Kentucky's Bourbon Barrel Tax May Be Headed Toward Bitter Ending

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There were reportedly more than 11.5 million barrels of bourbon aging in Kentucky as of October 2022. The industry has seen exponential growth over the last several years, with hundreds of millions of dollars in distillery expansion investments announced in the state in 2022 alone. With this increased economic presence has come increased pressure on Kentucky's ad valorem tax on distilled spirits.

Unlike every other state, Kentucky imposes a state and local ad valorem tax on bourbon (and any other distilled spirit) located in its borders. Given the current number of barrels in the state, as well as the expected expansion of barrels, this has become a lucrative revenue source for state and local government.

While all manufacturers in Kentucky are subject to tax on their inventory being stored in the state, and the distilled spirits tax is in essence the bourbon industry's equivalent of the general inventory tax, the industry is uniquely positioned to be disproportionately impacted. Because barrels of bourbon are often aged in Kentucky rickhouses (the industry term for warehouses storing aging bourbon in barrels) for many years, the distillers must pay tax on that inventory for all of those years, as opposed to other manufacturers that may only store inventory for short periods of time.

To address these concerns, the Kentucky General Assembly created an income tax credit in 2014 to help lessen the tax burden on the bourbon industry. The credit allowed businesses to apply the ad valorem tax paid on distilled spirits as a credit against their Kentucky income tax liability.

While this was a win-win in theory, as it offered a reduced tax burden for distillers without taking revenue from local governments, the credit hasn't proven to be a benefit to distillers. In 2018, Kentucky switched its income tax apportionment method to a single sales factor formula, which slashed many businesses' income

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tax burden, including distillers. As the credit couldn't be transferred or monetized, many distillers were left with credits far exceeding their income tax liability and no way to benefit from the excess credits.

Hearing the bourbon industry's concerns with the actual benefit of the credits, the General Assembly created the Bourbon Barrel Tax Task Force. It began meeting in June 2022 to brainstorm other options in reforming tax on distilled spirits, and to hear from local governments as well as representatives from the bourbon industry. The result of the task force's research and discussions is House Bill 5, introduced in February during the Kentucky 2023 Regular Legislative Session.

H.B. 5 proposes a total phase-out of Kentucky's ad valorem tax on bourbon. It proposes an end of accumulation of income tax credits from ad valorem tax paid on distilled spirits beginning Jan. 1, 2024. However, the bill allows the credit to be carried forward and applied to future years. Then, beginning Jan. 1, 2026, the bill gradually phases out the tax. With a 3% exemption in 2026, by 2039, the tax on distilled spirits would be eliminated.

The goal is that a gradual elimination ultimately would benefit the bourbon industry and allow local governments several years to budget for such changes—and possibly find additional revenue sources to replace these funds through future local tax reform and/or agreements with distilling partners in their districts.

The bill was anticipated to gain significant momentum, given it is sponsored by two influential leaders—House Speaker David Osborne (R) and House Appropriations and Revenue Committee co-chairman Jason Petrie (R)—but has not moved quite as quickly as some expected.

Not only has there been significant pushback from local governments and school boards, but many also have argued that, given the above referenced historic expansions announced in the state, tax reform isn't necessary to ensure continued growth of the industry in Kentucky. Although, as reported during presentations to the Bourbon Barrel Tax Task Force, bourbon expansion has increased in several competitor states with more advantageous

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taxing schemes for distillers.

Despite the pushback, H.B. 5 was voted out of the House 59–40 on Monday and now heads to the Kentucky Senate. While the phase-out remains in the current version, a House committee added a substitute creating the power for local government (city, county, or fire district) to impose a storage license fee for the privilege of storing distilled spirits in the jurisdiction from 2026 until 2049.

The legislation now provides that the storage license fee shall not exceed the amount of ad valorem tax paid by the taxpayer in 2023. It also allows fire and emergency service providers to impose a fee to cover the services rendered for the premises, if the premises aren't financed through an industrial revenue bond (which is financing used as an economic incentive for many, including several distillers).

Regardless of the impact on attraction and retention, the industry undoubtedly will continue feeling the effects of this tax as their capacity grows, which in turn will apply more pressure on the General Assembly. This isn't the first time the tax on distilled spirits has been under scrutiny and, even if H.B. 5 doesn't pass this session, it likely won't be the last. However, while Republicans currently enjoy a supermajority in the General Assembly, if the House and Senate split in the coming years, bourbon tax reform may become even more difficult to achieve.

For more information, contact the authors of this article or any member of Frost Brown Todd's Tax Practice. You can also visit our Tax Law Defined Blog for more insight into the latest developments in federal, state and local tax.

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