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TESORO REFINING AND MARKETING COMPANY

Plaintiff-Petitioner

vs.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE

Defendant-Respondent.

ON PETITION FOR REVIEW FROM
COURT OF APPEALS, DIVISION II

**SUPPLEMENTAL BRIEF OF PETITIONER
TESORO REFINING AND MARKETING COMPANY**

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I. INTRODUCTION

During the course of refining crude oil at the Anacortes, Washington refinery owned by Petitioner Tesoro Refining & Marketing Company (“Tesoro”), a byproduct called “refinery fuel gas” (or “refinery gas”) is produced. The refinery gas produced at the Anacortes refinery cannot be stored on site or sold to third parties. Most of the time, the refinery gas is burned up in the manufacturing process almost immediately after it is produced during the refining cycle to help provide heat for the refining process; the rest of the time, the gas is burned through the refinery’s external flare.

Historically, the Department of Revenue (“DOR”) did not apply the hazardous substances tax (“HST”) to refinery gas, because the DOR recognized that refinery gas does not fit within the intended scope of the HST. The HST is intended to tax hazardous substances that harm the environment, but refinery gas does not leave the refinery and therefore has no harmful effect on the environment.¹ The HST statute is ambiguous at

¹ It is undisputed that, from time to time, refinery gas generated during the refinery process is not consumed during that process, and instead is disposed of through the refinery flare (where it is burned in a flame that vents to the atmosphere). Tesoro agrees that refinery gas disposed of in this fashion is subject to the HST, as Chief Judge Quinn-Brintnall reasoned in her dissent. See Tesoro Refining & Marketing Co. v. Dept. of Revenue, 135 Wn. App. 411, 429, 144 P.3d 368 (2006) (Quinn-Brintnall, C.J., dissenting) (“[R]eading rule 252(7)(b) together with chapter 82.21 RCW, Tesoro is responsible for the hazardous substance tax on the gas it flamed off into the atmosphere. But under rule 252(7)(b), Tesoro is entitled to a refund of taxes

best as to whether it applies to refinery gas, and the DOR's administrative rule, issued to clarify the HST's scope, plainly and unambiguously declares that refinery gas is not subject to the tax.

More than a decade after the establishment of the HST, the DOR – in disregard of both its prior reading of the statute and the plain language of its own administrative rule – began assessing HST on refinery gas. Tesoro now asks this Court to hold that the HST does not properly apply to refinery gas. While the HST statute is ambiguous, nearly a century of Washington case law requires that its ambiguities be construed in favor of Tesoro, the taxpayer. And the DOR's administrative rule, which remains in place even today despite the DOR's insistence that the HST applies to refinery gas, is not ambiguous: The rule plainly does not impose HST on refinery gas.

This Court should reaffirm its longstanding rule that ambiguous taxation statutes are construed in favor of the taxpayer, require the DOR to obey its own duly enacted administrative rule, and grant Tesoro's petition for refund of HST paid on refinery gas.

it paid on gas that was created and immediately recycled and consumed during the refining process”).

II. SUPPLEMENTAL ARGUMENT

A. The Court of Appeals Ignored the Long-Established “Default Rule” in Washington, Which Requires Courts to Resolve Any Ambiguities Regarding Whether a Tax Applies in the First Instance in Favor of the Taxpayers.

It is the longstanding public policy of this state’s courts to construe any “[a]mbiguities in taxing statutes . . . ‘most strongly against the government and in favor of the taxpayer.’” Qwest Corp. v. City of Bellevue, 161 Wn.2d 353, 364, 166 P.3d 667 (2007) (quoting Estate of Hemphill v. Dep’t of Rev., 153 Wn.2d 544, 552, 105 P.3d 391 (2005), in turn quoting Dep’t of Rev. v. Hoppe, 82 Wn.2d 549, 552, 512 P.2d 1094 (1973)).² This default presumption in favor of taxpayers trumps the typical rule in administrative cases, which gives deference to administrative agencies’ interpretations of statutes within their fields: “We generally defer to the statutory interpretation of the agency charged with implementing a statutory scheme. However, any doubt as to the meaning of a tax statute is construed against the taxing power.” First Am. Title Co. v. Dep’t of Rev., 144 Wn.2d 300, 303, 27 P.3d 604 (2001).

² This pro-taxpayer presumption does not apply when an exemption from a tax, as opposed to that tax’s applicability or “incidence,” is at issue. See, e.g., Simpson Inv. Co. v. Dep’t of Rev., 141 Wn.2d 139, 149-50, 3 P.3d 741 (2000). While the DOR originally argued that this was an “exemption” case rather than an “incidence” case, the Court of Appeals determined that this was an incidence case, see Tesoro, 135 Wn. App. at 418, and the DOR did not cross-petition for review on that issue.

This Court most recently reaffirmed this longstanding presumption in Qwest Corp., but the pro-taxpayer presumption dates back nearly a century. This Court called the pro-taxpayer presumption “a basic rule of construction” in 1969, see Foremost Dairies, Inc. v. Tax Comm’n, 75 Wn.2d 758, 763, 453 P.2d 870 (1969), and treated this as a default rule as long ago as 1927, see Union Trust Co. of Spokane v. Spokane County, 145 Wash. 193, 196, 259 P. 9 (1927),³ when this Court cited and quoted the U.S. Supreme Court’s decision in Gould v. Gould, 245 U.S. 151, 38 S. Ct. 53, 62 L. Ed. 211 (1917):

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen.

Union Trust Co., 145 Wash. at 196 (citing and quoting Gould, 245 U.S. at 153).⁴

³ This Court has reiterated the default rule several times between Foremost Dairies and Union Trust Co. See, e.g., Buffelen Lumber & Mfg. Co. v. State, 32 Wn.2d 40, 43, 200 P.2d 509 (1948); Weyerhaeuser Timber Co. v. Henneford, 185 Wash. 46, 51, 53 P.2d 308 (1936).

⁴ The Supreme Court’s statement of the pro-taxpayer presumption has been embraced and continues to be adhered to by an overwhelming majority of other states’ courts. See, e.g., Rancho Colorado, Inc. v. City of Broomfield, 196 Colo. 444, 586 P.2d 659, 661 (1978); In re Tax Appeal of Hawaiian Tele. Co., 61 Haw. 572, 608 P. 2d 383, 388 (1980); Comptroller of the Treasury v. Clyde’s of Chevy Chase, Inc., 377 Md. 471, 833 A.2d 1014, 1036 (2003); Wyckoff v. City of Detroit, 233 Mich. App. 220, 591 N.W.2d 71, 73 (1999); IBM v. Dept. of the Treasury, 141 N.J. Super. 79, 357 A.2d 292, 295 (App. Div. 1976); Belnorth Petroleum Corp. v. State Tax Comm’n,

The Court of Appeals did not purport to disregard the presumption in this case, see Tesoro Refining & Marketing Co. v. Dep't of Rev., 135 Wn. App. 411, 418, 144 P.3d 368 (2006) (“Because this is a tax incidence case, we must interpret any ambiguity in the statute in Tesoro’s favor”), and the DOR has not challenged the requirement that “[a]mbiguities in taxing statutes [be] construed most strongly against the government and in favor of the taxpayer,” Qwest, 161 Wn.2d at 364. The problem with the Court of Appeals’ decision is not that the court stated the wrong legal standard, it is the court’s failure to apply the legal standard to which it paid lip service. Tesoro now asks this Court not only to reaffirm the default rule (a proposition the DOR does not appear to oppose), but also to enforce it (a proposition the DOR very much opposes).

As Tesoro has argued throughout this case, the ambiguity in the HST concerns how the word “or” should be read. The HST “is imposed on the privilege of possession of hazardous substances in this state.” RCW 82.21.030(1). Under the HST statute, “‘possession’ means the control of a hazardous substance,” and “[c]ontrol’ means the power to sell

845 P.2d 266, 271, n.8 (Utah Ct. App. 1993); Chevron U.S.A., Inc. v. State Bd. of Equalization, 918 P.2d 980, 984-85 (Wyo. 1996) (all adhering to Gould and ruling in favor of the taxpayer). It also continues to be the controlling rule in federal tax cases. See, e.g., The Falconwood Corp. v. United States, 422 F.3d 1339, 1348 (Fed. Cir. 2005); Greyhound Corp. v. United States, 495 F.2d 863, 869 (9th Cir. 1974); Security Bank Minnesota v. Comm’r of Internal Rev. Serv., 994 F.2d 432, 441 (8th Cir. 1993) (same).

or use a hazardous substance or to authorize the sale or use by another.” RCW 82.21.020(3) (emphasis added). This definition of “control” is ambiguous for two reasons:

First, it is not clear whether the language means: (1) having the ability to choose either to sell or use a hazardous substance; or (2) having the ability either to sell or use a hazardous substance, but not necessarily the ability to do both. Both definitions are admittedly plausible and reasonable based on the plain text of the statute. Based on the first definition, the HST would not apply to refinery gas because Tesoro does not have the ability to choose to sell it; it is undisputed that Tesoro either must burn up the gas during the refining process itself, or burn the gas through the refinery flare.⁵ Consequently, given that this Court must construe any ambiguities in the definition of “control” “most strongly against the government and in favor of the taxpayer,” Qwest, 161 Wn.2d at 364 (emphasis added), the ambiguous definition of “control” in RCW 82.21.020(3) should be construed in favor of Tesoro, and the HST should not apply to refinery gas.

Second, the definition of “control” is ambiguous because the intended construction of “or” is ambiguous. The word “or” is typically

⁵ As previously stated, Tesoro agrees that any refinery gas burned up through the flare is subject to the HST. See n.1, supra.

disjunctive, but this Court has held that it can mean something else if “the legislative intent is clearly contrary.” Childers v. Childers, 89 Wn.2d 592, 595-96, 575 P.2d 201 (1978) (quoting 1A C. Sands, Sutherland on Statutory Construction § 21.14 n.1 (4th ed. 1972)). In the context of the HST, it is at least ambiguous whether the “or” in the definition of “control” was meant to be disjunctive or conjunctive. The Legislature’s self-identified purpose in enacting the HST was to tax final products that “present a threat to human health or the environment.” RCW 82.21.010. If the HST applied to refinery gas, a substance that could not and does not leave the refinery would be taxed. Because refinery gas disappears shortly after it comes into existence (in most cases, within 30 seconds), it is at the very least doubtful whether the Legislature intended refinery gas to come under the ambit of the types of substances the HST was intended to cover.

Is the DOR’s interpretation of “the power to sell or use” reasonable? Probably. But that question is irrelevant to the proper analysis in tax cases. The statute’s conflicting statement of intent, which does not suggest that the HST should tax refinery gas, coupled with this Court’s case law allowing “or” to be something other than disjunctive when the Legislature meant otherwise, presents another reasonable interpretation of the HST statute – an interpretation that does not cover

refinery gas. Therefore, resolving all doubt in Tesoro's favor means that Tesoro's interpretation – not the DOR's – controls.

The Court of Appeals restated the rule that taxation statutes are construed most strongly in favor of the taxpayer, but it did not apply that rule. If anything, the court applied the rule in the breach. This Court should reverse the Court of Appeals, reaffirm the pro-taxpayer default rule, and enforce that rule by resolving the ambiguities in the HST statute in Tesoro's favor.

B. Rule 252 Plainly Does Not Impose the HST on Refinery Gas, and the DOR Cannot Create a “New” Administrative Interpretation of the HST Without Changing Rule 252 Pursuant to the Appropriate Administrative Procedure.

Putting aside the requirement that all doubts in the HST statute be construed in Tesoro's favor, this Court should also hold that the HST does not apply to refinery gas based on the plain language of the DOR's administrative rule implementing that statute. The rule reads as follows:

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.

WAC 458-20-252(7)(b) (“Rule 252”).

“As in statutory interpretation, where a regulation is clear and unambiguous, words in a regulation are given their plain and ordinary meaning unless a contrary intent appears.” Silverstreak, Inc. v. Dep’t of Labor & Indus., 159 Wn.2d 868, 881, 154 P.3d 891 (2007), quoted in Stevens v. Brink’s Home Security, Inc., ___ Wn.2d ___, 169 P.3d 473, 476 (2007). Here, no “contrary intent” appears and no ambiguities need be resolved in interpreting and applying Rule 252: Because refinery gas is “consumed during the manufacturing or processing activity,” it is not taxable under the plain and unambiguous language of the rule.

The Court of Appeals found three bases for ignoring the plain language of Rule 252, and this Court should reject all three:

First, the Court of Appeals noted that Rule 252 is titled “recurrent tax liability,” so, in that court’s view, it only addresses situations where there might be recurrent tax liability. See Tesoro, 135 Wn. App. at 425-26 (“Rule 252(7)’s title implies that the taxpayer must have at least two possible instances of taxable possession before the rule applies”). Since refinery gas cannot be subject to recurrent tax liability, the court reasoned, Rule 252 has no effect on the HST’s applicability to refinery gas. See id. This reasoning is flawed because the language in Rule 252 is crystal clear, and “a heading, although helpful to focus a reader on the substantive content of a rule, is not part of the rule.” State v. Whelchel, 97 Wn. App.

813, 820, 988 P.2d 20 (1999), rev. denied 140 Wn.2d 1024, 10 P.3d 405 (2000) (internal citation omitted). Indeed, as Chief Judge Quinn-Brintnall noted in her dissent, “one purpose of chapter 82.21 RCW is to prevent recurrent tax liability, but this purpose is not exclusive and, in my opinion, does not invalidate the plain meaning of rule 252(7)(b).” Tesoro, 135 Wn. App. at 429 (Quinn-Brintnall, C.J., dissenting). The “recurrent tax liability” heading does not create out of whole cloth an ambiguity that does not exist in the text of the rule, and this Court should enforce the plain language of Rule 252.

Second, the Court of Appeals reasoned that it was unable to “define the chemical processes that the Department intended to include within rule 252(7)(b)’s ‘otherwise consumed’ language.” Tesoro, 135 Wn. App. at 426. In fact, the meaning of “otherwise consumed” is perfectly simply to define. Rule 252(7)(b) reads in full:

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.

WAC 458-20-252(7)(b). In other words, an intermediate possession is not taxable under two circumstances: (1) “if the substance(s) becomes a

component or ingredient of the product being manufactured or processed,” or (2) if the substance “is otherwise consumed during the manufacturing or processing activity.” “Otherwise consumed,” therefore, means that the substance is consumed in any way that does not fit within the first circumstance. There is no ambiguity there, and the term “otherwise consumed” plainly encompasses refinery gas.

Third, the Court of Appeals reasoned that if Rule 252 meant what it said, it would be inconsistent with the HST statute and should be invalidated. See Tesoro, 135 Wn. App. at 426. But as Chief Judge Quinn-Brintnall explained in her dissent, “[b]ecause the rule furthers the legislature's purpose and intent for the pollution tax (RCW 82.21.030) by exempting from taxation those hazardous substances not released into the environment but created and immediately consumed during the manufacturing process, we can give effect to and harmonize the statute and the rule.” Tesoro, 135 Wn. App. at 429 (Quinn-Brintnall, C.J., dissenting) (citing King County v. Cent. Puget Sound Growth Mgmt. Hearings Bd., 142 Wn.2d 543, 560, 14 P.3d 133 (2000); S. Martinelli & Co. v. Dep’t of Rev., 80 Wn. App. 930, 940 n.6, 912 P.2d 521, rev. denied, 130 Wn.2d 1004, 925 P.2d 989 (1996)). As explained in the portion of this brief addressing the HST statute, that statute is facially ambiguous as to whether or not the HST applies to refinery gas. See pp.

5-7, supra. Given that ambiguity, it is certainly possible to “harmonize” the statute with the plain language of Rule 252(7)(b), which does not apply the HST to refinery gas.

In this case, the DOR (1) propounded a formal rule that plainly does not subject refinery gas to the HST, (2) ignored that rule by assessing HST on Tesoro’s refinery gas, and (3) when faced with the direct conflict between its actions and its own rule, argued that Rule 252(7)(b) must be invalid if it means what it says. This should not be allowed. The DOR, like every other administrative agency, has the power to make certain types of rules pursuant to the APA. The APA sets forth very specific procedural requirements agencies must follow when making rules. See RCW 34.05.310, et seq. One of the purposes of these procedures is, in the words of the APA’s preamble, “to provide greater public and legislative access to administrative decision making.” RCW 34.05.001. The DOR followed those procedures when it promulgated Rule 252(7)(b), but it did not follow anything resembling APA procedures when it decided in the course of this case to ignore – but not amend – that rule in order to support its subsequent decision to assess HST on Tesoro’s refinery gas.

As this Court has explained, the DOR, like all other administrative agencies, must follow and support the rules it promulgates pursuant to the APA and its statutory delegation:

DOR will stick by its rules (whether interpretive, procedural, or legislative) unless and until they are stricken by a court. For interpretive rules in particular, DOR will maintain it interpreted the underlying statutes correctly, and any taxpayer who disagrees will have to persuade a court otherwise. For legislative rules, a taxpayer who thinks the agency went too far in implementing the authorizing statutes will pursue precisely the same course: a lawsuit. Agency rules are de facto authoritative for the public until the public challenges them in court and the court agrees.

Ass'n of Wash. Business v. Dep't of Rev., 155 Wn.2d 430, 447-48, 120 P.3d 46 (2005).

Here, the DOR has ignored this Court's directive, first advancing a plainly implausible interpretation of Rule 252(7)(b), see DOR's Answering Brief at 17-18; Tesoro's Reply Brief at 16-18, and then insisting that, should Rule 252 be read as meaning what it says, it must be invalid, see DOR's Answering Brief at 26; Tesoro's Reply Brief at 18-19. This is precisely what agencies are not permitted to do. Administrative rules are enacted pursuant to a particular APA process, and they should only be repealed or altered pursuant to that same process. The DOR should not be permitted to unilaterally ignore its own rule without repealing it in accordance with appropriate administrative procedure.

In addition to Rule 252, the DOR also maintained in Excise Tax Advisory 540.04.22.252 ("ETA 540"), issued on August 19, 1988 and reaffirmed and republished on July 1, 1998, that the HST does not apply to

“products derived from refining crude oil [that] are . . . used as fuel” (CP 70-73). Although not a formal regulation, ETA 540 was an official, public position of the DOR, and it remained in force even after the DOR assessed HST on Tesoro’s refinery gas and was not cancelled by the DOR until after Tesoro began the legal proceeding that spawned this appeal. See Exh. 4 to the Appendix to Tesoro’s Opening Brief. Justices Madsen’s and Fairhurst’s concurrence in Stevens recognizes the role non-WAC agency opinions such as ETA 540 play in setting agency policy:

An agency policy can be useful in determining the meaning of statutory terms. See generally, e.g., Stahl v. Delicor of Puget Sound, Inc., 148 Wn.2d 876, 886-87, 64 P.3d 10 (2003). They need not be promulgated with the formality of rule making but must represent a uniformly applied interpretation. See generally, Cowiche Canyon Conservancy v. Bosley, 118 Wn.2d 801, 815, 828 P.2d 549 (1992).

Stevens, 169 P.3d at 479 (Madsen, J., concurring, joined by Fairhurst, J.)

Federal courts have repeatedly held that administrative agencies may not expediently revise their positions regarding the meaning of a statute to benefit a litigation position, while ignoring the procedural requirements of administrative procedure. In Lagandaon v. Ashcroft, 383 F.3d 983 (9th Cir. 2004), the Ninth Circuit observed that “agency litigating positions regarding the meaning of a statute . . . are not entitled to deference.” Id. at 990, citing Defenders of Wildlife v. Norton, 258 F.3d

1136, 1145 n.11 (9th Cir. 2001). And in Defenders of Wildlife, the Ninth Circuit stated this principle in terms that perfectly fit the circumstances of this case:

Nor do we owe deference to the interpretation of the statute now advocated by the Secretary's counsel – newly minted, it seems, for this lawsuit, and inconsistent with prior agency actions – as we ordinarily will not defer “to agency litigating positions that are wholly unsupported by regulations, rulings, or administrative practice.”

Defenders of Wildlife, 258 F.3d at 1146 n.11 (emphasis added) (quoting Bowen v. Georgetown Univ. Hospital, 488 U.S. 204, 212, 109 S. Ct. 468, 102 L. Ed. 2d 493 (1988)).

Here, Rule 252(7)(b) and ETA 540 represent the DOR's legitimate agency positions for purposes of this case. Although the DOR assessed HST on Tesoro's refinery gas and repealed ETA 540, the initial assessment of HST directly contradicted the then-effective ETA 540, and the revocation of ETA 540 took place during this lawsuit. The DOR's present position therefore constitutes, as Defenders of Wildlife put it, an “interpretation of the statute now advocated by the Secretary's counsel – newly minted, it seems, for this lawsuit, and inconsistent with prior agency actions.” And not only is the DOR's current position inconsistent with the proper pro-taxpayer construction of the HST statute, it directly contradicts the plain language of the DOR's own still-effective Rule 252(7)(b). This

Court should require the DOR to follow its own directives and rules and reverse the Court of Appeals.

III. CONCLUSION

The Court of Appeals failed to apply this state's longstanding rule that taxation statutes are construed in favor of the taxpayer, and it did not require the DOR to follow its own administrative rules and directives. This Court should reverse the Court of Appeals' decision, enforce the pro-taxpayer default rule of statutory construction, and insist that administrative agencies follow the rules they have put in place.

RESPECTFULLY SUBMITTED this 14th day of December, 2007.

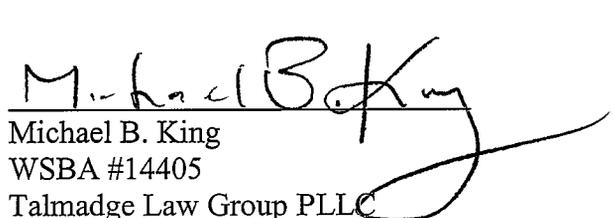
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I certify that I served a copy of this document on all parties or their
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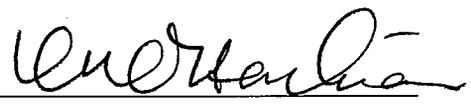
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I certify under penalty of perjury under the laws of the state of
Washington that the foregoing is true and correct.

DATED this 14th day of December, 2007 at Seattle, Washington.



Kristi Hartman