

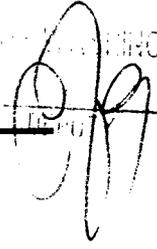
79661-1

FILED
COURT OF APPEALS

06 JAN -4 PM 2:16

STATE OF WASHINGTON

BY



NO. 33236-1-II

**COURT OF APPEALS FOR DIVISION II
STATE OF WASHINGTON**

TESORO REFINING AND MARKETING COMPANY,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

BRIEF OF RESPONDENT

ROB MCKENNA
Attorney General

ANNE E. EGELER
Senior Counsel
WSBA #20258
DEBRA E. CASPARIAN
Assistant Attorney General
WSBA #26354
7141 Cleanwater Drive SW
P.O. Box 40123
Olympia, WA 98504-0123
(360) 753-5528

TABLE OF CONTENTS

I.	ISSUE PRESENTED	1
II.	SUMMARY	1
III.	STATEMENT OF THE CASE	2
	A. Factual Background.	2
	B. Procedural History.	4
IV.	ARGUMENT	5
	A. Under The Plain Language Of RCW 82.21, Tesoro’s Possession of Refinery Gas Is Subject To The HST.....	5
	1. Tesoro’s possession of refinery gas meets the statutory requirements for imposition of the HST.....	5
	a. RCW 82.21.020 includes all petroleum products within the definition of a “hazardous substance.”	5
	b. Tesoro “possesses” refinery gas because it controls the gas and uses it for fuel.....	7
	2. Tesoro’s possession of refinery gas does not fall within any of the statutory exemptions from the HST.....	9
	B. Fuel Gas Is Intended To Be Subject To The HST.	10
	1. Statutory changes are intentional and are given meaning.	11
	2. The inclusion of specific exemptions from the HST implies that all omissions were intentional.	13
	3. Tax exemptions are narrowly construed.....	15

C.	Applying the HST To Tesoro’s Possession Of Refinery Gas Is Consistent With WAC 458-20-252.....	15
1.	Rule 252(7)(b) applies only to intermediate substances, not the products.	16
2.	Refinery gas is not an ingredient or component of any product.	18
3.	There is no HST exemption for using refinery gas as a manufacturing fuel.	19
4.	The HST tax does not require storage of hazardous substances.	22
D.	Rule 252 Implements the Current Version of the Hazardous Substance Tax Law.....	24
E.	The Department’s “ETA 540” Does Not Create A New Exemption From The HST.....	27
V.	CONCLUSION	28

TABLE OF AUTHORITIES

Cases

<i>Bird-Johnson Corp. v. Dana Corp.</i> , 119 Wn.2d 423, 833 P.2d 375 (1992).....	10, 27, 28
<i>Dep't of Ecology v. Theodoratus</i> , 135 Wn.2d 582, 957 P.2d 1241 (1998).....	26
<i>Edelman v. State ex rel. Public Disclosure Comm'n</i> , 152 Wn.2d 584, 99 P.3d 386 (2004).....	26, 27
<i>H&H Partnership v. State</i> , 115 Wn. App. 164, 62 P.3d 510 (2003).....	26, 27
<i>In re Estate of Black</i> , 153 Wn.2d 152, 102 P.3d 796 (2004).....	13
<i>In re Estate of Hansen</i> , 128 Wn.2d 605, 910 P.2d 1281 (1996).....	10
<i>Kitsap-Mason Dairymen's Ass'n v. Wash. State Tax Comm'n</i> , 77 Wn.2d 812, 467 P.2d 312 (1970).....	9, 20
<i>Lynch v. Dep't of Labor & Indust.</i> , 19 Wn.2d 802, 145 P.2d 265 (1944).....	11
<i>Pierce County v. State</i> , 66 Wn.2d 728, 404 P.2d 1002 (1965).....	20
<i>Port of Longview v. Taxpayers</i> , 85 Wn.2d 216, 533 P.2d 128 (1974)	11
<i>Pringle v. State</i> , 77 Wn.2d 569, 464 P.2d 425 (1970).....	20
<i>Queets Band of Indians v. State</i> , 102 Wn.2d 1, 682 P.2d 909 (1984).....	13

<i>Simpson Inv. Co. v. Dep't of Revenue</i> , 141 Wn.2d 139, 3 P.3d 741(2000)	15
<i>Spokane v. Taxpayers</i> , 111 Wn.2d 91, 758 P.2d 480 (1988).....	10
<i>State v. Adams</i> , 107 Wn.2d 611, 732 P.2d 149 (1987).....	26
<i>State v. McCraw</i> , 127 Wn.2d 281, 898 R.2d 838 1995.....	10
<i>State ex rel. West v. Seattle</i> , 50 Wn.2d 94, 309 P.2d 751 (1957).....	20
<i>Western Telepage v. City of Tacoma</i> , 140 Wn.2d 599, 998 P.2d 884 (2000).....	10, 13, 14

Statutes

Laws of 1987 3d Ex. Sess., ch. 2 § 47(3).....	24
Law of 1989 ch. 2 § 24	24
Laws of 1989, ch. 383.....	12
RCW 70.105D.070.....	12
RCW 82.21	passim
RCW 82.21.010	6, 14
RCW 82.21.020	5, 9
RCW 82.21.020(1)(b)	5, 6
RCW 82.21.020(1)(d)	6
RCW 82.21.020(2).....	5, 6
RCW 82.21.020(3).....	7, 22

RCW 82.21.030	passim
RCW 82.21.030(1).....	5, 15
RCW 82.21.030(2).....	12
RCW 82.21.040	15
RCW 82.21.040(1).....	16
RCW 82.22	12, 24, 28
RCW 82.23A.....	12
RCW 82.23A.005.....	12
RCW 82.23A.010(2).....	12
RCW 82.23A.020(1).....	12

Other Authorities

<i>Shell Oil Co. v. State,</i> BTA Dkt No. 93-28 (1997).....	21
---	----

Regulations

WAC 458-20-252.....	passim
WAC 458-20-252(7)(b)	16, 17, 18, 25
WAC 458-20-252(7)(b)(i)	17, 18
WAC 458-20-252(8).....	21
WAC 458-20-252(8)(c)	22, 23, 25, 26

Administrative Materials

Excise Tax Advisory 540.....	27, 28
------------------------------	--------

I. ISSUE PRESENTED

RCW 82.21.030 places a hazardous substance tax (HST) on the first possession of hazardous substances in this state. When a refinery processes oil into petroleum products, the HST is assessed on the products created. Did the superior court correctly hold that when a refinery processes oil and creates refinery gas, the HST applies?

II. SUMMARY

Under RCW 82.21.030, a hazardous substance tax (HST) is broadly assessed on the first possession of hazardous substances in Washington. Without question, the refinery gas at issue is a hazardous substance, first possessed by Tesoro Refining and Marketing Company (Tesoro) in Washington. Tesoro is liable for HST on its possession of refinery gas unless an exemption applies.

RCW 82.21 lists the specific exemptions from the HST. Tesoro is liable for HST on its possession of refinery gas unless an exemption applies. There is no exemption for use of a hazardous substance as a fuel. Nor is there an exemption for hazardous substances that are possessed for a short period of time. Since there is no exemption for Tesoro's possession of refinery gas, the tax was properly assessed.

III. STATEMENT OF THE CASE

A. Factual Background.

Tesoro operates a petroleum refinery in Anacortes, Washington. At the refinery, crude oil is heated to separate the oil into a variety of marketable fuels. During the stages of refining, fuel gases are produced that are uneconomical for Tesoro to recover and sell.¹ These gases include propane, hydrogen, methane, ethane, ethylene, butane, butylene and propylene. The gases are byproducts of processing units located throughout the refinery.² After each gas is created, it is piped to a fuel gas blender.³ The collected gases mix in the blender and form refinery gas.⁴

After the refinery gas is created, it is immediately piped to locations throughout the refinery and used as a fuel source. The refinery gas is burned to heat refinery units and steam boilers.⁵ When the gas is used as a fuel, it is always used to create heat on the exterior of the unit being heated.⁶ It never comes into physical contact with the contents of

¹ CP 152 (Deposition of Russell Crawford at 12, lines 8-12).

² CP 149 (Crawford Dep. at 9, lines 8-25).

³ CP 156 (Crawford Dep. at 16, lines 7-10).

⁴ CP 153-4 (Crawford Dep. at 13-14.) There is no chemical reaction. It is just a blending of the gases that maintain their separate physical characteristics. CP 17 (Crawford Dep. at 14, lines 16-23).

⁵ CP 177-8 (Tesoro's Answers to Defendant's Interrogatories, No. 3(a)).

⁶ CP 163 (Crawford Dep. at 23, lines 7-23).

the refining unit or steam boiler.⁷ Nor is it ever combined with other ingredients to create a new product.⁸

The volume of refinery gas created by Tesoro is not sufficient to meet the refinery's fuel needs. Therefore, it is supplemented with natural gas. On average, the ratio of refinery gas to other fuels is 75 percent refinery gas and 25 percent other fuel.⁹ According to Russell Crawford, Tesoro's Process Engineering Manager, creating refinery gas and using it as a fuel saves Tesoro the expense of buying additional natural gas.¹⁰ If insufficient refinery gas was created, Tesoro would have to pipe in natural gas to operate the refinery.¹¹ Mr. Crawford testified that "ironically, without this by-product gas, there's not enough energy to run the refinery. You could not operate without it."¹² Although natural gas can be used as a supplement, it cannot replace the refinery gas. As Mr. Crawford explained in his testimony, "it's physically impossible to bring in enough natural gas to run the refinery."¹³

⁷ CP 177-8 (Tesoro's Answers to Defendant's Interrogatories, No. 3(d)).

⁸ CP 178 (Tesoro's Answers to Defendant's Interrogatories, No. 4).

⁹ CP 177 (Tesoro's Answers to Defendant's Interrogatories, No. 2); CP 167-168 (Crawford Dep. at 27-28).

¹⁰ CP 167 (Crawford Dep. at 27, lines 3-5).

¹¹ CP 166-7 (Crawford Dep. at 26 - 27).

¹² CP 166 (Crawford Dep. at 26, lines 18-20).

¹³ CP 163 (Crawford Dep. at 23, lines 23-24).

Tesoro's goal is to use all of the refinery gas fuel it creates. However, if Tesoro creates more refinery gas than it can immediately use as fuel, it is "flared." That is, the gas is released through a valve and burned. Tesoro tries to avoid having to flare the gas, because it "doesn't want to lose the value of the fuel."¹⁴ Although Tesoro uses its refinery gas as a fuel, or flares a minuscule amount of it off, there are other uses for refinery gas. Refinery gas can also be sent to a chemical plant for use as a petrochemical feedstock.¹⁵

B. Procedural History.

Tesoro filed an action in Thurston County Superior Court, requesting a refund of \$937,889 of HST paid for its possession of refinery fuel from 1999 through June 2003, plus interest. In response to cross motions for summary judgment, the superior court denied the refund request. The court ruled that refinery gas is subject to tax under RCW 82.21. In his oral decision, the judge explained that "although I find the logic of the taxpayer persuasive, that persuasion is lost when I look at the context of the statute which talks about possession."¹⁶

¹⁴ CP 169 (Crawford Dep. at 29, lines 2-8). Extremely little of the gas is flared. CP 170 (Crawford Dep. at 30, lines 6-15).

¹⁵ CP 161-3 (Crawford Dep. at 21-3).

¹⁶ VRP 73-74.

IV. ARGUMENT

A. Under The Plain Language Of RCW 82.21, Tesoro's Possession of Refinery Gas Is Subject To The HST.

1. Tesoro's possession of refinery gas meets the statutory requirements for imposition of the HST.

Washington taxes 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.” Tesoro's possession of refinery gas meets the requirements of the plain language of the statute. Refinery gas is a hazardous substance, possessed by Tesoro, in the state of Washington. Therefore, the superior court was correct in upholding the tax.

a. RCW 82.21.020 includes all petroleum products within the definition of a “hazardous substance.”

Under RCW 82.21, refinery gas is a hazardous substance. The term “hazardous substance” is defined by RCW 82.21.020(1)(b) to include “petroleum products.” RCW 82.21.020(2) defines “petroleum products” to include “plant condensate, lubricating oil, gasoline, aviation fuel, kerosene, diesel motor fuel, such as butane, ethane, and propane, and **every other product derived from the refining of crude oil.**” Refinery gas is unquestionably a petroleum product, which Tesoro produces during

the refining of oil. Therefore, it falls within the plain language of the statutory definition of a hazardous substance.

Tesoro contends RCW 82.21 is ambiguous because the HST applies to all substances, yet also states it applies to substances recognized as hazardous by the Department of Ecology (DOE).¹⁷ That is incorrect. The plain language of RCW 82.21.030 taxes each hazardous substance. RCW 82.21.020(1)(b) and RCW 82.21.020(2) define the term “hazardous substance” to include all petroleum products, without limitation. RCW 82.21.020(1)(d) gives DOE the ability to add or delete “any other substance” the director of DOE has determined to be a threat to human health or the environment. In sharp contrast, the statute gives DOE absolutely no authority to limit the legislative inclusion of all petroleum products within the definition of a “hazardous substance.”¹⁸ There is no ambiguity. The HST plainly applies to all petroleum products.

//

//

//

¹⁷ Brief of Tesoro at 28-29, and footnotes 8 and 9.

¹⁸ This is consistent with the intent of the law. RCW 82.21.010 states that the intent is to tax “each hazardous substance” “including substances and products the department of ecology determines to present a threat to human health or the environment.” Contrary to Tesoro’s arguments, the intent is to include substances DOE considers harmful, not to exempt all other hazardous substances.

b. Tesoro “possesses” refinery gas because it controls the gas and uses it for fuel.

Tesoro contends it does not possess the refinery gas, because the gas is continually created and used.¹⁹ Yet Tesoro clearly meets the statutory definition of “possession.” Possession is defined by RCW 82.21.020(3), which 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 has actual possession of the refinery gas because it has both control of the gas and physical possession. Tesoro establishes physical possession by capturing gases that are created as by-products of various refining operations. It pipes these gases to an area where they are blended to form refinery gas. The refinery gas is then piped to specific burners at the refinery, and used as a fuel. It is not allowed to escape containment.

According to RCW 82.21.020(3), control exists when the taxpayer has the “power ... to use a hazardous substance.” The power to use its refinery gas is extremely important to Tesoro. Tesoro’s Process

¹⁹ Brief of Tesoro at 16-19.

Engineering Manager testified that without controlled burning of the refinery gas, Tesoro would not have sufficient energy to run the refinery.²⁰ Controlling the refinery gas and using it as a fuel enables Tesoro to keep its energy costs as low as possible. There is no question that Tesoro is using the refinery gas, and benefiting greatly from that use.

Under RCW 82.21.030, Tesoro's possession of refinery gas must be taxed. Contrary to Tesoro's arguments, there is no requirement that the hazardous substance be possessed for any length of time. Nor is there a requirement that the hazardous substance be sold. The plain language of RCW 82.21.030 states that the tax is imposed "on the privilege of possession of hazardous substances in this state." Since Tesoro meets each element of the statute, the superior court properly upheld the tax.

Tesoro notes that the Department of Revenue auditor overlooked the flared refinery fuel, and failed to assess tax on it. The auditor made a mistake. The law does not contain an exemption for flared refinery gas. Therefore, it should have been taxed. The state Supreme Court has ruled that even if a tax auditor misconstrues the law, "the erroneous construction

²⁰ CP 166 (Crawford Dep. at 26, lines 16-24).

is not controlling.”²¹ The state is not estopped from enforcing the law by an auditor’s error.²²

2. Tesoro’s possession of refinery gas does not fall within any of the statutory exemptions from the HST.

RCW 82.21.020 contains an exclusive list of exemptions from the HST. Possessors of hazardous substances are exempt from the tax if:

- 1) it is a successive possession of a previously taxed substance;
- 2) the substance is used for a personal or domestic purpose, “and not for any business purpose;”
- 3) a retailer possesses a minimal amount for resale to consumers, unless the substance is a petroleum product;
- 4) the substance is alumina or natural gas;
- 5) the U.S. Constitution prohibits taxing the possessor or activity; or
- 6) first possession occurred prior to March, 1989.

Tesoro does not claim to be entitled to any of the statutory exemptions.

Nor does it claim that the list of exemptions is ambiguous.

In essence, Tesoro requests the Court to expand the law to add an exemption for the possession of hazardous substances that are controlled and used, but only for a short time. The state Supreme Court repeatedly

²¹ *Kitsap-Mason Dairymen’s Ass’n v. Wash. State Tax Comm’n*, 77 Wn.2d 812, 818, 467 P.2d 312 (1970).

²² *Id.*

has cautioned that, “[t]he court will not read into a statute matters which are not there nor modify a statute by construction.”²³

B. Fuel Gas Is Intended To Be Subject To The HST.

Since the HST tax imposed by RCW 82.21.030 is plain on its face, there is no need for further inquiry. “In judicial interpretation of statutes, the first rule is ‘the court should assume that the legislature means exactly what it says. Plain words do not require construction.’”²⁴ RCW 82.21 was passed as an initiative. According to the State Supreme Court, “it has long been the rule that ‘[i]nitiatives are to be interpreted according to the general rules of statutory construction.’”²⁵

However, if this Court determines that the law is ambiguous, there are three rules of statutory construction that apply to this case and demonstrate legislative intent to terminate the prior exemption for fuel gas. First, changes in the law are presumed to be purposeful and are given meaning. Second, a specific list of exemptions implies exclusion of all other exemptions. And finally, tax exemptions are narrowly construed in favor of taxation.

²³ *In re Estate of Hansen*, 128 Wn.2d 605, 610, 910 P.2d 1281 (1996), quoting *King Cy. v. City of Seattle*, 70 Wn.2d 988, 991, 425 P.2d 887 (1967).

²⁴ *Western Telepage v. City of Tacoma*, 140 Wn.2d 599, 609, 998 P.2d 884 (2000), quoting *State v. McCraw*, 127 Wn.2d 281, 288, 898 P.2d 838 (1995).

²⁵ *Bird-Johnson Corp. v. Dana Corp.*, 119 Wn.2d 423, 426, 833 P.2d 375 (1992), quoting *Spokane v. Taxpayers*, 111 Wn.2d 91, 97, 758 P.2d 480 (1988).

1. Statutory changes are intentional and are given meaning.

When a change is made to a statute, there is a presumption that the change was deliberate and must be given effect.²⁶ In this case, as Tesoro admits, a prior version of the HST contained an exemption for “liquid fuel or fuel gas used in petroleum processing.”²⁷ In 1989, Initiative 97 amended the law and eliminated the exemption for liquid fuel or fuel gas used in petroleum processing.²⁸

When the people exercise the legislative power, legislative intent is determined by referring to the statements and arguments in the official voters pamphlet.²⁹ According to the statement in favor of the Initiative, the Initiative was intended as a “strong citizens’ initiative” to eliminate “loopholes” in the existing law. The statement for the Initiative states that “Washington is the second worst state west of the Mississippi for hazardous waste sites. Seeping landfills, pesticides, and petroleum products can cause cancer and birth defects.” Although much of the act contained in the Initiative is designed to stop pollution, that is not the effect of the HST. Rather, the HST is a funding mechanism for the remainder of the act. Taxes collected under RCW 82.21 are deposited in

²⁶ *In re Estate of Black*, 153 Wn.2d 152, 179, 102 P.3d 796 (2004).

²⁷ Laws of 1987, 3d Ex. Sess., ch. 2 § 47(3).

²⁸ Laws of 1989, ch. 2 § 24, effective March 1, 1989.

²⁹ *Port of Longview v. Taxpayers*, 85 Wn.2d 216, 232, 533 P.2d 128 (1974); *Lynch v. Dep’t of Labor & Indust.*, 19 Wn.2d 802, 812-813, 145 P.2d 265 (1944).

the toxics control accounts.³⁰ The Initiative completely removed the exemption for fuel gas, increasing funding for environmental protection and pollution enforcement.

Shortly after Initiative 87 passed, the legislature enacted the Petroleum Products Tax (PPT), found in RCW 82.23A.³¹ RCW 82.23A imposes a tax on the “possession of petroleum products in this state.”³² The PPT defines the terms “possession” and “control” in precisely the same manner as the HST.³³ As was the case with the earlier version of the HST, the legislature included an exemption from the PPT for possession of “liquid fuel or fuel gas used in petroleum processing.” This is noteworthy for two reasons. First, if “ephemeral” fuel gas could not be possessed, there would be no need for the exemption. Second, when the Legislature enacted the PPT, it opted not to override the will of the people and restore this exemption to the HST. On the contrary, the Legislature was careful to note that RCW 82.23A “is not intended to exempt any person from tax liability under any other law.”³⁴

Acting in their legislative capacity, the people of this state removed the tax loophole provided for fuel gas. “Courts presume a

³⁰ RCW 82.21.030(2); RCW 70.105D.070.

³¹ Laws of 1989, ch. 383.

³² RCW 82.23A.020(1).

³³ RCW 82.23A.010(2).

³⁴ RCW 82.23A.005.

change in legislative intent” whenever the Legislature “materially alters a statute” and that the Legislature intends to exclude any omitted terms.³⁵

In the face of this deliberate legislative act, it would be highly inappropriate to ignore the voters’ legislative decision and read the exemption back into the law.

2. The inclusion of specific exemptions from the HST implies that all omissions were intentional.

Tesoro does not claim to be entitled to any of the statutory exemptions from the HST. Rather, Tesoro seems to argue that an exemption for fuel tax is implied. When a statute lists the things it impacts, “there is an inference that the Legislature intended all omissions.”³⁶ The state Supreme Court has declared that the rule of “expressio unius est exclusio alterius” is equally applicable to tax cases.³⁷ In *Western Telepage v. City of Tacoma*, the Court considered taxing paging services as a network telephone service. Some telephone services were excluded from the statutory definition of network telephone service. Paging services were notably absent from the list of excluded services. The Court concluded that “where the Legislature did not expressly exclude paging services from the broad definition of network telephone services in

³⁵ *In re Estate of Black*, 153 Wn.2d 152, 179, 102 P.3d 796 (2004).

³⁶ *Queets Band of Indians v. State*, 102 Wn.2d 1, 5, 682 P.2d 909 (1984).

³⁷ *Western Telepage*, 140 Wn.2d at 611.

RCW 82.04.065(4), it must be assumed the Legislature did so intentionally.”³⁸ Thus, the Court held that taxing paging services was statutorily required.

As in *Western Telepage*, RCW 82.21 specifically lists the exemptions from the HST. Tesoro’s possession of refinery gas does not meet any of the listed exemptions. The law cannot be expanded to create an exemption for petroleum products that are used quickly and not stored, or petroleum products that are used for fuel at the refinery. Since the law specifically lists exemptions, it must be assumed that the omissions were intentional.

Reading RCW 82.21 as imposing a broad tax on the possession of hazardous substances, with limited exceptions, is also consistent with the legislative expression of intent. RCW 82.21.010 states:

It is the intent of this chapter to impose a tax only once for each hazardous substance possessed in this state and to tax the first possession of all hazardous substances, including substances and products that the department of ecology determines to present a threat to human health or the environment. However, it is not intended to impose a tax on the first possession of small amounts of any hazardous substance (other than petroleum and pesticide products) that is first possessed by a retailer for the purpose of sale to ultimate consumers....

³⁸ *Id.* at 611.

Although possession of minimal amounts of hazardous substances is exempt for the HST, the Legislature carefully noted that this exemption does not apply to petroleum products. The clear intent of RCW 82.21 is to impose the HST on every product derived from the refining of crude oil.

3. Tax exemptions are narrowly construed.

The last point to keep in mind when interpreting RCW 82.21.040, is that exemptions from the tax law are narrowly construed. When interpreting a tax exemption, the burden of showing qualification for the tax benefit is on the taxpayer.³⁹ If there is any ambiguity, the state Supreme Court has required that exemptions be construed strictly, though fairly, against the taxpayer.⁴⁰ Tesoro has made no effort to meet its burden by explaining how the statute provides for the exemption it is seeking. Instead, Tesoro asks this Court to ignore the law, and hold that an administrative regulation has recreated an exemption that was stricken from the law.

C. Applying The HST To Tesoro's Possession Of Refinery Gas Is Consistent With WAC 458-20-252.

RCW 82.21.030(1) places the HST "on the privilege of possession of hazardous substances in this state." The tax only applies once. Under

³⁹ RCW 82.32.180.

⁴⁰ *Simpson Inv. Co. v. Dept. of Revenue*, 141 Wn.2d 139, 149-50, 3 P.3d 741 (2000).

RCW 82.21.040(1), a successive possession of a previously taxed substance is exempt from the HST. Tesoro claims that WAC 458-20-252 (Rule 252) departs from the law and creates three exemptions from the HST that apply to Tesoro's possession of refinery gas. If the rule contained exemptions that are not authorized by the law, the rule is invalid. Rule 252, however, conforms with RCW 82.21. Each section Tesoro relies on implements the HST by ensuring that the tax is applied only to the first possession of a hazardous substance.

1. Rule 252(7)(b) applies only to intermediate substances, not the products.

Rule 252 administers the law by explaining that the HST will only be collected once. To implement the HST statutes and avoid taxing both the final product, and the ingredients used to create the product, the Department included the following provision in Rule 252(7)(b):

(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.

(i) However, when any intermediate hazardous substance is first produced during a manufacturing or processing activity and is withdrawn for sale or transfer outside of the

manufacturing or processing plant, a taxable first possession occurs.

Rule 252(7)(b) applies to two circumstances. The first circumstance is a chemical reaction in which a highly reactive intermediate substance is formed and then reacts further to create the product.⁴¹ Intermediate substances can never be a product or byproduct of the reaction. Rather, an intermediate substance is both created and destroyed in the chemical reaction. Rule 252(7)(b) recognizes that the HST is not due on transient substances that are consumed in the reaction. The HST is administered by collecting the tax on the product of the reaction. Rule 252 (7)(b)(i) explains that if the reaction is stopped, and the intermediate substance is withdrawn and sold, it is treated as a final product subject to the HST. In other words, when the substance is removed, it is no longer an intermediate substance because it will not be consumed in the reaction. It is, therefore, a taxable product.

For instance, such a situation occurs when methane and chlorine are mixed together. A series of intermediate compounds form, beginning with methyl chloride, then methylene, methylene chloride, and finally trichloromethane. At any point, the reaction can be stopped and an

⁴¹ Webster's dictionary defines the word "intermediate" as: "*Chem.* A substance formed as a necessary stage in the manufacture of a desired end product." Similarly, the Dictionary of Chemistry defines the term "intermediate" as "a transient chemical entity in a complex reaction. *See also* precursor."⁴¹

intermediate compound can be withdrawn and treated as a taxable, final product. If, however, the reaction is allowed to continue to completion, the resulting compound is carbontetrochloride. The intermediate substances are completely consumed in the reaction, and are not taxed. The tax is assessed only on the resulting compound.

Refinery gas is not an intermediate substance. When various products are made, some of the byproducts are fuel gases. Since these byproducts are not consumed in the reaction, they are not intermediate substances. These byproduct gases are moved to a fuel blender, and mixed together to create refinery gas. Refinery gas is formed when the gases are mixed. The refinery gas is the product --- not an intermediate substance. Therefore, the language in Rule 252(7)(b) and (7)(b)(i) relating to intermediate substances is inapplicable to this case.

2. Refinery gas is not an ingredient or component of any product.

The second circumstance under which Rule 252(7)(b) applies is when there is a question about taxation of ingredients and components. Rule 252(7)(b) explains that the HST is not imposed on a substance that “becomes a component or ingredient of the product being manufactured or processed or is otherwise consumed during the manufacturing or processing activity.” If the Department were to tax an ingredient or

chemical that is an ingredient or component of the product, the substance would, in effect, be taxed twice. For example, assume 10 gallons of substance A are mixed with 10 gallons of substance B to form 20 gallons of product C. Chapter 82.21 RCW indicates that the tax should be assessed only on the first possession. It would violate the express legislative intent if substances A and B were taxed first as individual substances, and then again as part of the total volume of the end product - substance C.

3. There is no HST exemption for using refinery gas as a manufacturing fuel.

Tesoro contends that Rule 252 creates an exemption for all hazardous substances that are “consumed” in any manner during the manufacturing process.⁴² This expansive reading of the rule is possible only if RCW 82.21 is ignored. But the rule must be read within the context of the underlying statutory authority. The state Supreme Court has made it clear that “[a]n agency may not legislate under the guise of the rule making power. Rules must be written within the framework and

⁴² Brief of Tesoro at 27.

policy of the applicable statutes.... They may not amend or change enactments of the legislature.”⁴³

The rule’s reference to something “otherwise consumed during the manufacturing or processing activity” must be read in context. RCW 82.21 repeatedly states that only the first possession is taxable. The rule attempts to avoid double taxation of a substance that is first created and then consumed in the manufacturing of a product.

Tesoro uses the refinery gas as a fuel to heat its steam plant and refinery units. When used as a fuel, the gas heats the outside of the boiler unit. A chemical reaction occurs within the unit, but the refinery gas is not part of that reaction. It is never added to the inside of the unit with the ingredients being heated.⁴⁴ Since the fuel is not consumed in the product, there is no risk of the refinery gas being taxed twice.

This interpretation of the “otherwise consumed” language is the only interpretation of Rule 252 that is consistent with RCW 82.21. If Tesoro’s argument were accepted, it would create an enormous new exemption from the HST. Every manufacturer that creates a hazardous substance to provide heat in a manufacturing process would be entitled to this new exemption. The rule would override the Initiative that enacted

⁴³ *Kitsap-Mason Dairymen’s Ass’n*, 77 Wn.2d at 815, citing *State ex rel. West v. Seattle*, 50 Wn.2d 94, 309 P.2d 751 (1957), *Pringle v. State*, 77 Wn.2d 569, 464 P.2d 425 (1970), *Pierce County v. State*, 66 Wn.2d 728, 404 P.2d 1002 (1965).

⁴⁴ CP 163 (Crawford Dep. at 23, lines 5-23.)

RCW 82.21. Although the voters chose to remove the exemption for fuel gas, under Tesoro's broad reading of the administrative rule, the exemption would be reenacted.

If the rule cannot be read in a manner consistent with RCW 82.21, the rule is invalid. It is beyond the power of the Department's rule-making authority to add an exemption to the law. If Tesoro wishes to restore the fuel tax exemption, it must seek a legislative change.

The Department's reading of the law, and interpretation of its rule, is consistent with the Board of Tax Appeals' application of the law, in *Shell Oil Co. v. State*, BTA Dkt No. 93-28 (1997).⁴⁵ Like Tesoro, Shell used refinery gas to heat its refinery heaters and boilers. Shell contended that refinery gas is an intermediate substance, exempt from the HST. The Board of Tax Appeals rejected the argument. The Board noted that the refinery gas is not combined or blended into a final product. Nor is refinery gas an intermediate substance that reacts with other substances to form a different product. *Id.* at 17. Therefore, the Board held that Shell's possession of refinery gas is subject to the HST. On May 1, 1998, Tesoro acquired the Anacortes refinery at issue in *Shell Oil*.⁴⁶

⁴⁵ A copy of the Board's decision is included as Attachment A.

⁴⁶ Petroleum News, May 1998. (Available at <http://www.petroleumnews.com/newsbulletin/467598220.html>.)

4. The HST tax does not require storage of hazardous substances.

In addition to clarifying which substances are subject to the HST, Rule 252 sets out the timing for payment of the tax. Section (8) of the rule states that the HST “is due for payment together with the timely filing of the return upon which it is reported, covering the tax reporting period during which the hazardous substance(s) is first possessed within this state.”

The rule contains a separate provision regarding the time that tax will be due from refiners that store their products. Section (8)(c) states:

Special provision for manufacturers, refiners, and processors. Manufacturers, refiners, and processors who possess hazardous substances are required to report the tax and take any available exemptions and credits only at the time that such hazardous substances are withdrawn from storage for purposes of their sale, transfer, remanufacture, or consumption.

The rule must be read in conjunction with the statute. Under RCW 82.21.030, the hazardous substance tax is due on the first possession of a hazardous substance in this state. “Possession” is defined by RCW 82.21.020(3):

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

Although refinery gas can be moved to the burn points in as little as thirty seconds, Tesoro clearly has physical possession and control of the gas. The gas is not allowed to dissipate into the air. Rather, refinery gas leaves the pipeline only at the point it is removed and consumed as a fuel or flared. Tesoro's Process Engineering Manager testified that "it's physically piped to be burned in our heaters."⁴⁷ Tesoro has a significant financial interest in maintaining possession of the refinery gas. "Without this by-product gas, there's not enough energy to run the refinery. You could not operate without it."⁴⁸

Section (8)(c) of Rule 252 does not add a new requirement for the imposition of the tax. It does not seek to change the Legislature's definition of "possession." The function of Rule 252(8)(c) is to provide an administrative convenience to refiners with respect to the due date of the tax. Until a product is sold or consumed, refiners do not always know whether the substance will be entitled to an exemption or credit under chapter 82.21 RCW and Rule 252. For example, a hazardous substance may be stored and then used as an ingredient to produce a taxable end product. Rule 252(8)(c) does not set any limits on the storage time. This is a tremendous economic benefit to refiners. A substance can be stored

⁴⁷ CP 162 (Crawford Dep. at 22, l. 15-18).

⁴⁸ CP 166 (Crawford Dep. at 26, l. 16-24).

until it is needed. When it is removed from storage, it is taxed.

Conversely, a hazardous substance can be stored for a very short period of time before it is consumed. When a petroleum product is immediately sold or consumed, the refiner knows whether it is entitled to an exemption or credit and there is no reason to delay implementation of the tax.

D. Rule 252 Implements the Current Version of the Hazardous Substance Tax Law.

The heart of Tesoro's argument appears to be that Rule 252 should be read in conjunction with a former version of the hazardous substance law. As Tesoro correctly points out, prior to 1989, the hazardous substance tax was contained in chapter 81.22 RCW. The prior version of the law exempted from the HST:

(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.

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. 1989 ch. 2 § 24, effective March 1, 1989.

Tesoro claims that Rule 252 still recognizes an exemption for fuel gas used in petroleum processing, so the current version of the law should not be applied. This is incorrect for two reasons. First, Rule 252

implements the current version of the law. Second, if Rule 252 granted an exemption that is not contained in the law, the Rule would be invalid.

Rule 252 was revised when the law changed. At that time, section (7)(b) of the rule needed no adjustment. As explained above, section (7)(b) administers the law by ensuring that the HST will be collected only once. If a substance is first produced in a chemical reaction, and is consumed in the reaction, it is not subject to tax. Only the product is taxed. This is an appropriate application of the existing law.

Rule 252(8)(c) also correctly administers the current law. If a substance is stored, the Rule benefits businesses by allowing them to wait and pay the tax when the substance is used. This ensures that the excess tax will not be paid. The Rule does not seek to rewrite the law and add an exemption for hazardous substances that are not stored. Rather, it is a reasonable attempt to fairly administer the HST and make sure each substance is properly taxed under the law.

The Department is confident that Rule 252 properly administers the law. If the Court finds, however, that the Department created new exemptions, the rule exceeds the Department's authority and is invalid.

“An agency may not promulgate a rule that amends or changes a

legislative enactment.”⁴⁹ Rule 252 does not create new exemptions. Each section Tesoro relies on seeks to implement the HST by applying the tax to the first possession of the substance.

Yet amending the law is exactly what Tesoro claims the Department has done. Tesoro contends that Rule 252 gives life to an exemption that no longer exists in the law. The rule implements the law in effect, not the revoked exemption. If Rule 252 conflicts with the HST statutes, the law is controlling. “When exercising its rule-making authority, and agency may draft only those rules which fit within the framework and policy of the applicable statute.”⁵⁰ The Department cannot amend the HST statutes through a rule or policy statement.

When a state agency acts in a manner contrary to law, its actions are ultra vires.⁵¹ The state Supreme Court has held that if an agency engages in a long standing practice that is contrary to law, abandoning the ultra vires application of the law is neither arbitrary nor capricious.⁵² The state Supreme Court has been equally clear with respect to the prospect of an administrative agency attempting to change the law through rule

⁴⁹ *Edelman v. State ex rel. Public Disclosure Comm'n*, 152 Wn.2d 584, 591, 99 P.3d 386 92004); see also *H&H Partnership v. State*, 115 Wn. App. 164, 170, 62 P.3d 510 (Div. II, 2003).

⁵⁰ *Bird-Johnson Corp.*, 119 Wn.2d at 428.

⁵¹ *State v. Adams*, 107 Wn.2d 611, 615, 732 P.2d 149 (1987).

⁵² *Dep't of Ecology v. Theodoratus*, 135 Wn.2d 582, 957 P.2d 1241 (1998).

making. Agencies “cannot modify or amend a statute by regulation.”⁵³ If Rule 252(8)(c) imposes a new requirement that a substance must be stored in order to be taxed, the rule is invalid. RCW 82.21.030 clearly imposes the HST on the first possession of a hazardous substance in this state. There is no storage requirement in the law. The Department of Revenue has authority to administer collection of the tax. It does not, however, have any authority to alter the law by exempting substances that are not stored prior to use or sale. “An agency may not promulgate a rule that amends or changes a legislative enactment.”⁵⁴

E. The Department’s “ETA 540” Does Not Create A New Exemption From The HST.

Tesoro’s final argument is that an informational Department of Revenue publication created a new exemption from the HST. The publication at issue is Excise Tax Advisory 540.04. It was written and published in 1988. When it was published, these types of Department publications were called Excise Tax Bulletins (ETBs). In 1998, ETA 540 was converted from an ETB to an ETA. This was not a “readoption” and the Department did not “reaffirm” the bulletin. It was simply an administrative change that was made to the title of all ETBs.

⁵³ *Bird-Johnson Corp.*, 119 Wn.2d at 428.

⁵⁴ *Edelman*, 152 Wn.2d at 591, 99; see also *H&H Partnership*, 115 Wn. App. at 170.

ETA 540 was written in 1988 and references only chapter 82.22, the prior version of the HST law. At no point in the ETA is chapter 82.21 mentioned. ETAs are advisory only until they are superceded by court, legislative or administrative action. The section relied upon by Tesoro was superceded by legislative action. It applies the exemption in the old law for "liquid fuel or fuel gas used in petroleum processing." That exemption does not exist in the current law. As a result, the ETA has been withdrawn.⁵⁵

If an agency's informational bulletin could reincarnate a repealed statutory exemption, it would put tremendous power in the hands of administrative agencies. The Legislature would be unable to change the law if the change conflicted with an administrative publication. In reality, of course, an administrative rule or publication that conflicts with the law is invalid. An administrative agency cannot amend or modify the law.⁵⁶

V. CONCLUSION

The superior court properly applied the plain language of RCW 82.21.030. RCW 82.21.030 taxes the possession of hazardous substances in Washington. Without question, the refinery gas at issue is a hazardous substance, first possessed by Tesoro. The only issue is whether the possession is exempt from taxation. RCW 82.21.040 lists each exemption

⁵⁵ ETA 540 was withdrawn in May, 2005.

⁵⁶ *Bird-Johnson*, 119 Wn.2d at 428.

from the tax. There is absolutely no exemption for possession of refinery gas. Therefore, like all other manufacturers, Tesoro must pay the HST. Using a hazardous substance as a fuel does not entitle a manufacturer to an exemption from the tax.

RESPECTFULLY SUBMITTED this 3rd day of January, 2006.

ROB MCKENNA
Attorney General

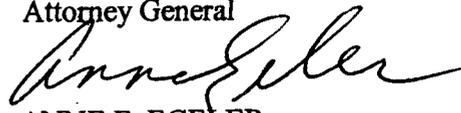
ANNE E. EGELER
Senior Counsel
WSBA #20258

DEBRA E. CASPARIAN
Assistant Attorney General
WSBA #26354

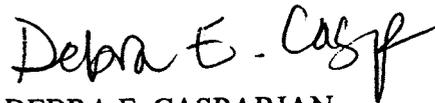
from the tax. There is absolutely no exemption for possession of refinery gas. Therefore, like all other manufacturers, Tesoro must pay the HST. Using a hazardous substance as a fuel does not entitle a manufacturer to an exemption from the tax.

RESPECTFULLY SUBMITTED this 3rd day of January, 2006.

ROB MCKENNA
Attorney General



ANNE E. EGELER
Senior Counsel
WSBA #20258



DEBRA E. CASPARIAN
Assistant Attorney General
WSBA #26354

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 This matter came before the Board of Tax Appeals (Board) for
12 a formal hearing on August 28, 1996. Sara D. Trapani, Senior Tax
13 Attorney, Shell Oil Co., appeared for Appellant, Shell Oil Co.
14 (Shell). Cameron G. Comfort, Assistant Attorney General, appeared
15 for Respondent, Department of Revenue (Department).

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

19 ISSUES

20
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 valua-tion of large volume exchange transactions (exchanges), (2)
27 assess-ment 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 timeliness 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

tankers, and pipelines are not loaded at truck racks.¹

1
2
3
4
5
6
7
8
9
10
11
12
13
14

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

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

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

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

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

¹ Arosell, Tr. at 55-56, 59-60, 63.

² Arosell, Tr. at 56.

³ Arosell, Tr. at 56.

⁴ Arosell, Tr. at 57-58.

order of 250,000 barrels.⁵

1
2 7. In the Anacortes area (Northwest), barges are used to
3 move product within the region. Barge transportation of oil prod-
4 ucts is very labor intensive due to difficulty of maintaining
5 quality and adhering to environmental standards. A barge trans-
6 ports quantities on the order of 5,000 to 40,000 barrels. Barge
7 transportation is more costly and less efficient than pipeline
8 transportation.⁶

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

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

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

⁵ Arosell, Tr. at 57-58.

⁶ Arosell, Tr. at 58-59.

⁷ Arosell, Tr. at 87.

0 0
/ / /

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.⁸

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.⁹

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.¹⁰

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

/ / /

17 ⁸ Arosell, Tr. at 61-62, 86-87, 90.

18 ⁹ Arosell, Tr. at 88-89.

19 ¹⁰ 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.¹¹

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).¹²

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

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

20 ¹² Arosell, Tr. at 65-66; Ex. AH-4, AH-5.

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

1
/ / /

2
E. EXCHANGES BETWEEN OIL COMPANIES.

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

10
20. Exchanges that take place outside Washington are
11 referred to as "transfers", and do not include transportation
12 charges to deliver the product to the point of exchange.

13
21. No money changes hands for exchanges unless there is
14 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

¹³ Arosell, Tr. at 66, 68, 120-21.

¹⁴ Arosell, Tr. at 59-60.

negotiated and is based on the location with the most representative or believable prices.¹⁵

///

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

F. HOW SHELL REPORTED THE EXCHANGES FOR TAX PURPOSES.

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

24. Because the gross proceeds of Shell's exchanges of finished petroleum products are unknown, for tax purposes, Shell filed its tax returns using its own cost methodology for products exchanged at the Anacortes refinery and other locations in Washington and shipped via transportation other than by pipeline. However, on those same tax returns, Shell chose to value its

¹⁵ Arosell, Tr. at 103-104, 131; Ex. R-9 - R-18.

¹⁶ 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.¹⁷ 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
9 25. Shell developed its cost system specifically for the
10 purpose of valuing exchanges in Washington--the Comprehensive
11 Transfer Cost Calculation (CTCC).

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

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

23 ¹⁷ Ex. A-5 at 00084; Nelson, Tr. at 282, 284.

24 ¹⁸ Wood, Tr. at 136, 140; Ex. A-11.

¹⁹ Wood, Tr. at 140-42.

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

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

4
5 H. THE AUDIT.

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

7 31. The Department audited Shell for the period January 1,
1985, through December 31, 1989. Shell and the Department
8 executed a waiver deferring issuance of the Department's
assessment for 1985 and 1986 pending completion of the audit.²¹ In
9 exchange, Shell waived, during the period ending June 30, 1991,
any legal or equitable defense to the tax liability incurred
10 during the period January 1, 1985, through December 31, 1986, but
only upon the ground that the assessment was not made within the
11 time prescribed by statute.²²

12
13 ²⁰ McMinn, Tr. at 226.

²¹ Tr. at 281.

²² Ex. R-1 at 8.

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

33. The Department issued a second post-audit adjustment
4 on September 24, 1992. In the second post-assessment audit, the
Department, for tax year 1985, imposed an additional assessment of
5 \$11,514 and granted a credit to Shell of \$1,087. For tax year
1986, a credit of \$26,912 was given. For tax year 1987, a credit
6 of \$25,032 was given. For tax year 1988, a credit of \$1,396,360
was given. For tax year 1989, a credit of \$20,648 was given. As
7 a result of these adjustments, Shell's assessment was reduced to
\$3,998,816.

8
34. Shell appealed to this Board within thirty days of the
9 Department's final determination.

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

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

3 / / /

4 I. VALUE OF EXCHANGES.

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

7
8 38. The Department valued in-state exchanges reported at
cost at the same average wholesale value of sales which Shell used
to report all activity on the pipeline.²³ The Department did not
9 use Platt's.

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

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

13 ²³ 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.²⁴

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.²⁵

9 42. Platt's also came into play with
10 Determination No. 93-05. At that time, the Department
11 acknowledged that its sales represent producer-to-distributor
12 sales, not producer-to-producer sales.²⁶ In its Determination No.
13 93-118, the Department says: "As an alternative to its actual
14 wholesale prices at its truck terminal, for large scale exchanges
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:²⁷

Audit

Platt's Seattle

²⁴ Nelson, Tr. at 284, 294-98, 311; Interrogatory No. 23.

²⁵ Ex. AH-5; Tr. at 286.

²⁶ Determination No. 93-118 at 8.

²⁷ Ex. A-3 Audit Work Papers; Ex. AH-4, AH-5.

	DOR Value	Shell's Cost ²⁸	Rack	Barge (Monthly Average)
1	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
2	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.

///

///

Platt's LA

RackPipeline

6	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.²⁹ This Board finds in favor of the Department that Shell's CTCC system does not

²⁸ Audit at 110, 116, 120, 124.

²⁹ Ex. AH-4, AH-5.

measure the market value of exchange products.

1

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.³⁰

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

³⁰ 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.

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

4 J. ASSESSMENT OF HST.

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

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

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

13 ³¹ Ex. AH-4, AH-5.

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

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

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

13 K. INTEREST ON PROPERLY DUE TAX.

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

³² Wall, Tr. at 178, 181.

³³ Wall, Tr. at 178, 181, 290.

The second issue is the exchange of finished products.³⁴

1
2 57. In the 1983 letter, the Department stated that Shell
3 could value transfers of raw products, which do not have a market,
4 based on cost. However, if a market developed, Shell would be
5 required to value transfers of raw products based on the market
6 value. With respect to exchanged products, the letter explicitly
7 states that exchanged final products can be valued through the use
8 of a cost system only in the absence of an established market
9 price.³⁵

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

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

11 60. The Department secured two waivers, first for the year
12 1985, and then another in the latter part of 1990 for the years
13 1985 and 1986. These waivers preclude Shell from appealing only

13 ³⁴ Ex. A-2.

³⁵ Ex. A-2 at 2.

the timeliness of the assessments.¹⁶

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

15 CONCLUSIONS OF LAW

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

18

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

21 ¹⁶ 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

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

3
9. RCW 82.21.030 imposes a tax on the privilege of
4 possess-ing hazardous substances in this state. The tax is placed
on the first possession of the substance. RCW 82.21.010. The
5 definition of the term "hazardous substance" specifically includes
petroleum products. RCW 82.21.020(1)(b).

6
10. WAC 458-20-252(7)(b) exempts from the HST the inter-
7 mediate possession of substances which are later used as an
ingredient or component of another product. The exemption
8 prevents double taxation of a substance: first as a single
ingredient, and then as part of a final product.

9
11. Under RCW 82.21.030, the Department correctly assessed
10 the HST on the refinery waste gas and off-spec propane. This was
the first possession of a petroleum product. The refinery waste
11 gas and off-spec propane are not intermediate products entitled to
an exemption under WAC 458-20-252(7)(b).

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

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

1

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.

3

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.

6

From these conclusions, this Board enters this

7

///

8

DECISION

9

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.

10

11

DATED this ____ day of _____, 1997.

12

BOARD OF TAX APPEALS

13

LUCILLE CARLSON, Member

14

We concur.

LAWRENCE KENNEY, Chair

MATTHEW J. COYLE, Vice Chair

1

2

3

4

5

6

7

8

9

10

11

12

13

14

NO. 33236-1-II

**COURT OF APPEALS FOR DIVISION II
STATE OF WASHINGTON**

TESORO REFINING AND
MARKETING COMPANY,

Appellant,

v.

STATE OF WASHINGTON,
DEPARTMENT OF REVENUE,

Respondent.

DECLARATION OF
SERVICE

FILED
COURT OF APPEALS
DIVISION II
WASHINGTON
JUL 11 2 19 PM
BY STAFF
OFFICE

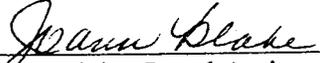
I, Jo Ann Blake, declare as follows:

1. That at all times mentioned herein, I was over 18 years of age and not a party to this action.
2. That I am a legal assistant employed by the Washington State Attorney General's Office, 7141 Cleanwater Drive S.W., P.O. Box 40123, Olympia, Washington 98504-0123.
3. That on the 3rd day of January, 2006, I deposited in the United States mail, postage pre-paid, true copies of the Brief of Respondent and Declaration of Service, to the following attorney of record:

George C. Mastrodonato
Lane Powell Spears Lubersky LLP
1420 5th Avenue, Suite 4100
Seattle, WA 98101

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 3rd day of January, 2006, at Olympia, Washington.



Jo Ann Blake, Legal Assistant