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## B&O TAX PYRAMIDING IN PETROLEUM DISTRIBUTION

### BRIEFLY

For the Washington Oil Marketers Association, the Washington Research Council examined the pyramiding of the Business & Occupation tax imposed on petroleum products at each point of sale during the distribution process. This brief contrasts the current system with a revenue-neutral alternative—a modified B&O tax collected just once, at the beginning of the in-state distribution process.

### 1. OVERVIEW

This report examines the Business and Occupation (B&O) taxes charged during the petroleum distribution process and presents a modified B&O tax structure that is revenue neutral.

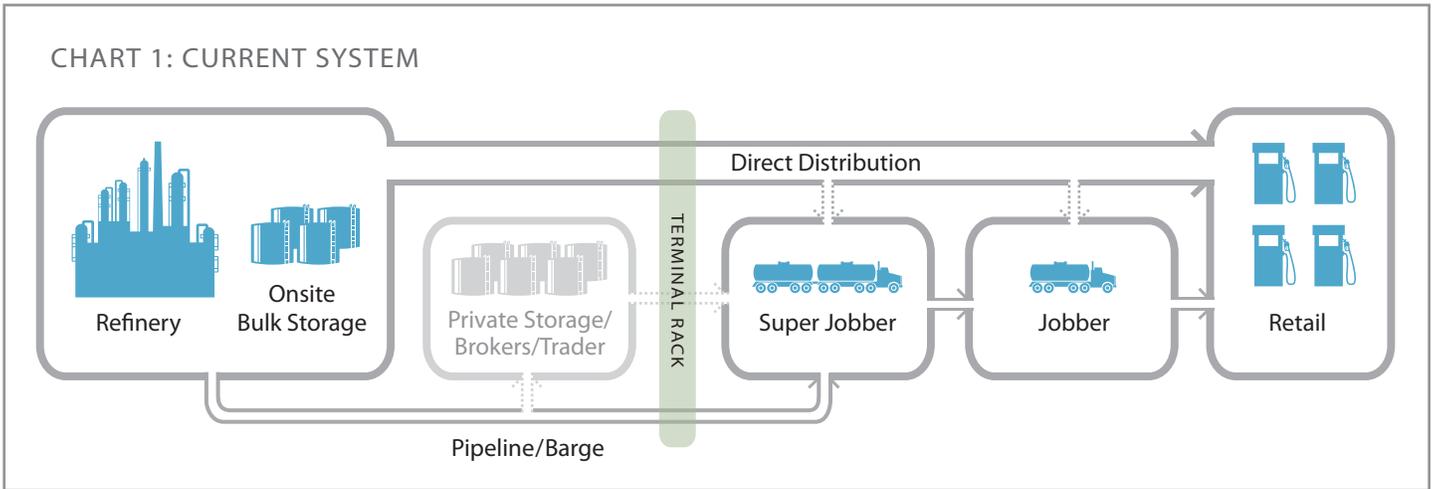
In 2008, over 3.4 billion gallons of motor fuel were distributed and sold in Washington state. There are several methods of distributing fuel, as outlined in this report, but the current tax system is structured in a way that favors a vertically-integrated distribution system over one that has multiple tiers. The B&O tax is collected at every level of the distribution process, unless a single entity maintains control of the product. In comparing different tax scenarios, vertically-integrated companies were found to have significant competitive advantages over a distribution process that used several independent businesses. A scenario following the distribution of one million gallons of fuel found that the tax required of a vertically-integrated business was approximately \$14,000 while a multi-business scenario had a tax obligation of nearly \$56,000. The reasons include: multiple levels of taxation, tax inequity among competitors, unnecessary layers of regulatory compliance and tax collections, and the creation of a barrier for entry of new fuel storage capacity.

A modified B&O tax on petroleum is outlined in the report in which the tax would only be charged once at the beginning of the distribution process. To maintain a revenue neutral modification, the rate would be set at 1.54 percent and charged at the “terminal rack”—the same location the gas tax is currently collected. It would be paid by the party that sells the refined product over the “terminal rack” and the costs of the tax would trickle down through the distribution system in an equitable manner. The benefits of a B&O tax being collected just once at a single point in the process are: tax efficiency, preservation of state revenue, the creation a level playing field and the potential for minimized gas price spikes in the future.

### 2. PETROLEUM DISTRIBUTION SYSTEM IN WASHINGTON STATE—DESCRIPTION

The illustration in Chart 1 shows the process by which crude oil is imported into our state, refined into a finished petroleum product, and distributed to retailers and end users.

CHART 1: CURRENT SYSTEM



**Crude Oil**

Washington has no indigenous crude oil production so it relies exclusively on imports to provide for its energy needs. Crude oil arrives in Washington by two methods—ship/barge or pipeline. The preponderance of crude arrives by barge from Alaska’s North Slope. However, with the decline in production in Alaska, Washington is becoming more dependent on crude oil imports via pipeline from Alberta, Canada and by barge or ship from other countries. The crude oil is received by one of Washington’s privately-owned refineries.

**Refineries**

There are five refineries in Washington state—BP Cherry Point (Ferndale), Conoco Phillips (Ferndale), Shell Oil (Anacortes), Tesoro (Anacortes), and US Oil (Tacoma). A variety of petroleum products flow from these refineries; however, gasoline, diesel oil, and jet fuel make up 77 percent of their total production. Eighty-seven percent of the gasoline sold in our state comes from these refineries. Other finished products include: liquid petroleum, marine fuel, residual fuel oil, coke, sulfur and emulsified and road asphalt. This report will focus on the refining, distribution and sale of gasoline and diesel, both of which will be referred to as “fuel.”

**Bulk Storage Tanks and Pipelines**

Once the refining is complete, the fuel produced at these refineries is stored at on-site bulk storage tanks—tanks that hold over 100,000 barrels of storage capacity—or transported to regional terminals by pipeline or barge, for distribution throughout the state. Eastern Washington also imports fuel directly from the Yellowstone Pipeline, which originates in Montana, and the Chevron Pipeline, which originates in Utah. The level in the distribution chain at which the fuel is being transferred from the pipeline or storage facility into ground transportation, such as a truck or trailer, is called the “terminal rack.”

**Terminal Rack:**

A terminal rack is the platform or bay at which motor vehicle fuel from a refinery, pipeline, vessel or storage facility is delivered into trucks, trailers, rail cars or barges.

**Private Storage/Brokers/Traders**

Companies that generally have the ability to warehouse product in large storage facilities to take advantage of market displacement. Selling to all other classes of trade, this group purchases petroleum products from the refiners, other trading entities and imports refined products to the market for sale to distributors and end-users.

**Distributors—Jobbers, Super Jobbers and Direct Distributors**

Ground transportation may be provided by the major oil companies who own the refineries. They are called “direct distributors.” Fuel may also be transported from the terminal rack to retailers by “jobbers” or “super jobbers.”

**Jobber**

Also known as the “middle man,” a “distributor” or a “marketer,” a jobber purchases and transports the fuel by truck or trailer from the terminal rack to a retailer (i.e., gas station) or to the end user (industrial or home heating oil for homeowners). Jobbers sometimes obtain the fuel from larger jobbers known as “super jobbers.”

**Super Jobber**

While not a formally defined term, a “super jobber” is a jobber that generally moves over 100 million gallons of fuel a year. Super jobbers also get their finished petroleum product from the terminal rack at refineries or pipelines; however, they get volume discounts from oil companies because of their high volume purchases. Super jobbers often sell to, and share volume discounts with, jobbers. A jobber under contract with a super jobber will either obtain the fuel at the terminal rack or at a fuel storage tank owned by the super jobber. Both super jobbers and jobbers provide fuel to retailers. In some cases, retail gas stations are owned by jobbers.

**Direct Distributors**

Another means by which fuel gets to the pump is when a major oil company directly distributes to the retailer, bypassing super jobbers and jobbers. This still involves trucks or trailers transporting the fuel, however, the major oil company uses a vertically integrated business model in which the work from manufacture through the distribution system is performed by the major oil company.

**Retailers**

Retailers rely on customers to purchase their fuel. They are the gas stations, big box stores and grocery stores. While the majority of gas stations bear the names of major oil companies such as Shell, BP or Exxon, most are not owned or operated by these major oil companies. They are owned and operated by independent business people, but carry the brand name product of the major oil company. There are also “unbranded”

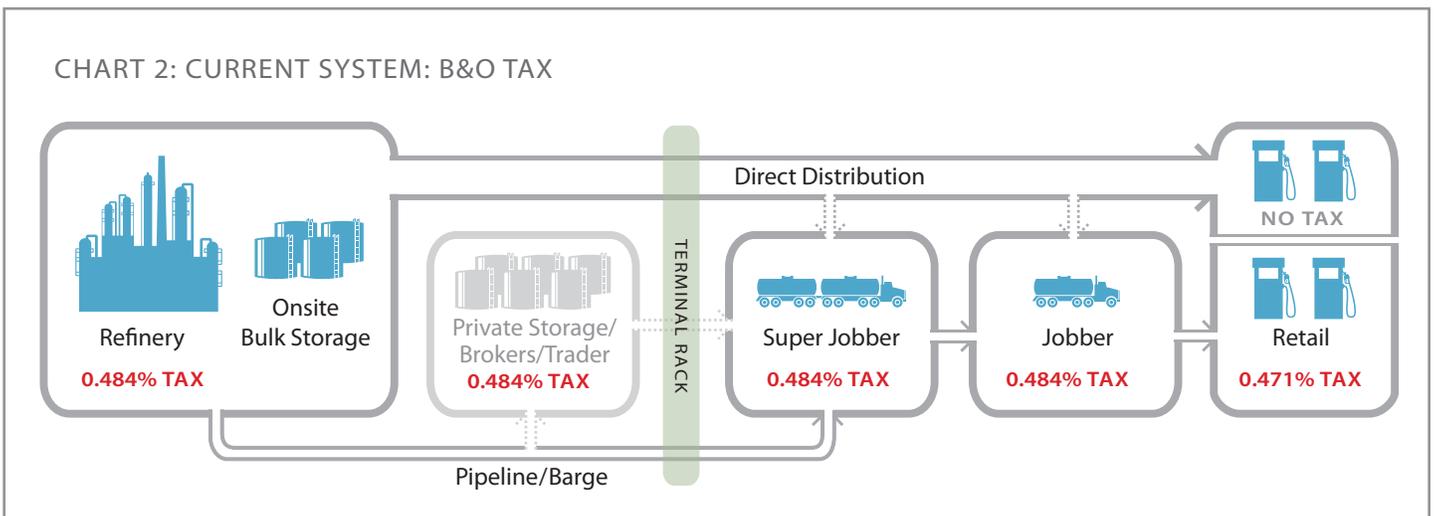
stations owned and operated by independent business people that sell fuel, but do not carry the branded product of the major oil companies. These stations generally sell pure gasoline with no engine performance enhancing additives. All told, there is a mixture of major oil company-owned, jobber-owned, chain store-owned, and independently-owned retail gas stations throughout Washington.

### 3. THE BUSINESS & OCCUPATION TAX: A “PYRAMIDING” TAX

Washington state levies a unique Business & Occupation (B&O) tax on all businesses operating in the state. It is a tax on gross receipts (gross income, gross sales or value of products), meaning no deduction is allowed for the costs of doing business. Because there is no deduction for losses, a business must pay taxes on its receipts regardless if it turns a profit. The B&O tax rate for manufacturing, wholesaling and certain other activities is 0.484 percent. For retail, the rate is 0.471 percent.

This form of tax, by design, creates an extra layer of taxation at each stage of production and distribution. In other words, a single product will be taxed multiple times as it makes its way from being manufactured to wholesale to retail sale. Because products are taxed at the top and continue to be taxed each step they take, the gross receipts B&O tax is commonly referred to as a “pyramiding tax.”

To better illustrate tax pyramiding in the petroleum distribution system, Chart 2 replicates the distribution system from Chart 1 but includes points where B&O tax is collected. A detailed description follows.



**Multiple Activities  
Tax Credit (MATC):**

When a business performs more than one taxable activity for the same product, it reports each activity under the proper classification, but takes the MATC credit so B&O tax is not paid twice on the same amount. For instance, a business that both manufactures and sells a product at wholesale in Washington does not pay both manufacturing and wholesaling B&O tax. A credit is allowed so that B&O tax is paid only once. This also applies to a business that has paid a gross receipt tax to another state.

**CRUDE OIL: The B&O tax is not charged at this level.**

**REFINERY: The first B&O tax occurrence takes place at the refinery.**

The B&O tax of 0.484 percent is charged to the major oil company that owns the refinery for the manufacturing or wholesaling of the finished petroleum product. The B&O tax applies to both the manufacturing and wholesaling but Washington has a Multiple Activities Tax Credit (MATC) that only requires B&O tax to be applied at the wholesale level when both activities are performed by the same company. Therefore, the B&O tax is paid once, at this level.

**PRIVATE STORAGE / BROKERS / TRADERS: B&O tax is not charged for bulk storage tanks if owned by the refinery.**

The wholesale B&O tax of 0.484 percent is charged if the tanks are owned by a different company. Only the five major oil companies that own the refineries in Washington state currently have bulk fuel storage tanks that hold over 100,000 barrels. The B&O tax is a significant barrier for entry for privately owned bulk storage tanks. While one of the five major oil companies can disperse the fuel product from their own bulk storage tanks without a tax occurrence, if a private storage company were to purchase the fuel from one of the majors, they would be required to pay a 0.484 percent B&O tax when fuel is sold.

**JOBBERS: Wholesale B&O tax of 0.484 percent is charged at the time fuel is sold by the jobber to a retailer, to another jobber or, if one existed, to a privately-owned bulk storage facility.**

This tax is paid whether the jobber purchased the fuel from an in-state source or imported it from out of state.

**SUPER JOBBER: Wholesale B&O tax of 0.484 percent is charged at the time fuel is sold by the jobber to a retailer, to another jobber or, if existing, to a privately-owned bulk storage facility.**

As with the jobber, this tax is paid whether the super jobber purchases the fuel from an in-state source or imports it from out of state. The tax would also be charged if a super jobber or jobber sold fuel to a privately-owned bulk storage tank operator.

**DIRECT DISTRIBUTOR: No B&O taxes charged for direct distribution because the fuel hasn't left the major oil company's possession.**

As illustrated in Chart 2, B&O taxes are paid at the refinery level by the major oil company and no additional B&O tax is charged until the retail sale of the fuel. However, if the major oil company also owns the retail station, then the MATC is applied. With MATC, the company only pays the tax once at the manufacturing rate of 0.484 percent. This creates an incentive for refining and distribution to be vertically integrated.

**RETAILERS: B&O tax of 0.471 percent is charged to the retailer for the value of fuel sold.**

However, the multiple activities tax credit applies to direct distributors as well as to jobbers who own the retail stations. Therefore, if a jobber or super jobber owns the retail station they deliver fuel to, they would take a credit for the retail B&O tax and only be obligated to pay the B&O tax once at the wholesale rate of 0.484 percent.

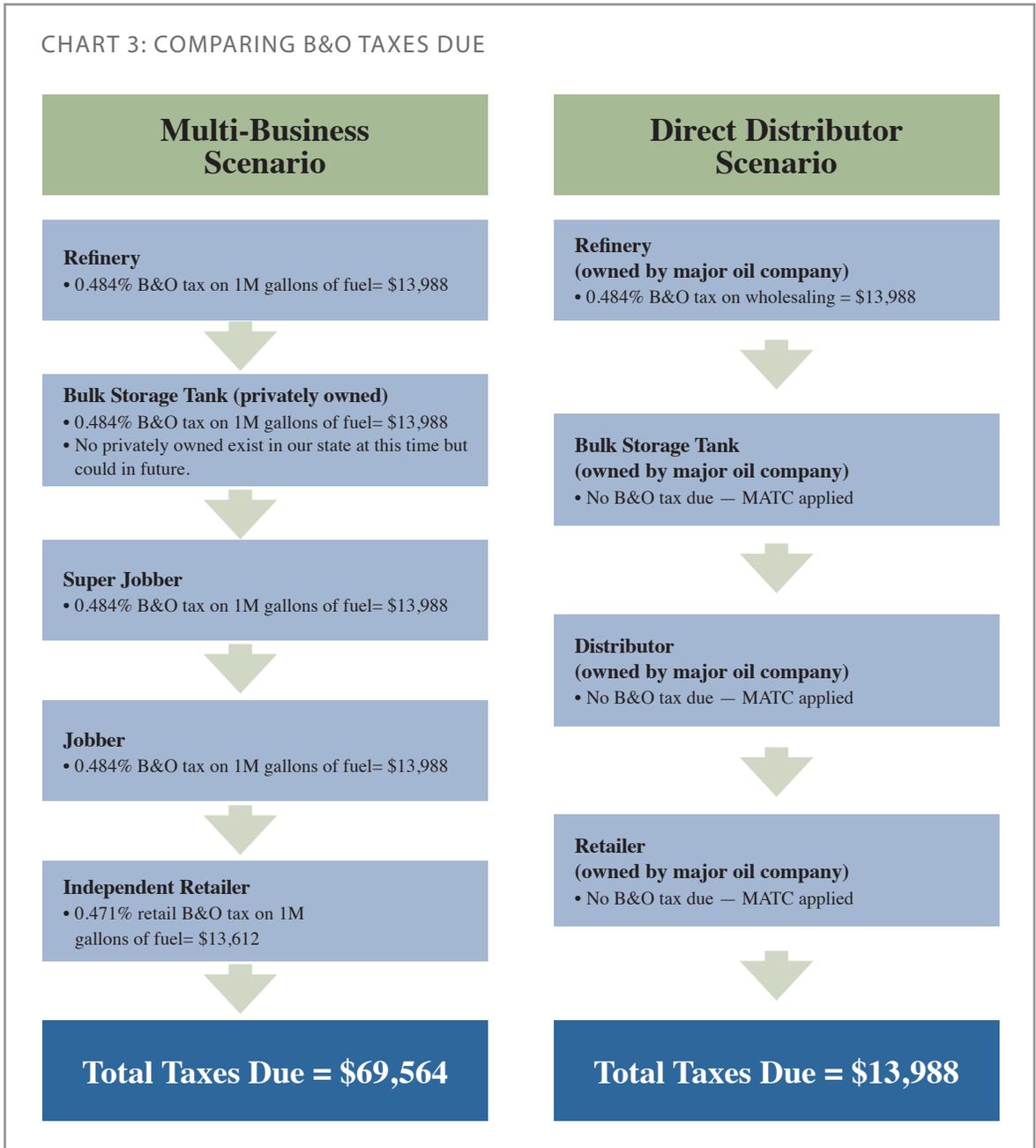
#### **4. THE COST OF B&O TAX PYRAMIDING**

Tax pyramiding creates an incentive for businesses to either manufacture products outside of the state to avoid the multiple layers of taxation or to implement a vertical integration business model that results in fewer in-state jobs. The Washington Tax Structure Committee found that tax pyramiding is more prevalent in petroleum refining than in any other industry in the state.

This is best illustrated by comparing the amount of state B&O tax that is charged for a vertically-integrated petroleum distribution system with one in which multiple businesses take part in the distribution process. Chart 3 compares the difference by following one million gallons of gasoline through the distribution process. Using the Washington State Department of Licensing's 2008 average gasoline price per gallon of \$3.45, minus the 55.9 cents for federal and state gas taxes, the average commodity cost of fuel in 2008 was \$2.89. Therefore, the one million gallons of fuel would have a gross receipts value of \$2.89 million. By multiplying this by the 0.484 percent and 0.471 percent B&O tax rates, at every point it is required, it quantifies the competitive advantage enjoyed by vertically-integrated businesses utilizing direct distribution. In this scenario, the direct distributors pay \$55,576 less in taxes for the product than is paid in the other distribution model.

In the multi-business model, the B&O tax is collected at every step of the distribution process. The B&O tax of 0.484 percent for wholesale is charged four times, with the fifth tax collection taking place at the retail level at a rate of 0.471 percent. Using the \$2.89 million value, the total tax collected is \$69,564.

In the direct distribution model, the B&O tax is only collected at the first level of the process with Multiple Tax Activities Credit being applied thereafter. This results in total B&O tax collections of \$13,988 — a discount of \$55,576.



**Five Downfalls of “Pyramiding”**

- **B&O tax is charged multiple times.** As discussed and illustrated above, the current B&O tax system results in taxes being charged multiple times on the same product—driving up costs to consumers who ultimately pay.
- **Creates tax inequity among competitors.** The current tax system on petroleum distribution provides an advantage for oil companies with a vertically-integrated business model while adding layers of taxes on those who don't.

**“Gas Tax” Description:**

The state collects an excise tax on motor vehicle fuel (i.e., gasoline) and special fuel (i.e., diesel) based on each gallon of gas that is delivered through the terminal rack. These taxes are commonly known as the “gas tax.” The current state tax is 37.5 cents per gallon. In 2008, the state collected over \$1.2 billion dollars from the sale of over 3.4 billion gallons of fuel. The tax is charged just once, at the terminal rack. It is paid by the supplier, if located in the state, or the importer, if the fuel is being transported into the state. The Department of Licensing administers the tax and describes it as “inexpensive to collect, since only a small number of taxpayers report and pay the tax.”

- **Requires layers of tax filings and additional resources to enforce compliance.** Taxes being charged multiple times to different employers not only increases costs for businesses, it requires the state to dedicate more money for processing and compliance.
- **Creates a barrier of entry for new businesses, such as bulk fuel storage tank operators (brokers and trading companies).** Currently, the companies that own the refineries are the primary owners of bulk fuel storage tanks with capacity over 100,000 barrels. This is not the case in other states where private companies build large storage tanks that help feed the market when demand is high and supply is low, creating a benefit to consumers. One of the main barriers to entry for privately-held storage tanks in Washington is the B&O tax. If a private storage company were to purchase the fuel from one of the majors or receive it from out of state, they would be required to pay a 0.484 percent tax.

**5. MODIFIED PETROLEUM B&O TAX**

A non-pyramiding alternative to the B&O might be implemented in a number of ways. However, the most straightforward way to modify the tax for petroleum distribution would be to model it after an already existing tax—the motor vehicle fuel tax, most commonly known as the “gas tax.”

**Revenue Implications**

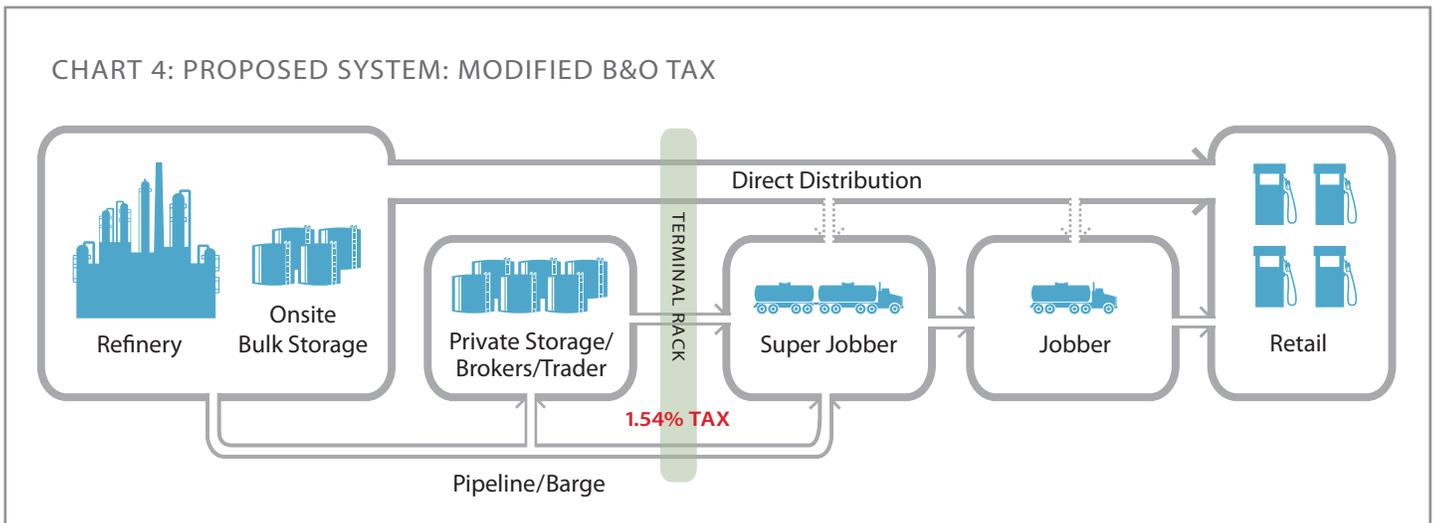
We estimate that in 2008 motor fuel consumed in Washington generated \$139.9 million in B&O tax for the state and that a non-pyramiding tax at the rate of 1.54 percent applied just once, at the rack, would have generated as much revenue. Our calculations assume that 88 percent of motor fuel is supplied from in-state refineries and that 5 percent of refineries’ in-state sales are direct to end users, 5 percent of their sales are to retailers and the remaining 90 percent are to marketers.

An online survey by the Washington Oil Marketers Association of its members found that 51 percent of marketers motor fuel sales are to retailers, 13 percent to end users and 36 percent to other marketers. We use these percentages to characterize the flow of motor fuel through the marketing sector, capping at three the number of marketers that handle any given barrel of motor fuel.

(We must emphasize that the 1.54 percent rate is just an estimate, based on limited information. If a bill to implement such a non-pyramiding replacement for the B&O taxes on motor fuels receives serious consideration in the Legislature, analysts from the Department of Revenue—with access to much better information than is available to us—will calculate their own revenue impact as part of the fiscal note process.)

Chart 4 illustrates the modified B&O tax.

CHART 4: PROPOSED SYSTEM: MODIFIED B&amp;O TAX



Proponents argue that by modifying the current B&O tax pyramiding system on petroleum products to reflect the tax structure in place for the gas tax, the state could provide regulatory efficiency, preserve state revenue, create a level playing field and minimize gas price spikes in the future.

- Provide Regulatory Efficiencies.** The newly-created Department of Commerce has made regulatory efficiencies a priority. A modified B&O tax on petroleum could be a step in that direction. By applying the B&O tax at only one level in the manufacture and distribution system, it would alleviate multiple tax filings and redundant compliance enforcement. It would simplify the paying and processing of taxes, enabling businesses to focus on processing goods and providing jobs, not incurring costs for regulatory compliance.
- Preserve State Revenue.** This modified petroleum B&O tax would be revenue neutral. In other words, the state would keep collecting the same amount of money as they were before. It may also enhance revenues by capturing the B&O taxes on fuel sold to non-taxable entities such as tribes or those located in international tax free trade zones.
- Create a Level Playing Field.** With taxes collected at one single point it would alleviate the tax advantages given to vertically-integrated businesses and allow competition to flourish.
- Minimize Fuel Price Spikes.** The modified tax would make it more cost feasible for bulk fuel brokers, independent of the major oil companies, to compete in the state. By eliminating the tax barrier, businesses, in addition to the major oil companies, could increase the storage capacity. With more supply available to enter the market during peak travel times, the fuel price spikes that are common would likely be less severe in the future.

## 6. CONCLUSION

The discussion of different tax systems is as common in Olympia as rain is in the winter months. Usually the discussion entails scrapping one form of tax in favor of another. The purpose of this study was not to get involved in the overall debate of major tax reform, but instead explore the option of modifying the current B&O tax system on the petroleum distribution system.

With the state of the economy, policymakers are exploring opportunities to support job growth while searching for ways to create a leaner state budget. It makes sense to consider revenue-neutral tax modifications that will encourage jobs while resulting in regulatory savings to the state. The pyramiding B&O tax on the petroleum distribution process ought to be part of the discussion.

## REFERENCES

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