

BEFORE THE INTERPRETATION AND APPEALS SECTION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition)	<u>D E T E R M I N A T I O N</u>
For Ruling of Tax Liability of)	
)	No. 88-15
)	
)	Registration No. . . .
. . .)	Pollution Control Cert. . . .
)	
)	
)	

[1] **RULE 242A:** POLLUTION CONTROL CREDIT -- "NET COMMERCIAL VALUE OF RECOVERED PRODUCTS" -- "COSTS INCURRED IN PROCESSING". Only those processing and overhead costs incurred after a "product" is "recovered" may offset the "net commercial value of recovered products" when calculating the pollution control credit for a single purpose facility.

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:

Request for written opinion and ruling regarding the calculation of "Net Commercial Value of Recovered Products" for the purpose of calculating the Pollution Control Tax Credit.

FACTS AND ISSUES:

Burroughs, A.L.J. -- In the course of an audit, the above-referenced Pollution Control Tax Credit Certificate, originally issued December 9, 1982, was adjusted by the Department. The Department reduced the tax credit available for 1986 by \$ [X], which amount represented the value of products recovered from the taxpayer's pollution control facility during 1981-82.

The salient facts were outlined by the taxpayer as follows:

[The taxpayer] operates a pulp mill at . . . Washington (the "Mill"). The Mill produces chemical pulps which are sold to customers who use them in the production of

plastics, rayon, film and other products. The original mill was built in the 1930's. In more recent years [the taxpayer] has been required to build a pollution control facility at the mill to remove pollutants from water being discharged from the mill.

The water pollution control facility at the mill consists of several components. The Primary Effluent Treatment System is designed to remove the heavy solids from pulp effluent. After passing through the primary system the effluent goes to a Secondary Effluent Treatment System which is designed to remove biological oxygen demand (BOD) from the pulp mill effluent. BOD is organic matter in the effluent, which if discharged into surface water would be decomposed by the action of microorganisms occurring naturally in the water. In this process the microorganisms consume oxygen from the water, reducing the amount of oxygen available to other populations, such as fish. Removal of BOD is accomplished by cultivating similar microorganisms in digestion tanks. As the microorganisms consume the organic matter their population grows. The microorganisms are then separated from the effluent as sludge. When the secondary treatment facility began operating in 1980, the sludge was disposed of by hauling it by truck from the mill to a landfill site. In 1982 [the taxpayer] completed construction of a sludge dewatering system and began pumping sludge from the Secondary Effluent Treatment System to this new system.

The Sludge Dewatering System consists of presses, evaporators, and centrifuges which remove additional water from the sludge and produce a high protein bi-product. Chemicals (flocculent and coagulant) are added to the sludge which enable the microorganisms to be extracted from the sludge material. After extraction the microorganisms are further processed by pressing, drying (using a centrifuge process) and pelletizing. This process requires labor in the form of operating and maintenance personnel; materials, including chemicals and supplies; and factory overhead including power, management costs, facility costs, and miscellaneous expenses. The following are the operational costs incurred in operating the sludge dewatering system during 1982:

Chemicals	\$ [X]
Electricity	[X]
Steam	[X]
Labor and Benefits	[X]
Maintenance	[X]
Miscellaneous Expenses	[X]

Facility Costs	[X]
Supplies	<u>[X]</u>
Total	\$ [X]

The above operating costs do not include any amounts representing the cost or depreciation of the sludge dewatering system itself. Depreciation alone for the sludge dewatering system during 1982 amounted to \$ [X]. During 1982 a portion of this by-product known as . . . [brand name] . . . , was being sold for use as cattle feed and the remainder was being used for boiler fuel in the steam boilers at the Mill.

In May of 1983 the Department audited the records of the Mill including records relating to [the] Certificate [here at issue]. As a result of this audit the tax credit allowed under [the] Certificate . . . was reduced by \$ [X], representing the gross sales receipts from sales of [the product], and by an additional \$ [X] representing the value of the boiler fuel used at the Mill, for a total reduction of \$ [X].

The Department has taken the position that the definition of "net commercial value of recovered products" set forth in WAC 458-20-242A and quoted above must be construed to mean those costs incurred in processing products after they have been recovered and that only processing, overhead, and sales costs incurred from the point of recovery to the point of sale are an allowable adjustment in arriving at net commercial value. The Department has further taken the position that the point of recovery for purposes of the credit is deemed to be the point at which the recovered material exits the facility According to the Department the operating and overhead costs of the facility in producing the materials were not allowable as adjustments in arriving at net commercial value The Department erroneously claims that these operating costs would occur even if there were no recovered material.

TAXPAYER'S EXCEPTIONS:

The taxpayer argues that the applicable statutory and regulatory language is clear, and that the "processing" referred to in WAC 458-20-242A has to be the processing which takes place in the facility since no other processing can have taken place at the point materials are "captured or recovered by the pollution control facility."

The taxpayer reasons that the legislature very specifically exempted the cost and depreciation of the facility itself from the

calculation of "net commercial value," and that if the legislature had also intended to exempt the costs of labor, materials, and overhead from the calculation of "net commercial value," it could have done so with language no more and no less specific than the language referring to cost and depreciation of the original facility. Since the legislature chose not to do this, the taxpayer concludes that it was its clear intent that the costs of operating facility should be taken into account in arriving at "net commercial value."

The taxpayer further notes that the Department's regulation also specifically provides that the cost or the depreciation of the facility shall not be included in the calculation of net commercial value. Since "facility" is specifically defined as the physical machinery, equipment, structures, etc., it is clear that the cost or depreciation referred to in the regulation is the cost of purchasing and installing the physical pieces which together make up the facility and the depreciation which may be assigned thereto. The taxpayer contends that if the Department, in drafting the regulation, had intended to also exclude the operating costs of the facility in determining net commercial value, it could have done so by adopting equally specific language, but that the regulation would then have been invalid because it would have been in contravention of the clear meaning of the statute.

The taxpayer contends that the policy reason behind the legislature's specific exclusion of installation and depreciation costs from the calculation of "net commercial value" was that the original credit allowed was already equal to the facility's cost. To allow the taxpayer to again deduct the original cost of the facility (or a depreciation amount based on that cost) in determining "net commercial value" would result in allowing that cost to be counted twice. No such double crediting would result if the operating costs of the facility were deducted in arriving at "net commercial value" because the operating costs never entered into the calculation of the credit in the first place.

In the alternative, it is argued that both the statute and the regulation are ambiguous with regard to the interpretation urged by the Department. The taxpayer, in its letter dated August 24, 1983, states that a Department employee represented the Department's position to be that the regulation must be strictly construed against the taxpayer. The taxpayer contends in rebuttal that the law of the state of Washington is to the contrary, since courts have consistently held that if there is any doubt as to the meaning of a tax statute it must be construed most strongly against the taxing authority and in favor of the taxpayer.

Finally, the taxpayer argues that it is not true that the cost of operating the sludge dewatering system would have been incurred even if there were no recovered material. This is clearly demonstrated by the fact that prior to completion of the sludge

dewatering system the sludge, which at that point had no commercial value, was being hauled away to a landfill site. By processing the sludge through the sludge dewatering system a product with commercial value is produced. The costs of operating the system are incurred in processing the sludge to produce the drier product which has commercial value. Both the statute and the regulations specifically provide that it is not the gross commercial value of any product produced which is deducted from the tax credit otherwise allowable, but only the net commercial value after the costs of producing the commercial product are taken into account.

In summary, the taxpayer takes the position that RCW 82.34.060 and WAC 458-20-242A, read as a whole, provides that the operating costs of a pollution control facility (that is to say the processing and overhead costs) are to be taken into account in determining the "net commercial value" of products "captured or recovered by the pollution control facility." This "net commercial value" is a deduction from the credit otherwise allowable. In the taxpayer's case, the operating costs exceeded the total commercial value of the products produced. Therefore, the adjustment made to the taxpayer's Pollution Control Tax Credit Certificate for the year 1982 should be reversed and the reduction of \$ [X] in credit restored.

ISSUE:

The issue to be decided here may be stated as follows:

Where a water pollution control facility as defined in RCW 82.34.010(1)(b) produces by-product materials which have commercial value, may the operating costs incurred in producing such materials at the facility (excluding the cost or depreciation of the facility itself) be deducted from such commercial value in arriving at "net commercial value" under RCW 82.34.060(2)(b) and WAC 458-20-242A?

DISCUSSION:

The term "water pollution control facility" for which the taxpayer obtained a pollution control certificate is defined in RCW 82.34.010(1) to include

any treatment works, control device or disposal system, machinery, equipment, structures, property or any accessories thereof installed or acquired for the primary purpose of reducing, controlling or disposing of sewage and industrial waste which if released to a water course could cause water pollution: Provided, That the word "facility" shall not be construed to include any control device, machinery, equipment, structure, disposal system or other property installed or constructed . . .

RCW 82.34.060 provides that the certificate entitles the taxpayer to a credit against various business and occupation taxes, which amount must first be offset by the "net commercial value of any materials captured or recovered:"

(2) When the operation of a facility has commenced and a certificate pertaining thereto has been issued, a credit may be claimed against taxes imposed pursuant to chapters 82.04, 82.12 and 82.16 RCW. The amount of such credit shall be 2% of the cost of a facility covered by the certificate for each year the certificate remains in force. Such credit shall be cumulative and shall be subject only to the following limitations:

. . .

(b) The net commercial value of any materials captured or recovered through use of a facility shall, first, reduce the credit allowable in the current reporting period and thereafter be applied to reduce any credit balance allowed and not yet utilized: provided, that for the purposes of this chapter the determination of 'net commercial value' shall not include a deduction for the cost or depreciation of the facility.

The Washington Administrative Code Section 458-20-242A provides for the implementation of RCW 82.34.060 with regard to a single purpose facility as follows:

UTILIZATION OF EXEMPTION AND CREDIT

SALES TAX EXEMPTION. The original acquisition of the facility, or the modification (meaning a substantial improvement resulting from added capacity in the removal of pollutants from the air or water) of an existing facility by the holder of a certificate shall be exempt from sales tax imposed by Chapter 82.08 RCW and use tax subsequent to the effective date of the certificate . . . This exemption does not extend to servicing, maintenance, repairs or replacement parts after a facility is complete and placed in service

BUSINESS AND OCCUPATION, USE, OR PUBLIC UTILITY TAX CREDIT. With respect to a facility which has been placed in operation and for which a certificate has been issued, a tax credit not exceeding 2% of the cost of a new facility or of the depreciated cost of an existing facility may be taken for each year the certificate is in force. Such credit may be claimed against business and occupation, use, or public utility tax liability; however, it shall not exceed 50% of the tax liability for any reporting period for which it is claimed nor shall

the cumulative amount of credit allowed for any facility exceed 50% of the cost of the facility.

CREDITS TO BE REDUCED. Credits claimed will be reduced by the net commercial value of materials captured or recovered by the pollution control facility.

For purposes of the above provisions the term "net commercial value" is defined as follows:

(3) "Net commercial value of recovered products" shall mean the value of recovered products less the costs incurred in processing, including overhead costs, and costs attributable to their sale, or other disposition for value. The term shall not include a deduction for the cost or depreciation of the facility. (Emphasis added.)

The definition of "net commercial value of recovered products" directly relates to the determination of the amount of a tax credit and therefore must be strictly construed. Budget Rent-A-Car v. Dept. of Revenue, 81 Wn.2d 171, 174 (1972).

Thus, a strict reading of the term "costs" in Rule 242A would require inclusion only of those costs incurred in processing products after they have been recovered, since it is only the costs of "processing" already "recovered products" which are allowed to reduce the "net commercial value of recovered products" (the term "overhead costs" merely expanding the scope of such "processing"). In short, "costs" must be read to include only those "overhead costs" which relate to the processing of products after they have been "recovered." This has been the Department's consistent interpretation of this rule over the course of many years.

It is recognized that, when the facility was first in operation, the recovered material, in sludge form, was taken and buried. We would agree that the materials in sludge form were "recovered" materials. The Department of Ecology subsequently refused to renew its permission to use the landfill disposal system, however, and the taxpayer was forced to develop another system to dispose of the pollutants. The taxpayer's solution was to add the sludge dewatering system to the facility so that the materials could be commercially disposed of, even though at a financial loss.

We are of the opinion that the addition of the sludge dewatering system added another step to the pollution control system, and effectively extended the "capture" or "recovery" point of the pollutant materials from the time they were in the form of wet sludge (which material was then hauled and buried) to the point at which the materials were dried and pelleted into cattle feed additives and boiler fuel. Thus, the "overhead costs" relative to the sludge dewatering system were attributable to the processing of

pollutant materials before they were "recovered," and thus cannot be taken into account in reducing the "net commercial value of recovered products."

As to the taxpayer's arguments regarding legislative intent, well-settled rules of statutory construction are that

. . . where a statute is ambiguous, the construction placed upon it by the department or an officer charged with its administration, while not binding upon the courts, is entitled to considerable weight in determining the intention of the legislature"

and

. . . "where the legislature has silently acquiesced" in the administrative construction [of a statute] by failing to amend the particular act, "the executive construction is accepted generally by the courts as persuasive."

Smith v. Northern Pac. R. Co., 7 Wn.2d 652,

There has been no evidence that the legislature has objected to the Department's longstanding construction and interpretation of RCW 82.34.060 as set forth in Rule 242A and the determinations issued thereunder. Therefore, it must be assumed that the Department's interpretation carries out the legislature's true intent.

RULING:

Only those processing and overhead costs incurred after a "product" is "recovered" may offset the "net commercial value of recovered products" when calculating the pollution control credit for a single purpose facility.

DATED this 29th day of January 1988.