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SALES & USE TAX

AN OVERVIEW FOR OIL & GAS PRODUCERS IN TOP PRODUCING STATES

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Sales and use taxes can have a significant financial impact on drilling and completion cost centers at an oil and gas company. In times of falling prices, monitoring sales tax expenditures and vendor tax collection is especially important. Because laws are complex, and large outlays of sales tax can easily be incurred during drilling, completion and daily operations, opportunities to both avoid exposure and more often, to reduce overpayments of tax, abound. This article is intended to provide a high-level overview of how these taxes typically affect producers in states with substantial oil and gas activity. Note that the states listed below are included in order of their rankings for production of oil and gas.

TEXAS

Oil and gas producers doing business in Texas must understand sales and use tax laws which are particularly complex. Specifically: pertaining to oil and gas producers is complex because of the following issues:

- Texas' manufacturing exemption applies to certain 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 of the equipment used in 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.

Texas statutes are unique in that they enumerate a wide range of services which are subject to tax. By default, services that are not included in the statutory list are not taxable. While the list is too extensive to incorporate, it includes repairs to both tangible personal and real property. Notably, 34 Tex. Admin. Code § 324 provides in detail that services involved in drilling and completion, as well as plugging and abandonment of wells, are not taxable.

With respect to construction work, both the form of the contract and the type of construction performed impact whether or not a transaction is subject to tax. 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.

Finally exemptions for utilities used in extracting or transporting oil and gas, and for certain chemicals used in producing oil and gas, are included among other special provisions.

OKLAHOMA

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 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 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 do not allow an exemption for isolated sales, which typically apply to transfers of tangible personal property between various leases having non-common ownership. 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 of leases has a significant impact on taxes incurred. Taxable equipment includes both surface and downhole equipment, with the exception of real property which generally includes cemented casing. Careful planning and consideration of this issue should be undertaken when leases are sold.

WYOMING

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 an 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 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.

NORTH DAKOTA

No sales and use tax exemption is provided for materials or equipment used specifically for the 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. In both cases, the exemptions do not apply to materials used to repair or replace an existing system, unless the replacement creates an expansion of the system. Owners of new or expanded systems may apply for refunds of sales tax paid by their contractors. Additionally, an 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.

COLORADO

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 does provide an exemption for oil and gas companies, if the wells are located in Colorado designated enterprise zones. To qualify for the exemption, the machinery must:

- Be used in Colorado;
- 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 credit under the definition of section 38 property found in the Internal Revenue Code of 1954, as amended. This includes tangible personal property with a useful life of one year or more and limits qualifying purchases of used equipment to a maximum of $150,000 annually; and
- Be included on a purchase order or invoice totaling more than $500.

The exemption applies not only to machinery, but also to machine tools, as well as materials for construction or repair of machinery or machine tools, so long as the machinery is used exclusively in an enterprise zone.

Colorado does not impose sales and use tax on the sales or use of electricity, coal, gas, fuel oil, steam, coke, or nuclear fuel used in processing, manufacturing, mining (inclusive of oil and gas exploration and production), refining, and all industrial uses. 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.

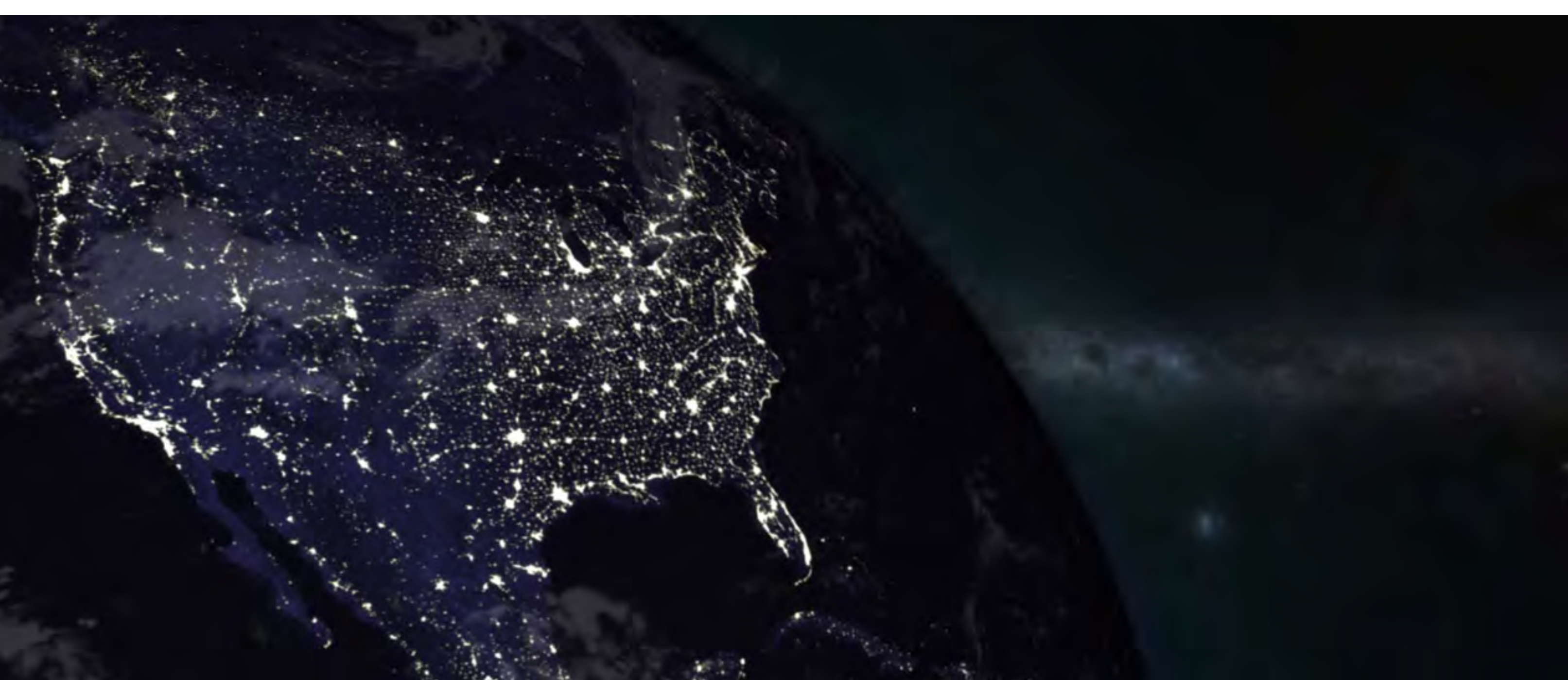
Note that this article addresses only state-imposed sales/use tax. In order to properly assess the taxability or exemptions of operations in a home-rule jurisdiction, one would need to check with that local jurisdiction's impositions.

NEW MEXICO

New Mexico does not provide explicit exemptions from sales and use tax for materials or equipment used specifically for production of oil and gas. However, New Mexico does allow for the presentation of a non-taxable transaction certificate for those purchasers classified as manufacturers or processors. Acceptance of this certificate allows a seller to deduct certain receipts in computing sales tax due. A manufacturer or processor could qualify for this treatment if: (i) that person combines or processes components or materials, (ii) the value of the tangible personal property which has been combined with other tangibles or which has been processed has increased as a direct result of the manufacturing process, and (iii) the person manufacturing sells the same or similar type of manufactured products in the ordinary course of business. Further, receipts from selling tangible personal property that is a consumable and that is used in such a way that it is consumed in the manufacturing process of a product (not to include a tool or equipment used to create the manufactured product), to a person engaged in the business of manufacturing that product and who delivers a nontaxable transaction certificate to the seller may be deducted at an amount of 100% of receipts received on or after January 1, 2017 (prior to 2017, a lower percentage of receipts was deductible).

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.

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.



LOUISIANA

Louisiana does not provide an 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. Notably, Louisiana classifies property in three categories: movable (tangible), immovable (real), and other constructions (property affixed to real property). Louisiana Civil Code Article 475 states that "All things, corporeal or incorporeal, that the law does not consider as immovable, are moveables." Under Article 462, "Tracks of land, with their component parts, are immovable." Article 463 states, "Buildings, other constructions permanently attached to the ground, standing timber… are component parts of a track of land when they belong to the owner of the ground." Article 464 expands, "Buildings and standing timber are a separate immovable when they belong to a person other than the owner of the ground."

As a result of recent law changes, the treatment of non-building structures built upon land, previously treated as immovable property, are only treated as immovable property if the other construction belongs to the owner of the land on which they are located. When the owner of the other construction does not own the land, the other construction is treated as moveable property. Since the majority of oil wells, tank batteries, pipelines etc. are built upon leased land, these will no longer qualify as immovable properties. The distinction between movable and immovable property is important because it changes the taxability of related repair and construction labor from non-taxable to taxable.

Prior to April 1, 2016, the person constructing or repairing the other construction was treated as a contractor. Contractors are generally considered the consumers of the materials used in construction and are ultimately responsible for paying the related sales taxes. Further, the final lump sum charge from the contractor to the purchaser for the construction would not be taxable. As of April 1, 2016, the party performing the construction is no longer treated as a contractor. Thus, both the materials and repair labor used to construct or repair the other construction will be subject to sales tax. Separately stated charges for installation remain treated as a non-taxable service.

Louisiana does allow an exemption for electricity, natural gas, and water utilities, but it is suspended until June 30, 2018. Louisiana's occasional sale exemption was also temporarily suspended from April 1, 2016 until it was reinstated on June 23, 2016, after the legislature's second special session.

PENNSYLVANIA

Pennsylvania provides for 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 operation activities include (in addition to 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 (Sept. 22, 2014), at *1). To determine exemption, the Commonwealth looks to the (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. (Pa. Reg. § 32.1; Pa. Dep't of Rev., Info. Notice SUT 2014-02 (Sept. 22, 2014), at *1)

Purchases are only exempt if used more than 50% of the time in direct-use mining activities (61 Pa. Code § 32.35(a)(2)). Generally, the Commonwealth exempts (if the purchases meet the definition of a mining activity):

- 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 (61 Pa. Code § 32.35(a)(2)(i)(J); Info. Notice SUT 2014-02, at *5-6); and
- 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 (61 Pa. Code § 32.35(a)(2)(ii); Info. Notice SUT 2014-02, at *5).

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

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Brent Watson, CPA, is a state and local tax manager for Grant Thornton LLP in Tulsa, Okla. Brent is an active member of the Oklahoma Society of Certified Public Accountants (serving on their Oil & Gas Committee) and of the Institute for Professionals in Taxation. He has 27 years of experience in sales and use taxes and concentrates in the manufacturing, oil and gas, multi-state contracting and retailing industries.