

# Kentucky's Manufacturing Supplies Sales Tax Exemption: Century Aluminum

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Kentucky's manufacturing supplies sales tax exemption was recently addressed by the Kentucky Court of Appeals in *Century Aluminum of Kentucky, GP v. Department of Revenue*, 2020-CA-0301-MR (Ky. App. July 9, 2021), which held in favor of the Department of Revenue in an opinion designated not to be published. The taxpayer has filed a motion for discretionary review with the Kentucky Supreme Court. Should Kentucky's highest court review *Century Aluminum*?

### Is the *Century Aluminum* case a Big Deal?

Every manufacturer with a plant in Kentucky purchases supplies used in their manufacturing operations to which the manufacturing supplies exemption of KRS 139.470(9)(b)2.b may apply to exempt such supplies for sales and use tax purposes. Accordingly, this particular exemption is of widespread application and importance to many Kentucky taxpayers.

Although tax exemptions are generally narrowly or strictly construed, sales tax statutes have long been generally construed to avoid a sales tax on a sales tax, often referred to as "pyramiding of taxes". *George v. Scent*, 346 S.W.2d 784, 790 (Ky. 1961). Significantly, the manufacturing supplies exemption serves this function, *i.e.*, to prevent manufactured goods from bearing a sales tax since the ultimate consumers of such goods will ultimately pay sales (or use) taxes on the sale at retail of such manufactured goods. Anti-pyramiding provisions like the manufacturing supplies exemption, the materials exemption for ingredients and component parts, the industrial tools exemption, manufacturing machinery exemptions and resale exemptions are what make a consumer sales tax what it is, *i.e.*, a sales tax on the ultimate consumer. Otherwise, the consumer sales tax is a tax on a tax on a tax, etc. all along the supply chain.

Repair, replacement or spare parts, however, are excluded from the supplies exemption. The scope of this carve-out causes quite a bit of friction between taxpayers and the Department. The taxpayer in *Century Aluminum* is no exception.

### What Was at Issue in *Century Aluminum*?

Claims for refund of sales tax were filed on the manufacturer's purchases. *Century Aluminum, supra*, at 1. But, the Department denied them, stating the items were "repair, replacement, or spare parts," which are not exempt from sales and use tax under KRS 139.470(9). *Id.*

Notably, each item at issue was on its face a supply used in manufacturing. "Century manufactures 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...." *Id.* The manufacturing supplies sales tax exemption applies to "[o]ther tangible personal property which is directly used in the manufacturing or industrial processing process, if the property has a useful life of less than one (1) year" that are categorized as supplies. *Id.* at 2 (quoting KRS 139.470(9)(b)). "This category includes supplies such as lubricating and compounding oils, grease, machine waste, abrasives, chemicals, solvents, fluxes, anodes, filtering materials, fire brick, catalysts, dyes, refrigerants, and explosives. The supplies indicated above need not come in direct contact with a manufactured product to be exempt." *Id.* (quoting KRS 139.470(9)(b)2.b)). Seems pretty clear, right?

So, why did the Court of Appeals hold that the items were not tax-exempt? The Court relied upon an exclusion from the exemption. "**Supplies' does not include repair, replacement, or spare parts of any kind...**" and "**The exemption ... does not include repair, replacement, or spare parts[.]**" *Id.* at 2-3 (emphasis in original, quoting KRS 139.470(9)(b)2.b & (e)).

### Was the Court's Focus on the Supplies Exemption or on the Repair, Replacement, or Spare Parts Exclusion?

It is interesting that the Court of Appeals affirmed the Franklin Circuit Court which had reversed the Kentucky Claims Commission (now the Kentucky Board of Tax Appeals). The Court of Appeals, borrowing heavily from the Circuit Court, focused its analysis on whether each item at issue was a repair, replacement, or spare part because it was (or was not) "tangible personal property used to maintain, restore, mend, or repair machinery or equipment". *Id.* at 3-4. Should "maintain" be construed in the context of restore, mend or repair? And, should the exclusion be more narrowly construed? After all, it is an exclusion to an exemption, not an exemption itself.

...The anode stubs are part of the larger anode assembly consisting of the anode rod and a "yolk," to which the anode stubs are welded using the welding wire and industrial gases. ...[T]he anode stubs are used to "maintain" the anode assembly and that replacing the anode assembly is necessary to maintain the entire manufacturing process....

...[T]he welding wire and industrial gas must be used to "restore" the anode assembly....

...[T]he thermocouples and tube assemblies, which ... act as a thermometer and need regular replacing due to metal fatigue from the high temperature baths in the manufacturing process....

... [T]he Inductotherm lining, which ... separates the molten cast iron from the furnace components in the manufacturing process... was used to "maintain" the induction furnaces....

Note that in each instance, the focus was on the repair, replacement, or spare parts exclusion and not on whether each item was a supply, which logically implies that each item was a manufacturing supply.

## Should the Kentucky Supreme Court Review *Century Aluminum*?

Despite the case being designated as not to be published by the Court of Appeals, several factors indicate that the case merits review by the Kentucky Supreme Court.

First, the extent of the repair, replacement, or spare parts exclusion from the supplies exemption is a question of statewide significance. There are many manufacturers in the Commonwealth, all across the state. All manufacturers purchase supplies of various sorts for use in their manufacturing operations, just like the taxpayer in *Century Aluminum*. Whether such supplies are excluded from the supplies exemption because they maintain, restore, mend or repair machinery or equipment is an issue that every manufacturer must confront.

Second, the question is novel. The *Century Aluminum* court did not rely on any published case to illuminate the meaning of maintain, restore, mend or repair. “Maintain” is a particularly vague word.

Third, construction of the Kentucky Claims Commission and the Circuit Court are at odds. “The Commission, relying on *Mansbach Metal Co. v. Department of Revenue*, 521 S.W.2d 85, 87 (Ky. 1975) [a published case issued by Kentucky’s highest court] held that a distinction must be drawn between items that are used up and items that simply wear out to determine if the items are tax-exempt. Based on ... testimony that the Department does not consider this distinction, the Commission held that the Department erroneously interpreted KRS 139.470(9) and KRS 139.010(34) because ‘[a]lmost all exempt supplies’ also fit the definition of non-exempt supplies.” *Century Aluminum*, *supra*, at 3. As noted, the Court of Appeals did not rely on any published case concerning the meaning of maintain, restore, mend or repair, but rather, construed the statutory text as a matter of first impression. One has to admit that there is a certain *je ne sais quoi* to construing the exclusion to the supplies exemption so that items that are used up are exempt and items that simply wear out are non-exempt.

In sum, the *Century Aluminum* case is the kind of case that the Kentucky Supreme Court should review.

Should the General Assembly Eliminate the Repair, Replacement, or Spare Parts Exclusion from the Supplies Exemption?

The repair, replacement, or spare parts exclusion from the supplies exemption is inconsistent with the rule against the pyramiding of taxes. Other states, like Indiana, do not restrict the exemption of industrial supplies like Kentucky does. Ind. Code § 6-2.5-5-5.1(b); Ind. Admin. Code 45 § 2.2-5-12(a).

## What Should Kentucky Manufacturers Do?

Kentucky manufacturers should review their purchases of supplies. And, they should evaluate them to see whether or not they may be repair, replacement, or spare parts. They should also continue to watch the *Century Aluminum* case.

How will *Century Aluminum* turn out? Will the Kentucky Supreme Court review the case to interpret the repair, replacement or spare parts exclusion from the supplies exemption? Will the General Assembly eliminate the repair, replacement, or spare parts exclusion? The suspense is terrible.

This is a modified version of Mark A. Loyd’s regular column, *Tax in the Bluegrass*, “Kentucky’s Manufacturing Supplies Sales Tax Exemption: *Century Aluminum*” which appeared in Issue 4, 2021 of the Kentucky CPA Journal.

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