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This article provides an overview of sales tax laws applicable to drilling, completion and operation of oil and gas wells in Arkansas, Oklahoma and Texas. Together, these states account for approximately 50% of the oil and 40% of the gas produced in the U.S.

ARKANSAS

Arkansas provides an exemption from sales and use tax for equipment used in the production of oil and gas. This exemption is based on the inclusion of extraction of oil and gas in the definition of "manufacturing" in the exemption statute for manufacturing. The regulation addressing oil and gas operations, Ark. Regs. GR-57, describes the subsequent treatment of gas as a refining process.

The exemption is applicable to not only well equipment, but also equipment used by drilling vendors to drill wells. Like manufacturing, the exemption has a beginning and ending point with the beginning point considered to be the erection of a drilling rig, and the termination of manufacturing considered the end at the point product enters the final settling tank prior to transportation (sales meter) from the site (for oil) or at the discharge outlet of the final compressor (for gas). For drillers, drilling mud and proppants are exempted but not water. For well operators, the exemption covers equipment at the well site, including wellhead equipment, tubing, pumps and flow lines within the manufacturing operation, but not storage tanks.

Surface casing, pit liners and saltwater disposal wells are exempted based on the pollution control exemption.

GR-57 has not been updated since 2008 and does not comport with the change in law applicable to manufacturing that now exempts repairs to equipment used in manufacturing. This regulation states that repairs and workovers (such as re-acidization and re-fracturing) are taxable. However, because the manufacturing exemption now applies to repairs, we believe that the regulation as written is not correct. Additionally, GR-57 fails to incorporate the exemption that was enacted in 2016 for proppants.

OKLAHOMA

Oklahoma does not provide exemption from sales and use tax for materials or equipment used in the production of oil and gas. Additionally, Oklahoma's manufacturing exemption, provided by Okla. Stat. tit. 68, § 1352(15), states that extractive and field processes for oil and gas production are not deemed to be manufacturing processes. Therefore, equipment and materials used at lease sites are typically taxable in Oklahoma. While equipment used at gas processing plants could be eligible for the manufacturing exemption, a special manufacturing sales tax exemption permit (MSEP) must be obtained in order to qualify. Purchases made before an MSEP is obtained are taxable.

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.

Oklahoma does not provide an exemption for utilities used in production except in special circumstances involving enhanced recovery and water flood processes.

Oklahoma is one of the few states that does not allow an exemption for "isolated sales" involving the sale of business (fixed) assets not normally sold in the business. This

causes problems in two ways: (1) for transfers of tangible personal property between various leases having non-common ownership; and (2) the sale of fixed assets, including tangible personal property included in sales of leases. Sellers are responsible to file a "Casual Sales Tax Return" to report such transactions.

The valuation of the tangible personal property included in the sales of leases directly impacts taxes incurred. Taxable equipment includes both surface and downhole equipment. The Oklahoma Tax Commission (OTC) has taken the doubtful position that cemented casing is personal property and taxable.

Careful planning concerning this issue should be undertaken when leases are sold. It is wise to include a breakdown in the PSA to specify the value of TPP included in the sale. Another good option is to have an appraisal firm that specialized in oil and gas property to render an opinion of value for the personal property. The OTC reviews corporate income tax returns and asserts that any values of tangible personal property on Forms 4797 (for gain or loss on sale of business assets) should have sales tax reported on it. Often transactions reported are for property that is out-of-state, is undeveloped wells or is otherwise not taxable. Additionally, the basis for income tax is not an accurate measure of fair market value.

Some producers that have had significant material transfers between wells with differing ownership have set up procurement companies to hold the materials until they are actually used, thus avoiding the tax on transfers.

Since pipelines are classified as tangible, personal property (no matter if they are permanently affixed to the earth), sales of pipeline are subject to sales tax.

If assets are placed in a separate legal entity that is spun-off, this would be a non-taxable sale of an intangible. Careful legal analysis of these types of transactions is necessary.

The OTC disallows exemption for compression units that pressure up gas to enter a gas plant unless the units are located on the manufacturing premises.

Finally, the OTC has been asserting that contracts for compression services are not truly for services, but for rentals. Therefore, they have been assessing tax on both the user as well as the vendor in many cases, even though the vendor has already paid sales tax on the units being used to provide these services. This assertion is being contested and not settled at this time.

TEXAS

Texas sales and use tax laws applicable to oil and gas producers are particularly complex. Specifically, this complexity is due to the following issues:

- Specific "enumerated" services have taxes imposed on them – all other services are not taxable.
- Texas construction and contractor sales tax rules are uniquely intricate.
- The manufacturing exemption applies to certain—but not all—equipment at lease sites.
- Some chemicals are not taxable while others are taxable.
- Utilities used in extracting and transporting oil and gas are not taxable.
- Specific types of materials are not taxable for sales tax because they are taxable under another type of tax.
- Naturally occurring water or earth materials are not taxable.

We will examine each of these issues.

Taxation of Services

Texas imposes sales tax on a wide range of services. By default, services for which taxes have not specifically been imposed are not taxable. While the list is too extensive to incorporate, the three main taxable services that affect operators are: (1) real property services—garbage removal (except that removal of waste materials that result from oil and gas drilling operations, is excluded), janitorial, landscaping, lawn maintenance, pest control and some surveying (to determine boundaries); (2) repair of tangible personal property; and (3) repair of real property.

However, repair of items that qualify for the manufacturing exemption are not taxable. Likewise, services involved in drilling and completion, recompletion, stimulation or plugging and abandonment of wells are not taxable (detailed in 34 Tex. Admin. Code §3.324). Types of services classified as stimulation detailed in that rule include acidization, fracturing, changing zones, drilling deeper, jetting with nitrogen, etc. Many services are not taxable because they fall outside of the services that have been taxed. Provision of equipment with an operator is a service, not a rental. In the past two years, the Comptroller has asserted that frac water transfer services are rentals with supervisors and not operators. This position is currently being contested.

Construction and Contractors

Taxability of contracts depends on both the form of the contract and the type of construction performed.

Specifically, lump sum construction 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. Both lump sum and separated contracts for remodeling are taxable. Projects that include both new construction and re-work should be segregated so that the new construction portion can be excluded from taxation; otherwise, the entire amount is treated as re-work and is taxable.

Manufacturing Exemption

Equipment (including repair parts) as well as consumable materials used or consumed in a manufacturing process are exempt. This includes equipment like separators, dehydrators, heater-treaters, condensing units, amine units, etc. that treat the raw product from a well to make it marketable, as well as equipment at gas processing facilities. The exemption includes certain chemicals—used to dehydrate or sweeten gas and fluids, etc.—used in the operation of the manufacturing equipment. Some compression units may qualify as manufacturing equipment, but this is a complex matter.

Pollution Control

An exemption applies to equipment used to prevent pollution, including the re-use of water in hydraulic fracturing.

Chemicals

By default, chemicals are taxable. However, oil-soluble chemicals have traditionally been considered to be resold with the crude oil in which they are dissolved, and hence, exempt as purchased for resale. The manufacturing exemption applies to chemicals consumed in the treatment of gas as explained above. In the past two years, the Comptroller has asserted that both oil-soluble and gas-treatment chemicals are taxable. Currently, auditors have unofficially told us that gas treatment chemicals are now considered to be used in manufacturing. The Comptroller's treatment of oil-soluble chemicals has changed multiple times and is unclear. Many audits and refund claims in which these exemptions have been denied are being contested.

Utilities Used in Extraction and Transportation of Oil and Gas

Electricity used to operate manufacturing equipment (at gas treatment plants, etc.) is exempt under the manufacturing exemption (34 Tex. Admin. Code § 3.300). Electricity or propane used to operate oil or gas wells is exempt (34 Tex. Admin. Code §3.295).

Property Taxable Under Another Type of Tax

Sales of some materials are subject to other special taxes and are therefore exempt from sales taxes. This includes oil, motor fuels, cement and motor vehicles. Certain non-highway equipment that can travel on roadways to move from on-site to another is classified as "movable specialized equipment" rather than vehicles and is subject to sales tax.

Naturally Occurring Water or Earth Materials

Materials extracted from the earth—such as dirt, clay, caliche, sand, river rock and gravel—are not taxable when sold in their unprocessed state. Naturally occurring water—including natural brine water—is not taxable; however, water that is mixed with salt to make brine water, or that is mixed with any other substance—such as KCl—is taxable.

Direct Payment Permits

Direct Payment Permits are a popular way of managing sales taxes for production companies. They offer an opportunity to reclassify transactions for local sales tax purposes for purchases of materials that originate inside Texas. As a result of this reclassification, the local tax that applies can be changed from the origin in Texas (usually inside a city) to the place received or used (usually rural).

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