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Once Again, Connecticut Supreme Court Rejects DRS's Restrictive Reading of a Statute

In its recent decision in *Sikorsky Aircraft Corp. v. Commissioner*,[1] the Connecticut Supreme Court rejected the position of the Department of Revenue Services (DRS) that items used in research and development did not qualify for the aircraft manufacturing exemption of Conn. Gen. Stat. § 12-412(78) because they had not been installed in an aircraft manufacturing facility and used predominantly for manufacturing qualifying property. The essence of the DRS position was a restrictive reading of the exemption that required exempt items to be used directly in the production process and also narrowed the meaning of "aircraft manufacturing facility" to encompass only that portion of a plant dedicated directly to acting upon the raw materials.

In arriving at its decision, the court made a point of reminding the DRS that it cannot simply rely upon the maxims that exemptions are to be strictly construed or that ambiguities are to be resolved against the taxpayer. Thus, with *Rainforest Café* and *Key Air*, *Sikorsky* is the latest in a series of decisions in which the court has reined in hypertechnical and antitaxpayer interpretations of sales tax statutes by the DRS.

THE OPPOSING POSITIONS

In *Sikorsky* , the DRS auditors took the position that items used in research and development (R&D) at an aircraft manufacturing facility in Stratford, Connecticut were not exempt from sales tax under Conn. Gen. Stat. § 12-412(78), the aircraft manufacturing exemption. The statute exempts from tax the purchase "by an aircraft manufacturer operating an aircraft manufacturing facility in this state of materials, tools, fuel, machinery and equipment used in such facility." Under the traditional manufacturing exemptions of Conn. Gen. Stat. § 12 412(18) and (34), R&D items are not exempt because their use in the actual fabrication of property or the manufacturing production process is not direct. Here, however, the taxpayer's position was that the aircraft manufacturing exemption requires only that items be used in an aircraft manufacturing plant, not that they be used directly in the fabrication or process. As a consequence, R&D items do qualify under the aircraft manufacturing exemption.

THE TAX SESSION'S AND SUPREME COURT'S HOLDINGS

In a 2002 Superior Court Tax Session decision, the Commissioner had lost the identical issue

against a Sikorsky affiliate and had not appealed.[2] Nevertheless, in *Sikorsky*, the Commissioner made a final determination that the audit position was correct, leading the taxpayer to appeal. In the Tax Session, Judge Aronson reconsidered his previous decision but again held for the taxpayer. In response to the Commissioner's appeal, the Supreme Court exercised its authority to take the case directly and affirmed the Superior Court decision, holding:

1. The prior final decision in *Pratt & Whitney* did not preclude the Commissioner's assessment against Sikorsky because collateral estoppel does not apply to lawsuits by the state.

2. It was not the intent of the General Assembly to limit the aircraft manufacturing exemption to items used directly in fabrication or the manufacturing production process but to include items used in any part of an aircraft manufacturing facility where activities related to manufacturing are conducted. Consequently, R&D equipment used at such a facility is exempt.

CONNECTICUT'S MANUFACTURING EXEMPTIONS

The Traditional Exemptions

In providing its rationale for the second holding, the court examined the history of the manufacturing exemptions, beginning with the earliest exemptions for manufacturing activity, Conn. Gen. Stat. § 12-412(18) and (34). In these exemptions:

- Machinery, materials, tools and fuel are exempt, but equipment is not;

- Materials, tools and fuels qualify only if used directly in the fabrication of the finished product or in the manufacturing production process, each of which is closely tied to direct action upon the raw materials themselves; and

- Machinery qualifies only if used exclusively for such purposes.

The 1992 Manufacturing Recovery Act

The court explained that the passage of the Manufacturing Recovery Act (MRA) in 1992 changed the manufacturing exemption landscape to apply to manufacturing, fabrication and processing a 50% exemption in which:

- Equipment is exempt along with machinery, materials, tools and fuel;

- Materials, tools and fuel qualify as exempt if used in the manufacturing, processing or fabricating of products to be sold, **in any process preparatory or related thereto**, or in the measuring or testing of such products; and

- Machinery and equipment qualify if used **primarily** (not exclusively) in the process of manufacturing, processing or fabricating.

Under the MRA, there is no requirement that exempt items be used directly in a manufacturing process or in the actual fabrication of the finished product. The property need only be used in a process related to, or in preparation for, manufacturing — thus qualifying R&D items for the MRA exemption.

The Aircraft Manufacturing Exemption

The Supreme Court looked to the legislative intent of the aircraft manufacturing exemption because the provision contains neither the "used directly" language of the traditional exemptions (Conn. Gen. Stat. § 12-412(18) and (34)) nor a provision explicitly adopting the standards of the MRA. Based on its review of the legislative intent, the Supreme Court reasoned that the legislature intended the exemption in question to have the broader scope of the MRA based on the following: The adoption of the aircraft manufacturing exemption followed closely on the heels of the enactment of the MRA; the aircraft manufacturing exemption omits any reference to use "directly" in the manufacturing process; and the aircraft manufacturing exemption includes a predominant use requirement as opposed to exclusive use. Any potential ambiguity was dispelled, however, by exchanges on the floor of the Senate, making clear that in adopting the aircraft manufacturing exemption the legislature was expanding the Conn. Gen. Stat. §§ 12-412 (18) and (34) exemptions.

CONCLUSION: THE DRS READING OF THE STATUTE IS SIMPLY WRONG

In short, the court held that the DRS position was incorrect because it ignored the fact that the requirement for direct use is omitted from the statute and because the plain language of the statute makes clear that an item qualifies based on where it is used, not on how it is used. The Commissioner's alternative position that the aircraft manufacturing facility encompassed only those areas of the plant where activities directly connected to manufacturing occur was also not persuasive because it disregarded both the omission of "directly" and the legislative intent that the aircraft manufacturing exemption take the same approach to manufacturing as the MRA.

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[1] 297 Conn. 540 (2010).

[2] Pratt & Whitney Div. v. Commissioner, Super. Ct. Nos. CV 01 0509576 S, CV 01 0509577S (J.D. New Britain July 3, 2002)

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