Kentucky Tax Talk: Clash Over Industrial Supplies Exemption

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On Dec. 15, 2022, the Kentucky Supreme Court unanimously delivered a huge win for Kentucky manufacturers.

In Century Aluminum v. Department of Revenue,[1]the court found that repeat purchases of industrial supplies qualified for Kentucky's sales tax exemption for manufacturing supplies, tools and materials, allowing Kentucky manufacturers to breathe a sigh of relief.

However, recent legislative committee testimony may cause another battle for manufacturing taxpayers during the 2024 legislative session, as they continue to try to protect generations-old exemptions for industrial supplies.

Kentucky authorizes a wide array of tax exemptions for taxpayers engaged in manufacturing activities. In particular, and at issue in the Century Aluminum case, was Kentucky's sales tax exemption found in Kentucky Revised Statute 139.470(9).

This statutory provision exempts items directly used by a manufacturer or industrial processor in the manufacturing or industrial processing process at a plant facility from Kentucky's 6% sales and use tax.

While at first blush the statute seems relatively broad, KRS 139.470 goes on to provide specific categories of items that may qualify for the exemption:

- Materials that enter into and become an ingredient in or component part of the manufactured products;
- 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; and
- 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.

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Within this third category, the statute sets forth three sub categories: raw materials, industrial supplies and industrial tools. And within these three subcategories, the statute provides a list of approximately 15 specific items that are considered "supplies," as well as items similar in nature to the enumerated supplies.

It is important to note that the statutory exemption specifically excludes purchases of repair, replacement or spare parts. Thus, the issue at hand — and the primary issue in Century Aluminum — is differentiating between (1) taxable repair and replacement parts and (2) exempt industrial supplies with a useful life of less than one year that are fully used in the manufacturing process.

Century Aluminum argued in its refund claims that several recurring purchases of industrial supplies used in its aluminum manufacturing facility qualified as exempt supplies under KRS 139.470. Alternatively, the Department of Revenue argued that these items at issue were instead taxable repair and replacement parts.

While the Kentucky Claims Commission — now the Kentucky Board of Tax Appeals — ruled in favor of the taxpayer, the Franklin Circuit Court reversed the commission's final order, holding that the items were not exempt.

The Court of Appeals affirmed the Franklin Circuit Court's holding and the Kentucky Supreme Court subsequently granted discretionary review. After hearing oral arguments on the issues, the Kentucky Supreme Court reversed the Court of Appeals' holding and found that the taxpayer's items must be considered exempt industrial supplies in order to give proper meaning to the statute.

This decision was important not only for aluminum and metal manufacturers with supplies similar to Century Aluminum, but for all Kentucky manufacturers. This delicate balance between exempt industrial supplies and taxable repair or replacement parts is something that all manufacturers grapple with.

In Century Aluminum, 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," in part

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because the Department of Revenue's interpretation otherwise would have made the long-standing statutory exemption meaningless.

Despite the Kentucky Supreme Court's clear ruling in favor of the taxpayer in December 2022, just a few months later, as the 2023 regular legislative session was preparing to close, the Department of Revenue attempted to legislatively limit the court's Century Aluminum holding.

The Department of Revenue lobbied for an addition to the bill to legislate that the Century Aluminum ruling would only apply to the taxpayer and only for purchases made between November 2010 and May 2015, via a Senate committee substitute to H.B. 360.

While this push to legislatively limit the Century Aluminum decision was supported by a fiscal impact analysis from the Office of State Budget Director reporting that the refund claim liability from the decision was estimated to be approximately $547 million for fiscal years 2019-2022, ultimately, the amendment was abandoned by the Legislature.

It was clear to all in the business community, and seemingly to the General Assembly, that the fiscal impacts projected by the budget director were not substantiated. Rather, this fiscal impact report was built on a gross overstatement of the impact of the court's holding.

The court in Century Aluminum only recognized that the Department of Revenue's categorization of the items in dispute as taxable repair and replacement was incorrect; however, the budget director's analysis deduced that, instead, the repair and replacement exclusion was completely overhauled. This led to an assumption that 80% of the use tax paid by manufacturers would become tax-exempt.

Now, almost a year after the Kentucky Supreme Court issued its published and precedential opinion, and after an amendment to limit the decision was dismissed last year by the General Assembly, the taxability of industrial supplies is again being scrutinized.

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In a recent report prepared for and presented to the Kentucky Consensus Economic Forecasting Group, a committee of independent economists that formulate the economic forecast for the state and help guide the budgeting process for the General Assembly, the deputy executive director of the office of state budget again set forth the expected fiscal impact of the Century Aluminum decision.

The report states that the expected fiscal impact is a decrease in state revenue of $140 million in fiscal year 2024, $155 million in fiscal year 2025 and $145 million in fiscal year 2026. The report indicates that the projected impact is the result of reduced payments of sales tax as well as potential refund liabilities.

While the above impacts are not insignificant, they are likely still grossly overstated under the purported belief that the Kentucky Supreme Court expanded the industrial supplies exemption when in reality, the court simply relied on a plain reading of the statute and distinguished between exempt supplies consumed in a manufacturing process, from taxable repair, replacement or spare parts.

This can be seen in the report to the Consensus Forecasting Group, in which a representative from the state budget director's office asserted that the Century Aluminum case was the "expansion of the supplies exemption to include repair, replacement, and spare parts used in the industrial or manufacturing process."

This appears to be a mischaracterization of the Century Aluminum decision. The Kentucky Supreme Court did not find that all repair and replacement parts are now exempt industrial supplies — rather, the court held that the materials at issue in the case were not taxable repair and replacement parts, but instead were exempt industrial supplies.

If the Consensus Forecasting Group used the position that all, or at least a significant amount of repair and replacement parts will now be exempt from sales tax as a basis of modeling the fiscal impact of the case, it would result in an inflated impact. How the group calculated this impact was not made clear during the presentation at its most recent September meeting.

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Nevertheless, multimillion-dollar revenue cuts in years in which the General Assembly is focused on increasing sales tax revenue in the state in order to meet the thresholds to reduce the individual income tax rate will likely not go unnoticed.

Significant impacts being reported, even if inflated or misconstrued, could lead to potential proposed legislation addressing the industrial exemption during the upcoming 2024 regular legislative session, after attempts to do so at the very end of the 2023 regular legislative session via H.B. 360 failed.

In other words, the General Assembly may push back on the Kentucky Supreme Court's ruling and add clarifying language to the statute limiting the sales tax exemption for manufacturing materials and supplies.

However, expect the manufacturing industry, trade groups and chambers of commerce to strongly push back on any sort of legislation that could limit Kentucky's broad industrial supplies and other manufacturing-related sales tax exemptions that have helped spur the recent growth in capital investment in the commonwealth the past several years.

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

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[1] Century Aluminum v. Department of Revenue, 664 S.W. 3d 546, 2022.

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