

## **Updated Statement of Reasons for the Proposed Amendments to California Code of Regulations, Title 18 Regulation 1435, Tax Paid Twice on Diesel Fuel**

The California Department of Tax and Fee Administration (Department) proposes to amend California Code of Regulations, title 18, section (Regulation) 1435, *Tax Paid Twice on Diesel Fuel*, to clarify when a supplier may report a credit or file a claim for refund for diesel fuel tax paid twice on gallons of diesel fuel.

### **Current Law**

The Diesel Fuel Tax Law (DFTL) was enacted in 1994. The diesel fuel tax is imposed upon each gallon of diesel fuel when it is:

- Removed from the terminal or refinery rack,<sup>1</sup>
- Removed by bulk transfer<sup>2</sup> and the refiner or the owner of the diesel fuel, immediately before the removal, does not hold a valid diesel fuel supplier license with the Department,
- Imported into this state by bulk transfer and the enterer does not hold a valid diesel fuel supplier license with the Department,
- Imported into this state and the import is not a bulk transfer,<sup>3</sup>
- Removed or sold to a person that does not hold a valid diesel fuel supplier license with the Department, and the diesel fuel was untaxed, or
- Blended diesel fuel which has been removed or sold by the blender.<sup>4</sup> The number of gallons of blended diesel fuel subject to the tax is the difference between the total number of gallons of blended diesel fuel removed or sold and the number of previously taxed diesel fuel gallons used to produce the blended diesel fuel.

The DFTL also contains a “backup tax” imposed on diesel fuel when the tax was not previously paid or has been refunded. (Revenue and Taxation Code (RTC) section 60058.) The backup tax is imposed on the delivery into the fuel tank of a diesel-powered highway vehicle of any diesel fuel that contains a dye,<sup>5</sup> any diesel fuel for which a claim for refund has been allowed, or any liquid on which tax has not been imposed.

### *Biodiesel Fuel*

Biofuels are transportation fuels made from biomass materials; biodiesel is one of the most common biofuels. Biodiesel is a fuel made fully or partially from vegetable oils or animal fats. It is typically produced by combining a vegetable oil or animal fat with an alcohol,

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<sup>1</sup> The rack is a mechanism used for delivering fuel from a refinery or terminal into a truck, trailer, railcar, or other means of nonbulk transfer. (RTC section 60006.)

<sup>2</sup> "Bulk transfer" means any transfer of diesel fuel by pipeline or vessel. (RTC section 60029.)

<sup>3</sup> In most cases this is done by truck.

<sup>4</sup> Blenders produce or convert blended diesel fuel (including biodiesel) outside the bulk transfer/terminal system. (RTC section 60012.)

<sup>5</sup> "Dyed diesel fuel" means diesel fuel that is dyed under United States Environmental Protection Agency (EPA) or the Internal Revenue Service (IRS) rules for high sulphur diesel fuel or low sulphur diesel fuel or any other requirements subsequently set by the EPA or the IRS and considered destined for nontaxable, off-highway uses. (RTC section 60031.)

such as methanol or ethanol, in the presence of a chemical catalyst to produce mono-alkyl esters and glycerin. Biodiesel does not contain any petroleum diesel but can be blended with petroleum diesel to create a biodiesel blend. Under the DFTL, biodiesel fuel is subject to the diesel fuel excise tax. Most biodiesel produced in the United States comes from the Midwest region. Since this biodiesel fuel distribution occurs outside the normal bulk transfer (pipeline or vessel) or terminal system, it is subject to the diesel fuel tax upon entry into the state (e.g., brought in by truck). As the biodiesel fuel products enter the market from outside California, the enterer<sup>6</sup> is responsible for the diesel fuel tax when it enters the state. Biodiesel fuel that is produced in California is generally taxed upon removal from the fuel production facilities rack.

#### *Tax Paid Twice on Diesel Fuel*

Subdivision (a)(4)(J) of RTC section 60501 provides a credit or refund for diesel fuel taxes paid twice when the fuel is “removed from an approved terminal at the terminal rack, but only to the extent that the supplier can show that the tax on the same amount of diesel fuel has been paid more than one time by the same supplier.” Subdivision (a) of current Regulation 1435 provides that a “supplier who removes diesel fuel from a terminal rack on which a prior tax was paid to the state may either file a claim for refund with the [Department] or in lieu of a refund take a credit on its tax return.”

Current law authorizes the Department to provide a credit or refund of taxes paid on biodiesel that is blended with ex-tax (tax not yet imposed) diesel fuel in a tank at an approved terminal and then removed as dyed blended biodiesel fuel. (RTC section 60501, subdivision (b).) It also allows for a credit or refund of taxes paid on diesel fuel that is subject to a tax a second time if the supplier can show that the tax on the same amount of diesel fuel has been paid more than one time by the same supplier. (RTC section 60501, subdivision (a)(4)(J).) These credits or refunds are designed for a single supplier to avoid double-taxation on removals of diesel fuel and taxation of otherwise exempt dyed blended biodiesel. While there is some ambiguity as to whether the “same amount” language of subdivision (a)(4)(J) of RTC section 60501 refers to the specific type of diesel fuel (i.e., tax-paid, ex-tax) or simply the quantity of fuel, the reference in Regulation 1435 to removals of diesel fuel “on which a prior tax was paid” differentiates between tax-paid and ex-tax diesel fuel, thus indicating that a credit or refund is only available for removals of tax-paid diesel fuel and does not include removals of ex-tax diesel fuel. Accordingly, the current language of Regulation 1435 has unintentionally narrowed the definition contained in statute. The purpose of the Department’s proposed amendments is to address this discrepancy and bring the regulation into alignment with the statute. This will result in a supplier who has an adequate amount of tax-paid diesel fuel inventory at an approved terminal being able to claim a tax-paid twice credit when it makes removals of its diesel fuel inventory at an approved terminal.

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<sup>6</sup> Importer of record or owner of the fuel. (RTC section 60013).

## **Proposed Amendments**

### *First Discussion Paper and Interested Parties Meeting*

The Department prepared and distributed an initial discussion paper explaining the proposed amendments to Regulation 1435. The paper was posted to the Department's webpage on September 10, 2018. Interested parties were invited to attend the September 20, 2018, meeting to discuss these amendments. In general, the interested parties approved of staff's recommendations. Alston and Bird (A&B), representing Idemitsu Apollo Corporation, was the only interested party to suggest alternative language. The Department held teleconferences with A&B to discuss its suggestions in greater detail.

### *2019 Issue Paper*

After the teleconferences with A&B, the Department considered their comments and determined that additional revisions were needed to the amendments proposed in the initial discussion paper. The 2019 Issue Paper discusses the Department's proposed amendments to Regulation 1435 and was posted to the Department's website on July 2, 2019. The paper discusses the proposed revisions by subdivision as noted below.

### *Regulation 1435(a) – Issue Paper*

Revisions proposed to subdivision (a), include adding the title "In General" and updating the reference "Board" to "Department." In addition, the language "...for up to the same amount of tax-paid gallons of diesel fuel it previously contributed to that terminal for which it has not yet taken a credit on its return or filed a claim for refund." was added to broaden the interpretation of Regulation 1435 to match the language of the statute. Currently, Regulation 1435 references removals of diesel fuel "on which a prior tax was paid" differentiating between tax-paid and ex-tax diesel fuel. By doing so, the regulation indicates that a credit or refund is only available for removals of tax-paid diesel fuel and not for removals of ex-tax diesel fuel.

For example, Supplier X deposits 100 gallons of tax-paid biodiesel fuel (B100) into an approved terminal community tank containing ex-tax diesel fuel from other suppliers and on a later date removes 100 gallons of blended biodiesel fuel (B05). Under the current regulation, if Supplier X removes 100 gallons of blended biodiesel B05 (five gallons of tax-paid biodiesel fuel and 95 gallons of ex-tax petroleum diesel fuel), Supplier X is only eligible for a credit or refund for the five gallons of tax-paid biodiesel fuel that is contained in the B05 blend Supplier X removed from the terminal rack. A refund or credit is not available for the other 95 gallons of petroleum diesel fuel that is part of the B05 blend because a "prior tax" was not paid on those gallons of diesel fuel.

### *Regulation 1435(b) – Issue Paper*

Following the review of submissions and discussions with interested parties, there was concern that Regulation 1435 could be inconsistent with RTC section 60501, subdivision (b) which states, "Where tax is not imposed on dyed blended biodiesel fuel upon removal from an approved terminal at the terminal rack, if tax was previously imposed on the biodiesel fuel portion of the dyed blended biodiesel fuel, then, pursuant to paragraph (1) of

subdivision (a), a claim for refund is allowed for the tax that was paid on that biodiesel fuel, but only to the extent a supplier can show that the tax on that biodiesel fuel has been paid by the same supplier.” There were concerns that proposed revisions to subdivision (a) of Regulation 1435, as described in the initial discussion paper, may create a loophole where a supplier could potentially claim a credit against removals of dyed blended biodiesel fuel, consisting of tax-paid biodiesel fuel and ex-tax petroleum diesel fuel, when a second tax had not been paid on the exempt removal. To remedy this, current subdivision (b), “Conditions to Allow a Credit on a Tax Return” was renumbered to subdivision (d) and new subdivision (b) “Dyed Blended Biodiesel Fuel” was added. The new subdivision clarified that the general rule in subdivision 1435(a) does not apply when dyed blended biodiesel fuel is removed from an approved terminal rack and states a refund is available in that instance only to the extent the supplier can show that tax on that biodiesel fuel has been paid by the same supplier.

#### *Subdivision 1435(c) – Issue Paper*

Current subdivision (c), “Reporting Requirements” was renumbered to subdivision (e) and new subdivision (c) “Definitions” was added. The proposed definitions include terms that are commonly used by the fuel industry and the Department. Initially proposed definitions included the following terms: “rack/terminal rack,” “above the rack,” and “below the rack.” The definition of “rack” comes from RTC section 60006 and the definitions for “above the rack” and “below the rack” are based on the location of diesel fuel inside of and outside of the bulk transfer/terminal system as defined by RTC section 60030. In addition, the terms “first tax/first taxpayer” and “second tax/second taxpayer,” located in subdivision (b) of the current regulation, were moved to new subdivision (c) with additional language included for clarification.

With input from A&B, additional language was added to the definitions of “first tax/first taxpayer” and “second tax/second taxpayer” to provide that the taxpayer “paid the applicable diesel fuel tax.” The “paid” language is to be construed broadly to include offsetting credits. The terms “biodiesel” and “blended biodiesel” were also added to the subdivision as the terms are used throughout Regulation 1435. Finally, the term “renewable diesel fuel” was added to subdivision (c) of Regulation 1435 to explain the differences from it and biodiesel.

#### *Subdivisions 1435(d) and (e) – Issue Paper*

Current subdivision (d), “Claim for Refund” was renumbered to subdivision (f) and is discussed below. Renumbered subdivision (d), “Conditions to Allow a Credit on a Tax Return” and renumbered subdivision (e), “Reporting Requirements” explain when credits are allowed, and the records needed for support.

The language in these subdivisions was simplified and made more concise by using the new defined terms, “first taxpayer” and “second taxpayer.” Additional criteria were recommended for a supplier to take a credit. This includes reconciliation by terminal of the number of tax-paid gallons of diesel fuel that was subsequently removed from the terminal rack. This will allow the supplier and the Department to track tax-paid inventory that is above the rack and available for credit as a tax-paid twice removal. The proposed

new language addresses situations in which a supplier is both the first and second taxpayer, as well as when they are different suppliers.

*Subdivision 1435(f) – Issue Paper*

Subdivision (d), setting forth the information required to be included in a claim for refund, was renumbered to subdivision (f). Language was inserted referencing subdivision (d), and revisions were made to the seven current types of information that a claim for refund must contain. Initially, requirements (1) and (2) were eliminated, and new requirements (1) through (4) were added to provide the specific documentation necessary for all diesel fuel claims for refund. Proposed new requirements included:

- (1) The name, address, telephone number, and permit number of the person that sold the diesel fuel to the claimant and the date of the purchase.
- (2) A statement by the claimant that the diesel fuel covered by the claim did not contain visible evidence of dye.
- (3) A statement, which may appear on the invoice, original invoice facsimile or similar document, by the person that sold the diesel fuel to the claimant that the diesel fuel sold did not contain visible evidence of dye.
- (4) The total amount of diesel fuel covered by the claim.

In subsequent discussions, A&B suggested subdivision (f)(10) be added for situations where the documents described in (f)(8) and (f)(9), do not exist. After discussing A&B's concerns, its suggested language was accepted with minor modifications.

*Subdivision 1435(g) – Issue Paper*

New subdivision (g), titled “Examples of Tax Paid Twice” was proposed to include examples of situations in which a supplier seeks a credit or refund. Examples 1-3 address scenarios in which different suppliers are the first and second taxpayer. In the examples, B100 biodiesel fuel is imported into California or purchased from an in-state production facility and then blended with clear ex-tax diesel fuel at an approved terminal. The number of gallons that can be taken as a credit on a return is computed. Examples 4-6 illustrate situations in which the same supplier is the first and second taxpayer and the diesel fuel is imported into the state and then blended in a community tank at an approved terminal. The examples, which address blended biodiesel and renewable diesel, explain how diesel fuel should be reported and when credits can be claimed against tax.

*The Department's 2021 Revision to Proposed Amendments to Regulation 1435*

In preparation for the formal rulemaking process, the Department again reviewed the proposed amendments to Regulation 1435 as described in the 2019 Issue Paper. The Department also shared concerns and new suggested changes with A&B, and A&B subsequently submitted alternative language in 2020 for the Department's consideration. The Department's final revisions to proposed amendments are the result of the post-Issue Paper review and the incorporation of some of the language suggested by A&B. The Department believes these final amendments will resolve issues the Department discovered as well as improve readability.

### *Regulation 1435 – Title Change – 2021 Revision*

Currently, Regulation 1435 is titled, “Tax Paid Twice on Diesel Fuel.” The amendments added the phrases “the Amount of” and “Removed from an Approved Terminal” to the title to better describe the intent of Regulation 1435. The revised title now reads, “Tax Paid Twice on the Amount of Diesel Fuel Removed from an Approved Terminal.”

### *Regulation 1435 – Subdivision (a), Definitions – 2021 Revision*

The Department moved the definitions from subdivision (c) to subdivision (a) to define terms before they are used in the regulation. A definition for “Department” to mean the California Department of Tax and Fee Administration was added. In addition, a definition for “diesel fuel” was added to clarify that “diesel fuel” includes “biodiesel fuel,” “blended biodiesel fuel,” and “renewable diesel fuel.” The addition of this definition provides a consistent reference for the use of those terms throughout the regulation.

The definitions for “first tax/first taxpayer” and “second tax/second taxpayer” were revised from their definitions in the issue paper. The “first tax” now refers to the diesel fuel tax, imposed pursuant to RTC sections 60051 or 60052, and is on the diesel fuel gallons a supplier placed into inventory at an approved terminal. For the “second tax,” it is the diesel fuel tax imposed pursuant to RTC section 60051 on diesel fuel removed from an approved terminal at the rack.

Other revisions to subdivision (a) include a more concise definition for the term “renewable diesel fuel” that is consistent with the information about renewable diesel fuel available on the Internet, including information on the Department of Energy’s website. This revised definition still serves the Department’s purpose of distinguishing renewable diesel fuel from biodiesel fuel. Finally, the word “fuel” was inserted after the terms “biodiesel” and “blended biodiesel” to be consistent with the rest of Regulation 1435.

The definitions were also placed in alphabetical order to comply with the Office of Administrative Law requirement that definitions be listed in alphabetical order.

### *Regulation 1435 – Subdivision (b), In General – 2021 Revision*

The Department replaced the text in the renumbered subdivision (b) to explain that a supplier who has placed tax-paid diesel fuel into inventory at an approved terminal may claim a refund or credit when it removes diesel fuel from that terminal at the rack and reports the removal as a taxable transaction. This revision maintains the original intent of the proposed amendments and keeps renumbered subdivision (b) from applying to nontaxable removals, including removals described in RTC section 60501, subdivision (b)<sup>7</sup>. The Department also added a reference to “tax reimbursement” to the stand-alone sentence

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<sup>7</sup> Removing language referring to nontaxable removals eliminates the additional issues that would be encountered if the provisions for claiming these refunds and credits under Regulation 1435 also applied to claims for refund and credits for all nontaxable removals of tax-paid diesel fuel. It also avoids conflicts with Regulation 1430, *Shipments Out of State*, which currently applies to refunds and credits under RTC section 60501, subdivision (a)(4)(B), and Regulation 1432, *Other Nontaxable Uses of Diesel Fuel in a Motor Vehicle*, which currently applies to refunds and credits under RTC section 60501, subdivisions (a)(4)(A) and (C). If the Department determines there is a need to clarify when a taxpayer can claim a refund or credit for tax-paid dyed biodiesel removed, then the agency can later propose amendments to Regulations 1430 or 1432 or propose a new regulation.

at the end of renumbered subdivision (b) to avoid confusion and make the sentence consistent with the other references to tax reimbursement in the revised amendments. Revisions to subdivision (b) only change the requirements for claiming a refund under RTC section 60501, subdivision (a)(4)(J) and claiming a credit under RTC section 60508, in lieu of that refund.

*Regulation 1435 – Subdivision (c), Conditions to Allow a Credit on a Tax Return or a Claim for Refund – 2021 Revision*

Amendments, including amendments made after the Issue Paper, include the following:

- Inserted “or a Claim for Refund” to the title of renumbered subdivision (c).
- Inserted “or refund” to renumbered subdivision (c).
- Deleted proposed text incorrectly identified as a second subdivision (c)(2) and revised (c)(1) to now read as “The first taxpayer bought, imported, or produced the diesel fuel on which the first tax was imposed below the rack.”
- Revised proposed text for (c)(3) to now read as, “The second taxpayer placed the diesel fuel on which the first tax was imposed into inventory at an approved terminal, removed diesel fuel from the same approved terminal at the rack, and reported the removal of the diesel fuel on the second taxpayer’s tax return as a taxable transaction.”
- Revised amended text for (c)(4) to now read as, “The second taxpayer either takes a credit on a tax return filed within three months after the close of the calendar month in which the diesel fuel was removed from the approved terminal at the rack or files a timely claim for refund that meets the conditions in subdivision (e).”
- Revised amended text for (c)(5) to now read as, “The first taxpayer has met the reporting requirements of subdivision (d) and the subsequent seller has met the requirements of subdivision (d) if the diesel fuel was bought from a person other than the first taxpayer.”
- Inserted “or tax reimbursement the second taxpayer” to proposed (c)(6) and changed “storage” to “inventory.”
- Proposed subdivision (c)(8) was renumbered to (c)(7). The subdivision has been revised, reformatted and had some punctuation changed for increased clarity and now reads as, “The second taxpayer prepares and retains, subject to inspection by the Department, a reconciliation by transaction of the number of tax-paid gallons of diesel fuel the second taxpayer placed into inventory at the approved terminal and had available for a credit or refund during the reporting period for the tax return on which the credit is taken or each reporting period for which a claim for refund is filed that includes:

(A) If the second taxpayer is the first taxpayer for any tax-paid gallons of diesel fuel the second taxpayer placed into inventory at the approved terminal, the reporting periods the first tax was reported to the state on the second taxpayer’s tax return on those tax-paid gallons of diesel fuel;

(B) If the second taxpayer is not the first taxpayer for any tax-paid gallons of diesel fuel the second taxpayer placed into inventory at the approved terminal, the purchase invoice number(s) and date(s) of purchase for the gallons of tax-paid diesel fuel;

(C) Bill of lading number(s), date(s), and product code(s) for the number of gallons of tax-paid diesel fuel the second taxpayer placed into inventory at the approved terminal;

(D) The date(s), number of gallons, and document number(s) for the second taxpayer's taxable removals of diesel fuel from inventory at the approved terminal on which a second tax was reported and a credit was taken on its return for the reporting period or a claim for refund was filed for the reporting period; and

(E) A running balance of the number of gallons of tax-paid diesel fuel inventory the second taxpayer has at the approved terminal available for a credit or refund in subsequent periods.”

- Proposed subdivision (c)(7) was renumbered to (c)(8), the revised text now reads as “The second taxpayer retains copies of the first taxpayer’s reports required or received under subdivision (d) and copies of statements of a subsequent seller required or received under subdivision (d).”

*Regulation 1435 – Subdivision (d), Reporting Requirements – 2021 Revision*

The previously renumbered subdivision was changed back to its originally numbered subdivision (d) with the references in the subdivision being revised. Additionally, throughout the subdivision, references to “preparing” reports were changed to “completing” reports and the term “first taxpayer” replaces a person preparing a first taxpayer’s report. In subdivisions (d)(3)(C)1 and (d)(3)(C)2, “satisfies the requirements of paragraph (c)(3)(D) of this section” was replaced with “is in substantially the same form as the model statement provided in Appendix B.” Finally, in subdivision (d)(3)(D), the word “complete” was inserted before “statement” and the final sentence was clarified to end with “and need not be in the same format as the model statement provided in Appendix B.”

*Regulation 1435 – Subdivision (e), Claim for Refund – 2021 Revision*

The previously renumbered subdivision was changed back to its originally numbered subdivision (e). The word “supplier” was changed to “second taxpayer.” In the first sentence, the phrase “meets all the conditions in subdivision (d) but” that was added with the issue paper has been deleted, with “diesel fuel was removed from an approved terminal at the rack, as required by subdivision (c)(4)” now inserted at a point later in the same sentence. It was clarified that the claim for refund must be filed with the Department “timely” to recover the “second” tax “imposed on the removal of that diesel fuel.”

In subdivisions (e)(1)-(10) the word “claimant” was changed to “second taxpayer.” In subdivision (e)(8), new text “if such a report is required or received under subdivision (d)” was inserted at the end of the sentence to remove an unintended limitation and revise the reference. In subdivision (e)(9), the existing phrase “that the claimant received” was deleted and “required or received under subdivision (d)” was inserted in its place. Further, for subdivision (e)(10), a reference was revised, and “claimant has available for credit or refund at a specified approved terminal” was replaced with “second taxpayer placed into inventory at the approved terminal and has available for credit or refund during each

reporting period for which the claim or refund is filed.” Finally, the following sentence was added at the end of subdivision (e)(10): “Also, if the documents described in items (8) and (9) of this subdivision do not exist, the second taxpayer is not required to retain the documents under subdivision (c)(8) to claim a refund.”

*Regulation 1435 – Subdivision (f) – 2021 Revise*

The previously proposed new subdivision (g) was renumbered as subdivision (f) and retitled as “Examples of Tax-Paid Twice on the Amount of Diesel Fuel Removed from an Approved Terminal at the Rack.” The subdivisions referenced in the first sentence were revised. The example titles for subdivisions (f)(1)-(6), except for (f)(3), have been revised.

In addition (f)(1)-(6) were reworded for clarity and consistency. The examples in subdivision (f) were proposed as follows in their entirety:

“(1) Example 1 – Taking a Credit for Tax-Paid Biodiesel Fuel Blended with Ex-Tax Diesel Fuel at Approved Terminal. Supplier A imports 100,000 gallons of biodiesel fuel (B100) via truck into California and remits the diesel fuel tax on its tax return. Supplier A sells the 100,000 gallons of tax-paid B100 to Supplier B invoicing them reimbursement for the diesel fuel tax. Supplier B places the 100,000 gallons of tax-paid B100 into a community blending tank at an approved terminal, which also contains ex-tax petroleum diesel fuel, creating blended biodiesel fuel (B05). Supplier B removes 10,000 gallons of the blended biodiesel fuel (B05) from the blending tank at the approved terminal at the rack and reports the removal of the 10,000 gallons as a taxable transaction on its tax return. Supplier B may and does take a credit on its tax return for 10,000 gallons of tax-paid diesel fuel removed.

(2) Example 2 – Taking a Credit for Remaining Tax-Paid Biodiesel Fuel Inventory that was Blended with Ex-Tax Diesel Fuel at Approved Terminal. The next month, Supplier B (from Example 1) places 30,000 gallons of ex-tax petroleum diesel fuel into the community blending tank mentioned in Example 1, and then removes 98,000 gallons of blended biodiesel fuel (B05) from the blending tank at the approved terminal at the rack and reports the removal of the 98,000 gallons as a taxable transaction on its tax return. Supplier B may take a credit on its tax return for 90,000 gallons of tax-paid diesel fuel removed, the remaining tax-paid diesel fuel inventory available at the approved terminal (100,000 tax-paid gallons placed into inventory – minus the credit for 10,000 tax-paid gallons removed, as described in Example 1).

(3) Example 3 – Taking a Credit for Tax-Paid Diesel Fuel Inventory when only Ex-Tax Diesel Fuel was Removed. Supplier C purchases 50,000 gallons of biodiesel fuel (B100) from an in-state biodiesel production facility. Supplier C is invoiced for and pays the diesel fuel tax. Supplier C has the tax-paid B100 transported by truck and placed into a storage tank at an approved terminal where Supplier C also has ex-tax petroleum diesel fuel inventory stored in a different tank. Supplier C removes 250,000 gallons of ex-tax petroleum diesel fuel from the approved terminal at the rack and reports the removal of the 250,000 gallons as a taxable transaction on its tax return. Supplier C may take a credit on its tax return for 50,000 gallons of tax-paid diesel fuel removed.

(4) Example 4 – Taking a Credit for Tax-Paid Biodiesel Fuel Blended with Ex-Tax Diesel Fuel at Approved Terminal. In December 2019, Supplier D imports 20,000 gallons of biodiesel fuel (B100) via rail and places it into its proprietary storage tank used for blending at an approved terminal, which also contains ex-tax petroleum diesel fuel, creating blended biodiesel fuel (B05). In the same month, Supplier D removes 100,000 gallons of blended biodiesel fuel (B05) from the tank at the approved terminal at the rack. Supplier D reports the 20,000 gallons of B100 as a taxable import below the rack and the removal of the 100,000 gallons of blended biodiesel fuel (B05) as a taxable transaction on its December 2019 tax return. Supplier D may take a credit on its tax return for 20,000 gallons of tax- paid diesel fuel removed.

(5) Example 5 – Available Tax-Paid Diesel Fuel Inventory Balance to Carry Forward. Supplier E imports 1,000,000 gallons of renewable diesel fuel by rail and remits the diesel fuel tax on its May 2019 tax return. Supplier E places the renewable diesel fuel into a community blending tank at an approved terminal, which also contains ex-tax petroleum diesel fuel, creating blended renewable diesel fuel. In June 2019, Supplier E removes 100,000 gallons of blended renewable diesel fuel from the approved terminal at the rack and reports the removal of the 100,000 gallons as a taxable transaction on its June 2019 tax return. Supplier E may take a credit on its June 2019 tax return for 100,000 gallons of tax-paid diesel fuel removed and if Supplier E takes the credit it will have 900,000 gallons of tax-paid diesel fuel inventory at the approved terminal available for a credit or refund when future taxable diesel fuel removals from the approved terminal are reported.

(6) Example 6 – Removal of Blended Biodiesel Fuel from Community Storage. Supplier F imports 1,000,000 gallons of biodiesel fuel (B100) by rail and places it into a community blending tank at an approved terminal, which also contains ex-tax petroleum diesel fuel, creating blended biodiesel fuel (B05). In the same month, Supplier F removes 700,000 gallons of blended biodiesel fuel (B05) from the community blending tank at the approved terminal at the rack. Supplier F reports the 1,000,000 gallons of B100 as a taxable import and the removal of the 700,000 gallons of blended biodiesel fuel (B05) as a taxable transaction on its tax return for that month. Supplier F may take a credit on its tax return for 700,000 gallons of tax-paid diesel fuel removed.”

#### *Economic and Fiscal Impact*

The proposed amendments to Regulation 1435 impact diesel fuel suppliers, specifically those that involve biodiesel fuels or the blending of biodiesel fuels. The number of businesses impacted by the proposed amendments is approximately 208 with about 10 of the diesel fuel suppliers considered to be small businesses. Amendments provide an additional resource to educate suppliers on the application of tax for their products. In addition, proposed definitions allow readers to understand the Department’s interpretation of industry specific terminology, which will reduce confusion. The inclusion of examples is for taxpayer-improved clarity and will likely lead to more accurate reporting, possibly resulting in fewer refund issues, audit findings, billings, and appeal hearings. However, the Department cannot quantitatively determine these benefits.

There are no comparable Federal regulations. In the absence of Federal regulation, state regulation is needed, and the Department is the state agency responsible for administering diesel fuel taxes. The Department considered whether to begin the formal rulemaking process to adopt the proposed amendments at this time or, alternatively, whether to take no action at this time. No additional alternatives were considered.

In addition, the proposed amendments to Regulation 1435 do not impose any new registration, reporting, or record keeping requirements on distributors. Therefore, the Department does not anticipate that the proposed amendments to Regulation 1435 will impose any new compliance costs on distributors.

Furthermore, the Department estimates an annual revenue loss to be \$520,000. Staff projects the annual revenue losses based on refund cases directly related to the issue that this proposal addresses. The Department's refund requests totaled \$1.3 million for a two-and-a-half-year period ( $\$1.3 \text{ million} / 2.5 \text{ years} = \$520,000$ ). This amount represents revenue that cannot be refunded under the current tax regulation even though it is revenue to which the state is not entitled.

As a result, the Department estimates that the proposed regulatory action will not have a measurable economic impact on individuals and businesses. The Department has determined that the proposed regulatory action is not a major regulation, as defined in Government Code section 11342.548 and California Code of Regulations, title 1, section 2000, because the Department has estimated that the proposed regulatory action will not have an economic impact on California business enterprises and individuals in an amount exceeding fifty million dollars (\$50,000,000) during any 12-month period. The Department has also determined that the adoption of the proposed amendments to Regulation 1435 will neither create nor eliminate jobs in the State of California nor result in the creation of new businesses or the elimination of existing businesses within the state and will not affect the expansion of businesses currently doing business within the state.

Furthermore, the proposed amendments to Regulation 1435 do not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Department has determined that the adoption of the proposed amendments to Regulation 1435 will not affect the benefits of the regulation to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Department's initial determination that the adoption of the proposed amendments to Regulation 1435 will likely lead to more accurate reporting, possibly resulting in fewer refund issues as well as audit findings, billings, and appeal hearings on business. The Department anticipates:

- No businesses or jobs will be created because of the regulatory change.
- The regulation will not affect the ability of California businesses to compete with other states by making it more costly to produce goods and services here.
- The regulation does not directly impact housing costs.

- There are no benefits of the regulation, including, but not limited to, benefits to the health, safety, and welfare of California residents, worker safety, and the state's environment and quality of life, among any other benefits identified by the agency.

Additionally, there is no estimated change of investment in the state; no incentive for innovation in products, materials, or processes; and no fiscal impact. The regulation does not mandate specific technologies or equipment. This regulatory change does not affect any local entity or program and does not affect any federally funded state agency or program. The Department will update the version of Regulation 1435 on its website and incorporate the amendments into industry guidance. The workload associated with incorporating these changes is considered routine. Any corresponding cost would be absorbed within the Department's existing budget.

### **Update to the Statement of Reasons**

The Department mailed, published, and posted its notice for the adoption of the proposed amendments to Regulation 1435 on September 24, 2021. The notice explained that November 8, 2021, was the deadline for written comments regarding the adoption of the proposed amendments to Regulation 1435 and that the Department had not scheduled a public hearing to discuss the proposed regulatory action, but the Department would hold a public hearing if a written request for a public hearing was received no later than 15 days before the close of the written comment period.

The Department received timely written comments from Valero Energy Corporation (Valero) regarding the proposed amendments to Regulation 1435 in an email dated November 2, 2021, which are summarized and responded to below. No other written comments regarding the proposed regulatory action and no requests for a public hearing were received in response to the notice.

#### *Valero's Comments*

Valero commented on new subdivision (a)(7) and said that "These regulations need to consider the 'First Tax' can also be imposed on product delivered into a bulk storage facility NOT considered an approved terminal but still viewed in the bulk terminal transfer system." The Department determined that the definition of "first tax" in new subdivision (a)(7) does include tax imposed on diesel fuel delivered into a bulk storage facility and that it was not necessary to change new subdivision (a)(7) in response to the comment.

Valero commented on renumbered subdivision (b) and said that "We are not clear why this must occur at the same terminal. Tax-paid product can be moved between facilities and sold at a subsequent terminal." Regulation 1435 has historically required a supplier to remove tax-paid gallons of diesel fuel from the approved terminal where it was stored to claim a refund under subdivision (a)(4)(J) of RTC section 60501 or take a credit on its return in lieu of a refund under RTC section 60508. The Department determined that a supplier that removes ex-tax gallons of diesel fuel from an approved terminal at the rack and reports the removal as a taxable transaction can also claim a refund under subdivision (a)(4)(J) of RTC section 60501 or take a credit on its return in lieu of a refund under RTC section 60508 if the supplier has the *same amount* of tax-paid gallons of diesel fuel in inventory at the same approved terminal for which it has not yet taken a credit on its return or filed a claim for refund. Also, the

Department does not think that subdivision (a)(4)(J) of RTC section 60501 allows a supplier that removes ex-tax diesel fuel from an approved terminal to claim a refund just because it has tax-paid diesel fuel stored somewhere else in California, and that the Department could not effectively administer such a provision. So that is why the Department is amending renumbered subdivision (b) to require that a supplier remove diesel fuel from the same approved terminal where it has tax-paid gallons of diesel fuel in inventory to claim a refund under subdivision (a)(4)(J) of RTC section 60501 or take a credit on its return in lieu of a refund under RTC section 60508.

Valero commented on renumbered subdivision (c)(1) and said that the “[f]irst tax can potentially be imposed above the rack in bulk sales. This may occur when a licensed supplier sells to an unlicensed supplier.” The Department agreed that the “first tax,” as proposed to be defined in new subdivision (a)(7), can be imposed above the rack. The Department also determined that it was necessary to change renumbered subdivision (c)(1) to remove the phrase “below the rack” because it is inconsistent with the definition of “first tax” and unnecessarily limits the types of first taxes that will satisfy the regulation’s conditions for claiming a credit or refund.

Valero commented on renumbered subdivision (c)(3) and said that “With concept of tax paid inventory in bulk, what is the refund process of this inventory when it is blended and sold in bulk to a licensed customer.” Regulation 1435 and the proposed amendments to Regulation 1435 implement, interpret, and make specific the provisions of subdivision (a)(4)(J) of RTC section 60501, which only apply to tax paid on diesel fuel removed from an approved terminal at the rack and do not apply to diesel fuel sold in bulk. Therefore, the Department determined that this comment asked a general question that did not relate to the proposed amendments to Regulation 1435 and that it was not necessary to change renumbered subdivision (c)(3) in response to the comment.

Valero commented on new subdivision (c)(7)(A), said that it “is a very confusing paragraph,” and asked the Department to “[p]lease clarify” it. The Department discussed these comments with Valero and determined that it was necessary to make changes to new subdivisions (c)(7)(A) and (B) to make them read more clearly. The Department also determined that these changes are not substantive and do not alter the meaning or effect of these subdivisions.

Valero commented on renumbered subdivision (d)(3)(E), said that “Often subsequent purchases of tax paid fuel will be resold and further segmented,” and asked, “Are the original ‘First Taxpayer’ reports to be passed on with the segmented sales even if the volumes do not match?” The Department’s answer is “yes” because renumbered subdivision (d)(3)(E) provides that “If the first taxpayer’s report relates to diesel fuel divided among more than one buyer, multiple copies of the first taxpayer’s report must be made at the stage that the diesel fuel is divided and each buyer must be given a copy of the report.” Also, the Department determined that the answer to Valero’s question is clear from the text of renumbered subdivision (d)(3)(E) and that it was not necessary to change the subdivision in response to the question.

Valero commented on renumbered subdivision (e)(2) and asked, “If tax-paid product is dyed and sold as dyed diesel? What are the procedures for obtaining a refund since there will be NO second tax paid tax?” Regulation 1435 and the proposed amendments to Regulation 1435

implement, interpret, and make specific the provisions of subdivision (a)(4)(J) of RTC section 60501, which only provide for the refund of tax paid on diesel fuel removed from an approved terminal at the rack and do not apply when no tax is paid on the removal of dyed diesel fuel. Therefore, the Department determined that this comment asked a general question that did not relate to the proposed amendments to Regulation 1435 and that it was not necessary to change renumbered subdivision (e)(2) in response to the comment.

Valero commented on the example in new subdivision (f)(1) and said, “We want to confirm the intent here. Does the [Department] understand when these 10,000 gallons are sold only 500 gallons will be a tax paid (Second tax paid) biodiesel. This section states the credit should be taken for the entire 10,000 gallons. (9500 tax unpaid diesel inventory + 500 tax paid biodiesel). Is this correct?” The example is correct. The Department determined that a supplier that removes ex-tax gallons of diesel fuel from an approved terminal at the rack and reports the removal as a taxable transaction can also claim a refund under subdivision (a)(4)(J) of RTC section 60501 or take a credit on its return in lieu of a refund under RTC section 60508 if the supplier has the *same amount* of tax-paid gallons of diesel fuel in inventory at the same approved terminal for which it has not yet taken a credit on its return or filed a claim for refund, as illustrated in the example.

Valero included a comment after the regulation’s authority and reference note, which said that “There is no process for refund for taxpaid B100 or B99 fuel held in bulk inventory and resold in bulk to a licensed supplier in CA. Suppliers should not be burdened by the capital involvement of tax for product subsequently resold in the bulk terminal transfer system.” Regulation 1435 and the proposed amendments to Regulation 1435 implement, interpret, and make specific the provisions of subdivision (a)(4)(J) of RTC section 60501, which only provide for the refund of tax paid on diesel fuel removed from an approved terminal at the rack and do not apply to diesel fuel when it is sold in bulk. Therefore, the Department determined that this was a general comment that did not relate to the proposed amendments to Regulation 1435 and that it was not necessary to change the proposed amendments in response to the comment.

Valero commented on the first answer to question six on the form in Appendix A and said, “add the word ‘Rack.’” The Department disagreed with the suggestion because the first answer to question six refers to tax imposed on the removal of diesel fuel from a refinery “by bulk transfer” under subdivision (a)(1) of RTC section 60052 and “at the refinery rack” under subdivision (a)(2) of RTC section 60052, and the change would limit the meaning of the answer.

Valero commented on the second answer to question six on the form in Appendix A and said, “Add the words ‘not by bulk transfer.’” The Department disagreed with the suggestion because the second answer to question six refers to tax imposed on the entry of diesel fuel into this state “by bulk transfer” under subdivision (b)(1) of RTC section 60052 and “not by bulk transfer” under subdivision (b)(2) of RTC section 60052, and the change would limit the meaning of the answer. Also, the answer has been in the form since 2002 and the Department is not aware of any issues or confusion that would require a change.

Valero commented on the third answer to question six on the form in Appendix A and said, “This is not addressed in the regulation.” The Department disagreed with this comment

because the proposed amendments define “first tax” to mean diesel fuel tax imposed pursuant to RTC section 60051 or 60052 and the third answer refers to tax imposed on the removal or sale of diesel fuel in this state to an unregistered person under subdivision (c) of RTC section 60052.

Valero commented on the fourth answer to question six on the form in Appendix A and said, “Bulk transfers are not necessarily all received at an approved terminal. They can be received into bulk storage which is part of the bulk terminal transfer system.” The Department agrees that a bulk transfer can be received into bulk storage and that bulk storage is part of the bulk transfer/terminal system if the storage is part of the diesel fuel distribution system consisting of refineries, pipelines, vessels, and terminals. The Department also determined that this was a general comment that did not relate to the proposed amendments to Regulation 1435 and that it was not necessary to change the fourth answer to question six on the form in Appendix A in response to the comment.

Valero commented on the fifth answer to question six on the form in Appendix A and said that “to an unregistered entity” should be added to the end of the answer “for clarity.” The Department generally agreed that it was necessary to make the requested change to clarify the fifth answer to question six per Valero’s request because the answer refers to tax imposed on the sale of diesel fuel in this state to an unregistered person under subdivision (c) of RTC section 60052. However, the term “person” is being used instead of “entity” because “person” is a defined term in the Diesel Fuel Tax Law.

Valero commented on question seven on the form in Appendix A and asked, “[w]hy is it important to the state of CA how much Federal taxes were paid.” The Department determined that it does not need to know how much federal excise tax the first taxpayer paid on diesel fuel to grant a claim for a credit or refund under Regulation 1435 and that it was necessary to delete “Federal excise tax paid and” from question seven on the form in Appendix A to avoid requesting unnecessary information in the future.

Finally, Valero commented on question eight on the form in Appendix A and asked, “[w]hy is the location of the [Internal Revenue Service (IRS)] center important to the state of CA.” The Department determined that it does not need to know the location of the IRS service center where the first taxpayer reported the federal excise tax on diesel fuel to grant a claim for a credit or refund under Regulation 1435 and that it was necessary to delete question eight from the form in Appendix A because it is unnecessary for the Department’s purposes.

### *Notice of Changes*

The Department prepared a revised version of the text of the proposed amendments to Regulation 1435 with the changes to the new text proposed to be added to renumbered subdivision (c)(1), new subdivisions (c)(7)(A) and (B), and the report in Appendix A of the regulation (described above) clearly indicated in double strikeout and double underline format. The Department mailed and emailed a notice regarding the changes to the interested parties on December 2, 2021, which identified the changes, explained how to submit written comments regarding the changes, and explained that December 17, 2021, was the deadline for written comments regarding the changes. The Department also made the revised version of the text of the proposed amendments to Regulation 1435 available to the public on December 2, 2021, by placing it in the rulemaking file and posting it on the Department’s website at

[www.cdtfa.ca.gov](http://www.cdtfa.ca.gov). However, no written public comments were received regarding the changes and the Department adopted the proposed amendments to Regulation 1435 with the changes.