

**Revenue Ruling
No. 05-005
September 13, 2005
Corporation Income and Franchise Taxes
Characterization of Transaction as “Exchange” for Elimination From
Apportionment Ratio**

The primary purpose of this Revenue Ruling is to provide guidance to the taxpayer as to what is necessary to qualify a transaction as an “exchange” for the purposes of franchise tax rule LAC 61:I.306.A.1. A secondary purpose of this Revenue Ruling is to state that, while not addressed by regulation, it is the Secretary’s position that such exchanges must similarly be excluded from the corporation income tax revenue ratio.

According to the provisions in LAC 61:I.306.A.1, transactions in which raw materials, products, or merchandise are transferred to another party at one location in exchange for raw materials, products, or merchandise at another location in agreements requiring the subsequent replacement of such materials, products, or merchandise with similar property on a routine, continuing, or repeated basis must be excluded from the revenue ratio because the transactions constitute exchanges, not sales.

Exchanges are excluded from the revenue ratio for franchise tax purposes because the transactions do not qualify as sales made to a customer. For both income and franchise tax purposes, exchanges, taken as a whole, do not generate revenue for the taxpayer, but instead are intended to reduce costs for both parties to the exchange. A transaction that is an exchange is not a sale and must be excluded from the revenue ratio for both corporation income tax and corporation franchise tax purposes.

The examples below are provided to illustrate the circumstances under which the transaction is or is not qualified as an exchange.

Example 1. “Corp. A”, with crude oil production in Texas, sells crude oil to customers in Louisiana. Corp. A also has a refinery in Louisiana. “Corp. B”, with crude oil production in Louisiana, sells crude oil to customers in Texas. Corp B also has a refinery in Texas. Initially, each supplies crude oil to its own refinery from its own production. In order to save crude oil transportation costs associated with their respective refinery operations, Corp. A and Corp. B enter into a long-term agreement to exchange, each delivering an agreed upon and roughly equal amount of crude oil to the other’s refinery. This exchange has not been entered into by the “seller” for the purpose of making a sale within the market. The “seller” is in the same position as originally, possessing the same amount of crude oil after the exchange, and ultimately selling the same amount of crude oil to its customers and using the same amount of crude oil in its refinery. For both parties, the purpose of the transaction was to reduce transportation costs. Because this transaction is on a routine basis, the exchanges are of similar property, and, the purpose is reduction of costs rather than generation of revenue, the transaction is considered an exchange and not included in the numerator or denominator of the revenue ratio.

A Revenue Ruling is written to provide guidance to the public and to Department of Revenue employees. It is issued under Section 61:III.101(C) of the Louisiana Administrative Code to apply principles of law to a specific set of facts. A Revenue Ruling does not have the force and effect of law and is not binding on the public. It is a statement of the department’s position and is binding on the department until superseded or modified by a subsequent change in statute, regulation, declaratory ruling, or court decision.

Example 1a. If in example 1, Corporations A and B were not each able to supply crude oil to their respective refineries from their own production because the quality of crude did not meet the requirements of their refineries, there would be no possibility of an exchange. The products are somewhat similar, but not interchangeable. In this situation, neither has the product required by its refinery and acquires the necessary product from the other. Therefore, neither is in the same position with respect to ownership of the raw material, product, or merchandise before and after the transactions between themselves.

Example 2. “Corp. A”, with crude oil production in Texas, routinely sells crude oil to customers in Louisiana. Corp. A does not have a refinery. “Corp. B”, with crude oil production in Louisiana, routinely sells crude oil to customers in Texas. Corp B does not have a refinery. In order to save the transportation costs associated with their respective sales, Corp. A and Corp. B enter into an agreement to routinely exchange, each delivering its crude oil to a location near the other’s customers. Even though a sale is associated with this transaction, it is still considered an exchange and excluded from the revenue ratio for the same reasons stated in Example 1. The fact that Example 1 involves a reduction in cost associated with a production process while Example 2 involves a reduction in cost associated with a sale does not change the analysis.

Example 2a. If in Example 2, Corp. A produces a high sulphur content crude oil and has a customer in Louisiana who requires a low sulphur content crude oil and Corp. B produces low sulphur crude and is near Corp. A’s customer and Corp B has a customer in Texas that purchases high sulphur crude, Corp. A cannot engage in an exchange agreement with Corp. B. The products are somewhat similar, but not interchangeable as far as the customer is concerned. The physical characteristics of the products are sufficiently different that they cannot be used for the same purposes or use. Neither seller can fulfill its respective sale to its customer in the market because neither has the product to sell. In this example, both have to acquire the product in order to sell it. Therefore, neither is in the same position with respect to ownership of the raw material, product, or merchandise before and after the transactions between themselves. This transaction would be considered a sale.

Example 3. Same facts as Example 2 above in that the corporations have a mutual exchange agreement except that the exchange agreement has dollar figures associated with each delivery of crude oil, and the parties submit invoices and payments to each other. In order to reduce direct costs associated with their respective sales, each is delivering its crude oil to a location near the other’s customer. Unlike Example 2, dollar amounts are accounted for, charged, and paid. This transaction may be an exchange for the purposes of elimination from the revenue ratio calculations. Typically, an exchange will be consummated through contract and not through invoice and remittance. However, the use of an invoice and remittance method for record keeping, inventory control, or similar reason would not necessarily void the transaction as an exchange. For example, if large quantities of crude oil are regularly exchanged between Corp. A and Corp. B by proper

agreement, and the companies use invoice and remittance for purposes of record or inventory control, the fact that invoice and remittance procedures were followed will not change the fact that the transactions were exchanges. At the end of the exchange, each party has the same amount of product and the same amount of money as before the exchange. By way of explanation, as in the prior examples, it is anticipated that the exchange of certain products may be substantially similar, but not exactly the same, such as in the case of crude oil, where gradations of quality may permissibly be exchanged. In such instances, it will be anticipated that valuation may have variations as well, but not significant enough to change the character of the product so as to invalidate the exchange for tax purposes.

Example 4. Same facts as Example 2, except that the corporations do not enter into an exchange agreement requiring equal deliveries to each other. This transaction will not be characterized as an exchange and will be included in the numerator and/or denominator of the revenue ratios for corporate income and franchise taxes.

In general, to qualify as an exchange, there must be an agreement between the vendors that identifies the product and sets forth the terms of the mutual transactions between the parties, and the resulting transactions must balance the quantity and value of the exchanged product.

In transactions that would otherwise qualify as exchanges, relatively minor inequities in volume or quality that are settled with cash will not necessarily negate the treatment of the transaction as an exchange. Cash settlements of inequities in volume or quality will be treated as sales and included in the income and franchise tax apportionment ratios.

It has been and is the intent of the Department to recognize a transaction as an exchange for the purpose of computing the sales factor for Corporate Income Tax in the same manner as for Franchise Tax.

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