

NO. 79661-1

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**SUPREME COURT OF THE STATE OF WASHINGTON**

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TESORO REFINING AND MARKETING COMPANY,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

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**SUPPLEMENTAL BRIEF OF RESPONDENT  
DEPARTMENT OF REVENUE**

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STATE OF WASHINGTON

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## I. INTRODUCTION

Tesoro contends that the Court of Appeals and the trial court erred in concluding that its possession of refinery gas is subject to the hazardous substance tax imposed by RCW 82.21. The tax is imposed on the first possession in Washington of hazardous substances, including petroleum products. RCW 82.21.030. The statute plainly defines possession to include “the power to sell *or* use a hazardous substance or to authorize the sale *or* use by another.” RCW 82.21.020(3). Tesoro’s petition does not dispute that refinery gas is a hazardous substance under the statute. Nor does Tesoro dispute that it has the power to use its refinery gas.<sup>1</sup> In fact, Tesoro uses the refinery gas in its manufacturing process, and its use is valuable to Tesoro, saving it the cost of purchasing other fuel for that purpose.

Rather, in its Petition for Review, Tesoro claims it is not subject to the hazardous substance tax on its possession of refinery gas for two reasons. First, Tesoro contends that although RCW 82.21.020(3) plainly defines possession of a hazardous substance to include “the power to sell *or* use a hazardous substance,” the statute does not mean what it says. According to Tesoro, possession requires the taxpayer to have the power

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<sup>1</sup> Although Tesoro asserts that refinery gas “cannot be sold,” the record does not support this assertion. Petition for Review at 9; CP 148-9. The record merely establishes that Tesoro does not sell its refinery gas.

both to use *and* sell a hazardous substance. There is no textual support for Tesoro's request that the plain language of the statute be ignored.

Second, Tesoro claims that a rule issued by the Department of Revenue grants a statutory exemption for its use of refinery gas, an exemption that appears nowhere in the governing statutes, and that the Department's rule somehow overrides the statutes that impose the tax. As demonstrated below, this proposition is unsound. If, as Tesoro contends, the Department's rule purports to create such an exemption, and the Department does not believe that it does, the rule would be invalid. The Department lacks authority to create a tax exemption by rule where none is created in statute, just as the Department lacks authority to impose a tax by rule, where none is imposed by statute.

## II. ARGUMENT

### A. **Under The Plain Language Of RCW 82.21, Tesoro's Possession Of A Petroleum Product Is Subject To Tax**

Washington places a hazardous substance tax on the first possession of nearly all hazardous substances. RCW 82.21.030(1) states that "[a] tax is imposed on the privilege of possession of hazardous substances in this state." The plain language of the statute requires taxation when two elements are present. The first is that there is a hazardous substance. The second is that the substance is possessed in

Washington. Because Tesoro's possession of refinery gas meets both elements, and admittedly does not qualify for any of the exemptions provided in RCW 82.21.040, Tesoro is subject to the tax.

**1. Refinery gas is a hazardous substance under RCW 82.21.020.**

Under RCW 82.21.020(1), refinery gas is a hazardous substance. The term "hazardous substance" is defined by RCW 82.21.020(1)(b) to include "petroleum products." The definition of "petroleum products" expressly includes *every* product derived from the refining of crude oil. As Tesoro concedes, refinery gas is derived from processing crude oil. Therefore, the Court of Appeals correctly concluded that "refinery gas is a petroleum product and a hazardous substance under RCW 82.21.020(1)(b)." *Tesoro Ref. & Mktg., Co. v. Dep't of Rev.*, 135 Wn. App. 411, 419, 144 P.3d 368 (2006).

**2. Under the plain language of RCW 82.21, Tesoro "possesses" the refinery gas created and used at the refinery.**

Tesoro's use and power to use its refinery gas meets the definition of "possession" of a hazardous substance. RCW 82.21.020(3) states:

"Possession" means the control of a hazardous substance located within this state and includes both actual and constructive possession. "Actual possession" occurs when the person with control has physical possession. "Constructive possession" occurs when the person with control does not have physical possession. "Control"

means the power to sell or use a hazardous substance or to authorize the sale or use by another.

Tesoro admits, as it must, that it uses the refinery gas and derives significant economic benefit from its use. According to Tesoro's engineer, using refinery gas to heat the refinery burners saves Tesoro the expense of purchasing natural gas. CP 167. In fact, although natural gas is used as a partial fuel supplement, it is physically impossible to run the refinery without the use of the refinery gas. CP 163, 166-67.

The Court of Appeals properly rejected Tesoro's request that the statutory definition of control as the power to "sell *or* use" the hazardous substance be replaced with the power to "sell *and* use" the hazardous substance. *Tesoro*, 135 Wn. App. at 423. As early as 1906, this Court announced that the "exceptional" construction of replacing "or" with "and" "can only be resorted to where the act itself furnishes cogent proof of the legislative error." *State v. Tiffany*, 44 Wash. 602, 604, 87 P. 932 (1906). Since then, this Court has repeatedly stated that "'or' does not mean 'and'." *E.g., Childers v. Childers*, 89 Wn.2d 592, 596, 575 P.2d 201 (1978); *Cerrillo v. Esparza*, 158 Wn.2d 194, 204, 142 P.3d 155 (2006). Statutory interpretation of "or" is appropriate "only when the language of the statute is ambiguous." *State v. Judge*, 100 Wn.2d 706, 711, 675 P.2d 219 (1984).

Tesoro points to nothing in RCW 82.21.020(3), or any other portion of RCW 82.21, that creates an ambiguity about the meaning of “or” in the definition of control. Nor does Tesoro offer any other textual reason to support the view that “or” means “and.” On the contrary, the ordinary disjunctive meaning of “or” is supported by the use of the same word two other times in the same sentence. *Timberline Air Serv. Inc., v. Bell Helicopter-Textron, Inc.*, 125 Wn.2d 305, 313, 884 P.2d 920 (1994) (“When the same words are used in different parts of the same statute, it is presumed that the legislature intended that the words have the same meaning.”) Second, the statutory exemptions from the tax in RCW 82.21.040 support the plain meaning of “or” in RCW 82.21.020(3). RCW 82.21.040(2) exempts from the tax:

Any possession of a hazardous substance by a natural person under circumstances where the substance is used, or is to be used, for a personal or domestic purpose (and not for any business purpose) by that person or a relative of, or person residing in the same dwelling as, that person.

If use of a hazardous substance were not itself subject to the tax, this exemption would be unnecessary. Moreover, it makes it plain that use of a hazardous product “for any business purpose” is not exempt.

In fact, the exemption sought by Tesoro did exist in the past, but was removed from the law by the voters. Prior to 1987, the hazardous substance tax exempted:

(3) any possession of (a) alumina, (b) natural gas, (c) petroleum coke, (d) *liquid fuel or fuel gas used in petroleum processing*, or (e) petroleum products that are exported for use or sale outside this state as fuel.

Laws of 1987, 3d Ex. Sess., ch. 2 § 47(3) (emphasis added). In 1989, Initiative 97 amended the law and eliminated the exemption for liquid fuel or fuel gas used in petroleum processing. Laws of 1989, ch. 2 § 24. When an amendment omits statutory language, the courts “assume . . . that the Legislature intended to exclude the term and that it meant what it said.” *Rhoad v. McLean Trucking Co., Inc.*, 102 Wn.2d 422, 427, 686 P.2d 483 (1984).

The ordinary disjunctive meaning of “or” also is consistent with the intent of the law, expressed in RCW 82.21.010, to tax the first possession of all hazardous substances. And it is consistent with the chapter’s definition of “hazardous substances” as “petroleum products,” including butane, ethane, propane and “every other product derived from the refining of crude oil.” RCW 82.21.020(1)(b); RCW 82.21.020(2).

This Court has repeatedly stated that its fundamental objective is “to ascertain and carry out the Legislature’s intent, and if the statute’s

meaning is plain on its face, then the court must give effect to that plain meaning as an expression of legislative intent.” *E.g., Dep’t of Ecology v. Campbell & Gwinn, L.L.C.*, 146 Wn.2d 1, 9-10, 43 P.3d 4 (2002). Since there is no ambiguity in the statute, the superior court and the Court of Appeals properly gave the word “or” its plain disjunctive meaning.

As the trial court and the Court of Appeals correctly determined, under the plain language of RCW 82.21, the hazardous products tax applies to Tesoro’s possession of refinery gas. Under the plain language of RCW 82.21.020(3), Tesoro possesses refinery gas. And, under the plain language of RCW 82.21.040, possession of refinery gas is not among the specific exemptions from the hazardous substance tax. Since there is no ambiguity in the law, the case is properly determined by applying the statutory language, and no further analysis is required.

**B. WAC 458-20-252(7)(b) Does Not, And Cannot, Create A New Exemption From The Tax Law**

Even though the statutes imposing the hazardous substance tax are plain, Tesoro argues that the Court should find an ambiguity in the law based on a rule of the Department of Revenue. As stated above, because the law is unambiguous, there is no reason for the Court to reach this argument. However, if it does so, Tesoro’s position is unsound for several reasons.

**1. Agency rules cannot change the plain language of the law.**

This Court repeatedly has held that agency rules, including tax rules, cannot create ambiguity in the plain language of the law. *Agrilink Foods, Inc. v. Dep't of Rev.*, 153 Wn.2d 392, 103 P.3d 1226 (2005). After finding that the tax statute at issue in *Agrilink* was plain, the Court repeated the longstanding rule that “[w]here statutory language is plain and unambiguous courts will not construe the statute but will glean the legislative intent from the words of the statute itself, *regardless of contrary interpretation by an administrative agency.*” *Agrilink*, 153 Wn.2d at 396 (emphasis added), citing *Bravo v. Dolsen Cos.*, 125 Wn.2d 745, 752, 888 P.2d 147 (1995) and *Wash. Fed'n of State Employees v. State Pers. Bd.*, 54 Wn. App. 305, 309, 773 P.2d 421 (1989); *Cerrillo*, 158 Wn.2d at 203-04 (“For a statute to be ambiguous, two reasonable interpretations must arise from the language of the statute itself, not from considerations outside the statute.”).

Tesoro’s request that the Court abandon this well-established legal principle, and find that agency rules can create ambiguity in the law where none otherwise exists, would undermine the fundamental structure of our government, and elevate administrative agencies above legislative bodies. If an agency may alter the plain language of the law by adopting a rule,

then agencies may commandeer the authority of the Legislature to enact laws, and the authority of the courts to interpret them.<sup>2</sup>

**2. Considered in context, Rule 252(7)(b) simply ensures that each hazardous substance is taxed only once.**

Contrary to Tesoro's claims, Rule 252(7)(b) does not create a new tax exemption. Rule 252(7) is entitled "Recurrent tax liability." The rule begins by restating that the statutory intent "that all hazardous substances possessed in this state should incur this tax liability only once unless they are expressly exempt." Rule 252(7). To that end, Rule 252(7)(b) states:

(b) When any hazardous substance(s) is first produced during and because of any physical combination or chemical reaction which occurs in a manufacturing or processing activity, the intermediate possession of such substance(s) within the manufacturing or processing plant is not considered a taxable possession if the substance(s) becomes a component or ingredient of the product being manufactured or processed or is otherwise consumed during the manufacturing or processing activity.

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<sup>2</sup> Moreover, even if the Court accepted Tesoro's reading of the rule, Tesoro does not explain how the rule suggests an ambiguity in RCW 82.21.020(3) or supports its argument that the first "or" in RCW 82.21.020(3) means "and." Even if the rule is read as Tesoro asks, it would provide that certain uses are exempt from the tax, not that the taxpayer must have the power to use *and* sell the hazardous product to be subject to the tax.

As the Court of Appeals recognized, “[w]hen read together with chapter 82.21 RCW, rule 252(7)(b) is intended to . . . avoid double taxation of a substance that is first created and then consumed in the manufacturing process.” *Tesoro*, 135 Wn. App. at 425. The hazardous substance is taxed upon its first creation and possession, and not again upon its subsequent use in the manufacturing process.

The partial dissent to the Court of Appeals’ decision suggests that in addition to addressing recurrent tax liability, Rule 252(7) implements a legislative “purpose and intent” to tax only substances released into the air. *Tesoro*, 135 Wn. App. at 429, citing RCW 82.21.030. There is nothing in the language of RCW 82.21.030, or any other substantive provision legislative intent, to support this. RCW 82.21.020(1)(b) defines the term hazardous substance to include, without limitation, all petroleum products.

The Department’s reading of Rule 252(7), as an administrative provision that prevents recurrent tax liability, is evident from its interaction with Shell Oil, the company from which Tesoro purchased its refinery. After the voters eliminated the exemption for fuel gas by enacting Initiative 97, the Department of Revenue began collecting hazardous substance tax on the possession of refinery gas. In a case before the Board of Tax Appeals, Shell Oil, the prior owner of Tesoro’s

refinery contested assessment of hazardous substance tax on refinery gas. Like Tesoro, Shell contended Rule 252(7) restored the statutory exemption for fuel gas. In a published opinion, the Board of Tax Appeals rejected Shell Oil's argument and found that hazardous substance tax was properly assessed on the refinery gas produced and burned at the refinery. *Shell Oil Co. v. State*, BTA No. 93-28 at 21 (1997) (Attachment A).<sup>3</sup>

If Rule 252 creates an extra-statutory exemption from the hazardous substance tax as Tesoro claims, then it is invalid. “[A]n agency may only do that which it is authorized to do by the Legislature.” *Moore v. Whitman Cy.*, 143 Wn.2d 96, 100, 18 P.3d 566 (2001). The authority for enactment of Rule 252 is found in RCW 82.32.300, which states: “The department of revenue shall make and publish rules and regulations, *not inconsistent therewith*, necessary to enforce provisions of this chapter and chapters 82.02 through 82.23B and 82.27 RCW.” (Emphasis added). The Department of Revenue only has authority to adopt rules that are not inconsistent with the underlying tax statutes.

Tesoro contends that even if the Department enacted an invalid rule it should be given effect until the Department amends or repeals it.

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<sup>3</sup> In light of the plain language of RCW 82.21, and in light of this published opinion of the Board of Tax Appeals, rejecting the very claim Tesoro now makes based on the same activity at the same refinery, Tesoro's claim that it should be able to rely on its reading of the Department's rule rings hollow.

On the contrary, as this Court has held, abandoning the ultra vires application of the law is appropriate course. *Dep't of Ecology v. Theodoratus*, 135 Wn.2d 582, 598, 957 P.2d 1241. (1998). Indeed, it is the only course consistent with our structure of government.

Tesoro has no right to the benefit of an extra-statutory tax exemption purportedly created by rule, any more than the Department could claim the benefit of a rule denying a statutory exemption during the pendency of an invalid rule. This Court rejected Tesoro's argument in *Coast Pac. Trading, Inc. v. Dep't of Rev.*, 105 Wn.2d 912, 719 P.2d 541 (1986). Coast Pacific claimed it was entitled to rely on a Department of Revenue rule that was contrary to statute. The statute provided a tax deduction for amounts the state was prohibited from taxing under the constitution or laws of the United States. RCW 82.04.4286. An administrative rule was enacted which recognized that the United States Supreme Court had interpreted the constitution in a manner that limited the ability of the state to assess the tax. *Coast Pac.*, 105 Wn.2d at 916-17. When the United States Supreme Court subsequently changed its analysis and reinstated the state's authority to assess the tax, the rule was not amended. This Court ruled that Coast Pacific was not entitled to rely on the outdated rule because it exceeded the scope of the deduction contained in the statute. *Id.* at 917-18. The Department of Revenue "cannot

properly carve out an exemption . . . when the statute makes no such exemption.”” *Id.* at 917, quoting *Budget Rent-A-Car of Washington-Oregon, Inc. v. Dep’t of Rev.*, 81 Wn.2d 171, 176, 500 P.2d 764 (1972).<sup>4</sup>

### III. CONCLUSION

The Department of Revenue requests the Court of Appeals’ decision be affirmed.

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<sup>4</sup> This Court’s decisions in *Coast Pacific* and *Budget Rent-A-Car* are consistent with the decisions of the United States Supreme Court, holding that taxpayers are not entitled to rely on erroneous regulations or rulings of the Internal Revenue Service. *E.g.*, *Comm’r of Internal Rev. v. Schleier*, 515 U.S. 323, 115 S. Ct. 2159, 132 L.Ed.2d 294 (1995); *Manhattan Gen. Equip. Co. v. Comm’r of Internal Rev.*, 297 U.S. 129, 56 S. Ct. 397, 80 L. Ed. 528 (1936).

# Attachment A

BEFORE THE BOARD OF TAX APPEALS  
STATE OF WASHINGTON

1 SHELL OIL COMPANY, )  
2 )  
3 Appellant, ) Docket No. 93-28  
4 )  
5 v. ) Re: Excise Tax Appeal  
6 )  
7 STATE OF WASHINGTON ) AMENDED FINAL DECISION  
8 DEPARTMENT OF REVENUE, )  
9 Respondent. )  
10 )  
11 )  
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9 This matter came before the Board of Tax Appeals (Board) for  
10 a formal hearing on August 28, 1996. Sara D. Trapani, Senior Tax  
11 Attorney, Shell Oil Co., appeared for Appellant, Shell Oil Co.  
12 (Shell). Cameron G. Comfort, Assistant Attorney General, appeared  
13 for Respondent, Department of Revenue (Department).

15 This Board heard the testimony, reviewed the evidence, and  
16 considered the arguments made on behalf of both parties. This  
17 Board now makes its decision as follows:

18  
19 ISSUES

21 CARLSON, Member--This is an appeal of the Department's Deter-  
22 mination No. 93-118. This appeal involves Shell's Washington  
23 Business & Occupation Tax (B&O Tax), Hazardous Substance Tax  
24 (HST), and Petroleum Products Tax (PPT) liabilities for the years  
25 1985 through 1989. Shell presented three issues on appeal: (1)  
26 valuation of large volume exchange transactions (exchanges), (2)  
27 assessment of HST on petroleum and refinery waste gas, and (3)

1 interest on additional tax properly due. All of the issues relate  
2 to the years 1985 through 1989. In its hearing brief, Shell  
3 raised a new, fourth issue regarding the timeliness of the  
4 assessment for 1985. This Board finds: (1) the Department  
5 overstated the market value of exchanges by including "rack"  
6 prices in its averaging from Shell's own sales journals; (2) the  
7 assessment of HST is properly due except on mixed butanes; (3)  
8 interest is due on tax properly due; and (4) Shell waived its  
9 right of appeal only on the timeli-ness of the 1985 assessment.  
10

11 FINDINGS OF FACT  
12

13 A. MARKETING OF OIL PRODUCTS.  
14

15 1. Shell is engaged in the business of refining petroleum  
16 products. Shell has a refinery in Anacortes, Washington, where it  
17 refines crude oil into various products.  
18

19 2. Refineries furnish products for markets throughout a  
20 region. "Bulk" shipments move the products from the refinery to  
21 distribution terminals in major markets. The product is stored in  
22 distribution terminals, then moved to the "rack". A "rack" is a  
23 facility connected to the terminal where trucks (and sometimes  
24 tank cars) are loaded with the product to carry it to end users  
25 such as service stations, railroads, and cab companies. Barges,  
26

1 tankers, and pipelines are not loaded at truck racks.<sup>1</sup>

2 3. Anacortes is not a major marketing area for refined  
3 petroleum products; most of what is produced at Shell's Anacortes  
4 refinery must be moved away from the refinery in "bulk" shipments  
5 to a terminal to be marketed.<sup>2</sup>

6 B. THE "BULK" MARKET: PIPELINE AND MARINE.

7 4. The two major "bulk" markets for moving product from a  
8 refinery to the marketing terminal area are pipeline and marine.<sup>3</sup>

9 5. Pipeline is the most efficient and inexpensive way  
10 to move product from refinery to market. Pipeline movement is  
11 relatively free of quality and environmental concerns. Pipeline  
12 quantities are on the order of 15,000 to 60,000 barrels (one  
13 barrel equals forty-two (42) U.S. gallons). The Olympic pipeline  
14 serves the Northwest region. It runs from Anacortes to Seattle  
and to Portland.<sup>4</sup>

6. The marine market consists of moving product by barge  
or tanker. Tankers are the least expensive means of moving  
product out of the region. A tanker transports quantities on the

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<sup>1</sup> Arosell, Tr. at 55-56, 59-60, 63.

<sup>2</sup> Arosell, Tr. at 56.

<sup>3</sup> Arosell, Tr. at 56.

<sup>4</sup> Arosell, Tr. at 57-58.

order of 250,000 barrels.<sup>5</sup>

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7. In the Anacortes area (Northwest), barges are used to move product within the region. Barge transportation of oil products is very labor intensive due to difficulty of maintaining quality and adhering to environmental standards. A barge transports quantities on the order of 5,000 to 40,000 barrels. Barge transportation is more costly and less efficient than pipeline transportation.<sup>6</sup>

8. The two "bulk" areas that are generally referred to in this case are barge and pipeline. Purchasers of "bulk" volumes are generally major oil companies, traders, brokers, and others who purchase in large volume in order to "break bulk" and redistribute the product to the end users.

C. THE "RACK" MARKET: TANK CAR AND TRUCK.

9. Products are sold at the "rack" in tank truck volumes, which are much smaller than barge or pipeline volumes.<sup>7</sup> Trucks move quantities of up to 200 barrels. Products moved by truck are more costly than those moved by either pipeline or barge.

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<sup>5</sup> Arosell, Tr. at 57-58.

<sup>6</sup> Arosell, Tr. at 58-59.

<sup>7</sup> Arosell, Tr. at 87.

1 // /

1 10. Products sold at the "rack" may not be of the same  
2 quality and character as that product sold in barge or pipeline  
3 quantities. At the "rack", components which cannot be added to  
4 pipeline or marine shipments are added to make "branded" products,  
5 or to enhance safety.<sup>8</sup>

6 11. At the "rack", there are additional costs associated  
7 with terminaling the barrels, putting them in storage again and  
8 loading to a truck.

9 12. Products sold at the "rack" would not be sold under the  
10 same conditions of sale as products sold in barge or pipeline  
11 quantities.<sup>9</sup>

12 13. Products sold at the "rack" would not be sold to the  
13 same type of purchaser as products sold in barge or pipeline  
14 quantities.<sup>10</sup>

15 14. Purchasers at the "rack" are generally end users, such  
16 as dealers, jobbers, and retailers.

17 // /

18 <sup>8</sup> Arosell, Tr. at 61-62, 86-87, 90.

19 <sup>9</sup> Arosell, Tr. at 88-89.

20 <sup>10</sup> Arosell, Tr. at 87.

1 / / /

2 D. VALUE OF "BULK" AND "RACK" SALES.

3 15. "Rack" sales are not entirely comparable (in the  
4 ordinary meaning of comparable) to "bulk" (pipeline/marine) sales.  
5 There is a difference between "rack" price and pipeline price.<sup>11</sup>

6 16. Platt's, one of several commercial services that pub-  
7 lishes product pricing information, reports different prices for  
8 pipeline, barge, and "rack" transactions. Platt's refers to  
9 "rack" sales as "Tank Car/Truck Transport" or "TC/TT" and  
10 "estimated spot" as "Barge or Pipeline".

11 17. Platt's publishes a daily report and a monthly report  
12 that recaps prices on a monthly basis. Platt's reports price  
13 information by geographic region (such as West Coast), and by  
14 market within region (such as Seattle and Spokane).<sup>12</sup>

15 18. Platt's has been used for many years by oil companies  
16 as one of many tools in the day-to-day business of negotiating  
17 product trades. In the Platt's reports submitted, the market  
18 reported for Seattle-Tacoma is a "rack" market (truck) and a barge

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19 <sup>11</sup> Arosell, Tr. at 57, 60-63, 86; Ex. AH-4, AH-5.

20 <sup>12</sup> Arosell, Tr. at 65-66; Ex. AH-4, AH-5.

market, rather than a pipeline market (see Ex. AH-4, AH-5).<sup>13</sup>

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E. EXCHANGES BETWEEN OIL COMPANIES.

3  
4 19. Shell is involved in large volume exchanges with other  
5 producers. An exchange is a transaction whereby a party delivers  
6 barrels of product to an exchange partner and receives back a like  
7 amount of barrels at another place or another time. The products  
8 exchanged are transported to the exchange partner, stored at an  
9 outlying terminal, and then moved to a "rack" for distribution to  
10 end users.<sup>14</sup>

11 20. Exchanges that take place outside Washington are  
12 referred to as "transfers", and do not include transportation  
13 charges to deliver the product to the point of exchange.

14 21. No money changes hands for exchanges unless there is  
an exchange imbalance over 5,000 barrels. Although there is no  
evidence in this case that any of the contracts were liquidated  
during the years 1985 through 1989, by agreement, settlement may  
occur. Imbalances on exchange agreements may be settled on the  
basis of published prices. If so, the location of settlement is

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<sup>13</sup> Arosell, Tr. at 66, 68, 120-21.

<sup>14</sup> Arosell, Tr. at 59-60.

1 negotiated and is based on the location with the most representa-  
2 tive or believable prices.<sup>15</sup>

3 / / /

4 22. On the West Coast, refiners settle exchange imbalances  
5 on the basis of the value per barrel reported in Platt's Oilgram  
6 with reference to the Los Angeles and/or San Francisco "bulk"  
7 markets, rather than the Washington market. Los Angeles and/or  
8 San Francisco "bulk" market data is more dependable since it  
9 involves more "bulk" transactions.<sup>16</sup>

10 F. HOW SHELL REPORTED THE EXCHANGES FOR TAX PURPOSES.

11 23. The valuation issue in this case relates to six  
12 products involved in these exchanges: regular gasoline, unleaded  
13 gasoline, premium unleaded gasoline, diesel (No. 2 fuel), jet  
14 fuel, and resid (No 6 fuel).

15 24. Because the gross proceeds of Shell's exchanges of  
16 finished petroleum products are unknown, for tax purposes, Shell  
17 filed its tax returns using its own cost methodology for products  
18 exchanged at the Anacortes refinery and other locations in  
19 Washington and shipped via transportation other than by pipeline.

20 However, on those same tax returns, Shell chose to value its

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21 <sup>15</sup> Arosell, Tr. at 103-104, 131; Ex. R-9 - R-18.

22 <sup>16</sup> Arosell, Tr. at 104-106.

1 pipeline exchanges, both within and without of the state, based  
2 on the average value of comparable sales reflected in Shell's  
3 wholesale sales journals.<sup>17</sup> This latter valuation method was  
4 accepted by the Department. The exchanges are reflected on Audit  
5 Schedule XXVII.

6  
7 G. SHELL'S COST SYSTEM.

8 25. Shell developed its cost system specifically for the  
9 purpose of valuing exchanges in Washington--the Comprehensive  
10 Transfer Cost Calculation (CTCC).

11 26. Shell's CTCC system is a very complex cost system  
12 developed, at least in part, by engineers and technical personnel.  
13 The CTCC is based on allocating cost data to the various hydro-  
14 carbon streams as they pass through the refinery processing units  
15 and is made on the basis of volume.<sup>18</sup>

16 27. The CTCC includes three elements: crude oil costs,  
17 manu-facturing costs, and overhead (direct, indirect, and  
18 allocable corporate overhead).<sup>19</sup> The CTCC does not include  
19 transportation costs to the exchange site or producer profit.

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20 <sup>17</sup> Ex. A-5 at 00084; Nelson, Tr. at 282, 284.

21 <sup>18</sup> Wood, Tr. at 136, 140; Ex. A-11.

22 <sup>19</sup> Wood, Tr. at 140-42.

1 28. It is Shell's position that the cost to the producer is  
2 the appropriate value to place on exchanges. Shell began  
3 reporting exchanges at the refinery, shipped other than by  
4 pipeline, at cost in 1979. Shell used the CTCC system to develop  
5 the cost numbers for all the years at issue here.<sup>20</sup>

6 29. Shell did not use the cost system to value pipeline  
7 exchanges.

8 H. THE AUDIT.

9 30. The Department is an agency of the state of Washington,  
10 vested by statute with the duty to collect state taxes.

11 31. The Department audited Shell for the period January 1,  
12 1985, through December 31, 1989. Shell and the Department  
13 executed a waiver deferring issuance of the Department's  
14 assessment for 1985 and 1986 pending completion of the audit.<sup>21</sup> In  
15 exchange, Shell waived, during the period ending June 30, 1991,  
16 any legal or equitable defense to the tax liability incurred  
17 during the period January 1, 1985, through December 31, 1986, but  
18 only upon the ground that the assessment was not made within the  
19 time prescribed by statute.<sup>22</sup>

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<sup>20</sup> McMinn, Tr. at 226.

<sup>21</sup> Tr. at 281.

<sup>22</sup> Ex. R-1 at 8.

1 32. Based on its audit, the Department issued an additional  
2 assessment on exchanges for B&O Tax, HST, and PPT in the amount  
3 of \$6,042,689. The additional tax, among other items, included  
4 B&O Tax with respect to gross receipts derived from exchanges with  
5 other refiners. Subsequently, the Department reduced that assess-  
6 ment to \$5,888,136 and then further to \$3,998,816.

7 33. The Department issued a second post-audit adjustment  
8 on September 24, 1992. In the second post-assessment audit, the  
9 Department, for tax year 1985, imposed an additional assessment of  
10 \$11,514 and granted a credit to Shell of \$1,087. For tax year  
11 1986, a credit of \$26,912 was given. For tax year 1987, a credit  
12 of \$25,032 was given. For tax year 1988, a credit of \$1,396,360  
13 was given. For tax year 1989, a credit of \$20,648 was given. As  
14 a result of these adjustments, Shell's assessment was reduced to  
\$3,998,816.

34. Shell appealed to this Board within thirty days of the  
Department's final determination.

35. On August 2, 1996, this Board entered an Order On  
Motion for Partial Summary Judgment holding that, as a  
manufacturer, Shell's exchanges do not qualify as accommodation  
sales exempted from B&O Tax under RCW 82.04.425. This Board  
precluded Shell from presenting any evidence or argument at the  
hearing that its exchanges constitute tax exempt accommodation  
sales.

1           36. Shell presented three issues on appeal: (1) valuation  
2 of exchanges, (2) assessment of HST on petroleum and refinery  
3 waste gas, and (3) interest on taxes if properly due. All of the  
4 issues relate to the years 1985 through 1989.

5           / / /

6 I.   VALUE OF EXCHANGES.

7           37. For the value of exchanges, the Department accepted  
8 Shell's reported value on pipeline exchanges based on the average  
9 sale price of its sales journals but found Shell's cost method on  
10 exchanges at the refinery unacceptable.

11           38. The Department valued in-state exchanges reported at  
12 cost at the same average wholesale value of sales which Shell used  
13 to report all activity on the pipeline.<sup>23</sup> The Department did not  
14 use Platt's.

15           39. Schedule 5 of the audit reflects the Department's  
16 revalu-ation of all in-state exchanges based on this average  
17 price.

18           40. Shell's sales journals contain an average of Shell's

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19           <sup>23</sup> Nelson, Tr. at 283.

1 monthly wholesale sales in Washington charged to buyers at Shell's  
2 truck terminal ("rack" transactions). The Department did not make  
3 any adjustments to these sales.<sup>24</sup>

4 41. The Department checked this average wholesale price  
5 from Shell's sales journals with Platt's. The Department found,  
6 on a yearly basis, the value stated in Shell's wholesale journals  
7 is almost exactly the same as the "rack" value published in  
8 Platt's.<sup>25</sup> 42. Platt's also came into play with  
9 Determination No. 93-05. At that time, the Department  
10 acknowledged that its sales represent producer-to-distributor  
11 sales, not producer-to-producer sales.<sup>26</sup> In its Determination No.  
12 93-118, the Department says: "As an alternative to its actual  
13 wholesale prices at its truck terminal, for large scale exchanges  
14 the taxpayer may use Platt's Oilgram or OPIS."

43. Since this case primarily involves barge and pipeline  
"bulk" transfers, this Board analyzed the values used in this case  
by both parties and compared it to Platt's. For the month of  
March for each year in regard to one product, regular gasoline,  
the data shows the following:<sup>27</sup>

Audit

Platt's Seattle

<sup>24</sup> Nelson, Tr. at 284, 294-98, 311; Interrogatory No. 23.

<sup>25</sup> Ex. AH-5; Tr. at 286.

<sup>26</sup> Determination No. 93-118 at 8.

<sup>27</sup> Ex. A-3 Audit Work Papers; Ex. AH-4, AH-5.

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	DOR Value	Shell's Cost <sup>28</sup>	Rack	Barge (Monthly Average)
March 1985	0.7816	0.7130	0.7560 *	
March 1986	0.5481	0.3910	0.4821	0.4485
March 1987	0.5156	0.3630	0.5131	0.4950
March 1988	0.5270	0.5199	0.5015	0.4885
March 1989	0.5705	0.4816	0.5617	0.5268

\* No Seattle Barge reported for this period.

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/ / /

Platt's LA

RackPipeline

March 1986	0.5065	0.4914
March 1987	0.5572	0.5323
March 1988	0.5315	0.5234
March 1989	0.6621	0.6855

44. In general the prices for unleaded gasoline are about the same.

45. The market evidence supports a conclusion that Shell's CTCC system does not reflect the market value of the products. In all but one case, the cost numbers Shell created are significantly lower than market data, including Platt's barge prices reported for the Seattle and Los Angeles pipeline prices.<sup>29</sup> This Board finds in favor of the Department that Shell's CTCC system does not

<sup>28</sup> Audit at 110, 116, 120, 124.

<sup>29</sup> Ex. AH-4, AH-5.

measure the market value of exchange products.

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2 46. The market evidence, although not perfect, provides the  
3 best indication of value in this case.

4 47. The Department's value figures are more in line with  
5 "rack" prices than "bulk" prices. The Department's auditor testi-  
6 fied that he would have considered a price breakout if it  
7 indicated the average calculated price was not in the ballpark for  
8 pipeline or barge transactions.

9 48. We find the average wholesale price overstates the  
10 value of exchanges. In order to be truly comparable, the  
11 Department's value should be adjusted by the difference between  
12 "bulk" (pipeline or barge) and "rack" prices.

13 49. The only market data available for pipeline is Los  
14 Angeles data. This data shows that the difference between "rack"  
and pipeline prices is 1 cent in 1985, 3 cents in 1986, 1.86 cents  
in 1987, 4 cents in 1988, and 2.8 cents in 1989. This is about a  
5 percent differential.<sup>30</sup>

50. This Board's comparison of barge and "rack" prices

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<sup>30</sup> Mr. Arosell testified that these are the comparison of West Coast pipeline prices to "rack" prices for the years 1985 to 1989. Our review of the data indicates that Mr. Arosell's testimony is accurate.

1 for the Seattle area also supports a 5 percent differential for  
2 "rack" versus "bulk" prices.<sup>31</sup> A reasonable inference is that  
3 this differential accounts for the size, profit, and trade level  
4 differences mentioned by Shell. While it is true that there are  
5 no exact market comparisons for each year, this Board finds an  
6 adjustment of 5 percent is supported by the evidence.

7 J. ASSESSMENT OF HST.

8 51. For purposes of the HST and the PPT, Shell valued all  
9 large volume exchanges and transfers at cost. As reflected in  
10 Audit Schedules XXXI and XXXII, the Department assessed the HST on  
11 refinery waste gas and off-spec propane manufactured and used by  
12 Shell.

13 52. RCW 82.21.030 imposes a tax on the privilege of  
14 possess-ing hazardous substances in this state. The tax is placed  
15 on the first possession of the substance. RCW 82.21.010. The  
16 definition of the term "hazardous substance" specifically includes  
17 petroleum products. RCW 82.21.020(1)(b).

18 53. WAC 458-20-252(7)(b) exempts from the HST the inter-  
19 mediate possession of substances which are later used as an  
20 ingredient or component of another product. The exemption

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21 <sup>31</sup> Ex. AH-4, AH-5.

prevents double taxation of a substance: first as a single ingredient, and then as part of a final product.

54. Since refinery waste gas and off-spec propane are petroleum products derived from the refining of crude oil, they are hazardous substances.

55. Refinery waste gas and off-spec propane are not combined or blended into a final product; nor are they by-products which are disposed of or "flared".<sup>32</sup> Rather, they are consumed as final products in Shell's refinery heaters and boilers to generate steam.<sup>33</sup> Therefore, Shell's possession of refinery waste gas and off-spec propane is not an intermediate possession of substances which are later combined with other substances to form a different product.

K. INTEREST ON PROPERLY DUE TAX.

56. Shell claims it developed its cost methodology in response to a letter written to Shell in 1983, by then Department employee John Olson. The 1983 letter discusses two issues. The first is the transfer of raw products out of state for mixing with other elements to produce consumer products. The letter states that there is no consumer market for the transferred raw products.

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<sup>32</sup> Wall, Tr. at 178, 181.

<sup>33</sup> Wall, Tr. at 178, 181, 290.

The second issue is the exchange of finished products.<sup>34</sup>

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57. In the 1983 letter, the Department stated that Shell could value transfers of raw products, which do not have a market, based on cost. However, if a market developed, Shell would be required to value transfers of raw products based on the market value. With respect to exchanged products, the letter explicitly states that exchanged final products can be valued through the use of a cost system only in the absence of an established market price.<sup>35</sup>

58. Shell recognizes that there is a market for the finished exchanged products at issue in this case. Shell has shown its recognition of this market by using Platt's in its exchange contracts and by using Platt's to value its pipeline transfers. Therefore, Shell's failure to pay the tax was not the direct result of written instructions from the Department.

59. The 1985 tax is properly listed on the Notice of Appeal to this Board.

60. The Department secured two waivers, first for the year 1985, and then another in the latter part of 1990 for the years 1985 and 1986. These waivers preclude Shell from appealing only

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<sup>34</sup> Ex. A-2.

<sup>35</sup> Ex. A-2 at 2.

the timeliness of the assessments.<sup>36</sup>

1  
2 61. At the hearing, the Department requested that Shell be  
3 precluded from submitting testimony or evidence in support of its  
4 proposed cost method for valuing exchanged final products. In  
5 support of its request, the Department relied primarily on ER  
6 1006. During the hearing, the Department also requested that Shell  
7 be precluded from asserting refund claims not raised in its Notice  
8 of Appeal--pertaining to the time bar for assessments and the  
9 improper valuation and assessment of butanes--based on RCW  
10 82.03.190 and WAC 456-09-310, -345, and -705. This Board denied  
11 the Department's requests.

12 62. Any Conclusion of Law which should be deemed a Finding  
13 of Fact is hereby adopted as such.

14 From these findings, this Board comes to these

CONCLUSIONS OF LAW

1. This Board has jurisdiction over the subject matter of  
this appeal and the parties thereto.

2. Shell's exchanges do not qualify for the accommodation  
sales exemption under RCW 82.04.425.

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<sup>36</sup> Nelson, Tr. at 279, 281.

1           3.    Shell waived its right to contest the assessment for  
2           1985 only on the issue of timely assessment.

3           4.    Under RCW 82.04.450(2), when the value of a product is  
4           unknown, the value shall correspond as nearly as possible to the  
5           gross proceeds from sales in this state of similar products of  
6           like quality and character, and in similar quantities, by other  
7           tax-payers.

8           5.    WAC 458-20-112 clarifies the controlling statute by  
9           stating that value must correspond as nearly as possible to the  
10          gross proceeds of other sales at comparable locations in this  
11          state of similar products of like quality and character, in  
12          similar quantities, under comparable conditions of sale, to  
13          comparable purchasers, and shall include subsidies and bonuses.

14          6.    In accordance with the law, cost should be substituted  
            only when comparable sales data is unavailable.

            7.    Shell bears the burden of showing by the preponderance  
            of the evidence that the Department's method of valuing the  
            product is flawed and results in overvaluation of exchange  
            products.

            8.    Shell has shown by the preponderance of the evidence

1 that the Department's method did not properly adjust for the  
2 different trade levels reflected by "bulk" and "rack" sales. As a  
3 matter of fact, this Board concludes that the preponderance of the  
4 evidence shows that a 5 percent adjustment to the Department's  
5 figures is warranted.

6  
7 9. RCW 82.21.030 imposes a tax on the privilege of  
8 possess-ing hazardous substances in this state. The tax is placed  
9 on the first possession of the substance. RCW 82.21.010. The  
10 definition of the term "hazardous substance" specifically includes  
11 petroleum products. RCW 82.21.020(1)(b).

12  
13 10. WAC 458-20-252(7)(b) exempts from the HST the inter-  
14 mediate possession of substances which are later used as an  
ingredient or component of another product. The exemption  
prevents double taxation of a substance: first as a single  
ingredient, and then as part of a final product.

15  
16 11. Under RCW 82.21.030, the Department correctly assessed  
17 the HST on the refinery waste gas and off-spec propane. This was  
18 the first possession of a petroleum product. The refinery waste  
19 gas and off-spec propane are not intermediate products entitled to  
20 an exemption under WAC 458-20-252(7)(b).

21  
22 12. The Department incorrectly included HST on mixed  
23 butanes which are intermediate products entitled to an exemption

under WAC 458-20-252(7) (b) .

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13. Mixed butanes are part of the tax properly appealed. Shell has shown that HST is not due on mixed butanes which are intermediate products.

14. Under RCW 82.32.050, interest must be assessed when a taxpayer pays less than the amount of tax properly due.

Any Finding of Fact which should be deemed a Conclusion of Law is hereby adopted as such.

From these conclusions, this Board enters this

/ / /

DECISION

The Determination of the Department of Revenue is set aside. This matter is remanded to the Department for recalculation of the tax and interest due.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 1997.

BOARD OF TAX APPEALS

\_\_\_\_\_  
LUCILLE CARLSON, Member

We concur.

1 LAWRENCE KENNEY, Chair

2 MATTHEW J. COYLE, Vice Chair

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