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Louisiana Supreme Court Holds Fuel Purchased to Operate Drilling Barges is Taxable in Louisiana

by

Michael W. McLoughlin, William M. Backstrom, Jr. and Mark T. Hennen

In a decision that demonstrates an extremely narrow view of statutory construction and could have a negative impact on barge owners, fuel suppliers and barge repair businesses in Louisiana, the Louisiana Supreme Court has held that “barges” do not qualify as “vessels” for purposes of the Louisiana state and local sales/use tax exemption (La. R.S. 47:305.1(B)¹) for purchases of materials and supplies for and repairs to “ships or vessels.” In addition, the court found that recent amendments to the exemption statute regarding the definition of foreign and interstate coastwise commerce could not be applied retroactively without violating the Supremacy Clause of the Louisiana Constitution. The court further held that diesel fuel purchased in Louisiana to operate the drilling barges at issue was not consumed as part of interstate commerce and did not meet the requirements for the state sales and use tax exclusion for “bona fide interstate commerce” (La. R.S. 47:305(E)). *Mallard Bay Drilling, Inc. v. Kennedy*, No. 2004-C-1089 (La., June 29, 2005).

The drilling barges at issue were used by Mallard Bay Drilling, Inc. (“Mallard Bay”) to provide drilling services to its customers - oil and gas exploration and production companies that were engaged in the exploration for oil and gas along the Gulf Coast. The drilling barges did not operate under their own power, but instead had to be towed from one location to another and put into position by tugboats. Mallard Bay’s drilling barges were for hire wherever a job was to be performed for a customer. The drilling barges would be towed to a customer’s drilling location, used to perform the drilling services and then remain at the drilling site until a platform and production equipment could be set in place. Mallard Bay’s drilling barges also acted as temporary platforms to secure the oil and gas once drilling was complete and prior to set up of the platform and production facilities. The oil and gas then would be offloaded and shipped to a refinery in either Texas or Louisiana and refined and sold virtually anywhere.

Mallard Bay purchased diesel fuel from Louisiana vendors to operate the drilling barges during the drilling process. Mallard Bay paid Louisiana sales taxes on the purchases of the diesel fuel, but then filed refund claims asserting that the diesel fuel was purchased to operate the barges in interstate commerce, even though the drilling barges mainly operated in Louisiana waters. Mallard Bay argued that under either La. R.S. 47:305.1(B) or La. R.S. 47:305(E) the purchases of the diesel fuel were not taxable because of its consumption of the diesel fuel in foreign or interstate coastwise commerce. In addition, Mallard Bay argued that the imposition of Louisiana sales taxes on the diesel fuel violated the Commerce Clause of the United States Constitution.

¹ While most state-level sales/use tax exemptions are currently suspended, La. R.S. 47:305.1 has been specifically excluded from the suspension of exemptions by La. R.S. 47:302(R) and remains fully in effect. The suspension of exemptions does not apply at the local level, so the La. R.S. 47:305.1 is fully effective at the local level.

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Louisiana R.S. 47:305.1(B) provides an exemption from state and local sales and use taxes for “. . . materials and supplies purchased by the owners or operators of ships or vessels operating exclusively in foreign or interstate coastwise commerce. . . .” The exemption also applies to repair services performed upon and laundry services provided to ships or vessels operating exclusively in foreign or interstate coastwise commerce. This exemption has been in the Louisiana statutes in virtually the same form since 1959.

In previously analyzing this exemption, the Louisiana Supreme Court held in *Archer Daniels Midland Co. v. St. Charles Parish*, 802 So.2d 1270 (2001), that tugboats operated solely in Louisiana waters were not operating exclusively in foreign or interstate coastwise commerce even though they were an integral part of the interstate and foreign transportation of the cargo. Thus, materials and supplies purchased for use or consumption in the maintenance and operation of the tugboats and repairs to the tugboats did not qualify for the exemption in La. R.S. 47:305.1. The holding in *Archer Daniels Midland* was essentially overruled by Act Nos. 40 and 41 of the 2002 Regular Session of the Louisiana Legislature, which amended La. R.S. 47:305.1 to add a specific definition of the term “foreign or interstate coastwise commerce.” This new definition provides that:

(1) For purposes of this Section [La. R.S. 47:305.1], the term ‘foreign or interstate coastwise commerce’ shall mean and include trade, traffic, transportation, or movement of passengers or property by, in, or on a ship or vessel:

(a) Between a point in one state and a point outside the territorial boundaries of such state;

(b) Between points in the same state where the trade, traffic, transportation, or movement of passengers or property traverses through a point outside of the territorial boundaries of such state;

(c) At a point in or between points in the same state as part of or in connection with the business of providing or delivering materials, equipment, fuel, supplies, crew, repair services, laundry services, dredging waterways services, stevedoring services, other loading or unloading services, or ship or vessel movement services to or for ships or vessels that are operating in foreign or interstate coastwise commerce as defined in this Subsection; or

(d) At a point in or between points in the same state when such trade, traffic, transportation, or movement of passengers or property is part of or consists of one or more segments of trade, traffic, transportation, or movement of passengers or property that either (i) follows movement of passengers or property into or within the state from a point beyond the territorial boundaries of such state, (ii) precedes movement of the passengers or property from within the state to a point outside the territorial boundaries of such state, or (iii) is part of a stream of trade, traffic, transportation, or movement of passengers or property originating or terminating outside the territorial boundaries of such state or otherwise in foreign or interstate coastwise commerce, as defined in this Subsection.

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Although the effective date of the 2002 amendments to La. R.S. 47:305.1 was June 25, 2002, the legislation explicitly stated that the amendments were to be applied retroactively to all claims arising or actions filed on and after the effective date of the 2002 legislation. Section 2 of the 2002 legislation provided as follows:

The provisions of this Act are interpretive of R.S. 47:305.1 and are intended to explain and clarify its original intent, notwithstanding the contrary interpretation given in *Archer Daniels Midland Company v. The Parish School Board of the Parish of St. Charles*, 01-C-0511 (La. 11/28/01), 802 So.2d 1270, and all cases consistent therewith. Therefore, the provisions of this Act shall be applicable to all claims existing or actions pending on its effective date and to all claims arising or actions filed on and after its effective date.

After ruling that the court had jurisdiction to consider the Department's constitutional challenge to Act Nos. 40 and 41, the court then turned its attention to whether the Acts could be applied retroactively. The court relied on its recent decision in *Unwired Telecom Corp. v. Parish of Calcasieu*, Docket No. 03-CA-0732 (La. 1/19/05), and held that the retroactive application of Act Nos. 40 and 41 to legislatively overrule *Archer Daniels Midland*, violated the separation of powers provisions of the Louisiana Constitution. In *Unwired*, the court relied on the separation of powers provision of the Louisiana Constitution (La. Const. Art. II, Section 2) to strike down the retroactive provisions of Act No. 85 of the 2002 Regular Session of the Louisiana Legislature, which was designed to have retroactive application and addressed the sales/use taxation of sales of cellular telephones to customers at discounted prices as part of cellular telecommunications packages. Act No. 85 was enacted in response to an appellate court's decision in *Mercury Cellular Telephone Co. v. Calcasieu Parish*, 773 So.2d 914 (La. App. 3rd Cir. 2000), writ denied, 787 So.2d 314 (La. 2001), which upheld the imposition of Calcasieu Parish use tax on the wholesale price of cellular phones provided to customers at discounted prices as part of cellular telecommunications packages.

The court in *Unwired* stated that La. Const. Art. II, Section 2, establishes three separate branches of government (legislative, judicial and executive) and none of these branches is allowed to exercise powers belonging to one of the others. Because Act No. 85 had retroactive effect, the court had to determine whether the statute was an interpretative law that ran afoul of the separation of powers provisions. The court found that the legislature can enact clarifying legislation where ". . . the courts indicate the necessity of doing so," but the interpretation of the law ". . . is the designated function of the judiciary, not the Legislature." The court further stated that while in certain circumstances, the legislature may be the author of "so-called" interpretative legislation, ". . . it is not within the province of the Legislature to interpret legislation after the judiciary has already done so." The court concluded that by enacting the retroactive legislation, ". . . the Legislature clearly assumed a function more properly entrusted to the judicial branch of government." The court held that even though the legislature had the authority to change the law after the *Mercury Cellular* decision, it could only do so prospectively without violating the Louisiana Constitution.

Applying the *Unwired* decision in *Mallard Bay*, the court determined that the legislature's enactment of Act Nos. 40 and 41 ". . . clearly sought to abrogate this court's interpretation of La. R.S. 47:305.1(B) in *Archer Daniels . . .*" and that the legislature ". . .

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improperly assumed the function of the judicial branch of government.” Thus, the court held that Act Nos. 40 and 41 could only have prospective application and could not be applied in the *Mallard Bay* case. Instead, the court applied La. R.S. 47:305.1(B) as it existed prior to the amendments by Act Nos. 40 and 41, and subject to the court’s interpretation of that statute in *Archer Daniels Midland*.

The court noted that a tax exemption is an exceptional privilege that must be expressly and clearly conferred in plain terms and must be strictly construed against the taxpayer. With this in mind and interpreting the provisions of La. R.S. 47:305.1 prior to the amendments by Act Nos. 40 and 41, the court noted that three statutory elements must be satisfied in order to take advantage of the exemption: (i) the taxpayer must be an owner or operator of a ship or vessel purchasing materials or supplies; (ii) the materials or supplies must be used or consumed in the maintenance or operation of the ship or vessel; and (iii) the ship or vessel must operate exclusively in foreign or interstate coastwise commerce.

There is no question that the *Mallard Bay* was the owner and operator of the drilling barges. Apparently, the lower courts either assumed or concluded that the drilling barges were “vessels” within the meaning of La. R.S. 47:305.1(B). Thus, the lower court opinions in *Mallard Bay* focused solely on whether the drilling barges were operated in foreign or interstate coastwise commerce. The Louisiana Supreme Court acknowledged that *Mallard Bay* is the owner and operator of the drilling barges. Instead of focusing on whether the drilling barges were operating in foreign or interstate coastwise commerce, the court chose instead to focus on whether the drilling barges qualified as “ships or vessels” for purposes of the exemption. This choice is interesting because many taxpayers and their advisors, as well as the Louisiana Department of Revenue², have for many years believed that barges are “vessels” for purposes of the exemption in La. R.S. 47:305.1(B).

The court noted that La. R.S. 47:305.1(A) (“Subsection A”) specifically addresses “ships, vessels or barges,” while La. R.S. 47:305.1(B) (“Subsection B”) only addresses “ships or vessels.” According to the court, this is an indication that the legislature did not intend for Subsection B to apply to barges. The court wrote that the law must be applied as written and that “. . . we must presume that the legislature deliberately omitted ‘barges’ from the exemption provided in subsection (B), and that ‘barges’ has a distinct meaning, rather than one that is meaningless or redundant.”

²The Department’s own regulation, L.A.C. §61:I.4403(C), for years has defined “ship, barge or vessel” for purposes of La. R.S. 47:305.1 together as follows:

- [A]ny craft used primarily in transporting persons or property by water, or any craft designed or altered to perform specialized marine-related services, such as dredging, fleetng, geological surveying, cargo transferring, and which possesses all of the flowing characteristics:
- a. the craft performs its services in navigable waters; and
 - b. the craft is capable of being moved by flotation from one location to another in navigable waters; and
 - c. the craft is eligible for registration as a vessel with the United States Coast Guard, or is in fact registered as such.

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Interestingly, the court theorized that the legislature enacted Subsection (A) because it was concerned with providing an exemption to the Louisiana shipbuilding industry, but did not appear to have “the same concern” for owners of barges operating exclusively in foreign or interstate coastwise commerce. Under the court’s theory, the legislature wanted to protect the shipbuilding business in Louisiana, but not Louisiana businesses that sell materials and supplies, repair services and laundry services to barges. The court’s theory may be flawed because many shipbuilding yards in Louisiana may also be engaged in the business of repairing barges that operate exclusively in foreign or interstate coastwise commerce. The barge repair business certainly is an important business in Louisiana and it is difficult to imagine that the legislature would provide an exemption for building both vessels and barges, but only provide an exemption for repairing vessels and not barges.

If the court’s theory is correct, barge repair businesses in Louisiana may have cause for concern regarding their ability to compete with states that do not impose sales/use taxes on barge repairs. For years, Louisiana state and local sales/use tax officials apparently have considered barges to be “vessels” for purposes of La. R.S. 47:305.1(B). For years, repairs to barges operating exclusively in foreign or interstate coastwise commerce have been exempt from both state and local sales/use taxation. Disputes may have arisen as to whether a particular barge was used exclusively in foreign or interstate coastwise commerce, but rarely, if ever, was there a dispute over the classification of a barge as a vessel. Under any definition, a barge is a vessel. Even the Department of Revenue treated a barge and a vessel as one in the same.³ The exemption in La. R.S. 47:305.1(B) certainly has had a positive economic benefit to the barge repair facilities in Louisiana. It may now be in jeopardy if the court’s theory of the legislature’s intent is followed.

The court dismissed Mallard Bay’s well-supported argument that the inclusion of the term “barges” in Subsection B was not necessary because a barge qualified as a vessel for purposes of other sections of the Louisiana tax code and under general maritime law. The court found that each statutory definition of the term “vessel” throughout the tax code was “. . . limited by its own terms to a particular Chapter or Part of the Revised Statutes.” In response to Mallard Bay’s argument that it is indisputable that a barge is a vessel under general maritime law, the court found that the term “vessel” is interpreted very broadly for maritime purposes, while tax exemptions are to be strictly construed against the taxpayer. Thus, the broad interpretation of the term “vessel” for maritime purposes was rejected by the court. The court noted that it might have been persuaded by the definition of “vessel” under general maritime law except for the fact that in Subsection A, the legislature had specifically included the term “barges,” while in Subsection B, the term “barges” was omitted. According to the court, this choice by the legislature is presumed to be deliberate.

³ See L.A.C. § 61:I.4403(C), which is reproduced in footnote 1 above.

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The court's analysis of the definition of "vessel" in Subsection (B) seems to be contrary to the statutory interpretation provisions of Louisiana Civil Code article 11, which provides that "[t]he words of a law must be given their generally prevailing meaning." When the law involves a technical matter, however, "[w]ords of art and technical terms must be given their technical meaning" La. Civ. Code art. 11. Under either requirement, the term "vessel" certainly includes barge. The cases cited by the court support this conclusion, but the court apparently did not consider the mandatory provisions of Civil Code article 11. Instead, the court concluded that ". . . [t]here is no evidence that the legislature intended the word 'vessel' as used in La. R.S. 47:305.1(B) to be interpreted by referring to one of several statutory definitions of the term that were enacted for different purposes." This conclusion ignores the mandatory provisions of Civil Code article 11.

After determining that the terms "vessel" and "barge" have different meanings, the court next examined whether the drilling barges should be classified as "vessels" or "barges" for purposes of La. R.S. 47:305.1(B). The court determined that the drilling barges could not be vessels because they had no "motive power" and required another craft to move them from place to place. Thus, the court concluded that Mallard Bay's drilling barges were not vessels and did not qualify for the exemption in La. R.S. 47:305.1(B). Interestingly, the court added the caveat that this conclusion applies ". . . at least prior to the effective date of Act 40" This caveat could leave open the possibility that amendments made by Act Nos. 40 and 41 operate to treat barges as vessels for purposes of La. R.S. 47:305.1(B). The court did not elaborate any further on this point.

Mallard Bay also argued that even if the purchases of the diesel fuel did not qualify for the exemption under La. R.S. 47:305.1(B), they should nevertheless be excluded from sales/use tax pursuant to the bona fide interstate commerce exclusion in La. R.S. 47:305(E), which provides in pertinent part, that "[i]t is not the intention of any taxing authority to levy a tax upon articles of tangible personal property imported into this state, or produced or manufactured in this state for export; nor is it the intention of any taxing authority to levy a tax on bona fide interstate commerce . . . It is, however, the intention of the taxing authorities to levy a tax on the sale at retail, the use, the consumption, the distribution, and the storage to be used or consumed in this state of tangible personal property after it has come to rest in the state and has become part of the mass of property in this state."

The court noted its previous determination in *Columbia Gulf Transmission Co. v. Broussard*, 653 So.2d 522 (La. 1995), *cert. denied*, 516 U.S. 908 (1995), ". . . that La. R.S. 47:305.1(E) 'clearly intends taxation of property consumed in the state.'" Applying the exclusion to Mallard Bay's purchases of diesel fuel from Louisiana vendors, the court found that the ". . . diesel fuel was consumed in Mallard's drilling operations in Louisiana, it came to rest and became a part of the state's property." Thus, the court concluded that the consumption did not constitute "bone fide interstate commerce" and the exclusion did not apply to Mallard Bay's diesel fuel purchases.

The court then examined the application of the Louisiana sales tax under the four-part test set out by the U.S. Supreme Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), to determine whether sales taxes on the diesel fuel purchases violated the U.S. Commerce Clause. The court found that the sales had substantial nexus with

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Louisiana because the taxes were imposed on diesel fuel that was sold and consumed in Louisiana. The court also found that the tax was fairly apportioned to economic activity within the state and did not discriminate against interstate commerce because it applied equally to both interstate and intrastate commerce. Finally, the court found that the tax was reasonably related to Mallard Bay's drilling activities in the state. Thus, the court concluded that the taxes at issue did not run afoul of the Commerce Clause.

Based on the U.S. Supreme Court's holding in *Maryland v. Louisiana*, 451 U.S. 725 (1981), Mallard Bay argued successfully in the lower courts that the flow of oil and gas from the well to the ultimate consumer was clearly interstate commerce that started when the oil and gas was removed from the earth and ended when the oil and gas was used by a consumer, which use could take place anywhere in the world. In *Maryland v. Louisiana*, the U.S. Supreme Court had invalidated Louisiana's first use tax on natural gas brought into the state that had not been previously taxed by another state or the U.S. government. The Court held that the flow of gas from the wellhead to the consumer was interstate commerce that may have been "interrupted" in Louisiana, but was still "... a continual flow of gas in interstate commerce."

The court in *Mallard Bay* found that while the drilling activities "... may constitute an involvement in interstate commerce, ..." there was no constitutional prohibition against taxing the diesel fuel purchases because it was sold, delivered and consumed in Louisiana. Had the diesel fuel been purchased in another state and brought into Louisiana to operate the drilling barges, the court may have reached a different conclusion.

Based on the holding in *Mallard Bay*, owners of barges, whether they are drilling barges or barges that move cargo over the inland waterways through Louisiana, would be well advised to consider making all of their purchases of materials and supplies, including diesel fuel, for their barges and having all of their barge repairs performed outside Louisiana. Thus, the court once again has done its part to encourage economic development in the transportation industry; unfortunately, that growth will be in states other than Louisiana, a result that undoubtedly is contrary to the legislature's intent when it enacted La. R.S. 47:305.1 and one that will not sit well with the legislature when they return to session in Baton Rouge.

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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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¹ Also admitted in Mississippi

² Also admitted in Mississippi and Washington, DC

³ Also admitted in New York