in order to limit the amount of power drawn from the system when starting the equipment and that the starters also protected the motors from spikes in service, which increased the equipment's longevity. (Tr. 47). He described how the wiring used in the electric system was industrial and "very high-tech cabling." (Tr. 47-48). The purpose of some of the wires was to deliver power to the machines but other "control wires" were used to shut down the motors in the event of a problem. (Tr. 48). Similarly, he stated that there were other mechanisms that would shut the machines down in the event they overheated such as the NEMA overload relay. (Tr. 49).

The AHC found that Dreyer was entitled to a sales-tax refund on the total amount requested by Dreyer based on all of the disputed items in Exhibit 2. (L.F. 14-23). This appeal follows.

STANDARD OF REVIEW

A decision of the Administrative Hearing Commission must be affirmed if "(1) it is authorized by law; (2) it is supported by competent and substantial evidence on the whole record; (3) mandatory procedural safeguards are not violated; and (4) it is not clearly contrary to the reasonable expectations of the General Assembly." *Brinker Mo., Inc. v. Dir. of Revenue*, 319 S.W.3d 433, 435-436 (Mo. banc 2010); § 621.193, RSMo; *Union Elec. Co. v. Dir. of Revenue*, 425 S.W.3d 118, 121 (Mo. banc 2014). This Court reviews the Commission's interpretation of revenue statutes *de novo*. *Brinker Mo., Inc.*, 433 S.W.3d at 435. Exemptions are strictly construed against the taxpayer, "and any doubt must be resolved in favor of application of the tax." *Emerson Elec. Co., v. Dir. of Revenue*, 204 S.W.3d 642, 644 (Mo. banc 2006); *Bartlett Int'l, Inc. v. Dir. of Revenue*, 487 S.W.3d 470, 472 (Mo. banc 2016). The taxpayer bears the burden of proving that "an exemption applies 'by clear and unequivocal proof[.]'" *TracFone Wireless, Inc. v. Dir. of Revenue*, 514 S.W.3d 18, 21 (Mo. banc 2017).

"[T]he purpose of exempting machinery and equipment used in manufacturing or mining products to be sold for final use or consumption is to encourage the development of such enterprises to produce products in this state which are subject to sales tax when sold and thus build up the economy of this state." *W. Lake Quarry & Material Co. v. Schaffner*, 451 S.W.2d 140, 142 (Mo. banc 1970); *See Lincoln Indus., Inc. v. Dir. of Revenue*, 51 S.W.3d 462, 465 (Mo. banc 2001) ("In this particular case, the exemption and others were enacted by the legislature to encourage the production of items ultimately subject to sales tax and to encourage the location and expansion of industry in Missouri.").

It is a "well-established principle that an exemption must be narrowly and strictly interpreted against the taxpayer according to its plain and ordinary meaning." *IBM Corp. v. Dir. of Revenue*, 491 S.W.3d 535, 536 (Mo. banc 2016), as modified (May 24, 2016), overturned on other grounds due to legislative action[5] (citing *Ben Hur Steel Worx, LLC v. Dir. of Revenue*, 452

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[5] The Commission incorrectly held that *IBM* was abrogated in its entirety. (L.F. 21). This Court held in *IBM* that computer hardware and software used to transmit and analyze credit card transactions was not exempt under the manufacturing exemption provided under Section 144.054.2. *Id.* at 541-542. The decision abrogated *Southwestern Bell Tel. Co. v. Dir. of Revenue*, 78 S.W.3d 763 (Mo. banc 2002) and *Southwestern Bell Tel. Co. v. Dir. of Revenue*, 182 S.W.3d 226 (Mo. banc 2005) "to the extent [that those cases] suggest that an expansive interpretation of the word 'manufacturing' is authorized by the 'manufacturing' exemption, and to the extent that they hold that the electronic transfer of voices is itself manufacturing as that term is used in the exemption." *Id.* at 541. The legislature overturned *IBM* to the extent that it applied to telecommunication services only, and clarified that:

> [T]he term "manufacturing" shall include the production, or production and transmission, of telecommunications services…and accordingly abrogates the Missouri supreme court's interpretation of those exemptions in *IBM Corporation v. Director of Revenue*, 491 S.W.3d 535 (Mo. banc 2016) to the extent inconsistent with this section and *Southwestern Bell Tel. Co. v. Director of Revenue*, 78 S.W.3d 763 (Mo. banc 2002) and *Southwestern Bell Tel. Co. v. Director of Revenue*, 182 S.W.3d 226 (Mo. banc 2005)[.]

S.W.3d 624, 626-627 (Mo. banc 2015); *Union Electric Co.*, 425 S.W.3d at 124; *Brinker*, 319 S.W.3d at 437.

TELECOMMUNICATIONS—TAXATION, 2018 Mo. Legis. Serv. S.B. 768 (VERNON'S) (West's No. 49).

POINT RELIED ON

The AHC erred in determining that Dreyer was entitled to a refund of sales tax collected from the sale of the disputed items, because these items, including such things as basic electrical outlets, were not exempt from sales tax under the manufacturing exemption provided in § 144.030.2(5), in that the disputed items are either not used or are only indirectly used in the manufacturing process.

Floyd Charcoal Co., Inc., v. Dir. of Revenue, 599 S.W.2d 173 (Mo. banc 1980).

Southwestern Bell Telephone Co., v. Dir. of Revenue, 182 S.W.3d 226 (Mo. banc 2005).

12 C.S.R. 10-111.010(2)(J).

ARGUMENT

The AHC erred in determining that Dreyer was entitled to a refund of sales tax collected from the sale of the disputed items, because these items, including such things as basic electrical outlets, were not exempt from sales tax under the manufacturing exemption provided in § 144.030.2(5), in that the disputed items are either not used or are only indirectly used in the manufacturing process.

a. The Manufacturing Exemption

Dreyer claimed that it was entitled to a sales-tax refund on the disputed items under the manufacturing tax exemption set out in § 144.030.2(5), which exempted from sales tax:

> Replacement machinery, equipment, and parts and the materials and supplies solely required for the installation or construction of such replacement machinery, equipment, and parts, *used directly* in manufacturing, mining, fabricating or producing a product which is intended to be sold ultimately for final use or consumption[.]

§ 144.030.2(5), RSMo, (2016) (emphasis added).

"This Court reviews the [AHC]'s interpretation of a revenue statute *de novo*." *IBM Corp.*, 491 S.W.3d at 538. "This Court's primary rule of statutory interpretation is to give effect to legislative intent as reflected in the plain language of the statute at issue." *Krispy Kreme Doughnut Corp. v. Dir. of Revenue*, 488 S.W.3d 62, 70 (Mo. banc 2016). The plain language of

§ 144.030.2(5) clearly limits the exemption to "replacement machinery, equipment, and parts and the materials and supplies solely required for the installation or construction of such [items]…*used directly in manufacturing*[.]" § 144.030.2(5) (emphasis added). The use of the words "used directly in manufacturing" modify the exemption to certain equipment that is "used directly" as opposed to all equipment that is necessary to the operation. The dictionary defines "directly" as inter alia:

> in a straight line: without deviation of course: by the shortest way: straight on along a definite course of action without deflection or slackening: purposefully or decidedly and straight to the mark: in a straightforward manner without hesitation, circumlocution, or equivocation…without divergence from the source of the original[.]

Webster's Third New International Dictionary (1986).

The Missouri Code of State Regulations defines manufacturing as:

> i) the alteration or physical change of an object or material to produce an article with a use, identity and value different from the use, identity and value of the original; or
> ii) a process which changes and adapts something practically unsuitable for any common use into some-thing suitable for common use; or
> iii) the production of new and different articles, by the use of machinery, labor and skill, in forms suitable for new applications; or
> iv) a process that makes more than a superficial transformation in quality and adaptability and creates an end product quite different from the original; or
> v) requires the manipulation of an item in such a way as to create a new and distinct item, with a value and identity completely different from the original.

12 C.S.R. 10-111.010(2)(E).

Looking at these two definitions and applying them to the facts of the present case, the plain language of the statute limits the exempt machinery, equipment, and parts to only those items that are directly involved in the alteration of the graded logs into the final products that B&B produces. Under the plain language of the statute, replacement machinery and equipment and parts (and the materials and supplies solely required for these items' installation or construction) that are used *indirectly* in B&B's manufacturing processes are not exempt from sales tax. The disputed items are not exempt from sales tax because they are either not used in the manufacturing process or are indirectly used in B&B's manufacturing process. (Tr. 10-11, 31-34, 36-37, 48).

The disputed items that are not used in B&B's production line at all include: (1) the electrical outlets in Building A and wires running to them because these items serve no permanent purpose and the manufacturing machinery is not plugged into them; (2) the lighting system including the light bulbs, bases, and wires; and (3) the H2009B-3 heater element that provides heat to Building A and is not used for any manufacturing purpose. (Tr. 31, 33-34, 51-52).

The other category of non-exempt disputed items are those that are used to "support" the manufacturing process. (Tr. 13-14, 22-24, 36-37). These items include the 1200 AMP disconnect service, the NEMA Overload Relay, and the wires/screws/other parts used to make the electrical system for the manufacturing machinery. Some of these items work to deliver and control power to the manufacturing machinery; other items are required by the electric company solely for safety reasons and are not necessary to power the equipment. The items that work to deliver and control power, while necessary, are causally one step removed from the actual manufacturing process itself and thus are not exempt under the manufacturing statute.

b. The Case Law Applicable to This Claim

The case law surrounding this issue contemplates "non-exempt" equipment. *See Wilson & Co. v. Dep't of Revenue*, 531 S.W.2d 752, 752-753 (Mo. banc 1976) (determining whether certain machinery and equipment used in the facility was exempt from tax as opposed to non-exempt machinery and equipment stipulated by the parties); *Floyd*, 599 S.W.2d at 173 (purchased stairways and ramps used by manufacturer of charcoal briquettes were not exempt from sales tax as directly used in manufacturing process, in absence of showing they were an integral part of processing system); *Southwest Bell*, 182 S.W.3d at 233-234 (holding that vertically integrated systems did not include every system involved in the process, but only those that met the three prongs of the integrated-plant doctrine and pay phones were not used directly in the production process of transmitting a person's voice via telephone lines).

Items used as a prelude to manufacturing do not qualify for the manufacturing exemption. *See Emerson*, 204 S.W.3d at 646-647 (holding that design and development equipment was not used directly in manufacturing). Additionally, items used post-production do not qualify; *See Utilicorp*, 75 S.W.3d at 727-729 (holding equipment used in the transmission and distribution of electricity was not entitled to manufacturing exemption for the electric company because it was not "used directly" in manufacturing); 12 C.S.R. 10-111.010(2)(J). *But see Wilson*, 531 S.W.2d at 754 (holding that a hog plant was engaged in manufacturing and noting in dicta that: "The energy, other than human, necessary for the operation of this 'production line' comes from the 'power' department which employs miscellaneous electric motors and switch controls, water pumps, boilers, air compressors, and ammonia compressors and other refrigeration equipment.")[6]

c. Underlying Facts

In this case, the record demonstrates that the electrical system is separate from the manufacturing machinery. B&B and Dreyer classified the items in Exhibit 2 as "support items" and the owner of the sawmill testified that none of the items were "used directly" in manufacturing. (Tr. 13-14, 22-24, 36-37). The system designer testified that some, but not all, of these items

[6] *Wilson* did not specify whether this equipment was included or excluded in the tax exemption. *Id.*

were necessary to transfer electricity to the motors contained within the manufacturing machinery. (Tr. 13-14, 22-24).

The records kept on the cost of this equipment did not list any manufacturing machinery, motors, or equipment used on the production line. (Ex. 2 p. 1-4). Instead, the disputed items include clearly non-exempt items such as fluorescent light bulbs (F032/850/ECO FLUOR LAMP), the bases for the light bulbs, (8' 4-1.AMP TANDEM STRIP), and light switches (l'S20ACI-120A S-l'OLE IV SWITCH). (Ex. 2 p. 1-4). Dreyer's invoice lists all of the disputed items as "taxable." (Ex. 2, p. 1-2). No evidence was adduced at the hearing on whether B&B sought an exemption for its previous electrical system and the owner did not know how these items were categorized on B&B's 2016 Federal Tax Returns. (Tr. 41-42).

d. The Integrated-Plant Doctrine:

Whether an item is used directly in the manufacturing process is determined by this Court using the integrated-plant doctrine. *Floyd Charcoal Co., Inc., v. Dir. of Revenue*, 599 S.W.2d 173, 176-178 (Mo. banc 1980); *See Southwestern Bell Telephone Co.*, 182 S.W.3d at 230. Under this theory there are three prongs that a reviewing Court considers: "(1) Is the disputed item necessary to production? (2) How close, physically and causally, is the disputed item to the finished product? (3) Does the disputed item operate harmoniously with the admittedly exempt machinery to make an integrated and synchronized system?" *Floyd*, 559 S.W.2d at 177.

Floyd's three-prong "integral plant" doctrine is derived from the statute's "used directly in manufacturing" language, and must be applied accordingly. Since its inception, the sales tax exemption on equipment used in manufacturing has been narrowly tailored to only equipment that is "used directly in" the manufacturing process. *See W. Lake Quarry*, 451 S.W.2d at 142; *Floyd*, 599 S.W.2d at 173; *Concord Pub. House, Inc. v. Dir. of Revenue, State of Mo.,* 916 S.W.2d 186, 192-193 (Mo. 1996); *Sw. Bell*, 182 S.W.3d at 233-234; *Emerson*, 204 S.W.3d at 646-647; *Utilicorp United, Inc. v. Dir. of Revenue*, 75 S.W.3d 725, 727-729 (Mo. banc 2001). The integrated-plant doctrine does not change this statutory language; the included equipment has always been only the equipment that is actually used to transform initial materials into a new and distinct final product. *See Id.* The Missouri Code of State Regulations explains that the language "used directly in manufacturing" exempts purchases of articles that are "substantially used in, essential to, and comprising an integral part of the manufacturing…process." 12 C.S.R. 10-111.010(1). The regulation lists the three requirements of the integrated-plant doctrine and states:

> Under the integrated plant theory, adopted by Missouri, it is not sufficient to meet only one of these requirements. *For example, items used in material storage or handling before the*

> *manufacturing process begins may be essential to the process, but generally are not an integral part of the manufacturing process and are therefore not used directly in manufacturing.*

12 C.S.R. 10-111.010(2)(J) (emphasis added).

e. Analysis of the Disputed Items

Examples of B&B's replacement equipment and machinery that are used directly in manufacturing include the manufacturing machinery, the motors inside the manufacturing machinery, and any parts and materials used to install this machinery. The disputed items fall under two distinct categories of items that are not "used directly" in B&B's manufacturing process: items that are not used in the manufacturing process at all and items that are used indirectly in the manufacturing process.

The first subcategory of items not used in the manufacturing process includes the light bulbs and light bases used in the lighting system, the heating element, which the record shows solely is used to provide heat to the building and is not used to operate the manufacturing machinery, and the parts used for the electrical outlets that do not play any role in the manufacturing process. (Tr. 31-32, 46-49, Ex. 2).

While lights and heat may be "necessary" for people to work in any manufacturing facility, none of these secondary systems have ever been considered tax exempt under the manufacturing exemption because it only exempts equipment used directly in the manufacturing process. *See W. Lake*

Quarry, 451 S.W.2d at 142; *Floyd*, 599 S.W.2d at 173; *Concord*, 916 S.W.2d at 192-193; *Sw. Bell*, 182 S.W.3d at 233-234; *Emerson*, 204 S.W.3d at 646-647; *Utilicorp*, 75 S.W.3d at 727-729.

Under the second prong of the integrated-plant doctrine, all of the disputed items are physically close to the manufacturing machinery and the finished product—they are located in Building A. (Tr. 9, 27). However, the lights, heating, and other electrical outlets in Building A are not causally connected to the manufacturing process in that the parts have the sole purpose of powering these separate systems which do not cause a change to any raw materials and are not a part of the production line. (Tr. 10-11, 31-32, 36-37).

The only exempt items should be those that are considered integral to the production process. *Floyd,* 599 S.W.2d at 177; *Sw. Bell*, 182 S.W.3d at 237; 12 C.S.R. 10-111.010(3)(A). This does not include the heating element, electrical outlets, light bulbs and bases, or anything that does not "operate harmoniously with the admittedly exempt machinery to make an integrated and synchronized system." *Floyd*, 559 S.W.2d at 177.

Examples of replacement equipment and machinery and parts that are used indirectly in B&B's manufacturing process are the devices that are required for safety purposes by the electric company, such as the wires running to the circuit breakers which are not used to power or control the equipment but to shut the equipment down in case of malfunction. (Tr. 51-52). The tax exemption under § 144.030.2(5) is not for safety equipment but for manufacturing equipment. To say that such safety items are necessary to the process because they are legally required misconstrues and broadens the first prong of the integrated-plant doctrine under *Floyd*. 599 S.W.2d at 176-178. To find that an item is necessary by operation of law is not the same thing as a finding that the item is necessary in order to manufacture the final products. (L.F. 9) (The AHC found that the breakers were "an important safety feature for employees who work on the machinery."). These circuit breakers and the NEMA overload relay are not causally connected to the production of timber products—they are not on the production line and they do not deliver power to the manufacturing machinery. Admittedly, the items affect the production line in that these items shut the machinery down but this is an example of an indirect use in manufacturing. To include these items is to include everything that is used, or touches, or affects the manufacturing equipment and such a broad interpretation would negate the purpose of the use of the limiting word "directly" before "used" in the statute.

All of the disputed items were classified by B&B and Dreyer as "support items" that were not "used directly" in manufacturing. (Tr. 13-14, 22-24, 36-37). Some, but not all, of the disputed items are necessary to transfer electricity to the motors contained within the manufacturing machinery. (Tr. 13-14, 22-24).

Turning to the disputed items that act to deliver and control power to the manufacturing equipment such as the starters, and power and control wires. (Tr. 13-14, 22-24, 44-47). The testimony at the hearing supports a finding that these items meet the first prong under the integrated-plant theory in that these items are "necessary" to operate the manufacturing machinery. *Floyd*, 599 S.W.2d at 176-178. However, these items are still causally one step removed from the production line and form a secondary system that is designed to "support" and "deliver power" to the exempt equipment. (Tr. 13-14, 22-24). While the regulation defining "used directly in manufacturing" states that the "requirement is not limited to those items of machinery, equipment, and parts that produce a direct physical change in the composition of the raw materials…*the integrated and synchronized system begins when raw materials enter the production process and ends when the product is finished*." 12 C.S.R. 10-111.010(2)(J) (emphasis added). The requirement is thus appropriately limited to only the equipment that is actually used in the line of production. This comports with the definition of "directly" which includes "in a straight line: without deviation of course: by the shortest way: straight on along a definite course of action without deflection or slackening[.]" Webster's Third New International Dictionary (1986).

The exempt equipment includes the headsaws, the log rollers, the debarker, as well as the internal motors— items, which transform raw materials into a final product that will be subject to sales tax. The plain language of the exemption states "machinery, equipment, and parts…used directly in manufacturing." § 144.030.2(5). The statute does not include all equipment used in the manufacturing process. To include all of the equipment necessary to run the secondary systems used indirectly in the manufacturing process is to expand the exemption far beyond what the plain language of the statute states.

In *Concord*, this Court held that the integrated-plant doctrine could include equipment that spanned two different locations and two different corporate entities so long as both worked together to create a single product and the exchange between them "occurred as a coordinated and necessary step in the manufacturing process." *Concord Pub. House, Inc. v. Dir. of Revenue, State of Mo.,* 916 S.W.2d 186, 192-193 (Mo. 1996) (holding the computers used to format, edit, and design the newspapers were exempt from sales tax under the integrated plant doctrine). Thus, under the integrated-plant doctrine equipment from two different systems may be exempt so long as the equipment is used directly to manufacture a product that will result in a final sale on which sales tax is to be collected. *Id*. Here, unlike the computers in *Concord* which were used directly to manufacture the final product, the disputed items do not act in a similar way to cause a change to the graded timber. The items merely acted as a conduit between the source of electrical power and the admittedly exempt manufacturing machinery.

Just as the transmission and distribution of electricity to the consumer is not part of manufacturing the electricity itself, so the transmission and distribution of electricity from the electrical grid to the consumer's equipment is not an integrated part of manufacturing the end product. *Utilicorp*, 75 S.W.3d at 727-729. Other states with similar tax exemptions have noted that electrical equipment simply supplies the intervening machinery that is itself "used directly" in manufacturing. *See Southwire Co. v. Chilivis*, 228 S.E.2d 295, 296 (Ga. Ct. App. 1976) (holding that electrical equipment like rectifiers, electrical switches, and electrical metering and monitoring equipment were only "indirectly used in the manufacturing process" carried out by an "intervening agency"); *Rotek, Inc. v. Limbach*, 552 N.E.2d 640, 643 (Ohio 1990) (electrical substation was not "used directly in manufacturing" or even "adjunct to direct use in manufacturing"). This is consistent with a broader body of law finding that infrastructure surrounding the manufacturing process is not itself a direct part of the manufacturing process. *See Webster Brick Co., Inc. Dep't of Taxation*, 245 S.E.3d 252, 256-57 (Va. 1978) (rejecting contentions that "the entire manufacturing plaint" is ""used directly' in manufacturing" and that climate-control ventilators was used directly in manufacturing); *Blackmon v. Screven Cty. Indus. Dev. Auth.*, 205 S.E.2d 497, 499 (Ga. Ct. App.

1974) (holding that climate control equipment, "though essential to the manufacturing operation" was not directly used in manufacturing process); *Indiana Dep't of State Revenue v. RCA Corp.*, 310 N.E.2d 96, (Ind. Ct. App. 1974) (environmental control equipment used in plant manufacturing television tubes was not used "directly" in manufacturing). The electrical system consists of "support items" which are necessary to transfer electricity to the motors contained within the manufacturing machinery. (Tr. 13-14, 22-24). B&B requested an exemption for these "support materials" which the Director denied. (Ex. C p. 2).

The AHC erroneously concluded that the disputed items were, in their entirety, replacement equipment, and further concluded that the disputed items were used directly used in the manufacturing process. (L.F. 14-23). The disputed items form a separate electrical system that is distinct from the manufacturing machinery that is used directly in the manufacturing process. The electrical system is used to transfer power from the electric company utilities to the motors contained within the manufacturing equipment, thus it is an intermediary system that is used at best only indirectly in the manufacturing process. The plain language of the statute limits the exemption to only items "used directly" in the manufacturing process. As such, it is not eligible for the sales tax exemption. The inclusion of all of the disputed items under the statute produces an absurd result. *Murray v. Missouri Highway and*

Transp. Comm'n, 37 S.W.3d 228, 233 (Mo. banc 2001) (holding that statutes should be construed so as to avoid unreasonable and absurd results). Under the AHC's interpretation of the manufacturing exemption, the equipment and parts used to provide electricity to the workers' cell phones and the breakroom coffee pot are items that are "directly used" in manufacturing.

Exemptions are strictly construed against the taxpayer, "and any doubt must be resolved in favor of application of the tax." *Emerson*, 204 S.W.3d at 644; *Bartlett Int'l*, 487 S.W.3d at 472. The taxpayer bears the burden of proving that "an exemption applies 'by clear and unequivocal proof[.]'" *TracFone Wireless*, 514 S.W.3d at 21. It is a "well-established principle that that an exemption must be narrowly and strictly interpreted against the taxpayer according to its plain and ordinary meaning." *IBM*, 491 S.W.3d at 536.

Here, the AHC considered all of the items "replacement equipment" even though some are clearly parts, and found that all of the items were "directly used in manufacturing" even though many of the items were not used at all in the manufacturing process. This was in clear contrast to the testimony of the witnesses, who stated that disputed items included parts for the lighting system and random electric outlets that have no permanent purpose, and the "H2009B-3 heater element" that was "for the heater" and not any manufacturing purpose. (Tr. 31, 33-34, 51-52). Thus, the taxpayer did not demonstrate by "clear and unequivocal proof" that all of the disputed items qualified for the manufacturing exemption in that they were "used directly" in B&B's manufacturing process. *TracFone Wireless*, 514 S.W.3d at 21.

This Court should find that the disputed items do not qualify for the tax exemption either because they are not used in the manufacturing process (the lights, heater, and electrical outlets) or because they are only indirectly used to cause a change in the manufactured lumber.

CONCLUSION

For the foregoing reasons, the Director of Revenue respectfully requests that this Court reverse the judgment of the Administrative Hearing Commission.

Respectfully submitted,

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CERTIFICATE OF SERVICE AND COMPLIANCE

I certify that a copy of the above Appellant's Brief was served electronically by Missouri CaseNet e-filing system on November 8, 2019, to all parties of record.

I also certify that the foregoing brief complies with the limitations in Rule No. 84.06(b) and that the brief contains 5,970 words.

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