

Approved: 2-2-00  
Date

MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE.

The meeting was called to order by Chairperson Senator Audrey Langworthy at 11:08 a.m. on February 1, 2000, in Room 519-S of the Capitol.

All members were present except: Senator Dick Bond – Excused

Committee staff present:

April Holman, Legislative Research Department  
Don Hayward, Revisor of Statutes Office  
Shirley Higgins, Committee Secretary

Conferees appearing before the committee: Shirley Sicilian, Kansas Department of Revenue

Others attending: See attached list.

The minutes of the January 31, 2000, meeting were approved.

Senator Langworthy called upon Shirley Sicilian, Kansas Department of Revenue for an informational briefing on the integrated plant sales tax theory. Ms. Sicilian noted that the briefing was timely because Kansas is poised to become an integrated plant state. She went on to define “integrated plant theory” as a concept used to determine the scope of sales tax exemptions for manufacturing machinery and equipment.

Ms. Sicilian reviewed the background of this theory. Her review included a description of the two basic standards for determining what is meant by “manufacturing, assembling, or processing” (the Ohio rule and the integrated plant rule). She also discussed the Department’s interpretation of “integrated plant” and judicial interpretation. Ms. Sicilian concluded that the Legislature is the most practical forum for accomplishing an adoption of a Kansas integrated plant rule because it is able to articulate policy intent and provide necessary clarity. She noted that **HB 2009**, which was introduced in the 1999 legislative session, would allow an integrated plant rule. She suggested technical clean-up if the Legislature should favor the **HB 2009** approach. (Attachment 1)

Committee discussion and questions followed. Ms. Sicilian clarified that **HB 2009** would broaden the current Kansas law to move away from the Ohio interpretation and provide an integrated plant bill. She explained that the bill would be more restrictive than the court’s interpretation but more liberal than the Department’s interpretation. Senator Langworthy informed the Committee that **HB 2009** was amended into **HB 2543** during the 1999 Legislative Session.

The meeting was adjourned at 11:50 a.m.

The next meeting is scheduled for February 2, 2000.

# SENATE ASSESSMENT AND TAXATION COMMITTEE GUEST LIST

DATE: February 1, 2000

NAME	REPRESENTING
Judith Han	DOB
Stan Parsons	KGC
Bob Kuhlend	KIOGA
Jennifer Crow	Federico Consulting
Cathia Smith	KOPL
Wendy Warner	KAPA
Woody Wenzel	KAPA
Geoff Whits	KFB
Graig Johnson	KFB
Nave Holtham	Western Resource
Sandra Braden	McGill, Gaches & Assoc.
Bernie Koch	Wichita Area Chamber
MARK A. BURGHART	WESTERN ASSN.
Ken Penner	KFB
DAVE SCHWEDEIS	WRI
Mike Stadler	WRI
Ashley Sherard	Overland Park Chamber
JACQUE CLARK	Hallmark CARDS, INC
Kelley Kuetala	City of Overland Park



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## Office of Policy &amp; Research

## TESTIMONY

**To:** Senator Langworthy; Chair, Senate Assessment and Taxation Committee  
 Representative Wagle; Chair, House Taxation Committee  
**From:** Shirley K. Sicilian  
**Re:** **Informational Briefing on Integrated Plant Theory**  
**Date:** February 1, 2000

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Good morning Senator Langworthy, Representative Wagle, and members of the committees. Thank you very much for the opportunity to provide you this informational briefing on the "integrated plant theory," and the ongoing struggle to adopt it in Kansas. This discussion is timely because Kansas is poised to become an integrated plant state. The legislature has been working toward that end for some time and has gotten as far as conference committee with a 1999 session bill that would accomplish this goal. Meanwhile, the courts are also moving in that general direction, although the judicial interpretation of "integrated plant" appears to be significantly different from the legislative proposal, and at this point, may only apply to the "consumed in production" exemption.

### I. Background on the Integrated Plant Theory.

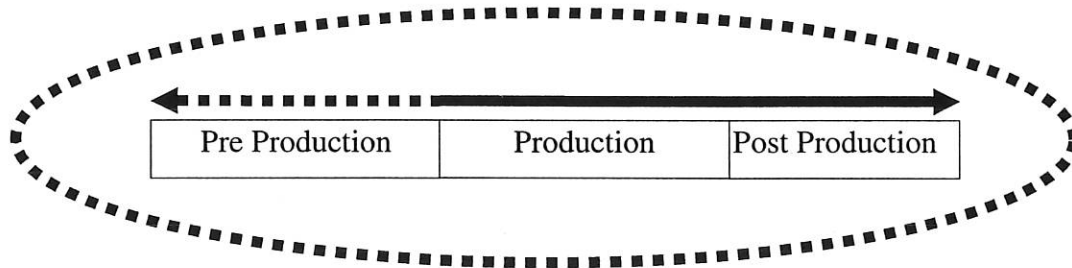
The "integrated plant theory" is a concept used to determine the scope of sales tax exemptions for manufacturing machinery and equipment. Almost all states have some form of sales tax exemption for manufacturing machinery and equipment. The exemption makes sense from a tax policy perspective. In principle, sales taxes are designed to be levies on final consumer expenditures. If goods used in production are taxed, as well as the goods that are finally produced, there is an element of multiple taxation. In some states the manufacturing machinery exemption has a second purpose: to promote economic development and create new jobs.

Kansas has *both* an economic development related exemption and a straight manufacturing machinery and equipment exemption. K.S.A. 79-3606(cc) is the statute focused on economic development. It is a very broad exemption for *all* tangible personal property, including machinery and equipment, and services purchased "in conjunction with constructing, reconstructing, enlarging or remodeling a business or retail business" which has increased its employment by at least two.

Where there is no increase, or even a decrease, in employment, machinery and equipment may still be exempt in Kansas under K.S.A. 79-3606(kk). This statute has no employment criteria and provides an exemption for "machinery and equipment used directly and primarily" for "manufacturing, assembling, processing, finishing, storing, warehousing or distributing articles of tangible personal property ..."

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 Attachment 1

There are two basic standards for determining what is meant by “manufacturing, assembling, [or] processing.” One standard, usually called the **physical transformation or Ohio rule**, requires that exempt machinery and equipment have a “direct and immediate effect” on the raw materials being processed. The other standard is the **integrated plant rule**. The integrated plant rule only requires that exempt machinery and equipment perform an “integral or essential function in the manufacturer’s production process.” For example, under the “physical transformation rule,” a machine that drills holes in the property being processed would be exempt. Under the “integrated plant rule,” the machine that purifies the oil used to lubricate that drill would also be exempt. Even though it has no “direct effect” on the raw materials, it performs an “essential function.”



Physical Impact Rule      **—————**

HB 2009 Integrated Plant      **■■■■■■**

As initially proposed in 1988, K.S.A. 79-3606(kk) would have exempted machinery and equipment which creates a “direct and immediate physical change” on the property being processed, the Ohio rule. Before being enacted, the bill was amended to explicitly add a few other types of machinery and equipment. The result is a combination of the two different theories, which has been difficult for the department to interpret and administer consistently over the years.

For example, one Kansas appellate court judge stated, albeit in an unpublished opinion dealing with a superseded statute, that Kansas has adopted the integrated plant theory.<sup>1</sup> Because the court did not publish this ruling, its legal impact is limited to the parties to the case. Meanwhile writers for publications that provide in-depth tax analysis, classify Kansas as an “Ohio rule” state.<sup>2</sup> Furthermore, as recently as July 10, 1998, the Kansas Supreme Court upheld the department’s understanding of the statute and explicitly rejected the Board of Tax Appeals application of the integrated plant theory to the “major component” determination of K.S.A. 79-3606(kk). The Court overturned BOTTA and cited it with disapproval:

In BOTTA’s view an exempt item would be “integral to the process,” would have an “essential function” and without it, “the operation would quickly grind to a halt.” (The Kansas Supreme Court in its *Alsop* decision overturning BOTTA).<sup>3</sup>

<sup>1</sup> *In re Lubrication Eng’rs, Inc.*, No. 70,980 (Kan. Filed Mar. 10, 1995) (No. 94-70980-A).

<sup>2</sup> See e.g. Goodman, Marcus and Husghes, 1330 Tax Management, Inc., Sales and Use Taxes: *The Machinery and Equipment Exemption; Multistate Tax Portfolio Series* (1997).

<sup>3</sup> *In re Alsop Sand Company, Inc.*, Docket No. 76,870 (Kansas Supreme Court; Filed July 10, 1998).

The *administrative* history of this statute is clear. Since its enactment ten years ago, the department has understood it to be “an Ohio rule with a handful of enumerated expansions,” and this understanding has not been overturned.<sup>4</sup>

During the 1998 session, the Governor proposed House bill 2643 which would have, among other things, clarified and expanded the manufacturing machinery and equipment exemption. The clarifications would have made it crystal clear Kansas is adopting a broadly defined integrated plant theory. But those provisions did not pass. Over the 1998 interim session, the department worked closely with members of the Tax Coalition and the Kansas Chamber of Commerce and Industry on improvements to the Governor’s proposal. The improved proposal, along with additional exemptions for oil and gas exploration and drilling equipment, was adopted as an Interim Committee bill and then pre-filed as House bill 2009. The provisions of House bill 2009 were later amended, along with several other provisions, into House bill 2543.

## **II. Adopting the Integrated Plant Theory in Kansas.**

### **A. Administrative - Rule or Regulation.**

Some have suggested that the current statute could simply be interpreted as an integrated plant exemption by department rule or regulation.<sup>5</sup> We do not believe that creating an integrated plant exemption this way is appropriate given the department’s long standing interpretation of the statute to the contrary, and the statute’s explicit use of key Ohio rule phraseology in exempting machinery which has a “direct and immediate physical change on the item undergoing the manufacturing process.” It is especially difficult in light of the Supreme Court rejection of BOTA’s application of the integrated plant rule.<sup>6</sup> Under the doctrine of separation of powers, the administrative branch does not have authority to interpret the State’s laws to reflect alternative policy choices. We believe this authority rests with the legislature.

### **B. Judicial - Court Reversal of Department Interpretation.**

Another option some have suggested is to wait and see if the courts would eventually disagree with the department’s published interpretation. In fact, in August of 1999, the Kansas Court of Appeals found that electricity purchased by a water utility and used in its pumping stations to pressurize water being distributed is exempt as “consumed in production,” under K.S.A. 79-3606(n).<sup>7</sup> In making its determination, the Court stated that “the pressurization of water is an *integral part* of the manufacturing process and *changes its fundamental physical characteristics.*”<sup>8</sup> (emphasis added). This statement seems to include both “integrated plant” and “physical transformation” tests. However, along the way, the Court also opined that “[w]e are convinced our Supreme Court adopted the integrated plant theory in *Collingwood Grain.*”<sup>9</sup> In December of 1999, the Kansas Supreme Court denied the department’s petition for review, so that decision is now final. We estimate the Johnson County Water Case will have an annual fiscal impact of approximately \$3 million. This implies refunds could also be requested this year totaling an additional \$9 million.

The Department does not interpret *Water District No. 1* to require a change in our policy regarding the 79-3606(kk) sales tax exemption for manufacturing machinery and equipment.

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<sup>4</sup> See Department of Revenue Information Guide 19-88-1 (1988).

<sup>5</sup> Hager, *Kansas’ Sales and Use Tax Law: Exemptions for manufacturing Machinery and Equipment and the Integrated Plant Theory*, Washburn L.J. 543 (1998).

<sup>6</sup> *Alsop.*, *Supra.*

<sup>7</sup> *In re Tax Appeal of Water District No. 1 of Johnson County*, Docket No. 79,842 (Kansas Court of Appeals; Filed August 13, 1999).

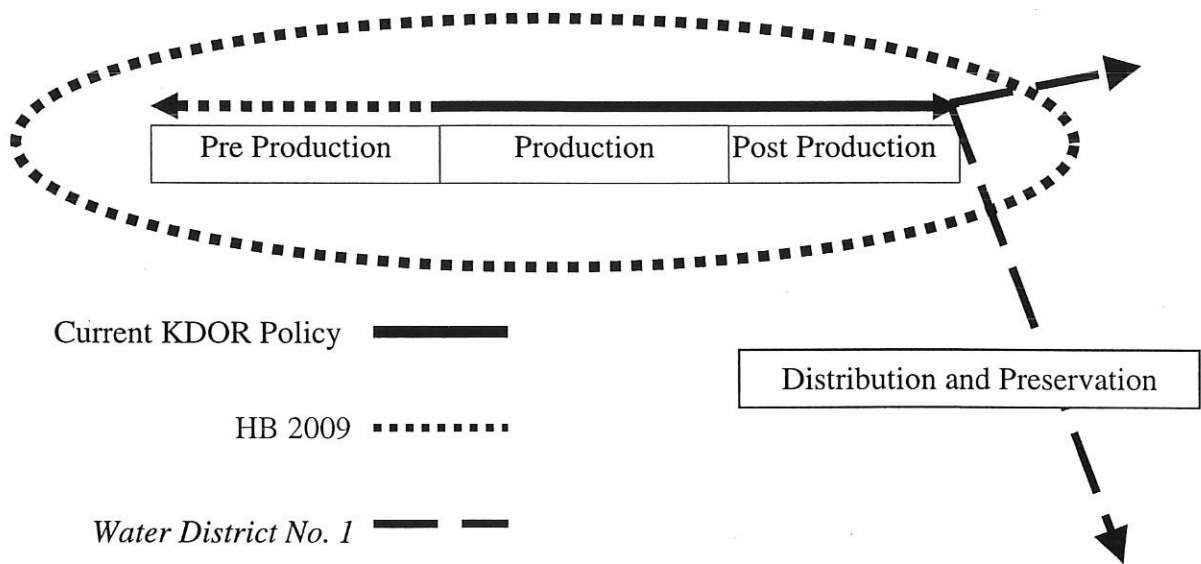
<sup>8</sup> *Ibid.*, pg. 9.

<sup>9</sup> *Ibid.*, pg. 7, referencing *In re Tax Appeal of Collingwood Grain, Inc.*, 257 Kan. 237, 891 P.2d 422 (1995).

Mainly because both *Water District No. 1* and *Collingwood Grain* dealt with “consumed in production,” which is a different exemption with different language and history. However, this interpretation will certainly be challenged.

If the legislature does want an integrated plant rule for Kansas, this path of litigation may not be the most efficient way to accomplish it. Litigation would cost both the state and taxpayers significant amounts of time and money, and more importantly, the results would be uncertain. For example, the “integrated plant” rule developed by the Court of Appeals arguably includes distribution and quality preservation in the definition of production. In this respect, the Court case would impose a broader exemption than that proposed in House bill 2009. It is also broader than the “integrated plant” theory developed by the New York Court of Appeals in *Mohawk Power Corp. v. Wanamaker*<sup>10</sup>, which is credited by the Hager law journal article<sup>11</sup> as the case in which the “integrated plant” theory found its “genesis.” In *Mohawk Power Corp.* the New York Court held that substations, transformers, towers and poles, conductors, voltage regulators, circuit breakers and similar equipment, were not tax exempt because they were used in transmission or distribution of electricity, not its production.<sup>12</sup>

On the other hand, the Court’s interpretation of the rule seems to also require that there be some physical change, in addition to the performance of an essential function. In this respect, the Court case would impose a narrower exemption than that suggested in House bill 2009.



If the Courts did interpret the manufacturing machinery and equipment exemption as providing the *Water District No. 1* type of integrated plant exemption, there would be multitudes of implications to be worked out in regulation and, most likely, many more years of litigation on the details. We estimate the fiscal impact from Court adoption of a *Water District No. 1* type “integrated plant” rule would be \$12 million annually, implying a potential for three years worth of refunds totaling an additional \$36 million. The department has already received refund requests of more than \$5 million, based on an application of *Water District No. 1* to the

<sup>10</sup> *Mohawk Power Corp. v. Wanamaker*, 286 App.Div. 446, 144 N.Y.S.2d 458 (1955).

<sup>11</sup> Hager, *Supra*, 37 Washburn L.J. at 564

<sup>12</sup> *Mohawk Power Corp.*, *Supra* at 462-3, citing *Peoples Gas & Elec. Co. v. State Tax Comm.*, 238 Iowa 1369, 28 N.W.2d 799 (1947) also relied on by BOTA in upholding the Department in *Water District No. 1*.

manufacturing machinery and equipment exemption. Denial of these requests would certainly be appealed.

**C. Legislative Action.**

The legislature is the most practical forum for accomplishing an adoption of a Kansas integrated plant rule. The legislature is able to articulate the policy intent and provide the necessary clarity. Clarity is important because there is no one single integrated plant theory. Each state that has adopted the integrated plant theory has some degree of variation in what is encompassed by the theory. In those states where the statutes were written loosely, the *statutes* may appear simple, but the *administration* is then complicated, which tends to invite litigation. Statutory specificity would allow the legislature, rather than the courts, to define the scope of the expanded exemption. If the legislature defines the scope, we reduce the need for the State and Kansas businesses to define it through costly litigation.

As I mentioned above, House Bill 2009 would amend 79-3606(kk) to allow an integrated plant rule for the manufacturing machinery and equipment exemption. Last year we provided a fiscal note of \$4.3 million for this bill. If we were 100% sure of withstanding a court challenge to our policy, the fiscal note would remain \$4.3 million. But we are not. Furthermore, in some respects the bill would be more restrictive than the application of *Water District No. 1* to (kk), at least going forward. Thus the bill could have some positive fiscal impact by reducing the potential \$12 million fiscal note which would result from a loss in court. Taking into account these potential impacts and the risk of litigation causes us to revise the fiscal note for 2009 to \$0.7 million.

If the legislature favors the House bill 2009 approach, we would suggest some technical clean-up to be very clear that exempt "distribution" equipment refers to equipment at a warehouse and distribution facility only. While utility generation equipment would be exempt production equipment, we have never read the current or the proposed House bill 2009 exemption as extending to equipment used in the actual transportation, transmission or distribution of utilities or any other commodities.