

COUNCIL OF PETROLEUM ACCOUNTANTS SOCIETIES

ACCOUNTS

WINTER 2017

WINTER FEATURES

INTRODUCING THE NEW
COPAS.ORG WEBSITE

SALES AND USE TAX



ACCOUNTS

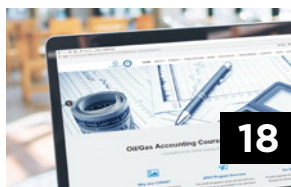
WINTER 2017

CONTENT



13

SALES AND USE TAX



18

NEW COPAS WEBSITE REVIEW

6

President's Message

8

Home Office Message

11

Meeting Schedule

24

Industry News

32

Legislative & Regulatory Update

40

Committee News

44

Project Status Report

46

Fall Meeting Recap

48

Winter Committee Meeting

49

Society News

55

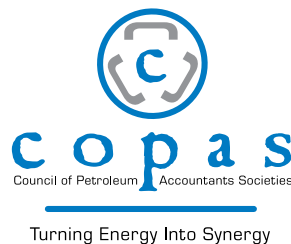
Ring of Honor

56

Voting Results

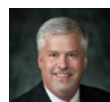
58

Photo Pages



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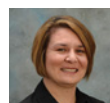
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FEATURED IN THIS ISSUE



The Summer 2017 edition of *ACCOUNTS* contained an overview of sales and use tax laws in the top eight producing states that are applicable to oil and gas production. In this article, we will delve deeper into the effect of sales taxes laws as they apply to drilling, completion and daily operations during production of oil and gas affecting Oklahoma and Texas producers. Together, these two states accounted for nearly 50% of the oil, and 38% of the gas marketed in the US in 2016.

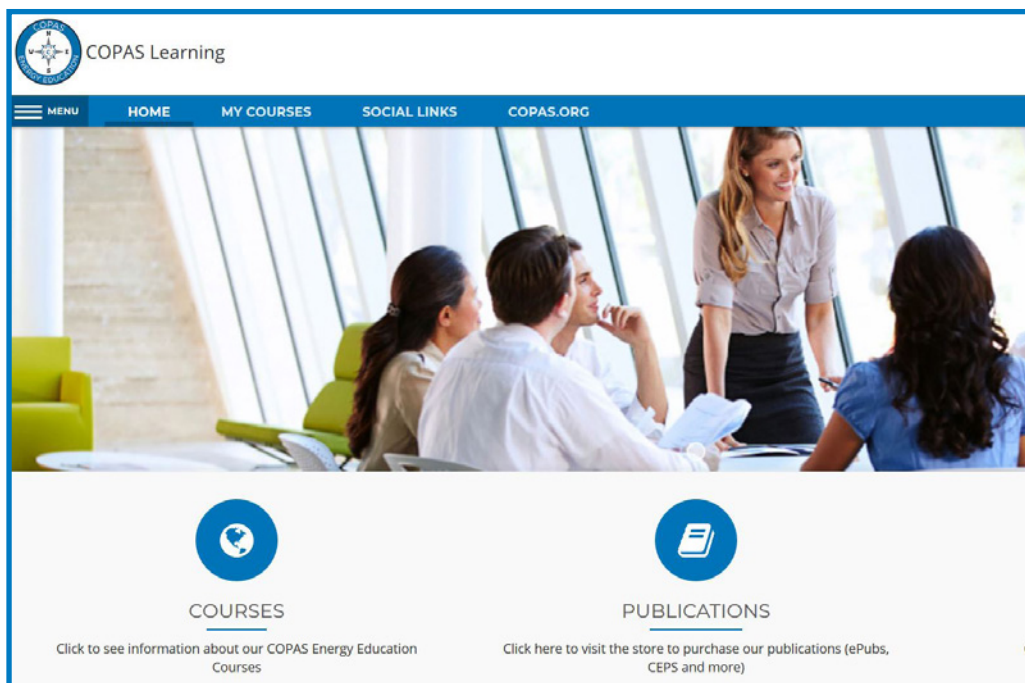
**SALES AND USE TAX
A DEEPER LOOK FOR OIL AND GAS PRODUCERS IN TEXAS AND OKLAHOMA**

**READ MORE ON
PAGE 13**

The COPAS website has a new look beginning Fall 2017. The functionality is largely the same, although some of the file locations have changed from the prior website locations.

The website is now paired with a Learning Management System platform (COPAS Learning) and new shopping cart as we launch more educational offerings.

Please read further to learn more about the new website features and accessing COPAS Learning platform.



**READ MORE ON
PAGE 18**

NEW COPAS WEBSITE REVIEW

SALES AND USE TAX

A DEEPER LOOK FOR OIL AND GAS PRODUCERS IN TEXAS AND OKLAHOMA



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The Summer 2017 edition of *ACCOUNTS* contained an overview of sales and use tax laws in the top eight producing states that are applicable to oil and gas production. In this article, we will delve deeper into the effect of sales taxes laws as they apply to drilling, completion and daily operations during production of oil and gas affecting Oklahoma and Texas producers. Together, these two states accounted for nearly 50% of the oil, and 38% of the gas marketed in the US in 2016.

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 had 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 on which taxes have not specifically been imposed are not taxable. While the list is too extensive to incorporate here, 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 & gas drilling operations is excluded), janitorial, landscaping, lawn maintenance, pest control, some surveying (to determine boundaries), (2) repair of tangible personal, 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). The types of services classified as stimulation are detailed in that rule and include acidization, fracturing, changing zones, drilling deeper, jetting with nitrogen, etc. Many services, such as frac water transfer, 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.

CONSTRUCTION AND CONTRACTORS

Taxability of contracts depends on both the form of the contract and the type of construction performed in determination of 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. 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 so that it can be marketable, as well as equipment at gas processing facilities. This also 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 are considered to be resold with the crude oil in which they are dissolved, and are exempt as items purchased for resale. The manufacturing exemption applies to some other chemicals consumed in the treatment of gas as explained above.

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, 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 where received or used (often rural).



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 ("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 which does not allow an exemption for "isolated sales," which involves 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 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. The OTC has taken the doubtful position that even cemented casing is personal property and taxable.

Careful planning and consideration of 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 Oklahoma Tax Commission ("OTC") has been reviewing corporate income tax returns and asserting 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, such property is out-of-state, is the result of a pass through from another entity, or is intangible or otherwise not subject to sales tax. Additionally, the undepreciated value 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

that they are permanently affixed to the earth), the sale of pipeline is subject to sales tax.

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

Another recent development with the OTC is that they have been disallowing exemption from compression units that pressure up gas to enter a gas plant unless the units are located on the manufacturing premises. Formerly they had allowed these compressors even if they were miles from the processing plant.

Finally, some Oklahoma auditors have 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, despite the fact that the vendor has already paid sales tax on the units being used to provide these services. This assertion is being hotly contested and is not settled at this time.

