



# This Week in State Tax (TWIST)

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## Washington: Court of Appeals finds oil spill equipment not eligible for exemption

A Washington state appellate court determined that an oil and gas contractor was liable for use tax on goods and services it used in constructing an oil containment system, reversing a trial court decision in favor of the taxpayer. The taxpayer had contracted with a deepwater oil and gas producer to provide and operate a containment system—which included a floating barge, high pressure hoses, and a containment dome—intended to mitigate the impact of an oil well blowout. To fulfill the contract, the taxpayer leased a barge, and the oil producer paid the taxpayer \$89 million to modify and outfit the vessel and \$86 million to construct and outfit the containment system. Once the vessel and containment system were fully outfitted, the taxpayer leased the containment system (including the vessel) to the oil producer and towed the vessel to the Arctic near the drilling operation. During the subsequent drilling season, the taxpayer’s employees visited the vessel daily to ensure it was functioning properly and maintained a crew of employees on standby to operate the containment system if it was needed. After one oil drilling season, the oil producer decided to abandon its operation in the region and cancelled its contract with the taxpayer. The taxpayer purchased the vessel from the lessor and sold it to an unrelated thirty party. The Washington Department of Revenue subsequently audited the taxpayer and assessed unpaid use tax on the amounts spent to outfit the vessel and containment system plus penalties and interest. The Board of Tax Appeals upheld the assessment, but a trial court reversed. The Department brought the matter to the appellate court.

Before the appellate court, the taxpayer argued that its use of the property to build the containment system and modify the vessel was not subject to use tax because the taxpayer used the disputed goods and services to produce items that were leased to its customer. The use of a product is exempt from taxation when the use is for the production of a new article that will be sold or leased to a consumer. According to the taxpayer, because it leased the containment system and vessel to the oil producer, their use was exempt from tax. However, the appellate court noted that a transaction is not considered a lease when the lessor provides an operator that is necessary for the operation of the item. Department rules apply a true object test to determine whether the transaction is a lease of property or the rental of equipment with an operator. Applying this test, the court determined that the continual services of the operators provided by the taxpayer was a fundamental part of the contract, meaning the transaction was not a lease for purposes of the use tax exemption.

The taxpayer also argued, in the alternative, that the vessel was exempt from use tax because it was a watercraft used primarily in interstate and foreign transportation of property for hire. Here, the court determined that, although a portion of the taxpayer’s fee under its contract with the oil producer was to transport property, this was only a small part of the overall contract. Therefore, the vessel was not used *primarily* in interstate and foreign commerce. Because neither exemption applied, the assessment was upheld. Please contact [Michele Baisler](#) with questions about [Superior Energy Services v. Department of Revenue](#).

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