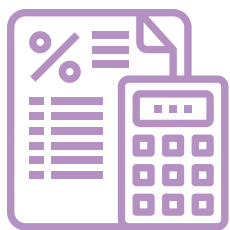


Manufacturing Supplies Sales Tax Exemption

Dentons SALT Insights

Manufacturing sales tax exemptions are important to Kentucky manufacturers. Currently, the Kentucky Court of Appeals is considering *Century Aluminum of Kentucky, GP v. Dep't of Revenue*, No. 2020-CA-0301, which concerns the manufacturing supplies sales tax exemption. The appeal has been briefed.



As a matter of legislative policy, should the “repair, replacement or spare parts” language be eliminated by the General Assembly?

Century Aluminum presents a question regarding the extent of the exclusion of repair, replacement, or spare parts from the manufacturing supplies exemption. Does the exclusion subsume the exemption? It would seem that it should not, especially given that the purpose of manufacturing exemptions, including the supplies exemption, is to encourage manufacturing in Kentucky.

As a matter of legislative policy, should the “repair, replacement or spare parts” language be eliminated by the General Assembly? Most other states do not similarly limit their sales tax exemptions for manufacturing supplies. And, should the General Assembly update the text of the manufacturing supplies exemption to reflect modern manufacturing practices? Could that limit or eliminate disputes between Kentucky manufacturers and the Department of Revenue? Would not such a change be consistent with reducing pyramiding of the sales tax?

Exempt Manufacturing Materials, Industrial Tools and Supplies

Similar to goods purchased for resale, items such as ingredients and component parts purchased to be used in manufacturing or industrial processing at a plant to produce a good for sale, i.e., manufacturing materials, are exempt from sales tax under KRS 139.470(9)(b)1. During the manufacturing and processing of goods, other items are consumed, and these may be exempt under KRS 139.470(9)(b)2 if the item is directly used in manufacturing or industrial processing and has a useful life of less than one year, including materials, industrial tools, and supplies.

These exemptions began as an administrative regulation adopted in the 1960's, and they were later codified by the General Assembly in the early 1990's into a statute. The regulation was based on the sale for resale exemption and was consistent with a policy of reducing pyramiding, which occurs when tax is imposed on multiple transactions related to a good that is ultimately sold to the consumer of that good.

Statutory examples of exempt industrial tools include, "jigs, dies, drills, cutters, rolls, reamers, chucks, saws, spray guns, etc., and...tools attached to a machine such as molds, grinding balls, grinding wheels, dies, bits, cutting blades, etc." KRS 139.470(9)(a)2.c. Statutory examples of exempt industrial supplies include, "lubricating and compounding oils, grease, machine waste, abrasives, chemicals, solvents, fluxes, anodes, filtering materials, fire brick, catalysts, dyes, refrigerants, explosives, etc." KRS 139.470(9)(a)2.b. The exemptions' lineage accounts for the examples therein being based on 1960's manufacturing technology and processes. Note that the exemption statute uses "etc.", which indicates that the examples are not exclusive of other industrial tools and supplies.

Certain items are excluded from the supplies exemption via the definition of repair, replacement, or spare parts. These are statutorily defined as "any tangible personal property used to maintain, restore, mend, or repair machinery or equipment" and are thus not exempt. KRS 139.470(9)(e) & KRS 139.010(34). By statute, machine oils, grease, and industrial tools are not repair, replacement, or spare parts.

Century Aluminum's Finding that Supplies are Exempt

In *Century Aluminum of Kentucky, GP v. Dep't of Revenue*, No. 17-R-39, Order No. K-25903 (KCC Mar. 27, 2019), the Kentucky Claims Commission held that the Department incorrectly interpreted KRS 139.470 in denying refund claims to Century for sales and use tax paid on certain parts, including anode stubs; inductotherm lining; thermocouples and tube assemblies; welding wire and industrial gases; refractory material used to seal pots and keep gases from escaping; refractory paper used in the inductotherm furnace; and refractory material used

to fill holes between firebricks in the carbon bake furnace. Century argued that these were exempt supplies. The Department argued they were taxable repair, replacement or spare parts.

In finding for Century, the Commission focused on the relationship between the supplies exemption and the repair, replacement and spare parts clause. The Department argued that if any part can be construed as affecting any piece of machinery or equipment, then it is a taxable repair, replacement or spare part. But, Century argued that the Department's interpretation of the test would render the supplies exemption virtually meaningless, as seemingly all exempt supplies could conceivably fall within such a broad definition of repair, replacement or spare parts. The Commission noted the absurdity of this analysis particularly in the case of firebrick, which is specifically mentioned in the supplies exemption statute.



Novelis Finding that Supplies are Exempt

Another supplies exemption case, *Novelis Corp. v. Dep't of Revenue*, No. 16-CI-000189 (Madison Cir. Ct. Jul. 2, 2019), specifically regarding refractory material, was being litigated at the same time as *Century Aluminum*. Obviously agreeing with the *Century Aluminum* administrative decision, the Madison Circuit Court overturned the administrative decision which had found for the Department and instead held that supplies, including refractory materials, that are consumed in the manufacturing process are exempt from sales tax. *Id.* As noted, Kentucky's supplies exemption identifies by example certain manufacturing supplies, like fire brick. Below, the taxpayer, which processes aluminum cans, had argued that the refractory materials it used in its manufacturing process were similar to fire brick. The administrative decision found that the materials were not actually fire brick and thus were not exempt.

Reviewing the case *de novo*, the Madison Circuit Court held that the administrative decision was not supported by substantial evidence, given testimony that "refractory" meant the same thing as "fire brick." The Court also held that the statute was not meant to be an exhaustive list of supplies which might be exempt, but rather was meant to provide examples.

In *Novelis*, like *Century Aluminum*, the Department took the position that, "The 'repair, replacement or spare parts' language is deemed to be controlling" and that "based upon this language" there was "no example where a taxpayer could ever claim an industrial supplies exemption for a 'fire brick' purchase." The Madison Circuit Court, however, rejected the Department's position, reasoning that the Department's interpretation would nullify the supplies exemption:

The Court does not agree with this position and finds it to be a flawed interpretation of the statute. Such an interpretation means that some items that are specifically designated an industrial supply and exempt from tax, would yet be subject to sales tax if it also meets the definition of repair, replacement or spare parts. Nowhere in the statute does it say that the repair, replacement or spare parts

language, even though more recently passed by the legislature, supersedes the industrial supplies exemption. The Department's interpretation essentially nullifies the supplies exemption.

Obviously attempting to harmonize the supplies exemption with the "repair, replacement or spare parts" language, the Court held that, "As it currently exists, however, the industrial supplies exemption is still maintained, together with the repair, replacement or spare parts language. Thus, the statute must be interpreted accordingly."

The *Novelis* case was not appealed to the Kentucky Court of Appeals.

Franklin Circuit Court's Holding that Supplies were Not Exempt

The Franklin Circuit Court went the opposite way of the reasoning of the Madison Circuit Court:

Century argues that the Court must harmonize the use of "repair, replacement, or spare parts" in KRS 139.010(34) and KRS 139.470(9)(a)(2)(b). The Court disagrees. KRS 139.010(34) merely defines "repair, replacement, or spare parts." KRS 139.470(9)(a)(2)(b) provides examples of included exempt supplies, however, the statute makes clear that if the supplies are purchased as "repair, replacement, or spare parts" the supplies are not exempt from the sales and use tax.... The Madison Circuit Court found that the "repair, replacement, or spare parts" language essentially nullifies the entire supplies exemption. As stated above, the Court disagrees....

The Court finds that the items at issue, the anode stubs; Inductotherm lining; thermocouples and tube assemblies; and welding wire and industrial gases, are all subject to the sales and use tax under KRS 139.470(9)(a)(2)(b) because they are "repair, replacement, or spare parts," which the statute explicitly excludes from the sales and use tax exemption for supplies....

The evidence in the record and testimony by *Century's* expert make clear that the anode stubs; Inductotherm lining; thermocouples and tube assemblies; and welding wire and industrial gases

were introduced to maintain, restore, mend, or repair machinery or equipment used at Century’s facility, so the items are subject to the sales and use tax under KRS 139.470(9). Because the items were introduced to maintain, restore, mend, or repair machinery or equipment, the Court does not need to determine whether the items fit any of the tangible personal property examples provided in KRS 139.470(9)(a)(2)(b).

Notably, refractory material and paper were no longer at issue when the Franklin Circuit Court considered the case.

Juxtaposed Approaches

The Madison Circuit Court and the Franklin Circuit Court approach the supplies exemptions’ scope in two starkly different ways.

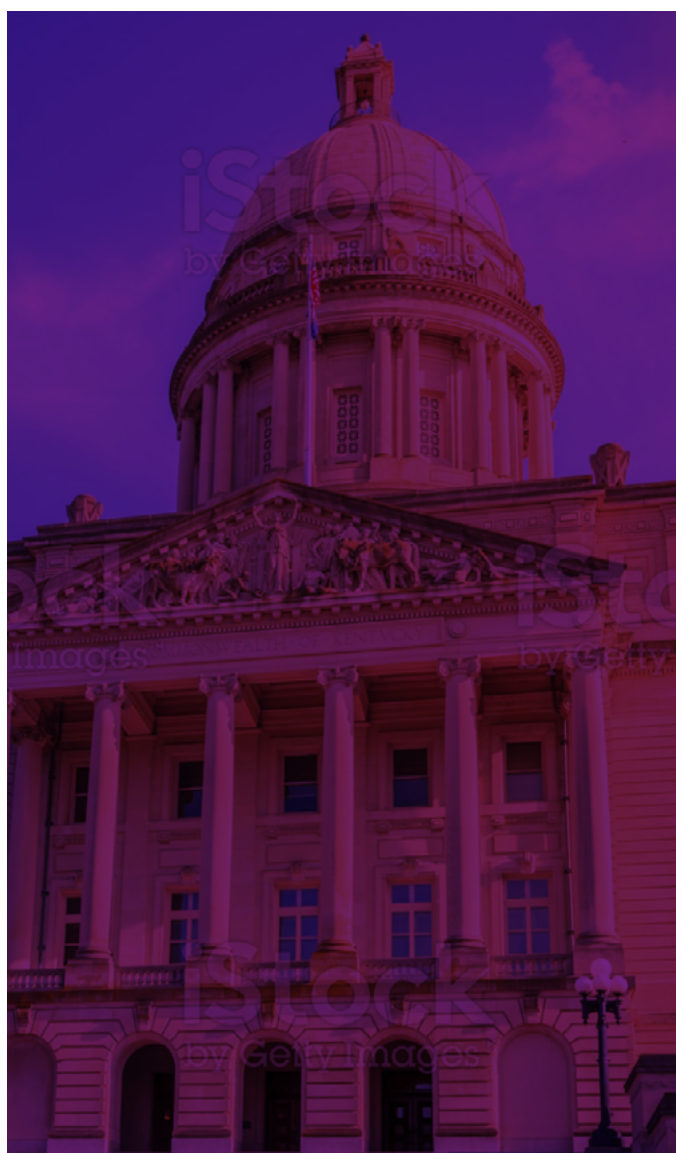
The Madison Circuit Court would appear to determine whether an item comes within the scope of the supplies exemption: Is the item directly used in manufacturing or industrial processing? Does it have a useful life of less than one year? Is the item like one of the examples of supplies (i.e., encompassed by the supplies exemption) or is the item a repair, replacement or spare part (i.e., excluded from the supplies exemption)? The Madison Circuit Court’s approach appears to harmonize the statutory text of both the supplies exemption and the repair, replacement or spare part exclusion, giving effect to both.

The Franklin Circuit Court and the Department appear to approach the issue, starting by determining whether the item is a repair, replacement, or spare part. As the Madison Circuit Court observed, this could have the effect of nullifying the supplies exemption. The Department seems to confirm this by taking the position that there was “no example where a taxpayer could ever claim an industrial supplies exemption for a ‘fire brick’ purchase.” This would seem to mean an item that the supplies exemption statute specifically identifies as a supply is not a supply but rather is a repair, replacement or spare part. If that was the legislative intent, why did the General Assembly leave “fire brick” and the other supplies listed in the supplies

exemption in the statutory text? The seemingly obvious answer is that listed supplies and supplies like the listed supplies are not repair, replacement or spare parts; rather, they are supplies.

The Kentucky Court of Appeals will have the opportunity to explain the effect of the exclusion of repair, replacement, or spare parts in relation to the supplies exemption.

This is a modified version of Mark A. Loyd’s regular column, Tax in the Bluegrass, “Manufacturing supplies sales tax” which appeared in Issue 5, 2020 of the Kentucky CPA Journal.



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