Finally, Some Clarity and a Big Win for Kentucky Manufacturers on Taxability of Supplies v. Repair, Replacement or Spare Parts

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Authors:

Rachael High Chamberlain
Elizabeth M. Ethington
Daniel G. Mudd

On December 15, 2022, the Kentucky Supreme Court handed a major win to Kentucky manufacturing taxpayers with its decision in *Century Aluminum of Kentucky, GP v. Department of Revenue*. With this decision, designated for publication, the Court has validated the position claimed by many manufacturers that repeat purchases of industrial supplies are entitled to a Kentucky sales tax exemption.

Specifically, the Court held that if an item is an industrial supply that is being consumed in the manufacturing or industrial process within one year, future purchases of the items remain entitled to exemption as an industrial supply and are not treated as taxable purchases of repair parts. The Court also agreed that the judicial principles of the *Mansbach Metal Co. v. Department of Revenue* case prevail, meaning that items listed as supplies in the statute are consumed in the manufacturing process and cannot by definition also be taxable repair parts. Finally, the Court held that the Kentucky Department of Revenue's ("Department") overly broad reading of KRS 139.470(9) makes the statute meaningless, in violation of the law.

Century Aluminum involved the application of the manufacturing exemptions found in KRS 139.470(9), and specifically the language of KRS 139.470(9)(e), which bars a sales and use tax exemption for purchases of "repair, replacement, or spare parts."

KRS 139.470(9) allows for some items to be purchased without the application of sales tax if those items are used by a manufacturer or industrial processor "directly" in the manufacturing or industrial processing of tangible personal property at a plant facility. Distillers, rectifiers, wineries, malt beverage producers and brewers are also eligible for the exemption. Thus, the exemption affects a large number of taxpayers within the Commonwealth.

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Broadly speaking, there are three categories of items that qualify for the exemption under KRS 139.470(9)(b). The first category includes materials that enter into and become an ingredient in or component part of the manufactured products. The second category includes other tangible personal property that is directly used in the manufacturing or industrial processing process, if the property has a useful life of less than one year. This category contains three subcategories – raw materials, industrial supplies, and industrial tools. Further, within these three subcategories, the statute provides a list of approximately fifteen specific items that are considered "supplies," as well as items similar in nature to the enumerated supplies. The statute explicitly states that "supplies does not include repair, replacement, or spare parts of any kind." The third category of exempt items includes materials and supplies that are not reusable in the same manufacturing or industrial processing process after the completion of a single manufacturing or processing cycle.

While the supplies subcategory statutory language explicitly excludes repair, replacement, or spare parts from the definition of supplies, KRS 139.470(9)(e) goes further, stating that the "exemption provided in this subsection does not include repair, replacement, or spare parts." In addition, KRS 139.010(34) provides that "repair, replacement or spare parts" means "any tangible personal property used to maintain, restore, mend, or repair machinery or equipment." It goes on to state that "repair, replacement or spare parts" does not include machine oils, grease, or industrial tools.

Century Aluminum involved the second category of exemption. During the tax years at issue, Century Aluminum Co. manufactured aluminum in its facility in Hawesville, Kentucky. For its manufacturing process, Century purchased anode stubs, Inductotherm lining, thermocouples and tube assemblies, welding wire, and industrial gases. Century paid the sales tax and eventually, with assistance from its vendors, filed sales and use tax refund claims, arguing that these items were exempt under KRS 139.470(9). The Department denied the refund claims, arguing that each item at issue was a repair, replacement, or spare part and thus taxable.

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Century appealed to the then-Kentucky Claims Commission. The Commission ultimately adopted the recommended order of the hearing officer, who found that the items were exempt supplies under KRS 139.470(9). The Department appealed to the Franklin Circuit Court, which reversed the Commission's final order, holding that the items were not exempt. The Commission's reasoning was similar to that of the prior decision in *NovelisCorp. v. Department of Revenue,* 16-CI-00189 (Madison Cir. Ct., July 2, 2019).

In *Novelis*, the Madison Circuit Court examined the application of the statute to the taxpayer's refractory materials, which were regularly replaced. Just as it did in *Century Aluminum*, the Department also argued in *Novelis* that based upon the "repair, replacement, or spare parts" language in the statute, "anything that is purchased as a repair, replacement, or spare part . . . doesn't qualify for the industrial supply exemption," and noted that its own training materials explicitly state that even if an item is listed as an industrial supply, if it is being purchased as a repair, replacement or spare part, it doesn't qualify for exemption. In 2019, the Madison Circuit Court disagreed with the Department's position, stating that it creates a situation in which an explicitly exempted item may not be exempt, essentially nullifying the supplies exemption. The court further noted that courts have recognized the distinction between industrial supplies and repair or replacement parts, and pointed to dicta in *Mansbach*, noting that nothing in the supplies exemption is in the category of a part. Thus, the court found that the refractory materials at issue were consumable supplies and properly exempt from tax. The court also favorably cited the Commission's findings in *Century Aluminum*.

With both cases before respective lower tribunals, the Department decided not to appeal the *Novelis* decision, and instead moved forward with an appeal in the *Century Aluminum* case. At the court of appeals, Century argued that the circuit court did not harmonize KRS 139.470(9)(b)(2) with KRS 139.010(34). Century claimed that the two statutes conflict by exempting some items from the sales and use tax while also defining some of the same items as subject to the sales and use tax. Practically speaking, Century argued, this means that because almost all items that qualify for a tax exemption under the industrial supplies exemption are also used to maintain, restore,

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mend, or repair machinery or equipment, and thus, if the two statutes are not harmonized, KRS 139.470(9) would be meaningless and void.

The Court of Appeals disagreed. In fact, it found that the two statutes do not conflict at all. The court went on to reject a proposed four-part test that Century claimed would determine if exemption was proper.

In the December 15, 2022 published (a/k/a precedential) opinion, the Kentucky Supreme Court reversed the Court of Appeals' finding. The Court held that "a tax-exempt supply is consumed within the manufacturing process and has a useful life less than one year, making it an item which the manufacturer inevitably, regularly, and/or frequently buys to maintain the manufacturing process." The Court made clear that regularly consumed supplies are distinguishable from a taxable repair, replacement or spare part, "which maintains, restores, mends or repairs solid machinery or equipment of a long-term or permanent nature and which does not necessarily have a known, limited useful life," because the Department's interpretation otherwise would've made the longstanding statutory exemption meaningless.

The Court's recognition of the difference between regularly replaced supplies, versus repair, replacement or spare parts, is a major win for taxpayers who have long argued that the Department's interpretation of the statute was overly broad to the point of being nonsensical. With the Court's published ruling, this distinction is now binding precedent with the ability to positively impact multiple industries within the Commonwealth.

For more information, please contact any attorney with Frost Brown Todd's Tax practice group.

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