

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

In the Matter of the Petition            ) D E T E R M I N A T I O N  
For Refund of                                 )  
                                                      ) No. 89-551  
                                                      )  
                                                      ) Registration No. . . .  
                                                      )  
                                                      )

- [1] RULE 136: B&O TAXES -- MANUFACTURING -- BYPRODUCT -- MANUFACTURED IN CONJUNCTION WITH A MARKETABLE PRODUCT -- VALUE -- REFINERY GAS. The manufacturing tax applies to both products and byproducts of the same manufacturing process measured by the gross proceeds of sale of all products and byproducts sold, plus the value of any byproduct produced and put to commercial or industrial use.
- [2] RULE 112: & RCW 82.04.450 -- B&O TAXES -- MANUFACTURING -- VALUE OF PRODUCTS -- COMMERCIAL SALES -- COST -- ALTERNATIVE METHODS. RCW 82.04.450 and Rule 112 do not limit a determination of the "value of products" solely to a comparison of similar commercial sales, but allows for other alternative methods. In the absence of comparable sales of similar products, the cost basis is one of several alternatives that may be used. Another alternative is to use sales of similar products as a guide.
- [3] RULE 112 -- B&O TAXES -- MANUFACTURING -- VALUE OF PRODUCTS -- WASTE. Still gas which is flared into the atmosphere, because it could not be sold to third parties, and from which the taxpayer derived no benefit, is considered a waste product with no taxable value.

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.

TAXPAYER REPRESENTED BY: . . .  
DATE OF TELEPHONE CONFERENCE: May 25, 1989

#### NATURE OF ACTION:

A taxpayer petitions for a refund of B&O taxes paid in error.

#### FACTS AND ISSUES:

Okimoto, A.L.J. -- . . . , (taxpayer) operates an oil refining plant in . . . , Washington. In the course of reporting its business activity to the Department of Revenue, (Department), the taxpayer has been paying Manufacturing B&O tax on still gas. Still gas is automatically produced in the refining process of crude oil and although it has no commercial market value, it can be burned as fuel in the refining process. In fact, the taxpayer has a specially designed refining system which enables it to recapture the still gas and either funnel it into the burners to be used as fuel, or in the alternative, flare the excess gas into the atmosphere. The taxpayer describes the refining process as follows:

1. The crude oil (a mud like substance) is boiled by burners in a pressure cooker type apparatus.
2. This boiling process produces vapors with differing weights and densities which accumulate at different levels in the vertical columns of the cooker. This results in each product or byproduct, (jet fuel, gasoline, diesel, and still gas) forming a series of layers inside the columns. Each layer has holes in the side of the columns which allow the individual products to be withdrawn from the refining process and either stored, further refined, or otherwise disposed of.
3. Still gas vapors are withdrawn from the refining process and either funneled back into the burners and utilized as fuel, or flared into the atmosphere. Flaring occurs only if the amount of still gas produced exceeds the amount of fuel required to run the burners. Because still gas is too volatile to be stored, it must be either immediately burned as fuel or flared.

The taxpayer concedes that it derives significant benefit from the use of still gas as a fuel, and if it were not available, the taxpayer would be required to purchase some other source of energy. Nevertheless, the taxpayer argues that it is entitled to a refund on B&O taxes paid on the gas for the following reasons:

1. The business and occupation tax does not separately apply to byproducts produced as part of the process of manufacturing a marketable product. In essence, the taxpayer argues that once the Manufacturing tax has been paid based on the sales price of the marketable product, its tax liability has been satisfied. This is because all costs attributable to manufacturing both the marketable product and the byproduct have been recovered in the sales price of that marketable product. The taxpayer further argues that to apply Manufacturing tax on both the product and the byproduct constitutes a double taxation.

2. In the alternative, if the business and occupation tax is found to apply, the taxpayer argues that the tax must be applied based on the commercial market value of the byproduct to third parties which it contends is zero. In support of this the taxpayer states in its petition:

The gas has no market value because of (i) its high free hydrogen content (which makes it too explosive for conventional transportation), (ii) its high water vapor content (which makes it unsuitable for conventional fuel uses), and (iii) its high sulfur content (which makes it unsuitable for commercial uses). In order to safely dispose of the still gas, . . . burns it at its . . . refinery.

3. The taxpayer also argues that natural gas and still gas are not similar products within the meaning of RCW 82.04.450 and WAC 458-20-112 (Rule 112). Because they are not similar products, the taxpayer argues that Rule 112 requires that the cost method of valuation be used. The taxpayer further argues that because it allocates all of the costs for producing still gas to the marketable products that it sells, and not to the still gas, then its cost of producing still gas is zero.

#### ISSUES:

1. Is the manufacturing tax applicable to a substance that is produced in the refining process and then immediately reintroduced and burned as fuel in that same refining process?

2. If the manufacturing tax is applicable to the production of still gas, and there are no sales of similar products, then how is the value of the product to be determined?

3. What is the value of a manufactured byproduct which can not be sold to third parties, and is not put to commercial or industrial use by the manufacturer?

#### DISCUSSION:

[1] RCW 82.04.120 imposes the Manufacturing B&O tax upon "... all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use ..." RCW 82.04.130 further defines "commercial or industrial use as:

... the following uses of products, including byproducts, by the extractor or manufacturer thereof:

- (1) Any use as a consumer; and
- (2) The manufacturing of articles, substances or commodities. (Emphasis ours.)

RCW 82.04.210 defines "byproduct" as:

... any additional product, other than the principal or intended product, which results from extracting or manufacturing activities and which has a market value, without regard to whether or not such additional product was an expected or intended result of the extracting or manufacturing activities.

RCW 82.04.450 defines "value of products" as:

- (1) The value of products, including byproducts, extracted or manufactured shall be determined by the gross proceeds derived from the sale thereof whether such sale is at wholesale or at retail, to which shall be added all subsidies and bonuses received from the purchaser or from any other person with respect to the extraction, manufacture, or sale of such products or byproducts by the seller, except:

(a) Where such products, including byproducts, are extracted or manufactured for commercial or industrial use; ...

(2) In the above cases the value shall correspond as nearly as possible to the gross proceeds from sales in this state of similar products of like quality and character, and in similar quantities by other taxpayers,

...

We believe the Legislature meant to impose the manufacturing tax on the value of all products or byproducts that are either produced for sale or produced for commercial or industrial use that result from that manufacturing process. This is clearly indicated in the above statute by the use of the plural in the phrase "value of products, including byproducts." Such language must mean that the "value of products" subject to manufacturing tax is the sum of the gross proceeds of product sales, and the value of products or byproducts put to commercial or industrial use. Nor do we believe that such an interpretation constitutes a "double taxation." On the contrary, this interpretation merely provides for a single incidence of taxation on a single manufacturing process based on the full "value of products" produced.

Furthermore, if the taxpayer had sold the still gas, or utilized it to heat another building, there would be no question that the gas would be subject to tax. This result does not change simply because the taxpayer has decided to use the product in the same manufacturing process from which it was produced. In fact, we find this case to be closely analogous to the production and use of hog fuel by the lumber industry. Hog fuel consists of chips, bark and sawdust, (waste products from the production of lumber) which were formerly discarded, but which are now burned as fuel for the production of heat or power. The production of hog fuel has uniformly been subject to the Manufacturing B&O tax. The legislature has specifically exempted from the use tax "the use of fuel by the extractor or manufacturer thereof when used directly in the operation of the particular extractive operation or manufacturing plant which produced or manufactured the same." RCW 82.12.0263. The fact that this specific exemption was allowed under the use tax and not under the business and occupation tax is a clear indication that the Legislature intended the latter tax to apply.

[2] Although the taxpayer contends that commercial sales, or sales to third parties are the sole means of determining

"market value," we do not agree. Indeed, this very issue covering the same type of gas was specifically addressed in a case heard before the Board of Tax Appeals. Texaco, Inc. v. Department of Rev., Docket # 70-4, (1970). While finding that commercial sales were only one method of determining the "market value" of refinery gas, the Board stated:

Thus under exceptions (1) and (2) [of RCW 82.04.450] a market value for byproducts can be established on a basis other than that of commercial sales prices. Commercial sales prices appear as only one basis of establishing market value. We are of the opinion the exception (1) of this statute is definitely applicable to the appellant's refinery gas in issue in this appeal. We likewise are of the opinion the value placed upon the gas by the appellant and agreed to by the respondent is reasonable and is the proper value under RCW 82.04.450 to be used in measuring the assessment made by the respondent.

We also are not persuaded by taxpayer's argument that WAC 458-20-112 (Rule 112) requires the cost method be used in determining the value of the still gas. Rule 112 merely states:

In the absence of sales of similar products as a guide to value, such value may be determined upon a cost basis. (Emphasis ours.)

By using the word "may," Rule 112 leaves the issue of whether the cost method should be used under a specific set of facts to be determined on a case by case basis. Certainly, if the cost basis is neither a practicable, nor reasonable method of valuation, the rule does not require that it be used. It is merely one of several options available to the Department, and the taxpayer. In this instance where the taxpayer allocates no costs to the production of still gas, it is clearly inappropriate.

We believe that another option available to both the Department and the taxpayer is the valuation of still gas using the "sales of similar products as a guide." We note that this reasoning is consistent with the determination made by the Board of Tax Appeals in the Texaco case. In that case, the Board stated:

... It was explained the auditor considered this value [of refinery gas] to be reasonable when compared to the value placed upon such gas by other refineries and when compared to the price charged for natural gas. In making the comparison with natural gas, the difference in the qualities of the two gases was taken into consideration. (Emphasis and brackets ours.) Texaco, at page 2.

The Board later added:

We are of the opinion that the comparison made by the respondent between the value placed refinery gas and the commercial charges made for natural gas meets the requirements of the last paragraph of RCW 82.04.450, Both gases perform the same function even though there is a difference in their BTU qualities. The same burners and method of delivery to the burners are used, taking into consideration that the source of supply is different. Texaco, at page 3.

Clearly, the refinery gas and natural gas were not identical products sold under identical circumstances, but were sufficiently similar in nature from which the Board was able to use those sales "as a guide." When utilizing the purchase price of natural gas as a guide, the differences in BTU's of the respective gases, and other differences in quality must be taken into consideration before determining the appropriate value of the product produced. Therefore, to the extent that the taxpayer has not taken into account the differences in BTUs of still gas and natural gas or of the impurities contained in the still gas which make it a less desirable fuel, we believe the valuation to be in error. The taxpayer is directed to reanalyze its reporting of still gas and recompute its value after taking into consideration the differences in the burn quality of the two gases. Subject to verification of this recomputed valuation by the audit section, the taxpayer's petition is partially sustained.

[3] The taxpayer also contends that it has paid B&O tax on all still gas produced, including that portion of the still gas that is flared into the atmosphere. We agree with the taxpayer that the value of still gas which can neither be sold to third parties, nor put to commercial or industrial use by the taxpayer and must be disposed of by flaring into the atmosphere has no taxable value. The taxpayer is directed to determine the amount of Manufacturing tax that it has paid on

still gas that is flared into the atmosphere. Accordingly, subject to verification by the audit section, the taxpayer's petition is sustained on this issue.

DECISION AND DISPOSITION:

The taxpayer's petition is sustained in part. The taxpayer's file shall be remanded to the audit section for adjustment consistent with this determination.

DATED this 21st day of December 1989.