Maximizing Sales Tax Savings for Oil and Gas Producers in Top Producing States

BY BRENT WATSON, CPA

Sales and use taxes significantly impact costs of drilling, completing and operating wells given the large value of expenditures incurred and application of taxes at rates often ranging between 5% to 9% that potentially apply to those costs. Because sales tax laws are complex, vendors defensively collect sales tax on invoicing for goods and services. This article is intended to point out savings opportunities in states with substantial oil and gas activity.

TEXAS

- Savings on Equipment

While Texas does not provide a general exemption for purchases of goods or services used in production of oil and gas, Texas's manufacturing exemption applies to equipment that makes or causes a chemical or physical change to products. The exemption has been deemed to apply to scrubbers, separators, heater-treaters, gas chilling units, amine units, dehydrators and similar equipment used at well sites, as well as equipment used in gas processing plants. Likewise, repairs and consumables used in these processes are exempt from tax. A separate exemption applies to equipment used to prevent pollution, including the re-use of water in hydraulic fracturing.

- Savings on Chemicals

Chemicals that produce a chemical change in natural gas or oil produced are exemptible under Texas' manufacturing exemption. Additionally, oil soluble chemicals that are injected into the well are exemptible based on a resale exemption.

- Savings on Services

By default, services are not taxable in Texas; however, sales tax is imposed on many services, most notably on repairs to both tangible personal and real property. Services provided during the drilling, completion, stimulation, or plugging and abandonment of wells are exempted from tax. 34 Tex. Admin. Code §324 provides a detailed explanation of the taxability of many oil-well services.

With respect to construction work, both the form of the contract and the type of construction performed impact whether or not billings are subject to tax. Specifically, lump sum contracts for new construction are not taxable. In separated contracts for new construction, charges for materials are subject to tax and those for services are exempt. Separately stated materials and repair services are always taxable.

- Savings on Utilities

An exemption is provided for utilities used in extracting or transporting oil and gas.

- Direct Payment Permits

Direct payment permits ("DPP") can be used to manage sales taxes. They offer an opportunity to (1) utilize exemptions for qualifying purchases and (2) gain local tax savings. Purchases from vendor's locations inside Texas are subject to the local tax applicable in the place of origination (usually at the maximum local tax rate of 2%); however, purchases paid for utilizing a DPP are subject to local tax based on the place where goods are received or used – usually at locations having no city tax.

OKLAHOMA

- Opportunities for Savings Related to Oil & Gas are Limited

Oklahoma does not provide a general exemption applicable to purchases related to production of oil and gas.

- Equipment & Utilities at Gas Processing Plants

Equipment, consumables, and electricity used in processing at gas processing facilities are exempted under Oklahoma's generous manufacturing exemption. However, the exemption is only available to taxpayers who obtain an MSEP (manufacturer's sales tax exemption permit) from the Oklahoma Tax Commission.

- Local Tax Savings

A common strategy in states like Oklahoma in which local taxes are based on destination is to locate materials yards in low-tax rate areas, typically outside city limits.

- Sales of Business Assets

Because Oklahoma is one of the few states which does not provide an exemption for isolated sales, sales of business assets to third parties are taxable. Careful planning pertaining to this issue should be undertaken when leases are sold, and could include:

- Language in the purchase and sale agreement specifying the value of TPP included in the sale
- Using an appraisal firm that specializes in oil and gas property to render an opinion of value for the personal property
- Usage of a separate legal entity to house the items sold. Sales of separate legal entities are non-taxable sales of intangibles. Careful legal handling for this type of transaction is necessary

Similarly, transfers of tangible personal property between various leases are taxable to the extent of non-common ownership. A purchasing company can be used to eliminate this exposure.

- Purchases from Manufacturers for Usage Outside Oklahoma

Oklahoma provides a special exemption for goods purchased from Oklahoma manufacturers for usage and immediate transportation out-of-state. For example, an operator purchasing separators in Oklahoma for usage in Texas may claim this exemption. Since Texas considers these to be exempt manufacturing equipment, no tax would be incurred on the purchase.

WYOMING

- Opportunities for Savings Related to Oil & Gas are Limited

Wyoming does not provide a general exemption applicable to purchases related to production of oil and gas. Wyoming's manufacturing exemption applies only to the operations classified under NAICS codes of 31-33, which excludes extractive processes as well as gas processing plants.

- Power Used in Gas Processing Plants

Power used in processing gas is exempt pursuant to an exemption for "sales of power or fuel" for direct consumption in "processing."

- Services in Drilling of Wells

Wyoming taxes "...the repair, alteration, or improvement of tangible personal property; and various services related to oil and gas exploration and production...." However, an exemption is provided for services that are completed prior to the setting of production casing, including seismic and geologic services. The exemption applies to the deepening of an existing well. Other services performed in constructing a well past the stage where the casing is set, or later to repair, overhaul, or stimulate a well, are taxable.

NORTH DAKOTA

- Opportunities for Savings Related to Oil & Gas are Limited

North Dakota does not provide general exemptions applicable to purchases related to production of oil and gas, and North Dakota's manufacturing exemption specifically excludes purchases made for refining or extracting oil and gas.

- New or Expanded Systems Related to (1) Natural Gas Collection and Processing and (2) Carbon Dioxide for Enhanced Recovery

An exemption is provided for materials used to construct or expand systems used to compress, process, gather, collect, or refine gas recovered from a well or used to expand or build a gas processing facility. Owners of new or expanded systems may apply for refunds of sales tax paid by their contractors.

A similar exemption is provided for construction or expansion of systems used to compress, gather, collect, store, transport, or inject carbon dioxide (carbon dioxide capture system) for use in the enhanced recovery of oil or natural gas. Carbon dioxide used for enhanced recovery of oil or natural gas is exempted.

- Rebates of Local Taxes

Rebates may be applied for from the Tax Commission for local taxes paid on invoices on taxable amounts in excess of maximums per invoice that are set by local taxing authorities.

COLORADO

- Opportunities for Savings Related to Oil & Gas are Limited

Colorado does not provide general exemptions applicable to purchases related to production of oil and gas.

- Enterprise Zones

An exemption for purchases of machinery used in oil and gas production applies if wells are located in enterprise zones. To qualify for the exemption, the machinery must:

- Be used directly and predominantly in manufacturing; however, for purposes of this exemption, the definition of "manufacturing" includes refining, blasting, exploring, mining and mined land reclamation, quarrying for, processing and beneficiation, or otherwise extracting from the earth
- Be capitalizable equipment (qualified for the federal investment tax credit under the definition of section 38 property found in the IRC)
- Be included on a purchase order or invoice totaling more than $500; and
- Purchases of used equipment are limited to a maximum of $150,000 annually

- Manufacturing

A lawsuit decided in favor of DCP Midstream determined that machinery used in gas processing or refining is exempt under the statewide exemption for manufacturing equipment, regardless of whether or not the equipment is located in an enterprise zone.

NEW MEXICO

- Opportunities for Savings Related to Oil & Gas are Limited

New Mexico law provides very few opportunities for sales tax savings. New Mexico's manufacturing exemption specifically excludes coverage of processes used to process natural resources.

LOUISIANA

- Opportunities for Savings Related to Oil & Gas are Limited

Louisiana does not provide general exemptions applicable to purchases related to production of oil and gas. Furthermore, Louisiana's manufacturing exemption applies only to industries within specific NAICS code sectors which excludes exploration and production and processing of natural gas produced from those activities.

- Repair to movable property (tangible personal property) vs. immovable property repairs

Although repairs to moveable property are taxable, repairs of equipment that is immovable property are not taxable, rather, the contractor as the end user of material purchased, incurs tax on these purchases. Purchases of repairs to immovable property should not be taxed.

- Rental vs. services

While rental of equipment without an operator is taxable, provision of equipment with an operator is not taxable. Often, invoices do not clearly reflect the true nature of the transaction – presenting a transaction as a charge for equipment, when the underlying transaction is actually a service (equipment with an operator). If tax is charged on services, that tax is refundable.

- Credit for sales tax paid in another state.

Louisiana provides a credit for sales/use tax paid on tangible personal property imported into the state. While the taxable basis for both state and parish taxes is the same: the cost or market value when property enters the state (for fully depreciated assets, the taxable value is customarily 25% of the original capitalized value), the calculation of the credit at the state level differs from the parish level. The state level credit is calculated based on the value/cost price at the time the property is imported into the state (R.S. 47:303(A)(3)(c)); while the parish level credit is based on the original cost of the item (R.S. 47:336.86). Improper calculation of the credit could cause a taxpayer to incur excess parish level taxes.

PENNSYLVANIA

- Opportunities for Savings Related to Oil & Gas Abound

Pennsylvania provides a very generous general exemption related to goods used mining, including production of oil and gas

- Qualifying mining activities include fracturing, exploring, extracting, blasting, mining, drilling or any combination thereof, provided that the purpose of the operation is the removal of natural resources from the earth or refining natural resources once removed from the earth (Pa. Reg. § 32.1; Pa. Dep't of Rev., Info. Notice SUT 2014-02
- Qualifying purchases used in mining include
  - Fracking and drilling equipment;
  - Equipment to actively monitor, extract and handle waste;
  - Protective gear and supplies worn by personnel during production activities

WEST VIRGINIA

- Opportunities for Savings Related to Oil & Gas Abound
- An exemption applies to services, machinery, supplies and materials directly used or consumed in the production of natural resources (including fracking)
- Taxpayers cannot claim these exemptions as would be allowed in most states by supplying an exemption certificate to the vendor; rather, purchasers must either: (1) apply for refunds of tax from the state after the tax is initially paid to vendors; or (2) obtain a direct pay permit from the state, then issue an exemption certificate citing the direct payment permit to vendors ensuring tax is not charged at the initial purchase.

SUMMARY

Operators of upstream and midstream oil and gas properties can reap significant savings related to costs of drilling, completing and operating wells by managing their purchases to avoid overpayments of sales and use taxes.

ABOUT THE AUTHOR

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