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FEDERAL COURT HOLDS THAT A “SALE” BETWEEN AFFILIATES IS NOT A “SALE” FOR SALES AND USE TAX PURPOSES

By

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In *School Board of the Parish of St. Charles v. Shell Oil Co.*, 2007 U.S. Dist. LEXIS 41183 (June 6, 2007), the Federal District Court for the Eastern District of Louisiana enumerated the following principals:

1. A sale in form is not necessarily a sale in substance. The Court will look to the substance of the transaction to determine if a sale in form is really a sale for sales tax purposes. Even if the parties structure a transaction as a sale, it will only be taxable as a sale if the underlying substance is a sale.
2. If there is no market for an asset, i.e., no willing independent third party buyer for an asset, the asset does not have a market value. Therefore, it does not have a cost price and is not subject to a use tax.
3. Waste gases, in certain circumstances, are exempt from use tax as byproducts even though there may be some level of further processing and fabrication prior to their use as fuel.

The case involved Shell Chemical Company (“Chemical”), Shell Norco Refining Company (“Refining”), and Shell Oil Company’s polypropylene unit, all of which shared facilities at a manufacturing and refining plant in St. Charles Parish, Louisiana. Chemical and Refining each produced waste gases which were routed to a Fuel Gas System. The Fuel Gas System, co-owned by Chemical and Refining, was a series of pipes used to gather and distribute the waste gas streams for use as fuel for boilers and furnaces throughout the Refining and Chemical complexes. Because the waste gases are not sufficient enough alone to provide the required fuel, Chemical, as operator of the Fuel Gas System, purchased natural gas on behalf of both owners and homogenized and lowered the velocity of the gases in the Blend Drum to allow for safer and more consistent burning of the blended fuel.

As operator of the Fuel Gas System, Chemical allocated the fuel costs between itself and Refining on a neutral basis, that is to say, neither derived a profit from the other from the operation or the contents of the Fuel Gas System. Each was credited for the amount of waste gas it deposited into the Fuel Gas System, and each was charged for its use of the blended fuel coming out of the system. In order to facilitate the accounting of each facility’s energy use, all waste gases provided to the Fuel Gas System

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were assigned the same cost as a similar unit of natural gas. During later periods, Refining and Chemical went as far as to account for the costs of the Fuel Gas System using invoices and cash payments to settle credits and debts, e.g., sales.

The United States District Court for the Eastern District of Louisiana held that the alleged sales were not subject to St. Charles Parish sales or use taxation. The Court held that the alleged sales were not subject to sales tax because the “sales” were not sales for sales tax purposes. The court reasoned that although the accounting system used by the parties provided the appearance of a sale, in substance it functioned to track waste gas in and out of the Fuel Gas System and to allocate the costs of operating the Fuel Gas System. No new product was fabricated and no consideration was provided from one party to the other. Therefore, in substance there were no sales, so no sales tax could be imposed on the accounting.

The Court went on to hold that the waste gas was not subject to use tax because the waste gas had no value, thus, it had no “cost price” for which to determine the tax. Although, the parties assigned a value to the waste gases equal to the value of natural gas, it was only for accounting purposes. Further, the waste gases could not be sold or transported through the U.S. natural gas pipeline system. Because the court found that there was no willing third party buyer for the waste gases, there was no market for waste gases. Even though the waste gas has utility and value for Chemical and Refining, the Court, citing Louisiana case law, held that value in use is not indicative of the market value. Considering all these facts, the Court held that the waste gases did not have a market value, and as a result, were not subject to a use tax.

The Court went on to alternatively hold that, even if the waste gases were found to have a market value for use tax purposes, the waste gases were exempt under La. R.S. 47:305(g) and (h) as residues or byproducts of the processing of raw materials into articles for sale. Generally, this exemption is not applicable if the byproduct is subject to further processing. However, the Court held that when the waste gases pass through the Blend Drum “the streams are not fabricated into a new product for sale.” Therefore, the exemption would apply.

It is important to note that this holding is not limited only to the oil and gas industry. Rather, transactions between affiliated entities that are accounted for as sales solely for accounting purposes may not be “sales” for sales tax purposes, with the result that these transactions would not be subject to Louisiana state or local sales tax.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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