

BEFORE THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS

IN THE MATTER OF THE APPEAL
OF WARD KRAFT FORMS, INC.,
FROM AN ORDER OF THE DIVISION OF
TAXATION ON ASSESSMENT OF
RETAIL SALES TAX

Docket No. 2005-786-DT

**ORDER GRANTING THE KANSAS DEPARTMENT OF REVENUE'S
MOTION FOR SUMMARY JUDGMENT AND DENYING WARD KRAFT'S
CROSS MOTION FOR SUMMARY JUDGMENT**

COMES NOW this cause before the Kansas State Board of Tax Appeals (the "Board") on motion for summary judgment filed by the Kansas Department of Revenue (the "Department") on November 4, 2005, and on cross motion for summary judgment filed by Ward Kraft Forms, Inc. ("Ward Kraft") on December 15, 2005. Having considered the motions and all supporting memoranda and evidence filed therewith, and the applicable law, it is hereby

ORDERED AND ADJUDGED that the Department's motion for summary judgment is granted and Ward Kraft's cross motion for summary judgment is denied for the reasons set forth hereinafter.

I.

Uncontroverted Facts

The Department's memorandum lists eleven facts upon which it relies for its motion. Ward Kraft does not controvert the facts as set forth in the Department's memorandum and it provides in its responsive memorandum six additional facts. At the hearing of this matter, the Department stipulated on the record that it did not controvert the six additional facts set forth in Ward Kraft's motion. Consequently, the Board finds the material facts set forth by both parties in their respective memoranda to be uncontroverted and this motion to be ready for summary judgment.

The facts, summarized, are as follows. Ward Kraft is a Kansas corporation engaged in the business of printing goods. The Department conducted a tax audit of Ward Kraft's business for the period between March 1, 2001 and February 29, 2004. After its audit, the Department issued a final notice to Ward Kraft for the underpayment of taxes, interest and penalties in the amount of \$37,183.00 for purchases of electricity consumed by air-conditioning equipment used to cool its plant. Upon appeal of the assessment, the secretary's designee affirmed the Department's assessment. On March 1, 2005, Ward Kraft filed the instant appeal with the Board.

Ward Kraft appeals from the Department's assessment, seeking exemption from retailer's sales taxation for all electricity used by its air conditioning equipment to control temperature and humidity throughout its printing plant. Ward Kraft claims exemption pursuant to K.S.A. 79-3606(n), which provides exemption for tangible personal property consumed in the "production, manufacture, processing, ... refining or compounding" of tangible personal property. According to the manufacturer's specifications for Ward Kraft's printing equipment, the printing plant requires sufficient air conditioning to compensate for the heat output from the presses and other equipment. The manufacturer's specifications also require that for ideal printing performance, the printing plant should be maintained at approximately 71° F and 45 percent relative humidity (35 percent during the heating season). In addition, the specifications address plant airflow, storage and conditioning of paper and printing materials, all of which are dependent upon plant atmospheric conditions.

II. Analysis

Summary judgment is appropriate where the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. K.S.A. 60-256(c); *Mitzer v. State Dept. of SRS*, 257 Kan. 258, 260, 891 P.2d 435 (1995). The purpose of summary judgment is to eliminate delay in legal disposition where there is no real issue of material fact. *Timi v. Prescott Bank*, 220 Kan. 377, 386, 553 P.2d 315 (1976). In the instant case, the parties stipulate as to the material facts of the case and assert that the matter is ready for summary judgment. The Board agrees.

The central issue in this appeal is whether the electricity consumed by air conditioning machinery and equipment used to control the temperature and humidity throughout Ward Kraft's printing plant qualifies as exempt tangible personal property consumed in the "production, manufacture, processing, ... refining or compounding" of tangible personal property under K.S.A. 79-3606(n). For the periods in issue, K.S.A. 79-3606(n) provides in pertinent part a retail sales tax exemption for the following:

All sales of tangible personal property which is consumed in the production, manufacture, processing, mining, drilling, refining or compounding of tangible personal property, the treatment of by-products or waste derived from any such production process, the providing of services or the irrigation of crops for ultimate sale at retail within or without the state of Kansas....

For the period in issue, the term "property which is consumed" is defined by statute as specifically including electricity. K.S.A. 79-3602(dd) (previously codified until July 1, 2003, at K.S.A. 79-3602(m)).

Ward Kraft argues that because controlled temperature and humidity are essential and indispensable in the printing process, the electrical current driving the air conditioning equipment that cools its entire plant area should be exempted under K.S.A. 79-3606(n). In support of its argument, Ward Kraft cites two Kansas appellate cases, *In re Appeal of Collingwood Grain, Inc.*, 257 Kan. 237, 891 P.2d 422 (1995) and *In re Appeal of Water District No. 1 of Johnson County*, 26 Kan. App. 2d 371, 988 P.2d 267 (1999). According to Ward Kraft, these cases compel the result that the electricity in question should be exempt pursuant to K.S.A. 79-3606(n) under the so-called “integrated plant theory.”

The Department, however, contends that K.S.A. 79-3606(n) is not in itself dispositive of the instant appeal. The Department maintains that if this exemption were granted, any industry that utilizes plant equipment that must be operated “above sub-zero, and below heat wave, temperatures would be tax exempt.” Such an interpretation, the Department contends, would necessarily extend exempt status to all heating and cooling equipment used in plant areas, along with all electricity purchases consumed by that equipment. According to the Department, Ward Kraft’s interpretation of the exemption statute forces an absurd outcome and one that is contrary to settled law.

From the outset it should be noted that in Kansas taxation is the rule and exemption is the exception. *Assembly of God v. Sangster*, 178 Kan. 678, 680, 290 P.2d 1057 (1955). The burden of establishing an exemption from taxation rests with the party claiming exemption. *Director of Taxation v. Kansas Krude Oil Reclaiming Co.*, 236 Kan. 450, 454, 691 P.2d 1303 (1984). Tax exemption statutes are to be construed strictly in favor of imposing the tax and against allowing the exemption for an applicant who does not clearly qualify. *Bd. of Sedgwick Co. Comm’rs v. Action Rent to Own, Inc.*, 266 Kan. 293, 301, 969 P.2d 844 (1998).

The Board finds that Ward Kraft has failed to satisfy its burden. Even though electricity driving the air conditioning equipment clearly qualifies as consumable tangible personal property, more is required for the electricity to be exempted under K.S.A. 79-3606(n). The electricity must also be consumed in the “production, manufacture, processing, ... refining or compounding” of tangible personal property.

As a practical matter, electricity consumption cannot be examined without first examining the machinery and equipment upon which the electricity acts. Thus, in order to determine whether the electricity in question is consumed in the “production, manufacture, processing, ... refining or compounding” of tangible personal property, the Board first must consider the character of the processes, equipment and machinery consuming the electricity under the integrated plant theory. *See, generally, In re Appeal of Collingwood Grain, Inc.*, 257 Kan. 237, 891 P.2d 422 (1995); see also *In re Appeal of Water District No. 1 of Johnson Co.*, 26 Kan. App. 2d 371, 374, 988 P.2d 267 (1999). In this case, the equipment and machinery in question is the plant’s air conditioning equipment and machinery.

In its initial conception, the integrated plant theory was a judicial model used to assist in the determination of what processes, machinery and equipment in a plant are so directly involved in manufacturing that they should be accorded exemption status. The Kansas Court of Appeals summarized the theory in 1999, stating that a sales and use tax exemption may be obtained for equipment and machinery that perform an “essential or indispensable function in the manufacturing process, regardless of whether a physical change is actually caused in raw materials.” See *Water District No. 1*, 26 Kan. App. 2d at 374 (recognizing Kansas Supreme Court’s adoption of “integrated plant theory” and rejecting more rigid “physical change” rule).

As is apparent in both *Collingwood* and *Water District No. 1* – cases upon which Ward Kraft relies extensively – the integrated plant theory must be extended, not only to the exemption of machinery and equipment in a plant, but also to the exemption of electricity consumed by machinery and equipment in the plant. Thus, in any analysis of a claimed exemption of electricity under K.S.A. 79-3606(n), it is important to consider whether the electricity is consumed by machinery or equipment that would qualify for retail sales tax exemption under the integrated plant theory.

In 2000, after the *Collingwood* and *Water District No. 1* decisions, the Kansas Legislature codified the integrated plant theory at K.S.A. 79-3606(kk). That statute contains seven well-defined subsections. Subsection (1) sets forth the general parameters of the exemption, which include “all sales of machinery and equipment which are used in the state as an integral or essential part of an integrated production operation by a manufacturing or processing plant or facility.” Subsection (2) defines the salient terms used in the exemption. Subsection (3) defines the various types of equipment that qualify for exemption. Subsection (4) specifies additional machinery and equipment that qualify for exemption even though they would not otherwise qualify under the integrated plant theory. Subsection (5) specifies certain machinery and equipment that do not qualify for exemption. Subsection (6) explains how machinery and equipment used both for production and non-production purposes should be treated under the statute. And subsection (7) directs the Department to adopt rules and regulations to implement the exemption.

Ward Kraft states specifically in its memorandum that the issue in this case is whether the subject electricity is “consumed in production as contemplated under K.S.A. 79-3606(n) and the integrated plant theory.” See Ward Kraft’s SJ Memo, page 3 (emphasis added). Furthermore, at the hearing of this matter, Ward Kraft acknowledged that the 2000 Legislature codified the integrated plant theory at K.S.A. 79-3606(kk). Yet Ward Kraft argued at the hearing that the Kansas case law predating the adoption of the 2000 integrated plant legislation should control the instant appeal. Ward Kraft’s argument is not persuasive.

The 2000 statute provides a distinct scheme for determining what machinery and equipment in a plant are so directly involved in manufacturing that they should be

accorded exemption status under Kansas law. Thus the more general explanation of the integrated plant theory by the courts prior to 2000 has been supplanted by the Kansas Legislature's explicit definition of what machinery, equipment, and processes fall within – and without – an “integrated production operation.” The statute, not the case law, defines the parameters of the integrated plant theory in Kansas.

Subsection (5) of K.S.A. 79-3606(kk) is of particular relevance in the instant case. Subsection (5) specifically provides that “[m]achinery and equipment used as an integral or essential part of an integrated production operation” shall *not* include machinery or equipment used for general plant heating or cooling. K.S.A. 79-3606(kk)(5)(H). Under the statute, the only machinery and equipment used for heating and cooling included as an “integral or essential part of an integrated production operation” are machinery and equipment used to maintain “air quality, humidity, or temperature *in special and limited areas of the plant or facility, where such regulation of temperature or humidity is part of and essential to the production process.*” K.S.A. 79-3606(kk)(3)(K) (emphasis added).

Although the issue was not raised by either party in their motions, the Board is compelled to address whether some or all of Ward Kraft's plant might qualify as a “special and limited area” under K.S.A. 79-3606(kk)(3)(K). The Board notes that the language of K.S.A. 79-3606(kk)(3)(K) is perhaps not as precise as it could be. The statute does not clearly define “special and limited areas of the plant or facility” other than to say that such areas must be areas where regulation of temperature or humidity is “part of and essential to the production process.” *See id.* (emphasis added). It should be noted, however, that the Department's Notice 00-08 provides some illustrative guidance. The Notice explains that K.S.A. 79-3606(kk)(3)(K) is intended to exempt machinery and equipment used to provide and control the environment in special areas of the plant, such as clean rooms, painting areas, and freezing or cold storage areas.

Moreover, the Department has promulgated administrative regulations specifically addressing what uses of electricity are – and are not – exempt from retailer's sales taxation. Under K.A.R. 92-19-53(e), electricity consumed by machinery and equipment actually used to produce tangible personal property *is* exempt as consumed in production, while under K.A.R. 92-19-20(a), exemption for electricity *is not* allowed when the electricity is used for heating, cooling and lighting buildings or business premises. These administrative regulations are consistent with the Department's statutory grant of authority under K.S.A. 79-3606 and should be accorded reasonable deference by the Board.

III. Conclusion

In view of the uncontroverted facts, the Board finds no genuine dispute that the electricity in issue operates air conditioning machinery and equipment which, although required in the production process, is used for general plant cooling and humidity control. Such use of electricity is taxable under Kansas law. Ward Kraft has made no showing

that the plant's air conditioning machinery and equipment – or the electricity driving it – is used to maintain temperatures and humidity levels in “special and limited areas of the plant or facility, where such regulation of temperature or humidity is part of and essential to the production process.” Ward Kraft has thus failed to satisfy its burden of establishing its entitlement to exemption from retail sales tax under K.S.A. 79-3606(n) for the electricity in issue.

Any party to this appeal who is aggrieved by this decision may file a written petition for reconsideration with this Board as provided in K.S.A. 77-529. The written petition for reconsideration shall set forth specifically and in adequate detail the particular and specific respects in which it is alleged that the Board's order is unlawful, unreasonable, capricious, improper or unfair. Any petition for reconsideration shall be mailed to: Secretary, Board of Tax Appeals, DSOB Suite 451, 915 SW Harrison St., Topeka, KS 66612-1505. A copy of the petition, together with all accompanying documents submitted, shall be mailed to all parties at the same time the petition is mailed to the Board. Failure to notify the opposing party shall render any subsequent order voidable. The written petition must be received by the Board within fifteen (15) days of the certification date of this order (allowing an additional three days for mailing pursuant to statute if the Board serves the order by mail). If at 5:00 pm on the last day of the specified period the Board has not received a written petition for reconsideration, this order will become a final order from which no further appeal is available.

IT IS SO ORDERED

THE BOARD OF TAX APPEALS