Sales and Use Tax

An Overview for Oil and Gas Operators in Top Producing States

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The difference between success or failure in oil and gas production ventures depends on the quality and management of producing assets, and controllable costs operating those assets. Sales and use taxes can be a significant factor in controllable costs associated with drilling and completion and, to a lesser extent, operating wells. Because laws are complex, and large outlays of sales tax can easily be incurred during drilling and completion, opportunities to both avoid exposure and more often, to reduce overpayments of tax, abound. This article provides a high-level overview of how these taxes affect producers in the top ten oil and gas producing states.

TEXAS

2021 Production: Oil: 49.5% - Gas 26.4%

Oil and gas producers must understand that sales and use tax laws in Texas are particularly complex. Specifically, the general manufacturing exemption applies to some but not all equipment at lease sites, Texas imposes taxes on a wide range of services, Texas' construction and contractor sales tax rules are uniquely intricate, and other special tax provisions are often applicable.

While Texas does not provide a general exemption for mining or drilling equipment, the manufacturing exemption provided in Tex. Tax Code Ann. § 151.318 is deemed to apply to equipment that makes or causes a chemical or physical change to the product. The exemption typically applies to scrubbers, separators, heater treaters, chilling units (for gas), amine units, dehydrators and similar equipment used at well sites, as well as much equipment used in in gas processing plants. Likewise, repairs and consumables used in these processes are exempt from tax. Historically, this has applied to gas treatment chemicals such as sweeteners and dessicants. The Comptroller recently denied exempt treatment of these chemicals, but we expect that denial to be reversed. Oil soluble chemicals likewise have been afforded exempt status until recent controversy from the Comptroller. That issue continues to be unresolved. A separate exemption applies to equipment used to prevent pollution, including the re-use of water in hydraulic fracturing.

Texas imposes tax on a wide range of services. By default, services are not taxable unless they are one of the 17 specified types of taxes. While the list of taxable services is too extensive to cover, it in-

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cludes repairs to both tangible personal and real property. Notably, 34 Tex. Admin. Code § 324 provides in detail that services involved in drilling and completion, stimulation, and plugging and abandonment of wells are not taxable. In another recent controversy, the Comptroller has reversed settled treatment of water transfer services from being exempt services to being asserted to be rentals with supervisors. This issue is unresolved.

With respect to construction work, both the form of the contract and the type of construction performed impact the taxability of that work. 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. For repair work, both lump sum and separated contracts are taxable.

While charges for tools lost downhole are non-taxable reimbursements, charges to repair leased items is taxable.

Exemptions are provided for utilities used in extracting or transporting oil and gas, for services subject to the oilwell service tax, and for naturally occurring earth substances such as unprocessed sand, caliche and water.

NEW MEXICO

2021 Production: Oil: 15.3% - Gas 5.5%

New Mexico does not provide explicit exemption from sales and use tax for materials or equipment used for production of oil and gas. Unlike most states, New Mexico generally imposes sales tax on all services rendered unless an exemption (deduction) applies. Thus, charges for services that are not commonly subject to tax, such as transportation of gas or oil, are taxable.

However, the manufacturing exemption applies to oil refining or gas treatment operations. The exemption is claimed by issuance of exemption certificates, called non-taxable transaction certificates ("NTTCs") to vendors. Acceptance of these certificates allows the seller to deduct these sales in computing sales tax due. The exemption applies to materials incorporated into the final product, materials consumed in the manufacturing process, and effective January 1, 2022, equipment (including repair parts) used directly in manufacturing.

New Mexico allows for an exemption from the gross receipts tax for the lease of oil, natural gas, and mineral interests. Also, receipts from sales of products for which the severance was subject to the oil and gas severance tax are exempt from the gross receipts tax.

PENNSYLVANIA

2021 Production: Oil: 0.1% - Gas 20.2%

Pennsylvania provides an exemption from sales and use tax for tangible personal property and services purchased for use directly and predominantly in mining activities in 72 Pa. Cons. Stat § 7201(k)(8) & (o)(4). Mining activities include operations to remove natural resources from the earth or to refine natural resources removed from the earth. Factors considered in determining exemption include (i) physical proximity to the mining operation; (ii) temporal proximity to the mining operation; and (iii) the existence of an active causal relationship between the use of the property and the mined product.

Purchases of equipment are exempt if used more than 50% of the time in the following direct-use mining activities:

- General digging, fracking, and drilling equipment
- Equipment to actively monitor, light, refine, extract and handle waste
- Protective gear and supplies worn by mining personnel during production activities
- Pollution control devices "designed and used to control, abate, or prevent air, water or noise pollution," provided they are generated from and used directly in the mining process.

Lastly, the mining exemption applies to subcontractors performing production operations if purchases meet the mining activities exemption requirements.

NORTH DAKOTA

2021 Production: Oil: 10.9% - Gas 2.5%

No sales and use tax exemption is provided for materials or equipment used for production of oil and gas. Additionally, North Dakota's manufacturing exemption, which is provided in N. D. Cent. Code § 57-39.2-04.3.6.e, states that the manufacturing exemption excludes purchases made for mining, refining, or extracting oil and gas. Therefore, equipment and materials used at lease sites are taxable in North Dakota.

Notably, however, exemptions are provided for materials used to construct or expand systems used to (1) compress, gather, collect, store, transport, or inject carbon dioxide (carbon dioxide capture system) for use in the enhanced recovery of oil or natural gas, and to (2) compress, process, gather, collect, or refine gas recovered from an oil or gas well or used to expand or build a gas processing facility. These exemptions do not apply to materials used to repair or replace an existing system unless the replacement creates an expansion of the system. The owner of the facility to be expanded must receive certification from the Tax Commission to claim the exemption. If the certification is not received before purchases occur, tax must be paid, but a claim for refund can be filed. Owners of new or expanded systems may apply for refunds of sales tax paid by their contractors. Additionally, exemption is provided for carbon dioxide used for enhanced recovery of oil or natural gas.

North Dakota does not impose sales tax on sales of electricity or gas utilities, and generally does not tax services. Rentals with operators are considered to be a service and are not taxable.

OKLAHOMA

2021 Production: Oil: 4.2% - Gas 7.8%

Oklahoma does not provide an 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 manufactur ing processes. Therefore, equipment and materials used at lease sites are taxable in Oklahoma. While equipment used at gas processing plants could be eligible for the manufacturing exemption, a special manufacturing sales tax exemption permit must be obtained in order to qualify.

Oklahoma does not provide an exemption for utilities used in production except in special circumstances involving enhanced recovery and water flood processes. Further, Oklahoma is one of the few states which does not allow an exemption for isolated sales including transfers of tangible personal property between leases having non-common ownership. Imposition of tax on transfers between these leases can be minimized by having a separate purchasing company own the materials until they are used at a field location. Likewise, tangible personal property included in sales of leases is generally taxable. Sellers are responsible to file a "Casual Sales Tax Return" to report such transactions. The related valuation of the tangible personal property included in the sales agreements can impact determination of taxable basis. Taxable equipment includes both surface and downhole equipment except for real property which generally includes cemented casing. Careful planning and consideration of this issue should be undertaken when leases are sold.

LOUISIANA

2021 Production: Oil: 1.0% - Gas 9.1%

Louisiana does not provide exemption from sales and use tax for materials or equipment used in production of oil and gas. Louisiana's manufacturing exemption applies only to industries within specific NAICS code sectors. Since exploration and production is not included in the list of qualifying NAICS codes, the manufacturing exemption does not apply. Therefore, equipment and materials used at lease sites are taxable.

Services are generally not taxable in Louisiana, but tax is imposed on the repair of movable (tangible) property. Louisiana classifies property in three categories: movable (tangible), immovable (real), and other constructions (property affixed to real property owned by another party). Louisiana Civil Code Article 475 states that "All things, corporeal or incorporeal, that the law does not consider as immovable, are movables." Under current law, constructing or repairing "other construction" are treated the same as work on immovable (real) property.

Vendors working on immovable property are classified as contractors, and as such are generally considered the consumers of the materials used in construction and are responsible for paying the related sales taxes. Further, the final lump sum charge from the contractor to the purchaser for construction would not be taxable.

Louisiana treats fabrication of tangible personal property as a sale and not a service. This includes instances when the owner furnishes the materials to be fabricated into tangible personal property. Welding services are often assessed tax on audits under the fabrication concept.

Louisiana provides an exemption for electricity, natural gas, and water utilities.

COLORADO

2021 Production: Oil: 4.3% - Gas 5.6%

Colorado does not provide a general exemption from sales and use tax for materials or equipment used for production of oil and gas. However, Colorado provides exemption for oil and gas production equipment if the wells are located in Colorado designated enterprise zones. To qualify for the exemption, the machinery must:

- Be used directly and predominantly to manufacture tangible personal property for sale or profit
- Be of a nature that would have qualified for the federal investment tax.
- Be tangible personal property with a useful life of one year or more (qualifying purchases of used equipment is limited to a maximum of $150,000 annually
- Be included on a purchase order or invoice totaling more than $500

Colorado does not impose sales and use tax on the sales or use of electricity or gas used in industrial uses including oil and gas exploration and production, gas processing, and refining. Colorado generally does not tax services.

Colorado does not recognize isolated sales exemptions on the sale of tangible personal property. Accordingly, sales of tangible personal business assets (i.e., pipeline used to carry the oil or gas, compressors used to move gas through a pipeline, etc.) are typically taxable.

Note that this article addresses only state-imposed sales/use tax. To properly assess the taxability or exemptions of operations in a home-rule jurisdiction, that local jurisdiction's impositions must be checked.

WEST VIRGINIA

2021 Production: Oil: 0.4% - Gas 7.3%

West Virginia imposes sales tax on sales of tangible personal property and most services. While most states tax only specified services, West Virginia applies tax by default to services unless an exemption applies. West Virginia exempts services during fracking and mining operations. The exemption applies to services, machinery, supplies and materials directly used or consumed in the production of natural resources (including fracking).

West Virginia treats processing of natural gas as manufacturing which qualifies for that exemption.

Unlike most states, West Virginia requires purchasers to initially pay tax to the vendor and then apply for a refund or credit from the state; or provide a direct pay permit number to vendors ensuring tax is not charged at the initial purchase. Oil and gas operators should regularly review purchase invoices and follow up with refund requests from the state if the company does not have a direct pay permit.

OHIO

2021 Production: Oil: 0.6% - Gas 6.7%

Ohio has a broad sale and use tax base but exempts services rendered to mining and oil and gas producers during mining and fracking operations. The state also exempts machinery, equipment and other tangible personal property used or consumed in mining activities. The exemption applies to items used directly in mining, including extraction of crude oil and natural gas. The exemption also applies to services directly related to exempt mining machinery and equipment.

Ohio's mining exemption applies to:

- Machinery, equipment, or other property used to transport the excavated substance from the mine to a processing plant
- Safety gear used for the physical protection of mining employees while they are in the process of mining/excavating or in the transportation of the substances to the processing plant.

Equipment must be directly used in the actual production process to be exempt. Producers must be aware of whether their activities are treated as pre- or post-production activities in Ohio. Examples of services that do not qualify for exemption include waste removal activities (considered post-production) and a blender used to mix fracturing material unless the material is pumped directly into the well (considered pre-production).

WYOMING

2021 Production: Oil: 2.4% - Gas 3.7%

No exemption from sales and use tax is provided for materials or equipment used for production of oil and gas. Wyoming's manufacturing exemption states that the manufacturing exemption only applies to the operations classified under NAICS codes of 31-33, which exclude extractive and field processes for oil and gas production. Therefore, equipment and materials used at lease sites and gas processing facilities are taxable.

Wyoming does not provide exemption for utilities used in production of oil and gas. Power used in processing gas is exempt pursuant to an exemption for "sales of power or fuel" to a person for direct consumption in "processing."

Also, Wyoming does not generally exempt isolated sales of tangible personal property. Therefore, sales of tangible business assets (such as excess pipe) are taxable. However, sales of interests in leases constitute the sale of an intangible, and not the sale of tangible personal property. Additionally, a sale of more than 80% of a business is excluded from the definition of a "sale" for sales tax purposes.

Wyoming Stat. Ann. § 39-15-103(a)(viii) specifically 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 must be completed prior to the setting of production casing, including seismic and geologic services. The exemption also 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.

MINOR STATES WITH MAJOR IRREGULARITIES:

ARKANSAS

2021 Production: Oil: 0.1% - Gas 1.4%

Arkansas is included in our overview because in 2021 an exemption was changed that very beneficially impacts operators in the state. Because Arkansas treats oil and gas production as a form of manufacturing, when Arkansas enacted a full exemption for manufacturing equipment including repairs, this made many services to oil and gas wells exempt. It should be noted that Arkansas has not updated sales and use tax Rule GR-57 that pertains to oil and gas operations to reflect this change.

MISSISSIPPI

2021 Production: Oil: 0.4% - Gas 0.1%

Mississippi is included to highlight their unique tax scheme in which nearly all services provided within the oil field are taxable. This includes services not enumerated as taxable when performed outside of the oil field such as engineers, geologist, consultants and even grass cutting. The state also taxes components of the third-party Joint Interest Billing including the overhead and accounting charges by the operator.