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NOT TO BE PUBLISHED

Commonwealth Of Kentucky

Court of Appeals

NO. 2002-CA-001787-MR

MORTON BUILDINGS, INC. — APPELLANT

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE WILLIAM L. GRAHAM, JUDGE
ACTION NO. 01-CI-01341

REVENUE CABINET, COMMONWEALTH OF KENTUCKY AND KENTUCKY BOARD OF TAX APPEALS, COMMONWEALTH OF KENTUCKY — APPELLEES

OPINION

AFFIRMING

** ** ** ** **

BEFORE: EMBERTON, CHIEF JUDGE; KNOPF AND SCHRODER, JUDGES.

SCHRODER, JUDGE: Morton Buildings, Inc. (“Morton”) appeals from a judgment of the Franklin Circuit Court affirming a decision of the Kentucky Board of Tax Appeals (“the Board”). The circuit court held that the Board correctly determined that Morton was subject to Kentucky’s use tax on raw materials purchased and used to make building components that are eventually assembled

into prefabricated buildings in Kentucky. After reviewing the record and the applicable law, we affirm.

Morton is an Illinois corporation with its principal place of business in Morton, Illinois. Morton manufactures, sells, and erects prefabricated buildings that are used primarily for business, farming, and industrial purposes. Morton purchases raw materials, such as lumber and steel, from states other than Kentucky and uses those materials to manufacture building components at factories located outside of Kentucky. Morton does not purchase specific raw materials for a particular customer's project. Rather, Morton obtains the amount and type of raw materials it needs after reviewing sales projections and prior supply storage histories on a factory-by-factory basis. The manufacturing process performed at the out-of-state factories, which result in raw materials being used to create building components such as trusses, purlins, corrugated side steel, and roof steel, are largely uniform.

Morton sells its prefabricated buildings to Kentucky customers at its three Kentucky offices. When a Kentucky customer orders a building from Morton, Morton withdraws the necessary raw materials from storage and transforms those materials into the building components needed for that building, according to the customer's specifications. The manufacture of the building components to be used in Kentucky takes place

entirely in factories located in Illinois and Ohio. After being manufactured, the building components are transported into Kentucky and taken to the customer's construction site. Morton then erects buildings for its Kentucky customers using the prefabricated building components. The erected buildings constitute an improvement to the customer's real property in accordance with Kentucky law.

On December 22, 1989, Morton filed a Sales and Use Tax Refund Application with the Kentucky Revenue Cabinet (the "Cabinet") for recovery of use tax in the amount of $248,580.39 it claims to have overpaid during the period of November 1, 1985 through October 31, 1989. In its refund request, Morton alleges that it erroneously paid use tax on the cost of out-of-state purchases of raw materials used in the out-of-state manufacturing of the company's building components. Morton also requested a refund for the labor costs in manufacturing building components and for use tax associated with certain "pass-through" items.[1] The Cabinet denied Morton's refund claim, but provided that Morton could be entitled to a refund on use tax it paid relating to its labor costs in manufacturing the building components. Morton filed a protest of this initial denial, causing the Cabinet to conduct a field audit. The field audit

[1] "Pass-through" items are building materials purchased from vendors for incorporation into the building but had not been further manufactured, fabricated or modified by Morton. Morton conceded that the pass-through items were, in fact, subject to Kentucky's use tax.

confirmed the initial amount of Morton's refund claim to be $248,580.39. As a result of the audit, the Cabinet refunded to Morton its labor costs of $5,191.56, but denied the remaining claim of $243,388.83. Morton timely appealed the Cabinet's denial to the Board.

On appeal to the Board, Morton admitted that it occasionally made over-the-counter retail sales in Kentucky of tangible personal property that was not erected into a building. Further, Morton conceded that the pass-through items, representing 16.6124% of its total refund claim, were subject to Kentucky's use tax. Accordingly, Morton reduced its claim to $202,956.10.[2] On August 30, 2001, after receiving evidence during a hearing, the Board issued Order No. K-18239 affirming the Cabinet's determination that Morton was required to pay use tax on the raw materials used to manufacture the building components. Morton timely appealed the Board's decision to the Franklin Circuit Court. The circuit court, after considering arguments from both parties, affirmed the decision of the Kentucky Board of Tax Appeals. This appeal followed.

On appeal, Morton presents several arguments for our review. First, Morton argues that the Board and the trial court erred in finding that the raw materials used in constructing the building components were subject to Kentucky's use tax. In

[2] On appeal, Morton asserts that its claim was reduced to $166,667.00.

support of this argument, Morton asserts that KRS 139.310 cannot apply to the raw materials because these materials are purchased outside of Kentucky and manufactured into building components outside of Kentucky. Further, Morton argues that it possessed no specific intent to use any of the raw materials in Kentucky. We disagree.

Our examination of the arguments Morton brings before us must begin with an examination of Kentucky's sales and use tax scheme. Kentucky's sales and use tax laws are integrated elements of a taxing program designed to reach all transactions in which tangible property is sold inside or outside of Kentucky for storage, use or consumption within this state. Revenue Cabinet v. Lazarus, Inc., Ky., 49 S.W.3d 172, 175 (2001) (citing Genex/London, Inc. v. Kentucky Bd. Of Tax Appeals, Ky., 622 S.W.2d 499, 506 (1981)). The use tax is frequently called a backstop to the sales tax because it ensures that transactions in other states are treated just as if they had taken place in this state and been subjected to the sales tax. Commonwealth, ex rel. Ross v. Lee's Ford Dock, Inc., Ky., 551 S.W.2d 236 (1977).

During the time period for which Morton claims entitlement to a use tax refund, KRS 139.310 imposed a use tax "on the storage, use, or other consumption in this state of tangible personal property purchased on or after April 1, 1968

for storage, use or other consumption in this state. . .” In reviewing this statute, it is clear that KRS 139.310 establishes four requisite conditions for the imposition of the use tax. First, the matter to be taxed must be “tangible personal property.” Second, the property must have been “purchased.” Next, the property must be intended for storage, use or other consumption within the borders of this state. Finally, the property must actually be stored, used or consumed in Kentucky. The record clearly shows that the raw materials at issue herein constitute tangible personal property and that Morton purchased these materials. Morton, however, strongly asserts that the third and fourth conditions requisite to invoking the application of KRS 139.310 have not been met. We disagree.

In its brief, Morton contends that because the raw materials were not purchased for application to any particular customer order in Kentucky, the purchase of these raw materials was for use only in its out-of-state factories. Accordingly, Morton believes that the raw materials were neither purchased for, used in, nor were ever intended for use in Kentucky. However, specific intent is not required to establish whether an item is intended for use in a particular state as intent can be inferred from the taxpayer’s activities within the taxing jurisdiction. United States v. H.M. Branson Distributing Co., 398 F.2d 929, 943 (6th Cir. 1968). “Intent may be proved by

circumstances as well as by declarations." Harkey v. Haddox, 244 Ky. 380, 50 S.W.2d 955, 956 (1932). Here, Morton concedes that it maintained sales offices in Kentucky in order to sell prefabricated buildings to Kentucky residents. Moreover, the record contains evidence that Morton performed at least 700 jobs in Kentucky during the four-year period in controversy. Finally, Morton actually does business inside this Commonwealth, giving rise to the assumption that it must also intend to use some raw materials in Kentucky so that it may conduct its business. On these facts, it is not necessary that Morton knew precisely which two-by-four or bracket would be used in constructing buildings in Kentucky. Instead, it is sufficient for Morton to know that it would be using a portion of raw materials in Kentucky. Hence, we conclude that Morton intended to use at least a portion of the raw materials at issue in Kentucky during its normal course of conducting business.

Morton also asserts that the record is devoid of evidence establishing that the fourth requisite condition of KRS 139.310 has actually been met. Morton's argument is based on the notion that the processing of raw materials in locations outside of this Commonwealth somehow precludes their latter use in the construction of buildings in Kentucky since those materials are actually being consumed elsewhere. Therefore, according to Morton, the raw materials cannot be subject to use

tax pursuant to KRS 139.310 since this property must be used, consumed or stored in Kentucky to be subject to the tax. To accept Morton's argument is contrary to the applicable statutory definition of the word "use."

The Kentucky General Assembly has broadly defined "use" for the purposes of the use and sales tax statutes. "Use," as defined by KRS 139.190, includes "the exercise of any right or power over tangible personal property." In this matter before us, there is no question that the raw materials, despite their alteration at the out-of-state factories, constitute tangible personal property actually used in Kentucky as components for Morton's prefabricated buildings. The raw materials, in their altered form as building components, are actually used in Kentucky when Morton assembles those building components into prefabricated buildings. Accordingly, we conclude that Morton actually "uses" the raw materials in Kentucky because the company exercises a right or power over those raw materials when it erects the prefabricated buildings.

Morton also argues that, in finding that it actually used or otherwise consumed the raw materials in Kentucky, the Board and the trial court relied solely and improperly upon 103 KAR 26:070. Morton believes that the Board and the trial court wrongly interpreted 103 KAR 26.070 as imposing use tax on the raw materials. Morton contends that this regulation does not

and cannot impose use tax upon Morton because KRS 139.310 does not apply. We deem this argument to be without merit.

103 KAR 26:070(6) is the regulation applicable to this matter before us. This regulation states:

> In the event that any contractor, subcontractor, builder, or contractor-retailer is the manufacturer of the building material or supplies he uses in his construction business, the tax shall apply to the sales price to him or all tangible personal property which enters into the manufacture of such materials or supplies.

103 KAR 26:070(6).

Morton argues that this regulation unlawfully enlarges the scope of KRS 139.310. This argument is completely without merit because a panel of this Court has previously held that 103 KAR 26:070 was constitutional and represented a proper and reasonable clarification of KRS 139.310. Pete Koenig Company v. Department of Revenue, Ky. App., 655 S.W.2d 496 (1983). From our review, we believe that the trial court and the Board did not err in using this regulation to interpret KRS 139.310 because this regulation clarifies how KRS 139.310 should be applied to contractors who make improvements to real property.

In this case, Morton manufactures the building components that are used in its construction business. Pursuant to KRS 139.310, as interpreted by 103 KAR 26:070(6), the raw materials were used in Kentucky by virtue of their incorporation

into realty located in Kentucky as part of the structure that is erected by Morton. Since this regulation merely interprets Kentucky's use tax statute, it is clear to us that that the raw materials are actually used and consumed in Kentucky when Morton transports those materials into this state for use as building components. Moreover, the plain language of this statute and regulation appears to impose use tax on the raw materials regardless of whether or not those materials are first manufactured. Accordingly, we hold that the trial court properly affirmed the Board's determination that Morton is not entitled to any refund of use tax paid on the raw materials.

Morton also asserts that the Board and the trial court improperly ignored decisions from courts of other jurisdictions. Morton places heavy emphasis on decisions from New York, Connecticut, Texas, and Massachusetts that it believes support its argument that Kentucky cannot impose use tax on the raw materials that make up the building components.[3] In each of these cases, Morton Bldgs., Inc. v. Chu, 126 A.D.2d 828, 510 N.Y.S.2d 320 (N.Y. 1987); Morton Bldgs., Inc. v. Bannon, 222 Conn. 49, 607 A.2d 424 (Conn. 1992); Sharp v. Morton Bldgs.,

[3] Morton also relies heavily on unpublished decisions from Missouri and Wisconsin in support of its arguments herein. Citing an unpublished opinion in a brief submitted to this Court is improper practice under CR 76.28(4)(c). Jones v Commonwealth, Ky. App., 593 S.W.2d 869 (1979). While we consider this violation harmless in this appeal, we strongly caution Morton's counsel to avoid such improprieties in the future.

Inc., 953 S.W.2d 300 (Tx. App. 1997); Morton Bldgs., Inc. v. Commissioner of Revenue, 43 Mass. App.Ct. 441, 683 N.E.2d 720 (Mass. App. 1997), the respective courts found that the raw materials Morton converted into building components at its out-of-state factories were not subject to use tax. However, Kentucky law is very clear that "[i]n construing a statute, text book authority and cases from other jurisdictions, although informational and persuasive, are not decisive." Epsilon Trading Co. v. Revenue Cabinet, Ky. App., 775 S.W.2d 937, 941 (1989), quoting Collins v. Kentucky Tax Com., Ky., 261 S.W.2d 303 (1953). This Court has also held that:

> Although our legislature may adopt a statute which is identical or very similar to one in another state, we are not necessarily required to adopt the construction and application placed on the statute in the foreign jurisdiction.

Epsilon, 775 S.W.2d at 941.

Clearly, the trial court and the Board are not required to follow the cases from foreign jurisdictions cited by Morton that ruled in favor of that company. As such, we cannot hold that the failure of the trial court and the Board to follow, apply or otherwise consider the cases Morton cited constituted an abuse of discretion. Accordingly, we deem Morton's assertions concerning the refusal of the Board and the

trial court to consider holdings of other jurisdictions to be completely without merit.

Next, Morton argues that the Board improperly rejected its proposed apportionment method for valuating the "pass-through" items it concedes are subject to the use tax. Since we have determined that Morton is not entitled to any refund of use taxes paid from 1985 to 1989, this issue is moot. Hence, we need not address Morton's arguments on this issue.

Finally, Morton argues that the trial court erroneously found the Board's citing of inadmissible "Ohio evidence" in its order to be harmless error. We disagree.

During the proceedings before the Board, the Cabinet sought to introduce testimony and documents regarding an unrelated refund claim Morton made in Ohio regarding a tax assessment.[4] The Board excluded all of this "Ohio evidence" from being introduced. The documents, however, were placed into the record as avowal exhibits. Despite excluding the "Ohio evidence," the Board made the following two findings:

> For tax liability with the state of Ohio, Morton entered a settlement agreement for building components it manufactured at its Kenton, Ohio plant. Morton acknowledged in that settlement agreement that: "The amount computed above representing materials purchased for use outside Ohio." *Letter of Agreement Between State of Ohio Department of Taxation and Morton Buildings, Inc.,*

[4] This "Ohio evidence" shows that Morton admitted that the raw materials were used outside of Ohio.

> *signed 7/17/97 and attached as Exhibit D to Abraham Stanger's letter to the Kentucky Revenue Cabinet dated December 8, 1997. Appendix 8.*
>
> In Ohio, Morton admitted that the materials (the same sort for which Morton seeks a refund of Kentucky sales and use tax) were used outside Ohio. Morton contends the items were not subject to sales and use tax in either the plant's jurisdiction or the destination jurisdiction.

In making its conclusions of law, the Board did not cite this excluded evidence in support of its determination that Morton's raw materials are subject to Kentucky's use tax. Rather, the Board based its decision upon the language of KRS 139.310 and 103 KAR 26.070. The trial court found that the Board's inclusion of this evidence in its findings of fact was error. However, the trial court found this error was harmless because the "Ohio evidence" was merely cumulative and not crucial to the Board's finding that the use tax applies to the raw materials.

CR 61.01 provides as follows:

> No error in either the admission or the exclusion of evidence and no error or defect in any ruling or order or in anything done or omitted by the court or by any of the parties is ground for granting a new trial or for setting aside a verdict or for vacating, modifying, or otherwise disturbing a judgment or order, unless refusal to take such action appears to the court inconsistent with substantial justice. The court at every stage of the proceeding must disregard any error or defect in the

> proceeding which does not affect the substantial rights of the parties.

Kentucky law clearly provides the trial court with the ability to, at every stage of the proceeding, disregard error or defect that does not affect the substantial rights of the parties. Callis v. Owensboro-Ashland Co., Ky. App., 551 S.W.2d 806 (1977). Moreover, when testimony is merely cumulative, the inclusion of such testimony is harmless error and does not constitute prejudicial error warranting reversal. See, Louisville & Jefferson Co. Board of Health v. Mulkins, Ky., 445 S.W.2d 849, 852 (1969); Prudential Ins. Co. v. Asbury, Ky., 291 Ky. 400, 164 S.W.2d 957, 959 (1942); Reddy Cab Co. v. Harris, 262 Ky. 661, 90 S.W.2d 1004, 1006 (1936).

In the matter before us, the record clearly demonstrates that, while Morton may not have had a specific intent to use the raw materials at the time of purchase, Morton does maintain sales offices in Kentucky, the raw materials were brought into and stored in Kentucky as building components, and that Morton used these building components to erect buildings in Kentucky. The Board and the trial court both found from these facts, without making reference to the inadmissible "Ohio evidence," that the raw materials are subject to use tax in Kentucky. The record clearly supports this conclusion. Since the Board made no reference to inadmissible evidence in reaching

its final conclusion, it appears to us that the trial court properly disregarded the Board's error as harmless.

For the aforementioned reasons, the judgment of the Franklin Circuit Court is affirmed.

EMBERTON, CHIEF JUDGE, CONCURS.

KNOPF, JUDGE, CONCURS WITH SEPARATE OPINION.

KNOPF, JUDGE, CONCURRING: I agree with most of the reasoning and the result reached in the majority opinion. On the substantive issue, I agree with the majority that 103 KAR 26:070(6) is constitutional and represents a reasonable and proper clarification of KRS 139.310. However, I disagree that this Court's decision in Pete Koenig Company v. Department of Revenue, Ky. App., 655 S.W.2d 496 (1983), is entirely dispositive of the question.

In Pete Koenig, this Court considered the propriety of subsection (3) of the regulation, which provided that a contractor is a consumer of materials which it uses in fulfillment of its contracts even if the entity it contracts with is itself exempt from the tax. Since that section of 103 KAR 26:070 merely clarified how KRS 139.310 should be applied to contractors, this Court concluded that it did not improperly expand the scope of the statute. Id.

This case, however, involves subsection (6) of the regulation, which was not before the Court in Pete Koenig.

Nonetheless, the analysis in that case, while not controlling, remains persuasive. Although generally an appellate court must defer to an administrative agency's interpretation of its own regulations, an agency cannot by its rules and regulations, amend, alter, enlarge or limit the terms of legislative enactment. Camera Center, Inc. v. Revenue Cabinet, Ky., 34 S.W.3d 39, 41 (2000). However, I fully agree with the majority that 103 KAR 26:070(6) does not improperly enlarge the scope of the use tax.

KRS 139.310 imposes an excise tax on the “storage, use, or other consumption in this state of tangible personal property purchased on and after April 1, 1968, for storage, use, or other consumption in this state at the rate of six percent (6%) of the sales price of the property.” "Use", as defined in KRS 139.190, includes "the exercise of any right or power over tangible personal property incident to the ownership of that property, or by any transaction in which possession is given, except that it does not include the sale of that property in the regular course of business." The General Assembly employed broad language so that the use tax would reach all forms of tangible property used in the state. Revenue Cabinet v. Lazarus, Inc., Ky., 49 S.W.3d 172, 175 (2001).

Furthermore, and contrary to Morton’s argument, the sales and use tax laws are integrated elements of a taxing

program that is designed to reach all transactions in which tangible property is sold inside or outside of Kentucky for storage, use, or consumption within Kentucky. The use tax is frequently called a backstop to the sales tax because it ensures that transactions in other states are treated just as if they had taken place in this state and been subjected to the sales tax. Id. To this end, 103 KAR 26:070(6) states that "[i]n the event that any contractor, subcontractor, builder, or contractor-retailer is the manufacturer of the building material or supplies he uses in his construction business, the tax shall apply to the sales price to him of all tangible personal property which enters into the manufacture of such materials or supplies."

Far from expanding the scope of KRS 139.310, the regulation, like the one at issue in Pete Koenig, merely clarifies the scope of the statute. As set forth in the trial court's opinion, "[t]he manufacture of raw materials into the building components out-of-state will not aid Morton in avoiding the use tax. The regulation makes it clear raw materials are consumed in Kentucky when they are brought in the state for use whether or not they are first manufactured."

I also write separately to disagree with the statement in footnote 3 that Morton's citation to unpublished cases from Missouri and Wisconsin constitutes a violation of CR

76.28(4)(c). Although that rule prohibits citation of unpublished opinions, it is clear from the context of the rest of the rule that it prohibits only citation of unpublished opinions by Kentucky's appellate courts. CR 76.28 specifically addresses the rendition and publication of opinions issued by the appellate courts of this state. The Supreme Court of Kentucky and this Court each has the authority to designate which of its own cases shall be published and cited as authority. CR 76.28(4) sets forth how this Court or the Supreme Court may do so, and subsection (4)(c) specifically states that opinions which this Court or the Supreme Court have designated "not-to-be-published" shall not be cited or used as authority in any court in this state. But the rule does not purport to designate which cases from our sister jurisdictions may be cited. Moreover, by definition, the opinions issued by courts of our sister states are accorded only persuasive value, rather than precedential authority. Thus, while we should endeavor to respect the publication rules of the rendering courts, I cannot agree that Morton's citation of these cases violates CR 76.28(4)(c).

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