IN THE SUPREME COURT
OF THE
STATE OF SOUTH DAKOTA

APPEAL NO. 27152

NORTHERN BORDER PIPELINE
COMPANY,

Appellee,

v.

SOUTH DAKOTA DEPARTMENT OF
REVENUE,

Appellant.

APPEAL FROM THE CIRCUIT COURT,
SIXTH JUDICIAL CIRCUIT
HUGHES COUNTY, SOUTH DAKOTA

THE HONORABLE MARK W. BARNETT

BRIEF OF APPELLANT
SOUTH DAKOTA DEPARTMENT OF REVENUE

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PRELIMINARY STATEMENT

For the convenience of the Court, Appellant South Dakota Department of Revenue will be referred to as the "Department." Appellee Northern Border Pipeline Company will be referred to as "Northern Border."

Reference to the Settled Record will be indicated by "R. __." The Administrative Record will be cited as "AR __." The Hearing Transcript contained in the Administrative Record will be cited as "HT __." The Appendix will be cited as "APP __."

JURISDICTIONAL STATEMENT

The Hughes County Circuit Court entered an Order on June 16, 2014, reversing the Secretary of the Department of Revenue's Final Decision. R. 44-62. Notice of Entry was served on July 2, 2014. R. 88. On July 23, 2014, the

Department filed its Notice of Appeal, a Docketing Statement, and a Certificate of Service with the Circuit Court. R. 115-170.

STATEMENT OF LEGAL ISSUES

ISSUE 1. WHETHER THE CIRCUIT COURT ERRED IN HOLDING THAT SDCL 10-46-55 EXEMPTS FROM USE TAX COMPRESSOR FUEL USED BY NORTHERN BORDER.

The Circuit Court ruled that the compressor fuel Northern Border used was exempt from South Dakota use tax based on SDCL 10-46-55.

Relevant Case(s):

Magellan Pipeline Co., LP v. South Dakota Dep't of Revenue, 2013 S.D. 68, 837 N.W.2d 402.

Great Lakes Gas Transmission L.P. v. Comm'r of Revenue, 638 N.W.2d 435 (Minn. 2002).

Northern Border Pipeline Co. v. Comm'r of Revenue, 2009 WL 173959 (Minn. Ct. App. 2009).

Relevant Statute(s):

SDCL 10-45-1(14)

SDCL 10-45-2

SDCL 10-46-2

SDCL 10-45-4.1

SDCL 10-46-55

STATEMENT OF THE CASE AND FACTS[1]

A. Background of Northern Border's Challenge to the Department's Imposition of South Dakota Use Tax in this Case.

Northern Border operates a natural gas pipeline system that extends from Monchy, Saskatchewan, through South Dakota, until it connects with another pipeline in North Hayden, Indiana. HT 77–78. Northern Border has always operated as a "transportation-only" pipeline, and sells transportation services, i.e., it transports the gas of others through its pipeline. HT 80. As the operator of an interstate natural gas pipeline, Northern Border's transportation services are regulated by the Federal Energy Regulatory Commission ("FERC").

Applying the definitions of the FERC Gas Tariff to this case, Northern Border's customers are "shippers" of natural gas that enter into agreements to use Northern Border's transportation services. *See* AR 167 (Ex. 3, Part 6.1 ¶ 99) (defining "shipper"); AR 169 (Ex. 3, Part 6.1 ¶ 113) (defining "transportation path"). As the transporter company, Northern Border is bound by the terms of its

[1] Throughout this litigation, the terms "compressor fuel" and "compressor gas" have been used interchangeably. For the convenience of this Court, throughout this brief, both will be referred to as "compressor fuel."

Tariff.[2] AR 157 (Ex. 3, Part 6.1 ¶ 23). Northern Border is authorized to impose specified charges for its transportation services provided to its shippers under the Tariff, but it cannot provide services that are not authorized under the Tariff. *Id*.

Northern Border's transportation services include firm transportation service and interruptible service. AR 68-153 (Ex. 3, Part 5). For each of these services, the shipper nominates a quantity of gas for transportation through the pipeline, which is delivered to Northern Border at a receipt point and received by the shipper at a delivery point. AR 68-88 (Ex. 3, Part 5.1), AR 104-113 (Ex. 3, Part 5.4); *See* AR 164 (Ex. 3, Part 6.1, ¶ 82, 84) (defining point of receipt and point of delivery). Based on the quantity nominated and the distance traveled, the shipper pays, depending on the form of service, a daily reservation rate and/or a commodity rate, plus a commonly shared industry charge. AR 68-88 (Ex. 3, Part 5.1)

[2] Northern Border's FERC Gas Tariff ("Tariff") identifies the terms and conditions under which Northern Border will transport gas for shippers; and the services provided by Northern Border must be consistent with the requirements in the Tariff. AR 56 (Ex. 3, Part 2); AR 1645; HT 83. The Tariff is a comprehensive document that is intended to address and identify all of the services that Northern Border provides to shippers and is intended as a full disclosure of the rules under which Northern Border will transport gas. *Id*.

(explaining rates for firm service); AR 72–73 (Ex. 3 Part 5.1.3.1), AR 107–108 (Ex. 3, Part 5.4.3) (listing rates for each form of service plus Compressor Usage Surcharge and ACA charge); AR 326 (Ex. 3, Part 6.44) (explaining Compressor Usage Surcharge); AR 235 (Ex. 3, Part 6.16 ¶1) (explaining ACA charge).

Gas moves through the pipeline based on its pressure. HT 98. During passage through the pipeline, the gas loses pressure due to friction. *Id.* In order to keep the pressure at the level necessary for efficient movement through the pipeline, Northern Border has nineteen compressor engines or stations (hereinafter "compressors") located along its pipeline. AR 46 (Ex. 1); HT 98–99.[3] Fifteen of the compressors, including three in South Dakota, are powered by natural gas taken from the pipeline. HT 99–100. The remaining four are powered by electricity. *Id.*[4]

[3] The compressors along Northern Border's pipeline, including those in South Dakota, are located 55–65 miles apart for maximum efficiency and optimal pressure. AR 46 (Ex. 1).

[4] Like the cost of electricity, Northern Border's Tariff contemplates that use tax will be imposed on the consumption of natural gas quantities at natural gas powered stations along Northern Border's system. AR 326 (Ex. 3, Part 6.44). Also, like the electrical costs, Northern Border may recover the use tax assessed on the use and consumption of those natural gas quantities through a surcharge in its rates. AR 326 (Ex. 3, Part 6.44 ¶ 2(a)).

"Company use" gas encompasses the quantity of gas that Northern Border uses from the stream of natural gas it transports in the pipeline, to fuel the natural gas compressor engines, some utility fuel to heat the compressor building or provide hot water, gas used for testing purposes, or lost gas. HT 100; AR 157 (Ex. 3, Part 6.1 ¶ 24) (defining "Company Use Gas"). Whether or not the company use gas is used during the transportation process, the company use gas is not returned to a shipper when the shipper's nominated quantity of gas is removed from the pipeline at the delivery point. HT 101.

Once the gas (nominated for transportation and company use) is delivered to Northern Border for transportation, Northern Border has possession, custody, and responsibility of all the gas it transports through its pipeline until that gas is delivered back to the shipper. HT 102; AR 231-232 (Ex. 3, Part 6.13) (Delivery of Gas), AR 234 (Ex. 3, Part 6.15) (Responsibility for Gas). Northern Border acknowledges that it possesses the company use gas upon delivery from the shipper and that its Tariff authorizes it to use that gas in operating the engines on its pipeline "*as determined by Northern Border*." HT 102-104. AR 157 (Ex. 3, Part 6.1 ¶ 24) (The Tariff provides Northern Border discretion as to how and when company use gas is used).

B. Northern Border Uses The Company Use Gas.

Northern Border admits that it uses and consumes quantities of natural gas to operate its pipeline and perform transportation services permitted under the Tariff. *Id.* Northern Border uses the majority of the company use gas that it receives from its shippers as fuel for its compressor engines. *Id.*

A smaller portion of the company use gas is used to heat the buildings that house the compressor stations and for testing and pipeline shutdowns. Ex. 3, Part 6.1 ¶ 24; HT 100 (Some company use gas is "utility fuel used at the compressor stations to warm the buildings, to provide hot water . . ."). Using meters at compressor stations, Northern Border continuously measures the amount of company use gas used for compressor fuel and for utility fuel to heat the facilities or other portions of the pipeline operations. HT 115; AR 24 (Ex. A at 16).

Northern Border tracks the quantity of company use gas received from its shippers used as compressor fuel, by dekatherms, on a monthly basis. AR 24 (Ex. A at 16). Northern Border's Tariff also provides that:

> [Northern Border] may purchase and/or sell gas to the extent necessary to: (i) balance Company Use Gas; (ii) maintain system pressure and line pack; (iii) manage imbalance quantities; (iv) perform other operational functions of Company in

> connection with transportation and other similar services; and (v) otherwise protect the operational integrity of Company's pipeline system. Any such purchases or sales shall be made on an unbundled basis. Operational purchases or sales shall have a lower transportation priority than firm service.

AR 327-328 (Ex. 3, Part 6.45).

C. Assessment of Northern Border.

This matter arises due to an audit conducted on Northern Border. On September 6, 2011, the Department issued a certificate of assessment to Northern Border in the amount of $5,760,120.25, consisting of $4,160,745.59 of tax and $1,599,374.66 of interest. AR 11 (Ex. A at 3). The assessment was based on Northern Border's use of compressor fuel (tangible personal property). In a letter dated November 3, 2011, and received by the Department on November 4, 2011, Northern Border requested an administrative hearing. AR 42-45 (Ex. B). A hearing was held on May 1, 2012 before Chief Hearing Examiner Hillary Brady.

On September 9, 2013, after reviewing the evidence, the arguments of the parties, and the law, the Hearing Examiner entered a Proposed Decision affirming the certificate of assessment issued to Northern Border. AR 1778-91. On September 12, 2013, the Secretary issued a Final Decision adopting the Hearing Examiner's Proposed

Decision in its entirety. AR 1794. Notice of Entry of the Final Decision was issued on September 13, 2013. AR 1792-93. Northern Border executed a Notice of Appeal to the Sixth Judicial Circuit Court and served the Notice of Appeal on the Department on October 10, 2013. SR 1-18.

After the issues were fully briefed, the matter was heard by the Honorable Mark Barnett on March 3, 2014. On June 16, 2014, the circuit court entered an Order reversing the Secretary of the Department of Revenue's Final Decision. R. 44-62. Notice of Entry was served on July 2, 2014. R. 88. On July 23, 2014, the Department filed its Notice of Appeal, a Docketing Statement, and a Certificate of Service with the circuit court. R. 115-170.

STANDARD OF REVIEW

The applicable standard of review "will vary depending on whether the issue is one of fact or one of law." *Orth v. Stoebner & Permann. Constr., Inc.*, 2006 S.D. 99, ¶ 27, 724 N.W.2d 586, 592 (*quoting Tischler v. United Parcel Service*, 1996 S.D. 98, ¶ 23, 552 N.W.2d 597, 602). When the court reviews a question of fact, "the actions of the agency are judged by the clearly erroneous standard; and when the issue is a question of law, then the actions of the agency are fully reviewable [i.e., *de novo*]." *Id.* Furthermore, when an agency makes factual determinations on

the basis of deposition testimony or documentary evidence, the matter is reviewed *de novo*. *McKibben v. Horton Vehicle Components, Inc.*, 2009 S.D. 47, ¶ 11, 767 N.W.2d 890, 894 (*citing Truck Ins. Exch. v. CNA*, 2001 S.D. 46, ¶ 6, 624 N.W.2d 705, 708).

"Whether a statute imposes a tax under a given factual situation is a question of law and thus no deference is given to any conclusion reached by the Department of Revenue or the circuit court." *TRM ATM Corp. v. S.D. Dep't of Revenue & Regulation*, 2010 S.D. 90, ¶ 3, 793 N.W.2d 1, 2 (citing *S.D. Dep't of Revenue v. Sanborn Tel. Coop.*, 455 N.W.2d 223, 225 (S.D. 1990)). "Statutes which impose taxes are to be construed liberally in favor of the taxpayer and strictly against the taxing body. Statutes exempting property from taxation should be strictly construed in favor of the taxing power." *Butler Mach. Co. v. S.D. Dep't of Revenue*, 2002 S.D. 134, ¶ 6, 653 N.W. 2d 757, 759 (internal citations omitted). "Exemptions from tax are privileges accorded as a matter of legislative grace and not as a matter of taxpayer right . . . Tax exemptions are never presumed . . . [T]he general rule has been established that the taxpayer has the burden of proving entitlement to a statutory exemption." *Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255 (S.D. 1990).

ARGUMENT

ISSUE 1. THE CIRCUIT COURT ERRED IN HOLDING THAT SDCL 10-46-55 EXEMPTS FROM USE TAX THE COMPRESSOR FUEL USED BY NORTHERN BORDER.

In its decision, the circuit court erred in finding that SDCL 10-46-55 exempts from use tax the compressor fuel (tangible personal property) used by Northern Border. R. 44-62. As discussed below, SDCL 10-46-55 exempts natural gas transportation *services*.[5] The application of SDCL 10-46-55 to Northern Border's use of compressor fuel is erroneous and must be reversed.

1. Natural gas is tangible personal property subject to South Dakota sales or use taxes absent a specific exemption.

Northern Border's purchase of compressor gas from the shippers and use of that compressor gas presents a straight-forward application of South Dakota's sales and use tax statutory scheme. Within that statutory scheme, SDCL 10-45-2 imposes South Dakota sales tax upon the sale of all tangible personal property.[6] In instances when no

[5] The Department has never assessed South Dakota sales or use tax on Northern Border's natural gas transportation services. *See* AR.

[6] SDCL 10-45-2 provides:

> There is hereby imposed a tax upon the privilege of engaging in business as a retailer, a tax of four percent upon the gross receipts of all sales of tangible personal property consisting of goods, wares,

sales tax has been remitted, the user of that tangible personal property is subject to use tax. SDCL 10-46-2; 10-46-3; 10-46-4[7]. Specifically, SDCL 10-46-2 imposes a use tax on "the privilege of the use, storage, and consumption in this state of tangible personal property purchased for use in this state." SDCL 10-46-3 further imposes a use tax on tangible personal property used, stored, or consumed in this state regardless of whether it was purchased in this state:

> SDCL 10-46-3. An excise tax is imposed on the privilege of the use, storage or consumption in this state of tangible personal property or any product transferred electronically not originally purchased for use in this state, but thereafter used, stored or consumed in this state, at the same rate of percent of the fair market value of the property at the time it is brought into this state as is imposed by § 10-45-2 . . .

Therefore, unless sales tax has been paid on tangible personal property, that property is specifically subject to South Dakota use tax when it is used, consumed, or stored within the State of South Dakota. See SDCL 10-45-1(14); 10-45-2; 10-46-2; 10-46-3; 10-46-4.

> or merchandise, except as otherwise provided in this chapter, sold at retail in the State of South Dakota to consumers or users.

[7] SDCL 10-46-4 provides that, "[i]n addition, said tax is hereby imposed upon every person using, storing, or otherwise consuming such property within this state until such tax has been paid directly to a retailer or the secretary of revenue as hereinafter provided."

For purposes of sales and use tax, "tangible personal property" is statutorily defined as "personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. The term includes electricity, water, *gas*, steam, and prewritten computer software." SDCL 10-45-1(14) (emphasis added). Natural gas is tangible personal property subject to South Dakota sales tax when sold and subject to South Dakota use tax when it is used, consumed, or stored. SDCL 10-45-2; 10-46-2; 10-46-3; 10-46-4. Here, it is undisputed that natural gas is tangible personal property. *Id.*; *see* AR, SR.

In this case, Northern Border owes use tax on its use and consumption of compressor gas. Northern Border is paid by the shippers to transport gas from point A to point B. Payment comes in the form of money and compressor fuel, which, as stated above, is undisputedly tangible personal property.[8] That compressor fuel is placed into Northern Border's pipeline, without sales tax ever being paid on it. When compressor fuel (tangible personal property) is removed from the pipeline and used, consumed, or burned to

[8] If Northern Border did not receive the compressor fuel (tangible personal property), it would have to purchase it on the open market and pay sales tax on that purchase. SDCL 10-45-1(14), 10-45-2.

fuel Northern Border's compressors, it is subject to South Dakota use tax. *See* SDCL 10-45-1(14); 10-45-2; 10-46-2; 10-46-3; 10-46-4; *see also Great Lakes Gas Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435 (Minn. 2002) and *Northern Border Pipeline Co. v. Comm'r of Revenue*, 2009 WL 173959 (Minn. Ct. App. 2009) (both finding that use tax applies to the value of the gas used in the compressors). Therefore, in this case, the Department correctly assessed Northern Border use tax on the compressor gas that Northern Border used and consumed without ever remitting sales tax. AR 11 (Ex. A at 3).

2. The Circuit Court erred in finding that SDCL 10-46-55, an exemption for natural gas transportation services, exempts Northern Border's use of compressor fuel (tangible personal property).

In this case, the Circuit Court found that SDCL 10-46-55 exempted Northern Border's use of compressor fuel (tangible personal property). The plain language of SDCL 10-46-55 indicates that it is an exemption for natural gas transportation *services*. This Court, in *Magellan Pipeline Co., LP v. S.D. Dep't of Revenue*, 2013 S.D. 68, 837 N.W.2d 402, specifically recognized that the Legislature limited the natural gas pipeline exemption to "transportation services":

> Entitlement to a tax exemption must be based on the language of the statute. *Sioux Falls Shopping News,*

> *Inc. v. Dep't of Revenue & Regulation*, 2008 S.D. 34, ¶ 26, 749 N.W.2d 522, 527 (noting that a court may not include language in the tax statutes that the Legislature did not employ). The Legislature limited the natural gas pipeline exemption to "transportation services[.]"

Id. at ¶ 34. The use of compressor fuel (tangible personal property) does not fit within the statutory definition of a service. See SDCL 10-45-4.1. Therefore, the application of SDCL 10-46-55 to Northern Border's use of compressor fuel is erroneous.

A. <u>The plain language of SDCL 10-45-4.1, defining a service, evidences that the use of tangible personal property is not a service.</u>

The circuit court erred in concluding that Northern Border's use of compressor gas was a "service." However, the use of compressor fuel is the use of tangible personal property; not a service as contemplated by SDCL 10-45-4.1. South Dakota law defines a "service" and distinguishes it from the "use of tangible personal property." *Compare* SDCL 10-45-4.1 (defining a service) to 10-45-2; 10-46-2; 10-46-3; 10-46-4 (imposing taxes on tangible personal property and the use of such property). South Dakota law defines a service as:

> SDCL 10-45-4.1. "Service" means all activities engaged in for other persons for a fee, retainer, commission, or other monetary charge, which activities involve predominantly the performance of a service as distinguished from selling property. In determining what is a service, the

> intended use, principal objective or ultimate objective of the contracting parties shall not be controlling. For the purposes of this chapter services rendered by an employee for his employer are not taxable.

According to SDCL 10-45-4.1, "'Service' means all activities *engaged in for others for a fee, retainer, commission, or other monetary charge*[.]" (Emphasis added).[9] Alternatively, SDCL 10-46-1(17) defines, in pertinent part, the use of tangible personal property as:

> SDCL 10-46-1(17). "Use," the exercise of right or power over tangible personal property or any product transferred electronically incidental to the ownership of that property, except that it does not include the sale of that property in the regular course of business. . . .

The plain language of these statutes demonstrates that statutorily services are distinguishable from the use of tangible personal property. *Compare* SDCL 10-45-4.1 to 10-46-1(17).

The use of compressor fuel is not a service as contemplated by SDCL 10-45-4.1. No one is paying Northern Border to burn the company use gas – Northern Border acknowledges that it is in possession of the company use gas upon delivery from the shipper and that its Tariff authorizes it to use that gas in operating the engines on

[9] Like the statutes governing tangible personal property, when sales tax is not collected and remitted on services, use tax is due. SDCL 10-46-2.1.

its pipeline, "*as determined by Northern Border*." HT 102-104. AR 157 (Ex. 3, Part 6.1 ¶ 24) (The Tariff provides Northern Border discretion as to how and when company use gas is used).[10]

South Dakota law clearly distinguishes between what constitutes the use of tangible personal property and what constitutes a service. *See* 10-45-2, 10-46-2, 10-46-3, 10-46-4, and 10-45-4.1. In this case, Northern Border uses the compressor fuel (tangible personal property) at its discretion – it is not an activity performed for another person for a fee. Therefore, it does not fall into the statutory definition of a service. *See* SDCL 10-45-4.1.

B. The Circuit Court misapplied SDCL 10-46-55 and improperly bundled Northern Border's use of tangible personal property with its transportation services.

Under the facts of this case, the SDCL 10-46-55 use tax exemption should never apply to Northern Border because it is not a purchaser of natural gas transportation services. *See* SDCL 10-46-55; SDCL ch. 10-46 (use tax exemptions apply to the purchasers). Moreover, the circuit court's analysis improperly bundles Northern Border's (1) natural gas transportation services with (2) Northern

[10] Northern Border's customers cannot use the transportation services without delivering a required quantity of gas that will not be returned to the customer and that is used as Northern Border alone, at its discretion, decides to use it. HT 101, 102-104. AR 157 (Ex. 3, Part 6.1 ¶ 24).

Border's purchase and use of compressor fuel (tangible personal property). These are two separate and distinct transactions – Northern Border's natural gas transportation services are not even at issue.

SDCL 10-45-67 exempts a specific transaction: natural gas pipelines do not have to collect and remit sales tax on their natural gas transportation *services*.

> SDCL 10-45-67. The provision of natural gas transportation *services* by a pipeline is exempted from the provisions of this chapter and from the computation of the tax imposed by this chapter.

(Emphasis added). Since the incidence of the sales tax is on the retailer, sales tax exemptions benefit sellers. *See* SDCL 10-45-2; 10-45-22. Northern Border, as the seller of natural gas transportation services, benefits from the SDCL 10-45-67 exemption because Northern Border does not have to remit sales tax on its gross receipts received for natural gas transportation services. SDCL 10-45-67.

As is the case for many sales tax exemptions, the legislature enacted a corresponding use tax exemption. *See* SDCL 10-46-55. SDCL 10-46-55 provides the corresponding use tax exemption for shippers, the users of natural gas pipeline transportation *services* from use tax on the pipeline's natural gas transportation *services*.

> SDCL 10-46-55. The provision of natural gas transportation *services* by a pipeline is exempt from

> the provisions of this chapter and from the computation of the tax imposed by this chapter.

(Emphasis added). Use tax is complementary and supplementary to the sales tax. *See Sioux Falls Newspapers, Inc. v. Secretary of Revenue*, 423 N.W.2d 806 (S.D. 1988). The benefits of use tax exemptions flow to the purchasers of goods or services.[11] *State v. Dorhout*, 513 N.W.2d 390, 393 (S.D. 1994) (the imposition of tax is on the purchaser, not the seller.). Consequently, the purchasers, in this case the shippers, of Northern Border's natural gas transportation services reap the benefits of the SDCL 10-46-55 use tax exemption when they purchase Northern Border's natural gas transportation services. Ultimately, the SDCL 10-46-55 use tax exemption should never apply to Northern Border as it is not a purchaser of natural gas transportation services.

Moreover, at issue in this case is Northern Border's use of compressor fuel, not the taxability of Northern Border's transportation services.[12] SDCL 10-46-55 only exempts transportation *services*, not the use of tangible

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[11] "A use tax is a tax on the enjoyment of that which was purchased." *State v. Dorhout,* 513 N.W.2d 390, 392 (S.D.1994)).

[12] The Department did not assess sales tax on the fee Northern Border charged the shippers for its natural gas transportation services. *See* AR.

personal property, such as materials, parts, or as in this case, compressor fuel. The South Dakota Supreme Court has "frequently held that, when examining whether a tax applies, the focus belongs on the transaction, not the character of the participants." *Media One,* 1997 S.D. 17, ¶ 17, 559 N.W.2d at 880; *Coop. Agronomy Servs. v. S.D. Dep't of Revenue,* 2003 S.D. 104, ¶ 8, 668 N.W.2d 718, 721. Simply because Northern Border is a pipeline that provides transportation services does not mean that all activities it engages in are exempt from tax. *See Mauch v. Dep't of Revenue & Regulation*, 2007 S.D. 90, ¶ 17, 738 N.W.2d 537, 542 (determinations of taxability are based on the transaction, not the classification of the taxpayer). Northern Border's purchase and use of compressor fuel (use of tangible personal property) is a separate and distinct transaction from its natural gas transportation services.

Here, Northern Border is using and consuming the compressor fuel. Northern Border's use of compressor fuel is no different than if one of the compressors were to break down and Northern Border were to use a part in its inventory to repair the compressor. *See* SDCL 10-46-2, 10-46-3, 10-46-4. Similar to using a part from its inventory, Northern Border is using the compressor fuel when needed and at its sole discretion. AR 157 (Ex. 3, Part 6.1 ¶ 24).

Northern Border's use of gas to fuel its compressors, like the use of a part to repair its compressors is not a transportation service – it is the use of tangible personal property.

In this case, there are two transactions: Northern Border's natural gas transportation services and Northern Border's use of compressor fuel. One is a service, the other is not. SDCL 10-46-55 only exempts natural gas transportation *services* and would never apply to Northern Border because it is not the purchaser of transportation services. *See Magellan*, 2013 S.D. 68, ¶ 34, 837 N.W.2d at 411 (stating that "[t]he Legislature limited the natural gas pipeline exemption to "transportation services[.]"). Northern Border's natural gas transportation *services* were not assessed upon in this audit. SDCL 10-46-55 does not exempt a natural gas pipeline's use of tangible personal property, in this case, compressor fuel.

An absurd result is reached if you bundle Northern Border's use of the company use gas in with its transportation services. This would mean that Northern Border is the user of the transportation services, which would necessarily mean that the shippers are the retailers of the transportation services. The statute, however, expressly prohibits this interpretation because it requires

the services to be conducted "by a pipeline." *See* SDCL 10-46-55.

Under the facts of this case, the benefits of the SDCL 10-46-55 use tax exemption would never apply to Northern Border as it is not the purchaser of natural gas transportation services. More importantly, Northern Border's natural gas transportation services are not even at issue – it is Northern Border's use of compressor fuel (tangible personal property). A plain reading of South Dakota's statutes requires a reversal of the Circuit Court's decision. *See* 10-45-2; 10-46-1(17); 10-46-2; 10-46-3; 10-46-4; 10-45-4.1; 10-45-67; 10-46-55.

C. The Minnesota cases support the Department's position.

On two separate occasions, Minnesota has addressed whether natural gas used in compressors is subject to use tax. *Great Lakes Gas Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435 (Minn. 2002); *Northern Border Pipeline Co. v. Comm'r of Revenue*, 2009 WL 173959 (Minn. Ct. App. 2009). In *Great Lakes Gas Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435, the Minnesota Supreme Court held that "the substance of the transaction [in which a transportation-only pipeline receives the compressor fuel gas from its shippers] is an exchange of the compressor-

consumed gas for transportation services. 638 N.W.2d at 439. Both Courts agreed that the use tax applies to the value of the gas used in the compressors. *Great Lakes Gas Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435 (Minn. 2002); *Northern Border Pipeline Co. v. Comm'r of Revenue*, 2009 WL 173959 (Minn. Ct. App. 2009). Considering Minnesota's statutory sales and use tax scheme is substantially similar to South Dakota's scheme, the same conclusion is warranted in this case.

The Circuit Court attempted to distinguish the Minnesota cases from the present case by equating the exemption found in SDCL 10-46-55 to Minnesota's pre-amended industrial-production exemption. SR 44-62. At the time of *Great Lakes*, Minnesota's industrial-production exemption exempted from use tax:

> "the storage, use, or consumption of all materials, including chemicals, fuels, petroleum products * * * used or consumed in * * * industrial production of personal property intended to be sold ultimately at retail." "Industrial production" is defined in Minn. R. 8130.5500, subp. 1:
>
> > Agricultural and industrial production includes any step or steps in the production process. * * * Generally, the production process begins with the removal of raw materials from stock for the purpose of commencing activities effecting changes thereon in the course of producing the intended product. The production process ends when the completed state is achieved. * * * If the product is not packaged, the process ends when it is placed into finished goods inventory.

> If the package is not placed into finished goods inventory prior to shipment, the process ends when the last process prior to loading for shipment has been completed.
>
> As to natural gas specifically, the rule provides the following in pertinent part: "The purchase of fuel, electricity, *gas,* steam, and water that is used or consumed directly in agricultural or industrial production is not taxable." *Id.,* subp. 4a (emphasis added).

Great Lakes, 638 N.W.2d at 439-40. This statute has been subsequently amended and the Court in *Northern Border*, 2009 WL 173959, found that Northern Border was subject to use tax on its use of compressor fuel.

Unlike Minnesota at the time of the *Great Lakes* decision, South Dakota law does not provide an industrial-production exemption for natural gas pipelines. *See generally* SDCL chs. 10-45; 10-46. Absent an industrial-production exemption, Minnesota has held that use tax applies to the value of the gas used in compressors – that same conclusion is warranted here and the decision of the Circuit Court must be reversed. *See Northern Border*, 2009 WL 173959.

CONCLUSION

This case is a straight-forward application of South Dakota's use tax. Northern Border transports natural gas from Point A to Point B for shippers in exchange for money and natural gas. No sales tax was paid on this

transaction. The natural gas is then stored in Northern Border's pipeline and used at Northern Border's discretion to fuel its compressors.

When the gas is used to fuel the compressors, it is consumed. That consumption makes it subject to use tax because no sales tax has been paid. The use and consumption of that fuel is no different than the use and consumption of a repair part or the use and consumption of any other form of tangible personal property. *See* SDCL 10-46-1(17); 10-46-2; 10-46-3; 10-46-4. South Dakota use tax applies to the value of the gas used and consumed in the compressors. SDCL 10-46-2; 10-46-3; 10-46-4.

Here, the circuit court erred in holding that Northern Border's use of compressor fuel (tangible personal property) fits squarely within the natural gas transportation services exemption contained within SDCL 10-46-55. *See Magellan*, 2013 S.D. 68 at ¶ 34, 837 N.W.2d at 411 (stating that "[t]he Legislature limited the natural gas pipeline exemption to "transportation services[.]"). Under South Dakota law, SDCL 10-46-55 should never apply to Northern Border as it is not a purchaser of natural gas transportation services. Furthermore, a service is distinguishable from the use of tangible personal property. *Compare* SDCL 10-45-2; 10-46-1(17); 10-46-2; 10-46-3; 10-46-

4 *with* 10-45-4.1. The plain language of the aforementioned statutes and 10-46-55 requires that the decision of the circuit court be reversed and the Decision of the Secretary be affirmed in its entirety.

Respectfully submitted this 8th day of September, 2014.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that two true and correct copies of Appellant South Dakota Department of Revenue's Brief in the matter of Northern Border Pipeline Company v. South Dakota Department of Revenue were served on:

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Dated and mailed this 8th day of September, 2014.

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IN THE SUPREME COURT
OF THE
STATE OF SOUTH DAKOTA

No. 27152

NORTHERN BORDER PIPELINE COMPANY,

Appellee,

vs.

SOUTH DAKOTA DEPARTMENT OF REVENUE AND REGULATION,

Appellant.

Appeal from the Circuit Court
Sixth Judicial Circuit
Hughes County, South Dakota

The Honorable Mark W. Barnett, Presiding Judge

BRIEF OF APPELLEE

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Notice of Appeal filed July 23, 2014

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JURISDICTIONAL STATEMENT

This appeal arises from an Order and Judgment entered by the Sixth Judicial Circuit Court on June 16, 2014. CR 61. (In this brief, Northern Border Pipeline Company ("Northern Border") will reference the Certified Record as "CR" and the Administrative Record as "AR," each followed by the appropriate index designation, such that documents in the indices are cited by the documents' first page designation. The hearing transcript will be referenced as HT, followed by the appropriate page designation in the CR or AR, as applicable.) Northern Border gave notice of entry of the Order and Judgment on July 2, 2014. CR 88. The Order and Judgment reversed a September 12, 2013 Final Decision of the Secretary of the South Dakota Department of Revenue (the "Department"). AR 1794. The Department's Final Decision considered and adopted in full a proposed decision of a hearing examiner, affirming a certificate of assessment of use tax against Northern Border. AR 1794. The Department filed notice of appeal of the circuit court's Order and Judgment on July 23, 2014, and, consistent with SDCL § 15-26A-22, Northern Border timely filed notice of review on August 12, 2014.

STATEMENT OF THE ISSUES

1. The natural gas burned in Northern Border's compressors was not subject to use tax under SDCL § 10-46-2 under either or both of the following:

A. This natural gas was not "used" by Northern Border in South Dakota, as required by SDCL § 10-46-2, incidental to ownership.

Circuit court decision: The circuit court did not address this issue.

SDCL § 10-46-1(17).

SDCL § 10-46-2.

Hallett Constr. Co. v. Gillis, 119 N.W.2d 117 (S.D. 1963).

Friessen Constr. Co. v. Erickson, 238 N.W.2d 278 (S.D. 1976).

B. This natural gas was not purchased by Northern Border, and there was no purchase price paid by Northern Border for this natural gas, both of which are requirements under SDCL § 10-46-2.

Circuit court decision: The circuit court did not address this issue.

SDCL § 10-46-1(9).

SDCL §10-46-2.

Department v. Sanborn Tele. Coop., 455 N.W.2d 223 (S.D. 1990).

2. The natural gas burned in Northern Border's compressors was exempt from use tax under either or both of the following:

A. This natural gas was entirely exempt from use tax under SDCL § 10-46-55.

Circuit court decision: The circuit court ruled the exemption under SDCL § 10-46-55 applied, and the gas burned in Northern Border's compressors was exempt from use tax under SDCL §10-46-2.

SDCL § 10-46-55.

B. A determination must be made of the extent to which this natural gas was exempt under SDCL § 10-46-6 before use tax can be assessed against Northern Border.

Circuit court decision: The circuit court did not address this issue.

SDCL § 10-46-6.

South Dakota Attorney General Opinion No. 82-9 (Feb. 3, 1982).

3. The natural gas burned in Northern Border's compressors cannot be subject to South Dakota use tax because such taxation is unconstitutional under either or both of the following:

A. Under the Supremacy Clause of the United States Constitution, any application of South Dakota law that treats Northern Border as the purchaser or owner of this natural gas is pre-empted by federal law.

Circuit court decision: The circuit court did not address this issue.

Pliva, Inc. v. Mensing, 131 S.Ct. 2567 (2011).

B. Subjecting this natural gas to South Dakota use tax interferes with interstate commerce as defined in ARSD 64:09:01:09.

Circuit court decision: The circuit court did not address this issue.

ARSD 64:09:01:09.

Mississippi River Transmission Corp. v. Weiss, 65 S.W.3d 867 (Ark. 2002).

4. The assessment of use tax and interest was erroneous due to clear factual and legal errors.

A. The tax was incorrectly computed, based on incorrect and inapplicable data, and relevant information was incorrectly excluded from consideration based on SDCO §§ 10-59-3 and 10-59-7.

Circuit court decision: The circuit court did not address this issue.

SDCL § 10-59-3.

SDCL § 10-59-7.

ARSD 64:06:01:35.05.

B. To the extent tax was due, the Department failed to reduce or abate interest and/or tax under SDCL, Ch. 10-59.

Circuit court decision: The circuit court did not address this issue.

SDCL § 10-59-28.

STATEMENT OF THE CASE

This matter began as an administrative proceeding before the Department. The Department conducted an audit and, on September 6, 2011, issued a certificate of assessment upon Northern Border. HT, Exhibit A. Northern Border requested a contested case hearing, which occurred on May 1, 2012, before a hearing examiner appointed by the Department. HT 1. The hearing examiner issued a proposed decision, which was adopted by the Department in its entirety as its final decision. AR 1783-1791; 1794.

Northern Border appealed the Department's decision to circuit court, and the circuit court reversed the Department's decision by its Order and Judgment on June 16, 2014. CR 61. The Department appealed the circuit court's decision on July 24, 2014. CR 115. Because the circuit court did not address several

issues raised by Northern Border, Northern Border timely filed a notice of review for these issues on August 12, 2014.

STATEMENT OF FACTS

Northern Border transports natural gas in interstate commerce. HT 80. Northern Border's pipeline system begins at the international boundary in Montana and extends southeasterly to its terminus in Indiana, crossing northeastern South Dakota. HT 15, 77-78.

As required by the Federal Energy Regulatory Commission ("FERC"), Northern Border is a transportation-only pipeline, which means it is not permitted to own any gas it transports, including gas burned in its compressors. HT 80, 97, 127-31 & Exhibit 5; *In re ConocoPhillips Co.*, 138 FERC 61,004, 2012 WL 57373 *2 ("A central requirement of the Commission's open-access transportation program is that all shippers must have title to the gas at the time the gas is tendered to the pipeline or storage transporter and while it is being transported or held in storage by the transporter"); *Enron Energy Servs., Inc.*, 85 FERC 61, 221, 1998 WL 790795 *1 ("Although the language of the tariff provisions may only indicate the shipper must have title to gas at the time it delivers the gas to the pipeline for transportation, longstanding Commission policy also requires that the shipper must continue to hold title to the gas throughout the entire course of the transportation of the gas"). The natural gas

transported through the pipeline is owned by purchasers of transportation services from Northern Border, i.e., the "shippers". HT 127, 129-130, 147. Most of the shippers purchase natural gas in Alberta, Canada at a market hub known as AECO or the AECO C Hub. HT 82, 90-91. While gas is delivered from the pipeline at several locations in South Dakota, none of the gas is received into the pipeline in South Dakota. HT 84.

Pressure causes the gas to move through the pipeline; however, as the gas moves through the pipeline, the pressure decreases. HT 98. To maintain pressure and keep the gas moving, gas is routed continuously through compressor stations located along the pipeline where it is compressed and then returned to the pipeline. HT 98-99, 110-112, 114, 116. The diverted portion of the gas is unidentifiable due to the fungible nature of the gas. HT 113. Although nearly all of the gas routed through a compressor station returns to the pipeline, a very small amount of gas is burned to fuel the compressors. HT 103, 111. To deliver a particular quantity of gas to a specified destination, the shipper must place a negligibly larger quantity of natural gas into the pipeline at the origin of the shipment because a portion of the gas will burn in the compressors and not reach the delivery point. HT 151. These compressor stations, including three in South Dakota, are an integral part of the pipeline because they literally cause the transportation of gas through the pipeline. HT 98-99, 112-113. Northern Border could not provide natural gas transportation services without the compressors. HT 98, 112-113.

All aspects of Northern Border's interstate natural gas pipeline are strictly regulated by FERC. HT 23 & Exhibits 3 & 4. The South Dakota

Public Utilities Commission lacks jurisdiction over Northern Border as it transports natural gas in interstate commerce. HT 122. Northern Border can only provide services to shippers consistent with FERC policy pursuant to transportation services agreements that incorporate Northern Border's tariff. HT 130. The tariff, which must be approved by FERC, prescribes the terms and conditions of services provided by Northern Border and includes form transportation service agreements, pre-approved by FERC, for use between shippers and Northern Border. HT 124.

According to policy reflected in FERC Order No. 636, the shippers must own the gas transported in Northern Border's pipeline. HT 130-131, 134; Exhibit 5; *See supra*, pp. 4-5. Consistent with FERC policy, Northern Border's tariff requires the shipper hold title to the gas. *Id.;* HT Exhibit 3, Part 6.14. This means the natural gas transported and burned in the compressors must be provided by the shippers and cannot be owned by Northern Border. *Id.;* HT 133-34; Exhibit 3, Part 5.1.8. This is a federal requirement, and <u>not</u> a choice or business decision by Northern Border. HT 97, 127-31.

Northern Border was audited by the Department for the period from July 2007 through December 2010. HT, Exhibit A. The Department's auditor agrees Northern Border cooperated with the audit and provided all requested information to the Department on a timely basis, with a single exception of the

disputed request discussed in Issue 4 below. HT 66-68. The Department issued a certificate of assessment on September 6, 2011, assessing tax against Northern Border totaling $4,160,745.59, plus $1,599,374.66 of interest, for a total of $5,760,120.25. HT, Exhibit A, p. 3. Of the tax amount, $4,133,907.80 is use tax assessed on the natural gas burned in the compressors. HT, Exhibit A, Schedule VII. Despite the fact that the Department previously audited Northern Border at least twice since Northern Border went into service in 1982, this is the first time the Department assessed use tax on such gas. HT 76, 153.

ARGUMENT

It is well settled in South Dakota that statutory interpretation and whether a statute imposes tax under a given factual situation are questions of law to be reviewed *de novo* by the Court, with no deference given to any conclusion reached by the Department. *Magellan Pipeline Co. v. Department of Revenue,* 2013 SD 68, ¶ 7, 837 N.W.2d 402, 404. When the statutory text itself is clear, certain and unambiguous, the Court's only function is to declare the meaning of the statute as clearly expressed. *Id.* at ¶¶ 9 & 11. Every word in a statute is presumed to have been used for a purpose, and every word excluded from a statute is presumed to have been excluded for a purpose. *Id.*

Statutes are construed as a whole and in light of other enactments on the same subject. *Simpson v. Tobin*, 367 N.W.2d 757, 763 (S.D. 1985).

The Department claims this case presents a straightforward application of South Dakota's sales and use tax statutory scheme, and that the scheme imposes sales tax upon the sale of all tangible personal property, and when no sales tax has been remitted imposes use tax. *See* Department's Brief pp. 11-12. It is unclear why the Department did not pursue this "straightforward" application during prior audits over the last twenty years, but perhaps the Department's over-reaching view that everything is taxable explains why it overlooks many requirements for the imposition of tax and unduly restricts available exemptions.

1. Use tax cannot be imposed on Northern Border on the natural gas burned in the compressors because Northern Border does not "use" or "purchase" the gas.

To impose use tax under SDCL § 10-46-2, the Department must prove, among other things, both (1) "use" of the tangible personal property by Northern Border in South Dakota and (2) "purchase" of such property by Northern Border for use in this state. SDCL § 10-46-2. Both of the terms "use" and "purchase" are statutorily defined. *See* SDCL §§ 10-46-1(9); 10-46-1(17). Statutes imposing taxes are construed liberally in favor of the taxpayer and strictly against the taxing body. *Matter of Sales & Use Tax Refund*

Request of Media One, 1997 SD 17, ¶ 9, 559 N.W.2d 875, 877; *Sioux Valley Hosp. Assn. v. State,* 519 N.W.2d 334, 335 (S.D. 1994) (Department bears burden to prove elements of imposition statutes). Because Northern Border neither "uses" nor "purchases" the shippers' natural gas burned in the compressors, SDCL § 10-46-2 does not impose use tax on Northern Border on such gas.

Though citing SDCL §§ 10-46-3 and 10-46-4 in its brief, the Department is unclear on whether it now argues use tax should be assessed under SDCL §§ 10-46-3 and 10-46-4 instead of SDCL § 10-46-2. (Department's Brief 12-14) If it does, this Court's precedent requires it to refuse to address these arguments, as the Department never raised them below. *Watertown Coop Elevator v. Department of Revenue,* 2001 SD 56, 627 N.W.2d 167, 172 fn.5. There was no mention of these statutes in the certificate of assessment, the audit report, the hearing examiner's proposed decision, or the final decision of the Department. AR 1778, 1792; HT Exhibit A. Moreover, SDCL § 10-46-3 was not raised below, and the Department cited SDCL §10-46-4 below only in response to Northern Border's argument on the exemption under SDCL § 10-46-6, so the Department made no argument that SDCL § 10-46-4 independently imposed tax in this case. *Id.;* AR 1685. However, even if this

Court opts to consider these new arguments, neither of these statutes imposes use tax on Northern Border on the natural gas at issue.[1]

A. Northern Border did not "use" this natural gas.

South Dakota tax law defines "use" as the "exercise of right or power over tangible personal property . . . incidental to the ownership of that property." SDCL § 10-46-1(17) (emphasis added). This Court has consistently applied this "ownership" language as an explicit and essential requirement to impose use tax under SDCL § 10-46-2.[2] *Hallett Constr. Co. v. Gillis*, 119 N.W.2d 117 (S.D. 1963); *Friessen Constr. Co., Inc. v. Erickson,* 238 N.W. 2d 278 (S.D. 1976).

In *Hallett,* this Court recognized a taxpayer is not subject to use tax on certain materials unless that use is "incidental to ownership."[3] *Hallett*, 119 N.W.2d at 121. This Court subsequently illustrated the importance of the "incidental to ownership" requirement through its interpretation of another

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[1] The Department's theories for the assessment of use tax against Northern Border have evolved significantly since the audit. Despite the Department's choice to change its legal theories well after completion of the audit, the Department has also argued the taxpayer essentially cannot make any additional arguments or provide any additional documentation under SDCL §§ 10-59-3 or 10-59-7 after the sixtieth day following commencement of the audit, and this sixty-day period expired more than four months before issuance of the certificate of assessment. AR 1685.

[2] "Use" is defined the same for tax purposes of SDCL §§ 10-46-3 and 10-46-4. *See* SDCL § 10-46-1(17). So these statutes, even if applied, do not serve to impose tax.

[3] Unlike Northern Border, the *Hallett* taxpayer was found to own the materials at issue, so use tax was properly imposed. *Hallett*, 119 N.W.2d at 121.

statute. *Friessen*, 238 N.W.2d at 280. About three years after *Hallett*, the South Dakota Legislature enacted SDCL § 10-46-5, imposing a use tax on contractors (and only contractors) for their utilization of owner-provided materials (*i.e.*, property the contractors do not own) in construction projects. SDCL § 10-46-5. It did so by expressly stating the tax in that particular situation is imposed regardless of "whether the title to such property be in the contractor * * * or any other person* * *." *Id.*

In *Friessen,* contractors were taxed under SDCL § 10-46-5 on their utilization of items they did not own. *Friessen*, 238 N.W.2d at 279. After considering the predecessor to SDCL § 10-46-1(17) and its "incident to ownership" requirement, this Court noted that "there is an irreconcilability between the statutes in question as to whether a contractor may be subject to a use tax on property owned by the city." *Id.* at 280 (emphasis added). Thus, *Friessen* recognized that SDCL § 10-46-1(17) made the tax impermissible because the taxed contractors did not own the property, but use tax could be imposed on contractors under SDCL § 10-46-5 even though they did not own the property. *Id.*

The Court reconciled this inconsistency by holding SDCL § 10-46-5 should apply to contractors because it was enacted later, but "SDCL [10-46-1(17)] retains its validity in any situation not set out in SDCL 10-46-5." *Id.*

Therefore, *Friessen* confirms that SDCL § 10-46-1(17) does not permit use tax to be assessed under SDCL § 10-46-2 on property not owned by the taxpayer. Use tax can be assessed on property not titled in the taxpayer's name only under SDCL § 10-46-5. *Id.*

The Department has never asserted SDCL § 10-46-5 applies here, as Northern Border is not a contractor and cannot fall within that statute. Therefore, the statutory definition of "use" applies and does not permit imposition of a use tax on Northern Border under SDCL § 10-46-2 for the burning of gas in the compressors, since Northern Border does not own that gas.

The Department has consistently disregarded *Hallett* and *Friessen* and the "incident to ownership" requirement for "use." AR 1685 & 1792. Instead, the Department incorrectly equates consumption of property in the taxpayer's possession with "use" on the basis of inapplicable Minnesota case law.[4] AR 1817. This is clear error.

[4] Without citing relevant authority, the Department argues Northern Border owned the gas because Northern Border takes possession of the gas, controls it, and does not return it. AR 1685; (Department's Brief 6-7). The Department argues "control" based on "discretion" given to Northern Border in the tariff. The Department offers no evidence of its own and misconstrues Northern Border's testimony and the tariff. The Department fails to recognize the distinction that use tax can be assessed in Minnesota if consumption and transfer of possession occur. The Department cannot combine consumption and transfer of possession to establish ownership under South Dakota law.

The Department relies heavily upon *Great Lakes Transmission L.P. v. Comm'r of Revenue,* 638 N.W.2d 435 (Minn. 2002). Instead of relying on the record at hand, the Department imports factual findings from *Great Lakes*. Obviously, these findings are irrelevant to the case at bar and have no evidentiary value. *Great Lakes* is highly distinguishable from, and has almost no relevancy to, this case. Based on statutes that imposed use tax on the transfer of title or possession, *Great Lakes* imposed use tax on consumption and transfer of possession of the gas, and not based on transfer of title. *Id.* at 438-39. Minnesota law differs significantly from South Dakota law, which only permits use tax on use that is "incidental to ownership." *Compare* SDCL §§ 10-46-1(17) & 10-46-2 *with* Minn. Stat. § 297A.14, subd. 1 and subd. 3 (as quoted in *Great Lakes*, and now repealed and recodified). Therefore, it is clear that, although the distinguishable Minnesota statutes imposed use tax in *Great Lakes*, the result would have been different under South Dakota law. SDCL § 10-46-2 simply does not impose use tax on use that is not incidental to ownership, regardless of what Minnesota's statute allowed. Accordingly, Minnesota law provides no support for the Department's position here.

In contrast to Minnesota statutes that trigger use tax on the transfer of possession or ownership, other jurisdictions have imposition statutes similar to SDCL § 10-46-2 that by definition specifically incorporate the "incidental to

ownership" requirement. For example, in Arizona, "use or consumption" is subject to use tax only if "incidental to owning the property." A.R.S. §§ 42-5155(A) & 42-5151(20). Interpreting its statutes, Arizona courts recognized the significance of the "ownership" requirement.

In *Val Pak East Valley, Inc. v. Dep't,* 272 P.3d 1055 (Ariz. Ct. App. 1 2012), Val-Pak sold direct mail advertising coupons to clients by submitting their product information to another business that provided the paper and designed, printed, and inserted the coupons into envelopes. *Id.* at 1056. It then billed Val-Pak for design, printing and mailing and certain job-related charges. *Id.* The second business delivered the envelopes to the post office for mailing to addressees selected by Val-Pak's clients. The franchise agreement specified that the second business – and <u>not</u> Val-Pak – maintained ownership of the coupons, even though they were mailed pursuant to instructions from Val-Pak's clients. *Id.* at 1061.

Val-Pak first analyzed the "ownership" language, stating "[a]lthough the use tax statute does not define or describe the meaning of the phrase 'incidental to owning the property,' on its face this wording requires the exercise of a right or power that one has to tangible personal property <u>by virtue of owning it.</u>" *Id.* (emphasis added). *Val-Pak* then held it could not "gloss over the statutory requirement that a taxpayer's use must be incidental to owning the property"

and declined to impose use tax against Val-Pak on the coupons, since the second business (and not Val-Pak) owned them. *Id.* at 1061-62.

Similarly here, the Department cannot simply gloss over the fact that Northern Border did not, under its transportation service agreements with the shippers, own the natural gas burned in the compressors. Moreover, it legally cannot own this gas. *See supra* pp. 4-6. This fact precludes the imposition of use tax against Northern Border on that gas. *See Magellan*, 837 N.W.2d at 404 (every word of a statute is presumed to have been used for a purpose).

In keeping with this analysis, *Val-Pak* specifically distinguished the Arizona statute from a Nebraska statute imposing a tax on use "incident to ownership or possession." *Val-Pak* explained the Arizona Department's argument would have more force under such a statute. *Val-Pak*, 272 P.3d at 1062, n.7 (*comparing Val-Pak of Cent. Conn. N., Inc. v. Comm'r of Revenue Servs.,* 44 Conn.Supp. 133, 670 A.2d 343, 347 (1994), *aff'd,* 235 Conn. 737, 669 A.2d 1211 (1996) *with Val-Pak of Omaha, Inc. v. Dep't of Revenue of Neb.,* 249 Neb. 776, 545 N.W.2d 447, 449-50 (1996)). Even with similar facts, the results in these cases were diametrically opposed because the states' laws were different. Not only does *Val-Pak* provide a useful guidepost by interpreting South Dakota's nearly identical statutory requirement, it also illustrates the difference between the Minnesota and South Dakota use tax

statutes – Minnesota can impose use tax without ownership; South Dakota cannot. The Minnesota decisions are, therefore, irrelevant to prove "use" here.

Companies often enter into commercial agreements under which property separately owned by each of the companies is employed to accomplish a common business purpose. The fact that a company receives compensation from that arrangement does not mean that it owns the other company's separate property, even if such might be depleted in that arrangement. Rather, each retains ownership of its own property and, as such, is the user of the property under SDCL § 10-46-1(17).

For example, in *Val-Pak*, the second business provided paper and other materials for, and designed and printed, the coupons. *Val-Pak*, 272 P.3d at 1056. That did not mean Val-Pak owned the coupons. Rather, *Val-Pak* properly recognized the second business owned the coupons under the franchise agreement. *Id.* at 1061. The fact that the coupons were no longer available to the second business after the coupons were mailed did not alter the analysis – Val-Pak was not liable for use tax on coupons it did not own, notwithstanding that they were mailed and no longer available to the second business. Similarly, this Court should recognize that the gas burned in the compressors was not owned by Northern Border under its transportation

service agreements with shippers, even though burned pursuant to the transportation service agreements and no longer available to the shippers.

The Department bears the burden of proof on this issue, but offered no testimony or evidence to prove Northern Border owned the gas burned in the compressors. In fact, the testimony of the Department's own auditors was to the contrary. HT 63-64. Conversely, Northern Border presented substantial testimony and evidence that it did not own the gas burned in the compressors. HT 96-97, 132-35, 147. The lack of ownership was uncontroverted at the administrative hearing. Further, FERC policy, orders and rulings, *i.e.*, federal law, precludes Northern Border from owning the natural gas burned in the compressors. *See supra*, pp. 4-6.

Nonetheless, the Department claims Northern Border "admits" it uses and consumes the natural gas at issue. (Department's Brief at 7 (citing HT 102-104)) This misstates hearing testimony. HT 102-04. Despite the Department's repeated attempts to elicit such admissions from Northern Border's Manager of Marketing, he never testified Northern Border "used" or "consumed" the gas burned in the compressors, as those terms are used in SDCL §§ 10-46-1(17) and 10-46-2. A-76-78. The Department cannot establish a key element to the assessment of use tax through coy questioning

designed to elicit admissions by employing a common, non-legal meaning of a word that is statutorily defined – "use."

While consumption without ownership is insufficient to impose use tax under SDCL § 10-46-2, property does not fully escape South Dakota use tax simply because it is consumed by someone other than the owner. Rather, South Dakota law would impose use tax against the owner of the property that was consumed (and not the party that consumed, but did not own), subject to any other requirement for the imposition of use tax. *See* SDCL §§ 10-46-2;10-46-1(17); *see also* ARSD 64:06:02:88 (property owned by reservation service and provided for use to travel agency as part of reservation service is "used" by reservation service owner (not travel agency) for use tax purposes).

In summary, tangible personal property is subject to use tax under SDCL § 10-46-2 only if the property is purchased for "use" in South Dakota. The term "use," as defined in SDCL § 10-46-1(17), means "the exercise of right or power over tangible personal property… incidental to the ownership of that property." This language is clear, certain and unambiguous and has been construed in *Hallett* and *Friessen* as requiring ownership to impose use tax under SDCL § 10-46-2. It is uncontroverted that Northern Border did not own the gas burned in the compressors. The Department failed to meet its burden to prove that the gas was burned "incidental to ownership." As such, it cannot

assess use tax against Northern Border under SDCL § 10-46-2 on the natural gas burned in the compressors.

B. Northern Border did not "purchase" this natural gas or pay a "purchase price" for it.

SDCL § 10-46-2 imposes use tax on tangible personal property only if "purchased," for a "purchase price," for use in South Dakota. To prove a "purchase," the Department bore the burden of proving (1) a transfer, exchange or barter, (2) consideration, and (3) the transfer of legal title to the property purchased, unless legal title is retained by the seller as security for payment. SDCL § 10-46-1(9).[5] However, the Department proved none of the required elements here.

i. Transfer, Exchange or Barter.

The Department erroneously concluded the natural gas at issue was transferred, exchanged or bartered, but offered no evidence to substantiate such an occurrence. Rather, auditor Berglin admitted he found no evidence to show Northern Border purchased gas to burn in the compressors, paid money to shippers for this gas, or owned this gas. HT 67-68. Auditor Berglin never even asked Northern Border to provide documentary evidence of purchases or ownership of the gas because he understood Northern Border did not own it.

[5] The statutory definition of "purchase" applies throughout Ch. 10-46, including SDCL §§ 10-46-3 & 10-46-4. See SDCL § 10-46-1.

HT 67-68. Auditor Palmer, with over 30 years of audit experience, testified he could not recall any transactions involving barters or non-monetary consideration, demonstrating he found no in-kind exchange of gas for services in the Northern Border audit. HT 41.

Despite all evidence to the contrary, the Department concluded there was a transfer, exchange or barter by confusing that element with the element of consideration. AR 1778. "Transfer, exchange or barter" and "consideration" are separate elements of a purchase under SDCL § 10-46-1(9). The Department must prove them both.

That Northern Border did not purchase the natural gas burned in the compressors was undisputed at hearing. HT 83-84, 96-97, 127-29, 132-35, 152-54; Exhibit 3, Part 2, Part 5.18; Part 6.14; Exhibit 5 at 3, 4, 6, 14, 20, 41, 42, 53, 76 & 139; Exhibit 6 at 53 & 118; Exhibits 7 & 8. Moreover, FERC policy prohibited Northern Border from purchasing or owning the gas burned in the compressors. HT 97, 127-31. *See supra* pp. 4-6.

Without citation, the Department asserts that Northern Border is paid by the shippers to transport gas, and such payment comes in the form of money and gas. (Department's Brief, p.13). Citing only SDCL § 10-45-1(14), (defining tangible personal property) and SDCL § 10-45-2 (imposing tax on sale of tangible personal property), the Department states that if Northern

Border did not receive this gas from shippers, it would have to purchase gas on the open market. (Department's Brief, p.13 fn. 8).

Rather than offering evidence to prove its argument, the Department poses an absurd hypothetical that could not occur because it presupposes that Northern Border would act in contravention of FERC policy and regulation and purchase gas to burn in its compressors on the open market. This would never happen. Northern Border is only permitted to purchase gas for limited reasons explicitly enumerated in Part 6.45 of its Tariff, and purchasing gas to burn in its compressors is not one of them.[6] HT 97, 127-31 & Exhibit 3, Part 6.45.

The Department's contention that shippers transferred, bartered or exchanged the gas at issue to or with Northern Border simply lacks factual and legal basis.

ii. Consideration.

"Consideration" is the second requirement for a "purchase" under SDCL § 10-46-1(9). Similarly, SDCL § 10-46-2 imposes use tax on the "purchase price" paid. Under SDCL § 10-45-1.14 and SDCL § 10-46-1(10), the terms "purchase price," "consideration" and "gross receipts" are synonymous and

[6] "Balanc[ing] company use gas" is a reconciliation mechanism and does not mean Northern Border is allowed to purchase company use gas for any purpose it pleases. As a matter of fact, Northern Border's 2010 regulatory filing showed no purchase of gas for operational purposes. AR 1762.

mean the total amount "for which tangible personal property, *** or services are sold, leased, or rented." SDCL § 10-46-1(10). Thus, an amount is only "consideration" or a "purchase price" if it is paid for the sale, lease, or rental of tangible personal property or services. *Id*. Again, the Department bore the burden of proving Northern Border's transportation services were consideration for gas burned in the compressors, and there was no evidence of this at hearing.

Moreover, Auditor Berglin testified he found no evidence Northern Border paid money to the shippers for gas burned in the compressors. HT 67-68. Auditor Palmer testified Northern Border was not paying for the gas burned in the compressors, and there were no receipts or invoices showing Northern Border's purchase of any gas from shippers in the files he examined or any other source of which he was aware. HT 32-33. There was simply no "consideration" and no "purchase price", therefore, no "purchase" of this natural gas by Northern Border for purposes of SDCL § 10-46-2. HT 148-149, 151, 170-171.

iii. Legal Title.

The third requirement for a "purchase" under SDCL § 10-46-1(9) is a transfer of legal title to the property purchased, unless legal title is retained by the seller as security for payment. The Department does not acknowledge this,

instead defining "purchase" merely as a "transfer, exchange, or barter *** for consideration."[7] AR 1778. This disregards the "legal title" element, which is apparent from the last sentence of SDCL § 10-46-1(9): "A transaction, whereby the possession of property is transferred but the seller retains the title as security for the payment of the price, is a purchase." This is not mere surplusage; there is no reason for this language unless the corresponding general rule is that a "purchase" can only occur with a transfer of title.[8]

Northern Border never acquired legal title to the gas burned in the compressors. HT 97, 127-31; *see supra*, pp. 4 & 6. Because Northern Border

[7] Without analysis, the Department argued to the circuit court that neither *Hallett, Friessen, Sanborn, Val-Pak,* nor SDCL §§ 10-46-1(9) and (17) require transfer of legal title to prove ownership or purchase. This is wrong. SDCL § 10-46-1(9) and *Hallett* expressly address legal title, as does *Sanborn*, *see supra* pp. 10-17, 23-24. Although the term "title" is not used in SDCL § 10-46-1(17), which includes the "incident to ownership" requirement, when read in context with the definition of "purchase" and the later enacted SDCL § 10-46-5, it is clear that "ownership" in SDCL § 10-46-1(17) means "title." *See Simpson,* 367 N.W.2d at 763 (statutes construed as a whole in light of other enactments on same subject). That this is the case is further evident from *Friessen,* which compares the ownership requirement in SDCL § 10-46-1(17) to the without-regard-to-legal-title language in SDCL § 10-46-5, and in doing so clearly equates "ownership" for purposes of SDCL § 10-46-1(17) with "title." In *Val-Pak*, the Arizona Department of Revenue conceded that the taxpayer did not own the coupons.

[8] Indeed, any contrary interpretation would effectively render the above language superfluous. *See* 3A SOUTHERLAND STATUTORY CONSTRUCTION §66:3 (7th ed.); *Brim v. South Dakota Board of Pardons and Paroles*, 563 N.W.2d 912, 922 (S.D. 1994); *Estate of Flaws*, 2012 S.D. 3, ¶ 19, 811 N.W.2d 749, 754. Every word in a statute is presumed to have been used for a purpose, and the exception was purposefully included in SDCL § 10-46-1(9) to modify the general rule that no "purchase" occurs if the seller retains title. Thus, title must transfer before there is a "purchase" under South Dakota tax law.

never acquired legal title, Northern Border did not "purchase" the natural gas for purposes of SDCL § 10-46-1(9). HT 130, 133-35.

The Department once again cites inapplicable Minnesota cases to argue Minnesota courts have twice addressed whether the gas "used" in the compressors is subject to use tax, *i.e., Great Lakes,* 638 N.W.2d 435 (MN 2002); *Northern Border Pipeline Co. v. Comm'r of Revenue,* 2009 WL 173959 (Minn. Ct. App. 2009). (Department's Brief, pp. 22-23). The Department is simply incorrect. As discussed above, in South Dakota, a "purchase" not involving the retention of a security interest only occurs when there is a transfer of title. SDCL § 10-46-1(9). By contrast, in Minnesota, "purchase" includes any "transfer of title **OR** possession, or both, of tangible personal property." *Great Lakes,* 638 N.W.2d at 439 (quoting Minnesota Statute § 297A.01, sub 3 (1994)) (emphasis added). In fact, *Great Lakes* stated use tax was appropriate because there was a transfer of possession, not title. *Id.* at 439 (identifying the portions of the statute allowing use tax as "a transfer of * * * possession * * * for a consideration * * * or by exchange or barter.") (ellipses in original). Not only are these tax schemes not "substantially similar," their differences are actually outcome-determinative in the case at bar. Title to the natural gas was never transferred, so Northern Border did not "purchase" it

under South Dakota tax law. Minnesota law does not govern the imposition of use tax in South Dakota, no matter how often the Department cites to it.[9]

The case at bar is closer to *Department v. Sanborn Telephone Cooperative,* 455 N.W.2d 223 (S.D. 1990).[10] *Sanborn* held there was no "sale" of telephone directories because the telephone company retained title based on a statement in the directories that it did so. *Id.* at 226-27. The fact that the telephone company delivered the directories to its customers with no expectation of their return did not alter this conclusion. *Id.* at 227. Likewise, Northern Border's shippers retained title to the gas burned in the compressors, and the fact that they do not expect the gas to return does not mean title transferred or that Northern Border "purchased" it.

Indeed, the logical application of SDCL § 10-46-1(9) and the *Sanborn* decision compels the conclusion that the Department must prove there was a transfer of title from the shippers to Northern Border for there to have been a "purchase" of this gas for use tax purposes. There was no evidence that legal title for the natural gas burned in the compressors transferred from the shippers

[9] The Department has previously cited *Pursue Energy Corp. v. Mississippi State Tax Comm'n,* 968 So.2d 368, 374-76 (Miss. 2007) and *Bridges v. Production Operators, Inc.,* 974 So.2d 54, 61 (La 2007) for this argument. The statutes at issue in those cases are similar to those of Minnesota and likewise are irrelevant in construing South Dakota use tax statutes.

[10] Although *Sanborn* addressed a "sale," the definition of "purchase" in SDCL § 10-46-1(9) is identical to the definition of "sale" in SDCL § 10-45-1(12), except for the addition of the last sentence of the definition of "purchase."

to Northern Border. In fact, the Department's auditor acknowledged this gas was owned by the shippers, HT 63-64, and the Department's finding that Northern Border is a transportation-only pipeline supports the conclusion that no purchase of this gas by Northern Border could legally occur under FERC policy or Northern Border's tariff.[11] *See supra,* pp.4 & 6-7.

Only tangible property "purchased" by the taxpayer is subject to use tax under SDCL § 10-46-2. None of the elements for a purchase exists here: (1) there was no transfer, exchange or barter of this natural gas from the shippers to Northern Border; (2) there was no consideration, and (3) legal title to this gas did not (and legally could not) transfer to Northern Border. Because imposition of use tax requires the "purchase" of this gas, the Department failed to meet its burden of proving the prerequisites for imposition under SDCL § 10-46-2.

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[11] In *Atmos Energy Corporation*, 137 FERC 61,190, 2011 WL 6523679, FERC stated:

> A central requirement of the Commission's open-access transportation program is that all shippers must have title to the gas at the time the gas is tendered to the pipeline or storage transporter and while it is being transported or held in storage by the transporter.… Although the specific language of each interstate pipeline's tariff varies, the Commission has made clear that the shipper of record and the owner of the gas must be one and the same throughout the course of the transportation or the duration of storage on any pipeline. AR at 1766-77 (emphasis added).

2. Even if SDCL § 10-46-2 was satisfied, the natural gas burned in the compressors was exempt from use tax for each of the following reasons:

A. This natural gas was exempt from use tax under SDCL § 10-46-55.

As Judge Barnett ruled, the natural gas burned in the compressors was exempt from use tax under SDCL § 10-46-55, which exempts "[t]he provision of natural gas transportation services by a pipeline" from use tax. CR 31-42. South Dakota tax exemptions may be strictly construed in favor of the taxing power, but they must also be given a reasonable, natural and practical meaning to effectuate the purposes for which they were granted. *In re Royal Plastics*, 471 N.W.2d 582, 584 (S.D. 1991). Judge Barnett was correct – "SDCL § 10-46-55 provides a clear exemption for all transportation services and does not place any limit on the exemption." CR 41. The exemption applies to the natural gas burned in the compressors because it is undisputed that both (1) Northern Border is engaged in the business of providing natural gas transportation services by a pipeline, and (2) the natural gas is necessarily burned to provide that transportation service. HT 75-80, 108-09, 110-15, 145-47, Exhibits 3, 4, 5, 6, 7 & 8.

Burning natural gas in the compressors is an undivided and integral part of Northern Border's provision of natural gas transportation services as a pipeline. HT 113. The compressors that move the gas downstream are centrifugal and therefore require a constant stream of fuel. HT 112-14. The gas never stops moving. *Id*. At each compressor, a negligible portion of gas, unidentifiable because of its fungible nature, is burned to keep the gas moving. HT 113. The burning of gas in the compressors is unquestionably an integral, indivisible, and inherent part of Northern Border's pipeline transportation services. As the area manager, who actually managed the operations of these pipeline facilities and has

almost 30 years of operational experience in pipelines, testified, "It's all one entire process." HT 115.

Each shipper receives one invoice for the natural gas pipeline transportation service Northern Border provides to them, with no line item or entry for gas burned in the compressors. HT 154. Consistent with Northern Border's tariff, there is one transportation service agreement for this pipeline transportation service that provides all terms and conditions of service, including the burning of gas. HT 124 & 139. Nothing in the record suggests any transaction has occurred other than that contemplated by the transportation services agreement between Northern Border and the shipper.

In short, the burning of gas is an indivisible and necessary part of Northern Border's provision of the transportation services to shippers of natural gas. *Texas Gas Transmission Corp v. Benson*, 444 S.W.2d 137 (Tenn. 1969) (gas that furnishes energy to operate the compressors is a necessary and integral part of the interstate operation). The Department creates a fiction wherein burning the gas in the compressors was a separate and distinct transaction from Northern Border's provision of transportation services. (Department Brief 14-17) This is not true. The Department blithely ignores the true nature of the facts – burning the gas literally causes the compression which transports the gas.[12]

[12] The hypothetical transactions that the Department must create to attempt to impose use tax collapse on themselves when the Department must then undo those transactions to argue against the application of the SDCL § 10-46-55 exemption. To establish a "purchase" of gas occurs to impose use tax on the gas, the Department argues that this is all one transaction, *i.e.*, that Northern Border's compensation for transportation services includes both cash and the gas burned. However, to avoid the SDCL § 10-46-55 exemption, the Department then must reverse course and argue that there are two separate transactions. In the end, by arguing that Judge Barnett incorrectly "bundled" them in holding that the exemption applies, the Department effectively concedes that use tax should not be assessed on the gas under SDCL § 10-46-2.

Transportation and burning are not separable events. Not only is burning the gas part and parcel of the provision of the transportation services by a pipeline, it effectively is *the* service. Quite simply, no transportation of gas would occur on Northern Border's system without burning the shippers' gas in the compressors. Judge Barnett correctly identified the issue – the exemption does not contain the "fine hair-splitting razor" needed to create two separate transactions that the Department imagines, and burning the gas is "part and parcel of the services provided, and exempted under the broad exemption statute." CR 31 pp. 9 & 11.

The Department incorrectly cites *Magellan Pipeline Co., LP v. South Dakota Dep't of Rev.*, 2013 SD 68, 837 N.W.2d 402, to claim SDCL § 10-46-55 should not apply here. *Magellan* did not address the application of SDCL §10-46-55 to a situation like the present case. *Id*. at ¶ 12, 837 N.W.2d at 405.

It is important to remember that this exemption broadly covers the "provision of natural gas transportation services by a pipeline." SDCL § 10-46-55. Instead, the Department tries to rewrite the exemption to (1) cover only receipts from "transportation services," rather than the provision of transportation services, and (2) limit it only to "shippers." (Department's Brief 17-22) SDCL § 10-46-55 simply does not contain this limiting language. When appropriate, the Legislature has included such language to limit use tax exemptions, *e.g.*, SDCL § 10-46-62 (gross receipts from interest); SDCL § 10-46-71 (gross receipts from sale of coins), and it did not do so here. As in *Magellan*, this Court should reject the Department's ploy to insert language into SDCL § 10-46-55 to limit its scope. *Magellan*, 2013 SD 68, ¶ 34, 837 N.W.2d at 411.

The exemption explicitly covers the provision of natural gas transportation services by a pipeline, and it is not limited to shippers or to receipts. Neither the Department nor this Court may re-write the statute to add such limitations. It must be applied as written.

The Department also pitches a "floodgates argument," comparing the burning of this gas with Northern Border repairing a compressor with a part from inventory.[13] (Department's Brief 20) This is an incredibly disingenuous analogy. Northern Border has never argued all of its activities are tax-exempt and, to the contrary, has paid millions of dollars to South Dakota in use tax on its equipment throughout the years, never asserting this exemption for such tax. By applying the exemption to the gas burned in the compressors, the Court is not exempting Northern Border's use of parts or repair services. Comments to the contrary are merely scare tactics.

Finally, the Department tosses out a red herring about Judge Barnett's reference to the industrial production exemption applied in *Great Lakes*. Neither Judge Barnett nor Northern Border has ever suggested SDCL §10-46-55 is an industrial production exemption. Rather, Judge Barnett likened the broad reach of Minnesota's exemption with the broad exemption language of SDCL § 10-46-55.

As Judge Barnett concluded, burning gas in the compressors is an integral and inseparable "part and parcel" of the "provision of natural gas transportation services by a pipeline" under SDCL §10-46-55. CR 31, pp. 9 & 11. This exemption includes none of the

[13] As part of its "floodgates argument," the Department asserts the focus belongs on the transaction and not the character of the participants, (Department's Brief 20) Northern Border does not argue it is entitled to this exemption based on its character as a pipeline. Rather, the exemption applies because the nature of the transaction is the "provision of natural gas transportation services by a pipeline."

limitations the Department tries to insert. Accordingly, even if SDCL § 10-46-2 was satisfied, Northern Border would be exempt from use tax under SDCL § 10-46-55.

B. SDCL § 10-46-6 requires the Department to determine the extent to which the natural gas burned in the compressors is exempt under SDCL § 10-46-6 before use tax can be assessed against Northern Border.

Even if Northern Border were subject to use tax under SDCL § 10-46-2, Northern Border is entitled to an exemption under SDCL § 10-46-6 to the extent the gross receipts of the shippers from such sales "are to be included in the measure of the tax imposed by chapter 10-45," *i.e.*, sales tax. Before assessing use tax against Northern Border, the Department was required to determine the extent to which the proceeds from such purported sales of natural gas by the shippers were to have been included in the measure of the tax imposed by SDCL Ch. 10-45. *See* South Dakota Attorney General Opinion No. 82-9 (February 3, 1982). There is no evidence the Department made such a determination.

Rather, the Department has argued that SDCL §10-46-6 only applies if South Dakota sales tax is included in the sales price of a transaction, *i.e.*, that sales tax was actually paid. Again, the Department disregards the plain meaning of the statute. The exemption provided by SDCL § 10-46-6 applies if gross receipts from the sale of this natural gas "are to be included in the measure of the tax imposed by chapter 10-45," with no mention if sales taxes were actually paid. The phrase "are to be included" is not the same as "were included." Attorney General Opinion 82-9 observes this distinction. The Department's argument that courts are not bound by Attorney General's

opinion fails to take into consideration that (i) Attorney General opinions are nonetheless entitled to weight by the courts, *Matter of Construction of Article III, Section 5, of the South Dakota Constitution*, 464 N.W.2d 825, 827 (S.D. 1991), and (ii) such opinions should be binding on other executive agencies, such as the Department. *See McCarl v. Miguel*, 66 F.2d 564, 566 (D.C. Circuit 1933).

The Department also cites SDCL §§ 10-46-3 and 10-46-4 for the proposition that use tax remains payable until paid to the retailer or the Department. SDCL §§ 10-46-3 and 10-46-4 apply, by their terms, only to the payment of use tax actually due (which would reflect the application of the SDCL § 10-46-6 exemption). To the extent the exemption under SDCL § 10-46-6 applies, no (or a lesser amount of) use tax would be payable under SDCL §§ 10-46-3 or 10-46-4. Accordingly, these statutes do not justify the Department's failure to determine the extent to which the SDCL § 10-46-6 exemption applies.

3. Even if otherwise subject to use tax under SDCL § 10-46-2 the natural gas cannot be subject to South Dakota use tax for either or both of the following constitutional reasons:

A. The assessment of use tax violated the Supremacy Clause of the United States Constitution, which preempts any application of South Dakota law that treats Northern Border as the purchaser or owner of the natural gas.

By prohibiting Northern Border from purchasing and owning the gas, federal law preempts the application of SDCL § 10-46-2 in this case. Under the Supremacy Clause of the United States Constitution, federal law is the supreme law of the land and preempts state law to the extent they conflict. U.S. CONST., ART.VI, CL 2; *Pliva, Inc. v. Mensing*, 131 S.Ct. 2567, 2577 (2011). State and federal laws conflict when it is impossible for a private party to comply with both state and federal requirements. *Pliva*, 131 S.Ct. at 2577. Courts should not strain to find ways to reconcile federal law with seemingly conflicting state law. *Id*. at 2580.

Imposing use tax on Northern Border for gas burned in its compressors under SDCL § 10-46-2 clearly conflicts with federal law. To be liable for use tax under SDCL § 10-46-2, Northern Border must purchase and own the gas burned in the compressors. *See supra* pp. 17-25. Indeed, as discussed above, South Dakota cannot impose tax under SDCL § 10-46-2 without such a judicial finding. *Id*. However, such a finding would conflict with federal law, as FERC policy specifically prohibits Northern Border from purchasing and owning the gas. *See supra* pp. 4-6; Natural Gas Act, 15 U.S.C. 717 (FERC policy is federal law).

This would create a situation where South Dakota law deems Northern Border the owner and purchaser of the gas, while federal law requires Northern

Border to neither own nor purchase it. Northern Border could not comply with both state and federal laws in such a situation, so the state and federal laws conflict. Therefore, pursuant to the Supremacy Clause, FERC policy prohibiting Northern Border from owning the gas preempts any judicial finding that it purchased or owned the gas. Without this finding, SDCL § 10-46-2 cannot impose the tax at issue.

The Department's argument – that the Supremacy Clause does not preclude states from taxing pipeline operators in general – misses the point entirely. The point is that Northern Border cannot both (1) not purchase and own this gas, as federal law requires of it, and (2) purchase and own the gas, as the state law would require for use tax to apply under SDCL § 10-46-2. It is impossible for Northern Border to comply with the requirements of both of these laws. This creates a conflict, and this is how the Supremacy Clause factors into the analysis. The point is not that the Supremacy Clause prohibits a tax on pipelines; it is that a conflict arises in this case between SDCL § 10-46-2's purchase and ownership requirements and FERC policy, which prohibits them. The conflict between laws is the issue, and federal law must prevail.

B. Subjecting the natural gas to use tax interferes with interstate commerce as defined by ARSD 64:09:01:09.

Under ARSD 64:09:01:09, tangible personal property remains in interstate commerce, and as such exempt from use tax, until after the shipment in interstate commerce has ended. Even if SDCL § 10-46-2 were satisfied, ARSD 64:09:01:09 precludes the Department from imposing a use tax on Northern Border because the gas remains in interstate commerce when the natural gas is burned. This is because this natural gas moves, indivisibly, in interstate commerce; HT 34-35, 6880-84, 110-115; and it is burned during the shipment in interstate commerce, and not after its shipment in interstate commerce has ended. *See Mississippi River Transmission Corp. v. Weiss*, 65 S.W.3d 867 (Ark. 2002) (applying a similar statute, the court held that burning natural gas moving in a pipeline occurred before the gas had come to rest in the state and therefore was not use taxable).

The Department has argued A.R.S.D. 64:09:01:09 does not apply because Northern Border takes possession at the time of delivery from shippers to be used as it determines, and, therefore, interstate commerce has ceased. This is wrong because, even if the property came to Northern Border as a "purchaser" where delivered (which would be outside South Dakota), such delivery would be for "use" where delivered (and not for use in South Dakota). For the same reason, this argument is contradictory to the Department's assessment of use tax under SDCL § 10-46-2, which by its terms only applies

to property purchased for use in South Dakota. No natural gas enters the pipeline in South Dakota. *See* HT at 84. Thus, even if a first "use" were to occur where the shippers deliver gas into the pipeline, because all delivery into the pipeline occurs outside of South Dakota, no use tax may be imposed under SDCL § 10-46-2 because the gas would be "purchased" for use where delivered (and not in South Dakota).[14] *See supra* pp. 6-7.

4. The assessment of use tax and interest was erroneous due to clear factual and legal errors.

A. The tax was incorrectly computed, based on incorrect and inapplicable data, and relevant information was incorrectly excluded from consideration based on SDCL §§ 10-59-3 and 10-59-7.

A certificate of assessment is incorrect when it results from a mistake of fact or an error of law in the conduct of the audit. *Doctor's Assocs., Inc. v. Dep't of Revenue*, 2006 S.D. 18, ¶ 14, 711 N.W.2d 237, 242 (citing SDCL §§ 10-59-8 & 10-59-9). That is clearly the case here.

i. Improper Calculation.

[14] The Department likely recognized this flaw in its own argument because it now subtly raises the possibility that use tax could instead be assessed under SDCL § 10-46-3, which applies to property purchased for use outside the state and later brought into South Dakota for use. *Cf.* HT, Exhibit A (certificate of assessment does not list SDCL § 10-46-3 as statute under which tax assessed). Although the Department does not expressly argue that tax could instead be assessed under SDCL § 10-46-3, it now includes this section in its list of statutory provisions supporting the imposition of use tax. Any late attempt by the Department to assess use tax on this gas under SDCL § 10-46-3 (rather than SDCL § 10-46-2) should likewise be rejected as untimely. *See Watertown*, 627 N.W.2d at 172 fn. 5.

In its calculation, the Department multiplied the number of dekatherms of gas provided by Northern Border times a per-unit "City Gate" price. HT 92-95. Dekatherms are a unit of energy, not volume. *Id.* at 53-54, 69-71 & 93-95. However, the City Gate price is based on volume, *i.e.*, cubic feet of gas, rather than dekatherms. *Id.* The value of gas cannot be calculated by multiplying an energy-based measurement times a volume-based price factor. *Id.* Essentially, the Department calculated: [units of gas based on energy] x [price per cubic foot of gas]. *Id.* This clearly did not lead to the proper "price" of the gas. *Id*. Even the Department's auditor admitted his calculations would be erroneous if he had employed an incorrect multiplier. HT 71.

Moreover, even if the Department was using corresponding measurement and multiplication factors, it picked the wrong unit price to multiply by. It should have used AECO C Hub prices instead of City Gate prices. *Id.* at 91-92 & 92-93. City Gate prices are the prices of gas <u>as delivered</u> to Local Distribution Companies ("LDCs"), rather than <u>as received</u> into the pipeline by shippers, and include several factors in addition to gas. *Id*. In contrast, AECO C Hub prices would be more appropriate because they derive from a liquid, transparent market, and better approximate the price of the gas paid by shippers when placing it into Northern Border's pipeline, without additional costs or delivery to various locations along the pipeline. HT 92-93.

Thus, not only were the variables used in the calculation incompatible, they did not even reflect the relevant price. The calculation was seriously flawed, and the Department therefore based its certificate of assessment on material mistakes of fact in "pricing" the gas. The certificate is thus incorrect.

ii. Rejection of Relevant Information.

Oddly enough, when Northern Border offered the Department information to perform the proper calculations, the Department rejected it. Northern Border offered Exhibits 15 and 15A – AECO C Hub prices from Platts Price Dailys for the relevant time frame, using the correct dekatherm measurements and correct pricing location. HT 88-90. The Department wanted nothing to do with them and rejected them as irrelevant and not produced within sixty days following the commencement of the audit under SDCL §§ 10-59-3 & 10-59-7. *Id.* These documents are obviously relevant to the calculation, since they provide more appropriate multipliers for it. HT 90-95.

Moreover, neither SDCL § 10-59-3 nor § 10-59-7 bars the consideration of these exhibits. By their plain language, the statutes only apply to records, books, and documents taxpayers are required by law to keep. Applying these statutes to Exhibits 15 and 15A would impermissibly add language to these statutes. *Magellan,* 837 N.W.2d at 405. No law required Northern Border to keep Exhibit 15 or 15A, an industry periodical published by a third party which stated historical pricing information for gas and a spreadsheet summary of the pricing information. *See* SDCL §§ 10-45-45 & 10-46-43; A.R.S.D. 64:06:01:35.05 (none of which require a taxpayer to keep such information for determination of tax liability).[15] HT 178 (auditor agreeing that for audits, a taxpayer typically must retain items like gross receipts, records, billings, receipts, invoices, and cash register tapes).

[15] Even if SDCL § 10-59-7 required Northern Border to keep these documents, they should nonetheless be considered because: (1) the information is material – they include prices of the gas entering the pipeline, which is the value placed upon the gas by the shippers; (2) there were good reasons to not present the documents during the audit – Exhibit 15 did not exist then, and Northern Border did not know the Department would create calculations using inapplicable measurements; and (3) Northern Border submitted the documents to the

Thus, the Department clearly erred, in fact and in law, in calculating the amounts shown on the certificate of assessment, and the Court should reverse the Department's affirmance of its certificate of assessment.

B. To the extent tax was due, the Department failed to make any determination whether to reduce or abate interest and/or tax under SDCL, Ch. 10-59.

SDCL §§ 10-59-28, 10-59-31, and/or 10-59-6 permit a reduction or abatement of interest and/or tax if the Secretary of Revenue determines it would be just and equitable, among other reasons. Such reduction or abatement should have been made here for the following reasons:

- This assessment results from a change in Department policy and
- practice with no prior notice to Northern Border. For decades, Northern Border's pipeline openly burned natural gas in its compressors as a matter of public record. The Department audited Northern Border at least two prior times and never previously indicated such natural gas should be subjected to use tax. HT 13, 25-26 & 153. It is unjust and inequitable to penalize Northern Border now by assessing in excess of $1.5 million of interest (plus a nearly equal amount of interest since the date of the certificate of assessment), in addition to over $4 million of tax, when prior non-payment was tacitly approved.
- Until post-hearing, the Department itself could not or refused to explain why Northern Border should pay use tax on natural gas it neither purchased nor

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Department within a reasonable time period prior to the hearing while the parties were exchanging exhibits for use at the hearing.

owned. HT 26-27, 33 & 36 (auditor testifying his basis for assessing tax was as simple as the fact that Northern Border uses the gas, regardless of ownership or purchase.)

- The interest rate on tax assessments under SDCL § 10-59-6 is 1.25% per month, which translates into 15% per year. This rate is punitive and higher than many consumer credit card interest rates. *Cf.* Daily Treasury Bill Rates at http://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=billrates.
- There was a significant delay between the date Northern Border requested a hearing on November 11, 2011, and the issuance of the Department's final decision on September 13, 2013. If the assessment is upheld, additional interest continued to accrue during this period in the amount of $1,144,205.00 ($4,160,745.59 of tax x 1.25% x 22 months). It should be abated.

The Department never addressed any of these reasons, and ignored the request entirely. The Department has argued no such request was made, which is clearly incorrect as the request for reduction or abatement was included in the request for hearing. AR 1685. Further, the Department has argued only the Secretary can exercise this discretion, thereby attempting to place the matter outside the jurisdiction of this Court by procedural maneuvers. This failure to make any determination should be reversed as an abuse of discretion. *See*

SDCL § 1-26-30.1 (permitting appeal when agency fails to act upon matter submitted to it).

CONCLUSION

In accord with the foregoing legal authorities and arguments, Northern Border respectfully requests the Court affirm the Order and Judgment of the circuit court, ruling SDCL § 10-46-55 applies such that Northern Border's burning of gas in its compressors is exempt from South Dakota use tax. Further, Northern Border asks the Court to rule such gas cannot be subject to use tax because: Northern Border never owns or purchases it or pays a purchase price for it; the exemption under SDCL § 10-46-6 applies; and the assessment violates the Supremacy Clause and ARSD 64:09:01:09. Finally, the Department's calculations were clear error, and the Department erred in failing to make a determination with respect to abating or reducing tax and interest.

Dated at Sioux Falls, South Dakota, this 23rd day of October, 2014.

HURWITZ & SMITH, L.L.P.

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REQUEST FOR ORAL ARGUMENT

Appellee requests the Court hear oral argument in this matter.

/s/ Catherine A. Tanck
Catherine A. Tanck
Sandra Hoglund Hanson

IN THE SUPREME COURT
OF THE
STATE OF SOUTH DAKOTA

APPEAL NO. 27152

NORTHERN BORDER PIPELINE COMPANY,

Appellee,

v.

SOUTH DAKOTA DEPARTMENT OF REVENUE,

Appellant.

APPEAL FROM THE CIRCUIT COURT,
SIXTH JUDICIAL CIRCUIT
HUGHES COUNTY, SOUTH DAKOTA

THE HONORABLE MARK W. BARNETT

REPLY BRIEF OF APPELLANT SOUTH DAKOTA DEPARTMENT OF REVENUE

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Notice of Appeal Filed July 23, 2014

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PRELIMINARY STATEMENT

Pursuant to SDCL 15-26A-62, the Department submits this Reply Brief which is confined to the matters raised in the Brief of Northern Border Pipeline Company. For the convenience of the Court, Northern Border's brief will be cited as "Appellee's Brief at __" and the Department's initial brief will be cited as "Department's Brief at __." The transcript from the Circuit Court Proceedings will be cited as "TR __."

RESTATEMENT OF LEGAL ISSUES

In its initial brief, the Department raised the following issue:

ISSUE 1. WHETHER THE CIRCUIT COURT ERRED IN HOLDING THAT SDCL 10-46-55 EXEMPTS FROM USE TAX COMPRESSOR FUEL USED BY NORTHERN BORDER.

In its Notice of Review, Northern Border raised additional issues that were not addressed by the Circuit Court. Appellee's Brief at 1-3. Its issues are summarized below:

ISSUE 1. WHETHER NORTHERN BORDER'S USE OF THE COMPRESSOR FUEL SUPPLIED BY ITS SHIPPERS IS SUBJECT TO SOUTH DAKOTA USE TAX.

ISSUE 2. WHETHER NORTHERN BORDER PURCHASED THE COMPRESSOR FUEL.

ISSUE 3. WHETHER SDCL 10-46-6 EXEMPTS NORTHERN BORDER'S USE OF COMPRESSOR FUEL.

ISSUE 4. WHETHER FEDERAL REGULATIONS EXEMPT NORTHERN BORDER FROM STATE SALES AND USE TAXES.

ISSUE 5. WHETHER ARSD 64:09:01:09 EXEMPTS NORTHERN BORDER'S USE OF COMPRESSOR FUEL.

ISSUE 6. WHETHER THE DEPARTMENT ERRED IN CALCULATING THE VALUATION OF THE COMPRESSOR FUEL.

ISSUE 7. WHETHER THE DEPARTMENT ERRED IN NOT ABATING OR REDUCING INTEREST WHEN NO REQUEST WAS EVER MADE TO THE SECRETARY OF REVENUE.

In this brief, Northern Border's notice of review issues will be identified as "NOR Issue __."

STATEMENT OF THE CASE AND FACTS

The Department reaffirms and incorporates by reference its "Statement of the Case and Facts" as set forth in its initial brief. Department's Brief at 3-9. In its initial brief, the Department appealed the Circuit Court's holding that SDCL 10-46-55 exempted Northern Border's use of compressor fuel. *See* Department's Brief. On August 12, 2014, Northern Border filed a Notice of Review. This brief contains the Department's response to Northern Border's brief and its Notice of Review issues.

ARGUMENT

The issue before this Court is whether the circuit court erred in holding that SDCL 10-46-55 exempts Northern Border's use of compressor fuel. Therefore, the Department will first respond to Northern Border's arguments concerning the application of SDCL 10-46-55. The Department will then address Northern Border's Notice of Review and the issues raised therein.

ISSUE 1. THE CIRCUIT COURT ERRED IN HOLDING THAT SDCL 10-46-55 EXEMPTS THE COMPRESSOR FUEL USED BY NORTHERN BORDER FROM SOUTH DAKOTA USE TAX.

Aside from generally agreeing with the circuit court's order and making general statements against the Department's position and arguments, Northern Border has provided no statute, rule, or other authority to support the circuit court's application of SDCL 10-46-55.

A. The use of tangible personal property and a service are not the same.

In its brief, Northern Border makes the assertion that the use of compressor fuel and Northern Border's transportation services are one in the same. *See* Appellee's Brief at 25-26. Without citing any statutory authority, Northern Border even claims that the use of compressor fuel, i.e. tangible personal property, "is *the* service." *Id*. at 26. As discussed in the Department's previous submission to this Court, these claims are quickly dispatched when reviewing this Court's case law and the plain language of South Dakota's statutes.

In *Magellan Pipeline Company, LP v. South Dakota Department of Revenue*, this Court looked at the SDCL 10-46-55 exemption and specifically stated that "[t]he Legislature limited the natural gas pipeline exemption to "transportation services[.]" *Magellan*, 2013 S.D. 68 at ¶ 34, 837 N.W.2d at 411. South Dakota law defines a "service" and distinguishes it from the "use of tangible personal property." *Compare* SDCL 10-45-4.1 (defining a service) to 10-45-2, 10-46-2, 10-46-3, 10-46-4 (imposing taxes on tangible personal property and the use of such property); *See also* Department's Brief at 15. Specifically, services are "all activities *engaged in for others for a fee, retainer, commission, or other monetary charge*[.]" SDCL 10-45-4.1

(emphasis added). But here, no one is paying Northern Border to burn the compressor fuel. HT 102-104. AR 157 (Ex. 3, Part 6.1 ¶ 24) (The Tariff provides Northern Border discretion as to how and when compressor fuel is used). Therefore, the use of compressor fuel is not a service. *See* SDCL 10-45-4.1. Because it is not a service, it cannot be exempt transportation services under SDCL 10-46-55.

In its brief, Northern Border states that it is "incredibly disingenuous" to compare the use of repair parts to the use of compressor fuel. Appellee's Brief at 28. However, Northern Border provides no statute, rule, or other authority that would justify treating compressor fuel, one form of tangible personal property, differently from repair parts, another form of tangible personal property. *Id.* Under South Dakota law, the assessment of use tax on the use of compressor fuel is treated the same as the assessment of use tax on the use of a repair part – both involve the use of tangible personal property and neither use constitutes a service. *Compare* SDCL 10-45-4.1 to 10-45-2, 10-46-2, 10-46-3, 10-46-4. Northern Border's inability to distinguish the use of repair parts from the use of compressor fuel further reinforces that the use of compressor fuel is the use of tangible personal property and not the provision of a service.

B. The SDCL 10-46-55 use tax exemption should never apply to Northern Border as it is not a purchaser of natural gas transportation services.

South Dakota law controls who enjoys the benefits of exemptions. Since the incidence of the sales tax is on the retailer, sales tax exemptions benefit sellers. *See* SDCL 10-45-2; 10-45-22. Northern Border, as the seller of natural gas transportation services, benefits from the SDCL 10-45-67 exemption because Northern Border does not have to remit sales tax on its gross receipts received for natural gas transportation

services. SDCL 10-45-67. The benefits of use tax exemptions flow to the purchasers of goods or services.[1] *State v. Dorhout*, 513 N.W.2d 390, 393 (S.D. 1994) (the imposition of tax is on the purchaser, not the seller.). Consequently, the purchasers, in this case the shippers, of Northern Border's natural gas transportation services reap the benefits of the SDCL 10-46-55 use tax exemption when they purchase Northern Border's natural gas transportation services. As discussed in the Department's initial brief, the SDCL 10-46-55 use tax exemption does not apply to Northern Border as it is not a purchaser of natural gas transportation services – it is a user of tangible personal property. *See* Department's Brief at 24-28.

C. The circuit court erred in comparing SDCL 10-46-55 to Minnesota's industrial production exemption.

Northern Border asserts that the Department misread Judge Barnett's decision. Contrary to Northern Border's assertions, the Department maintains that *Great Lakes Gas Transmission L.P. v. Commissioner of Revenue* and *Northern Border Pipeline Co. v. Commissioner of Revenue* actually support the imposition of use tax on the compressor fuel. Both Courts held that without an applicable exemption, use tax was owed on the compressor fuel used in compressors. *Compare Great Lakes Gas Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435 (Minn. 2002) and *Northern Border Pipeline Co. v. Comm'r of Revenue*, 2009 WL 173959 (Minn. Ct. App. 2009) (both Courts agreed that the use tax applies to the value of the gas used in the compressors).

Initially, in *Great Lakes,* the Court held that the compressor fuel at issue was not subject to use tax because of an industrial production exemption exclusive to Minnesota's

[1] "A use tax is a tax on the enjoyment of that which was purchased." *State v. Dorhout,* 513 N.W.2d 390, 392 (S.D. 1994).

statutory code. Subsequently, in *Northern Border Pipeline Co.*, after the industrial production exemption was repealed, the court found that the compressor fuel at issue was subject to use tax. 2009 WL 173959. Although there were different outcomes, the difference in results between *Great Lakes* and *Northern Border Pipeline Co.* was directly attributable to the existence of an industrial production exemption.

No such exemption exists under South Dakota law. The current state of South Dakota's law as it pertains to the taxation of the use of compressor fuel more closely resembles Minnesota's at the time of *Northern Border Pipeline Co. v. Comm'r of Revenue* – there being no industrial production exemption and the use of compressor fuel being subject to use tax. Therefore, *Great Lakes* and *Northern Border* support the imposition of use tax on the compressor fuel. In this matter the circuit court erred in comparing SDCL 10-46-55 to Minnesota's industrial production exemption.

NORTHERN BORDER'S NOTICE OF REVIEW ISSUES

In its notice of review, Northern Border raises various issues that were not addressed by the circuit court.[2] Appellee's Brief at 1-3. Since the circuit court did not rule on them, these issues need not be addressed by this Court. *See Vanderwerff Implement, Inc. V. McCance*, 1997 S.D. 32, ¶ 18, 561 N.W.2d 24, 27 (holding, "[a]s we have stated numerous times, 'issues not addressed or *ruled upon* by the trial court will not be addressed by this Court for the first time on appeal.'") (citations omitted) (*emphasis added*). However, if the Court decides to address these issues, the Department's responses are discussed below.

[2] Although the circuit court did not rule on Northern Border's Notice of Review issues in its Memorandum Decision, the circuit court did appear to reject these arguments during oral argument. *See* Circuit Court Oral Argument Transcript.

NOR ISSUES 1 and 2. NORTHERN BORDER'S USE OF THE COMPRESSOR FUEL SUPPLIED BY ITS SHIPPERS IS SUBJECT TO SOUTH DAKOTA USE TAX

To this point, the argument that compressor fuel should not be subject to use tax in the first instance has generally been rejected. *See* AR 1778-91(Hearing Examiner Brady affirming the Department's Certificate of Assessment in full); Circuit Court Oral Argument Transcript; *Great Lakes Gas Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435 (Minn. 2002) and *Northern Border Pipeline Co. v. Comm'r of Revenue*, 2009 WL 173959 (Minn. Ct. App. 2009) (both Courts agreed that the use tax applies to the value of the gas used in the compressors). Based on the application of SDCL chapter 10-46, any argument against imposing use tax on compressor fuel in the first instance should continue to be rejected.

South Dakota law imposes a use tax on "the privilege of the use, storage, and consumption in this state of tangible personal property purchased for use in this state." SDCL 10-46-2. SDCL 10-46-3 further provides:

> An excise tax is imposed on the privilege of the use, storage or consumption in this state of tangible personal property or any product transferred electronically not originally purchased for use in this state, but thereafter used, stored or consumed in this state, at the same rate of percent of the fair market value of the property at the time it is brought into this state as is imposed by § 10-45-2 . . .

In sum, taxpayers are liable for use tax on tangible personal property if (1) the property is used, stored, or consumed in South Dakota and (2) the property is purchased for use in South Dakota. SDCL 10-46-2, 10-46-3, 10-46-4.

Natural gas is tangible personal property. SDCL 10-45-2, 10-46-2, 10-46-3, 10-46-4.[3] Northern Border does not argue that natural gas is not tangible personal property nor does Northern Border argue that natural gas is exempt from South Dakota sales tax. *See* Appellee's Brief. Rather, Northern Border argues that it is not liable for use tax because it did not use the compressor fuel, therefore failing to meet the first requirement for taxability. Appellee's Brief at 8-24. Additionally, Northern Border argues that its burning of compressor fuel does not satisfy the second requirement of being purchased for use in South Dakota. *Id*.

A. South Dakota's Use Tax is Imposed on Purchases Made For Consideration by Transfer, Exchange, or Barter.

In addressing Northern Border's latter argument first, Northern Border satisfies the definition of "purchase" as found in SDCL 10-46-1(9). According to that statute, a "purchase" includes any "transfer, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, for a consideration. . . ." SDCL 10-46-1(9). The reality of this transaction is that it is a transfer, exchange, or barter of the compressor-consumed gas for transportation services. 33 C.J.S. Exchange of Property § 2 ("Where the consideration is other property not measured in money terms, the transaction is an

[3] Northern Border argues that this Court should not consider SDCL 10-46-3 and 10-46-4 because the Department did not raise them. Both statutes were cited in the Department's Brief to the Circuit Court. Northern Border has not objected to the Department's citation of these statutes until now. "Generally, an objection to evidence must be made as soon as the opponent is aware of its objectionable nature and failure to object at a time when the court can take corrective action waives any later objection to the same evidence." *State v. Reiman*, 284 N.W.2d 860, 870 (S.D. 1979) (citing *Holmes v. State*, 76 Wis.2d 259, 251 N.W.2d 56 (1977)). *See also Veith v. O'Brien*, 2007 S.D. 88 ¶ 67, 739 N.W.2d 15, 34 ("When a party deprives the trial court an opportunity to rule on the issue by failing to object to argument at the time the objectionable comments are made, he waives his right to argue the issue on appeal.").

exchange."); *see also* BLACK'S LAW DICTIONARY (9th ed. 2009) (defining "transfer," "exchange," and "barter.").[4]

The hearing testimony and the Tariff support that Northern Border "transfer[red], exchange[d], or barter[ed]" for the compressor fuel. *See supra.* It is undisputed that Northern Border provides its natural gas pipeline transportation services to the shippers for a monetary fee and a quantity of natural gas for use in its compressors. It is also undisputed that Northern Border needs that natural gas to fuel its compressors. HT 114. Moreover, Northern Border concedes that the shippers transfer possession of the compressor fuel to them. HT 102; 118; 129; 140-42; 166; HT 101 (Mr. Fonda agreed that if a shipper does not provide the compressor fuel, Northern Border will not transport "one molecule" of the shipper's gas). The Tariff unambiguously confirms the same. AR 231-232 (Ex. 3 at 6.13) (Deliveries of Gas). In fact, the compressor gas is placed into Northern Border's pipeline/inventory for use at its discretion. HT 102-104. AR 157 (Ex. 3, Part 6.1 ¶ 24).

If the shippers did not provide the compressor fuel to Northern Border, Northern Border would have to secure that gas through other means. For example, in other states, electricity fuels some of Northern Border's compressors and the Tariff allows for an increase in pipeline rates to cover the cost. AR 326 (Ex. 3, Part 6.44 ¶ 2(a)). Contrary to

[4] Transfer: "1. Any mode of disposing of or parting with an asset or an interest in an asset, including a gift, the payment of money, release, lease, or creation of a lien or other encumbrance. The term embraces every method – direct or indirect, absolute or conditional, voluntary or involuntary – of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption. . . . "

Exchange: "1. The act of transferring interests, each in consideration for the other."

Barter: "The exchange of one commodity for another without the use of money."

assertions in Northern Border's brief, the Tariff also allows Northern Border to "purchase and/or sell gas to the extent necessary to: (i) *balance Company Use Gas* [compressor fuel]; (ii) maintain system pressure and line pack; (iii) manage imbalance quantities; (iv) perform other operational functions of Company in connection with transportation and other similar services; and (v) otherwise protect the operational integrity of Company's pipeline system. . . ." AR 327-328 (Ex. 3, Part 6.45); AR 1671 (*emphasis added*).

In determining whether a "purchase" occurred, the only question remaining is whether a consideration was present. Consideration is "[s]omething . . . bargained for and received by a promisor from a promise." BLACK'S LAW DICTIONARY 324 (8th ed. 2004). Consideration may consist of either a benefit accruing to a party or a detriment suffered by another party. *Poppenga v. Cramer*, 250 N.W.2d 278, 279 (S.D. 1977).[5] Consideration exists when something of value is given in return for performance or promise of performance. Restatement (Second) of Contracts § 72 (1981) ("any performance which is bargained for is consideration"). Consideration may also be found when one party voluntarily assumes an obligation on the condition that the other party take certain actions. SDCL 22-1-2(7). An "exchange" is a promise of performance given by one party and received by the other party in return for the second party's performance. 5 Corbin, Corbin on Contracts, § 1082.

[5] *See also* SDCL 22-1-2(7), which defines consideration as:

> any type of property or thing of legal value, whether delivered in the past, present or to be delivered in the future. The term includes an unfulfilled promise to deliver. The term may include an advantage or benefit to the promisor or a loss or detriment to the promisee. Any amount, advantage or inconvenience, no matter how trifling, is sufficient to constitute consideration[.]

In Minnesota, the Court of Appeals held that the compressor fuel is consideration for Northern Border's transportation services because the companies require the shippers to "provide the gas, one way or the other, if they want to use the transportation services." *Northern Border Pipeline Co. v. Comm'r of Revenue*, 2009 WL 173959 (Minn. Ct. App. 2009). Other courts, faced with similar facts, have reached the same conclusion. For example, the Mississippi Supreme Court has held that a gas pipeline and processing company was liable for use tax on the plant fuel gas supplied at no charge by the taxpayer's customers. *See Pursue Energy Corp. v. Mississippi State Tax Comm'n*, 968 So.2d 368, 374-76 (Miss. 2007). Similarly, the Louisiana Supreme Court has held that a pipeline company that received the necessary gas for its compressor engines was liable for use tax because the compressor fuel was part of the consideration for the pipeline's services. *See Bridges v. Production Operators, Inc.*, 974 So.2d 54, 61 (La. 2007) (noting that "businesses generally do not give away their assets," and thus inferring that "some type of consideration is present in any exchange of assets").

The facts of this appeal support the same conclusion. Northern Border takes possession of the compressor fuel as part of the consideration for its transportation services. In fact, Northern Border admitted that its shippers do not have an option; they must provide the compressor fuel if they want to use transportation services. HT 101. Northern Border admitted that its customers are required to provide the compressor fuel if they want "to transport one molecule of gas" on the pipeline. *Id.* These undisputed facts are fully consistent with the definition of consideration. *See supra.* Northern Border's customers cannot use the transportation services without delivering a required quantity of gas that will not be returned to the customer and that is used as Northern

Border alone, at its discretion, decides to use it. HT 101, 102-104. AR 157 (Ex. 3, Part 6.1 ¶ 24).

Ultimately, natural gas used for fuel in the compression engines is part of Northern Border's cost of service and is different from other elements of the cost of service only in that it is furnished by the shippers in-kind. Without the provision of compressor fuel, Northern Border would need to secure the gas or some alternative fuel through other means, at some cost, which it would either incur as a loss or offset through its transportation rates. Therefore, because the compressor fuel is "something of value" given in exchange for Northern Border's service, the compressor-fuel transfer from the shippers to the companies meets the definition of a "purchase," – a "transfer, exchange, or barter … for a consideration." SDCL 10-46-1(9).

B. Northern Border uses the Compressor Fuel it Receives from the Shippers to Fuel its Compressors.

After Northern Border receives the compressor fuel in exchange for its transportation services, the gas is put into the pipeline and the money, presumably, goes to the bank. The compressor fuel then flows through Northern Border's pipeline and remains under its possession and control, in its inventory, until it decides to use it. AR 157 (Ex. 3, Part 6.1 ¶ 24). These actions constitute "use" of the compressor fuel.

"Use" is broadly defined for tax purposes as "the exercise of right or power over tangible personal property . . . incidental to the ownership of that property, ..." SDCL 10-46-1(17). The general goal of the use tax statutes is to establish a complementary scheme whereby everything is presumed taxable unless specifically exempted. *Compare* SDCL ch. 10-45 to SDCL ch. 10-46. Consumption is a type of use. *See Great Lakes Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435, 439 (Minn. 2002)

("consumption qualifies as a type of 'use'- indeed, it could well be considered the ultimate use."). It is uncontested that Northern Border consumes, and thereby "uses," the compressor fuel in its South Dakota compressors. HT 101; AR 1644, Appellee's Brief at 5 (natural gas is burned in Northern Border's compressors). Consequently, Northern Border owes use tax on its use of compressor fuel in its South Dakota compressors. SDCL 10-46-2, 10-46-3, 10-46-4.[6]

C. Northern Border's Arguments do not Change its Use Tax Obligation.

Aside from the arguments already discussed, Northern Border makes a variety of arguments to explain away the otherwise fairly straightforward exchange of compressor

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[6] Northern Border attempted to distinguish 'use' from 'burn' during oral argument to the circuit court. The following exchange took place:

> THE COURT: All right. Well, you're claiming that you don't use the gas. Do you consume it?
>
> MS. HOGLUND HANSON: We do burn it. I mean, you get to the point where you almost feel like you're mincing words, Your Honor. But the gas is burned. It goes away.
>
> THE COURT: It got consumed, did it not?
>
> MS. HOGLUND HANSON: I don't see how we could say it did not. I just don't want to make admissions that are statutory admissions is all.
>
> THE COURT: Okay. Well –
>
> MS. HOGLUND HANSON: That's why we were so careful to say burned in the hearing because that's what the testimony was is that it was burned. We didn't want somebody to say if you made an admission against interest by using a very common term like the word used.

This goes to show that the difference between use and burn is a distinction without a difference. *See Great Lakes Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435, 439 (Minn. 2002) ("consumption qualifies as a type of 'use'- indeed, it could well be considered the ultimate use.").

fuel for transportation services. However, none of these arguments can change the economic reality of this transaction. Each argument will be discussed below.

1. Northern Border owns the compressor fuel.

First, Northern Border declares that use tax cannot be imposed under SDCL 10-46-2 because Northern Border never owns the compressor fuel.[7] *See* Appellee's Brief at 7-17 (basing its argument on the "incidental to ownership" language contained in the definition of "use." *See* SDCL 10-46-1(17)). In order to support its argument, Northern Border attempts to rewrite SDCL 10-46-1(9) and (17) to include a requirement that there must be a "transfer of legal title." No such requirement exists in the statutes or case law presented by Northern Border. *See* SDCL 10-46-1(9) and (17); *Hallet Constr. Co. v. Gillis*, 119 N.W.2d 117 (S.D. 1963); *Friessen Constr. Co. v. Erickson*, 238 N.W.2d 278 (S.D. 1976); *Val-Pak East Valley, Inc. v. Ariz. Dep't of Revenue*, 272 P.3d 1055 (Ariz. Ct. App. 1 2012).

Here, Northern Border owns the compressor fuel it purchases from the shippers. Ownership is "[t]he bundle of rights allowing one to use, manage, and enjoy property, including the right to convey it to others. Ownership implies the right to possess a thing, regardless of any actual or constructive control. Ownership rights are general, permanent, and heritable." BLACK'S LAW DICTIONARY (9th ed. 2009). As discussed above, Northern Border concedes that it takes possession of the compressor fuel, it controls the use of that gas in the operation of its pipeline, and it does not return any

[7] It appears the circuit court rejected this argument by Northern Border: "Why have [the shippers] not called the state's attorney to have you arrested for using something they own? If they own it and they have title and you took it from them without their consent, and without pricing it into the service, you stole it." Circuit Court Oral Argument Transcript at 23.

portion of that gas to its customers. *See supra* 13-17. In short, the lack of ownership interest Northern Border asserts in the compressor fuel is contrary to the facts and its own admissions.[8] *See* Appellee's Brief; AR 1644; HT 100; AR 157 (Ex. 3, Part 6.1 ¶ 24). Therefore, Northern Border's argument that it doesn't own the fuel is without merit.

2. Northern Border purchased the compressor fuel.

Equally irrelevant is the fact that Northern Border does not receive or pay any money for the compressor fuel.[9] Appellee's Brief at 17-24, AR 1659-1663. As discussed above, the reality of this transaction is that this is a "transfer, exchange, or barter of the compressor-consumed gas for transportation services," thus relieving Northern Border of a significant operating expense. *See discussion supra*. This conclusion is consistent with the holdings of the Minnesota Courts. *Great Lakes Gas Transmission L.P. v. Comm'r of Revenue*, 638 N.W.2d 435 (Minn. 2002); *Northern Border Pipeline Co. v. Comm'r of Revenue*, 2009 WL 173959 (Minn. Ct. App. 2009).

NOR ISSUE 3. SDCL 10-46-6 DOES NOT EXEMPT NORTHERN BORDER'S USE OF COMPRESSOR FUEL.

SDCL 10-46-2 imposes a use tax on the privilege of using tangible personal property in South Dakota. *See* Appellee's Brief at 17-18. On numerous occasions, the

[8] During oral argument, Judge Barnett observed that "the right of disposition strikes me as probably the strongest or the most important property right that you could ever have as one form of title. I mean, the title doesn't mean a whole lot to you unless you have the right to dispose of it in the way you see fit, that seems like a whole big piece of the concept, quote, "title," end quote." CT HT 25.

[9] Northern Border repeats its argument that there must be a "transfer of legal title." As previously discussed, no such requirement exists. *See* SDCL 10-46-1(9) and (17); *Hallet Constr. Co. v. Gillis*, 119 N.W.2d 117 (S.D. 1963); *Friessen Constr. Co. v. Erickson*, 238 N.W.2d 278 (S.D. 1976); *Val-Pak East Valley, Inc. v. Ariz. Dep't of Revenue*, 272 P.3d 1055 (Ariz. Ct. App. 1 2012); and *S.D. Dep't of Revenue v. Sanborn Tel. Co-op*, 455 N.W.2d 223 (S.D. 1990).

South Dakota Supreme Court has recognized that if sales tax is due, there is a corresponding use tax. SDCL 10-46-6 prevents the imposition of both taxes by providing that if South Dakota sales tax was included in the sales price of a transaction, it will not be subject to South Dakota use tax. *See also* SDCL 10-46-6.1 (providing a credit for sales tax paid in other states).

SDCL 10-46-6 is inapplicable to the present situation. *See* SDCL 10-46-2, 10-46-3, 10-46-4; AR 9-41 (Ex. A). Further direction is provided by SDCL 10-46-4 and 10-46-34. These statutes provide that persons using, storing, or consuming property subject to use tax remain liable for the tax until such time as the tax is paid, either to a retailer or directly to the Secretary of Revenue. SDCL 10-46-4, 10-46-34. These sections indicate that the Legislature intended for users of tangible personal property in this state to be liable for use tax on that property until the tax is paid either directly or indirectly. On the other hand, SDCL 10-46-6 applies only where sales tax is paid on the item. *Id*. Here, no corresponding sales tax was paid on the compressor fuel. *See* AR. Therefore, SDCL 10-46-6 does not exempt Northern Border from use tax on the fuel.

Northern Border relies on an Attorney General's opinion, Official Opinion No. 82-9 (February 3, 1992) in arguing that the shippers should be subject to sales tax and Northern Border should not be subject to use tax. Appellee's Brief at 29-30. The Attorney General's opinion asks "If [a] band does not pay sales tax, must the business pay a use tax?" This opinion is irrelevant because the Department currently collects use tax from a business if a band does not have a sales tax license or does not charge sales tax. *See* Restaurant and Bars Tax Facts.[10] In addition, the Attorney General's opinion is

[10] The Restaurant and Bars Tax Facts is available at: http://www.state.sd.us/drr2/businesstax/ publications/taxfacts/0713/barrest1113.pdf.

distinguishable from the present case as it deals with services, not tangible personal property.

Regardless, this Court has repeatedly held that "the opinions of the Attorney General are not binding on this Court." *Brim v. S.D. Bd. of Pardons & Paroles*, 1997 S.D. 48, ¶ 17, 563 N.W.2d 812, 816 (citing *Stumes v. Delano,* 508 N.W.2d 366, 372 (S.D. 1993)). Therefore, not only are the facts in the Attorney General's opinion different from the case at hand, but there is no need to look at an opinion of the Attorney General when the law is clear. SDCL 10-46-2, 10-46-2.1, 10-46-3, 10-46-4, 10-46-6, 10-46-6.1, 10-46-34. Ultimately, Northern Border's SDCL 10-46-6 argument fails as it is unsupported by law and, if adopted, it would lead to an absurd result – *effectively eliminating the need for the use tax chapter, SDCL ch. 10-46. Argus Leader v. Hagen*, 2007 S.D. 96, ¶ 15, 739 N.W.2d 475, 480 (citations omitted).

NOR ISSUE 4. FEDERAL REGULATION OF NORTHERN BORDER'S TRANSPORTATION SERVICES DOES NOT EXEMPT NORTHERN BORDER FROM STATE SALES AND USE TAXES.

Congress enacted the Natural Gas Act of 1938 ("NGA"), 15 U.S.C. § 717 et seq. to ensure that consumers of natural gas receive a fair price and to protect against economic power of the interstate pipelines. *Maryland v. Louisiana*, 451 U.S. 725, 747 (1981). Subsequently, the Natural Gas Policy Act of 1979 ("NGPA"), 15 U.S.C. §3301 et seq. was enacted to alleviate the adverse economic effects of the disparate treatment of intrastate and interstate natural gas sales. *Id*. The Federal Energy Regulatory Commission ("FERC") is the federal agency that enforces the NGA and NGPA.

Northern Border argues that the assessment of use tax on compressor fuel violates the Supremacy Clause. Appellee's Brief at 30-32. Challenges brought under the

Supremacy Clause start with the basic assumption that Congress did not intend to displace state law. *See Maryland*, 451 U.S. at 747 (internal citations omitted). Thus, absent an express declaration that state law is preempted, the party asserting a Supremacy Clause challenge must demonstrate that (a) "Congress has legislated comprehensively to occupy an entire field of regulation leaving no room for States to supplement federal law;" or (b) the state law conflicts with federal law because it is impossible to comply with both federal and state regulations; or (c) the state law is "an obstacle to the accomplishment and execution of congressional objectives." *Nw. Cent. Pipeline Corp. v. State Corp. Comm'n of Kansas*, 489 U.S. 493, 509, 109 S.Ct. 1262, 1273 (1989) (citations omitted).

The United States Supreme Court recognizes that "Congress carefully divided up regulatory power over the natural gas industry" when it enacted the Natural Gas Act and the Natural Gas Policy Act, and it did not "envisage federal regulation of the entire natural-gas field to the limit of constitutional power." *Nw. Cent. Pipeline Corp.*, 489 U.S. at 510, 109 S.Ct. at 1274 (quoting *FPC v. Panhandle E. Pipe Line Co.*, 337 U.S. 498, 502-03, 69 S. Ct. 1251, 1254 (1949)); *see also id.* at 511 n.9, 109 S.Ct. at 1275 n.9 (noting that certain state regulation was not preempted under NGPA); s*ee Exxon Corp. v. Eagerton*, 462 U.S. 176, 185-186, 103 S.Ct. 2296, 2302-03 (1983) (finding no preemption for tax imposed on intrastate activities, tax on interstate activities preempted because state law precluded pipeline from passing tax on to customer).

Several courts have specifically held that it is appropriate and permissible for a pipeline to factor the cost of taxes it pays for its pipeline operations into the rates it charges its customer for the transportation of natural gas. *See Fed. Power Comm. v.*

Memphis Light, Gas, & Water Division et al., 411 S.S. 458 (1973) (holding that the 1969 Tax Reform Act did not deprive the Federal Power Commission ("FPC") of authority under NGA to permit a utility to change its depreciation method for purposes of rate making); *see also City of Charlottesville v. Fed. Energy Regulatory Comm.*, 774 F.2d 1205 (D.C. Cir. 1985) (finding that the FERC expects a pipeline's taxes to be passed on to rate-payers as taxes are considered an operating expense or maintenance in the transmission process).

The Supreme Court has also interpreted preemption of FERC's regulation of the NGA and NGPA quite narrowly and will not find field preemption where a state statute may affect natural gas companies' rates and facilities. *Nw. Cent. Pipeline Corp. v. State Corp. Comm. of Kansas*, 489 U.S. 493, 494 (1989) (holding that a Kansas regulation which provided that producer's entitlements to assigned quantities of gas would be permanently cancelled if production was too long delayed was not preempted under the supremacy clause and did not violate the commerce clause); *Exxon Corp. v. Eagerton et al.*, 462 U.S. 176 (1983) (finding that although NGPA extended federal authority to control natural gas prices to the intrastate market, state taxation statute was not preempted as it applied to sales of gas within the state).

Similarly, courts have been reluctant to find preemption of state law even where the challenged state act is rate setting legislation that directly affects and interferes with interstate pipelines. *See Ky. W. Va. Gas Co., et al. v. Penn. Pub. Util. Comm.*, 862 F.2d 69, 74 (3rd Cir. 1988) (finding no violation of the supremacy clause or the commerce clause and permitting state retail rate procedures which delayed the utilities' recovery of

FERC approved wholesale costs and denied utilities' interest on such costs during the regulatory lag).

The above principles confirm that Congress did not expressly preempt state taxing authority in either the NGA or the NGPA. Further, the Supreme Court's recognition of the careful division of regulatory power in the natural gas industry confirms that there is no "comprehensive regulation" that would preclude state taxation of state activities. Northern Border must therefore demonstrate an implied preemption either by showing that it is physically impossible for the company to comply with South Dakota's tax laws while also complying with FERC regulations; or by showing that South Dakota's tax laws are an obstacle to the accomplishment of the FERC's purposes.

Thus, Northern Border cannot point to any evidence that shows it is a physical impossibility for it to pay South Dakota use tax on the fuel it burns in its compressors and to comply with the FERC regulations regarding the sale and transport of natural gas through its pipelines. Here, there are no facts that support the conclusion that Northern Border cannot comply with South Dakota's tax laws while also complying with FERC's regulations, or that South Dakota's laws pose an obstacle to FERC's purposes. *See generally* AR. In fact, Northern Border's FERC Tariff specifically contemplates state use taxes. *See* AR 71-72 (Ex. 3, Part 5.1.3.1) (firm transportation service rates); AR 107-108 (Ex. 3, Part 5.4.3) (interruptible transportation service rates); AR 326 (Ex. 3, Part 6.44) (compressor usage surcharge).

The FERC Tariff allows Northern Border to recover state use taxes imposed on the use and consumption of compressor fuel at its compressor stations through a compressor usage surcharge. AR 71-72 (Ex. 3, Part 5.1.3.1) (firm transportation service

rates); AR 107-108 (Ex. 3, Part 5.4.3) (interruptible transportation service rates); AR 326 (Ex. 3, Part 6.44) (compressor usage surcharge, including definition of usage costs). The compressor usage surcharge, which applies to both the firm transportation service rates and interruptible transportation service rates, requires the calculation of usage costs. *Id.* The Tariff defines usage costs as "the sum of the actual costs incurred by Company at any of Company's electric compressors installed along Company's system related to electricity *and use taxes imposed on the consumption of natural gas quantities at natural gas powered stations along Company's system*." AR 326 (Ex. 3, Part 6.44 ¶ 2(a)) (emphasis added). The plain language of Northern Border's FERC Tariff unambiguously contemplates state use taxes. Consequently, Northern Border's argument concerning the Supremacy Clause is without merit.

NOR ISSUE 5. NORTHERN BORDER MISAPPLIES ARSD 64:09:01:09.

Northern Border argues that ARSD 64:09:01:09 exempts its use of compressor fuel.

> 64:09:01:09. The fact that tangible personal property or any product transferred electronically is purchased in interstate or foreign commerce, does not exempt the storage, use, or other consumption of such property or product from use tax in this state after the shipment of property in interstate commerce has ended. After the property or product has come into the hands of the purchaser thereof for use, storage, or other consumption in this state, the interstate commerce has ceased and the property or product shall be taxed.

Again, Northern Border's transportation services themselves are never taxed. *See* SDCL 10-45-67; SDCL 10-46-55. As in its SDCL 10-46-55 argument, Northern Border focuses on its transportation services, not its purchase and use of compressor fuel. Appellee's Brief at 32-33. However, as previously discussed, Northern Border receives compressor fuel in exchange for the promise of transportation services. This is an in-kind exchange.

No tax is paid on the compressor fuel Northern Border receives from the shippers. If the shippers did not provide compressor fuel, Northern Border would have to purchase gas to fuel its compressors – gas that would otherwise be subject to South Dakota sales tax. At the time when the "property or product has come into the hands of the purchaser thereof for use, storage or other consumption in the state, the interstate commerce has ceased and the property or product [is subject to tax]." ARSD 64:09:01:09. Here, Northern Border acknowledges that it is in possession of the compressor fuel upon delivery from the shipper and that its Tariff authorizes it to use that gas in operating the engines on its pipeline, "*as determined by Northern Border*." HT 102-104. See AR 157 (Ex. 3, Part 6.1 ¶ 24) (The Tariff provides Northern Border discretion as to how and when compressor fuel is used). Consequently, the plain language of ARSD 64:09:01:09 does not exempt the gas Northern Border uses in its compressors.

NOR ISSUE 6. VALUATION OF THE COMPRESSOR FUEL.

Northern Border also argues that the Department incorrectly valued the gas used in its compressors and, therefore, the tax assessed was inaccurate. It is undisputed that during the audit, Northern Border provided the Department with the volumes of gas used in its compressors in South Dakota. AR 24 (Ex. A at 16). However, Northern Border did not provide the Department with information on how to value that fuel even though Northern Border knew that the Department considered the use of the compressor fuel a taxable event. During the administrative hearing, Auditor Berglin described his attempts to obtain a value for the compressor fuel:

> Q. Did you ask Mr. Thompson for evidence or documentation on how to value the compressor [fuel]?
>
> A. I did ask him for a valuation; he did not feel that it was a taxable event and that it wouldn't be – shouldn't be an issue for the audit.

Q. So you specifically asked Mr. Thompson for valuation information?

A. Yes.

Q. And specifically can you describe the reason he gave you?

A. He didn't agree with the Department's position that it was a taxable event. He mentioned that they do not own the gas and he didn't feel that it would be a tax liability to them.

HT 51. During direct testimony, Northern Border's tax manager, David Thompson, testified in accordance with the auditor's testimony. Mr. Thompson explained his refusal to provide the Department evidence or documentation on how to value the compressor fuel:

Q. You were involved in the audit of this case, correct?

A. Yes.

Q. When you were asked to provide records in this audit did you provide records?

A. Yes.

Q. And did you ever refuse to provide any Northern Border Pipeline records?

A. No.

Q. And why do you say that? Because you have heard the testimony that you refused to give pricing figures. Can you explain that?

A. *Yes. Yeah, the specific request for gas prices I felt was a ploy to help the Department of Revenue gather information to create a fictitious transaction that does not exist.*

HT 148 (emphasis added). Ultimately, the Department did not receive any documentation concerning the valuation of the compressor fuel from either Northern Border or its agents. HT 52.

In circumstances where a taxpayer's records are inadequate or they fail to comply with the requirements found in SDCL 10-45-45, an auditor is authorized to use alternative audit methods. ARSD 64:06:01:35.05; *see Matter of Reif*, 478 N.W.2d 815, 819 (S.D. 1991) (citing *Karras v. State Dep't of Revenue*, 441 N.W.2d 678, 680 (S.D. 1989)) (alternative audit methods are authorized even though they may not be as precise as a taxpayer's own accurate and complete records, assuming such records had been kept and produced). In *Karras v. State Dep't of Revenue*, the Court explained that:

> SDCL 10-45-45 mandates keeping books and records of sales and receipts so that the Department may verify the accuracy of sales taxes collected by a retailer and remitted to the state. *Failing to keep adequate records does not preclude proper verification of sales taxes by the Department, but such verification certainly is less precise.* In circumstances where a retailer's books and records are found to be insubstantial, the *Department may resort to other available information and auditing techniques to determine whether a sales tax deficiency exists.*

Id. at 680 (Citing *City of Lennox*, 278 N.W.2d 635, 637 (S.D. 1979)) (emphasis added). The Court also recognized that the Department needs the cooperation of taxpayers to facilitate the collection of state taxes and cautioned:

> If during an audit, Department determines the records maintained are not adequate, Department has the option to employ other auditing techniques to determine the amount of tax owed. *This option can obviously prove to be a disadvantage to the taxpayer, since properly maintained records could likely result in a lower tax determination than the alternate auditing techniques***.**

Matter of Reif, 478 N.W.2d 815, 819 (S.D. 1991) (citing *Karras*, *supra*) (emphasis added). In *Ruttman*, the Court added:

> As we stated in *City of Lennox, supra*, this method of extrapolating sales based on purchases may be avoided by simply and accurately keeping the books and records required by SDCL 10-45-45. *A contrary conclusion would invite inadequate record keeping as a means of evading full payment of the sales tax, which we believe would contravene the legislative intent.*

State v. Ruttman, 1999 SD 112, ¶ 20, 598 N.W.2d 910, 914 (emphasis added). All of these cases highlight the importance of the taxpayers' cooperation.

Here, Northern Border's decision to not provide information on how to value the compressor fuel necessitated the use of alternative methods to value the compressor fuel. In order to value the compressor fuel used, the auditor, after consulting with the South Dakota Public Utilities Commission on what could be used as a fair pricing method, used the Citygate price in South Dakota. AR 10 (Ex. A at 2). The Citygate price is the price at the point or measuring station at which a distributing gas utility receives gas from a natural gas pipeline company or transmission system. *Id*. Therefore, the auditor used the Citygate pricing for the months in the audit period and applied it to the gas volume monthly totals provided by Northern Border. *Id*.

Northern Border asserts that the Department used the wrong multiplier in calculating Northern Border's use tax liability. Appellee's Brief at 34-35. At the administrative hearing, Northern Border argued for the first time that the Department should have multiplied the volume amount, denominated in dekatherms, times a price determined on a per dekatherm[11] basis ($/Dth), not a price per thousand cubic feet of gas ($/Mcf). *Id*. Part 6.5 of Northern Border's Tariff sets forth the quality standards of gas to be received by Northern Border. AR 188-190 (Ex. 3, Part 6.5). Subsection (i) states: "The gas shall have a gross heating value of not less than 967 Btu[12] per cf.[13]" *Id*.

[11] For reference 1 dekatherm = 1,000,000 Btu's. Ex 3, Part 6.1 ¶ 33.

[12] The term "Btu" shall mean one (1) British thermal unit, the amount of heat required to raise the temperature of one (1) pound of water one (1) degree Fahrenheit from fifty-eight

Therefore, if Northern Border were to receive one thousand cubic feet of gas, the gross heating value would be at least 967,000 Btu. *See id*. The 967,000 *minimum* Btu per thousand cubic feet is nearly a one to one ratio of the 1,000,000 Btu per thousand cubic feet used to calculate dekatherms. In light of Northern Border's conscious decision not to provide records, the Department's assessment is reasonable.

Northern Border argues that the AECO Hub price for the natural gas is more representative of a fair price or value for the compressor fuel. However, the AECO price information and Platts documentation were not received by the Department until April 25, 2012, *422 days*, after the commencement of the audit. Therefore, the auditor was never given an opportunity to consider them. Under SDCL 10-45-45, Northern Border is required to "keep records and books of all receipts and sales together with invoices, bills of lading, copies of bills of sale, and *other pertinent papers and documents*." (Emphasis added). Here, Northern Border offers the AECO Hub prices and Platts documents as evidence to reduce tax and as such, are " . . . pertinent document[s]." *Id*. *Doctor's Assocs. Inc. v. Dep't of Revenue & Regulation*, 2006 SD 18, ¶21, 711 N.W.2d 237, 243 ("it is certainly evidence purporting to reduce, deduct or exempt [Northern Border's use of compressor fuel] from tax.") *Id*.

Because Northern Border asserts that those documents evidence a reduction, the AECO Hub prices and Platts documents should have been presented to the Department during the audit, as required under SDCL 10-59-3 and 10-59-7. *Id*. SDCL 10-59-3 provides that all documents evidencing reduction, deduction, or exemption of tax must be

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and one-half (58.5) degrees Fahrenheit to fifty-nine and one-half (59.5) degrees Fahrenheit. (Btu is measured on a dry basis at 14.73 psia.). AR 156 (Ex. 3, Part 6.1 ¶ 12).

[13] The term "cf" shall mean one cubic foot of natural gas measured at Standard Reference Conditions. Ex. 3, Part 6.1 ¶ 12.

presented to the auditor within sixty days of the commencement of the audit or they need not be considered by the auditor. Furthermore, SDCL 10-59-7 provides in pertinent part:

> Any documents or records required to be kept by law to evidence reduction, deduction, or exemption from tax not prepared for presentation to the auditor within sixty days from the commencement date of the audit do not have to be considered by the auditor or the secretary. However, additional pertinent papers or documents shall be considered if all the following apply:
>
> (1) The additional pertinent papers or documents are material;
>
> (2) There were good reasons for failure to present other pertinent papers or documents as referenced in § 10-45-45 or 10-46-43, within the prescribed time period; and
>
> (3) The additional pertinent papers or documents are submitted within a reasonable time period prior to any hearing scheduled pursuant to § 10-59-9.

[A]ccording to SDCL 10-59-3 and SDCL 10-59-7, the Department [is] not obliged to consider these records [required to be kept by law to evidence reduction, deduction, *or exemption from tax*] for audit purposes." *Matter of Pam Oil, Inc.*, 459 N.W.2d 251, 255, 257 (S.D. 1990); SDCL 10-59-3; 10-59-7. Because Northern Border failed to submit the evidence during the sixty days required under SDCL 10-59-3 and 10-59-7, Northern Border has no right to later offer this material. *Id*. *See also AT & T Corp. v. S.D. Dep't. of Revenue*, 2002 S.D. 25, ¶ 18, 640 N.W.2d 752, 757; *Matter of Pam Oil, Inc.*, 459 N.W.2d at 257. In order for additional pertinent papers or documents to be considered, Northern Border must meet all three requirements listed in SDCL 10-59-7. However, Northern Border does not argue that any of the exceptions are applicable. Appellee's Brief at 33-36.

Regardless, the exceptions do not aid Northern Border's argument. Northern Border was fully aware that the Department considered the use of gas in its compressors

a taxable event, yet *Northern Border made a conscious decision not to provide the Department with information on how to value that compressor fuel.* HT 148.

The second prong requires that there be good reasons for failing to "present other pertinent papers or documents as referenced in § 10-45-45 or 10-46-43, within the prescribed time period." SDCL 10-59-7. Northern Border argues that the information contained in AECO Hub prices and Platts documents is widely available. Yet at hearing, Northern Border's witness Mr. Fonda testified that in order to view the documentation a subscription would be necessary. HT 88 (a subscription is necessary), HT 90 (Northern Border must pay for that subscription). Not only are the AECO Hub Prices and Platts documents not widely available, but Northern Border did not provide these documents to the Department until April 25, 2012, *422 days*, after the commencement of the audit. Consequently, Northern Border fails the second prong.

Northern Border's conscious decision not to provide documentation to the Department concerning the valuation of the compressor fuel is precisely the situation contemplated by SDCL 10-59-3 and 10-59-7. If the Hearing Examiner or this Court were to consider these exhibits, it would encourage taxpayers to not cooperate with the Department in providing records. "To allow late submittal of these materials long after the audit has ended would make the audit process interminable and unworkable." *Doctor's Assocs., Inc. v. Dep't of Revenue & Regulation*, 2006 S.D. 18, ¶22, 711 N.W.2d 237, 243.

Ultimately, the hearing examiner agreed with the Department's calculations and specifically noted "that the Department met with Northern Border at a preliminary listing meeting (June 10, 2011) and at the final listing meeting (August 31, 2011). At the very

least, Northern Border had notice through those two meetings of the Department's calculation method of the use tax. At those meetings[,] Northern Border never disputed the valuation of the compressor fuel or provided any further evidence of a different method which might reduce their obligation." AR 1787. Based on Northern Border's "conscious decision not to provide the Department with information on how to value the compressor fuel[,]" and *Doctor's Assocs., Inc. v. Dep't of Revenue & Regulation*, the hearing examiner correctly found that "the value as arrived at on the Certificate of Assessment must be upheld and the admission of Exhibit 15 and 15-A must be denied." AR 1788.

NOR ISSUE 7. ONLY THE SECRETARY CAN EXERCISE THE SECRETARY'S DISCRETION.

Northern Border argues that interest should be reduced pursuant to SDCL 10-59-6. SDCL 10-59-6 allows the Secretary, upon application of the taxpayer, to establish a maximum interest rate. SDCL 10-59-6 provides in pertinent part that:

> The secretary may, upon application of the taxpayer, establish a maximum interest rate of thirty percent upon delinquent taxes if the secretary determines that the delinquent payment was caused by a mistake of law and was not caused by an intent to evade the tax.

Further, SDCL 10-59-28 allows the Secretary of the Department of Revenue ("Secretary") to reduce or abate interest or penalty in certain circumstances.

> SDCL 10-59-28. Penalty or interest may be reduced or abated if the secretary determines such reduction or abatement is just and equitable or that the department has been negligent by unduly delaying in giving notice to the taxpayer of the assessment or the tax liability.

Both statutes are discretionary to the *Secretary*. *See* SDCL 10-59-6 and 10-59-28. To date, the Secretary has not received a request from Northern Border to reduce, abate, or cap interest. *See* AR. Even though no request has ever been made to the Secretary,

Northern Border now, for the first time makes a request to this Court, and for the first time provides reasons to reduce or abate interest.[14] As it would be improper for the Office of Hearing Examiners or the circuit court to exercise its discretion in place of the Secretary's, it would also be improper for this Court to exercise its discretion in place of the Secretary's. Consequently, Northern Border's request must be dismissed.

CONCLUSION

In issuing its decision, the circuit court misapplied SDCL 10-46-55. A plain reading of South Dakota's statutes requires that the circuit court's decision be reversed. If this Court decides to address Northern Border's Notice of Review issues, the above arguments and authorities provide a sound basis to affirm the Certificate of Assessment in its entirety. Therefore, the Department respectfully requests that this Court reverse the decision of the circuit court and affirm the Certificate of Assessment and Final Decision of the Secretary in its entirety.

Respectfully submitted this 7th day of January, 2015.

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[14] In response to the reasons listed by Northern Border, aside from the fact that Northern Border was uncooperative, the Department would note that:

1. By statute, the use of tangible personal property is, and has been, subject to South Dakota use tax. SDCL 10-45-2, 10-46-2, 10-46-3, 10-46-4.
2. Interest rates are statutorily set. SDCL 10-59-6.
3. Northern Border could have stopped the accrual of interest (and in fact had the interest accruing in its favor) at any time by remitting the amount of the assessment. It chose not to. *Compare* SDCL 10-59-6 to SDCL 10-59-24.

CERTIFICATE OF COMPLIANCE

I certify that this brief complies with the requirements in SDCL 15-26A-66(b). This brief contains 8,847 words, excluding the table of contents, table of authorities, jurisdictional statement, statement of legal issues, and certificate of counsel. I have relied on the word count of Microsoft Word, which was used to prepare this brief.

Dated this 7th day of January, 2015.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that two true and correct copies of Appellant South Dakota Department of Revenue's Reply Brief in the matter of Northern Border Pipeline Company v. South Dakota Department of Revenue were served on:

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properly addressed as above, postage prepaid, by mailing first class United States mail at the United States Post Office, Pierre, South Dakota. The Department's Reply Brief was also electronically served on the parties listed above.

Dated and mailed this 7th day of January, 2015.

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