

**M e m o r a n d u m****545.0060**

To: Mr. James Black  
Headquarters Audit Evaluation  
and Planning Unit

August 7, 1989

From: Ronald L. Dick  
Tax Counsel

Subject: S---

SZ -- XX-XXXXXX

This is in reply to your May 10, 1989 memorandum requesting our opinion as to questions posed by Mr. Joe Dandurand of the Arcadia District office.

Mr. Dandurand explained that he is auditing S--- (S) for the period January 1, 1986 through December 31, 1988. (S) claimed a tax-paid purchases resold credit in the second quarter of 1987 for sales of low sulphur fuel oil (LSFO). The taxpayer's credit exceeded the quarterly liability, and the Board issued a refund warrant to (S). Mr. Dandurand is now questioning the credit and notes that two questions have arisen:

“1. The validity of the claim – general.

In a letter by E. H. Stetson on April 7, 1967 to taxpayer, it was the opinion of the staff that fuel oil is not held in ‘standby’ service as set forth in then Ruling No. 71. See copy of letter attached. Since that time economic conditions have changed considerably with respect to the use of LSFO by utilities. Fuel oil was the main fossil fuel burned during the 1960’s and 1970’s. With the advent of the ‘energy crisis’ and the subsequent deregulation of natural gas, (S) converted their generating plants to accept either natural gas or fuel oil. During the last seven or eight years natural gas has been the fuel of choice because of its low cost and non-polluting effects. Because of long-term supply contracts signed in the 70’s, (S) continued to buy LSFO at high contract prices and resell it on the open market at current market prices which generated large refund claims.

(S) maintains approximately 5,000,000 barrels of tax-paid fuel oil in inventory which, I am told, represents about three months usage if all plants burned fuel oil. The only time LSFO is used is if natural gas is not made available due to increased demands for natural gas by residential

customers as happened in December 1988. During that cold period, (S) burned about 2,000,000 barrels of fuel oil when natural gas supplies were curtailed.

With the above in mind, is it still our position that LSFO is not held in 'standby service'? It would seem that the only reason for (S) to purchase LSFO is to maintain an inventory for emergencies."

We believe that, generally, the "standby" rule applies to situations such as the purchase of a specific piece of equipment, e.g., where the equipment is specifically held by the purchaser in readiness for use should the need arise. (BTLG Annot. 570.0380.) On the other hand, we do not believe the rule should be applied to situations where a person may purchase fungible goods for either sale or use and sell some of the property prior to use. For example, if a construction contractor purchases materials to use in a construction project but sells the materials, the Board would not assert both use tax and sales tax. In fact, Sales and Use Tax Regulation 1701, Tax-Paid Purchases Resold, provides for this application at subdivision (b)(1) which provides that the tax-paid purchases resold credit is appropriate where the retailer, when making a purchase, intends to use the property rather than resell it but later resells it before making any use. Also, subdivision (b)(3) provides that the credit is appropriate when the retailer purchases particular property generally for use but incidentally resells a small portion.

On balance, we believe that, under the facts you presented, (S) purchases the property and stores it for either resale or use, and we believe that (S) is eligible for the tax-paid purchases resold credit.

Your second question concerned the proper method of determining the cost of the tax-paid property. You noted that for years, (S) has used the first-in first-out (FIFO) method of determining the cost of the credit. We understand that, since January 1, 1987, (S) has used a last-in last-out (LIFO) method for measuring the cost of its LSFO inventory. Mr. Dandurand believes that, for purposes of valuating the tax-paid purchases resold credit, (S) should use either the LIFO method or the average cost per barrel in inventory.

Since this latter question concerns a policy, rather than a legal issue, I am referring it back to your unit for handling.

The FIFO rule is generally a presumption that, what is first sold is what was first bought. It is not a rule of law nor of logic, but a rule of thumb. (See Black's Law Dictionary (4<sup>th</sup> Ed. 1968), page 763, column one, citing Ninth Bank and Trust Company v. U.S. 15 F.Supp. 951, 952.) (S) changed its method of measuring the cost of inventory for purposes other than the Sales and Use Tax Law; however, Mr. Dandurand believes that (S) should also change its method for sales and use tax purposes. Although by adopting that policy the staff may generate more revenue from this particular audit, the staff may be setting a not altogether beneficial precedent. For instance, if the staff adopts the policy, a taxpayer may change from FIFO to

LIFO and back again at will so long as the taxpayer changes the method of reporting for all purposes (income tax, etc.). Also, under the facts of this case, where the price of the fuel was generally falling, the FIFO method would generate less sales tax during the audit period, because the taxpayer is able to take a higher tax-paid purchases resold credit. On the other hand, if prices are generally rising, the FIFO method generates more tax, since the tax-paid purchases resold credit is smaller.

If you have any further questions regarding this, feel free to write again.

RLD:sr