Power Play – Emergence of Solar and Other Advancements in Energy Technologies May Light Up Old Manufacturing-Based SALT Benefits

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Every state provides several state and local tax exemptions, credits, abatements and incentives for taxpayers engaged in manufacturing and various types of industrial processing. No matter the jurisdiction, all of these manufacturing-based SALT benefits are: (i) long-established – typically added to a jurisdiction's tax code several decades ago; (ii) for defined processes which use power to create a new product from raw materials; and (iii) meant to encourage the location and expansion of such operations in the jurisdiction.

Given these basic characteristics, most state and local revenue departments (and taxpayers) only associate more traditional forms of manufacturing processes as qualifying for these tax benefits. But, because of the constant advancements in technologies, products, and energy sources, businesses must begin to consider whether its non-traditional operations now fall within a jurisdiction's (often outdated) statutory language to obtain previously untapped SALT benefits. This article focuses on a few of these newer processes that states are beginning to consider whether they fit within the legislative intent of their longstanding manufacturing-related tax provisions, including large-scale, commercial solar energy projects which continue to expand throughout the country at light speed.

Sparking Conversation – Solar Generation of Electricity as Manufacturing

Tax benefits and incentives for solar and other renewable energy projects are not new as most states have some form of alternative energy tax exemption, credit, rebate, or incentive to entice these operations to locate in rural areas to help provide power, but also

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increase tax revenue through additional property taxes, local taxes and improved infrastructure. Additionally, there are several federal tax benefits given to this industry, including the federal production tax credit and investment tax credit under Sections 45 and 48 of the Internal Revenue Code (the Code), respectively, especially after the IRS recently extended the continuity safe harbor for these credits due to the pandemic.[1]

But some states have begun phasing out many of the renewable energy SALT benefits and incentive programs enacted years ago for a variety of reasons. Thus, taxpayers in these industries are constantly looking for other SALT opportunities available to help make the numbers work as taxes play a large part in the overall decision of where to locate these projects. Manufacturing-related SALT tax breaks and incentives could be the answer.

Surging Ahead – Kentucky Shows the Good and Bad for Solar Industry

One example of recent changes to, and opportunities with, solar-based SALT incentives can be seen in my home state of Kentucky. Like many states, Kentucky enacted an incentive program for renewable energy projects several years ago called the Incentives for Energy Independence (IEIA) program which provided sales/use tax, severance tax, corporate income tax credits and wage assessment incentives[2]; however, this program was phased out after recent state tax reform efforts. To try and compensate for such sunset, two Kentucky incentive programs were amended to include renewable energy projects in 2018: the KEIA program which only provides sales/use tax refunds for building and construction materials, and the KBI program which provides corporate income tax credits and wage assessments but requires a minimum employment base that most renewable energy projects can't meet. [3] So, what other statutory tax benefits does Kentucky offer for the industry? Not much as Kentucky is also constitutionally prohibited from giving property tax abatements – a major disadvantage as most other state economic development agencies have this option in their toolbelt.

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Therefore, other than a complicated structure in Kentucky that can potentially mitigate property taxes for certain industries, including solar projects now[4], via industrial revenue bonds (IRBs), the Bluegrass State must depend on its other advantages to help land largescale developments: (i) low cost of living; (ii) central location as it is within a day's drive of two-thirds of the U.S. population; (iii) logistical advantages through its two international airports, three global shipping hubs, and proximity to highways, rail and barge/waterways; (iv) generally low property taxes; and (v) the lowest cost of electricity in the industrial sector among states east of the Mississippi River and one of the lowest in the U.S.[5] All of these advantages make Kentucky very enticing for renewable energy developers, but only if reasonable tax benefits are also available. Because manufacturing is Kentucky's largest industry sector, it, like many states, offers very broad SALT benefits for manufacturing operations – but do these tax benefits extend to newer processes like solar?

Kentucky case law has made clear for decades that the generation of electricity is considered "manufacturing" for both property tax and sales/use tax, but this is only for traditional forms of electricity generation due to the age of these decisions.[6] Kentucky is not alone in this regard as several states have likewise previously held that generation of electricity constitutes manufacturing for SALT purposes.[7] There are, however, no Kentucky cases, statutes or regulations which apply this general rule to non-traditional forms of electric generation like solar. But, there is substantial administrative guidance (e.g., instructions to certain business property tax returns, an administrative regulation, etc.) which show that certain tangible property used for solar generation is considered "actually engaged in manufacturing" and thus, the underlying process must be manufacturing too.

Why is this important? Because manufacturing property in Kentucky (like many states) is subject to favorable property tax rates, and if any solar equipment is classified as used in manufacturing, it would be eligible for a whole range of manufacturing-related sales and use tax exemptions.[8] So, if we assume that the solar generation of electricity, like traditional forms, is considered manufacturing, the next question is, when does this

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manufacturing begin and end for SALT purpose?

Kentucky follows the generally accepted definition for "manufacturing" – *any process* that turns material with little or no value into a product with increased commercial value.[9] When applied to a typical largescale, photovoltaic solar development, the manufacture of solar-generated electricity would begin when the raw material (sunlight) is captured by the solar panels/modules and arguably would not end until the electric current produced is in a form/level that can legally be transferred to and used by power purchasers for ultimate distribution to customers. And thus, virtually all solar equipment used between those two points could be considered directly used in the manufacturing process and potentially eligible for the various manufacturing-related tax benefits in Kentucky, and multiple other states.

While this is all positive, because alternative energy production is a relatively new concept in many states, this issue is still very uncertain and has yet to be tested. But given the rapid spread of solar projects in multiple states, this issue will likely be fleshed out by various states and courts in the near future.

Watt Else? – Other Non-Traditional Processes and Energy Advancements as Manufacturing

Solar is just one example of processes not traditionally considered manufacturing but may now meet such definition for SALT purposes in certain jurisdictions. There are likely several other examples of processes which are either: (i) new technologies trying to fit into long-established and/or outdated statutory definitions of manufacturing; or (ii) older processes that have grown in scale and scope over the years and thus may now be considered manufacturing or a similar process – both of which can lead to previously untapped SALT benefits.

One example is commercial greenhouses. Long considered to be agricultural only, but with the rise in large-scale and advanced forms of growing produce and other products, such as industrial hemp, the closer it inches towards manufacturing. And while most states have agriculture-based SALT benefits, manufacturing tax

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benefits are typically more generous and can cover more state and local taxes.

Kentucky again provides a perfect example of this developing situation. Historically Kentucky considered greenhouses to be agricultural in nature and thus not eligible for manufacturing-related exemptions, but instead qualify for a more limited agricultural/farm machinery exemption. However, as a result of the increased technology and advancements in the growing of plants and produce with commercial greenhouses overtime, such operations can now potentially be considered manufacturing and eligible for various other tax exemptions.

This development is the result of old Kentucky caselaw which held that the "enhanced" energy and technologies used in a greenhouse (as opposed to traditional farming) to produce plants and flowers qualified as an eligible "process" under Kentucky's energy exemption.[10] In making this determination, the court (and the former Kentucky Tax Commission) emphasized that Kentucky sales and use tax exemptions for manufacturing and other processes must recognize advancements in technology which will continuously expand the capabilities and production of previously determined non-manufacturing activities into manufacturing/processing. Thus, a commercial greenhouse's "enhanced" sunlight/growing process was sufficient to b e considered an industrial process eligible for the manufacturing-based exemption.

While this decades-old decision only focused on Kentucky's exemption from state-level sales/use tax, as well as a local utilities gross receipts license tax, imposed on energy costs used in manufacturing and other industrial processes – a decision the Department of Revenue formally adopted thereafter[11] – there is no reason to believe it cannot not extend to Kentucky's sales/use tax exemptions for property used directly in such process. Therefore, instead of only receiving Kentucky's limited agriculture exemption, a taxpayer could potentially qualify for both the expansive sales/use tax exemption on machinery and equipment used in the process (as well as reduced property tax rates on such property) *and* the exemption from state and local taxation of energy costs used in the

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process. Such interpretation could be particularly helpful for the burgeoning hemp/CBD industry that has increasingly ramped up growing operations in several states the past few years and are continuing to look for available state and local tax incentives and benefits to promote same.[12]

Next, unlike a greenhouse which has been around for generations, another situation is when a *new* form of technology or process changes industries and begins to blur the line between technology and manufacturing. One example can be seen with a technology that is commonly associated with the financial world only – blockchain – but given the expansion of this technology to the industrial world, it may now spill over into the manufacturing realm.

Blockchain-based manufacturing facilities have begun popping up throughout the globe, including in the United States, in massive new or former industrial plants because of nearby energy providers and infrastructure requirements. This is because global energy needed for blockchain process rival the total energy consumption of some nations, and is often significantly more than what is required for traditional manufacturing operations like a steel mill.

So why not blockchain? It does exactly what traditional forms of manufacturing do and meets the basic statutory requirements for manufacturing seen in most states – taking something that exists in nature, using machinery and equipment powered by substantial energy sources through a dedicated infrastructure and process that produces something new with increased commercial/monetary value (e.g., bitcoin, digital assets, and other property). Blockchain technology is far from a known commodity as these industrial-sized blockchain processing plants are just now getting established, and departments of revenue are always skeptical of new industries and processes. But, this could be the next process that states begin recognizing as manufacturing to attract this growing industry, and as always, bring in more tax revenue for the rural locations starving for any economic shot to the arm.

The Light Bulb Finally Went Off – I Get it Now

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Nothing ever stays the same in the SALT world, as seen by changes and disruptions caused by e-commerce and other technologies over the past several years. While these changes can lead to additional uncertainties and liabilities, they can also lead to significant SALT opportunities for both new and traditional businesses, including "new" manufacturing-based tax benefits that may now be available.

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[1] See Notice 2020-41, 2020-25 IRB 1 (May 27, 2020), available at https://www.irs.gov/pub/irs-drop/n-20-41.pdf.

[2] See KRS 154.27-010 through 154.27-090.

[3] KRS 154.31; KRS 154.32.

[4] See 2020 HB 351, c 91, § 47 (eff. 4-15-2020).

[5] Kentucky Cabinet for Economic Development, "Locating & Expanding: Why Kentucky," available at https://ced.ky.gov/Locating_Expanding/Why_Kentucky.aspx.

[6] *See e.g.*, City of Louisville ex rel. v. Howard, 208 S.W.2d 522, 526 (Ky. 1947); Reeves v. Louisville Gas & Electric Co., 160 S.W.2d 391 (Ky. 1942); Kentucky & W. Va. Power Co. v. Holliday, 287 S.W. 212, 214 (Ky. 1926); Kentucky Electric Co. v. Buechel, 143 S.W. 58, 60 (Ky. 1912); Dep't of Revenue ex rel. Luckett v. Allied Drum Service, Inc., 550 S.W.2d 564, 566 (Ky. App. 1977), *aff'd*, 561 S.W.2d 323 (Ky. 1978); Commonwealth ex rel. Luckett v. WLEX-TV, Inc., 438 S.W.2d 520, 521 (Ky. 1968).

[7] See e.g., Alabama: Curry v Alabama Power Co., 243 Ala 53, 8 So 2d 521 (1942); Southern Natural Gas Co. v State, 261 Ala 222, 73 So

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2d 731 (1953); Arkansas: Morley v Brown & Root, Inc., 219 Ark 82, 239 S.W.2d 1012 (1951); Massachusetts: Boston Gas Co. v Assessors of Boston, 334 Mass 549, 137 N.E.2d 462 (1956); Minnesota: Minnesota Power & Light Co. v Personal Property Tax, Taxing Dist. 289 Minn 64, 182 N.W.2d 685 (1970); Montana: Chicago, M., St. P. & P.R. Co. v Custer County, 96 Mont 566, 32 P.2d 8 (1934); New Jersey: Society for Establishing Useful Mfrs. v Paterson, 88 NJL 123, 96 A 92 (1915); New York: People ex rel. Brush Electric Illuminating Co. v Wemple 129 NY 543, 29 NE 808 (1892) & People ex rel. Edison Electric Light Co. v Campbell, 88 Hun 527, 34 NYS 711 (1895); South Carolina: Columbia R. Gas & E. Co. v Query, 134 SC 319, 132 SE 611 (1926) & Duke Power Co. v Bell, 156 SC 299, 152 SE 865 (1930).

[8] See e.g., KRS 139.480 & KRS 139.470.

[9] KRS 139.010(20).

[10] See Jefferson Greenhouse Co., Inc. v. Kentucky Tax Commission, Ky. State Tax Reporter ¶200-462 (Franklin Cir. Ct., 1961).

[11] See 103 KAR 30:140 §9.

[12] See my prior Journal of Multistate Taxation and Incentives, "You Down with CBD? Yea You Know Me – States Look to Incentivize and Tax Growing Hemp Industry," Vol. 29, No. 7 (October 2019).

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