Kentucky Tax Talk: Confusion Over Manufacturing Exemptions

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Kentucky's sales and use tax exemptions for machinery, equipment and supplies used in the manufacturing process are one fickle beast. Kentucky courts have grappled with the intricacies of placing definitions on what can and cannot fall under these exemptions for decades, often leaving taxpayers to reconcile conflicting, or at least not cohesive, interpretations of the same.

The Kentucky Court of Appeals recently weighed in with its decision in July 2021 in *Century Aluminum v. Department of Revenue*. But did this opinion clarify lingering issues? This article examines the continuing problems manufacturers and industrial processors face in the commonwealth — and what to do with its most popular exemptions.

There have been several statutory issues disputed over the years with Kentucky's two largest manufacturing-related exemptions, which cover: (1) machinery and equipment for new and expanded industry; and (2) industrial tools, supplies and materials. Whether an item is exempt under the above, or is a taxable repair, replacement or spare part, remains the primary issue.

Century Aluminum dealt with this issue head-on for the metals/refractory industries. But it is only one of a line of cases that continues to leave uncertainty, and risk, for both taxpayers and the Kentucky Department of Revenue.

Century Aluminum v. Department of Revenue

In *Century Aluminum*, the Kentucky Claims Commission, or KCC, found that various taxpayer purchases made in conjunction with its aluminum manufacturing facility — refractory materials, anode studs, inductotherm lining, thermocouples tube assemblies, welding wire and industrial glass — were exempt manufacturing supplies.

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However, the Franklin Circuit Court subsequently reversed the KCC order, finding instead that the supplies in question were considered repair and replacement parts, which are not exempt under the statute. The question before the KCC and courts was whether the applicable statutory definitions are conflicting for what is considered exempt and what is considered a repair, replacement or spare part.

Kentucky Revised Statute 139.470(9) provides that certain tangible property directly used in a manufacturing or industrial process is exempt from sales and use tax, and offers various examples of the types of materials, as well as supplies and tools with a useful life of less than one year, which qualify for the exemption. The statute also provides that "the exemption provided … does not include repair, replacement, or spare parts."

The taxpayer argued that this conflicts with the definition of repair and replacement parts in KRS 139.010(34)(a)-(b): "any tangible personal property used to maintain, restore, mend, or repair machinery or equipment." The taxpayer argued that almost all items that qualify for the exemption under KRS 139.470(9) could also be considered to maintain, restore, mend or repair machinery or equipment, effectively nullifying the exemption.

The department alternatively took the position that KRS 139.470 sets forth examples of what qualifies for the exemption and what does not, i.e., repair and replacement parts. KRS 139.010 simply clarifies what exactly does not apply for the exemption — meaning, no conflict exists.

The KCC held that the distinction lies with whether the materials are "used up" in the manufacturing process, or whether the items "wear out," to determine whether the item is exempt or not. Both the Franklin Circuit Court and the Kentucky Court of Appeals held that the KCC's analysis was incorrect, and that the statutes are not in conflict. The court held that all of the taxpayer's items were ultimately taxable as repair and replacement parts and materials.

Many taxpayers may not clearly understand — and the department may not assert — which items they purchase are exempt and taxable. Just two years prior to this decision, another circuit court

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ruled differently on this very issue, and essentially the very same or substantially similar aluminum processing operation and equipment/supplies.

Novelis Corp. v. Department of Revenue

On July 2, 2019, the Madison Circuit Court issued its opinion in *Novelis Corp. v. Department of Revenue*, analyzing the issue of whether a manufacturer's purchases were exempt or taxable. The taxpayer purchased various refractory materials for its aluminum processing facility — including many of the same or similar items in *Century Aluminum*, such as refractory materials, lining material, thermocouples and tube assemblies, and welding material — arguing such materials were exempt under KRS 139.470(9).

Just as in *Century Aluminum*, the department took the position that the taxpayer's refractory materials were considered a taxable repair or replacement parts. One major issue in the case was whether the taxpayer's refractory materials were considered "fire brick," which is expressly included in the statute as an example of exempt manufacturing supplies.

While the KCC — then known as the Kentucky Board of Tax Appeals — ruled in favor of the department, the Madison Circuit Court reversed the order, finding that the KBTA did not consider the totality of the evidence before it.

The circuit court held that not only did the KBTA disregard testimony from the taxpayer's credible witness as to the similarities between the refractory materials and fire brick, but it also did not consider that the list of supplies included in the statute is not exclusive. Even if the taxpayer's refractory materials are not considered fire brick, they could still function in a way that qualifies as an exempt industrial supply as recognized by prior Kentucky case law.[1]

The court also addressed the department's position that these supplies should be considered repair or replacement parts. The department argued that these were not separate supplies, but rather, parts of the furnace, and thus, the materials wore down and required replacement in the same location by the taxpayer. The

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court disagreed.

The court held that listing exempt items in KRS 139.470(9) and then claiming they, too, could fall under the definition of repair and replacement parts "essentially nullifies the supplies exemption." While the court did not come out and say that the two statutes conflict, it alluded to that conclusion, at least as it related to the facts and circumstances therein.

The court noted that the department had previously audited Novelis and agreed that the same items were exempt — supporting the conclusion that the items were exempt supplies or materials, not taxable repair or replacement parts. The department ultimately decided not to appeal *Novelis* to the Kentucky Court of Appeals. Instead, it moved forward with appealing the KCC's decision in *Century Aluminum*.

A taxpayer looking for guidance as to whether its purchases are manufacturing supplies, tools or materials, or are considering repair or replacement parts, may get a different result if relying on *Century Aluminum* or upon *Novelis*.

What This Means for Taxpayers Moving Forward

Without Kentucky Supreme Court precedent, many taxpayers are left to decide what purchased manufacturing industry items are taxable or exempt, and then brace themselves for an audit as the department continues to ramp up its enforcement under the current administration.

While *Century Aluminum* is pending discretionary review before the Kentucky Supreme Court, it is not likely that the court will accept discretionary review. If it does, then the state will have a new high court precedent on this issue. If it does not, taxpayers will continue to grapple with the *Century Aluminum* and *Novelis* decisions.

Although *Century Aluminum* is an appeals court decision — as opposed to the circuit court opinion in *Novelis* — the Kentucky Court of Appeals designated it as a nonpublished case. Therefore, it is not precedential for general taxpayers, but might still persuasive authority under Kentucky Rules of Civil Procedure (CR) 76.28(4).

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It is also noteworthy that while both cases involved similar processes (melting of aluminum or other metals for new products) and items (refractory materials, lining material, thermocouples and tube assemblies, welding material, etc.), the status of refractory materials, such as fire brick, at issue in *Century Aluminum* case was resolved separately by the parties prior to and in conjunction with the department's appeal to the Franklin Circuit Court, based on public filings,[2] and thus was not relied upon by the circuit court or the appeals court.

Does that mean *Novelis*, and the KCC's decision as it relates to refractory materials in *Century Aluminum*, remain the controlling precedent on the taxability of refractory materials? Arguably so.

There are dozens of cases that predate the above-discussed Kentucky cases on this and similar topics and issues. There continues to be uncertainty on how to classify and report these types of items in manufacturing or industrial processes. That uncertainty opens substantial risk if the department conducts an audit and determines items to be taxable repair or replacement parts, rather than exempt machinery, equipment, tools, supplies or materials, based on its interpretation of *Century Aluminum* and KRS Chapter 139.

Please reach out to the authors of this article, Mark Sommer, Daniel Mudd and Elizabeth Mosley, if you have questions about the impact of these two cases on manufacturing-related taxes. You can also continue to follow the Frost Brown Todd Tax Law Defined blog for more updates.

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[1] See generally, *Revenue Cabinet v. Armco Inc.*, 838 S.W.2d 396 (Ky. App. 1992); Ora Mae Coal Co. v. Revenue Cabinet, 1190 WL 204121 (KBTA1990).

[2] See Amended Petition for Judicial Review of Decision of Kentucky Claims Commission, Tax Appeals, filed Aug. 8, 2019 ("The parties having settled the matter of 'refractory materials' outside of this litigation and said matter no longer being at issue in this case, they have agreed to filing of the following Amended Petition").

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