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Commonwealth of Kentucky

Court of Appeals

NO. 2008-CA-000022-MR

FINANCE AND ADMINISTRATION
CABINET, DEPARTMENT OF REVENUE — APPELLANT

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE THOMAS D. WINGATE, JUDGE
ACTION NO. 07-CI-00435

ROHM AND HAAS COMPANY AND
ROHM AND HAAS KENTUCKY, INC. — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: ACREE, CLAYTON AND KELLER, JUDGES.

ACREE, JUDGE: The Finance and Administration Cabinet, Department of Revenue, (Cabinet) appeals from a decision of the Franklin Circuit Court which

overturned an order from the Board of Tax Appeals (Board). The Board's order upheld the Cabinet's denial of tax refunds claimed by Rohm and Haas Company and Rohm and Haas Kentucky, Inc., (Rohm and Haas) pursuant to Kentucky Revised Statutes (KRS) 139.480(3). We have considered the issues raised, the applicable law, and the oral arguments presented by the parties, and have determined that the circuit court's decision must be affirmed.

At its 400-acre plant in Louisville, Kentucky, Rohm and Haas processes a variety of chemicals for sale and use in the manufacture of various products. For accounting and other purposes, Rohm and Haas distinguishes the separate operations within its organizational structure. We are interested in three of those operations – the "Distilling Operation," the "Plexiglas Operation," and the "Emulsions Operation."

The "Distilling Operation" begins when liquid crude, or undistilled, methyl methacrylate (MMA) arrives at the Louisville plant. There is no ready market for undistilled MMA, but a substantial one for distilled MMA – a component part of many finished plastics, polyvinylchloride (PVC) products, and similar polymer-based products. The Distilling Operation processes the crude MMA by distillation. The distilled MMA – a clear liquid – is then stored on-site, for several days to as long as a month, in tanks with a capacity of ten million pounds. While in storage, the distilled MMA is tested and assessed for quality. At that point, the Distilling Operation is complete. Only then can the MMA be used in the manufacture of other products.

Rohm and Haas produces about one billion pounds of crude and distilled MMA annually. During the tax years for which the exemption is claimed, Rohm and Haas's other on-site operations consumed about 95 percent of the distilled MMA processed by the Distilling Operation. However, about 5 percent of its distilled MMA was sold to third parties, including Rohm and Haas competitors. When sold to third parties, the distilled MMA was, and still is, pumped out of the tanks and into trucks or railroad tank cars for delivery. The distilled MMA consumed by Rohm and Haas's other operations is delivered by pipeline.

From an accounting standpoint, Rohm and Haas's Distilling Operation was separate and distinct from the other processes at the Rohm and Haas facility. Rohm and Haas allocates to its Distilling Operation the cost of acquiring crude MMA, as well as all costs required to convert crude MMA to distilled MMA such as energy and labor.

In a separate process – the "Plexiglas Operation" – some of the distilled MMA from the Distilling Operation is used in combination with certain catalysts to produce Plexiglas pellets. There are distinct costs of production associated with the process that produces Plexiglas pellets. However, the Plexiglas Operation does not include the cost of acquiring crude MMA or the cost of converting crude MMA into the distilled MMA it consumes.[1] Effective July 1,

[1] A Rohm and Haas accountant testified that in order to assess the profits of the various operations, but not for tax purposes, a "transfer cost" of distilled MMA is attributed to the various "downstream" operations. The "transfer cost" to the "downstream" operations was roughly equivalent to what distilled MMA would have cost if acquired from a third-party vendor. However, since all costs associated with distilling MMA are allocated to the Distilling Operation for tax purposes, it would be improper to allocate the same costs a second time to another

1998, Rohm and Haas sold the Plexiglas Operation as an independent going concern. Consequently, the Distilling Operation's sales of distilled MMA to third parties rose from 5 percent to 55 percent.

In another separate process – the "Emulsions Operation" – distilled MMA is used in combination with other components to produce plastics additives, or emulsions. There are distinct costs of production associated with the process that produces these emulsions. Like the Plexiglas Operation, the Emulsions Operation does not include the cost of acquiring crude MMA or the cost of converting crude MMA to the distilled MMA it consumes.

Neither the Plexiglas Operation nor the Emulsions Operation is required to use distilled MMA from Rohm and Haas's Distilling Operation. These "downstream" operations can, and on occasion have, used distilled MMA acquired from independent sources.

Based on these facts, and in reliance upon KRS 139.480(3), Rohm and Haas sought refunds of sales and use tax imposed on energy costs for the period between January 1, 1995, and December 31, 1998, for the Plexiglas Operation and the Emulsions Operation, claiming those operations were separate and distinct from the Distilling Operation. Our starting point, therefore, is KRS 139.480(3).

> 139.480 Property exempt
>
> Any other provision of this chapter to the contrary notwithstanding, the terms "sale at retail," "retail sale," "use," "storage," and "consumption," as used in this

operation engaged in by this same taxpayer.

> chapter, shall not include the sale, use, storage, or other consumption of:
>
> . . . .
>
> > (3) All energy or energy-producing fuels used in the course of manufacturing, processing, mining, or refining and any related distribution, transmission, and transportation services for this energy that are billed to the user, to the extent that the cost of the energy or energy-producing fuels used, and related distribution, transmission, and transportation services for this energy that are billed to the user exceed three percent (3%) of the cost of production. Cost of production shall be computed on the basis of plant facilities which shall mean all permanent structures affixed to real property at one (1) location[.]

KRS 139.480(3). The parties agree that the principal case interpreting this statute is *Revenue Cabinet, Com. of Ky. v. James B. Beam Distilling Co*., 798 S.W.2d 134 (Ky. 1990).

In *Beam*, the taxpayer sought to assign portions of its total production costs to various operations at a single location. This allowed Beam to maximize its exemption with respect to its distillery operation. The Supreme Court interpreted KRS 139.480(3) as allowing the taxpayer to allocate its production costs among multiple operations subject to the taxpayer's ability to establish that those operations were "separate and distinct," "separate and complete," and "separate and discrete."[2]

[2] As the Cabinet points out, the Supreme Court used a variety of adjectives to describe the concept, including each of these.

Summarizing legislative intent in KRS 139.480(3), the Supreme Court injected what, at first blush, seems a different or additional criterion.[3]

> It seems only logical that a taxpayer which can demonstrate that the operation for which the exemption is claimed is a truly separate and complete operation, ***not dependent on the other operations at that site for production of a completed product or process***, need not include the costs of the other unrelated operations in its costs of production for that one operation.

Beam at 135 (emphasis supplied).

Seizing on the highlighted language quoted above, the Cabinet argues that *Beam* is inapposite. In *Beam,* the question was whether the "upstream" bourbon distilling operation was dependent upon the "downstream" operations of warehousing and bottling the bourbon. The Supreme Court concluded it was not. The case before us, so the Cabinet's argument goes, demonstrates that the opposite is not true. The Cabinet concludes that the downstream operations at Rohm and Haas (the Plexiglas Operation and the Emulsions Operation) *are* dependent upon its upstream Distilling Operation. Presenting a simple analogy, the Cabinet notes that it is possible to count to 1 without depending on 2 and 3 to get there; however, one cannot count to 3 without first counting through, and therefore depending upon, 1 and 2. This analogy, however, is an imperfect fit.

[3] Significantly, the Board's order held that "proof that the manufacturing of [P]lexiglas and emulsions are 'separate and complete' operations is not enough to bring these facts within the coverage of The Beam Case. Not only must the operations for which the exemption is claimed be 'separate and complete' but they must also be 'not dependent on other operations at that site for the production of a completed product or process.' " (Board's Order No. K-19757, February 13, 2007). This suggests that the Board interprets the language in *Beam* as creating that different or additional criterion.

We believe the Cabinet misinterprets the Supreme Court's use of the word "dependent" in *Beam*. Our reasons are at least three in number. First, if we were to accept the Cabinet's interpretation, no taxpayer's downstream operation could ever be deemed separate and distinct from its upstream operations. This seems to us inconsistent with legislative intent. *Beam* at 135("objective of the legislature in creating particular exemptions [is] to encourage the location and expansion of industries in Kentucky."). Second, such an interpretation would mean that even in *Beam* the downstream bottling operation was not separate and distinct from the upstream distilling operation – a paradoxical asymmetry we do not believe the Supreme Court intended. Third, the Supreme Court's use of the word "dependent" is better understood in the context of its analysis of other exemptions contained in the same statute.

In *Revenue Cabinet, Com. v. Amax Coal Co*., 718 S.W.2d 947 (Ky. 1986), the Supreme Court reviewed a claim of exemption under KRS 139.480(10)[4] . That section provides for an exemption from sales and use tax on "[m]achinery for new and expanded industry." The basis for the Cabinet's denial of the exemption claimed in *Amax Coal* was that the subject machinery was used in a process separate and distinct from the taxpayer's manufacturing process. *Amax Coal* at 949. Ironically then, to be entitled to the exemption in subsection (10), the

[4] When *Amax Coal* was decided, this exemption was contained in KRS 139.480(8) and it is referred to as such in that case and those preceding it. The Legislature's subsequent addition of even more exemptions resulted in renumbering the subsection as KRS 139.480(10). We refer to the current version of the statute in this opinion for consistency.

taxpayer needed to establish that its operations were *not* separate and distinct. Nevertheless, the question under either subsection (10) or subsection (3) is the same – what constitutes "separate and distinct" operations for purposes of KRS 139.480? The Supreme Court found the answer in its prior decisions.

Turning first to *Department of Revenue, ex rel. Luckett v. Allied Drum Service, Inc.*, 561 S.W.2d 323 (Ky. 1978),[5] the Court in *Amax Coal* said,

> [t]here [in *Allied Drum*], this Court defined "a manufacturing process" as:
>
> "Material having no commercial value for its intended use before processing has appreciable commercial value for its intended use after processing by the machinery." *Id.* at 325-26.

Amax Coal at 949. The Court further noted that, in assessing a claim of exemption, "a determination must be made as to when the manufacturing process begins and ends." *Id.,* quoting *Ross v. Greene & Webb Lumber Co., Inc*., 567 S.W.2d 302, 303 (Ky. 1978). These concepts were reiterated in *Revenue Cabinet v. Kentucky-American Water Co.*, 997 S.W.2d 2 (Ky. 1999), in which the Supreme Court also noted the importance of a concept from *Beam*:

> Although the principal thrust of the *Beam*, *supra*, opinion was the one location definition, this Court stated . . . *its product* [that is, the product produced by the separate and

[5] The unanimous opinion in *Allied Drum* reconciled a half dozen seemingly incompatible cases defining "manufacturing" noting that "[t]he thread that runs through all of these opinions is that material of little or no market value has been converted into a marketable product for its intended use." *Allied Drum* at 325. The Court seemed unsure if its definition would last, stating: "In any event, let us attempt this definition and await the test of future cases in this area." *Id*. at 326. The definition has lasted. The 2008 Session of the Kentucky General Assembly added a definitions section to Chapter 139. *See,* 2008 c 95, § 4, eff. 8-1-08. The language used in the statute reflects *Allied Drum*'s influence. *See* KRS 139.010(8).

> distinct operation,] . . . *must be marketable for its intended use without regard to the other operations*[.]

Kentucky-American at 6 (emphasis supplied).

We believe use of the word "dependent" in *Beam* is consistent with the rationale in these prior cases. To be separate and distinct, each operation must not be "dependent on the *other operations* at that site for production of a completed product or process[.]" *Beam* at 135 (emphasis supplied). Though Rohm and Haas's downstream operations are dependent upon distilled MMA, they are not dependent upon the Distilling Operation to produce it. In fact, the Plexiglas Operation was so separate and distinct from the Distilling Operation that the former could be packaged and sold as a going concern. Each of these three operations produces a "completed product" that is "marketable for its intended use without regard to the other operations[.]" *Beam* at 135; *Kentucky American* at 6. We believe these facts, which are reflected in the Board's Order, compel the finding as a matter of law that each of the three operations is separate and distinct from the others for purposes of KRS 139.480(3).

The Cabinet next argues that Rohm and Haas's attempt to distinguish the various stages of the process of converting crude MMA into Plexiglas and emulsions is at odds with the "integrated plant concept." We disagree.

Kentucky embraced the "integrated plant concept" in *Schenley Distillers, Inc. v. Commonwealth, ex rel. Luckett*, 467 S.W.2d 598 (Ky. 1971), to assist the analysis of taxpayers' claims that machinery acquired and incorporated

into the manufacturing process is exempt from tax under KRS 139.480(10).[6] In *Schenley*, the taxpayer claimed exemption for a conveyor system that ran through its plant carrying bottles to be filled with the taxpayer's product. The Cabinet relied on an Ohio case holding that machinery facilitating the "transportation to or from a particular activity generally does not involve tax-exempt machinery." *Schenley* at 600. Our former Court of Appeals pointed out, however, that the same authority made a distinction when such machinery "is an integrated part of the production process and the first movement is as essential as the last." *Id.*

The Cabinet argues that because distilled MMA is transported from the Distilling Operation to the downstream operations via pipeline, the entire process that converts crude MMA to Plexiglas and emulsions, like the bottle conveyor in *Schenley*, is a single integrated production process. This argument fails to persuade.

First, both *Schenley* and *Beam* addressed whether distilling and bottling were one integrated process. *Schenley* held it was, thereby allowing the exemption under KRS 139.480(10);[7] *Beam* held it was not, allowing the exemption under KRS 139.480(3). Rohm and Haas claims exemption under KRS 139.480(3). *Beam*, therefore, holds more authority in analyzing the matter before us.

[6] The "integrated plant concept" was also adopted in order to promote "the objective of the legislature in creating particular exemptions to encourage the location and expansion of industries in Kentucky." *Schenley* at 601.

[7] Again we note that when *Schenley* was decided, this particular exemption was set forth in KRS 139.480(8).

Second, the taxpayer in *Schenley* had designed its manufacturing process from beginning to end without interruption; it was one continuous operation. *Schenley* at 599("The process is continuous in this conveyor system from the movement of empty bottles through the bottling process and into filled cases of the ultimate product."). Unlike the case before us, the taxpayer in *Schenley* undertook no effort to separate its distillation operation from its other operations either physically or for accounting purposes. Rohm and Haas did both.

Third, nothing in *Schenley* indicates that a market existed for its product other than at the end of its production line. *Burke v. Stitzel-Weller Distillery*, 284 Ky. 676, 145 S.W.2d 861, 863 (1940)("with rare exceptions relating to rectifiers, other distillers and wholesalers, whiskey cannot be put on the market for the use for which it was intended until it is bottled."). Rohm and Haas demonstrated, and the Board found, that a market does exist for the distilled MMA manufactured by the Distilling Operation. By necessary implication, the Board's finding also means that distilled MMA can be acquired by the Plexiglas Operation and the Emulsions Operation from third parties. Rohm and Haas established as much. Therefore, these downstream operations are not dependent upon the Distilling Operation to provide distilled MMA. The fact that an economy of scale, or vertical monopolization, or any other cost consideration, justifies use by the downstream operations of a ready supply of distilled MMA produced on-site does not make those downstream operations dependent upon the Distilling Operation for purposes of the exemption.

Finally, the Cabinet argues that Rohm and Haas failed to include any raw materials in the "costs of production" of the Plexiglas Operation and Emulsions Operation. *See* KRS 139.480(3). Relying on *Louisville Edible Oil Products, Inc. v. Revenue Cabinet, Commonwealth of Kentucky*, 957 S.W.2d 272, 274 (Ky. 1997)(hereafter *LEOP*), the Cabinet argues that "costs of production" must include the cost of raw materials. This is a correct reading of *LEOP*, but it does not go far enough. To quote *LEOP*, "[t]he simple answer to this argument is that the statute requires the cost of materials to be factored in at least once *for each taxpayer*." *LEOP* at 275, quoting *McKinley Iron v. State Dir. of Revenue*, 888 S.W.2d 705 (Mo. 1994)(interpreting similar, but not identical, exemption provision; emphasis supplied by this Court in *LEOP*). The only taxpayer involved here is Rohm and Haas which did include all costs of crude MMA, as well as the costs of refining it, when it allocated these tax items to its Distilling Operation. Therefore, all costs of the raw materials used by the downstream operations were "factored in" by this taxpayer. This seems a proper allocation of those costs. Forcing those costs to be allocated to downstream operations that did not, in fact, acquire or refine the raw materials appears artificial, even fictional, if not contrary to generally accepted accounting principals.

We must reject the position of the Cabinet, despite the excellent briefs and skillful oral argument of its counsel. "Although, as the Cabinet argues, tax-exemption statutes are strictly construed against the taxpayer, we also must take into consideration the objective of the legislature in creating particular exemptions

to encourage the location and expansion of industries in Kentucky." *Beam* at 135, quoting *Schenley* at 601. Furthermore, tax statutes are not excepted from the maxim found in KRS 446.080(1) to the effect that all statutes are to be liberally construed with the view to promote their objects and carry out the intent of the legislature.

For the foregoing reasons, the order of the Franklin Circuit Court is affirmed.

ALL CONCUR.

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