

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment	)	<u>D E T E R M I N A T I O N</u>
	)	
	)	No. 96-031
	)	
...	)	Registration No. . . .
	)	FY. . ./Audit No. . . .
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RULE 252, RULE 175; RCW 82.04.433, RCW 82.21.050, RCW 82.23A.040: HAZARDOUS SUBSTANCE TAX; PETROLEUM PRODUCTS TAX; B&O TAX -- EXEMPTION/CREDIT -- FUEL-IN-TANKS -- MARINE LUBRICANTS. Marine lubricants are considered to be a fuel for purposes of a tax credit/exemption, only where they are concurrently consumed in the bunker fuel's combustion process.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

Taxpayer protests the assessment of additional retailing business and occupation (B&O) taxes, hazardous substance taxes, and petroleum product taxes on sales of lubricants that were delivered into the fuel tanks of ships engaged in foreign commerce.<sup>1</sup>

FACTS:

Okimoto, A.L.J. -- Taxpayer is a manufacturer and distributor of oil product derivatives. Taxpayer's books and records were examined by the Audit Division of the Department of Revenue (Audit) for the period January 1, 1988 through December 31, 1989. Audit also examined Taxpayer's books and

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<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410

records for the period January 1, 1990 through March 31, 1992. This income was reported under a separate registration number.

#### TAXPAYER'S EXCEPTIONS:

##### Unreported Sales of Lubricants - Hazardous Substance Tax

In the above tax assessments Audit assessed hazardous substance taxes on sales of marine lubricants that were delivered into fuel tanks of oceanbound ships while they were in transit through Puget Sound.

Taxpayer explained during the teleconference that it sells two types of oil lubricants to ships. Both are distillates of the crude oil refining process and are considered a higher grade of product than residual bunker fuel.

The first type is called a cylinder lubricant. It generally has a viscosity of SAE-50. Approximately 70 percent of Taxpayer's lubricant sales are of this type. Cylinder lubricants are delivered into a separate tank located on the ship. These lubricants are injected directly into the engine cylinders and burned along with the bunker fuel. This process is described in the following book published by the oil industry, Our Industry Petroleum, (P.A. Stockil, ed. 1977).

The cylinders and pistons are lubricated by a cylinder oil on a total-loss principle. Oil is injected by means of a pump and metering device through quills arranged round the cylinder. Used oil passes into the combustion chamber and is burnt and emitted with the exhaust gases.

Id. at 343-4.

Taxpayer stated during the teleconference that engine configurations are specifically designed to burn and consume all of the cylinder lubricants during the fuel's combustion process.

The second type of lubricant is the circulatory type and is used similar to automotive motor oil. Circulatory lubricants are also delivered into a separate tank on the ships. Once in the tanks, they are pumped into the engine's crankcase and used to coat and lubricate parts in that area of the engine. These lubricants circulate through the crankcase 7-14 times per hour and are not burned or consumed during the lubrication process. Shrinkage is very minimal and results primarily from leakage. Circulatory lubricants clean and lubricate until contaminants make them unfit for further use. Then they are removed from the crankcase and pumped into the fuel tanks and burned along with the bunker fuel.

Taxpayer argues that lubricants (both cylinder and circulatory) and fuel are inseparably connected to the ship's energy generation process and should not be distinguished for purposes of the tax credit/exemption. Taxpayer explained that both are purchased from the same supplier and are treated virtually the same for accounting purposes. In addition, Taxpayer states that both are

products or byproducts of the same oil refining process. Bunker fuel is the normal fuel used to power ships and is the "bottom of the barrel" in the crude oil refinement process. It is the residue remaining after all other more valuable products, such as lubricants and gasoline, have been skimmed off. Taxpayer argues that lubricants are merely higher grades of fuel and that they should be taxed in the same manner. In addition, Taxpayer states that both cylinder and circulatory lubricants are actually burned as fuel. Taxpayer further states that ships could burn lubricants as fuel exclusively for propulsion purposes, but that it is too expensive. Instead, ships use lubricants initially to lubricate engine parts and later, as fuel. Taxpayer believes that this intervening use should not preclude a lubricant from being designated as a fuel.

Taxpayer also relies on the broad definition of fuel contained in WAC 458-20-252 (Rule 252) in support of its position.

In addition to the above argument, Taxpayer contends that its sales of lubricants are exempt from taxation because the state of Washington is constitutionally prohibited from taxing these transactions. Taxpayer relies on Rule 252, Part I, (4)(e)(iv) in support of its position.

Taxpayer explained during the teleconference that up until September of 1991, all lubricants were manufactured in California and shipped to a storage tank facility in Tacoma where they stayed until ordered by a ship. When an order was received, Taxpayer trucked the lubricants from the storage tanks to the dockyard where they were loaded onto a barge. Taxpayer then contracted with a tugboat company to tow the barge to the customer's ship and pump the lubricants into the ship's tanks. Taxpayer billed the ship directly. Taxpayer estimates that its lubricant inventory in Washington turns over once every 30-45 days.

#### Unreported Sales of Lubricants - Petroleum Product Tax

Taxpayer makes similar arguments regarding the petroleum products tax on sales of lubricants to oceanbound ships pursuant to RCW 82.23A.040(1) and Rule 252, Part II, (5)(a). In the alternative, it also relies on RCW 82.23A.030(3) (constitutional prohibition), and RCW 82.23A.030(7) (products packaged for sale to ultimate consumer.)

#### Unreported Sales of Lubricants - Retailing B&O

In this portion of the tax assessments, Audit assessed retailing B&O taxes on sales of marine lubricants which were delivered into fuel tanks of ocean-bound ships while in transit through Puget Sound. Taxpayer had deducted its lubricant sales as sales of fuel to vessels used primarily in foreign commerce for consumption outside the territorial waters of the United States. Taxpayer relies on RCW 82.04.433 and WAC 458-20-175 (Rule 175).

#### ISSUES:

- 1) Are Taxpayer's sales of lubricants subject to retailing B&O taxes, hazardous substance taxes, and petroleum products taxes?
- 2) Are Taxpayer's payments for the use of the delivery barge subject to use and/or deferred sales tax?

#### DISCUSSION:

##### Unreported Sales of Lubricants - Hazardous Substance Tax

For ease of discussion, we will first analyze the hazardous substance tax issues. RCW 82.21.030 imposes upon the first possessor, a tax:

. . . on the privilege of possession of hazardous substances in this state. The rate of the tax shall be seven-tenths of one percent multiplied by the wholesale value of the substance.

RCW 82.21.050(1) allows a credit against this tax.

Credit shall be allowed in accordance with rules of the department of revenue for taxes paid under this chapter with respect to fuel carried from this state in the fuel tank of any airplane, ship, truck, or other vehicle.

The above statutory credit provision is implemented by Rule 252(5). It states in part:

(b) A credit may be taken in the amount of the hazardous substance tax upon the value of fuel which is carried from this state in the fuel tank of any airplane, ship, truck, or other vehicle.

(i) The credit may be claimed only for the amount of tax reported or actually due to be paid on the fuel, not the amount representing the value of the fuel.

(ii) The purpose of this credit is to exclude from taxation any possessions of fuel which remains in the fuel tanks of any carrier vehicles powered by such fuel when they leave this state, regardless of where or from whom such fuel-in-tanks was acquired.

(iii) The nature of this credit is such that it generally has application only for interstate and foreign private or common carriers who carry fuel into this state and/or purchase fuel in this state. The intent is that the tax will apply only to so much of such fuel as is actually consumed by such carriers within this state.

(iv) In order to equitably and efficiently administer this tax credit, any fuel which is brought into this state in carrier vehicle fuel tanks must be accounted for separately from fuel which is purchased in this state for use in such fuel tanks. Formulas approved by the department for reporting the amount of fuel consumed in this state for purposes of this tax or other excise tax purposes will satisfy the separate accounting required under this subsection.

Rule 252(2)(d)(i) contains the following definition of "fuel":

. . . "Fuel" includes all combustible gases and liquids suitable for the generation of energy. . . .

This definition was clarified in Det. No. 88-329, 6 WTD 321 (1988). That case involved the definition of "fuel" for purposes of a hazardous substance tax exemption for liquid fuel or fuel gas used in processing petroleum and for fuel exported for use or sale outside the state<sup>2</sup>. While denying the export exemption to an oil refinery for purchases of "feed" or "feedstock", we stated:

"The second exemption for export sale or use as fuel, is never available for substances which are not usable as 'fuel'."

Id. at 326.

Det. No. 88-329 went on to exclude items which were not generally sold or used as fuels from the exemption for exported fuel. In denying the exemption to certain non-fuel derivatives, we stated:

FCC feedstock, raw vacuum gas oil (RVGO), hydrotreated FCC feedstock, and treated vacuum gas oil are not generally sold or used as fuels. They are, at best, components or ingredients of further manufactured or processed end products. As such, possessions of these substances off the petroleum processing line are taxable possessions for which no exemption exists under the law or rule.

Id. at 337,338.

In conjunction with Det. No. 88-329, the Department issued Excise Tax Bulletin 540.04/22.252 (ETB 540) listing ". . . other products derived from refining crude oil, which are generally sold or used as fuel . . ." ETB 540 clearly states, however, that the list is not "all inclusive" and that other petroleum products might also be considered fuels.

Based on the above authority, we believe that in order for a substance to meet the definition of "fuel" for purposes of the hazardous substance tax credit, the product must be commercially suitable for use as a fuel.

Taxpayer's sales of cylinder lubricants satisfy the above test because they are commercially sold and used as a fuel. Taxpayer stated that cylinder lubricants are sold for two concurrent purposes; to lubricate the parts of the engine and, to serve as a fuel for propulsion of the vessel. We find it particularly significant that cylinder lubricants are consumed entirely in the initial lubrication and combustion process. Cylinder lubricants serve as a lubricant when they are initially pumped into the engine cylinders and, as a fuel when they are left in the combustion chamber and burned along with

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<sup>2</sup>Although these exemptions were later repealed by Laws of Washington 1989, Ch. 2, § 24, effective March 1, 1989, the definition of fuel contained in Rule 252 was retained.

the bunker fuel. Their significance as a fuel is reflected by the high quantities of cylinder lubricants consumed. Based on these factors, we find that cylinder lubricants are used equally and concurrently, as a lubricant and as a fuel, in the ship's propulsion process. Therefore, we find that cylinder lubricants are commercially suitable for use as a fuel and are entitled to the "fuel in tanks" credit under RCW 82.21.050(1)<sup>3</sup>. Taxpayer's petition is granted on this issue.

Circulatory lubricants, however, are a different matter. They are neither commercially sold as a fuel nor are they commercially suitable for use as a fuel<sup>4</sup>. Their purpose is primarily to lubricate the engine's crankcase and it is not until they exhaust their utility for lubrication that they are combined with bunker fuel and burned. Although some propulsion may result from burning these contaminated lubricants, we view this as more of a disposal process. Oils which function solely as lubricants are not normally considered fuels<sup>5</sup>. Accordingly, Taxpayer's petition is denied on this issue.

Regarding Taxpayer's contention that the state is constitutionally precluded from taxing these transactions, we believe Taxpayer's reliance on Rule 252, Part I, (4)(e)(iv) is misplaced. When interpreting section (iv), it must be read in conjunction with section (iii). The two sections state:

(iii) Out of state sellers or producers will be subject to tax upon substances shipped or delivered to warehouses or other in state facilities owned, leased, or otherwise controlled by them.

(iv) However, the tax will not apply with respect to possessions of substances which are only temporarily stored or possessed in this state in connection with through, interstate movement of the substances from points of origin to points of destination both of which are outside of this state.

Section (iii) states that the general rule is that out-of-state producers are subject to hazardous substance tax on substances shipped or delivered to Washington warehouses or storage facilities controlled by them. Section (iv) only excludes from tax those "limited possessions" where the substances are temporarily stored or possessed in Washington in connection with a through, interstate movement from an out-of-state producer to a customer at a point outside the state of Washington. Under these circumstances, the substances are merely "passing through" Washington on their way to their final out-of-state destination.

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<sup>3</sup>cf. Missouri Public Service Company v. Director of Revenue, 733 S.W. 2d 449 (Mo.App. 1986) (Holding that a substance that was used both as a fuel and to neutralize sulfuric acid constituted a fuel for purposes of a use tax exemption for "fuel".)

<sup>4</sup>Taxpayer has testified that it is too expensive to burn lubricants solely for propulsion purposes.

<sup>5</sup>cf. Lubrizol Corp. v. Environmental Protection Agcy., 562 F. 2d 807 (1977) [Holding that motor oil and motor oil additives were not a "fuel or fuel additive" for purposes of the Clean Air Act, 42 U.S.C. § 1857 (1970 and Supp. V 1975)].

Section (iv) is not applicable to Taxpayer's case. Here, Taxpayer ships the substances to its own terminals and stores them indefinitely pending a sale to anticipated, but unidentified customers. It is not part of a through, interstate movement. Taxpayer's petition is denied on this issue.

#### Unreported Sales of Lubricants - Petroleum Product Tax

The language of the statutory credits and exemptions relied upon by Taxpayer for petroleum product tax and contained in RCW 82.23A.040(1) and Rule 252, Part II, (5)(a) and RCW 82.23A.030(3) is identical to those relied on for the hazardous substance tax. Therefore, the above discussion is equally applicable to the petroleum product tax credit and exemption.

RCW 82.23A.030(7) is unique, however, and exempts from the petroleum product tax:

Any possession of petroleum products packaged for sale to ultimate consumers.

Rule 252, Part II, (4)(d) clarifies the exemption and states that it applies to:

Any possession of petroleum products packaged for sale to ultimate consumers. This exemption is limited to petroleum products which are prepared and packaged for sale at usual and ordinary retail outlets. Examples are containerized motor oil, lubricants, and aerosol solvents.

We believe Taxpayer's reliance on Rule 252 is misplaced. This exemption is not applicable to Taxpayer's sales of lubricants because it does not package the lubricants for sale. It merely stores fungible lubricants in terminal tanks pending sale and delivery to ships by barge. Accordingly, Taxpayer's petition is denied on this issue.

#### Unreported Sales of Lubricants - Retailing B&O

RCW 82.04.433(1) allows a deduction from B&O taxes for:

. . . amounts derived from sales of fuel for consumption outside the territorial waters of the United States, by vessels used primarily in foreign commerce.

The above statutory deduction is implemented by WAC 458-20-175 (Rule 175). It states in part:

However, on July 1, 1985, a statutory business and occupation tax deduction became effective for sales of fuel for consumption outside the territorial waters of the United States by vessels used primarily in foreign commerce. In order to qualify for this deduction sellers must take a certificate signed by the buyer or the buyer's agent stating: The name of the vessel for which the fuel is purchased; that the vessel is primarily used in foreign commerce; and, the amount of fuel purchased which will be consumed outside of the territorial waters of the United States. Sellers must exercise good faith in accepting such certificates and are required to add their own signed statement to the certificate to the effect that to the best of

their knowledge the information contained in the certificate is correct. The following is an acceptable certificate form:

Audit's grounds for denying the deduction was based solely on its contention that lubricants are not a "fuel" within the meaning of RCW 82.04.433 and Rule 175.

We believe that our discussion of whether lubricants are fuel for purposes of the hazardous substance tax and petroleum product tax is equally applicable for the B&O tax deduction contained in RCW 82.04.433. Accordingly, Taxpayer's petition is granted in respect to cylinder lubricants and denied in respect to circulatory lubricants.

#### DECISION AND DISPOSITION:

Taxpayer's petition is remanded to the Audit Division for the proper adjustments consistent with this Determination.

DATED this 28th day of February, 1996.