ST 98-6
Tax Type: SALES TAX
Issue: Whether the Sale of Refinery Fuel Gas Establishes A Fair Market Value

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS v. **TAXPAYER** Taxpayer	Case No. Claim for Credit Administrative Law Judge Mary Gilhooly Japlon

<u>RECOMMENDATION FOR DISPOSITION</u>

<u>Appearances:</u> Special Assistant Attorney General Alan Osheff on behalf of the Illinois Department of Revenue; Schain, Firsel & Burney, Ltd., by Brian L. Wolfberg and Jerome Wiener, on behalf of TAXPAYER

<u>SYNOPSIS:</u>

This matter comes on for hearing pursuant to the timely protest by TAXPAYER (hereinafter "taxpayer" or "TAXPAYER") of the Notice of Department's Tentative Determination of Claim (hereinafter "Notice") wherein the Department denied the taxpayer's claim for credit.

At hearing, Messrs. WITNESS A, WITNESS B, WITNESS C and WITNESS D testified on behalf of the taxpayer. The parties filed two stipulation of facts (hereinafter "Stip."). At issue is Use Tax assessed by the Department on the taxpayer's use of refinery fuel gas pursuant to section 3-10 of the Use Tax Act (35 ILCS 105/1 *et seq*.). More specifically, the issue is whether the sale of refinery fuel gas between TAXPAYER and CORPORATION establishes a fair market value under the provisions of section 3-10 of the Use Tax Act, so as to subject the taxpayer to use tax liability above the amount self-imposed by the taxpayer.

Following the submission of all evidence and a review of the record and briefs filed herein, it is recommended that this matter be resolved in favor of the taxpayer.

FINDINGS OF FACT:

1. TAXPAYER has paid $1,027,467 in tax and $190,537 in interest, for a total of $1,218,004, through a check in the amount of $1,215,524, and a credit in the amount of $2,480 developed pursuant to an audit by the Illinois Department of Revenue for the period of November 1988 through June 1990 ("audit period"). (Amended Stip.).
2. The taxpayer has borne the burden of these amounts, and has not shifted the burden to anyone else. (Stip., par. 7).
3. The taxpayer filed a claim for credit in the amount of $1,218,004 on January 31, 1991 for the period of November 1988 through June 1990. (Stip. par. 2; Dept. Ex. No. 1).
4. The Department issued a Notice of Department's Tentative Determination of Claim on March 23, 1992. (Stip., par. 3; Dept. Ex. No. 3).
5. The taxpayer filed a timely protest of the Department's denial of its claim. (Stip., par. 4; Dept. Ex. No. 3).
6. The amounts paid by TAXPAYER represent Use Tax assessed by the Department for waste products utilized in the taxpayer's refinery operations in both VICTITIOUS CITY, Illinois, and VICTITIOUS CITY, Illinois above the amounts self-assessed by the taxpayer for the audit period. (Stip. par. 5).

7. If the Department's assessment is found to be invalid, the amounts self-assessed by the taxpayer shall be considered to be correct. (Stip., par. 5).
8. The taxpayer is a purchaser of crude oil which, when refined, produces, among other things, the waste product at issue. (Stip., par. 6).
9. TAXPAYER's VICTITIOUS CITY and VICTITIOUS CITY refineries are fuel refineries, as opposed to petrochemical refineries. They produce gasoline, diesel fuel, propane and asphalt. (Tr. p. 18).
10. The taxpayer utilizes the waste product (refinery gas) as an energy source in the process of producing saleable products at both its VICTITIOUS CITY, Illinois and VICTITIOUS CITY, Illinois refineries. (Stip., par. 8).
11. The taxpayer has made no sales of refinery fuel during the audit period other than to B.T.L. of Illinois, Inc. under an Agreement dated September 16, 1985 and amended effective July 1, 1988. (Stip., par. 9).
12. The basis for reporting Use Tax on refinery fuel gas at TAXPAYER's VICTITIOUS CITY and VICTITIOUS CITY refineries during the period of November 1988 through June 1990 was Well Head Stop Price for natural gas as reported each month in the publication "National Gas Week." (Stip.)
13. Refinery fuel gas is a gas that is an unwanted material in the refining process that is generated by unwanted chemical reactions in some of the processes that use catalysts. (Tr. p. 18).
14. The refining process uses catalysts to change the molecular structure of the oil molecules; some gases are necessarily formed as waste byproducts. (Tr. pp. 18, 19, 20).

15. The refinery fuel gas system collects the different gas streams from different parts of the refinery, mixes them together, removes sulfur from the gases and redistributes the gas to the refinery heaters or furnaces for burning. (Tr. p. 19).
16. TAXPAYER primarily utilizes this waste byproduct in its 25 furnaces and 4 boilers. (Tr. pp. 19, 20).
17. The chemical plant was originally constructed, owned and operated by TAXPAYER. (Tr. p. 21).
18. The chemical plant was originally part of the refinery, and is surrounded by the refinery. (Tr. pp. 21, 24).
19. The refinery and the chemical plant are interconnected by pipelines, one of which transports refinery fuel gas from the refinery to the chemical plant. (Tr. p. 25).
20. The chemical processes that transpire at the chemical plant require heat input; the refinery fuel gas supplies that need. (Tr. p. 26).
21. Natural gas differs from fuel gas in that natural gas is derived from naturally occurring underground gas formations. It is transported on pipeline systems, and is about 95 percent methane. (Tr. p. 27).
22. Refinery fuel gas is produced as a waste by-product of refining operations, which are essentially chemical transformation operations. (Tr. p. 27).
23. Refinery fuel gas is not a desired product as it degrades the oil. It consists of 30 percent methane. (Tr. p. 27).
24. The quality of refinery fuel gas is not consistent; it is therefore not reliable for residential and commercial use. (Tr. p. 28).
25. Natural gas is marketable. (Tr. p. 29).

26. Refinery fuel gas is not marketable, and was not marketable during the audit period for several reasons. (Tr. pp. 29, 33, 57 78, 96).

27. For instance, refinery fuel gas would contaminate natural gas if it was put into the natural gas distribution network due to the fact that the specification for natural gas is about 95 percent methane. (Tr. p. 29).

28. Furthermore, given the Illinois Commerce Commission regulations concerning natural gas, refinery fuel gas could not be transported through a natural gas pipeline. (Tr. p. 95; Taxpayer's Ex. Nos. 4, 5).

29. In addition, refinery fuel gas is not marketable as it is unreliable due to the fact that its chemical composition changes from time to time. (Tr. p. 29).

30. This unreliability can cause distruptions to the facility itself; this is a problem in that the chemical industry is capital intensive, so if the facility breaks down there are tremendous financial consequences. (Tr. pp. 56-57).

31. The sulfur composition and hydrocarbon component is higher in refinery fuel gas than natural gas, and it has a much higher water content. These factors affect its ability to be transported via pipeline. (Tr. p. 30).

32. Refinery fuel gas cannot be transported by truck, either, unless the truck is a pressure vehicle built according to the standards of the American Society of Mechanical Engineers. (Tr. p. 38).

33. This would not be economically feasible as the truck would only be able to hold a very small quantity of gas. (Tr. p. 39).

34. In 1985 CORPORATION purchased the chemical phenol manufacturing facilities in VICTITIOUS CITY from TAXPAYER for a purchase price of $23 million for fixed assets

(land, building, machinery and equipment). Inventory and some receivables were also purchased. (Tr. pp. 44, 48-49).

35. The purchase of the plant was a strategic move by CORPORATION to become one of the major specialty thermosetting resin manufacturers in North America. (Tr. p. 45).
36. There were only three plants in North America of the size needed by CORPORATION to accomplish this goal; the only one on the market was TAXPAYER’s chemical plant. (Tr. p. 46).
37. The purchase price was originally $50 million. However, a purchase price of $23 million was negotiated when CORPORATION approached TAXPAYER a year after the plant was initially offered for sale. (Tr. pp. 46-47).
38. CORPORATION required that TAXPAYER continue certain services to the chemical plant in order to keep it operating. (Tr. p. 49).
39. TAXPAYER had certain requirements of CORPORATION, such as requiring BLT to use TAXPAYER’s refinery fuel gas and steam, because the steam was generated from the fuel gas. (Tr. pp. 49, 73).
40. The steam was used to heat the plant; the fuel gas was used for the cumene heater. (Tr. p. 49).
41. If CORPORATION did not agree to purchase the fuel gas as part of the transaction, TAXPAYER would not have sold its refinery to CORPORATION. (Tr. pp. 50, 52, 53; Taxpayer’s Ex. No. 6).
42. The fuel agreement between TAXPAYER and CORPORATION was part of the larger asset purchase agreement. (Tr. p. 51).

43. The fuel agreement contained a provision that any sale of the chemical plant by CORPORATION had to be approved by TAXPAYER; approval was contingent upon the new purchaser's acceptance of the refinery fuel gas. (Tr. p. 55).

44. CORPORATION negotiated a two year price cap on the fuel gas based upon TAXPAYER's internal documents concerning TAXPAYER's costs of transfering the fuel gas from their refinery to the chemical plant. (Tr. p. 54).

45. TAXPAYER determined the net present value of the fuel gas in pricing it as part of the deal; TAXPAYER needed to recoup what it could due to the asset sale price of $23 million. (Tr. pp. 50, 55).

46. When the contract was negotiated, if CORPORATION had a choice, it would have used natural gas, rather than fuel gas, to fuel its operations. (Tr. pr. 57).

47. Due to the unreliability of the refinery fuel gas, CORPORATION's chemical plant was not able to operate due to breakdowns a considerable amount of time during the first couple of years after the sale. (Tr. p. 64).

48. The fact that the refinery fuel gas cost CORPORATION less than natural gas was offset by the cost of repairing plant breakdowns. (Tr. p. 64).

49. CORPORATION sold the chemical plant to INDUSTRIES in 1995. (Tr. p. 69).

50. Aside from the agreement wherein CORPORATION had to use fuel gas from TAXPAYER's refinery, CORPORATION also had to use steam from the refinery. (Tr. p. 73).

51. Fuel gas ran the boiler that created the steam at TAXPAYER's refinery. (Tr. p. 73).

52. Ultimately, CORPORATION exercised its option to install its own boiler at the chemical plant so it could generate its own steam. (Tr. p. 73).

53. However, in accordance with the steam agreement, CORPORATION still had to use the equivalent amount of fuel gas to operate its own boiler that was used to run the boiler at the refinery that produced the steam supplied to CORPORATION. (Tr. p. 74).

54. An amendment to the original fuel contract provided that CORPORATION would still receive a 10 percent discount on the fuel gas if it only purchased it from TAXPAYER, eliminating any alternate source. (Tr. pp. 76-77; Taxpayer's Ex. No. 7).

55. The taxpayer had been self-assessing Use Tax based upon the Well Head Stop charged by TAXPAYER to CORPORATION, and subsequently, to INDUSTRIES. (Stip., Tr. p. 103).

CONCLUSIONS OF LAW:

Pursuant to an audit, the Department assessed Use Tax liability on a certain waste product, refinery fuel gas, consumed by the taxpayer. The taxpayer, TAXPAYER Refining & Marketing, Inc., subsequently paid the liability and filed a claim for credit. Due to the Department's denial of the claim, the taxpayer protested and requested a hearing.

The taxpayer had been self-assessing Use Tax based upon the Well Head Stop Price for Natural Gas, as reported monthly in the publication "National Gas Week", based upon TAXPAYER's assertion that there were no Illinois sales of the refinery fuel gas from which to determine a sales price. The Department, on the other hand, assessed a liability based on taxpayer's sale of the property to CORPORATION for a price greater than the amount ascribed to the gas by TAXPAYER. A fuel agreement between TAXPAYER and CORPORATION dated September 16, 1985 sets forth the amounts TAXPAYER charged CORPORATION for the gas. The Department considers the sales by TAXPAYER to CORPORATION to be fair market sales, and considers the selling price to be the fair market value, upon which the Use Tax is based. The taxpayer, however, asserts that the fuel agreement does not set a fair market value for refinery fuel gas as required by the pertinent statute because there is no market for this product.

The pertinent statute at issue, 35 **ILCS** 105/3-10, is set forth as follows:

> Rate of tax. Unless otherwise provided in this Section, the tax imposed by this Act is at the rate of 6.25% of either the selling price or the fair market value, if any, of the tangible personal property. In all cases where property functionally used or consumed is the same as the property that was purchased at retail, then the tax is imposed on the selling price of the property. In all cases where property functionally used or consumed is a by-product or waste product that has been refined, manufactured, or produced from property purchased at retail, then the tax is imposed on the lower of the fair market value, if any, of the specific property so used in this State or on the selling price of the property purchased at retail. For purposes of this Section, "fair market value" means the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. The fair market value shall be established by Illinois Sales by the taxpayer of the same property as that functionally used or consumed, or if there are no such sales by the taxpayer, then comparable sales or purchases of property of like kind and character in Illinois.

The above-referenced statute specifically provides that in cases where the property consumed is a waste product that has been refined from property purchased at retail, the Use Tax is imposed on the lower of the fair market value, if there is any, of the specific property used, or on the selling price of the property purchased at retail. The specific issue to be decided is whether there is a market for the refinery fuel gas, so as to determine the fair market value.

The facts of record establish that CORPORATION desired to purchase the TAXPAYER chemical plant because it was one of three plants in North America of the size necessary to supply CORPORATION's need for phenol, yet small enough so that CORPORATION did not have to become a marketer of this raw material. Phenol was necessary for CORPORATION's production of its main product. The TAXPAYER plant was also of interest to CORPORATION because at the time that CORPORATION was in the market for a plant, it was the only one available for sale. The purchase price of the chemical plant was $23 million; the previous year it had been for sale for $50 million. The purchase price included fixed assets; a separate fuel agreement contained the requirements that CORPORATION had to purchase refinery fuel gas and steam that was generated by the refinery fuel gas from TAXPAYER's plant. There is substantial testimony that there would have been no sale of the chemical plant's assets unless CORPORATION agreed to purchase the refinery fuel gas. The taxpayer agreed to a price for the fuel gas as set forth in TAXPAYER's financial statements. This price was based upon TAXPAYER's cost of transferring fuel gas between its own refinery and the chemical plant prior to CORPORATION's purchase.

In order to determine fair market value, there must be a market wherein willing buyers and sellers, under no compulsion and having reasonable knowledge of the relevant facts, buy and sell property. The facts establish that CORPORATION needed the TAXPAYER plant in order to expand in the industry, and that it could not acquire the facility without agreeing to purchase the refinery fuel gas, as well as steam. In the case of Reynolds v. Coleman, 173 Ill.App.3d 535, 594-595 (1988), the Court opined as follows:

> The fair market value of property is the amount of money which a purchaser, willing but not obligated to buy the property, would pay an owner, willing but not obligated to sell the property (citations omitted), … "and no account should be taken of values or necessities peculiar to either party" (citation omitted). The concept may be proven by an actual sale of the property, or by sales of properties that are reasonably comparable in locality, quality, character and usefulness to the valued property, so long as they are made freely in an open market. (Citations omitted). Evidence adduced to establish a sale must show that the sale was for money, and not wholly or partially for a consideration other than money." (Citation omitted).
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> Under these principles, the … transaction was not a "sale" capable of evidencing the fair market value of the Whitehall as a

> matter of law. The evidence … clearly demonstrates that the … transaction was part of a complex arrangement involving a tax shelter syndication and was not a conveyance of property to a typical purchaser from a typical seller. The transaction was not, therefore, governed by the open market considerations necessary to set fair market value, but instead was governed by the peculiar necessities and requirements of the Whitemont syndication.

In the case at bar, it is clear that due to necessities and requirements peculiar to both TAXPAYER and CORPORATION, the fuel agreement was a necessary part of the larger asset agreement. The transaction was not governed by open market considerations necessary to determine fair market value. There was in fact pressure exerted on CORPORATION to purchase the refinery fuel gas by TAXPAYER as there would have been no sale of the much desired chemical plant otherwise. In other words, CORPORATION was not a "willing buyer" under no "compulsion to buy" within the meaning of section 3-10 of the Use Tax Act. In fact, as part of the asset purchase agreement, CORPORATION had to accept the fuel agreement which provided, among other things, that TAXPAYER would have the right to approve any sale of the plant by CORPORATION, and that approval was contingent on the fuel gas being consumed by the new purchaser.

In addition, in order to determine a fair market value, there must be a market for the property. There is an abundance of evidence that there is no market for refinery fuel gas for many reasons relating to its intrinsic qualities. It is not a reliable product as its consistency varies greatly. This makes it ill-suited for residential or commercial use. Furthermore, there is no distribution system for refinery fuel gas. Its impurities would contaminate the natural gas pipeline system, and its high water content would result in freezing of the pipelines. Transportation by truck is not economically or physically feasible. CORPORATION itself would have preferred the use of natural gas due to the unreliability of refinery fuel gas.

TAXPAYER was able to transport the refinery fuel gas to the chemical plant owned by CORPORATION via pipeline and the steam via other connections due to the close physical proximity of the plant. The plant and refinery were tightly linked both in terms of supplying services and raw materials. This is a different situation, however, from transporting the gas for residential or commercial use.

Furthermore, in defining fair market value, section 3-10 of the Use Tax Act speaks of looking to more than one sale. The pertinent language is as follows:

> The fair market value shall be established by Illinois Sales by the taxpayer of the same property as that functionally used or consumed, or if there are no such sales by the taxpayer, then comparable sales or purchases of property of like kind and character in Illinois.

Obviously, as the evidence is conclusive that there is no market for refinery fuel gas, and there was no market during the taxable period, there are no other sales which can be used to determine fair market value. The one sale that was looked at (i.e., the transaction at issue) was not a typical sale involving a willing buyer under no compulsion to purchase the refinery fuel gas. Rather, the purchaser's peculiar need for the chemical plant offered for sale by TAXPAYER necessitated that it agree to also purchase the refinery fuel gas. Otherwise, there would have been no sale of the chemical plant. Certainly, fair market value cannot be determined from this transaction.

If the Department's position were to prevail herein, a taxpayer would be able to set any price at all for the transfer of waste products in a complex business deal wherein the waste product transfer was part of a larger transaction involving the purchase of an asset. The taxpayer could assign an arbitrarily low price to the waste product transfer, and a higher price to the asset transfer. Under its current position, the Department would have to accept this false value assigned to the waste products, resulting in an unrealistically low tax base. This could not have been the intended result of the statute at issue.

Therefore, it is my determination that the taxpayer has presented evidence sufficient to rebut the prima facie correctness of the Notice of Tentative Determination of Claim. Accordingly, it is my recommendation that the claim for credit be allowed. Pursuant to paragraph 5 of the Stipulation entered into between the parties, the amounts self-assessed by the taxpayer shall be considered correct.

RECOMMENDATION:

Based upon the foregoing, it is my recommendation that the claim for credit filed by TAXPAYER in the amount of $1,218,004 be allowed.

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Administrative Law Judge