



Texas Tax for the Oilfield Services Industry

2024

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Chapter I. Overview

Texas Tax for the Oilfield Services Industry

Various types of Texas state taxes apply to the various stages of oil & gas drilling and production and to the various parties involved. The Texas state taxes include the sales & use tax on materials, supplies, equipment, and services; the well services gross receipts tax on well-stimulation and related services; the oil & gas severance tax on production; the franchise (margin) tax on the entities' income; and the IFTA and motor fuels taxes on the finished products.

☞ **Important Note: Potential Severance Tax Savings.** While this course limits its content and discussion to the Texas sales tax and well servicing tax, it's important to note that the 2023 Texas Legislature passed HB 591 which provides a severance tax exemption for gas that is consumed at the well site and would otherwise have been lawfully vented or flared. To qualify, gas must come from a "qualifying well." A "qualifying well" is a well that is (1) connected to a pipeline on which pipeline takeaway capacity is not expected to meet the demand for gas produced from the well; (2) is not connected to a pipeline and for which connection to a pipeline is technically or commercially unfeasible but whose operator is contractually dedicated the well, the gas produced from the well, or the land/lease on which the well is operated to a pipeline operator; or (3) is not connected to a pipeline and whose operator has not contractually dedicated the well, the gas produced from the well, or the land/lease on which the well is located to a pipeline operator. HB 591 was signed into law on June 2, 2023 and took effect on September 1, 2023.

This outline limits its discussion to the Texas sales & use tax and well servicing tax as applied to the companies in the oilfield service industry.

If the service is performed on the well equipment, inside the casing of the well, or on the well site grounds, the activity may be taxable under the sales & use tax laws. The sales & use tax applies to well services activities that fall within the repair and remodeling rules for real and personal property and within the real property services rules.

In general, if the company performs services on the oil & gas producing formation itself (for example: fracking the formation to enhance the flow of oil), the charges are not subject to the sales & use tax laws. They are taxable under the well servicing tax.

Sales & Use Tax

Although many types of taxes apply to the oil & gas industry, the most significant tax is the sales & use tax. The Texas Limited Sales, Excise and Use Tax Act imposes a tax on the sale, lease or rental of tangible personal (touchable, movable) property and on certain

specified services.¹ Sales & use taxes are complementary. Together, they are intended to uniformly tax transactions only once whether in or out of Texas. Sales & use taxes account for 26% of all state revenues, roughly five times the contribution of any other tax.

Sales Tax

Texas imposes sales tax on retail sales of taxable items in Texas. The state rate is 6.25%. Various local sales taxes may be imposed in addition to this tax. The maximum combined tax rate for local taxes may not exceed 2% at any location. Therefore, the maximum possible sales tax rate is 8.25%.

Example

Oilfield Service Company is located in Odessa. It purchases fishing tools from a supplier located in Houston. This transaction is subject to *sales* tax. The law treats Oilfield Service Company as the consumer of the tools because its workers will use them to perform services at oil & gas well sites. Note that it doesn't matter whether Oilfield Service Company uses the tools to provide taxable or non-taxable services.

Use Tax

This tax presumptively applies when items are acquired out-of-state and brought into Texas within one year of purchase for storage, use, or consumption in Texas. Since the sale is made by a non-Texas seller, the seller would not collect Texas sales tax at the time of sale. Moreover, the seller would likely not collect the origin state's sales tax because the item is destined for Texas. This transaction is subject to the *use* tax.

Without the use tax, persons could purchase items from an out-of-state retailer, use the items in Texas, and escape paying any tax. The use tax prevents this abuse and places out-of-state vendors on an even playing field with Texas vendors. The use tax applies to "any taxpayer who purchases tangible personal property from any retailer for storage, use or other consumption in Texas."²

Example

Oilfield Service Company purchases fishing tools from a supplier located in Tulsa and has the tools sent delivered to its yard in Odessa. Oilfield Services Company owes Texas use tax. If sales tax was legally owed and paid in Oklahoma, Oilfield Service Company would be entitled to a tax credit against the Texas sales tax for the Oklahoma sales tax paid. If the Oklahoma retailer lacks nexus with Texas or

¹ Chapter 151 of the Texas Tax Code.

² Texas Tax Code §151.101.

does not otherwise collect the Texas sales tax, Oilfield Service Company must accrue and remit the Texas use tax.

Applied to Oilfield Services

Oilfield service companies may be subject to Texas sales & use tax or the Texas well servicing tax, or both. However, a single transaction cannot be subject to both taxes. The charges for labor to perform services taxed under the well servicing tax are not taxable under the Texas sales & use tax.

Generally, certain Texas sales & use tax provisions apply frequently to oilfield services activities. They include the provisions that impose the sales tax on charges for these types of taxable items:

Materials Transferred to the Well. The Texas tax code imposes the sales tax on sales of tangible personal property. For example, if a well operator purchases production tubing, the sale is subject to the Texas sales tax.

Supplies Consumed at the Well Site. The Texas tax code imposes the sales tax on the purchase of supplies that are consumed in the course of the taxpayer's business or while providing services (taxable or non-taxable). For example, a drilling contractor performing a turnkey contract owes sales tax on the drilling bits that are consumed in the course of drilling the well bore.

Equipment Used to Provide Services. The Texas tax code imposes the sales tax on the purchase of equipment and tools used to provide services (taxable or non-taxable). For example, a fishing services contractor owes Texas sales tax on the tools it purchases to fish broken pipe out of a well.

Leased Equipment (With and Without Operators). The Texas tax code and related Comptroller rules treat leases as taxable when the underlying property, if purchased outright, would be subject to tax. For example, a driller would owe sales tax on the monthly payments for the lease of a generator to run the draw works. When taxable items, such as tools, are leased with an operator, the application of the tax rules becomes more complex. We discuss the issues in further detail in the chapter discussing the Texas sales & use tax rules.

Information Services. Charges for certain types of information are subject to the Texas sales & use tax. For example, the charge for reports on the market pricing of different types of crude oil and natural gas constitutes a taxable information service.

Real Property Services. Charges for certain types of services, such as surveying, grounds cleaning, weed control, pest control are subject to the Texas sales & use tax. For instance,

the charges a well operator pays to survey the mineral lease or for pest control at the well site constitute taxable real property services.

Telecommunication Services. Charges for the electronic transmission or reception of sounds, data and information are taxable.

Tangible Personal Property Repairs, Maintenance, etc. The Texas tax code treats the charges for repairs to tangible personal property as taxable. For example, the charges to repair the flow lines, production tubing, and movable compressors at a well site are subject to the sales tax.

Real Property Repairs, etc. The Texas tax code treats the charges for repairs to real property as taxable. For example, the charges to repair lease access road are taxable.

Motor Fuel Tax, Diesel Fuel Tax, and Aviation Fuel

Motor Fuel Tax. Texas imposes a diesel fuel tax at the rate of 20 cents per gallon on the removal of diesel fuel from a terminal using the terminal rack other than by bulk transfer.³ This diesel fuel tax also applies to aviation jet fuel.⁴ An exemption applies to diesel fuel delivered or sold into a storage facility of a licensed aviation fuel dealer from which the diesel fuel will be delivered solely into the fuel supply tanks of aircraft. The Comptroller has held that a taxpayer failed to qualify for the exemption for sale to aviation fuel dealers because its evidence was insufficient to show that its customers acted as aviation fuel dealers.⁵

International Fuel Tax Agreement. The IFTA is an internationally agreement between the lower 48 states and Canadian provinces to simplify the allocation and reporting of fuel use by motor carriers that operate in more than one jurisdiction. The Comptroller is no longer mailing paper IFTA reporting forms to carriers, and now encourages carriers to file the reports electronically and pay the tax online using the Comptroller's Webfile, TEXNET, and Electronic Data Interchange systems.⁶

Texas Emissions Reduction Program (TERP) Surcharge

Texas law imposes a surcharge on the sale, use, lease, or rental of off-road, heavy-duty diesel equipment and is based on the sale, lease or rental amount. The surcharge is 1.5% of the sales or lease price of certain equipment. Reports are due monthly, quarterly, or annually,

³ Texas Tax Code § 162.201.

⁴ Texas Tax Code § 162.001(19).

⁵ Comptroller Hearings 115,113; 115,114 (Oct. 29, 2019).

⁶ Texas Comptroller, *International Fuel Tax Agreement (IFTA) Release* (Jan. 2020) available at <https://comptroller.texas.gov/taxes/fuels/ifta.php>.

based on the level of activity. The tax is due by the 20th of the month following the end of the taxable period.⁷

The surcharge applies not only to construction equipment but also to other off-road, heavy-duty diesel equipment, including but not limited to mining equipment; rock and gravel crushers; forklifts; cement mixers; tractors; and motorized cranes.

The surcharge does *not* apply to motor vehicles and equipment used directly in oil & gas exploration and production at an oil or gas well site.⁸ It also does not apply to recreational vehicles that are not held or used in the production of income.⁹

Contingent Expiration. The TERP surcharge will expire on the last day of the fiscal biennium during which the Texas Commission on Environmental Quality publishes a notice in the Texas Register regarding National Ambient Air Quality Standards.¹⁰ The TCEQ is required to publish the notice once the environmental health standards imposed by governmental authorities are attained. The Comptroller has amended the TERP rules to implement this legislation.¹¹

Well Servicing Tax

Texas law imposes an occupation tax on anyone in the business of providing certain well services, and who owns, controls, or furnishes the tools, instruments, and equipment used in providing well service; or uses any chemical, electrical, or mechanical process in providing service at any oil or gas well during the drilling and completion, or reworking or reconditioning of the oil or gas well.¹²

The oil & gas well servicing tax applies after a site has been developed and a hole has been drilled. The types of services taxable under the oil & gas well servicing tax are generally designed to stimulate production of an oil or gas well. It's important to distinguish which services are subject to Texas sales & use tax, which ones are subject to oil & gas well servicing tax, and which ones are nontaxable.

Oil & gas well services subject to the occupations tax are: surveying or testing the formation; cementing the casing seat; shooting the formation; fracking the formation; and acidizing the formation.

⁷ Texas Tax Code §151.0515.

⁸ Comptroller Rule §3.320(a)(1).

⁹ Texas Tax Code §152.0215. A recreational vehicle is defined as a motor vehicle primarily designed as temporary living quarters for recreational camping or travel.

¹⁰ H.B. 3745, 86th Leg., R.S. (to be codified as an amendment to Tex. Tax Code § 152.0215).

¹¹ 45 Tex. Reg. 763-64 (2020) (codified as an amendment to 34 Tex. Admin. Code § 3.96); 45 Tex. Reg. 382 (2020) (codified as an amendment to 34 Tex. Admin. Code § 3.320).

¹² Texas Tax Code §§191.081 *et seq.*

The tax is imposed at the rate of 2.42% of fees for the above services. Reports are due monthly on the 20th day of the month following the end of each calendar month. The service provider does not collect the tax from its customers but pays the tax based on its receipts from well services provided for consideration.

Chapter II. The Texas Sales & Use Tax Rules

Introduction

Generally, if the well servicing activity is performed on the *oil & gas formation*, the activity is subject to the Texas oil well services tax. If the activity is performed inside *the well bore, on the well site, or well site equipment*, the activity is subject to the Texas sales & use tax. And some well servicing activities are not subject to either tax.

We begin with a general discussion of the Texas sales & use tax rules that frequently apply in the oilfield services industry. They include the rules that impose the sales tax on charges for incorporated materials and consumed supplies, equipment (either purchased or rented), and certain taxable services. The rules for some taxable services apply differently to real property and tangible personal property, so we need to know how to classify different type of oil well property. We also discuss the exemptions that are either directly related to or common in the oilfield services industry.

Goods and Services Subject to Sales & Use Tax

The tax laws presume that all sales or uses of tangible personal property are taxable. Contrast this with the performance of taxable services where this presumption does not lie. The Texas tax code imposes sales tax on the “sales price” of each “sale” of a “taxable item” in “Texas.”¹³

Sales Price

This is the amount for which the item is sold, leased or rented without a deduction for the cost of transportation and other costs.

Entire Price Charged by the Seller. When a taxable item is sold, the tax laws impose the tax on the seller’s entire charge, regardless of whether individual components of the sale are stated separately, or even stated on different invoices. As a result, separately stating items, such as freight or transportation and similar costs, will not convert them to non-taxable charges. They will remain a component of the taxable sales price.

Exception for Certain Charges. Certain charges, if separately stated, are not subject to the tax. These include discounts, refunds, returns, finance charges, and trade-ins.¹⁴ Moreover, separately-stated property tax reimbursement charges are not part of a sales price (or rental charge) subject to the general sales and use tax under current Comptroller guidance. However, the Comptroller has stated that it intends to amend its lease rule (3.294) to state that such charges are taxable. Heavy equipment lessors may treat the separately-stated

¹³ Texas Tax Code §151.051.

¹⁴ Texas Tax Code §151.007.

charges for the Heavy Equipment Inventory Tax (HEIT) as non-taxable until the Comptroller amends Rule 3.294.¹⁵

Sale

The sales tax taxes sales. A sale occurs when the taxpayer transfers title or possession of a taxable item including tangible personal property for consideration (i.e., money or some other value).

The statute states several types of transactions that constitute “sales” when done for value (or consideration). The following types of sales occur in the oilfield services industry:

Title. Transferring title of tangible personal property is a sale. A sale still occurs if the seller keeps possession of the item sold but passes title.

Possession. Transferring possession of tangible personal property is also a sale if the possession is in lieu of transferring title or constitutes a barter or exchange.

Segregation. Merely segregating items in contemplation of transferring title or possession does not create a sale.¹⁶

Exchanges. The exchange or barter of tangible personal property constitutes a sale.

Trade-Ins. A trade-in to reduce the purchase price of a taxable item is a taxable barter, but only if the item given by the buyer is not sold in the seller’s regular course of business.¹⁷

Leases or Rentals. The lease or rental of tangible personal property without furnishing an operator constitutes a sale. There are two broad categories of leases: operating leases and financing leases.¹⁸ Both are taxable. However, the amount of tax and when it is paid is different for each.

Services. Performing a taxable service constitutes a sale. The Texas Tax Code treats about twenty (20) categories of services as taxable.¹⁹

Production. Producing, fabricating, processing, printing, or imprinting tangible personal property for persons who furnish the materials. Examples include developing photographs, tailoring, assembling toys and furniture, printing, calligraphy, and catering.

Divergent Use. Divergent use occurs when an item is initially purchased under a valid claim of an exemption and later the taxpayer uses the item in a taxable manner. For

¹⁵ Tax Policy Memo to Audit Division dated April 21, 2016 (201604756L).

¹⁶ Note that earlier versions of the statute treated segregation as a sale.

¹⁷ Comptroller Rule §3.302(g).

¹⁸ Comptroller Rule §3.294(a)(1).

¹⁹ Texas Tax Code §151.0101.

example, a when a company removes an item from its inventory for its own use, it will owe sales tax on the cost of the materials used to build the item.²⁰

Taxable Item

“Taxable Item” means tangible personal property and taxable services. Tangible personal property is property that can be weighed, measured, felt or touched or that is perceptible to the senses in any other manner, including computer programs²¹ and digital products.²² These are the twenty (20) types of services that the Texas tax code treats as taxable.

Essence of the Transaction Test

Texas courts look at the buyer’s intent to determine whether goods or services are being sold. In some cases, the parties’ intent may also bear on whether state law characterizes the item as tangible personal property or real property.²³

In *Williams and Lee Scouting Service, Inc. v. Calvert*,²⁴ the taxpayer sold oil well and field reports on computer tape to its customers. The court held the sale was for a non-taxable service and did not constitute the sale of tangible personal property (i.e., the computer tape). The “essence of the transaction” was the purchase of the information contained on the tape, and because information services were not yet taxable in Texas, the Court held that the transaction was, in essence, a non-taxable service.

☞ **Important Note:** The “essence of the transaction” doctrine is an all-or-nothing rule of law. A charge is either completely taxable or it is completely non-taxable. Therefore, if a taxpayer is able to show that the basic purpose of the transaction is the performance of a non-taxable service, sales tax is not due even on the portions of the service which are admittedly taxable. This is apparently true even if the charge was separately stated.

Entity Concept

Texas law follows the separate entity concept. The law treats each person or entity as a separate taxpayer regardless of whether they are owned or controlled by the same person(s). Accordingly, transactions between related taxpayers are usually subject to the sales or use tax. This includes, for example, the lease of equipment from an owner to his wholly-owned

²⁰ Texas Tax Code §151.3181 covers divergent uses of tangible personal property in the manufacturing process. This special divergent use rule is discussed later in these materials.

²¹ Texas Tax Code §151.009.

²² Effective Sept. 1, 2001. Added by S.B. No. 1125 (77th Legis. Session) in 2001.

²³ See, e.g., Comptroller Letter No. 200209423L (Sept. 11, 2002) (determining that broadcast towers were tangible personal property where the parties’ contract clearly stated that they intended the broadcast towers to be movable).

²⁴ 452 S.W.2d 789 (Tex. Civ. App., 1970, writ ref’d).

corporation. Sales between two separate corporations, even if they are related as brother-sister or parent-subsiary, are subject to sales & use tax. Sales or transfers between two divisions or agencies of the same corporation are not subject to sales tax even though the two divisions may treat the transfer as a sale and purchase on their records.

Credit for Tax Paid to Other States

Texas is a member of the Multi-State Tax Compact. As a member, Texas law allows a credit against Texas use tax for sales tax paid on the item to another state, if the other state grants Texas taxpayers reciprocal treatment.²⁵

Legally Due Requirement

Texas only allows the credit if the sales tax was legally due in the other state.²⁶ Texas generally defers to the other state's interpretation of whether tax was legally due.²⁷

Example

Under Louisiana sales tax law, a corporation owes sales tax if the buyer arranges for shipment from Louisiana to an out-of-state location. Louisiana sales tax is not due if the Louisiana seller ships the items to an out-of-state location either using its own vehicles or by common carrier hired by the Louisiana seller.²⁸

Example

A Louisiana company buys crushed rock in bulk and has the rock shipped to its location in Shreveport, Louisiana. The company pays Louisiana sales tax of 4% on the crushed rock. The company uses the materials in Texas in performing a lump-sum contract to repair private roads to oilfield sites located in East Texas. Texas auditors allege that the Louisiana company owes Texas use tax on the crushed rock unreduced by the 4% Louisiana sales tax if sales tax was not legally due in Louisiana.

Nexus

A business is "engaged in business" when it has some contact or physical connection with a taxing jurisdiction. In tax parlance, we call this "nexus."²⁹ Sometimes the sales tax auditors

²⁵ Texas Tax Code §151.303(c).

²⁶ Comptroller Rule §3.338.

²⁷ Comptroller Hearing No. 36,403 (1997).

²⁸ Comptroller Hearing No. 36,403 (1997).

²⁹ "Nexus" means "connection" in Latin.

use the term “representation” instead of “nexus.” Whether a taxpayer has nexus with a state determines the taxpayer’s collection responsibilities in that state.

Tax-Included Contracts

In a properly drafted “tax included” contract, the buyer shifts the sales tax liability to the seller. The buyer can do this only by stating in the contract that “the stated price includes sales or use taxes.”³⁰ This provision means that the agreed price includes the sales tax as one of its components, even though the sales tax is not separately stated. Buyers must use the specific language, verbatim as recited above in order to create a “tax included” contract. No other language will do.

Sales & Use Tax Permits

Sellers must obtain a sales tax permit for each place of business in Texas. Out-of-state sellers selling items for use in Texas must obtain a use tax permit if they have sufficient nexus with Texas. Sellers are required to report monthly, quarterly or yearly depending upon the amount of tax they expect to remit.

Place of Business

A place of business is store, office or other location where you receive orders for taxable goods or services at least three times during the calendar year. A warehouse or other storage facility is not a place of business unless three or more sales are made or orders taken there during a year.

Local Sales & Use Taxes

Local Sales Tax.³¹

Generally, local *sales* taxes are collected based on the location of the *seller’s place of business*. A “place of business” is a store, office, or other location operated for the purpose of receiving orders for taxable goods or services. A manufacturing plant, warehouse or other location not operated for the purpose of receiving orders for taxable items is not a place of business, unless three or more sales are made there, or orders are taken there, during a year.

One Place of Business. If the seller’s only place of business is in a local city, county special purpose district, and/or transit authority taxing jurisdiction, sales tax is collected for those jurisdictions on *all* sales of taxable items made to customers in Texas.

³⁰ Comptroller Rule §3.286(d)(3).

³¹ See Guidelines for Collecting Local Sales & Use Taxes. Comptroller Bulletin (February 2009).

More Than One Place of Business. When a seller has more than one place of business in Texas, the local tax collected is determined by the place of business from which the items are *shipped*, not the location where the order is received.³² If the seller ships items from a place of business in a taxing jurisdiction, local sales tax must be collected for that jurisdiction.

Orders Received at a Place of Business in Texas; Products Delivered by Third Party Vendor Located Outside Texas. If a seller receives an order at a place of business in Texas, and the taxable goods or services are delivered to Texas customers by a third party supplier located outside of Texas, the seller must collect local sales tax based on the place of business where the order was received. For example, assume a seller operates a place of business in Round Rock and receives an order from a customer for an item that must be ordered from a supplier located outside of Texas. The seller receives payment for the item from the customer. The seller instructs the supplier to ship the item directly to the customer's location in Texas rather than shipping it to the seller's place of business. Based on these facts, the seller should collect local sales taxes based on its place of business in Round Rock, which is the place of business where the order was *received*.

If a seller receives an order at a place of business in Texas, and the taxable goods or services sold are delivered to the customer in Texas from *the seller's* place of business located outside of Texas or from *the seller's* warehouse, distribution center or other location outside Texas (even if it is not a place of business that takes orders), the seller must collect local use tax based on where the product is *delivered*.

Local Use Tax

Local use tax is collected based on where the customer receives the goods or services: the point of delivery. Texas sellers may be required to collect local use taxes if they are engaged in business in the local taxing jurisdictions in effect at the point of delivery unless the two percent (2%) cap for local taxes would be exceeded.

Engaged in Business. If a seller of taxable items has any of the following within a local jurisdiction or does any of the following within a local jurisdiction, then the seller is engaged in business in that jurisdiction and may be required to collect local use tax on taxable goods or services delivered into that jurisdiction. The use of company vehicles (whether owned, leased or rented) to deliver taxable items to customers in the taxing jurisdiction means a seller is engaged in business there.

³² However, if the order is placed in person (e.g., at a furniture showroom), the local taxes are sourced to that location. Texas Tax Code §321.203(c).

No Place of Business. If a seller has no place of business in Texas, the seller should collect local *use* tax for the city, county, special purpose district, or transit authority jurisdictions in effect where the product is delivered if the seller is *engaged in business* in the jurisdiction.

Example

Mud Screens Co. sells screens used in oil & gas drilling operations. It has no place of business in Texas. It takes orders for screens from its customers at their well sites and delivers the screens to the customers' well sites. Mud Screens Co. should collect local taxes based on the location of its customers' well sites.

Orders Placed at a Seller's Place of Business in Texas; Products Delivered from a Seller's Out-of-State Location. If a seller receives an order at a place of business in Texas and the taxable goods or services sold are delivered to Texas customers from the seller's out-of-state location, and if the seller is engaged in business where the product is delivered, the seller should collect *use* tax for any city, county, special purpose district, and/or transit authority jurisdictions in effect where the product is delivered, if the seller is *engaged in business* in the jurisdiction.

Orders Placed With a Seller Located Outside Texas; Products Delivered From Within Texas. If a seller receives an order at a place of business located outside of Texas, but delivery or shipment is made to a customer in Texas from a location within the state that is not a place of business (such as a warehouse or distribution center), the seller must collect *use* tax for any city, county, special purpose district, and/or transit authority jurisdictions in effect where the product is delivered, if the seller is *engaged in business* in the jurisdiction.

Order Received by Salesperson Located Outside Texas; Products Delivered From Within Texas. If an order is received by a salesperson assigned to a place of business located outside Texas, and delivery or shipment is made from a location within Texas other than a place of business of the seller such as a warehouse or distribution center, the seller must collect *use* tax for the city, county, special purpose district, or transit authority jurisdictions in effect where the product is delivered if the seller is *engaged in business* in the jurisdiction.

Exception for Contractors with Separated Contracts for New Construction and for Residential Repair and Remodeling Projects. A *separated contract* provides separate charges for materials and labor. A contractor working under a separated contract for new residential construction, new commercial construction, or for residential repair and remodeling must collect local taxes on the charge for materials based on the location of the job site.

Under a *lump-sum contract* for residential repair and remodeling or new construction (residential or nonresidential), the contractor is considered the consumer of all materials and must pay tax to suppliers at the time of purchase; the contractor does not collect sales

tax on the charge to the customer. If the supplier delivers goods to the job site, the supplier will collect sales tax from the contractor based on the location of the supplier's place of business and may also collect local use taxes based on the point of delivery. A lump-sum contract is a contract in which the agreed contract price is one lump-sum amount and in which the charges for incorporated materials are not separately stated from charges for labor.

Record Retention Guidelines

Sales records must be kept for four years. This applies to all sellers, users/consumers of taxable items, and taxable service providers. The statute is extended indefinitely when no report is filed, the report is fraudulent or the report omits twenty-five percent (25%) or more of the tax required to be shown due on the report.

Direct Pay Permits

Purchasers who buy at least \$800,000 of taxable items for their own use may apply for a permit that allows the purchaser to pay sales tax on the purchased items directly to the Comptroller. This is in lieu of having the seller of items collect the sales tax from the purchaser and remit it to the Comptroller. A searchable listing of direct payment permit holders is available on the Comptroller's web site at:
http://aixtcp.cpa.state.tx.us/dirpay/dir_pay_srch.php.

Materials, Supplies & Equipment

This section covers the Texas sales & use tax rules for various types of tangible personal property that's often located at, incorporated in, or consumed at oilfield sites.

Materials

These are usually items that are either sold to others or are incorporated into real property improvements. Oilfield service providers who drill wells or provide related services are treated as contractors. The oilfield service provider's contract with its customer determines how the tax on materials is treated. Under a lump-sum contract, a contractor is considered the consumer of all materials incorporated into a customer's property. As a consumer, a contractor must pay tax to suppliers at the time the incorporated materials are purchased.

The contractor will also pay sales & use tax on consumable supplies and all equipment bought, leased, and rented for use on the job. The lump-sum charge to the customer is not taxable. Under a separated contract, a contractor is considered the retailer of all materials physically incorporated into the realty. As a retailer, a separated contractor must collect sales tax from the customer based on the agreed upon contract

price of the incorporated materials. The separately stated charge for labor is not taxable. A separated contractor may issue a resale certificate to purchase the materials. The contractor must pay sales tax on consumable supplies and all equipment bought, leased, or rented for use on the job.

Cement. The charge for cement is exempt from Texas sales tax.³³ Instead, cement is taxed under Chapter 181 of the Tax Code. The cement tax is imposed on a person who: (1) manufactures or produces cement in Texas or imports the cement into Texas and (2) distributes or sells the cement in intrastate commerce or uses the cement in Texas. The cement tax is based upon the amount of cement distributed, sold, or used by the person for the first time in intrastate commerce. The tax applies to only one distribution, sale, or use of cement.

Ready-Mix Concrete. Ready-mix concrete is a taxable manufactured product. Because ready-mix is processed with special equipment while being transported, the seller delivers the product to the buyer's job site. The seller should collect sales tax based on the total charge, which includes any transportation or delivery fee.³⁴

All transportation and delivery charges by a ready-mix company are part of the total charge for the product and thus taxable.

Charges for transportation and delivery by someone other than the ready-mix company are non-taxable services. These non-taxable services include the use of pumps and similar equipment to move the ready-mix from the seller's delivery trucks to the customer's forms.

Example

ABC Well Services sells and install casing in oil & gas wells. It bills its clients separately for the labor and material charges. The tax laws treat ABC Well Services as the reseller of the casing to the operator.

Supplies or "Consumables"

Supplies or "consumables" are items consumed at the well site. "Consumed" means that after being used once for its intended purpose, the item is completely used up or destroyed.

Oilfield service providers are generally (but not always) required to pay tax on their purchases of their supplies when they buy them. "Consumables" include such things as masking tape, corrugated cardboard, paint pot liners, steel strapping, sandpaper, and trash can liners. They do not include items that are incorporated into realty such as mortar, bricks, nails, and caulk.

³³ Texas Tax Code §151.308.

³⁴ Tax Policy News (July 2003).

Other examples include non-reusable concrete forms, non-reusable drop cloths, barricade tape, natural gas, and electricity.

We contrast consumables with incorporated materials, which are attached to or incorporated in the realty and become a part of the property. Welding illustrates this point. Welding rods are incorporated materials. When welding, the welding rod is melted into the joint in a building's structural steel and thus becomes incorporated into the realty. On the other hand, the welding gas is a supply. The gas used to heat the rod and make the weld is consumed in the process of welding, and so it is not incorporated into the realty.³⁵

While consumables used in construction are usually taxable, there is an exception that can apply when the oilfield service provider is providing non-taxable services under a separated contract that specifically provides that title to the consumables will pass to the customer upon receipt of the items by the oilfield service provider, and if no use of the items is made by the oilfield service provider prior to passage of title to the property to the customer.³⁶

Example

ABC Drilling Company contracts with an operator to drill a well. ABC Drilling Company will perform the work on a "turnkey" basis, meaning ABC Drilling Company is paid once it drills the well the depth specified in the drilling contract with the operator. During the drilling process, ABC Drilling Company uses three (3) drilling bits to drill through rock formations. The drilling bits constitute supplies consumed by ABC Drilling Company which it uses to complete its non-taxable drilling service.

Equipment

Drillers and other oilfield service providers must pay tax on all machinery and equipment that they purchase, lease, or rent for use in drilling and completing a well. Equipment includes items such as drilling rigs and their component parts, drill pipe, drill bits, and related items.

The operator may either purchase or rent the equipment. Or well service companies or other contractors may use it to provide services to the operator.

Example

ABC Drilling Company purchases a drilling rig which it uses to drill wells. ABC Drilling Company owes sales tax on the purchase price of the rig, including costs billed by the seller of the rig for transporting it to ABC Drilling Company's yard.

³⁵ Comptroller Letter No. 200904300L (April 6, 2009).

³⁶ Comptroller §Rule 3.291(b)(2) (B).

Motor Vehicle v. Moveable Specialized Equipment.

The classification of certain oilfield equipment significantly affects the amount of sales tax incurred on the purchase of the equipment and the taxability of future repairs.

Motor Vehicle. Motor vehicles are subject to the 6.25% motor vehicles sales tax. There is no local tax component. The motor vehicle tax is also due on the components and accessories that are attached to the vehicle at the time of sale. “Accessories” include items such as bodies, cement mixers, C.B. radios, refrigeration units, fertilizer spreaders, oil well servicing equipment and similar items. The charge for accessories attached after the sale are subject to the general sales and use tax.

A “component” of a motor vehicle means an item that is necessary for the vehicle to operate properly (e.g. tires, vehicle battery, or brakes).

When motor vehicles or their related components and accessories require maintenance or repairs, the underlying labor is not subject to either the motor vehicles sales tax or the general sales tax.

Defined. “Motor Vehicles” means: (a) a self-propelled vehicle designed to transport persons or property on a public highway, (b) a trailer and semitrailer, including a van, flatbed, tank, dumpster, dolly, jeep, stinger, auxiliary axle, or converter gear, and (c) a house trailer.³⁷

A motor vehicle does not lose its identity as such if tangible personal property is added to the vehicle to allow it to perform a specialized function even if it can no longer transport separate property or persons other than the driver.³⁸

However, a motor vehicle may subsequently lose its status as such if it was designed at the outset and specifically built to perform a specialized function which did not include transporting property separate from itself or persons other than the driver, such as a flat-bed truck upon which oil well servicing equipment is attached.



This may also occur if a trailer manufacturer modifies a trailer being built to include welded braces to hold equipment to be installed later. Later, when the equipment is installed, the motor vehicle may lose its status as such and become moveable specialized equipment if could then no longer transport property other than itself or person(s) separate from the driver. In this regard, the Comptroller has held that there is no de

³⁷ As defined by Chapter 501, Transportation Code

³⁸ Tex. Tax Code §3.88(a)(2).

minimis provision for the amount of separate property that would have to transportable separate from the unit itself.³⁹

Moveable Specialized Equipment. In contrast, Moveable Specialized Equipment (MSE) is subject to the general sales and use tax which includes local taxes. Thus, the tax rate for MSE purchases may be as high as 8.25%. Moreover, there is no provision that excludes the labor charges for repairs and maintenance from the general sales and use tax.

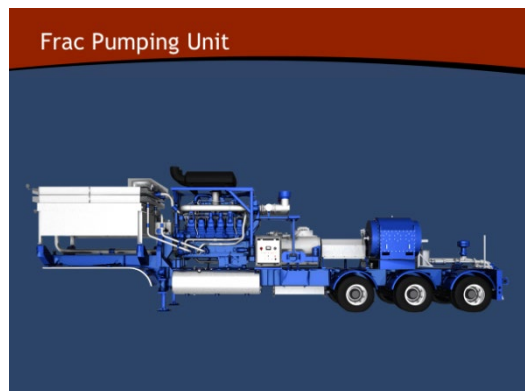
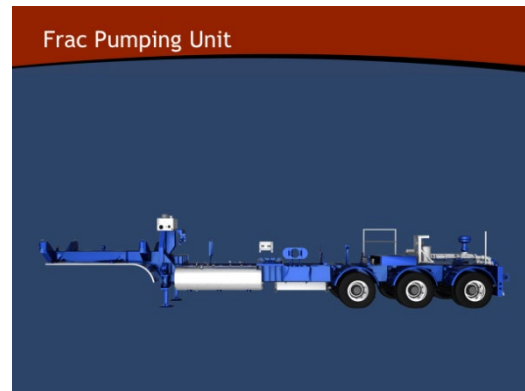
Therefore, repair labor is also potentially taxable at the highest (8.25%) tax rate.

A MSE is “[a] unit designed and built specifically to perform a specialized function that does not include transporting property separate from itself or persons other than the driver.⁴⁰ Examples include motorized cranes, motorized oil well servicing units, and mobile auto crushers.”

Frac Trailers. Frac trailers qualify as motor vehicles under certain circumstances. This occurs when the base trailers qualify as motor vehicles when purchased and prior to the installation of the fracking equipment. They must also carry property separate from the installed equipment that’s integral to the fracking process.

In Comptroller Hearing Dec. 106,629 (April 29, 2016), the taxpayer purchased base trailers that qualified as motor vehicles because they contained brakes, lights and tags and were capable of being drawn down the highways by self-propelled motor vehicles (i.e. trucks). The addition of structural supports for the fracking equipment to be added by the purchaser/taxpayer did not alter the initial motor vehicle status. Moreover, the subsequent attachment of fracking equipment did not transform the trailers into MSE because they carried property separate from the unit – large hoses – which were integral to the fracking process.

Fuel Tax Refunds. Oilfield service companies may claim refunds of diesel taxes for diesel consumed by MSE used exclusively in oilfield well servicing. To qualify, the company must be eligible to receive federal diesel fuel tax refunds under the Internal Revenue Code and



³⁹ Comptroller Hearing No. 106,629 (April 29, 2016).

⁴⁰ Comptroller Rule §3.88(a)(3).

the MSE must meet certain design-base and use-base tests. These tests are stated in Comptroller Rule 3.432(p)(1)(A) & (B).

Leasing or Renting Property Without an Operator

Leases are subject to sales tax if an outright sale of the underlying property would be subject to sales tax. This is because a sale or purchase includes a transaction in which a transfer of title or possession of tangible personal property occurs. The statute specifically provides that the lease or rental of tangible personal property is taxable.⁴¹ A lease is defined as a transaction in which possession but not title to tangible personal property is transferred for consideration. Only leases or rentals of tangible personal property (e.g. equipment) are taxable. Leasing or renting real property (e.g. buildings or land) is not taxable. In the case of taxable leases, the issue is when must the sales tax be paid, how much and by whom. The answer depends upon the type of lease.

Operating Leases

Under a true lease (called an “operating lease”), sales tax is imposed during the period in which the rental receipts are considered income under the lessor’s method of accounting.

Example

Mr. Smith leases a television from A-Z Rental for \$100 per month. Mr. Smith owes sales tax each month on this \$100 and must send it with his monthly lease payment.



Sales tax is based on the amount of each lease payment received by the lessor. Interest charges will also be included unless it is shown that they relate to late payments or other defaults under the lease, whether or not separately stated. Assigning the lease contract will trigger immediate payment of all sales & use tax due on any remaining lease payments.

☞ **Caution:** payments must represent a fair market value.⁴² In this hearing, the taxpayer entered into a lease agreement to lease pull units and drilling rigs from an affiliated entity. The taxpayer argued that the transaction was not a lease, because the consideration exchanged between the parties did not equal the fair market value of the leased items.

The Comptroller held that the validity of a lease does not turn on the profitability of the leases, but rather, the controlling requirement is that the transfer of possession to the

⁴¹ Texas Tax Code §151.005(1) &(2).

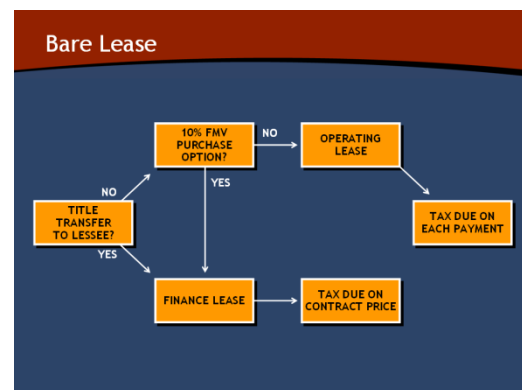
⁴² See Comptroller Hearing No. 110,461 (July 8, 2015).

lessee must be accompanied by an exchange of consideration. Although the consideration exchanged between the parties was less than market value in this case, the agreement was still considered a taxable lease.

Financing Leases

A financing lease is really a disguised sale of the property. A financing lease occurs when the lease contract contains a provision that title to the property must be transferred at the end of the lease or an option to purchase the property for a nominal price at the end of the lease (a price is considered nominal if it is estimated, at the time the contract is executed, to be less than ten percent (10%) of the property's fair market value when the option is exercised). Other circumstances may also apply which would create the presumption of the existence of a financing lease.⁴³

A financing lease is treated as a taxable sale. Tax is due when the buyer takes possession of the property or when the first payment is due, whichever is first.⁴⁴ If the lessee receives the property in Texas, sale tax is due on the total amount of the contract regardless of where the property is used during the lease. If the lease is made with an out-of-state lessor, the Texas lessee must accrue use tax.



Generally, a lessee owes use tax when the lessee signs a lease from an out-of-state lessor for property to be used in Texas. Property brought into Texas for use under either a financing lease or an operating lease is presumed to be subject to use tax. A credit is available for sales & use taxes paid to another state. An exception to imposing the Texas use tax applies if the property is used for more than one year outside Texas. When the leased property is brought into the state, no use tax will be due. The exemption for occasional sales does not apply to the rental or lease of taxable items.⁴⁵

Leasing or Renting Property with an Operator

The Comptroller applies different tax treatment to equipment leased with an operator (an "operator lease") and equipment leased without an operator. The latter is considered the lease of tangible personal property. The former is generally considered the performance of a service, which may or may not only considered a taxable sale if the service being

⁴³ Comptroller Rule §3.294(a).

⁴⁴ Comptroller Rule §3.294(f)(3)(B).

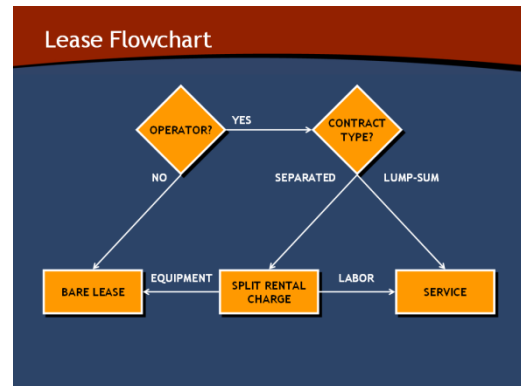
⁴⁵ Texas Tax Code §151.304(e).

performed is otherwise taxable (such as the repair or remodeling of commercial real property).⁴⁶

Lump-Sum v. Separated Leases

Operator leases are further broken down into two categories: If the lessor's contract charges its customer a lump-sum price (one charge for both equipment and operator), then the entire charge is treated as compensation for the *service* provided. If, on the other hand, the lessor's contract separately states the charge for the operator from the charge for the equipment, then the charge for the equipment becomes a taxable lease of *tangible personal property* regardless of the operator charge.⁴⁷

When a lessor bills an operator lease on a separated basis, the billing must properly allocate separate charges for labor and equipment. In other words, the lessor must be sure that the charge for the equipment is reasonably close to the fair market rental value of the equipment. The Comptroller may disallow an unreasonably low charge for equipment in lieu of an unreasonably high operator charge (presumably to reduce sales tax liability on the equipment lease portion).⁴⁸



The Comptroller also treats other lease charges as taxable. For example, the Comptroller considers separately-stated charges for labor or services rendered in installing, servicing, maintaining, repairing, supervision, set-up, hook-up, assembly, disassembly, erection and dismantling to be a part of the lease price, and hence taxable.⁴⁹

Service v. Rental

An issue often arises when property, such as equipment, is leased and accompanied by someone from the rental company. The issue is whether the rental company is providing a service or renting taxable property.

⁴⁶ Comptroller Rule §3.294(c)(1),(2).

⁴⁷ Comptroller Rule §3.294(c)(3).

⁴⁸ Comptroller Rule §3.294(c)(3)(A).

⁴⁹ Comptroller Rule §3.294(d)(1),(4).

The issue first surfaced in the case of *Davis-Kemp Tool Co. v. Bullock*.⁵⁰ There, Davis-Kemp provided fishing services for oil well drillers and producers. Davis-Kemp maintained a fishing tool warehouse where it stored tools on behalf of its suppliers. When a customer needed fishing services, Davis-Kemp workers would remove the appropriate tool from its warehouse and use it to retrieve the stuck pipe or other item lodged in the well bore.

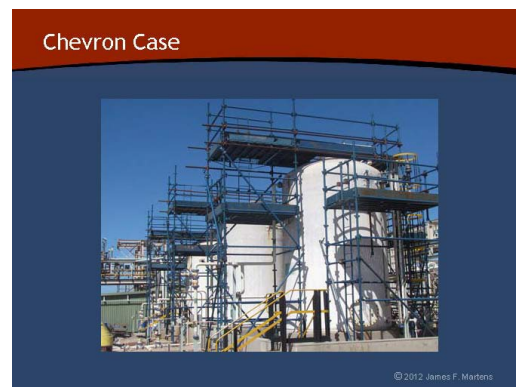


Davis-Kemp sent invoices to its customers containing separately-stated charges for the rental of the tool and the services of Davis-Kemp's workers who operated the tool. Davis-Kemp charged and collected sales tax on the tool rental charge. Under its agreement with its suppliers, Davis-Kemp paid them one-half of the amount collected from its customers for the tool rental and did not collect any sales tax on its payments to its suppliers for the tool.

The Comptroller disputed Davis-Kemp's classification of the tool rental charges on its invoices. The Comptroller alleged that Davis-Kemp's customers did not owe sales tax on the rental charge, but instead Davis-Kemp should have imposed it on the amounts Davis-Kemp paid the suppliers for the use of the tool.

The court agreed with the Comptroller reasoning that Davis-Kemp had not rented the fishing tools to its customers because it never transferred operational control of the tools to the customers. Instead, the fishing tools were used by Davis-Kemp workers to perform their services (taxable or nontaxable depending upon the nature of the fishing services provided).

In *Combs. v. Chevron, Inc.*⁵¹, Chevron hired contractors to install temporary scaffolding at one of its refineries to allow it to perform maintenance work on structures at the refinery. The contractors provided the scaffolding materials, built the scaffolds, monitored them for safety, and dismantled them when the job was complete. Chevron employees and other contractors Chevron hired used the scaffolding to



⁵⁰ 584 S.W.2d 579 (Tex. Civ. App.—Beaumont 1979) *aff'd*, 590 S.W.2d 708 (Tex. 1979).

⁵¹ 319 S.W.3d 836 (Tex. App.—Austin 2010, pet. denied).

perform the maintenance work. Third Court of Appeals found that the “essence of the transaction” was the rental of the scaffolds, which are tangible personal property, because Chevron primarily sought use of the scaffolds so Chevron and not the scaffolding company could perform maintenance work. Since Chevron held operational control of the scaffolding by performing maintenance work, the Court considered Chevron the lessor of the scaffolding structure and not the consumer of non-taxable services provided by the scaffolding company.

Taxable Services

Oil & gas well services may be taxable under either the sales & use tax laws⁵² or the oil well service tax statute.⁵³ Certain categories of oil & gas well services are not taxable at all. This discussion pertains only to services classified as taxable under the Texas sales & use tax laws.

It’s important to understand which services fall into which categories. Taxable service providers are required to collect sales tax from their customers but may purchase items under a resale exemption if they transfer care, custody and control of the items to their customers. In contrast, providers of non-taxable services must pay tax on all of their purchases, including items transferred, equipment and supplies.

Categories of Taxable Services Applicable to the Oilfield

Services are only subject to sales & use tax if they are included on the statute’s list of taxable services.⁵⁴ While the statute lists approximately twenty (20) services as taxable, generally, the following apply to the oilfield services industry data processing services; information services; repair, remodeling, maintenance and restoration of tangible personal property; real property repair and remodeling; real property services; and security services.

This course manual focuses only on those services which most commonly affect the oil & gas industry. Other taxable service categories exist and may apply to transactions conducted in the oilfield services; this manual only discuss the core taxable services on oilfield service provider will routinely encounter.⁵⁵

⁵² The official name is: The Texas Limited Sales, Excise and Use Tax and is found in Texas Tax Code §§151.001 et seq.

⁵³ See Texas Tax Code §§191.081 et seq.

⁵⁴ See Texas Tax Code §151.0101.

⁵⁵ The remaining taxable services include amusement, cable TV, debt collection, credit reporting, insurance services, internet access, motor vehicle parking and storage, security, personal services, telecommunications, and telephone answering.

Common Rules

The Texas tax code and applicable Comptroller rules provide common rules for most types of taxable services. We discuss them below and follow them with separate discussions of the individual categories of taxable services frequently found in the oilfield services industry.

Sales Price of Taxable Services. The total amount charged for a taxable service is subject to sales tax. This includes charges for labor, materials, overhead, transportation and profit, regardless of whether such charges are separately identified to the purchaser of the service.⁵⁶

Example

XYZ Machine Repair Company sends a repairman to fix ABC Company's machinery. XYZ charges \$100 per hour plus out-of-pocket travel. The entire charge, including travel costs, is subject to sales tax.



Property Used to Provide Services. A person performing either taxable or non-taxable services is the consumer of machinery, equipment, materials and supplies used in performing the service. As the consumer, the service provider owes sales tax on the sales price of the machinery, equipment, supplies, etc. used in the service.

Example

Triple A typing service performs taxable data processing services. It needs additional equipment, so it buys a used word processor. The sales tax laws treat Triple A as the consumer of the used word processor and it owes sales tax on the full purchase price.

Employee Services Excluded. The services performed by the business's own employees are not taxable.⁵⁷ The sales tax laws don't require taxpayers to determine the portion of time their employees spend performing taxable services and impute a value to the services to be taxed. The employee services exclusion also applies in the case of temporary help services.

Example

Quality Motel hires maids to clean rooms and handymen to make repairs. Both services are listed as taxable under the Tax Code. However, since employee labor

⁵⁶ Texas Tax Code §151.007(a).

⁵⁷ Texas Tax Code §151.057.

is exempt from the sales tax, Quality Motel does not owe sales tax on its employees' services.

Temporary Help. The taxable services provided by employees of a temporary help service⁵⁸ are not taxable if the temporary employees are hired to supplement the employer's existing work force, if the service is normally provided by the employer's own employees, all the supplies and equipment necessary are provided by the employer, and the temporary employees are supervised directly by the employer.⁵⁹

Example

Quality Motel contracts with "Made to Clean Company" to provide maid service for two weeks while the hotel's maids are on vacation. The contract cleaning service provided by "Made to Clean Company" is excluded from sales tax.

PEO Arrangements (formerly Leased Employees). A professional employer organization (formerly called "staff leasing company") hires a client company's employees and then leases them back to the client company. This arrangement relieves the client company of the paperwork burdens associated with maintaining personnel, including payroll and benefits.

Texas law exempts taxable services performed by covered employees if at least 75% of the assigned employees providing services under the professional employer organization were previously employees of the client company for a period of at least three months immediately before the start of the professional employer organization; none of the covered employees were employed previously by the company providing professional employer organization services under the contract unless the previous employment was through a shared employment relationship or by an entity that previously provided or currently provides taxable services to the client company; and a shared employment relationship exists between the client company and the professional employer organization as to the covered employees.⁶⁰ There are exceptions and special rules for companies that have been in business less than three months.



⁵⁸ The temporary employment service must meet the criteria set forth in Section 93.001 of the Labor Code (effective Sept. 1, 2001).

⁵⁹ Texas Tax Code §151.057.

⁶⁰ Texas Tax Code §151.057.

Mixed Services Problem. Generally, when a contract contains a single charge for both taxable services and non-taxable or exempt services or items, the total charge is taxable.

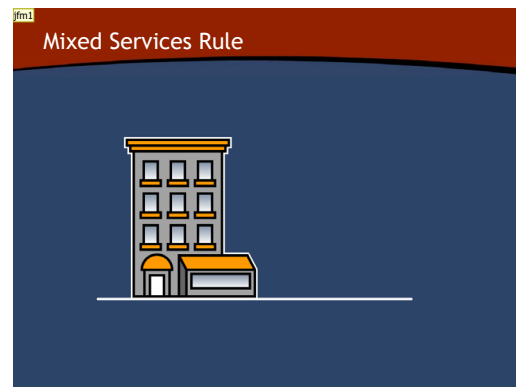
However, for certain specified services,⁶¹ if a nontaxable “unrelated” service and a taxable service are purchased for single charge and the portion of the fee relating to the taxable services represents more than five percent (5%) of the total charge, the entire fee is presumed to be taxable.⁶² A business may overcome this presumption by showing, through its books, a reasonable and proper allocation of its charges between the taxable and non-taxable portions of its charge. The business must also show that the non-taxable services are “unrelated.”

A service is unrelated if it is not a taxable service; it is a type of service which is commonly provided on a stand-alone basis; and the performance of the service is distinct and identifiable.

In *Chevron Pipeline Co. v. Strayhorn*,⁶³ a pipeline company purchased excavation and backfilling services in connection with the repair and recoating of its underground pipelines. The underground pipelines could not be recoated without excavating and backfilling and the pipeline company never contracted solely for excavation and backfilling services. The same contractor performed all the services. The court determined that these were not unrelated services because the performance of the service was not distinct and identifiable.

Example

A building is adding a new wing, connecting it with an archway to the old building. The service provider charges a single fee of \$100,000 to complete the work. If more than \$5,000 of the work is attributable to demolishing the old wall and adding the archway, the entire \$100,000 will be presumed taxable. It will then be up to the taxpayer to show a reasonable allocation to taxable/non-taxable portions based upon work sheets, bids or costs.



⁶¹ Only the services that became taxable after October 1, 1987 qualify.

⁶² Comptroller Rule §3.357(b)(3).

⁶³ *Chevron Pipeline Co. v. Strayhorn*, 212 S.W.3d 779 (Tex. App.—Austin 2006, pet. denied).

Note that if the portion of the charge relating to the nontaxable unrelated service is separately-stated, then only the taxable service is subject to tax. In general, the Comptroller allows this allocation for the services which became taxable after October 1, 1987.

Essence of the Transaction. Whenever a service provider's contract or invoices contain a single charge for providing both taxable and non-taxable services or when it encompasses both a non-taxable service and a taxable sale, the Texas courts examine it under the "essence of the transaction" doctrine. Under this doctrine, courts examine the intent or basic purpose of the parties entering into the transaction to determine its overall nature or "essence." If the parties intend to sell/buy a taxable service or tangible, personal property then the entire charge is taxable. The courts do not split the service or item into separate components and establish the separate taxability of each.

In *Williams and Lee Scouting Service, Inc. v. Calvert*,⁶⁴ the taxpayer sold oil well and field reports on computer tape to its customers. The court held the sale was for a non-taxable service and did not constitute the sale of tangible personal property (i.e., the computer tape). The "essence of the transaction" was the purchase of the information contained on the tape, and because information services were not yet taxable in Texas, the Court held that the transaction was, in essence, a non-taxable service.

In *Austin Engineering Co., Inc. v. Combs*,⁶⁵ the taxpayer provided erosion control services. The taxpayer installed silt fences and other erosion control devices as part of this service and charged a lump-sum fee for "erosion control improvements." The taxpayer argued that it provided non-taxable services. However, the Third Court of Appeals disagreed and found that the taxpayer made taxable sales of tangible personal property. The court reasoned that the "essence of the transaction" was that the customer wanted "erosion control on the construction site," which the erosion control devices themselves provided.

☞ **Important Note.** The "essence of the transaction" doctrine is an all-or-nothing rule of law. A charge is either completely taxable or it is completely non-taxable. Therefore, if a taxpayer is able to show that the basic purpose of the transaction is the performance of a non-taxable service, sales tax is not due even on the portions of the service which are admittedly taxable. This is true even if the charge is separately-stated.

Taxable Services and Items Transferred. Persons who provide taxable services may issue resale certificates for their materials, equipment or for subcontracted services only if the service provider transfers care, custody and control of the item to its customer.

⁶⁴ 452 S.W.2d 789 (Tex. Civ. App.—Austin 1970, writ. ref'd).

⁶⁵ No. 03-10-00323-CV, 2011 Tex. App. LEXIS 6122 (Tex. App.—Austin 2011, no pet.).

*Sharp v. Clearview Cable, Inc.*⁶⁶ Clearview installed equipment such as antennas, down converters and connecting wire outside the homes of its subscribers. Clearview had purchased the equipment tax-free under a resale exemption. The Comptroller challenged Clearview's right to the exemption for the outside equipment and loss. The appeals court held that Clearview was entitled to the resale exemption because it had transferred care, custody and control of the equipment to its subscribers.⁶⁷

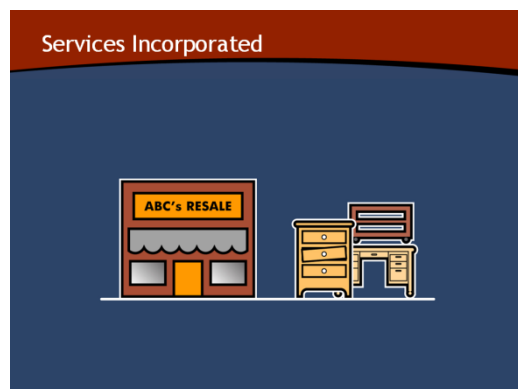
Reselling Services. A service provider's customer may issue a resale certificate for a taxable service only if the customer intends to transfer the service as an integral part of the taxable services it is providing to its customer. A service is an integral part of the taxable services provided only if it is essential to the performance of the taxable service and without which the taxable service would not be rendered.

Example

MLS Company provides information pertaining to the sales of homes to real estate brokers ("multiple listing services"). These services are taxable as information services. MLS Company hires a typing company on a contract basis to input data (home sales) into the database. MLS may issue a resale certificate to the typing company for the typing services.



Services Incorporated Into Taxable Property. A buyer may issue a resale certificate if the buyer intends to incorporate the entire taxable service into tangible personal property that will be resold.



Example

AB buys used furniture for resale. AB hires a repair company to restore and refinish the furniture before AB resells it. AB may issue a resale certificate to the repair company.

⁶⁶ 960 S.W.2d 424 (Tex. App.—Austin 1998, pet. denied).

⁶⁷ 960 S.W.2d 424 (Tex. App.—Austin 1998, pet. denied).

Services Performed on Exempt Personal Property. A service that is performed on tangible personal property that, if sold, leased or rented, at the time of the performance of the service, would be exempt from sales tax because of the nature of the property, its use, or a combination of both, is exempt from sales tax. Even if the item was not exempt when it was originally bought, if it qualifies as exempt when the taxable services are performed, then the taxable services are exempt.

Installation Labor. Installation is labor to place tangible personal property in position, without changing its form, where it will reasonably accomplish the purpose for which it was purchased. Charges for installation connected with the sale of tangible personal property are taxable.⁶⁸ However, the charge for installation, connected with the sale of tangible personal property that becomes a permanent improvement to realty, is taxable when it is part of the charge to repair or remodel nonresidential real property. The charges by a third party for installing an item sold by another person are not taxable.⁶⁹ Separately stated billings for supervising the installation of tangible personal property made by someone other than the seller of tangible personal property are not taxable.⁷⁰

Taxable Services Affecting Oilfield Service Providers

Data Processing Services

Taxable data processing services means the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information.⁷¹ This is a very broad and wide ranging definition, which the Comptroller has used to tax a variety of services when they are performed using a computer. Texas tax law exempts twenty percent (20%) of the charge for information services and data processing services.⁷²

Certain types of services that may arise in connection with oilfield services constitute taxable data processing, including computer aided drafting when the client provides specifications; data conversion services; information storage; producing reports from client's data.

Professional Services Exception. Data processing services do not include the use of a computer by a provider of other services when the computer is used to facilitate the performance of the service or the application of knowledge of accounting or law. This includes the use of a

⁶⁸ Texas Sales Tax Policy & Procedures Manual (Nov. 1993).

⁶⁹ Texas Sales Tax Policy & Procedures Manual (Nov. 1993).

⁷⁰ Texas Sales Tax Policy & Procedures Manual (Nov. 1993).

⁷¹ Comptroller Rule §3.330.

⁷² Texas Tax Code §151.351.

computer by a CPA firm, enrolled agent or bookkeeping firm to produce a financial report. It also does not include court reporting services whether provided as a paper transcript, audio or video tape or in a computer readable format. These types of services are not taxable under the data processing services rule: development of specifications for designs; evaluation of mineral deposits; forecasting; interpretation of client's data.

Information Services

Information services means furnishing general or specialized news or other current information, including financial information, unless furnished to a newspaper or to a radio or television station licensed by the FCC; or electronic data retrieval or research.⁷³

Taxable Information Service. This is information which is gathered, maintained, or compiled and made available by the provider of the information service to the public or to a specific segment of industry for a fee. In the oilfield services industry, these taxable services include scouting reports and surveys; news clipping services, wire services, and title abstracts.

Providing access to information (databases maintained by the seller of the service) on the Internet is a taxable information service. The information is taxed at the server location rate even though it may be downloaded anywhere in the country or around the world. Texas tax law exempts twenty percent (20%) of the charge for information services and data processing services.⁷⁴

Database subscription services, including scientific data libraries, constituted taxable information services.⁷⁵ Examples include scouting reports and surveys; title abstracts, providing access to information (databases maintained by the seller of the service) on the Internet. The Comptroller has taken the position that a service that provides information to the oil & gas industry regarding the availability of underground storage (such as salt dome reservoirs, abandoned salt mines and aquifers) is a taxable information service.⁷⁶ Similarly, taxable information services include the subscriptions by oil & gas producers to track market prices of fuel oil or other pertinent data.

Non-Taxable Information Services. This includes information which is gathered or compiled on behalf of a particular client if the information is of a proprietary nature and may not be sold to anyone else (i.e., opinion polls and management consultant reports); information derived from laboratory, medical or exploratory testing or experimentation or

⁷³ Comptroller Rule §3.342.

⁷⁴ Texas Tax Code §151.351.

⁷⁵ Comptroller Letter No. 200207275L (July 19, 2002).

⁷⁶ See Comptroller Letter No. 9604L1407D01 (April 3, 1996).

any similar method of direct scientific observation of physical phenomena (i.e., geological surveys and medical test results); information required to be furnished pursuant to the Open Records Act; and information furnished to a member of a homeowners' association by or on behalf of the association.

Texas tax law exempts twenty percent (20%) of the charge for information services and data processing services.⁷⁷

Telecommunication Services

These services are broadly defined as electronic transmission or reception of sounds, data and information and is not limited to current technology. Charges are subject to both state and local taxes and include basic service, installation and connection fees, call waiting, call forwarding, and mobile telephone services.⁷⁸

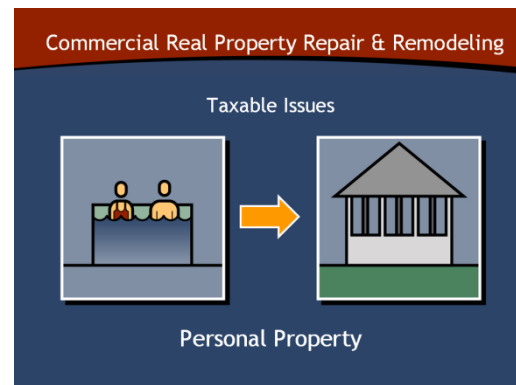
Oilfield Property: Personal v. Real Property

Before we turn to the rules for the core taxable services arising from the oil & gas well drilling process, we must first learn which types of oil & gas well property are treated as real property and personal property. While the charge for the repair of either is a taxable service, the distinction is critical to how the rules apply in a number of other contexts: maintenance, the classification of lease operating expenses, the classification of contracts between lump-sum and separated, and the exemptions that may apply, such as manufacturing.

Texas law defines real property as land including structures and other improvements embedded in or permanently affixed to the land. Texas law provides three factors which bear on the appropriate classification of real versus tangible personal property. The three factors are the mode and sufficiency of annexation to realty, the intent of the party who annexed the personal property to real property, and the intent of the parties.⁷⁹

Example

A hot tub is purchased and installed in a portable gazebo in a backyard. The portable nature of the gazebo may indicate an intent that the hot tub will be moved when the owner sells the house. This indicates that the hot tub is *personal* property.



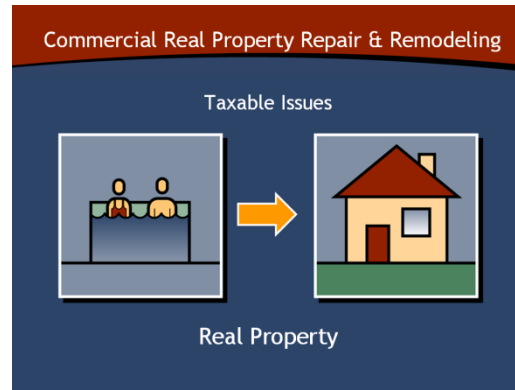
⁷⁷ Texas Tax Code §151.351.

⁷⁸ Comptroller Rule §3.344.

⁷⁹ *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); *O'Neal v. Quilter*, 245 S.W. 528, 529 (Tex. 1921).

Example

A hot tub is installed in a new addition to the house and is added to the new room as it is being built. Removing the hot tub would require tearing out one of the new walls. In this case, the hot tub is *real* property.



Modular Buildings. The Comptroller treats modular buildings as tangible personal property when the parties to the lease of the modular buildings agreed that the buildings were temporary and were to remain tangible personal property regardless of how they were installed or attached to the lessee's real property.⁸⁰

Real Property at the Oilfield Site. Over the years, the Comptroller has ruled on the classification of numerous types of property commonly used to drill for, produce and transport oil & gas. The Comptroller's policies treat the following items located at the oilfield site as real property: pump stations, booster stations; casing (in place); enhanced production-injection and recovery systems which cannot be moved intact (does not include equipment on lease or water well pump); storage facilities - tanks, standing alone or in batteries, each with a storage capacity of more than 500 barrels; vapor recovery systems; compressors at compressor stations other than leased compressors; production platforms with their supports permanently embedded in the sea bed; water disposal systems - same guidelines as storage facilities; gathering lines that are totally underground except for road or water crossings, and similar structures; and gas processing plants - not easily movable.

Real Property Not at the Oilfield Site. Similarly, the Comptroller has determined that other types of property not typically located at an oilfield site are appropriately classified as real property: roads other than board roads and board road turnarounds; pits (workover and reserve); underground storage facilities; pipeline transmission lines; machinery, equipment, and fixtures that are attached components of processing or manufacturing facilities. Items that are free-standing or which are bolted down but are readily removed without damage are classified as tangible, personal property; permanent lighting; and meters located on transmission lines/pipelines.

Tangible Personal Property at the Oilfield Site. The Comptroller has classified the following items located at the oilfield site as tangible personal property: Christmas trees, wellheads, well components, line heaters, wellhead/suction/vacuum compressors; storage facilities - tanks, standing alone or in batteries, that each have a storage capacity of five

⁸⁰ Comptroller Hearing No. 102,946 (2010).

hundred (500) barrels or less; separation and dehydration equipment; gathering lines that are totally above the ground or that have sections under water; flow lines that are above ground, below ground, partially above and below ground or under water; artificial lift equipment and their power source; the rig or production package attached to offshore platforms; electrical power systems that are easily removed; compressors that are easily moveable and located in the field (between the wellhead and booster stations); board roads and board turnaround areas; everything inside the casing of a well. (including, but not limited to, tubing, pipe, pumps, rods, gas-lift equipment, and packers inside the casing); meters at the lease site, well site, between the lease site and the transmission line/pipeline; meters located on or attached to flow lines or gathering lines including injection meters, volume meters, test meters, and LACT units; and microwave facilities.

Repairs to Personal Property

The charges for services to repair, restore, remodel, or maintain most tangible personal property are subject to Texas sales & use tax. This applies to all types of tangible, personal property except aircraft;⁸¹ water transportation vessels (except certain pleasure vessels); motor vehicles; and computer programs that are sold by someone other than the service provider (includes software development and modification).⁸²

The Texas tax code imposes the sales tax on the entire charge for materials, parts, labor, consumable supplies, equipment, and any charges connected to the repair, remodeling, restoration or maintenance service.

Charges for repairing items that if purchased today would be exempt from tax are also exempt.

Example

Mr. Smith purchases a hot tub from ABC Hot Tub Dealer under a medical prescription. If the exemption is properly claimed, repairs to the hot tub are also exempt.

Environmental Repairs. Texas law exempts labor charges (not materials) for repairing, remodeling, maintaining, or restoring tangible personal property if required by state or federal law in order to protect the environment or conserve energy.⁸³ Labor charges for

⁸¹ Comptroller Rule §3.292. The Comptroller requires contractors who remodel aircraft under lump-sum service contracts to pay sales tax on the purchase price of materials incorporated into the aircraft. The Comptroller's position is that the contractor may not charge sales tax to the customer, even if the customer is a dealer who is remodeling the aircraft for resale. See Comptroller Letter No. 200208398L (Aug. 30, 2002).

⁸² Comptroller Rule §3.292.

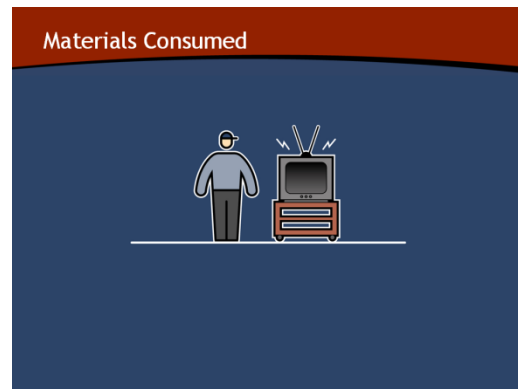
⁸³ Texas Tax Code §151.338.

these exempt repairs must be separately stated from any charges for non-exempt repairs and materials.⁸⁴

Materials Consumed During the Repairs. A service provider may purchase for resale materials that will be transferred to the care, custody and control of the customer. However, a service provider must pay sales tax on his purchases of supplies, tools, machinery and equipment that are purchased for use in performing the repair and are not transferred to the customer.

Example

A TV repair person services a broken television set. In the course of repairing the set, the repair person must purchase a new electronic transistor, a soldering gun and some solder. The repair person may purchase the transistor from his or her supplier tax-free by issuing a resale certificate. The care, custody and



control of the part will be transferred to the customer at the time of the repair. On the other hand, the repair person may not purchase the solder or the soldering gun tax free. The gun will be retained by the repair person. The solder itself (although the care, custody and control of it may technically be transferred to the customer) will be *consumed* during the repair and will not be in any usable condition separate and apart from the repair. The customer will owe sales tax on the entire charge for the parts and labor.

Warranties. Whether or not sales tax is due depends on the type of warranty. No tax is due on parts or labor furnished by the manufacturer to repair tangible personal property under a manufacturer's warranty. The rationale is that the consumer already paid sales tax on the manufacturer's warranty as a component of the item's sales price. The definition of "sale" or "purchase" includes charges for extended warranties or service contracts for the performance of a taxable service.⁸⁵ This is based on the premise that extended warranties are essentially pre-payments for taxable repairs to tangible personal property.

Sales tax is due on the sale of an extended warranty, service contract or service policy. The repairperson performing the service must collect tax on any charge to the owner for labor

⁸⁴ Comptroller Letter No. 201009943L (Sept. 21, 2010).

⁸⁵ Texas Tax Code §151.001(3).

or parts not covered by the extended warranty. The repairman may issue a resale certificate when purchasing the parts.

Oilfield Equipment Repairs. Generally, the full charge for repairing or maintaining equipment used in the drilling, completion and workover of oil wells is subject to the general sales and use tax. However, if the equipment qualifies as a motor vehicle, then the labor charge is not taxable, regardless of whether the repair is a lump-sum contract or a separated repair contract.⁸⁶ This also includes the repairs to component parts of motor vehicles, and motor vehicle accessories.⁸⁷

However, this exception only applies if the item repaired qualifies as a “motor vehicle”.⁸⁸ Whether equipment qualifies is a case-by-case determination. The definition of “motor vehicle” includes self-propelled vehicles that transport persons or property on public highways, as well as trailers. The taxability of repairs of items attached or integrated onto a motor vehicle depends on when the items were attached to the vehicle, how they are integrated into the vehicle, how the items affect the vehicle’s functionality, and the taxpayer’s primary purpose for the vehicle’s use.

A “component” of a motor vehicle means an item that is necessary for the vehicle to operate properly (e.g. tires, vehicle battery, or brakes). The taxability of repairs to component parts depends on how the repairs are performed. For the repair labor to be nontaxable, the item removed and repaired from the vehicle must be reinstalled on the vehicle. If a different component is used to replace the damaged component on the vehicle- whether new or used- the labor charge constitutes a taxable repair of tangible property.

For example, a tire is removed from a vehicle to be retreaded. The repairman replaces the tire with a used, repaired tire from his inventory, and adds the damaged tire to his inventory to later repair and place on a different vehicle. This is a taxable repair because the tire was not replaced on the *same vehicle* from which it was removed.⁸⁹

⁸⁶ See Comptroller Rule §3.290(g)(1) and (h)(2).

⁸⁷ See Comptroller Rule §3.290(b)(2).

⁸⁸ Tex. Tax Code §152.001(3).

⁸⁹ Comptroller Hearing No. 33,003 (Oct. 29, 1999).

Charges for equipment attached to the motor vehicle are subject to the general sales and use tax as tangible personal property.⁹⁰ Examples include cargo being transported to work sites (e.g. oil derricks, cherry pickers, or a hydromulcher attached to a cab chassis). Although these items of cargo may serve a significant purpose in the taxpayer's business, they are not integral to the vehicle's functionality.



Motor vehicle accessories consist of “nonessential” items for convenience or comfort; the vehicle can function properly with or without these items.⁹¹ If the equipment's purpose is to assist the taxpayer in transportation/ loading/ or unloading of other property, then the item is an “accessory,” rather than a component part of the vehicle. If the item has the capability of carrying a divisible load, then the court is more likely to find that it is taxed under the motor vehicle sales tax rules. However, if the purpose of the item is to assist the taxpayer in performing a task, then the item is more likely an “accessory.” For example, vacuum tanks mounted on a truck that are used to transport liquid waste to unloading sites are nontaxable motor vehicle accessories as long as the sole purpose of the tank is to transport liquid.⁹² However, a vacuum machine used for carpet cleaning is an attachment, because the primary purpose of the item is to clean carpets, not merely to transport the water used in the cleaning process.⁹³ In this case, it does not matter if the vacuum machine is fully integrated into the van, and the van would not be functional if the vacuum machine was disassembled, because the items shared a battery source. A second consideration is whether the modifications made to the vehicle (i.e., the accessories attached) have modified the vehicle to the point that it becomes moveable specialized equipment, rather than a vehicle with an attached accessory.

⁹⁰ Comptroller Rule §3.290(a)(5).

⁹¹ Comptroller Rule §3.290(a)(1).

⁹² Comptroller Letter No. 8101T0199D11 (Jan. 28, 1981).

⁹³ Comptroller Hearing 46,782 (Oct. 13, 2006).

Moveable specialized equipment is a unit of equipment designed and built specifically to perform a specialized function, which does not include transporting property separate from itself or persons other than the driver is not a motor vehicle.⁹⁴ Repairs to these items are taxable as tangible personal property; they are not considered a “component” of the motor vehicle. This category differs from equipment attachments in that the items are not merely cargo, but are fully integrated into the vehicle. Motorized cranes, motorized oil well servicing units, and mobile auto crushers are listed as movable specialized equipment by the Comptroller. Other examples of moveable specialized equipment include “frac tanks” on a specialized trailer, carnival rides installed on a trailer where the vehicle was modified specifically for the purpose of transporting and operating the rides, and portable MRI equipment.⁹⁵ These items were held to perform a highly specialized function, and do not qualify as “motor vehicles” on their own. The timing of the installation of the equipment also matters in this analysis. For example, a 1997 policy letter specifies that “[t]he MRI equipment is a motor vehicle if the equipment was attached to a trailer (a motor vehicle) rather than built from the ground up. If the MRI equipment was built from the ground up, it is moveable specialized equipment subject to limited sales tax.”⁹⁶ Although the issue in this analysis was whether the purchase of the item was subject to motor vehicle tax versus sales tax, rather than whether repairs to the item were taxable, the classification issue remains the same.



Haul trucks and other general-purpose trucks are classified as motor vehicles and any repairs to these trucks will be nontaxable. Forklifts, tractors with backhoes and loaders don’t qualify as motor vehicles and therefore the full charges to repair them (labor and materials) is taxable.⁹⁷

Non-Taxable New Construction Services

The charge for the service of new construction is not taxable. New construction is defined as all new improvements to real property including initial finish out work to the interior or

⁹⁴ Comptroller Rule §3.290(a)(12).

⁹⁵ Comptroller Hearing No. 44,148 (June 9, 2006 (aff’d on rehearing, Sept. 11, 2006)); Comptroller Hearing No. 42,326 (Apr. 12, 2006.)

⁹⁶ Comptroller Letter No. 9707599L (July 22, 1997).

⁹⁷ Comptroller Letter Nos. 200604602H (Nov. 4, 2005); 2002209467L (Sept. 25, 2002); 8503L0651C01 (March 1, 1985).

exterior of the improvement that has never been occupied for any reason. New construction is also the addition of new footage to an existing structure.

As a general rule, the Comptroller's policy holds that if a project adds additional footage to the real property, it is new construction. The footage does not have to be *useable* footage or even *square* footage. In one case, the Comptroller determined that the addition of a building facade added "footage" because it extended the front of the building a few inches out from the existing wall.

Also, the Comptroller's Office has ruled in private letters and in hearings that adding a second floor to a one-story building without raising the roof of the first floor is new construction.



Example

An office building adds a new wing adjacent to and connected to its old building. The project involves laying a foundation for the new wing and constructing the wing itself. A wall in the old building is knocked out and replaced with an archway to provide access to the new wing. While the new wing is clearly non-taxable new construction, the work associated with demolishing the old wall and replacing it with an archway are considered taxable repair and remodeling. The total charge would be apportioned accordingly.

Example

A pipeline services company is replacing a section of a large utility pipeline. In the first part of the job, the company shuts down the pipeline, excavates the old portion, and replaces the section of pipe before putting the line back in service. In the second part of the job, the company leaves the pipeline in service and constructs the new section in a separate ditch alongside the old line. When completed, the pipeline is shut down, the old line cut out, and the new line welded in. The pipeline is then restarted and the old section of pipe removed from the old ditch. Since pipelines are usually considered real property, the first part of the job clearly involves taxable repair and remodeling of real property. However, the Comptroller has held that the second part of the job constitutes non-taxable new construction except for the excavation of the old line and the connection of the new line into the pipeline.

☞ **Caution:** A Comptroller hearing decision determined that replacing an oil & gas storage tank's floating roof with a new cone roof was not new construction even though it added cubic footage to the tank.⁹⁸

Materials Incorporated Into Construction Projects

The taxability of materials that are transferred to customers (i.e. incorporated in the real property being constructed) in connection with non-taxable services, such as new construction services, depends upon the type of contract. There are two types: lump-sum and separated.

Lump-Sum Contracts. If new construction is performed under a lump-sum contract, the contractor is considered the consumer of materials used in performing the contract and the contractor must pay tax when he buys them. The contractor may not legally charge the customer the tax, although presumably, it would be included in the contractor's fee. Lump-sum contracts do not break out charges for materials and labor. Instead, these types of contracts state a single charge for both of these items. If the contractor instead performs new construction services under a separated contract, the contractor may issue a resale certificate for the materials. The charge for materials (including the mark-up) is taxable to the contractor's customer.

Separated Contract. Separated contracts show a separate charge for the labor and the materials on a construction job. If the construction is pursuant to a separated contract, the property owner rather than the contractor is considered the consumer and must pay tax on the materials purchased for construction. The contractor is responsible for collecting the tax from its customer (usually the property owner) and remitting it to the State.

Repairs to Real Property

Labor charges incurred for commercial real property repair, remodeling and restoration is a taxable service.⁹⁹ Remodeling is making over, rebuilding, replacing, or upgrading existing real property. Repair means "to mend or bring back as near as can be to its original working order real property which was broken, damaged or defective." Restoration is an activity performed to bring back as near as can be to its original condition real property which is still operating and functional but that has faded, declined or deteriorated. As we discussed above, the charge for "new



⁹⁸ Comptroller Hearing No. 38,069 (1999).

⁹⁹ Comptroller Rule §3.357.

construction,” as contrasted with the charge for labor to “repair and remodel,” is not a taxable service.

Maintenance Contrasted. “Maintenance” of real property is not considered repair, restoration or remodeling of real property. Again, the distinctions can be very slight. Maintenance is defined as the scheduled, periodic work necessary to sustain or support safe, efficient, continuous operations or to prevent the decline, failure, lapse or deterioration of the improvement. The key element is “scheduled and periodic.” The maintenance work must be contemplated and scheduled prior to the need for the work. As a rule of thumb, if work is done after the property has failed, it is considered repair. If you are working on it to prevent failure, it is probably maintenance.

Example

An elevator company signs a maintenance contract with a building owner to periodically inspect and maintain the building’s elevator and to repair it if it ever breaks down. The inspections are included in the maintenance contract price. However, major repairs are billed as needed. The fee for the maintenance contract is scheduled and periodic maintenance of real property, and hence not taxable. Although the inspections may necessitate minor repairs, this does not rob the contract of its maintenance status. However, once the company charges the building owner for a major repair after the elevator breaks down, it has performed services outside maintenance unless such fees were included and contemplated by the original contract.

Example

The Comptroller determined that railroad tie replacement services were real property repairs and not scheduled and periodic maintenance because, although the rail line regularly scheduled inspections of track segments, they only replaced the defective and damaged ties.¹⁰⁰

Materials Incorporated into Construction Projects. Unless an exemption applies, materials incorporated into the repair and remodeling of commercial real property are taxable to the owner. It does not matter if the contract is lump-sum or separated.

¹⁰⁰ Comptroller Hearing No. 41,840 (2003).

Real Property Services

This is a different category from real property repairs. The tax on real property services applies to both commercial and residential services. Contrast this with the tax on real property repairs which applies only to non-residential services. The taxable real property services are:



Garbage Collection. While waste removal is a taxable service, Texas exempts fees paid for the removal of industrial solid waste from sales tax. Industrial solid waste includes the solid waste resulting from or incidental to a process of industry, manufacturing, mining or agricultural operations.¹⁰¹ Texas also exempts fees paid for the removal of hazardous waste from sales tax.¹⁰²

Industrial Solid Waste. By rule, the Comptroller provides that those claiming the exemption for sales & use tax for charges for removal of industrial solid waste “may use any reasonable allocation” between waste subject to tax and exempt industrial solid waste that “is supportable by books and records.”¹⁰³ The Comptroller interprets this rule to require a contemporaneous, precise, objective record. The Third Court of Appeals upheld this interpretation in *Southern Plastics, Inc. v. Combs*.¹⁰⁴ In its decision, the Third Court of Appeals cited a Comptroller letter stating that taxpayers who generate industrial solid waste could use their knowledge of their business processes to create this record by “identifying and documenting in writing those processes that produce the various types and amounts of wastes.”¹⁰⁵ For example, a manufacturer who determines that it generates 100 pounds of office waste per week, 100 pounds of packaging waste per week, and 200 pounds of industrial solid waste from manufacturing each week could show that 50 percent of its waste is exempt industrial solid waste. The Comptroller states that the taxpayer could further support this record with photographs showing the volumes of types of waste it generates.¹⁰⁶

¹⁰¹ Texas Health and Safety Code, Ch. 361.

¹⁰² Texas Tax Code §151.0048(a)(3)(C).

¹⁰³ Comptroller Rule §3.356(h).

¹⁰⁴ No. 03-08-00149-CV, 2009 Tex. App. LEXIS 5107 (Tex. App.–Austin 2009, no pet.).

¹⁰⁵ No. 03-08-00149-CV, 2009 Tex. App. LEXIS 5107 (Tex. App.–Austin 2009, no pet.) (citing Comptroller Letter No. 200104170L).

¹⁰⁶ No. 03-08-00149-CV, 2009 Tex. App. LEXIS 5107 (Tex. App.–Austin 2009, no pet.) (citing Comptroller Letter No. 200104170L).

Oil Spill Cleanup. The taxability of oil spill cleanup services generally depends on the location where the service is performed.¹⁰⁷ Oil spill cleanup services are taxable if performed at a plant or on land not at the well site but are not taxable if performed at the well site. In Comptroller hearing no. 100,619, the comptroller held that the taxpayer in the petroleum and natural gas production business wasn't due a refund of taxes paid on oil spill cleanup services because the taxpayer provided no evidence showing where the service was performed.

Landscaping. This is the activity of arranging and modifying areas of land, natural scenery and other areas, such as indoor or outdoor patios, for aesthetic effect. Landscaping does not include the addition of sprinkler systems, retaining walls, ponds, pools or fences.¹⁰⁸

Erosion Control Services. The Comptroller takes the position that various erosion control services performed in connection with commercial new construction are taxable landscaping or the taxable rental of tangible personal property. For example, the Comptroller has ruled that payments for silt fencing used in erosion control projects are taxable rentals of tangible personal property, even though the silt fencing is either discarded or remains with and becomes part of the land.¹⁰⁹

Lawn and Yard Maintenance. This category includes mowing, trimming, fertilizing, watering and any other treatment or service which may be performed on private or commercial yards or lawns. It includes maintenance of trees and plants whether inside or outside a building. The term does not include activities such as clearing land for buildings, power line rights-of-way, pipeline rights-of-way, or maintenance on land belonging to a governmental entity when the service is required by the governmental entity.¹¹⁰

Grounds Cleaning. Residential or nonresidential building or grounds cleaning, janitorial or custodial services.¹¹¹ Cleaning, janitorial and custodial services may cover services that might otherwise be characterized as non-taxable real property maintenance, such as light bulb replacement and other minor repairs. However, they would not include major repairs or alterations, such as room painting or wallpapering.

According to the Comptroller, taxable cleaning, janitorial, and custodial services do not include power washing and similar cleaning services when performed on improvements to realty other than a building (or its components), building grounds, and parking lots. The Comptroller subjects these services to sales tax only when performed by the same person in

¹⁰⁷ Comptroller Hearing No. 100,619 (2009).

¹⁰⁸ Comptroller Rule §3.356(a)(4).

¹⁰⁹ Comptroller Letter No. 200309150L (Sept. 18, 2003).

¹¹⁰ Comptroller Rule §3.356(a)(5).

¹¹¹ Comptroller Rule §3.356.

connection with another taxable service, such as painting or making repairs to the property.¹¹²

Construction Site Clean-Up. A contractor may issue a resale certificate in lieu of paying tax on charges for the final clean-up of a construction site. The Comptroller considers this a service resold to the customer. Contractors must collect tax from their customers on charges for this service. However, a contractor must pay sales tax on charges for the daily clean-up of a construction site, because the Comptroller considers the contractor the consumer of this service.¹¹³

Pest Control Services. Pest control services are subject to sales & use tax unless they are performed under a license issued by the Texas Department of Agriculture.¹¹⁴ This includes identifying, preventing, controlling, or eliminating the infestation insects, spiders, mites, ticks, ants, bees, and other related pests, wood infesting organisms, rodents, weeds, nuisance birds, or any other obnoxious or undesirable animals which may infest households, railroad cars, ships, docks, trucks, airplanes or other structures or their contents; pests or diseases of trees, shrubs or other plantings in a park or adjacent to a residence, business establishment, industrial plant, institutional building, or street; and related activities, such as inspection or evaluation concerning the nature or extent of an infestation; reports; or performance of services to control pest or insect infestation. The charge for the service is taxable whether chemicals or mechanical devices are used.¹¹⁵

Surveying. For surveying services, the issue of taxability generally turns on boundaries. Taxable services include those performed to determine or confirm the real property boundaries, or to determine or confirm the location of structures or other improvements in relation to the boundaries of the property.¹¹⁶ The service involves the use of relevant elements of law, research, measurement, analysis, computation, mapping and land description. Taxable surveying includes boundary recovery, residential surveying, lot surveying, title surveying, as-built title surveying, and right-of-way surveying. As it pertains to the oil and gas industry, the following surveys are not taxable:

- Existing oil, gas, or oil and gas well surveys to gather the locations of existing oil or gas wells in relation to the location of proposed wells.¹¹⁷

¹¹² Comptroller Letter No. 200712999L (December 6, 2007).

¹¹³ Comptroller Letter No. 200602552L (February 16, 2006).

¹¹⁴ Comptroller Letter No. 200602552L (February 16, 2006).

¹¹⁵ Comptroller Rule §3.356(a)(8).

¹¹⁶ Comptroller Rule §3.276.

¹¹⁷ Comptroller Rule §3.276(c)(4).

- Oil or gas drilling unit, proration unit, and pooled unit plats. A drilling unit, proration unit, or pooled unit plat submitted to the Railroad Commission.¹¹⁸
- Seismic survey. A survey to determine the subterranean composition and structure in an area, generally by using a vibroseis or small explosives to measure vibrations.¹¹⁹
- Topographic survey. A survey to determine the configuration, relief, or elevations of a portion of the earth's surface, including the location of natural features.¹²⁰

¹¹⁸ Comptroller Rule §3.276(c)(8).

¹¹⁹ Comptroller Rule §3.276(c)(9).

¹²⁰ Comptroller Rule §3.276(c)(10).

Chapter III. Well Servicing Tax

After an oil or gas well is drilled, the operator must usually test and log the well to determine if a formation will produce oil or gas. If so, the operator must evaluate the potential of the pay zone. Once the operator determines that the formation is productive, the drilling is completed and the casing set. If the well has sufficient natural drive, it will begin flowing freely. If not, some form of well stimulation may be needed to start production.

Texas law imposes an occupation tax, commonly-known as the “well servicing tax”, on anyone in the business of providing certain well services, and who either owns, controls, or furnishes the tools, instruments, and equipment used in providing well service; or uses any chemical, electrical, or mechanical process in providing service at any oil or gas well during the drilling and completion, or reworking or reconditioning, of the oil or gas well.¹²¹

The oil & gas well servicing tax applies after a site has been developed and a hole has been drilled. The services that are classified as taxable under the oil & gas well servicing tax are those generally designed to stimulate production of an oil or gas well. It’s important to distinguish which services are subject to Texas sales & use tax, which ones are subject to oil & gas well servicing tax, and which ones are nontaxable.

Categories of Taxable Services

The services that are subject to the well servicing tax are limited to surveying or testing the formation; cementing the casing seat; shooting the formation; fracking the formation; acidizing the formation.

Tax Rate

The tax is imposed at the rate of 2.42% of fees for taxable services. Reports are due monthly on the 20th day of the month following the end of each calendar month. The well servicing provider does not collect the tax from its customers but pays the tax based on its receipts from well services provided for consideration.

¹²¹ Texas Tax Code §§191.081 *et seq.*

Example

Well Servicing Company (“WSC”) provides cementing, shooting, fracking, acidizing, and surveying services to the oil & gas industry. WSC must pay the well servicing tax on the fees it receives for its services. Unlike the sales tax, WSC may not collect the well service tax from its customers but must pay the well servicing tax on the gross amount received for the service after deducting the reasonable value at the well of material used, consumed, expended in or incorporated in the well. WSC may pass the cost along to its customers; however, if it does, the reimbursements are considered part of the taxable well service fee receipts.¹²²

Example

WSC also has a division which operates wells for various oil & gas companies. WSC and the well operating division are part of the same legal entity. Sometimes the well operating division will become a partner in an oil or gas well and WSC will issue an inter-company invoice, for accounting purposes, to document the inter-company transaction. In this case, WSC is not required to pay the well servicing tax because it is providing services for itself – it is not providing well services to third parties for consideration.¹²³

Non-Taxable Services

In connection with the services provided by a well-servicing company, there are charges which are NOT subject to the well servicing tax. The nontaxable charges include: the value of material used, consumed, expended in or incorporated into the well during the performance of a service subject to the well servicing tax. If the charge for the service is not separately stated, the value must be determined and deducted from the total amount to arrive at the amount of the service charge subject to the well servicing tax. In determining the value of the material, all reasonable or necessary elements of the value of the materials should be considered, including the cost of the materials, transportation, handling, profit on the sale, overhead, and similar items.

Also, charges for "waiting time" or "stand-by time" is not subject to the well servicing tax since no service is being performed. “Waiting time” is the period of time when a piece of service equipment (pump, lines, or tanks) is connected to other service equipment during a cementing, acidizing, or fracking job, but not put to immediate use. “Stand-by time” is the period of time when a piece of service equipment is at the well but is neither used nor

¹²² See Comptroller Letter No. 200106297L (June 19, 2001).

¹²³ See Comptroller Letter No. 200106297L (June 19, 2001).

connected to other service equipment. This may be before the service begins or during the time when no service is being performed due to causes beyond the control of the service company; Charges for computer analysis of cementing, fracking, acidizing, surveying or testing when performed at a location other than the well is not subject to the well servicing tax. However, the use of a computer or computer terminal at the well site will constitute a service performed in or at the well and thus subject to the well servicing tax.

A temperature survey to determine the results obtained in cementing a casing seat are not subject to the well servicing tax unless performed in connection with a service subject to the well servicing tax.

An addition, the following services are not subject to the well servicing tax: perforating and the taking of cores and cuttings; services performed in converting an oil or gas well into an injection well; receipts for equipment taken to a well but not connected in any way to the well or other equipment; tax reimbursement equal to that actually paid for sales or use tax on materials and supplies; receipts for frac tank services; receipts for reasonable mileage charges; receipts for services performed before or after a service has been commenced or completed; a dip recording survey made for the purpose of determining where to drill subsequent wells, when not made in connection with the drilling and completion of the well in which it is made; gas-oil ratio tests and cementing of the conductor pipe and surface casing.

Tax Reimbursement

Most well servicing companies bill their customers a tax reimbursement for the well servicing tax. Since the well servicing tax is imposed on the person performing the service, and not on the customer, this tax reimbursement becomes a part of the taxpayer's gross receipts subject to the well servicing tax.¹²⁴

¹²⁴ See Attorney General Opinion MS-172.

Resale Exemption

Taxpayers have sought the resale exemption under Texas Supreme Court precedent established in *Combs v. Roark Amusement & Vending* for sales tax paid on the purchase of proppants and other chemicals used to provide oil well services, such as fracking and acidizing.¹²⁵ A 2019 law,¹²⁶ if upheld by the courts, overturns the Texas Supreme Court's opinion in *Roark Amusement & Vending*.

In *Roark*, the court held that the resale exemption applies to purchases of taxable items resold as an integral part of a taxable service, even if the service is not actually taxed under the Texas Sales Tax.¹²⁷ Thus, the Texas Supreme Court determined that Roark was entitled to purchase tax-free plush toys that it later transferred as an integral part of its taxable amusement service (claw machines played by children), despite the fact that this amusement service was not actually taxed under the Texas Tax Code due to an exemption for coin-operated machines.

Similarly, taxpayers have sought the Texas sales tax resale exemption for proppants and chemicals used to provide oil well services, like fracking and acidizing. The new law amends the definition of a resale to expressly exclude “the sale of tangible personal property to a purchaser who acquires the property for the purpose of using, consuming, or expending it in, or incorporating it into, an oil or gas well in the performance of an oil well service taxable under Chapter 191.”

¹²⁵ Cudd Pumping Services, Inc. v. Hegar, No. D-1-GN-19-008478 (Travis County Dist. Ct. 2019)

¹²⁶ S.B. 1525, 86th Leg., R.S. (Tx. 2019).

¹²⁷ *Combs v. Roark Amusement & Vending, L.P.*, 422 S.W.3d 632 (Tex. 2013).

Chapter IV. Taxing the Oilfield Services Industry

In this chapter, we review from beginning to end the various phases of the oil well process and discuss how the Texas sales & use tax and well services tax rules apply to the activities within each of the phases.

Determining Where to Drill

Oil & gas companies identify areas of interest for exploring for oil & gas. Besides simply following where the competition goes, there are two general processes for determining where to drill.

Geological Research

The geologist uses a variety of information to prepare maps of underground formations that may hold producible quantities of oil & gas. First, he or she may review “well logs” that have been collected over time in the area of interest. In many states, the geological information from well logs becomes public information after a certain period of time. The geologist will map both active and abandoned wells in order to establish the areas where leases are not available. By implication, the remainder will constitute the portions of the areas of interest that aren’t yet leased up.

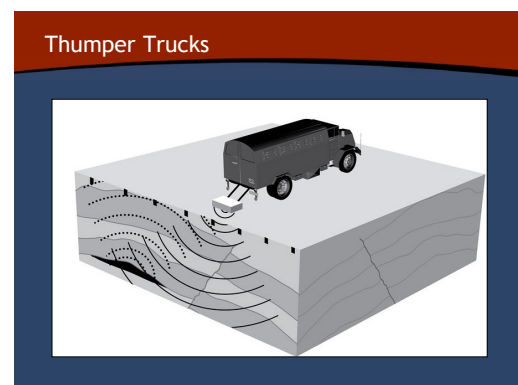
An independent geologist may do the work for a fee or for an overriding royalty interest in any oil & gas produced from the area.

Geophysical Research

If the area of interest does not have a sufficient number of wells drilled to provide well log data, the geologist may decide to “shoot seismic” across the area of interest. Seismic is shot by creating sound waves that penetrate the underground and bounce back, where they are read by instruments and the resulting information is recorded in a log. In addition to showing indications of the presence of oil, the seismic waves will also show the different layers and types of rock as well as any faults or other anomalies that the drilling company should know about.

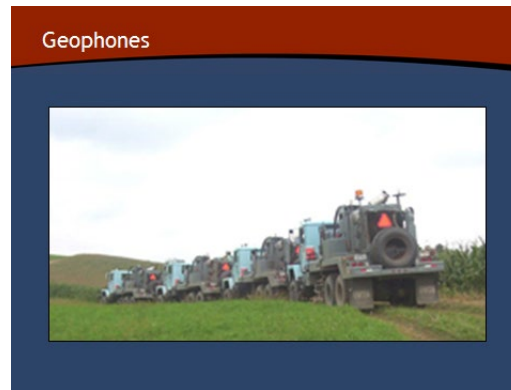
Thumper Trucks

Specialized trucks, called Thumper Trucks, may be used to create the sound waves. These trucks contain a large, heavy “foot” which, when activated, falls to ground, creating a concussion and resulting waves that penetrate the ground.



Geophones

These are the devices that receive the sound waves as they bounce off of the various underground formations that they encounter as they travel through the earth.



Surface Maps

Oil & gas producers use surface maps to establish well locations, determine land ownership, determine who owns the mineral rights, and to accurately plot property lines and boundaries. Drill rigs are very large pieces of equipment. They require substantial support equipment, supplies, and access roads. As a result, the area needed for drilling well may easily exceed forty (40) acres. Leasing surface rights from private land owners is required to establish a drill site.

Ownership Rights. An accurate surface map also helps determine the identity of the owners of the land above the oil & gas formations and who owns the minerals beneath the surface. The owners may be different. Producers must know this before they can proceed with their drilling plans. In any event, the producer needs permission to conduct operations from both the surface owner and the mineral owner. A landman is used to obtain that permission. The landman's job, in part, is to find the owners of both the surface and minerals.

Texas Sales & Use Tax Consequences

The Texas sales & use tax consequences vary depending upon the nature of the transaction. Certain items are taxable as the sale of tangible personal property. Others are taxed as information services, which are subject to a 20% statutory exemption.

Surface Maps. The sale of a map constitutes the sale of tangible personal property.¹²⁸

Oil & Gas Well Data Subscription Services. Generally, providing access to information, such as databases maintained by the seller of the service, constitutes a taxable information service.¹²⁹ Thus, subscription services that are statistical in nature and merely record data or facts about the scientific process, which data do not contribute directly to the purpose of the exploratory testing, are taxable.¹³⁰

¹²⁸ Comptroller Letter No. 201108234L (August 18, 2011).

¹²⁹ Comptroller Letter No. 201108234L (August 18, 2011).

¹³⁰ Comptroller Letter No. 8902L0945B09 (February 9, 1989).

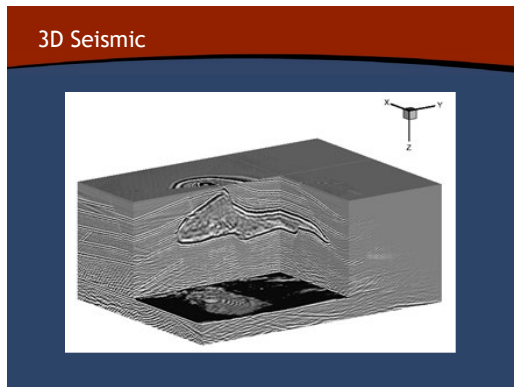
Example

Well Data Company owns a database of maps, well production data and well logs, specific to the oil & gas industry, for use by oil & gas professionals, who pay a monthly membership fee for access to the data. Well Data Company offers a monthly subscription service called: Well Completion Reports. The reports provide information about the number and names of the wells, the well locations, lease and land ownership information, completion dates, name and depth of reservoirs, casing and cementing records, perforation data and county/state boundaries. The monthly database fee constitutes a taxable information service.¹³¹

Example

Underground Storage Data Services is a service which provides information to the oil & gas industry regarding the availability of underground storage (such as salt dome reservoirs, abandoned salt mines and aquifers). Fees charged for the information area taxable information service.¹³²

Geophysical/Geological Surveys. Charges for information derived from exploratory



testing or any similar method of direct scientific observation of physical phenomena are not taxable.¹³³ In the oil & gas industry, exploratory testing includes serial surveying, geological studies, geophysical surveying, coring, and drilling of wildcat wells.¹³⁴

Both the sale of geophysical/geological surveys and subscription services to them and qualify for exemption if they were derived from exploratory testing. This includes charges the following, even if found in the public domain: borehole logs, paleo lithologic maps, core analysis, electrical well logs, subsurface maps, elevation maps, seismic surveys and remote sensing surveys.¹³⁵

However, if the subscription service is only statistical in nature and records data or facts about the scientific process, which data do not contribute directly to the purpose of the

¹³¹ Comptroller Letter No. 8902L0945B09 (February 9, 1989).

¹³² Comptroller Letter No. 9604L1407D01 (April 3, 1996).

¹³³ Comptroller Rule §3.342(d)(2).

¹³⁴ Comptroller Letter No. 8902L0945B09 (February 9, 1989).

¹³⁵ Comptroller Letter No. 8902L0945B09 (February 9, 1989).

exploratory testing or experimentation, then the resulting subscription services would be taxable.¹³⁶

Acquiring the Oilfield Leases

The producer needs to secure both the surface and mineral rights before any work can commence.

Surface rights

Surface ownership issues generally revolve around a short-term lease arrangement that allows the production company access to private property for the purpose of drilling the well. Payments are made to the property owner for user privileges, loss of crops by the property owner, use of water, rights of way for roads and pipelines, and for damages to the land and surrounding property. Production companies may also be required to install, at their cost, cattle guards, fences, and other specified items. This is spelled out in an agreement that is signed by both the property owner and the production company.

Mineral Ownership

Mineral ownership refers to the owner of the minerals under the surface, in this case oil & gas. The original land-owner may have sold a portion of the mineral rights to someone, given some to heirs who may have split up their interest, and retained a portion. Transfers of mineral ownership are accomplished by a legal instrument called a mineral deed. An owner of mineral rights without surface rights has no legal right to enter private property or to drill on it.

A mineral lease is a legal document; it conveys to the lessee from the mineral owner, who is called the lessor, the right to drill for and produce hydrocarbons. Leases are written to cover a specific period of time called the “primary term” generally for two (2), three (3), or five (5) years. Upon signing the lease, the land/mineral owner grants the production company certain subordinate rights.

The owner of the mineral rights, by signing the lease, can receive a bonus payment, agreed upon, for signing the lease; delay rentals if drilling is delayed or the well is shut-in for any length of time; and royalties which are expressed as a fraction of total production. Royalties are negotiable, but generally fall between 1/8th and 3/8^{ths}.

Landman

The landman’s role to the process is critical. This person is the field agent that locates mineral owners, verifies their ownership (through a legal description), and negotiates the

¹³⁶ Comptroller Letter No. 8902L0945B09 (February 9, 1989).

terms of the lease. Landmen may be women, they may be individuals owning independent businesses representing an unnamed third-parties, or they may work for the oil companies, operators or drilling companies. Their success often rests with their personal image strategy and on their ability to relate to a variety of people. Often, they drive a dusty pickup, wear faded jeans, and can carry on an intelligent and knowledgeable conversation with a farmer in need of some ready cash.

Landmen use their ability to get the best deal for themselves and the company they represent. There are no laws limiting the amount of royalties. One-eighth (1/8) was common for years, but now one-fourth (1/4) and even three-eighths (3/8) is far more common. A mineral owner may reject the first offer in order to buy time to determine what other mineral owners in the region have received.

And finally, there is no such thing as a standard oil & gas lease, although the term is used on a regular basis. A lease generally begins as a preprinted, fill-in-the-blank form purchased at a printer who also furnishes blank wills, deeds, and mortgages. There are many types of leases, each designed for a different purpose. It is always wise to have an attorney skilled in petroleum leases to review any legal documents before they are signed.

Lease Acquisition Costs

In addition to landman fees, they may include legal fees for research, issuing drilling title opinions and similar services, payments for recording fees, and so forth.

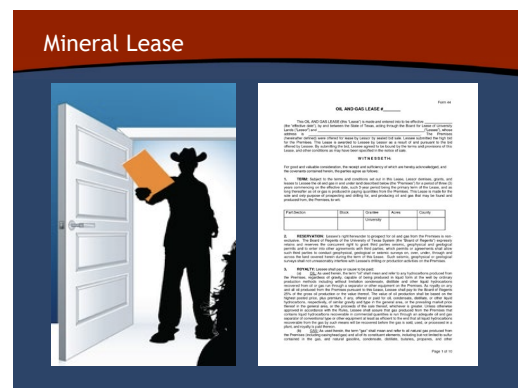
Taxability of Surface Owner Payments

Payments are made to the property owner for user privileges, loss of crops by the property owner, use of water, rights of way for roads and pipelines, and for damages to the land and surrounding property. Operators may also be required to install, at their cost, cattle guards, fences, and other specified items. Generally, the Comptroller treats payments to reclaim an oil & gas site to its original condition as not taxable.

Example

LR Co. provides land reclamation services by providing equipment with an operator to clean up and restore the well site area. Specifically, LR Co. will backfill the water pits, reserve and shale pits).

Generally, the water, reserve and shale pits are considered existing improvements to realty. Normally, the total charge for restoring commercial property



improvements is subject to sales tax. However, when the restoration is the actual reclamation of an oil & gas lease site to the land's condition before the drilling activity was begun, the charge for the restoration/reclamation is not subject to the sales tax.¹³⁷

Taxability of Lease Bonus, Delay Rentals & Royalties

These payments are not subject to the Texas sales & use tax because they do not constitute the sale of tangible personal property or taxable services. Lease bonus and delay rental payments are payments for the rental of real property. Royalties arise from the sale of oil & gas that's produced from the lease and are subject to severance taxes; not sales & use taxes.

Taxability of Landman Services

The Texas tax code excludes services performed by a landman from the definition of "real property service" if the services are necessary to negotiate or secure land or mineral rights for acquisitions or trade.¹³⁸ A landman's responsibility for collecting or paying sales tax depends on the service provided.¹³⁹

Non-Taxable Services. When a landman acquires leases, drafts and administers contractual agreements, and ensures that all transactions comply with governmental regulations, he is performing nontaxable services and must pay tax on all supplies and 80% of data processing and information services that he purchases.

The non-taxable services include determining ownership, negotiating a trade or agreement regarding land or mineral rights, drafting and administering contractual agreements, ensuring that all governmental regulations are complied with, and performing any other action necessary to complete the transaction related to the services listed above, other than information services.

Taxable Landman Services. A landman who only gathers and compiles information is performing a taxable information service and should collect tax on 80% of the total charge to the purchaser.

¹³⁷ Comptroller Letter No. 9609L1436A03 (Sep. 3, 1996).

¹³⁸ Texas Tax Code §151.0048.

¹³⁹ Comptroller Letter No. 200703984L (March 29, 2007).

Preparing the Site

Preparing a site for drilling an oil & gas well is initially similar, in many respects, to construction sites for buildings. However, due to the unique processes necessary for drilling a well, several areas will need to be excavated to serve specific purposes during drilling. We discuss these below.

Initial Surveying

The producer's representative (company man) will hire a surveyor to identify the drilling site location. He will mark the drill site with stakes. He will determine the specific topography of the area by "shooting elevations." This is necessary so that the dirt work contractors can level the area where the drilling equipment will be located and where the drilling operations will be conducted. He will also stake the exact location where the well will be drilled.



Well Placement Services. Well placement services consist of identifying the location of a proposed well site in relation to other wells and to the unit, tract, or lease lines. The RRC requires that a person seeking to drill, deepen, re-enter, or plug back a well submit a W-1 drilling application. The drilling application must include a plat showing the anticipated well location. The well placement service includes the preparation of a plat showing the information required by the RRC in connection with the submission of a W-1 drilling application.

The surveyor provides well placement services by first reviewing the oil & gas leases that cover the mineral rights affected by a pooled unit. Next, the surveyor identifies the portion of each leased tract that the oil company intends to include in the unit.

The surveyor assigns a field crew to locate and stake the proposed well. The field crew drives out to the area of the proposed well location and begins reconnaissance work. The field crew drives around the area and identifies points of access, rivers, trees, power lines, and any other types of improvements or obstructions. The field crew identifies a drilling site of approximately 100 yards by 100 yards.

The crew also identifies where the pits for the mud and water should be located. The field crew then drives a stake in the ground for the well location.

Unit Designation/Proration Unit Surveys. This service involves the designation of the size of the unit, the mineral rights owners who participate in the unit, and the extent to which each mineral rights owner participates. The surveyor performs this service by establishing the lease boundaries. Next, the surveyor calculates the acreage of each tract in

the well unit to prorate the percentage of royalty earnings to be received by each mineral owner.

Pipeline Rights of Way. This ground survey service involves establishing the right of way for a pipeline. To perform the service, the surveyor must determine the boundaries of the right of way and the boundaries of property that the pipeline will cross. It typically includes drafting or drawing plats, writing centerline descriptions, and permit drawings to obtain permission to cross highways, railroads, and other similar areas.

Centerline Pipeline Staking. Here, the surveyor determines the actual location of a pipeline to be built within a right-of-way. The surveyor is not establishing the right of way and the boundaries of the properties that the pipeline will cross.

Taxability of Surveying Work. Surveying charges associated with drill site preparation may or may not be taxable, depending upon the circumstances.¹⁴⁰

Well Placement Services. Well placement services and “staking packages” do not constitute taxable real property surveying because they do not involve the determination of boundaries with the degree of certainty and precision required to establish the boundary lines. They are performed merely to determine the approximate boundaries for drilling oil & gas.¹⁴¹

Unit Designation/Proration Unit Surveys. The charge for this service is taxable as a real property surveying service because it involves the determination of boundaries to real property.

Pipeline Rights of Way. The charge for the ground survey and the related services are treated as taxable real property surveying.¹⁴² A Right-of-Way agent may not classify himself as a “landman” in order to reclassify his surveying services as nontaxable. A land-surveying firm performed surveys to determine the boundaries of right-of-way (ROW) and property boundaries. The Comptroller held the services were taxable because the ROW agents performing the surveying are not landmen.¹⁴³

Under Texas law, a “landman” is someone who acquires or manages petroleum or mineral interests or performs title or contract functions related to those interests. Typically, where services performed by landmen to determine or confirm boundaries of real property are necessary to negotiate or secure land or mineral rights for acquisition or trade, those services are not regarded as “surveying” and are exempt from tax. A ROW agent, on the

¹⁴⁰ Comptroller Oil & Gas Well Servicing Audit Manual.

¹⁴¹ Comptroller Hearing No. 101,058 (2011); Comptroller Rule 3.276

¹⁴² Comptroller Letter 8802L0863B11 (Feb. 4, 1988).

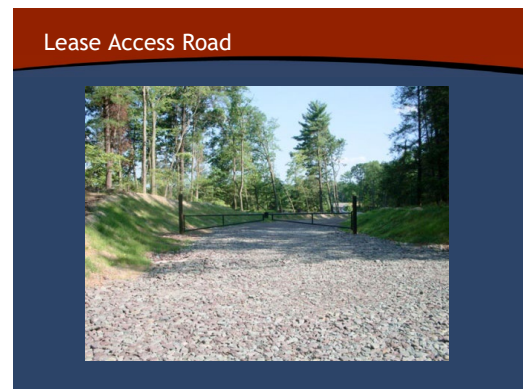
¹⁴³ Comptroller Letter No. 2017010110 (July 2018).

other hand, is generally engaged in obtaining an easement for construction of roads, bridges, oil and gas pipelines, and the associated infrastructure. Because the land-surveying firm's services were performed by ROW agents and not landmen, the services constituted taxable surveying of real property.

Centerline Pipeline Staking. This survey work is non-taxable because it merely involves determining the path of the pipeline in relation to the boundaries of the right of way. It does not include the determination of the boundaries of the right of ways themselves.¹⁴⁴ Drawing alignment sheets and piping drawings that show the valve connections, meter runs, and similar items for use by the contractor in building the pipeline are not taxable.¹⁴⁵

Constructing Lease Access Road

The operator will need to construct a road from the highway or ranch road out to the lease site. The soils may not be compacted sufficiently to support the heavy traffic of vehicles transporting equipment to the drill site. Therefore, the contractor must construct the lease access road with materials, such as road base, in order to provide stability for the heavy trucks and to allow rainwater to drain from the road.



Leveling & Stabilizing the Site

Grass, trees, bushes are removed. The site is leveled (if necessary) with a bulldozer and/or a grader. The drill site must be level and covered with materials that will provide a stable base for the drilling rig and related equipment and will allow water to drain away from the site. Often, the contractor will lay a thick layer of shale rock over the site and compact it with heavy equipment. Then, gravel may be spread to add additional support.



¹⁴⁴ Comptroller Letter 8802L0863B11 (Feb. 4, 1988) and Comptroller Hearing No. 101,058 (May 5, 2011).

¹⁴⁵ Comptroller Letter No. 8802L0863B11 (Feb. 4, 1988).

Excavating and Trenching

Most drilling locations require several earthen pits. The contractor will need to excavate a reserve pit. The reserve pit will hold the mud that is discharged once it circulates through the well bore. The contractor will use a bulldozer to excavate the pit. Then, the contractor will line the pit with waterproof liner to prevent the chemicals in the mud from mixing with the soil.

The contractor will excavate additional areas called “shale pits” and “water pits.” The shale pit holds the shale cuttings that arise from the drilling through shale. They become suspended in the mud, are removed once the mud returns to the surface and are discharged into the shale pit. The water pit is used to store fresh water for use in making the drilling mud.

On some drilling sites, a below-ground-level cellar may be excavated. This is done in order to keep the height of the drilling substructure as low as possible. This is where the main borehole will be drilled. The cellar also enables the drilling contractor to install parts of the wellhead below ground. The cellar is usually lined with boards, corrugated metal or the workers will pour concrete walls to keep the cellar from caving in.

Excavating the Drill Site



Constructing the Cellar



Mud Pits



The contractor will create a mud pit. A mud pit is a pit or tank in which a supply of drilling fluid is stored. The contractor will also create a waste pit to hold waste mud and cuttings, which is usually an excavated, earthen-walled pit. It may be lined with plastic to prevent soil contamination.

Mats & Board Road Rentals. Board roads are temporary roadways constructed of wooden planks in marsh areas such as oil field leases. They are often necessary due to the heavy weight of the drilling rigs and related well equipment as well as weather conditions.

Conductor Hole

This is a large diameter hole, lined with pipe, also called a starter hole, varies in depth down of tens of feet to a few hundred feet depending on the local geology. It's the hole through which all the drilling operations occur.



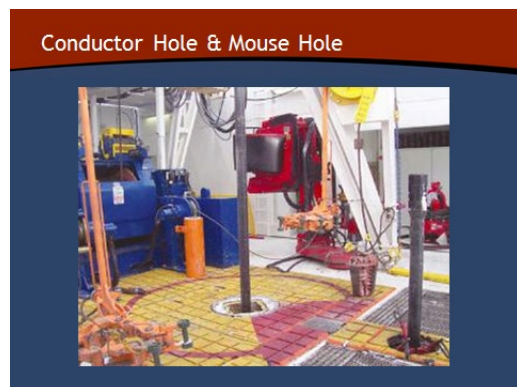
Rathole

A rathole is a hole in the rig floor, 30 to 35 feet deep, lined with casing that projects above the floor, into which the kelly is placed when hoisting operations are in progress. This is either done by the portable rig that drills the conductor hole or can be done by the primary rig after rigging-up.

Mousehole

A mousehole, like the rathole, is a shallow hole under the rig floor, usually lined with pipe. The driller uses it to temporarily store joints of drill pipe.

The mousehole is drilled either by the portable rig that drills the conductor hole or by the drilling rig itself, after it is rigged-up.



Taxability of Site Preparation

Generally, the Comptroller treats the charge for constructing the lease access road and drill site as non-taxable new construction. This includes digging of water, reserve, and shale pits and the drill pad area.¹⁴⁶ Accordingly, the labor component is not taxable and the type of contract (lump-sum or separated) will determine which party is treated as the consumer of incorporated materials. In the case of a lump-sum contract, the Comptroller treats the contractor as the consumer of the materials and owes sales tax on when the contractor purchases taxable materials. In the case of a separated contract, the labor charge is non-taxable and the tax laws treat the customer as the consumer of the materials. This rule applies to the construction of the lease access road, stabilizing and leveling the site, excavating and trenching, and drilling the conductor hole, mouse hole and rat hole.

Unprocessed Sand, Dirt, and Gravel. Persons who furnish, sell, or deliver unprocessed sand, dirt, and gravel are providing a nontaxable servicepersons who sell processed materials are selling tangible personal property and must collect tax on charges for

¹⁴⁶ Comptroller Letter No. 9609L1436A03 (September 3, 1996).

materials and delivery. Materials that have been only washed or sorted are considered unprocessed.¹⁴⁷

Processed Materials. Sales of processed materials are subject to the sales tax. Processed materials include stone that has been crushed and materials that are mixed such as spud mud or ready-mix concrete. Rock that has been blasted out of the earth or a hillside is considered processed.¹⁴⁸ The blasting company may purchase the explosives used to break up the rock tax free.¹⁴⁹

Sand, Dirt and Gravel. Sand, dirt, gravel and similar materials are used to prepare the drill site prior to drilling. These materials are subject to sales tax if they are sold in processed form. However, persons who furnish, sell, or deliver unprocessed sand, dirt, and gravel are providing a nontaxable service.¹⁵⁰ Materials that are only washed or sorted are considered unprocessed and therefore non-taxable.

Example

Rock (rip-rap), limestone, caliche and chipped rock are used in the oil & gas industry for construction of lease roads to the drilling location. Their purpose is to stabilize the soil and create an all-weather access. Screening or washing the materials is not considered processing. However, crushing the material is considered processing. The rip-rap, limestone and caliche are not taxable if they are sold in the condition that they are found in nature. These materials are taxable if they are crushed or mixed. The chipped rock is taxable because it has been processed.¹⁵¹

Example

Hauling Caliche. The charge for hauling caliche may be part of the sales price of the nonresidential repair service and taxed. The charge for hauling alone (not connected with a taxable sale) is not taxed.¹⁵²

¹⁴⁷ Comptroller Audit Manual.

¹⁴⁸ Comptroller Rule §3.300.

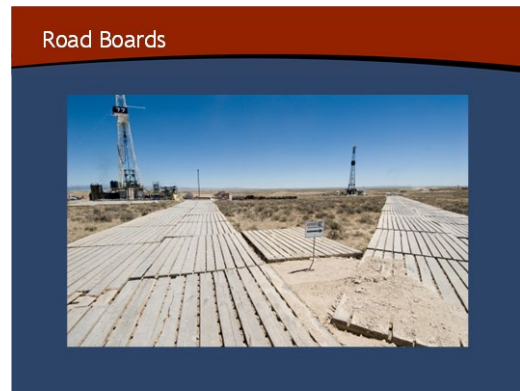
¹⁴⁹ Comptroller Rule §3.300.

¹⁵⁰ Effective June 13, 1988.

¹⁵¹ Comptroller Letter No. 8809T0895B04 (August 20, 1988).

¹⁵² Comptroller Letter No. 9410L1329G03 (October 6, 1994).

Mats & Board Road Rentals. Sales tax is due on the rental of board roads, drilling mats and board turn-around areas. The Comptroller's position is that the labor charges for assembling board roads and turn-around areas in oilfields are taxable fabrication labor rather than non-taxable installation labor. They are taxable even if separately stated by a third party.¹⁵³



Pit Liners. The installation of pit liners is an improvement to realty provided the pits are covered and the pit liners are not removed. In these circumstances, the installation of the pit liners is an improvement to realty. The contractor installing the pit liners is the consumer of materials and supplies incorporated into the project and must pay tax at the time they purchase these materials and supplies, and does not collect tax from the contractor's customer.¹⁵⁴

Moving Equipment & Rigging Up

Depending on the location of the well, access to the site may require preparation of a roadbed. A site, and its access road, must accommodate a large number of temporary and semi-permanent structures and tanks, all brought in by truck. The tasks are:

Transporting Equipment by Truck

Equipment is loaded onto trucks at the previous drill site or storage yard, secured and transported to the new drill site. At a new drill site, it's important that the soils are sufficiently compacted sufficiently to support the incoming heavy equipment which may become unstable if the soils are loose.



¹⁵³ See Comptroller Hearing No. 23,333 (1989) & Comptroller Oil & Gas Well Servicing Audit Manual.

¹⁵⁴ Comptroller Letter No. 7908L0146A02 (Aug. 16, 1979).

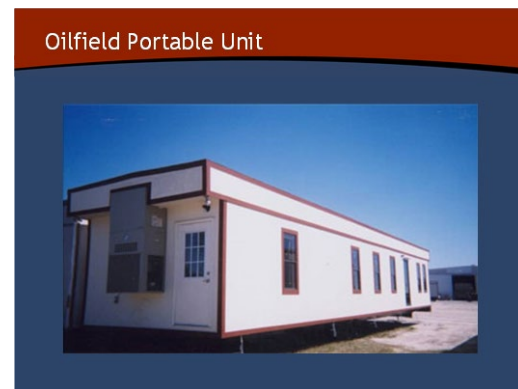
Taxability of Transporting Equipment. Transportation services provided on a standalone basis are not subject to Texas sales tax.¹⁵⁵ However, when the charge for transportation (or freight) is associated with the sale of taxable item and the seller bills the customer for the freight charge, the freight charge becomes a taxable component of the sales price of the taxable item. Note, that if the transportation is associated with the sale of a non-taxable item (such as water) or the provision of a non-taxable service (new construction), then the transportation charge remains non-taxable. However, if the seller of mud or drilling fluids transports or hires a third-party to transport the mud or drilling fluid to the well site, the charge for transportation, billed by the seller, is taxable as a component of the taxable price of the mud or drilling fluid.¹⁵⁶

Unloading at Drill Site

Equipment is unloaded and placed approximately where it will be rigged up.

Oilfield Portable Units.¹⁵⁷ An “oilfield portable unit” is a bunkhouse, manufactured home, trailer, or semi-trailer (other than a travel trailer) designed to be used for temporary lodging or as temporary office space that is used exclusively at any oil, gas, water disposal or injection well site to provide to well site employees, contractors or other workers sleeping accommodations or temporary work space, including office space; which does not require attachment to a foundation or to real property to be functional.¹⁵⁸

Taxability of Oilfield Portable Units. Oilfield portable units are subject to sales & use tax, not motor vehicle or hotel occupancy tax.¹⁵⁹



¹⁵⁵ Unless the service pertains to the taxable real property service of removing non-exempt garbage or trash. Separately stated charges for the disposal of waste associated with oil & gas exploration are not taxable. See Comptroller Letter No. 9003L0994C01 (March 22, 1990).

¹⁵⁶ Comptroller Letter No. 9003L0994C01 (March 22, 1990).

¹⁵⁷ Tax Policy News (August 2011).

¹⁵⁸ Texas Tax Code §152.001(20).

¹⁵⁹ Texas Tax Code §151.308(a)(5).

Bunkhouses, trailers, semi-trailers and manufactured housing used anywhere other than at a well site for sleeping accommodations or workspace are subject to the motor vehicle sales & rental tax, hotel occupancy tax and sales tax as applicable.

Rigging Up

“Rigging up” means placing and assembling the various parts of equipment that make up the rig, and then preparing the rig to drill the well.

During assembly of the rig, some equipment may be handled and set with crane, rig up trucks, or forklifts, depending on the size of the rig.

Substructure

The rig equipment is unloaded and positioned at the location where it will sit during the drilling operations. The substructure rests in the cellar on level ground. It is usually about 40 feet in height and serves as the foundation of the rig. By elevating the rig floor, room is provided to install the blowout preventer which is connected to the top of the well’s casing at the conductor hole.



The substructure is assembled, pinned together, leveled, and made ready for other rig components on the floor. It must be strong because it supports the weight of both the drilling rig and the string of drill pipe used to drill the well.

Usually, the workers will begin equipping the cellar. The workers will weld a drilling nipple to the conductor pipe and attaching a flow line.

Rig Floor and Mast

Once the substructure is set in place, the workers begin setting up the rig floor. They start by installing stairways and guardrails to allow access to the rig floor. Then, the drawworks is set up and secured to the substructure. The drawworks is the equipment used to raise and lower drill pipe, casing and other equipment into the wellbore.



Rigging Up the Mast



On mechanical rigs, the engines are set in place and connected to the drawworks. On electric rigs, the electric lines are run to the drawworks.

The bottom of the drilling mast is placed on the rig floor and pinned in place. The top (or crown section) is then raised into place on the derrick stand. Next, the drilling mast is secured by raising and pinning the "A-legs" in place.

The monkeyboard is pinned in place on the mast and all lines and cables are laid out to prevent tangling when the mast is raised. The monkeyboard is used to temporarily hold sections of drill pipe as they are placed into the wellbore or are removed from the wellbore.

The drilling mast is now raised. The engines are started and drilling line is spooled onto the drawworks drum. Once the mast has been raised and pinned, the remaining floor equipment can be set into place.

Power System

The workers install the power system simultaneously with setting up the rig floor because they need power to operate the equipment.

Setting Up the Mud System

While one crew finishes preparing the rig floor, another crew sets up the mud circulating system. First, the workers set up the tanks which hold the drilling mud and the associated mud pumps. Then, the workers connect the mud hoses and run the electric cords.

Raising the Mast

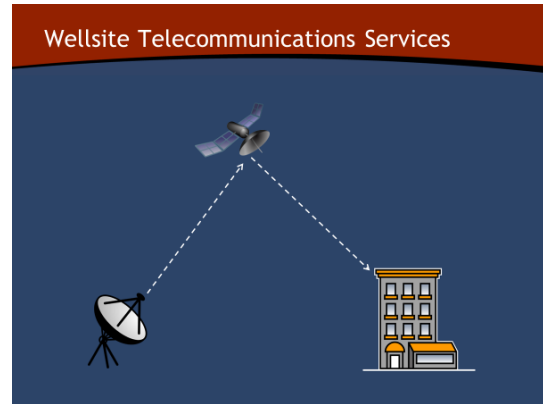


Engines and Generators



Installing Telecommunication and Internet

Operators often require voice telephone (cell and landline) and Internet services at oil and gas well sites. The operator and oilfield service companies use these services to monitor various aspects of the drilling and completion process. At the wellsite, there are often numerous trailers and vans positioned around the wellsite that hold office spaces and computer terminals used by the engineers for monitoring and controlling



different aspects of the drilling and completion processes. Examples include the “mud” trailer and the directional drilling, or “DD” trailer. The operator often purchases these services and leases or rents some of the equipment necessary to receive these services.

Telecom providers exist to perform these specialized services. Offsite, the telecom provider will usually own or lease and operate the facilities necessary to provide its services. The facilities are called the Telecommunications and Internet “backbone.” The provider must also contract with the owner of satellites in geosynchronous orbit to send and receive signals. The telecom provider’s facilities consist of one or more large satellite dish hubs and a “call manager” where the telecom provider’s network engineers are located. From there, they operate and troubleshoot problems with the network.

The satellite hubs receive and send signals to and from the smaller dish satellites located at well sites. The hubs transmit data to the orbiting satellite, which, in turn, transmits the data to the “call manager.” The “call manager” receives and sends signals to the smaller dishes located at the well sites so that the well site workers may use their cell and landline phones, internet, etc.

As an Internet provider, the telecom provider serves as an ISP for its customers. It supplies bandwidth, email services, email filtering, and web content. In addition, the telecom provider will usually own and operate its own email server and supply email addresses to customers.

To provide voice services, the telecom provider purchases phone numbers and voice services from a telephone utility and resells them to the well operators as part of a communications package. It serves as the ISP for these phone services. It contracts with the telephone utilities enable it to provide access to the Internet through their switching equipment, which it then uses to provide Voice Over Internet Protocol services to its clients.

At the well sites, the telecom provider sells, rents, provides and installs the equipment necessary for the workers at the well site to have voice and Internet access to persons

located offsite. These persons include its customers, remote engineers, geologists, and others who review, real-time, the telemetry data transmitted through the telecom provider's network described above. The well site workers have a number of trailers where the command centers for the various services are located.

Different types of sensors are located at the well sites, both at the surface and downhole. These sensors detect and transmit important data to the individuals monitoring the activity in the trailers. This sensor data, called telemetry, is used to determine whether the rig workers need to adjust or alter various activities at the well site.

For example, some sensors measure and transmit mud volume and pressure data. Engineers in the mud trailer will use the readings from these sensors to monitor and adjust the flow of drilling mud through the drill pipe and mud motor. Also, contractors and well site owners and operators also review and monitor the telemetry.

In order to provide these services, the telecom provider must install the necessary telecommunications equipment at the well site. Each site will have a small satellite dish through which signals are transmitted. The telecom provider will mount routers, antennas, and various well site equipment on the trailers. The telecom provider will install underground cable and wire at the well site in order to connect this peripheral equipment to the telecom provider's network. The peripheral equipment is configured before it is brought to the well site, so initial installation does not involve equipment configuration. Once the telecom provider installs the buried cable or wire and plugs in the peripheral equipment, the telecom provider's technician calls in a specific geocode to the call center to activate the equipment.

Taxability of Rigging Up

Generally, no Texas sales & use tax is due on any charges incurred to rig up the drilling equipment. This is because the service of rigging up doesn't constitute a taxable service. It is simply a component of the non-taxable labor incurred in connection with new, commercial construction.

If the drilling contractor rents bare equipment for use in the drilling process, the charge for the lease of the bare rental is taxable. Under the "sales price rule" all incidental charges made by the lessor become taxable as well. This would include charges for transporting and setting up the rented item.



Taxability of Telecommunication Services

The Comptroller treats the charge for the telecom provider's services as a Mobile Telecommunications Service pursuant to Comptroller Rule 3.344(a)(6). Under this rule,

local taxes are based upon the wellsite location. The telecom provider's work in installing the peripheral equipment, satellite dish and underground CAT-5 cables at the wellsite constitutes new construction work.

Drilling the Well

There are two general ways of vertically drilling a well: Using a rotary table or top drive. Workers drill wells by attaching strings of pipe to a "kelly" that is inserted through the "rotary table" located on the drill floor. Alternatively, they may drill using motor placed on top of the drill string called a "top drive."

Loading Drilling Pipe

The pipe is unloaded from trucks onto the pipe rack. The floor crew brings pipe from the pipe rack and catwalk, using the catline, air hoist or hydraulic winch, up to the drilling floor and places it in the mousehole. This is done for every connection.

Preparing Drilling Fluid

The drilling contractor or mud service company must prepare the drilling fluid (or "mud") prior to circulating it through the wellbore. The drilling fluid is necessary in order to cool and lubricate the drill bit, provide a medium to remove the rock fragments, or drill cuttings, from the area being drilled and transport them to the surface, provide weight to prevent oil, gas, and water from the formation from entering the well which can lead to a blowout, and prevent the uncased portion of the wellbore from caving in.

Types of Drilling Fluids. The drilling conditions dictate the type of drilling fluids that the mud company will use. There are several types:

Water-based muds. Water is the most common base. It may be either fresh water, or salt water.

Oil-based muds. The base fluid of oil-based mud is a petroleum product, such as diesel fuel. Oil-based muds have many benefits, including increased lubricity, enhanced shale inhibition, and greater cleaning abilities with less viscosity. However, they are more expensive and raise environmental

Drilling Rig



Catwalk and V-Door



Drilling Fluid - Mud



concerns.

Synthetic materials. The oilfield services industry has developed several oil-like synthetic drilling fluids. They include the vegetable esters, poly alpha olefins, internal olefins, linear alpha olefins, synthetic paraffins, ethers, and linear alkylbenzenes, among others.

Air and foam fluids. These fluids are less dense than drilling muds.

Drilling Fluid Additives. There are several types of drilling mud additives. They include weighting materials, primarily barite (barium sulfate), to increase the density of the mud.

Corrosion inhibitors to protect pipes and other equipment from acid and other corrosive compounds.

Dispersants which break up solids into smaller particles.

Flocculants which cause suspended particles to group together so they can be removed from the fluid at the surface.

Surfactants to emulsify the mud.

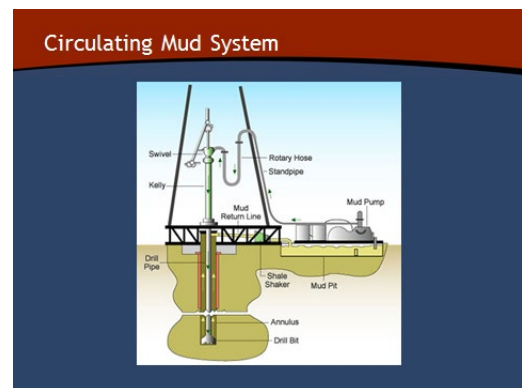
Biocides which kill bacteria and reduce the souring of drilling mud.

Circulating the Drilling Mud

The drilling mud travels through the suction line where it enters the mud pump. The mud pump pushes the mud first through the discharge line, standpipe, rotary hose and swivel, the kelly and finally into the drill pipe itself. The mud travels down the inside of the drill pipe, through the drill collar and drill bit, and emerges through nozzles located in the drill bit. The mud is sprayed between the teeth of the drill bit and the rock being drilled.

The mud then travels up the outside of drill pipe, to the surface, where it enters the mud return line. The mud return line sends the spent mud to the shale shaker, then to the desander, desilter, and degasser and finally back into the mud tank.

The mud is monitored throughout the drilling process. A mud engineer and/or the derrickman may periodically check the mud by measuring its viscosity, density, and other properties.



Taxability of Mud Services



Drilling mud or drilling fluid used during the drilling of an oil or gas well to circulate out cuttings and other functions while drilling a well is taxable. However, drilling mud additive may or may not be subject to tax. If the drilling mud additive is crude oil, unrefined liquid petroleum, then it is not subject to sales tax. If the drilling mud additive is a refined petroleum product, the drilling mud additive is taxable. If the drilling mud additive is

crude oil, the source needs to be determined. Production needs to be paid on oil recovered from salt water disposal wells or other salvage operations.¹⁶⁰

Drilling Mud. Drilling mud or drilling fluid is used primarily to circulate out cuttings, to maintain downhole pressure and to provide cooling for the drill bit during the drilling of an oil or gas well. The sale of drilling mud is taxable as the sale of tangible, personal property.

Drilling Mud Additives. Drilling mud additives may or may not be taxable. If the additive is crude oil, (unrefined liquid petroleum,) then it is not subject to sales tax. If the additive is a refined petroleum product, it is taxable.

Diesel Tax Refunds. Oilfield service companies may claim refunds of diesel taxes paid on diesel fuel used to make drilling mud (i.e. as a medium to remove drill cuttings from a well bore in the production of oil or gas).¹⁶¹

Disposal Services. After it is used in a well, drilling mud and drilling fluid must be removed and disposed of. Charges for vacuuming drilling mud and drilling fluid out of wells or vacuuming disposal saltwater out of producing wells are nontaxable. Texas generally imposes sales tax on charges for hauling and disposing of waste, treating these services as a taxable real property service.¹⁶² An exception applies, however, for hauling and disposing of waste which results from activities associated with the exploration, development, of oil, gas, and other minerals. As a result, hauling and disposing of waste from oilfield operations is nontaxable.¹⁶³ This nontaxable treatment applies even if the disposal contractor provides these services using onsite storage tank facilities. The disposal

¹⁶⁰ Comptroller Oil & Gas Well Servicing Manual.

¹⁶¹ Tex. Tax Code §162.229 and Comptroller Rule §3.432(q).

¹⁶² Comptroller Rule §3.356.

¹⁶³ Comptroller Letter No. 9810858L (Oct. 9, 1988).

contractor must pay tax on its purchase of storage tanks even if these tanks are temporarily left at a customer's location to store waste.

Mud Lost in Hole. Some well operators have taken the position that drilling mud lost down-hole should be treated as equipment lost, which the Comptroller treats as non-taxable because "losing equipment" does not constitute the "sale" of equipment. Auditors are directed to reject this position and treat all mud charges as taxable because drilling mud is a consumable, not machinery or equipment. When it dissipates into a well bore, it is not lost and does not qualify for Rule 3.324(f)(1).

Begin Drilling

To start drilling, a surface drill bit is attached to a bottomhole drill collar, which is in turn attached to the kelly. Once made up, the driller lowers the bit through the rotary table and engages the mud pump(s). The driller lowers the drill string and the kelly bushing is set in the rotary drive bushing and the rotary is engaged. The driller then slowly lowers the bit to bottom and begins the drilling operation.

Adding a New Section of Pipe. The driller stops the drill string from rotating, and hoists the drill string with the drawworks until the kelly is out of the rotary table. The driller then shuts down the mud pump(s). The floor hands set the slips around the joint of pipe.

The tongs are then latched onto the tool joints above and below the connection. The tongs and cathead are used to break out the pipe. Either the rotary table or kelly spinner is used to spin the drill string or kelly to unscrew it from the drill pipe joint.

Breaking Out Drill Pipe



Lowering Drill Bit into Rotary Table



Setting Slips



Securing the New Joint of Pipe. The crew swings the kelly out over the mousehole and stabs it into a new joint of pipe. The driller then spins up the kelly using the kelly spinner or spinning chain and the crew uses tongs to torque the joint.

Pulling the New Pipe Joint. The driller uses the drawworks to raise the kelly and attached joint out of the mousehole.

Adding the Pipe to the Drill String. The new joint is guided over to the drill hole where the crew “stabs” it into the end of the pipe suspended in the rotary table with the slips. The joints are threaded together using the pipe spinner, kelly spinner or spinning chain. Final torque is provided by the tongs. The drawworks lifts the kelly and the attached drill string so that the crew may remove the slips. At this point, the crew may resume drilling.

Resuming Drilling. The driller starts the mud pump and lowers the drill string until the kelly drive bushing engages the master bushing in the rotary table. Next, the driller begins rotating the drill string, lowers the bit back to bottom, and continues drilling the hole.

Tripping In/Out

Tripping refers to the process of removing and/or replacing pipe from the well when it is necessary to change the bit or other piece of the drill string, or when preparing to run certain tests in the well bore.

Directional Drilling

Directional (horizontal) drilling is the drilling of horizontal or otherwise non-vertical wells to intersect a producing formation laterally. Directional drilling contractors generally drill wells horizontally to increase the producing (pay) zone. A directional drilling contractor will design and plan a well path to intersect targets, plan a drilling assembly configuration, and design a drill string. Drilling contractor personnel install the tool assembly in the drill string under the supervision of the drilling company supervisor and operate the rig which controls the drill string downhole. Directional drilling contractors also operate

Making Up Mousehole Joint



Pulling Slips



Lowering Kelly Bushing



measurement while drilling (MWD) equipment that provides data about the location of the bottom hole assembly to facilitate precise drilling through the formation.

Taxability of Drilling

In general, the labor performed in drilling a new oil & gas well is not subject to either the sales & use tax or the oil well servicing tax. This includes the labor for site preparation and the labor of the various crews that drill well.

New Construction. New construction, as contrasted with “repair and remodeling,” is not a taxable service. In the oil & gas industry, drilling a new well (building a new location) is generally new construction. The labor charge for new construction is not taxed. However, tax is due on the materials and other taxable items used to perform the work. The contract determines who is responsible for paying the tax on the incorporated materials.¹⁶⁴

☞ **Caution:** A Comptroller hearing decision determined that replacing an oil & gas storage tank’s floating roof with a new cone roof was not new construction even though it added cubic footage to the tank.¹⁶⁵

The primary sales tax issue arising in drilling an oil & gas well concerns whether the charge is for the sale of tangible personal property or whether the charge is for the performance of non-taxable new construction.

An administrative hearing decision considered the issue of when the installation of pipe is nontaxable new construction, rather than a taxable repair to commercial real estate.¹⁶⁶ The Comptroller determined that the pipeline company could purchase labor tax-free to install new replacement pipe where the pipeline trenches were first lowered from a depth of 20 inches to a depth of 30 inches. The increased depth was required to comply with federal regulations and to allow room for sandbags to be placed under the pipelines to protect the pipe coating.

Machinery and Equipment. The provider of a nontaxable service must pay tax on any machinery or equipment purchased or rented to provide the service and on any materials (except cement) used, consumed, or expended in the well, including rubber goods such as stripper rubbers and swab cups. However, machinery, equipment, and replacement parts may qualify for the manufacturing exemption when used directly in processing oil or gas that will be resold, or if required by law or regulation to control pollution that results directly from the activity of processing oil or gas that will be resold. In addition, parts and labor to repair qualifying machinery or equipment also qualifies for the exemption.

¹⁶⁴ See, e.g., Comptroller Letter No. 9410L1329G03 (October 6, 1994).

¹⁶⁵ Comptroller Hearing No. 38,069 (1999).

¹⁶⁶ Comptroller Hearing No. 44,134 (2005).

Leased Equipment Lost or Damaged Beyond Repair. Oilfield service companies who lease or rent equipment do not owe sales tax on the separately stated charges for items lost or damaged beyond repair. However, as the following hearing decision illustrates, it's critical that the invoice language clearly establish that the charge is a reimbursement for items lost or damaged beyond repair.

In Comptroller Hearing 114,866 (May 19, 2019) the Comptroller rejected an oilfield equipment rental company's claim for tax exclusion for stators that were damaged beyond repair due to inadequate documentary evidence that the charges arose from stators damaged beyond repair after use to drill horizontal wells.

The oilfield equipment rental company leased hydraulic drilling motor assemblies for drilling horizontal well bores. The hydraulic drilling motor assemblies were made up of several internal components, including rotors, stators, flex rods, and bearings, all contained in a housing. The stator component varied between 9 and 16 feet long and consisted of a steel housing lined with a rubber compound. A stator's form varies to fit with the rotor inside the motor housing and allowed those components to work in tandem when pressurized liquid is forced through the motor.

During the horizontal drilling process, many of the stators were damaged beyond repair and, pursuant to its lease agreements, the oilfield equipment rental company separately stated charges for the stators were damaged beyond repair as "junk." The taxpayer also did not identify the charge as a "reimbursement" for the cost of the new stators.

Despite the oilfield equipment rental company's testimony that the term "junk" meant "damaged beyond repair" and other corroborating evidence, the Comptroller denied the tax exclusion alleging that the oilfield equipment rental company's invoice text was insufficient to meet the Comptroller's policy.

Recycling Fracking Equipment. The drilling process can consume millions of gallons of water. The Texas tax code provides companies with an incentive to encourage the recycling of wastewater arising from the drilling process. Equipment used to process, reuse, or recycle wastewater for use at oil & gas wells for fracking work is exempt from sales & use tax.¹⁶⁷

Rental v. Service. If a company provides equipment and a supervisor, the presumption will be that the company is renting equipment rather than providing a service. The total charge to the customer for the rental is taxable regardless of the type of service the equipment provides. The company may issue a resale certificate in lieu of tax when purchasing equipment for bare rental or rental without an operator. The service company must keep rental tools/equipment separate from those it uses to perform services. If rental

¹⁶⁷ Texas Tax Code §151.355(7) (effective September 1, 2007).

equipment is removed from a tax-free inventory is used to provide a taxable or nontaxable service, the service company owes tax on the fair market value for the time of divergent use.¹⁶⁸

Directional Drilling Taxability. Generally, when directional drilling contractors provide directional drilling services and measurement while drilling (MWD) services, these services are nontaxable. Provided the customer neither exercises control over the equipment nor over the operator of the equipment, these services are treated as nontaxable services, rather than rentals with an operator. Since the drilling contractor or directional drilling contractor operate the equipment and direct the operator of the equipment, these services are treated as nontaxable services regardless of whether they are billed as a single day rate charge or through separate labor and equipment charges.¹⁶⁹

☞ **Note.** When a contractor separately states service and rental charges on an invoice, the Comptroller's rules establish a presumption that rental charges are taxable as separately stated charges for the rental of tangible personal property. The Comptroller's rules also provide that well servicing providers separately stating equipment rental charges simply because of past industry practice rebuts this presumption, so that these "rental" charges are treated as nontaxable service charges.¹⁷⁰

A directional drilling contractor is providing a nontaxable service if it (1) performs the engineering and planning required to provide a drilling guideline, (2) provides necessary equipment and personnel for the drilling, and (3) monitors the progress of the drilling to ensure compliance with the customer's drilling guidelines. If a well owner contracts with a directional drilling contractor to provide a supervisor and directional drilling tools at a specified well site for a specified period of time to advise the oil and gas company, and the supervisor only acts in an advisory capacity, then this is treated as a taxable equipment rental with an operator. This type of service is treated as a tool rental even if the directional drilling company's supervisor monitors the performance of the directional drilling equipment to ensure it is performing in accordance with the plan developed by the oil and gas company. The directional drilling contractor must charge sales tax to its customer and may present resale certificates to its suppliers for the purchase or rental of equipment that is used exclusively on these jobs.¹⁷¹

¹⁶⁸ Comptroller Oil & Gas Well Servicing Audit Manual.

¹⁶⁹ Comptroller Letter No. 9203L1165C01 (Mar. 3, 1992).

¹⁷⁰ Comptroller Rule §§3.294, 3.324(b)(5).

¹⁷¹ Comptroller Letter No. 9308138L (Aug. 27, 1993); Comptroller Letter No. 9203L1165C01 (March 3, 1992).

Sometimes, a directional drilling contractor will purchase equipment under the resale exemption to rent in taxable equipment rental jobs, but later uses this equipment to provide nontaxable services. When a directional drilling contractor purchases equipment under the resale exemption, but uses this equipment to provide a nontaxable service, the directional drilling contractor must accrue and remit sales and use tax on the fair market rental value of the equipment for the time it is being used to provide the nontaxable service.¹⁷²

Flowback Services Charges Taxable as Rentals. The Comptroller's Tax Policy Division treats "flowback services" as non-taxable services. See Flowback Services below (in Well Stimulation).

Casing the Well

Casing pipe is usually larger in diameter and longer than drill pipe and is used to line the hole. Casing operations occur periodically throughout the drilling process starting with the surface casing, intermediate casing, and ending with production string which takes place during well completion.

An oil or gas well usually requires as many as three concentric strings of pipe or casing which are all cemented in place:

The Conductor Pipe. The conductor pipe is needed to prevent the wellbore from caving in at the surface. In very soft ground, the conductor pipe may extend down from the surface to 100 feet or more, but generally no more than 20 feet is required. The conductor pipe is usually cemented in place, but occasionally it is driven into place by means of a pile driver. Cementing the conductor pipe is not a taxable service.

The Surface Casing. The surface casing provides protection for freshwater formations, prevents loose shale, sand or gravel from falling into the hole, and affords a means of controlling the flow of drilling fluids from the well. The surface casing is run to a greater depth than the conductor strings but does not run to the producing zone. Cementing of the surface casing is not a taxable service.

The Oil String or Production String. The final casing for most wells, to prepare the well for production, is the production string, or oil string. In most wells the production string of casing is the last column of casing placed in a well and will extend from the surface through the producing or "pay" zone.

Preparing the Cement

Cement is brought to the well site in large transport trucks, mixed with water at the well, and forced into the wellbore in order to restrict fluid movement between formations and

¹⁷² Comptroller Letter No. 9203L1165D07 (Mar. 4, 1992).

to the surface; provide support for the casing; prevent pollution of fresh water formations; and prevent corrosion of the casing.

In some cases where the producing formation is tightly consolidated, the production string is run only to the top of the producing formation, and the hole is left open below that point. This is an "open hole completion" or a "barefoot completion."

In other instances, it is found desirable for economic reasons, or to facilitate subsequent operations, to run a shortened string of casing in the bottom portion of the hole, that will not extend to the surface but only to a portion already cased. This casing, used to extend the casing from the producing zone to a point already cased, is usually called a "liner."

In addition to the conductor pipe, surface casing and the oil string, an intermediate string of casing is often needed as a precautionary measure in nearly every deep well, and it is often needed in other wells when high pressure or troublesome formations are encountered. This casing is set in the wells after the surface casing and before the oil string.

In preparing a well for cementing, it is important to establish the amount of cement required for the job. This is done by measuring the diameter of the borehole along its depth, using a caliper log. Utilizing both mechanical and sonic means, multifinger caliper logs measure the diameter of the well at numerous locations simultaneously in order to accommodate for irregularities in the wellbore diameter and determine the volume of the open hole.

Additionally, the required physical properties of the cement are essential before commencing cementing operations. The proper set cement is also determined, including the density and viscosity of the material, before actually pumping the cement into the hole.

Special mixers, including hydraulic jet mixers, re-circulating mixers or batch mixers, are used to combine dry cement with water to create the wet cement, also known as slurry. The cement used in the well cementing process is Portland cement, and it is calibrated with additives to form one of eight different API classes of cement. Each is employed for various situations.

Additives can include accelerators, which shorten the setting time required for the cement, as well as retarders, which do the opposite and make the cement setting time longer. In order to decrease or increase the density of the cement, lightweight and heavyweight additives are added. Additives can be added to transform the compressive strength of the cement, as well as flow properties and dehydration rates. Extenders can be used to expand the cement in an effort to reduce the cost of cementing, and antifoam additives can be added to prevent foaming within the well. In order to plug lost circulation zones, bridging materials are added, as well.

Running Casing into the Hole

Casing is run into the hole to a pre-determined depth.

Circulating and Cementing

After the casing is run in the wellbore, drilling fluid is circulated through the casing and annulus to remove any residual gases and to condition the mud.

After circulating and conditioning the mud, the casing is cemented. During this process the casing is reciprocated or rotated to allow the scratchers to work to remove excess wall cake to give the cement a better bond.

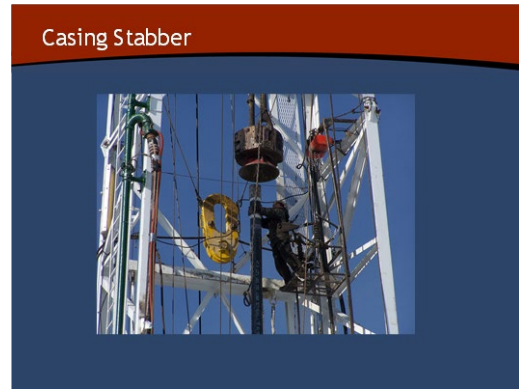
Cementing the Well

After casing, or steel pipe, is run into the well, an L-shaped cementing head is fixed to the top of the wellhead to receive the slurry from the pumps. Two plugs sweep the inside of the casing and prevent mixing: the bottom plug and the top plug.

Keeping the drilling fluids from mixing with the cement slurry, the bottom plug is introduced into the well, and cement slurry is pumped into the well behind it. The bottom plug is then caught just above the bottom of the wellbore by the float collar, which functions as a one-way valve allowing the cement slurry to enter the well.

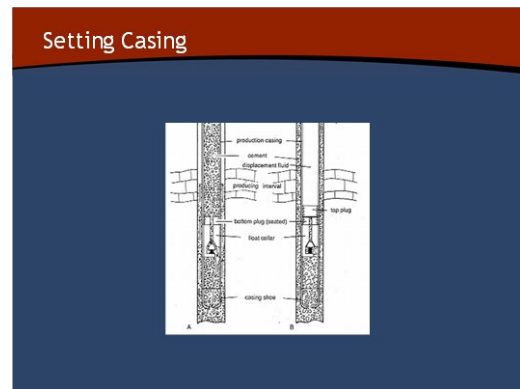
Then the pressure on the cement being pumped into the well is increased until a diaphragm is broken within the bottom plug, permitting the slurry to flow through it and up the outside of the casing string.

After the proper volume of cement is pumped into the well, a top plug is pumped into the casing pushing the remaining slurry through the bottom plug. Once the top plug reaches the bottom plug, the pumps are turned off, and the cement is allowed to set.



Taxability of Casing

The Texas sales tax consequences of installing the surface casing and the intermediate strings of casing are the same as the sale tax consequences of drilling a well. The casing is an incorporated material which is taxable as tangible, personal property. The charge for cement is exempt from Texas sales tax.¹⁷³ Instead, cement is taxed under Chapter 181 of the Tax Code. The cement tax is imposed on a person who: (1) manufactures or produces cement in Texas or imports the cement into Texas and (2) distributes or sells the cement in intrastate commerce or uses the cement in Texas. The cement tax is based upon the amount of cement distributed, sold, or used by the person for the first time in intrastate commerce. The tax applies to only one distribution, sale, or use of cement.



Fishing Services

There are a number of problems that can occur while drilling a well. A drill string may break and fall to the bottom of the wellbore. Or a tool may fall from the rig floor to the bottom of the well.

This stray equipment that has fallen into the well is referred to as fish or junk, and regular drill bits cannot drill through it. When stray equipment falls into a well, fishing is required to remove it.



The taxability of the charge for fishing depends upon the phase of the process. Well fishing services are not taxable when performed during activities such as starting initial production or workover.¹⁷⁴

Davis-Kemp Tool Co., Inc. v. Bullock,¹⁷⁵ considered whether a taxpayer was entitled to a resale exemption for renting fishing tools used in performing fishing services. Davis-Kemp rented the tools from a third party and then used them to perform fishing services for its customers. Davis-Kemp rebilled the tool rental charge, along with labor costs and transportation charges, to its customers. The court determined that Davis-Kemp was not entitled to claim a resale exemption on its lease of the equipment since Davis-Kemp's

¹⁷³ Texas Tax Code §151.308.

¹⁷⁴ Comptroller Letter No. 200002026L (February 4, 2000).

¹⁷⁵ 584 S.W.2d 579 (Tex. Civ. App.—Beaumont 1979) *aff'd*, 590 S.W.2d 708 (Tex. 1979).

customers never obtained any control or dominion over the equipment.¹⁷⁶ Davis-Kemp, not the customer, was the consumer of the equipment rental because the customer never had any control over the equipment or the taxpayer's personnel operating the equipment on the job site.¹⁷⁷

Completing the Well

After an oil or gas well is drilled, the operator must usually test and log the well to determine if a formation will produce oil or gas. If so, the operator must evaluate the potential of the pay zone. Once the operator determines that the formation is productive, the drilling is completed and the casing set. If the well has sufficient natural drive, it will begin flowing freely. If not, some form of well stimulation may be needed to start production.

In this phase of the development of an oilfield, Texas sales & use tax is not due. Instead, Texas law imposes an occupations tax, called the well servicing tax, on anyone in the business of providing certain well services, and who owns, controls, or furnishes the tools, instruments, and equipment used in providing well service; or uses any chemical, electrical, or mechanical process in providing service at any oil or gas well during the drilling and completion, or reworking or reconditioning, of the oil or gas well.¹⁷⁸

The well servicing tax applies after a site has been developed and a hole has been drilled. Services subject to the well servicing tax are those that are generally designed to stimulate production of an oil or gas well. It's important to distinguish which services are subject to Texas sales & use tax, which ones are subject to well servicing tax, and which ones are nontaxable.

The following five (5) oil & gas well services are subject to the well servicing tax: surveying or testing the formation; cementing the casing seat; shooting the formation; fracking the formation; and acidizing the formation.

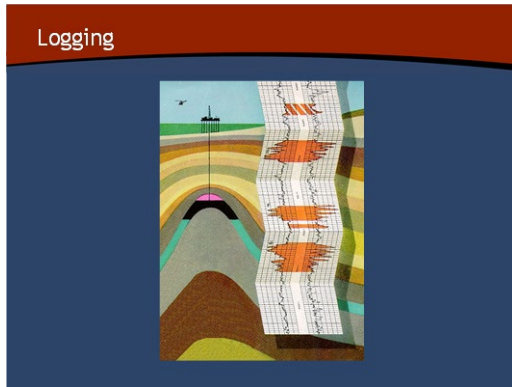
The well servicing tax is imposed at the rate of 2.42% of fees for taxable services. Reports are due monthly on the 20th day of the month following the end of each calendar month. The service provider does not collect the tax well servicing tax from its customers but pays the tax based on its receipts from well services provided for consideration.

¹⁷⁶ *Id.* at 580.

¹⁷⁷ *Id.* at 581.

¹⁷⁸ Texas Tax Code §§191.081 *et seq.*

Well Logging



Surveying or testing the sands or other formations or their contents by using instruments or equipment, at least a part of which are located in the well bore when the survey is made, is one of the services subject to the well servicing tax.

Surveys of the sands or other formations are normally recorded on some medium, and are referred to as "logs." Thus, this activity is also

known as "logging." Logging falls into three broad categories. They are open-hole logging; cased-hole logging; mud logging.

Surveys. Surveys also include: fluid level surveys; dip meter surveys; fluid ingress or egress surveys; deflection, deviation, and inclination surveys; depth surveys; corrosion surveys; and tracer surveys.

Well logging is used to identify formation and other downhole properties of the well bore. Logging tools can include radioactive, electric, mechanical, and sonic tools, among others.

Wireline Services

Wireline services are often used to lower the instruments into the wellbore. The wireline service company performs the service by attaching the instrument to a heavy duty wire which it lowers into the wellbore. In completing a well, wireline services are often used in connection with logging, perforating, setting of downhole tools, fishing, bailing, and swabbing.

Testing

The most common tests are drill stem tests; pressure tests; productivity index tests; potential tests; core tests; sidewall core tests; gas/oil ratio tests; and bottom-hole tests.

Conducting Drill Stem Test

To determine the potential of a producing formation, the operator may order a drill stem test. The crew makes up the test tool on the bottom of the drill stem, then lowers it to the bottom of the hole. Weight is applied to the tool to expand a hard rubber sealer called a packer. Opening the tool ports allows the formation pressure to be tested. This process enables workers to determine whether the well can be produced.

Coring

The operator will often request a core sample of the formation for testing. The driller secures a special core barrel to the bottom of the drill string. It is lowered into the wellbore and rotated to cut a core from the formation. The drilling brings the core to the surface where it may be examined to determine its contents.



Taxability of Logging & Testing. It is impossible to say whether a particular test or survey is always subject to the well servicing tax. A test or survey is subject to the well servicing tax if it meets the conditions of taxability. They are it must be a test or survey of the formation or its contents; instruments or equipment, or a portion of them, must be located in the well when the test or survey is conducted; the test or survey must be conducted during the drilling or completion, or re-working or re-completion of the well; the test or survey must be conducted by a person other than the one drilling the well.

Specific Rules

- **Acoustic Logs.** They measure the porosity of the formation by recording sound wave reflection. These are subject to the well servicing tax. If the acoustic log is used to survey a cement job, it is not subject to the well servicing tax.
- **Caliper Log.** This is a mechanical log used to profile the wall of the well. It is not subject to the well servicing tax.
- **Chlorine Log.** This is a nuclear log normally used to evaluate the presence of water in the formation. This log is usually run in older wells and would not be subject to the well servicing tax since it is not run during the completion of the well. If the well is being re-completed, it would be subject to the well servicing tax.
- **Collar Log.** This is a mechanical collar log is not subject to the well servicing tax since it is not a log of the formation or its contents. It is common to find a collar log included with a radioactive log. If the radioactive log is subject to the well servicing tax and the charge for the collar log is included in the total charge, it is also subject to the well servicing tax. If the charge is separated, it is not subject to the well servicing tax.
- **Core Tests.** These are rarely subject to the well servicing tax since they are taken by the person drilling the well. If a company specializing in coring furnishes the core cutter and supervision, the charge would be subject to the well servicing tax. The charge made by a person for analyzing the core is not subject to the well servicing tax, since the service is not performed at the well.

- **Correlation Log.** These are also rarely subject to the well servicing tax since the usual purpose is to position the perforating gun. These logs normally cover only a few hundred feet of the hole. The logging tool is usually run into the well along with a perforating gun. The casing collars are also normally located on this log to prevent perforating the collar.
- **Corrosion Survey.** This log surveys the condition of the casing or in-hole equipment. It is not subject to the well servicing tax.
- **Density Log.** This is a nuclear log generally used to evaluate the formation. It is usually subject to the well servicing tax.
- **Depth Survey.** This survey measures the total depth of the well. It is not subject to the well servicing tax.
- **Dip Meter Survey.** This survey is generally used to calculate the dip (angle) of the formation. Normally requires a survey of two or more wells. It is usually done after the well has been completed and would not be subject to the well servicing tax. If it is conducted during the drilling completion, re-working, or re-completion of the well, it is subject to the well servicing tax.
- **Deflection Survey.** This survey is used to determine the direction of the hole. It is not subject to the well servicing tax.
- **Deviation Survey.** This is same as deflection survey. It is not subject to the well servicing tax.
- **Drill Stem Test.** This is a production test of the contents of a particular zone conducted during the drilling of the well. A special tool is installed on the drill pipe. The tool and supervision are usually supplied by the person other than the driller, and the charge would be subject to the well servicing tax.
- **Dual Induction Log.** An electrical log. It is usually subject to the well servicing tax.
- **Dual Latero Log.** Also an electrical log. It is usually subject to the well servicing tax.
- **Electric Logging.** This is used in uncased holes to evaluate the formation. It is usually subject to the well servicing tax.
- **Feeler Log.** This is same as a caliper log. It is not subject to the well servicing tax.
- **Fluid Ingress or Egress Survey.** These are generally used to measure formation fluids entering or leaving the well bore with an instrument in the well. They are also known as a "spinner" survey or "water flow survey" - subject to the well servicing tax. If this is used to measure drilling fluids only, it is not subject to the well servicing tax.

- **Fluid Level Survey.** This is a sonic survey used to determine the fluid level in the well. If any part of the instrument used is located within the well, the survey is subject to the well servicing tax.
- **Focused Log.** This is an electrical log. It is usually subject to the well servicing tax.
- **Gamma Ray Logging.** This is one of the radioactive logging techniques. It is usually subject to the well servicing tax.
- **Gas Condensate tests.** This is a test to determine the ratio of produced gas to liquid hydrocarbons. Instruments may be placed within the tubing or drill pipe. If such tests are conducted during drilling completion, reworking, or reconditioning of the well, they are subject to the well servicing tax.
- **Gas/Oil Ratio Test.** This is a test to determine the ratio of produced gas to produced oil. It is not subject to the well servicing tax since an instrument is not placed in the well.
- **Induction Log.** This is an electrical log. It is usually subject to the well servicing tax.
- **Latero Log.** This is also an electrical log. It is usually subject to the well servicing tax.
- **Micro Log.** This is also an electrical log. It is usually subject to the well servicing tax.
- **Microlatero Log.** This is an electrical log. It is usually subject to the well servicing tax.
- **Micro Spherical Log.** This is an electrical log. It is usually subject to the well servicing tax.
- **Mud Logging.** This involves the collection and analysis of cuttings contained in the drilling fluid. This is not subject to the well servicing tax since it does not involve the placement of an instrument in the well.
- **Neutron Logging.** This is one of the radioactive logging techniques. It is usually subject to the well servicing tax.
- **Nuclear Logging.** This is one of the radioactive logging techniques. It is usually subject to the well servicing tax.
- **Potential Tests.** This is the analysis of pressures and flow rates to determine the productive potential of the well. This is not subject to the well servicing tax if instruments are not placed in the well.
- **Pressure Tests.** These tests may or may not involve instruments placed in the well. They may be conducted throughout the life of the well. The only time they are subject to the well servicing tax is when they are conducted during the completion or re-completion of the well, when an instrument is placed in the well, and when the

purpose is to test the contents of the formation. The instrument used is referred to as a "bottom-hole bomb."

- **Proximity Log.** This is an electrical log. It's usually subject to the well servicing tax.
- **Sidewall Core Test.** This is the taking of a core from the sidewall of the well rather than the core of the well. See core testing.
- **Spherical Focused Log.** This is an electrical log. It's usually subject to the well servicing tax.
- **Spinner Survey.** This is same as fluid ingress and egress survey.
- **Temperature Log.** This is a record of the temperatures encountered at various depths in the well. This is a subject to the well servicing tax service if it is to survey the fluids in the well. If it is used to check the results of cementing, it is not subject to the well servicing tax.
- **Tracer Survey.** This survey traces fluid movement, usually behind the casing. If the purpose of the survey is to check the results of cementing to stop the undesirable movement of these fluids, it is not subject to the well servicing tax. If the purpose is to analyze the movement of the fluids, it is subject to the well servicing tax.

☞ **Important Note.** Most surveys are run with a combination of several tools to save time and expense in obtaining the desired information. If a non-subject to the well servicing tax service is run simultaneously with a service to survey the formation, the entire operation is subject to the well servicing tax, if it is in direct connection with a primary subject to the well servicing tax service. For example, a gamma ray and a collar log are run simultaneously. The collar log is not subject to the well servicing tax because it has no connection with the gamma ray log.

Services Not Subject to the Well Servicing Tax. In connection with the services provided by a well servicing company, there are charges which are NOT subject to the well servicing tax under the statute.

The charges that are not subject to the well servicing tax include:

- The value of material used, consumed, expended in or incorporated into the well during the performance of a service subject to the well servicing tax. If the charge for the service is not separately stated, the value must be determined and deducted from the total amount to arrive at the amount subject to the well servicing tax. In determining the value of the material, all reasonable or necessary elements of the value of the materials should be considered, including the cost of the materials, transportation, handling, profit on the sale, overhead, etc.

- Charges for "waiting time" or "stand-by time" since no service is being performed. "Waiting time" is the period of time when a piece of service equipment (pump, lines, or tanks) is connected to other service equipment during a cementing, acidizing, or fracking job, but not put to immediate use. "Stand-by time" is the period of time when a piece of service equipment is at the well but is neither used nor connected to other service equipment. This may be before the service begins or during the time when no service is being performed due to causes beyond the control of the service company.
- Computer analysis of cementing, fracking, acidizing, surveying or testing when performed at a location other than the well. However, the use of a computer or computer terminal at the well site will constitute a service subject to the well servicing tax when performed in or at the well.
- A temperature survey to determine the results obtained in cementing a casing seat unless it is performed in connection with a service subject to the well servicing tax.
- Perforating and the taking of cores and cuttings.
- Services performed in converting an oil or gas well into an injection well.
- Receipts for equipment taken to a well but not connected in any way to the well or other equipment.
- Tax reimbursement equal to that actually paid for sales or use tax on materials and supplies.
- Receipts for frac tank services.
- Receipts for reasonable mileage charges.
- Receipts for services performed before or after a service has been commenced or completed subject to the well servicing tax.
- A dip recording survey made for the purpose of determining where to drill subsequent wells, when not made in connection with the drilling and completion of the well in which it is made.
- Gas-oil ratio tests.
- Cementing of the conductor pipe and surface casing.

Tax Reimbursement. Most well service companies bill their customers a tax reimbursement for the well servicing occupation tax. Since the well servicing tax is imposed on the person performing the service, and not on the customer, this tax

reimbursement becomes a part of the taxpayer's gross receipts subject to the well servicing tax.¹⁷⁹

Some correlation logs are subject to the well servicing tax services. Some are not. A log run to correlate a service company's equipment with an existing log is not a subject to the well servicing tax service since its purpose is to position equipment. A cased hole log used to correlate an open hole log is a subject to the well servicing tax service.

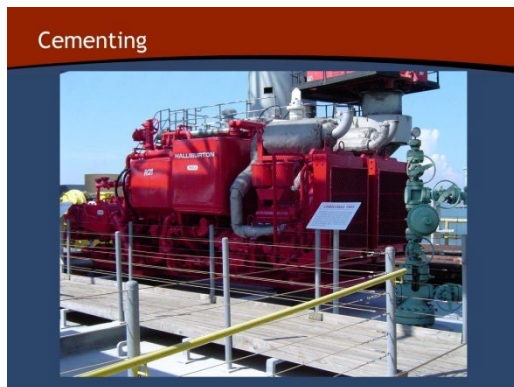
Installing the Production Casing

Once the well log data is examined, the producer must decide whether to complete the well for production or plug and abandon it. If the producer decides to complete the well for production, it will install production casing. Production casing is the final casing set in a well. It can be set from the bottom to the top. Sometimes a production liner is installed. This activity begins with the cementing of the casing seat.



Cementing. Cementing is one of the first steps in well completion and is normally provided by a well servicing company, not the driller.

In all methods of preparing the well for production, the column of casing at the bottom of the producing string is referred to as the "casing seat" or "shoe." This is subject to the well servicing tax.



well servicing tax.

Cementing of the casing seat is the operation by which cement is placed between the outside of the casing and the wellbore for the purpose of securing the casing in place and excluding water and other fluids from entering the wellbore. The cementing of a casing seat commences with the placing of the production string in the well and ends when the cement is in place. This is a service subject to the

The cementing material is mixed in a liquid state (slurry) at the surface and usually is either hydraulically pumped to the bottom of the wellbore through the casing, or through auxiliary tubing and is forced up behind the casing; or lowered to the bottom of the hole in a bailer and dumped there.

¹⁷⁹ See Attorney General Opinion MS-172.

The producing string is the last column of casing placed in a well and is often referred to as the "oil string". It is common practice for the producing string to extend from the seat to the surface; however, in some cases the string or casing is not extended to the surface but is run only part of the way up the well bore and is referred to as a "liner". A liner used to extend the cased interval of the hole below a previously cased section is a part of the producing string. In multiple completion operations, producing strings may be placed in the well for each producing zone, and each string cemented for the purpose of isolating each zone.¹⁸⁰

Cementing Services Subject to the Well Servicing Tax. The cementing of the casing seat, or the seat of liners when used as extensions of the production string, is the only cementing service subject to the well servicing tax.

Taxable cementing services are limited to the cementing of casing seating, cementing the bottom of liners used to extend the producing string, the cementing of each producing strings in a multiple completion operation, and cementing to repair or replace damaged casing seats in oil or gas wells being reworked or reconditioned.¹⁸¹

The taxable cementing of a casing seat commences with the placing of the producing string in the well and ends when the cement is in place; including the mixing of the cement slurry at the well, the blending of additives or inhibitors into the slurry at the well, the placing of cement packers, hangers, and other equipment necessary for a successful cementing job, and the pumping of the cement slurry from the mixer or blender to the well head pump.¹⁸²

Services which are subject to the well servicing tax when performed, or made available during or in association with cementing of the casing seat or the seat of liners, include: mixing the cement slurry at the well; blending additives and/or inhibitors into the slurry at the well; setting packers, hangers, or any other equipment into the well when the service is performed by the person doing the cementing, and when the service is associated with cementing the casing seat; pumping the slurry, or any other material; using any specialized equipment used in cementing the casing seat; any other services performed while cementing the casing seat; and well servicing tax reimbursement.

Cementing Charges Not Subject to the Well Servicing Tax. Charges for the following cementing services are not subject to the well servicing tax: mileage and/or stand-by charges; material used, consumed, or expended in or incorporated into the well; cementing of the conductor pipe or an intermediate string of pipe; cementing to control the

¹⁸⁰ Comptroller Letter No. 7707L1077C11.

¹⁸¹ Comptroller Letter No. 7707L1077C11.

¹⁸² Comptroller Letter No. 7707L1077C11.

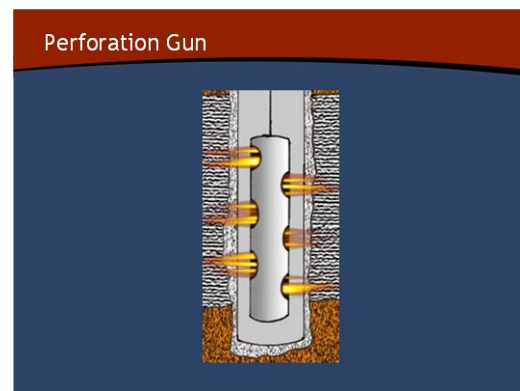
movement of fluids behind the casing, to correct lost circulation, or to repair casing leaks; cementing to re-complete the well at another depth; plug back operations (plugging); cementing for abandonment; squeeze cementing; cementing for whipstock operations; cementing to repair defective casing or cementing liners for remedial or repair operations; and pouring pads for wellhead equipment;

Cementing a casing seat begins with placement of the production string in the well and ends when the cement is in place. Cementing the bottom liner used as an extension of a non-continuous production string is a subject to the well servicing tax service.

The services involved in cementing the casing seat that are subject to the well servicing tax include mixing cement slurry; blending; setting packers or placing hangers, if done by the service company during the cementing operation; pumping slurry from the mixer and/or blender to the wellhead pump; and using equipment to pump cement into a well.

Shooting the Sands or Perforating the Formation

Usually, a specialized crew will transport and operate the perforating equipment. Upon arrival at the site, the tools are assembled, then lowered into the well by a wireline unit or conveyed by tubing. Then, a specialized gun shoots small holes into the casing of the producing zone. The perforations allow the oil or gas to flow into the casing or liner. If pressure is sufficient, the oil or gas will rise to the surface.



Taxability of Perforating or Shooting. Shooting the sands or other formations is the only shooting service subject to the well servicing tax.

No well servicing tax is due on cutting casing; shooting to remove fish; shooting to clean screens or strainers.

Other shooting services which may be performed that are not subject to the well servicing tax include: destroying objects lost/stuck in the hole ("fishing"); cutting casing; cutting or freeing stuck drill pipe; perforating the casing;¹⁸³ and clearing screens, strainers, or perforations ("string shot shooting").

¹⁸³ Research in the industry continues for a method in which the casing can be perforated and the formation fractured during one operation, which would result in a taxable service. This technology is apparently not available at the present time.

Starting Production Flow

Production flow is started by washing in the well and setting the packer. “Washing in” means to pump in water or brine to flush out the drilling fluid. Usually this is enough to start the well flowing. If not, then the well may need to be unloaded. This means to swab the well to remove some of the brine. If this does not work the flow might be started by pumping high-pressure gas into the well before setting the packer.



Swabbing. Swabbing is the act of pulling fluid from the well bore through the use of wire rope and cup assembly. Swabbing equipment includes a swabbing assembly, lubricator with an oil saver, and shut-off valve on the well, also called a swabbing valve. If the well does not flow on its own, well stimulation or artificial lift may need to be considered.

Taxability of Swabbing. Swabbing done to start production in a well or to restart production in a well is not subject to either the Texas sales & use tax nor the Texas well servicing tax.¹⁸⁴ The swabbing company must pay tax on all materials used or consumed in providing the service, including the cost of the rubber cups used downhole to pull the water up through the wellbore. The swabbing service will remain nontaxable even if small amounts of sand and paraffin are removed, so long as the purpose of the swabbing is to produce oil.¹⁸⁵

Well Stimulation

Well stimulation involves techniques to optimize the well’s performance. This may include pumping of acids, energized fluids, and various other chemicals to improve formation flow characteristics.

Water Transfer/Fluids Control. Operators often hire companies to manage the flow of fluids at a well site. Well site operations consume large quantities of liquids, typically water. Water is used in drilling mud operations and in fracking. The fluids control provider is responsible for providing the pumps, piping and personnel necessary to furnish water to the frac tanks and freshwater pits at flow rates that comport with the rates at which the fluids are being



¹⁸⁴ Comptroller Letter No. 200107379L (July 17, 2001).

¹⁸⁵ Comptroller Letter No. 200107379L (July 17, 2001).

drawn from the frac tanks and pits by the mud and fracking companies. The fluids control providers are also responsible for managing the removal of fluids that flow back out of the well.

In Comptroller hearing no. 107,928 (June 1, 2016), the Comptroller held that a fluids control provider properly treated his invoice charges as non-taxable. The provider's invoice charged amounts for the various pieces of equipment that the provider used to provide its fluid control services. No amounts were charged for operators or other personnel furnished by the fluids control provider. The auditor treated the charges as taxable rentals of equipment. After hearing the presentation of evidence, the Comptroller held that the fluids control provider performed non-taxable services and did not engage in taxable rentals. The Comptroller recognized that the provider never transferred operational control of the equipment to the operator. Instead, the fluid control provider's employees operated and managed all aspects of the process. This is the application of the operational control test discussed earlier in Chapter II.

Audit Policy. Auditors are directed to examine the underlying facts to determine whether a particular transaction is a taxable rental of tangible personal property or a non-taxable service.

If the water transfer services as billed as a lump-sum charge, the Comptroller directs the auditors to treat the charge as the taxable rental of tangible personal property. However, if the water transfer company provides proof that an operator is on-site to operate the water transfer equipment, the Comptroller states that the auditor may treat that transaction as a service rather than a taxable equipment rental.

When the facts show that a customer acquired operational control of the equipment, the transaction was a rental. However, when the water transfer company was able to show that it retained operational control of the equipment, the transaction was a service.

If the water transfer services company bills separate charges for the equipment and the operator, the auditor is directed to treat the equipment charges as taxable rentals. The charges for the operator are not taxable.

If the water transfer service company's invoice separately charges for the equipment and operator, sales tax will be due on the fair market rental value of the equipment if it was purchased under a resale certificate. See Rule 3.294(c)(3)(B). The auditor is directed to request contracts; invoices, including identification of the costs included on the invoices; statements of work; time sheets for on-site personnel; equipment schematics; pictures of the equipment and well-site; affidavits of seller/on-site personnel describing what they do; and any other relevant documentation to make this determination.

Revised Audit Policy. On December 13, 2023, the Comptroller issued an interoffice memorandum reversing prior policy and providing the circumstances under which flowback services and water transfer services are not subject to Texas sales. Prior policy treated these services as the taxable rental of the flowback and water transfer equipment. The principal requirement for flowback and water transfer services to receive nontaxable treatment is for the service provider to have on-site personnel who continuously regulate and control the operation of the equipment as needed.

Water transfer services are provided at oil and gas well sites to support hydraulic fracturing operations. Water transfer service providers move the water needed for the fracking operation to the wellsite. They use water transfer pumps, lay-flat hoses, water tanks, filters, and manifolds to provide this service. During the service, they monitor and adjust the flow rate of their equipment under the direction of the well operator.

The water transfer services described above have personnel continuously onsite to regulate or control the operation of (not just monitor, maintain, repair, or activate and deactivate) the equipment as needed. Therefore, the service providers maintain operational control over the equipment and the service provider does not transfer possession of the equipment to its customer. These transactions do not meet the definition of a lease or rental.

The new policy will take effect the date when the rule change to Comptroller Rule 3.324 is adopted.

Acidizing. Acid is extensively used in the oil & gas producing industry. However, the only acid service subject to the well servicing tax is whenever the acid is injected into the earth's formation. This is referred to as "acidizing the formation." The objective is to increase the rate of flow of oil and/or gas into the well bore.

Various chemicals may be mixed with the acid to prevent damage to down-hole equipment (inhibitors); prevent foaming (surfactants); prevent scaling (sequestering agents); and cause suspension of fine particles to prevent clogging (suspending agents). The total charge for acidizing the formation, less the cost of materials, is subject to the well servicing tax.

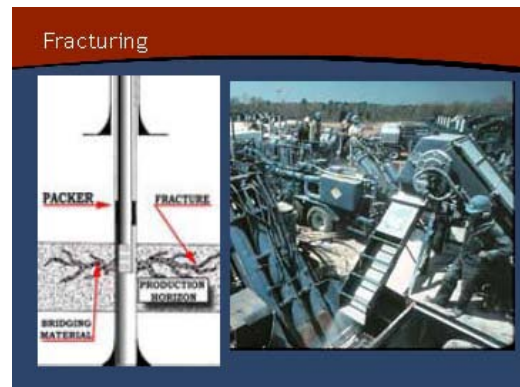
Preparing Perforations for Fracking. Often, acid is used to assist in the cleaning of the perforations in preparation for fracking the well. The first step is to hydraulically wash the perforated interval with salt water prior to installing sand control. This is to ensure the perforation is open. The next step is to surge the formation with a negative differential prior to installing sand control. Surging a formation is an alternative to cleaning perforation tunnels with a perforation wash tool. This is done by creating a vacuum below a squeeze packer. The surge tool consists of two surface-controlled valves with blank tubing between them.

The bottom valve is opened by annulus pressure. Then the surge operation takes place allowing formation fluids to flow into blank tubing placed between the two valves until the well bore is cleaned. Finally, acidizing is performed to remove formation damage incurred during the drilling process.

Generally, the charge for surging the formation is not taxable. Similarly, the charge for hydraulically washing the interval is not taxable. However, the charge for acidizing sands is taxable, while acidizing to clean perforations or to dissolve the drilling mud "cake" is not taxable.¹⁸⁶

Fracking. The charge for fracking the formation is subject to the well servicing tax. Like acidizing, the primary purpose of fracking the formation of a producing oil or gas well is to increase the rate of flow into the well bore.

After a well is drilled, an oilfield service provider may inject a mixture of water, sand and chemical additives under pressure to frac a shale reservoir, which enhances the flow of oil and gas into the wellbore and from there to the surface.



The sand remains in the cracks after the pressure is released; thus, serving to "prop" open the formation to allow the oil and/or gas to flow into the well bore.

It can take up to 4 million gallons of water to frac a horizontally-drilled shale well. Chemical additives make up less than one-half of 1 percent of the water used. The chemicals benefit the wellbore by preventing corrosion and reducing friction.

Most of the water remains underground, however about 15-20 percent returns to the surface through the wellbore and is temporarily stored in steel tanks ("frac tanks") or lined pits. The wastewater that returns to the surface after fracking is called "flowback."

Oil and gas well fracturing involves the use of numerous chemicals, including surfactants, breakers, stabilizers, and friction reducers. Surfactants are used to control for optimal viscosity of fracturing fluids, reduce surface tension between the shale formations and the fracturing fluid, assist fluid recovery after fracturing, alter the wettability of rock, and reduce flow friction of fracturing. Breakers make it easier for fluid to flow through the borehole by creating a reaction with a crosslinker and gel, which breaks down the gel. Stabilizers react with clay in the formation, stabilizing and locking it down in the shale. Friction reducers reduce the effects of friction in the pipe, which allows water to be pumped

¹⁸⁶ Comptroller Letter No. 8402L1077A09 (Feb. 10, 1984).

at a high rate while maintaining lower treating pressures during fracturing. Fracturing service providers mix the chemicals with water to create a “fluid system.”

The main functions of fluid systems are to open and transport proppants into the fractures. The specific chemicals included in a fluid system are chosen by a fracturing engineer. When the fracturing engineer develops the plan for each well, one of the main factors that determines which chemicals are included in the fluid system is the quality and characteristics of the water available for the fracturing job.

The measure to determine the cleanliness of the water being used is the Total Dissolved Solids (TDS) contained within each solution. Wastewater has a higher TDS level than freshwater. If freshwater is available, then the fracturing engineer can use generic chemicals within the fluid system. If there is not sufficient freshwater available, a fracturing engineer can also use wastewater in a fluid system. However, in order to use wastewater in a fluid system, the fracturing engineer must tailor the types and amounts of chemicals used to create the fluid system to compensate for the quality of the wastewater.

Texas Tax Code § 151.355(7) provides an exemption from Texas sales tax for “tangible personal property specifically used to process, reuse, or recycle waste-water that will be used in fracturing work at an oil or gas well.”

These fracking chemicals should qualify for exemption under this provision, but the Comptroller imposes additional burdens which are not present in the statute.

The Comptroller requires taxpayers to pay sales and use tax on all purchases of chemicals for fracturing fluid systems using wastewater unless the taxpayer establishes (a) the water being used in connection with the fracturing fluid chemicals is wastewater that was created by human activity, (b) the percentage of wastewater used within the fracturing fluid compared to the percentage of freshwater used, and (c) the tangible personal property is **solely** used to reuse or recycle wastewater.

☞ **Important Note.** *The Comptroller’s additional burdens and restrictions may not be valid under the law. However, opposition to the Comptroller’s policy will likely lead to litigation. We advise all affected oilfield service providers to consult with their CPA or Tax attorney as to whether protective refund claims should be filed.*

Flowback Services. The flowback operations begin when the high pressure created during the frac job is released. The frac fluid combined with oil, gas, and saltwater from the formation (collectively, flowback) flow up the wellbore.

At this point, the flow will be under the highest amount of pressure in the life of the well.



The equipment provided by the flowback companies is used to manage the flowback and keep the well open and flowing so that the well pressure can normalize.

Once the frac fluid and sand are removed from the well, the hydrocarbons from the formation flow more freely to the surface. The flowback equipment is made to handle and manipulate the high pressure created during the fracking of the well and to remove frac fluids, sand, and any debris exiting the wellbore under high pressure that may cause damage to the well production equipment.

Generally, flowback companies provide the following equipment at the well site in order to provide their flowback services:

- A choke manifold;
- A sand separator (sometimes referred to as a test separator) that may be equipped with gauges to determine oil, water and gas rates, diagnose well problems, evaluate production performance of individual wells and manage reserves properly;
- Flowmeters for gas and liquids;
- Tanks to hold resulting fluids;
- Transfer pumps and piping to hook everything together;
- A flare boom to burn off gas that cannot be captured (usually on exploratory wells with no pipelines in place to connect with transmission lines); and
- Various safety systems and emergency shutdowns.

The flowback water contains sand or other proppants which must be removed by recycling equipment. The recycling equipment typically consists of a sand separator and choke manifold. The manifold is placed upstream of the sand separator in order to reduce the pressure below the wellhead pressure. The flowback water then enters the sand separator where sand and other particles are removed.

The Comptroller initially viewed the provision of flowback services as occurring under these circumstances:

1. The well operator determined the temporary location of the equipment and the rate at which the equipment will flow the well.
2. After installation, the equipment worked automatically and only needed minor adjustments.
3. The flowback period typically lasted between 30 and 120 days. Most of the sand from fracking was removed from the well within two weeks. After this point, the flowback personnel usually left the wellsite. However, the equipment often remained at the wellsite afterwards for use to conduct additional testing to determine the economic potential of the well.
4. Once the well pressure had normalized and the frac fluids and proppants were no longer impeding production, the well is put into production.

Policy Prior to 2020. Prior to 2020, the Comptroller’s policy concerning the taxability of flowback services depended upon the nature of the arrangement and whether they were performed by the same company that is performing the hydraulic fracking services.

If the fracking company merely rented the flowback equipment without an operator, the Comptroller treated as the taxable rental of equipment. A person who only accompanies the equipment is not an “operator” and the Comptroller would not treat the transaction as a service. Specifically, the Comptroller treated the transaction as a rental of tangible personal property when the person accompanying the flowback equipment only performed non-operator functions such as maintenance, repair, or supervision.¹⁸⁷ It’s important to note that much of the rental equipment is likely exempt from sales tax under Texas tax code §151.355. This provision exempts from sales tax any equipment or supplies used to process, reuse, or recycle wastewater resulting from fracking an oil or gas well.¹⁸⁸

When the flowback company sent an operator who provided “hands on” operation of the sand separator, manifold and other equipment, the Comptroller treated the company as providing a flowback service.¹⁸⁹ If the same company that provides the fracking services also provides the flowback services, then the Comptroller viewed the flowback services as part of the overall fracking job and subjected it to the 2.42 percent oil well service.

Temporary Audit Policy (Anti-taxpayer). From 2020 to 2024, the Comptroller taxed the full charge for providing flowback services as equipment rentals. In doing so, not only did

¹⁸⁷ See Comptroller Rule §§3.294(a)(3) & 3.324(c)(1).

¹⁸⁸ Texas Tax Code §151.355(7); Tax Policy News (June 2011).

¹⁸⁹ See Comptroller Hearing No. 44,155 (Mar. 26, 2004).

he minimize the operational control aspects of the work performed by the operators of the flowback equipment, *he taxed the charges for their otherwise non-taxable labor as well.*

Future Audit Policy (Pro-taxpayer). On December 13, 2023, the Comptroller issued a memorandum reversing his Temporary Audit Policy and provided the circumstances under which flowback services and water transfer services are subject to sales tax. The new policy will be effective once the Comptroller amends Rule 3.324. Otherwise, see interim guidance stated on page 97.

Comptroller's current view of flowback? Flowback services are provided at oil and gas well sites to support hydraulic fracturing operations. Flowback operations involve the temporary use of oilfield equipment to handle the fluid that flows back from fracking operations. After the injection process in the fracking operation is completed, the internal pressure of the rock formation causes fluid to return to the surface. This flowback fluid contains the frack fluid plus other naturally occurring materials. Well operators hire flowback service providers to handle this fluid.

The flowback service provider designs an equipment package based on various factors. The service provider transports the equipment to the well site and may receive direction from the well operator to determine the temporary location of the equipment. The flowback service provider's personnel are responsible for set up and installation ("rig up"). Flowback personnel are onsite during the flowback operation and are trained to operate and regulate each piece of equipment. This may include metering equipment the flowback service provider uses to send the well operator measurements of flow rate, fluid properties and composition, pressure, and temperature. While the well operators may ask for a specific flow or choke rate, the well operator does not control or operate the equipment. After its work is complete, the flowback provider removes the equipment ("rig down") and the well operators separation equipment is installed.

Equipment Purchases. If a service provider performs a non-taxable flowback or water transfer service, they are required to pay sales tax on all the equipment and materials used to provide that service. Section 151.006(c) of the Texas Tax Code states that the sale-for-resale exemption cannot be applied to nontaxable items or services. Providers of flowback or water transfer services are, therefore, not allowed to use the sale-for-resale exemption because flowback and water transfer services are considered non-taxable services.

Required Records. Oilfield service providers who provide flowback and water transfer services must maintain adequate records to verify the non-taxability of their service. The records can include contracts, service agreements, invoices, bids, estimates, proposals, rate sheets, job logs, field tickets, monitoring logs, and pressure readings. These records should be able to show that personnel are onsite, identify the equipment used, show the time

period during which personnel and equipment are provided, and provide details on the personnel's job responsibilities and activities that demonstrate operational control over the equipment.

Same Company Providing Fracking and Flowback Services. If a company provides both fracking and flowback services at an oil or gas well site, the flowback services are subject to the 2.42 percent oil well servicing tax imposed under Chapter 191. The fracking service provider is also responsible for paying sales tax on the purchase of flowback service equipment and materials used in the flowback service at the time of purchase.

When does the new policy take effect? The new policy takes effect when the rule change is adopted. In the interim, the Comptroller provides the following guidance.

Interim Guidance: What if you're under audit or in hearings? For ongoing audits, the auditors are directed to examine the transactions for the entire audit period. If taxpayers have consistently treated the transactions the same way, there should not be any adjustments for flowback and water transfer transactions. For cases that went to the Administrative Hearings section, and where taxpayers were treating transactions consistently the Comptroller has stated that these cases should be dismissed, and the audits finalized with no assessment on the flowback and water transfer sales.

Who might be eligible for a refund of tax previously paid? Well operators who have paid sales tax on nontaxable water transfer or flowback services may be eligible for a refund. An oilfield service provider who collected tax in error from its customers would generally not be eligible to receive the refund, although it may be able to do so if it received an assignment from its customer.

What periods might be open for audits and refund claims? In general, the statute of limitations for filing a refund claim or conducting an audit in Texas is four years from the date on which the tax was due and payable to the Comptroller. The statute of limitations may be extended if an Agreement to Extend Period of Limitation (also known as a "statute waiver") is signed. Statute waivers are fairly common during audits, but they typically also extend the period during which the taxpayer can request a refund claim. The statute of limitations can also be tolled (the clock stops running) after a refund claim is filed, or while the issues related to a refund claim are pending in an administrative proceeding or in litigation.

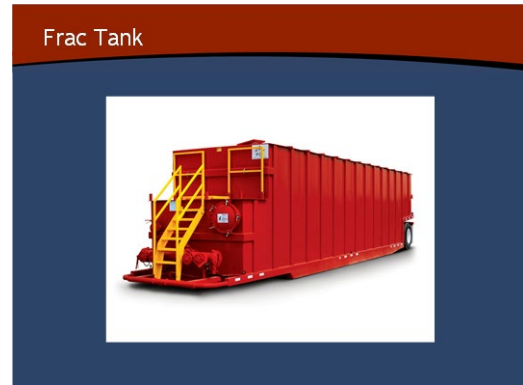
A copy the guidance is available here

<https://star.comptroller.texas.gov/view/202312010L>

Frac Tank Rental. The charge for renting a frac tank constitutes the taxable rental of tangible, personal property. Frac tanks do not require operators. They require set-up and

monitoring. A frac tank rental company may not avoid charging sales tax on the rental charges by claiming the person furnished with the frac tank is an operator.¹⁹⁰

The frac tank rental company will typically charge a set-up fee. The fee is intended to cover the preparation of the tank for delivery, transportation to the well site, testing for readiness, connecting and disconnecting the hoses from the tanks and well site. The set-up charge is taxable, even if separately-stated.¹⁹¹



In addition to renting and setting up frac tanks, the rental companies often provide additional services, selling and hauling fresh water, KCL¹⁹² and disposing of fluids. The charges for fresh water, the hauling of fresh water and the disposal of fluids is exempt from the Texas sales tax.¹⁹³ However, charges for the sale of KCL are taxable. The company must separately state the items on its invoices and apply the proper tax rules to each item.¹⁹⁴

Services Subject to the Well Servicing Tax. Services which are subject to the well servicing tax when performed, made available during or in association with acidizing or fracking, include: mixing the solutions at the well; blending additives or inhibitors into the fluid at the well; pumping charges for pumping the fluids, additives, inhibitors, and/or propping agents from storage tanks to the blender and/or the main injection pump at the wellhead and down the well; charges for the mixer; sealing perforated casing in multi-zone acidizing or fracking jobs (i.e., ball injector service); perforating the casing if performed simultaneously with acidizing or fracking (generally this is not done simultaneously); and specialized equipment charges, i.e., isolation tool, wellhead protection tool, manifolds, etc.

Fluid Recovery Gases. The use of nitrogen, carbon dioxide or compressed air to aid in fluid recovery in acidizing and fracking services is partially taxable. The cost of extracting or processing the nitrogen, carbon dioxide or compressed air is treated as materials used, consumed, expended in or incorporated in the well and not taxable. But the cost of

¹⁹⁰ Comptroller Letter No. 8809L1028A01 (Sept. 21, 1988).

¹⁹¹ Comptroller Letter No. 8809L1028A01 (Sept. 21, 1988).

¹⁹² KCL is potassium chloride. It is used to promote a better bond between the cement and the formation, minimize the migration of particles and accelerate the cement slurry setting times.

¹⁹³ Comptroller Letter No. 8809L1028A01 (Sept. 21, 1988).

¹⁹⁴ Comptroller Letter No. 8809L1028A01 (Sept. 21, 1988).

injecting the nitrogen, carbon dioxide or compressed air into the well is part of the taxable well servicing.¹⁹⁵

Services That Are Not Subject to the Well Servicing Tax. Services performed in connection with acidizing or fracking that are not subject to the well servicing tax include: tank rental; mileage, stand-by charges, or "waiting time"; acidizing to recover fish or stuck pipe; acidizing to clean screens or strainers; acidizing to dissolve mud sheaths on the wall of the hole; acidizing soluble metals (pipe or special tools); acidizing to dissolve paraffin deposits in the tubing; fracking of injection or disposal wells; and perforating the casing in preparation for acidizing or fracking.

Water Injection Wells & Water Disposal Wells. Work performed on these types of wells is not subject to the oil well servicing tax, but may be subject to the sales tax if the work involves the repair of the well bore or equipment located within it.¹⁹⁶

Taxability of Sand (Proppants). Texas imposes a sales tax on each sale or use in this state of tangible personal property and certain specified services.¹⁹⁷ Tangible personal property is defined as personal property that can be seen, weighed, measured, felt, or touched or that is perceptible to the senses in any other manner.¹⁹⁸ Although sand, rock, and gravel clearly meet the definition of tangible personal property, pursuant to Comptroller policy, the sale and delivery of unprocessed sand, gravel, and rock has not been subject to Texas sales and use tax since 1988.¹⁹⁹ The Comptroller, by policy, treats the sale and delivery of unprocessed sand, gravel and rock as the provision of a non-taxable service.²⁰⁰

In contrast, Texas sales and use tax is imposed on the sale and delivery of processed sand, gravel, and rock.²⁰¹ In Comptroller Rule § 3.300, Manufacturing; Custom Manufacturing; Fabricating; Processing, "processing" is defined as the physical application of the materials and labor necessary to modify or to change the characteristics of tangible personal property.²⁰² The issue of what constitutes processing routinely arises in cases where

¹⁹⁵ Comptroller Letter No. 7707L1077C11 (July 8, 1977).

¹⁹⁶ Comptroller Letter No. 9112L1146D01 (December 19, 1991).

¹⁹⁷ See Tex. Tax Code §§ 151.051 and 151.010.

¹⁹⁸ Tex. Tax Code § 151.009.

¹⁹⁹ See Star Doc. No. 9205091H, Comptroller Hearing Decision (May 27, 1992); See also Star Doc. No. 9205L1171G05, Comptroller Letter Ruling (May 21, 1992) and Star Doc. No. 8810L0904F07 Comptroller Letter Ruling (October 4, 1988); See also Tax Policy News, March 2012.

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² See 34 Tex. Admin. Code § 3.300 (a)(10).

taxpayers have claimed the manufacturing exemption [from sales and use tax] on equipment the taxpayer purchased for use in its manufacturing operations.

Texas law exempts from sales and use tax tangible personal property directly used or consumed in or during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary or essential to the manufacturing, processing, or fabrication operation and **directly makes a change or causes a chemical or physical change** to either the product being manufactured, processed, or fabricated for ultimate sale; or any intermediate or preliminary product that will become an ingredient or component part of the product being manufactured, processed, or fabricated for ultimate sale.²⁰³

The Comptroller has consistently held that screening, sifting, sorting, sizing, or cleaning materials, such as sand, gravel, rocks and vegetables, to remove dirt or other foreign materials is not processing because none of the operations modify or change the physical characteristic of the materials.²⁰⁴

However, crushing, cutting, or mixing sand, gravel and rock with other ingredients constitutes processing because these activities change the physical characteristics of the sand, gravel, and rock.²⁰⁵ Additionally, the Comptroller has determined that blasting rock and sandstone formations constitutes processing because the blasting causes a physical change to the formation by downsizing/breaking the formation into smaller pieces, thereby creating something (i.e., sand, gravel and rock) that did not previously exist in nature.²⁰⁶

Blasted from Sandstone. The Comptroller has held that the taxpayer's purchases of 20/40 mesh size sand [for use as a propping agent] were taxable because the sand had been processed during the blasting of the sandstone formation and the subsequent crushing of the blasted materials.²⁰⁷ The Comptroller rejected the taxpayer's argument that the sand was merely washed and sorted.

Instead, the Comptroller found that the hydraulic water system, which sprayed the sand with several high-powered streams of water downsized or liberated individual sand grains from the clumps and caused the release of impurities or other materials (such as silica and

²⁰³ Tex. Tax Code § 151.318(a)(2).

²⁰⁴ See Star Doc. No. 200808333H, Comptroller Hearing Decision (August 6, 2008); Star Doc. No. 9710787H, Comptroller Hearing Decision (August 8, 2008) (partially superseded on dual use/predominant use issue) and Star Doc. No. 9205091H, Comptroller Hearing Decision (May 27, 1992). See also Star Doc. No. 9205L1171G05, Comptroller Letter Ruling (May 21, 1992) and Star Doc. No. 8810L0904F07 Comptroller Letter Ruling (October 4, 1988).

²⁰⁵ See Star Doc. No. 9205L1171G05, Comptroller Letter Ruling (May 21, 1992).

²⁰⁶ See Star Doc. No. 8809H0900F07, Comptroller Decision No. 23,055 (September 29, 1988).

²⁰⁷ See Star Doc. No. 9205091H, Comptroller Hearing Decision (May 27, 1992).

iron oxide) from the sand grains.²⁰⁸ The Comptroller stated that while the mere washing of dirt, gravel and sand to remove clay and silt would not be considered processing, the hydraulic wash process used by the vendor changed or modified the characteristics of the sand.²⁰⁹

The ultimate issue appears to be whether the final product (i.e., the grain of sand) that is being sold has been changed from its native size. If the grain of sand has not changed from its native size and, instead, the waste particles that bind the sand grains together are being removed, then we believe strong arguments can be made that the sand remains “unprocessed.”

Recombined Sand. The taxability of two different sizes of sand sold by a taxpayer to oil and gas companies for use in well fracturing varied, depending upon whether the sand was recombined after washing, sorting and drying. Generally, sale of unprocessed sand is not taxable. However, the Comptroller deems as “processed” (and therefore taxable), sand that is crushed, mixed, or subject to any other process other than basic washing and sorting. The taxpayer sold two types of sand: “40/70” and “40/140.” The Comptroller privately ruled that the taxpayer’s charges for “40/70” sand were nontaxable because the taxpayer did not recombine the sand after washing, drying and sorting it. However, the Comptroller decided that charges for the taxpayer’s “40/140” sand were taxable because the taxpayer recombined the sand with a front-end loader.²¹⁰

Attrition Scrubbers. Attrition scrubbers do not change the physical properties of the individual grains of sand and thus using them does not convert otherwise unprocessed, nontaxable sand into taxable, processed sand. Sand is mixed with water to form a slurry that is fed into the attrition scrubbers. The attrition scrubbers act like washing machines, washing and agitating the sand slurry in order to remove impurities such as organics, clay, silt and other contaminants. No chemicals, acids nor additives are added to the sand slurry.²¹¹

Installing Production Tubing

A well is usually produced through tubing inserted down the production casing. Oil & gas is produced more effectively through this smaller-diameter tubing than through the large-diameter production casing.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ Comptroller Letter No. 201902003L (February 7, 2019).

²¹¹ Comptroller Letter No. 202007009L (July 2, 2020).

Joints of tubing are joined together with couplings to make up a tubing string. Tubing is run into the well much the same as casing, but tubing is smaller in diameter and is removable.

The drilling company performs these steps to install production tubing. First, tubing elevators are used to lift tubing from the rack to the rig floor. Then, the joint is stabbed into the string, which is suspended in the well, with air slips. Next power tongs are used to make-up tubing. This process is repeated until tubing installation is complete. Finally, the tubing hanger is installed at the wellhead.



New technology allows tubing to be manufactured in a continuous coil, without joints. Coiled tubing is inserted into the well down the production casing without the need for tongs, slips, or elevators, which takes considerably less time to run.

Installing Artificial Lift Equipment. Early in its production life, the underground pressure will often push the hydrocarbons all the way up the wellbore to the surface. Depending on reservoir conditions, this “natural flow” may continue for many years. When the pressure is insufficient for the oil to flow to the surface naturally, the well operator may use mechanical pumps to bring the oil to the surface.

This includes gas lift equipment, sucker rod pumps, hydraulic pumps, saltwater injection equipment, and steam injection equipment. The Comptroller states that pumping the product is not considered to be stimulating production.²¹²

Beam Pumping Units

If the well doesn't produce adequately, a beam pumping unit may be installed. There are four basic types of beam pumping units. Three involve a walking beam, which seesaws to provide the up and down reciprocating motion to power the pump. The fourth reciprocates by winding a cable on and off a rotating drum. The job of all four types is to change the circular motion of an engine to the reciprocating motion of the pump.

The pump units are brought in disassembled on trucks and off-loaded onsite. The many parts of the pump unit include large heavy metal pieces that need to be assembled.

²¹² Comptroller Oil & Gas Well Servicing Audit Manual. From Hrg Dec. 15,740 (Mar. 6, 1986).

Installing Production Surface Equipment

Once the oil & gas reach the surface, they are often mixed together and contain moisture and impurities. The well operator must install equipment to separate the oil from the gas, remove moisture and impurities before the oil & gas can be sold.

Dehydration Equipment. Natural gas usually contains significant quantities of water vapor. The gas cools as it travels up the well bore to the surface. As the gas cools, the water vapor may turn to liquid. The liquid water reduces line capacity and causes corrosion in the pipeline. Additionally, the liquid water can cause the formation of hydrates, which are solids that may plug the line. Gas dehydration units are used to remove the water vapor from natural gas produced from the well to prevent the formation of liquid water and hydrates. The equipment is exempt from sales & use tax under the manufacturing exemption because, by removing moisture, it causes a chemical or physical change to the gas.

Heater Treaters. A heater treater transfers heat to the produced gas stream. Heater treaters are used to treat oil-water emulsions so the oil can be accepted by the pipeline or transport. Heaters are especially used when producing natural gas or condensate to avoid the formation of ice and gas hydrates. These solids can plug the wellhead, chokes and flowlines. Heaters may also be used to heat emulsions before further treating procedures or when producing crude oil in cold weather to prevent freezing of oil or formation of paraffin accumulations.²¹³

Separators. A separator is a cylindrical or spherical vessel used to separate oil, gas and water from the total fluid stream produced by a well. Gravity segregation is the main force that accomplishes the separation, which means the heaviest fluid settles to the bottom and the lightest fluid rises to the top. Additionally, inside the vessel, the degree of separation between gas and liquid will depend on

Heater Treaters



Dehydration Equipment



Separator



²¹³ Comptroller Letter No. 9609L1435A12 (September 3, 1996); Comptroller Letter No. 9702256L (February 13, 1997); and Comptroller Letter No. 9910770L (October 13, 1999).

the separator operating pressure, the residence time of the fluid mixture and the type of flow of the fluid.

Gun Barrels. A gun barrel is a settling tank used for treating oil. Oil and brine are separated only by gravity segregation forces. The clean oil floats to the top and brine is removed from the bottom of the tank.²¹⁴

Vapor Recovery Units (VRUs). A vapor recovery unit (VRU)'s main purpose is to recover vapors formed inside completely sealed [crude oil](#) or [condensate](#) tanks.



The typical VRU consists of four principal components:

- Gas Compressor
- Scrubber
- Variable Frequency Drives (VFDs)
- Switching device

The switching mechanism in a VRU detects changes in pressure inside the tanks and activates the compressor. The primary function of the switch is to start and stop the operation automatically depending on the pressure conditions inside the tank. The scrubber is a device used to remove fluid impurities from a natural gas flow stream. The variable frequency drive adjusts the speed of the compressor depending on the rate of flow of gas into the VRU.

The VRU removes the vapors that collect inside sealed hydrocarbon tanks does this by gas compression and suction. The vapor recovery procedure involves the following steps:

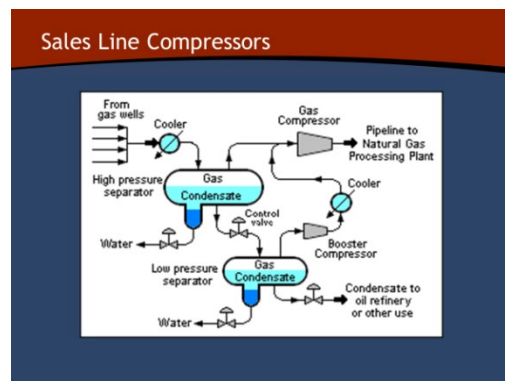
- The rotary screw gas compressor sucks liquid molecules into the scrubber
- The scrubber removes the water vapor, debris, and unwanted fluids from the tank.
- The recovered vapor is pumped into gas lines while the trapped liquids are channeled to the pipelines.

²¹⁴ Comptroller Letter No. 9609L1435A12 (September 3, 1996).

Taxability. VRUs may be eligible for the manufacturing exemption from sales tax. To prove the manufacturing exemptions for VRUs, the company should maintain accounting records, sales invoices, or other documentation to prove that they sold vapor. In addition, the company should maintain schematics of the equipment itself and be ready to identify the location of the equipment in relation to other pieces of equipment. The Comptroller directs his reviewing auditors to note where the equipment is located and how it is used. The Comptroller states that some equipment may qualify for the exemption, but divergent use principles may also apply.

For example, if a line splits out from the equipment and ties into a gas sales line, this would help establish the exemption. However, if the VRU is attached to a storage tank with no lines going away from the tank, that indicates that the company is using or storing the vapor and not selling it. Likewise, if flares are included in the rental package or attached to the equipment, this indicates that the vapor is being burned off and not sold. If there is divergent use, auditors will calculate the disqualified use by comparing the volume sold with the volume used.

Compressors. Compressors used to compress processed gas to a required pressure prior to entering a sales line qualify for the manufacturing exemption because they directly make or cause a physical or chemical change to the gas so that the gas stream has all of the physical properties required when it is sold.²¹⁵



To establish the exemption, the taxpayer must do both of these. First, the taxpayer must provide the sales contract to show that the gas must be at a certain pressure before entering the sales line.

Next, the taxpayer must show which compressor is used to increase the pressure. Taxpayers may do this by providing a schematic of the site and establishing the unit number or other identification of the

particular compressor that is located at the sales line.

²¹⁵

Section 151.318(a)(2).



Compressors necessary for the operation or used in conjunction with separators, dehydrators, line heaters, scrubbers, and other exempt equipment qualify for the manufacturing exemption because they power, supply, or support exempt equipment.²¹⁶

The taxpayer should provide the schematic of the lease site and show that the compressor is located before or in front of the separator, dehydrator, line heater, scrubber or other exempt equipment.

Compression Service. Historically, charges for compression services were not subject to sales tax. However, recently the Comptroller has alleged that compression services constitute a taxable rental of equipment. This issue is being litigated in *Absolute Oil field Services, LLC v. Hegar*. Many times, in the oil and gas industry invoices will state “rental” when in fact a service is being provided. A rental occurs when possession and control are transferred. Therefore, for the transaction to constitute a compression services the customer must not take possession or control of the compressors. When the compression company furnishes an operator and invoices lump-sum for the compression service, control and possession of the compressor is not transferred to the customer. To ensure that the charge is not treated as a rental, the compression company’s agreement with its customer should contain the following terms:

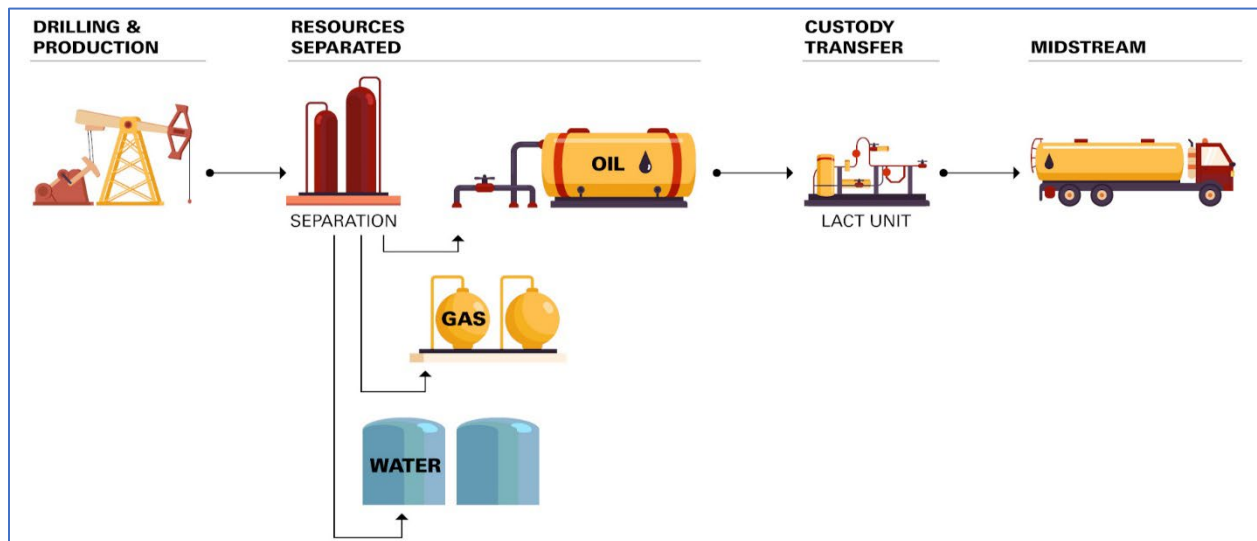
- The compressor company will provide all labor and materials necessary to operate the compression equipment.
- The compressor company will make routine inspections, not the customer.
- The compressor company will guarantee the compressors will be available for a significant percentage of time.
- The compressor company will monitor the alarms if equipment malfunctions and perform necessary repairs, maintenance or restart of the compressor.
- The customer will not take possession at any time.
- The customer will not have control of the compressor at any time.
- The customer will not perform preventative maintenance, inspections or repairs to the compressor.

²¹⁶ Tex. Tax Code § 151.318(a)(4).

A single charge for compressors and an operator is presumed to be a service. If the charge for the compressor and the operator are separated, the charge for the compressor is presumed to be the rental which can qualify for the manufacturing exemption as explained above, and the charge for the operator is non-taxable service. If the compressor does not qualify as explained above the rental charge is taxable as the rental of tangible personal property.

Lease Automatic Custody Transfer (LACT) Units. LACT stands for “Lease Automatic Custody Transfer.” A LACT Unit is oil and gas equipment which operators use to sample and measure oil so it can be transferred from one company to another.

After drilling and completing a well, the operator installs surface equipment to receive the oil and gas produced from the well. The LACT Unit is a type of surface equipment which operates after the oil and gas flowing from the well are separated into their various components (gas, oil and water) and prior to the transfer of custody or ownership of the oil to a midstream oil and gas company for storage or transportation.



LACT Units are the "cash register" of the oilfield because producers use the units to meter and calculate payments when selling the oil. LACT units not only measure the quantity of the product being transferred but also its quality—the amount of sediment and water in the oil. The allowable amount of basic sediment and water is typically established in the seller and purchaser's agreement.

Comptroller Policy: The Comptroller directs his auditors to treat LACT units as the taxable sale or rental of tangible, personal property and to not operators to claim the manufacturing exemption. The basis for the summary denial of the manufacturing exemption appears arises from the Comptroller allegation that LACT Units are typically used in transporting oil and is not used during the actual processing of oil.

This factual allegation appears to be subject to challenge as evidenced by this explanation of LACT Units from KimRay, Inc. <https://kimray.com/training/what-does-lact-unit-do>

How Does a LACT Unit Work?



- | | | |
|-------------------|-------------------------|---|
| 1. Pump | 4. Inlet Static Mixer | 7. Block & Bleed Valves / Proving Connections |
| 2. BS&W Monitor | 5. 3-Way Diverter Valve | 8. Spring-Loaded Back Pressure Valve |
| 3. Air Eliminator | 6. Coriolis Flowmeter | 9. Check Valve |



Pump

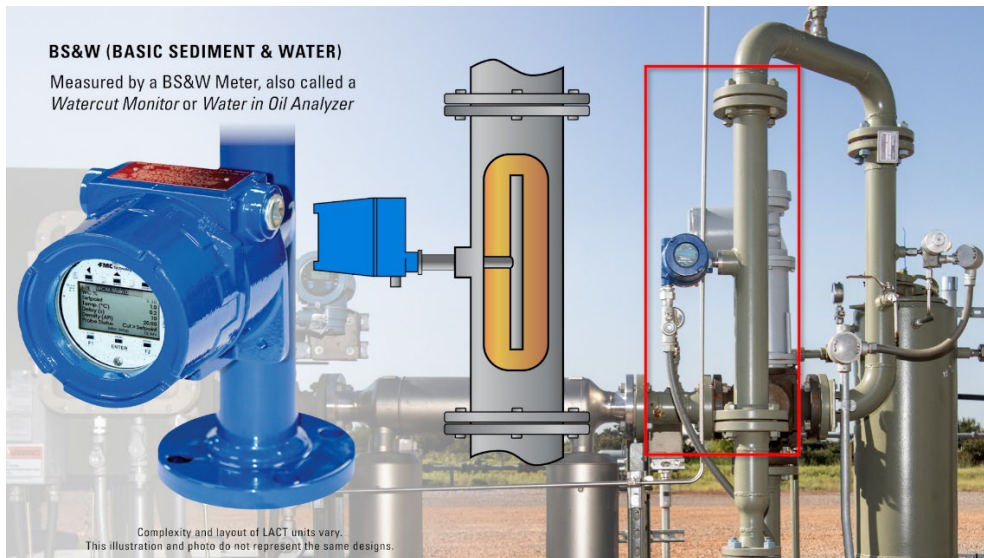
The pump draws oil from a storage tank into the unit.



BS&W

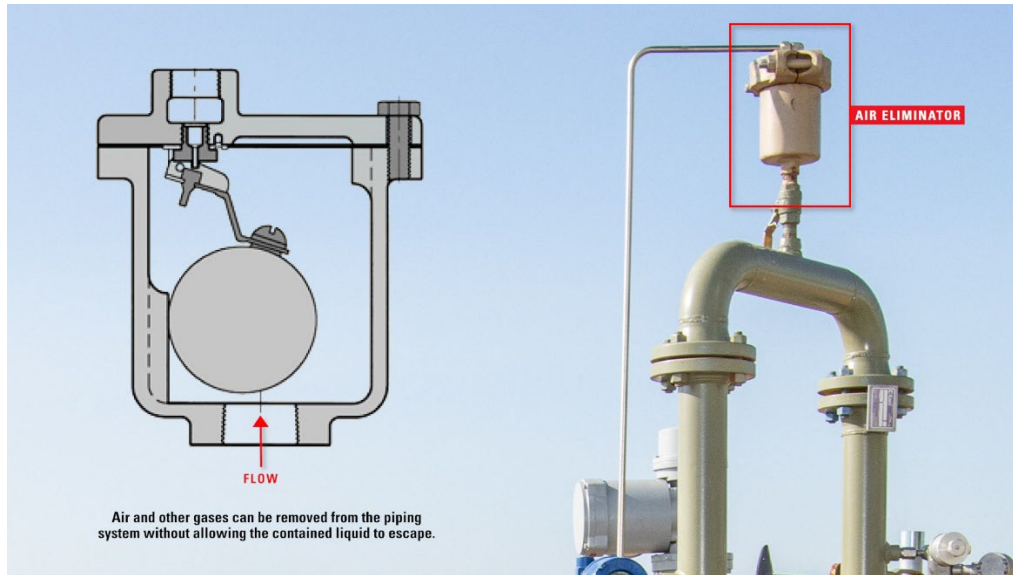
The levels of BS&W - Basic Sediment and Water - is read by a sensor and probe in the flow stream which is then communicated to a control panel. The BS&W Monitor records representative samples of the oil and the percentage of water.

Often these monitors will also read the temperature of the oil, which can affect the measurements.



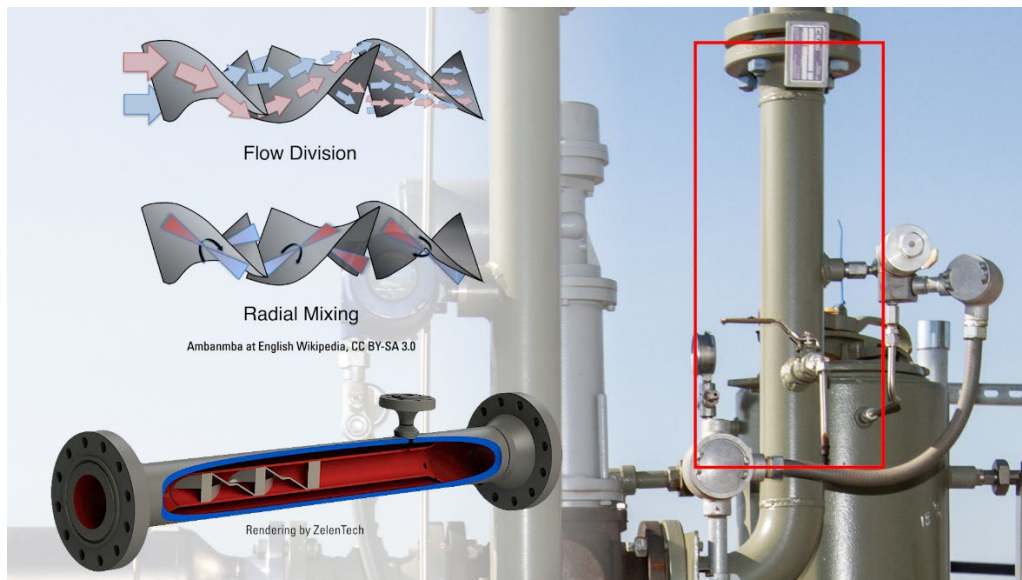
Air Eliminator

The oil travels through an air eliminator, which removes gas or air in the pipe without allowing the liquid to escape. This air can cause inaccurate metering if not removed.



Inlet Static Mixer

An inlet static mixer emulsifies the liquid so that an accurate volume measurement can be taken. There is natural separation when the fluid is flowing through a straight pipe which can lead to certain kinds of meters reading only one of the fluid phases and not both.



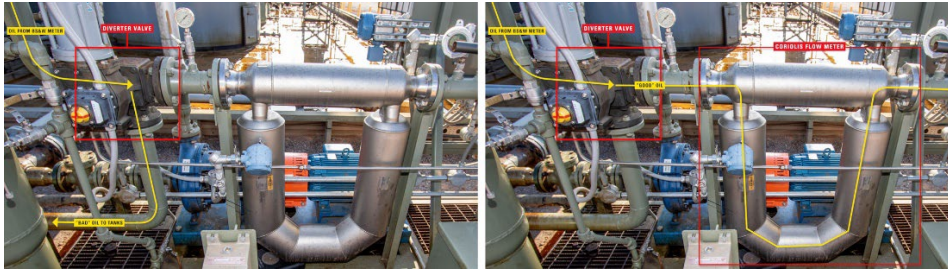
3-Way Diverter Valve

The BS&W monitor also controls a 3-way valve to direct the oil to its appropriate destination.

If the sediment and water amounts are too high, the diverter valve will route the oil to a separate "bad oil" tank to allow natural separation to occur before it is re-routed to the LACT unit again.

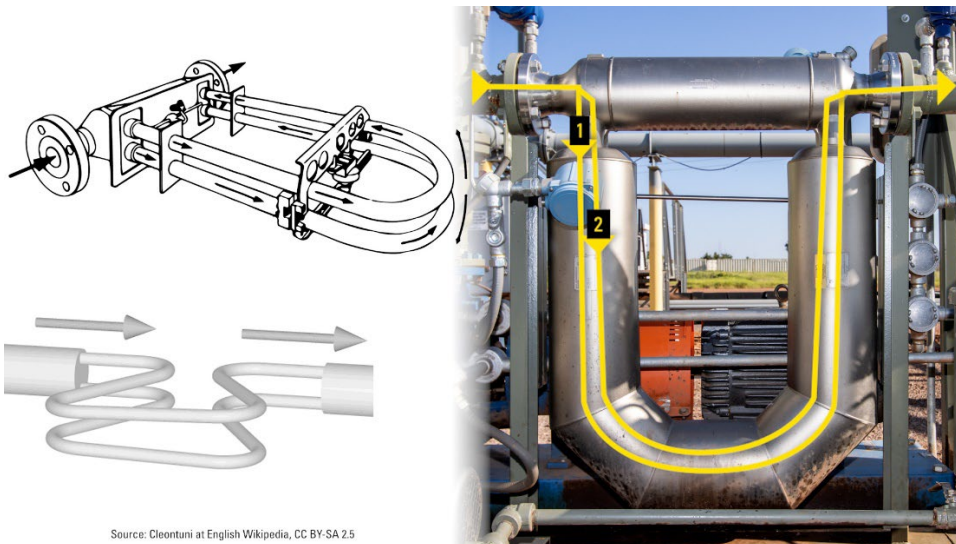
Bypass lines can direct the oil to the beginning of the separation process or a stand-alone heated vessel to remove high levels of BS&W.

If the sediment and water amounts are acceptable the 3-way diverter valve will open and send the oil to a flow meter to have the volume measured.



Coriolis Flow Meter

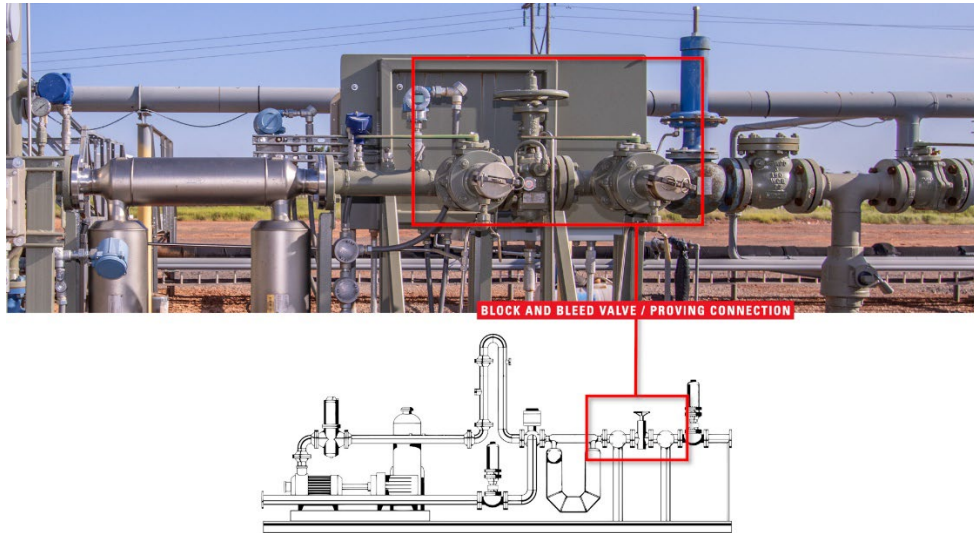
The type of meter is determined by the maximum mass and volumetric flow rate. On this location, a Coriolis meter is being used. Using motion mechanics, the meter splits the process fluid into two coils oscillating in opposite directions. Voltage is generated, sine waves are created, and the time delay in motion is proportional to the mass flow rate.



Source: Cleontuni at English Wikipedia, CC BY-SA 2.5

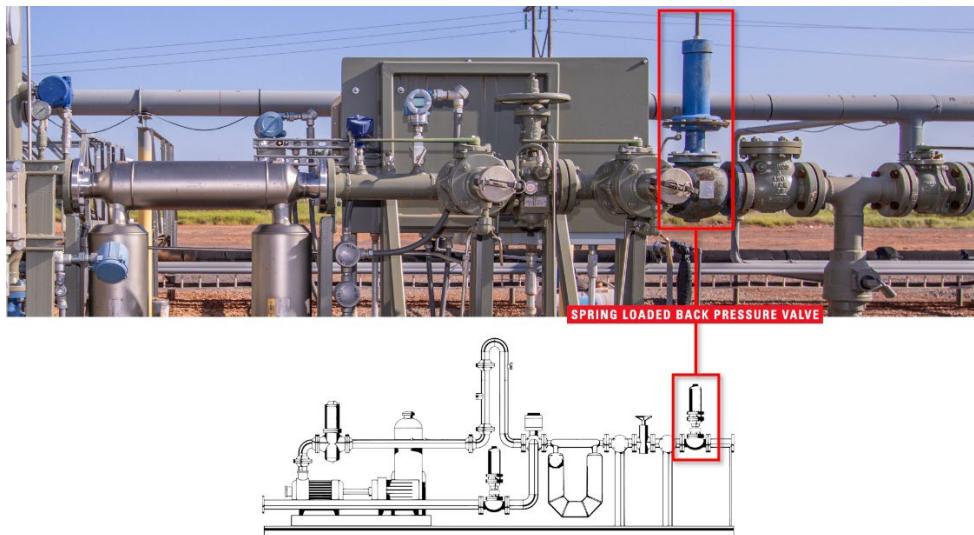
Block & Bleed Valves / Proving Connections

Located after the flow meter are block and bleed valves and proving connections. This is where a proving meter can be connected to periodically test the accuracy of the metering system.



Back Pressure Valve

The oil moves through a back pressure valve which holds pressure against the LACT unit. This is typically a spring-loaded back pressure valve because it requires no supply gas to operate.

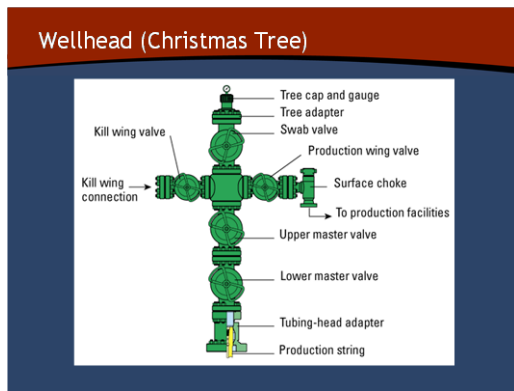


Check Valve

A check valve prevents the backflow of metered fluid from the pipeline back to the LACT unit.

The above breakdown of the components and function of LACT Units appears to establish that they perform quality control functions which is one of the qualifying uses of equipment in order to make it eligible for the manufacturing exemption.

Flow Lines and Gathering Lines. Different types of lines are found at oil & gas well sites. The lines are used to move oil to storage or gas to processing plants or pipelines.



Flow lines run from a well to a storage tank or to the various items of equipment that separate the oil from the gas, remove moisture, remove impurities.²¹⁷

Gathering lines are the lines from lease tank batteries to the transmission or trunk pipeline; and Transmission or trunk lines carry the product from gathering lines to a refinery.²¹⁸

The components of gathering lines (pipe, valves, etc.,) when initially purchased are tangible personal property. Once these items are connected and put in place for use they remain tangible personal property or become improvements to realty.²¹⁹

The basic definition for the classification of these lines is based upon their use. Gathering lines are the lines from lease tank batteries to the transmission or trunk pipeline.²²⁰

Gathering lines are then broken into two classifications: real property or tangible personal property.²²¹

Underground gathering lines are real property. The portions of underground gathering lines that are laid above ground, such as at river crossings or the risers containing the valves, are also real property.

Above-ground gathering lines are classified as tangible personal property. Gathering lines that are above ground but under water are tangible personal property, not improvements to realty.

Work performed on gathering lines is taxed according to the type of work performed and the classification of the line as tangible personal property or improvements to realty.

²¹⁷ Comptroller Letter No. 9111T1141A07 (Nov. 8, 1991).

²¹⁸ Comptroller Oil & Gas Well Servicing Audit Manual.

²¹⁹ See Comptroller Letter No. 9410L1318F05.

²²⁰ See industry books titled, *Modern Petroleum-A Basic Primer of the Industry and Manual of Oil & Gas Terms*.

²²¹ In 1991, the audit division asked for a definitive position on flow lines, gathering lines, and transmission lines. A response was provided in TR 1241.

For example, the sale and installation of an above-ground gathering line is the sale and installation of tangible personal property; the seller must collect tax on the total amount. However, the sale and installation of an underground gathering line is new construction; the charge for new construction labor is not taxed; the contractor's tax responsibility is determined by the type of contract: lump-sum versus separated.

Third-party Installation v. Assembly and Repairs. The Comptroller held that an oilfield roustabout company's charges to well operators for work on flow lines and other well equipment were taxable as either the repair and remodeling of commercial real property or tangible personal property or as fabrication.²²² The taxpayer used work crews to perform various tasks, primarily related to the replacing well-related equipment and welding flow lines and gathering lines. The well operators purchased the necessary equipment and well components and had them delivered to the well site. The taxpayer's invoices described its services as "Installation" which the taxpayer treated as non-taxable because the taxpayer did not sell the underlying equipment and well components. The Comptroller noted that much of the work involved the well operators' tangible, personal property which the taxpayer connected by welding. The Comptroller held that the taxpayer's activities went beyond third-party installation because it either repaired items by removing defective items and installing new ones or by physically altering the underlying items, which constituted taxable fabrication according to the Comptroller. The Comptroller noted that "[l]aying a new stretch of pipeline in a ditch is considered new construction" and the charge is nontaxable even if the contractor "also perform[s] the labor to cut, assemble, weld, prime, and wrap the pipe." However, "if a third-party contractor performs those services on pipe that is already attached to realty" that labor is taxable repair or remodeling labor.²²³

Rigging Down

After production casing is run and cemented, the rig is taken down and moved to another site. The rigging down process is basically the reverse of rigging up. The taxability of rigging down is the same as the taxability of rigging up. The tax laws treat the labor component of the charge as non-taxable. In the case of lump-sum contracts, like turnkey contracts, day rate

contracts and others commonly-used in the industry, the driller is treated as the consumer of the equipment used to perform the non-taxable service.



²²² Comptroller Hearing 114,472 (Sept. 19, 2019).

²²³ *Id.*

Operating the Producing Oilfield

After oil & gas wells produce oil & gas, they may need cleaning to clear the tubing or they may need repairs since parts of the oil & gas well equipment wear, corrode and break. The Texas sales & use tax applies extensively in this phase.

Component Parts or Materials

The parts and materials which become part of the wellbore are considered to be sold as a part of the taxable service and may be purchased tax-free by the well service company of the taxable service. Care, custody and control of the component parts and materials transfer to the well owner as part of the service.

Supplies

The well service company must also pay tax on any supplies (except cement) used or consumed in providing the service. This includes rubber goods such as stripper rubbers and swab cups. Stripper rubbers are used in well workovers. Stripper rubber is the sealing element used in coiled tubing or snubbing stripper systems. The stripper element is a consumable product and generally should be replaced for each operation. Coiled tubing elements can be replaced with the tubing in place, enabling a worn or leaking element to be replaced during an operation. Snubbing stripper rubbers are of single-piece construction and cannot be changed with the work string in place.

Swab cups are used in swabbing to bring oil to the surface. Swabbing reduces pressure in a wellbore by moving pipe, wireline tools or rubber-cupped seals (swab cups) up the wellbore. If the pressure is reduced sufficiently, reservoir fluids may flow into the wellbore and toward the surface. Swabbing is generally considered harmful in drilling operations, because it can lead to kicks and wellbore stability problems. In production operations, however, the term is used to describe how the flow of reservoir hydrocarbons is initiated in some completed wells.

The swab valve is used to control access to the wellbore when performing services, such as wireline or coiled tubing.

H₂S Scavengers. Natural gas produced from formation with high H₂S may be unsellable because of the corrosive effect H₂S has on pipelines. Many gas contracts require the operator to remove excessive H₂S scavengers are injected into produced gas to remove H₂S. Otherwise, the gas is unsellable. Thus, the injection of the H₂S Scavengers will make the gas more marketable and its purchase should qualify for the manufacturing exemption.

In Comptroller Hearing no. 115,726, the Comptroller denied the taxpayer's manufacturing exemption claim for its H₂S scavenger purchases because the taxpayer failed to show the point at which in the process the taxpayer injected the H₂S scavengers into the

gas. Presumably, the injection of the H₂S scavengers after the gas has been processed would not qualify for the manufacturing exemption under the Comptroller's policies.²²⁴

Equipment

The well service company must pay sales tax on any machinery or equipment the well servicing company purchases or rents to provide its services. This is true regardless of whether the well service company is providing taxable or non-taxable services.

Operating Lease Workers

The pumper is in charge of maintaining pump jacks, tanks, water separators, compressors and such that keep the oil flowing from the well. This is the backbone job of oil & gas production. Without oilfield pumpers the oilfield would shut down.

The duty of an oilfield gauger involves driving around an oil field and checking on multiple wells and tanks and recording the volume of oil produced. If an oil production employee works offshore he will likely ride a crew boat or helicopter to a production platform where he maintains automated equipment, valves and treatment equipment.

Example

Bill's Gauging provides pumping services. Daily, he reads production information at oil well and reports the results to the operator of the well. He also makes adjustments to oil & gas well instruments that affect well production and maintains and repairs the oil equipment located at the well site. The charge for reading gauges and providing written reports is nontaxable. The charge for adjusting the well instruments and maintaining and repairing the well site equipment is taxable. Bill's Gauging invoices should separately state the charges for providing gauging services from the other charges, or else the Comptroller will treat the total charge as taxable.

Gauging & Pumping Services. Reading production information on gauges and reporting results to a well operator is a nontaxable service. Separately stated charges for providing gauging services are nontaxable.²²⁵

Pumping services that make adjustments to oil and gas well instruments that affect well production are taxable. Maintaining equipment or providing repairs, even minor repairs, to equipment at a well site is a taxable service.²²⁶

²²⁴ Comptroller Hearing 115,726 (June 4, 2021).

²²⁵ Comptroller Letter No. 9803236L (March 30, 1998).

²²⁶ Comptroller Letter No. 9803236L (March 30, 1998).

Contractors frequently provide both pumping and gauging services. When providing both services, contract pumper/gaugers may separately state the nontaxable gauging charges from the taxable pumping charges. If contract pumper/gaugers bill a single lump sum charge for a combination of taxable and nontaxable services, the entire lump sum charge is taxable. Any charges to the customer for materials are generally taxable to the customer.²²⁷

In order to classify services into the appropriate category, we must first determine the location where services are provided. The service provider may perform them down the wellbore, at the well site surface, or away from well site.

If a producing well loses some or all of its natural drive, and the operator may need to hire a well service company to stimulate the well or to provide artificial lift in order to recover any remaining oil in the formation. We discuss the Texas sales & use and Texas well servicing tax in a separate section below.

Welding. The Comptroller assumes that all welding in the field is performed on tangible personal property. Therefore, the Comptroller presumes this welding is subject to the Texas sales & use tax unless the welder's billings clearly state that the work was part of either (1) the new construction of an improvement to realty or (2) a third party's initial installation of customer-owned equipment. Labor charges for welding in connection with the completion of a new oil or gas well are not subject to the Texas sales & use tax because they are performed in connection with new construction.²²⁸



Down The Wellbore

After oil & gas wells produce oil & gas, they may need cleaning to clear the tubing of deposits or they may need repairs since parts of the oil & gas well equipment wear, corrode and break.

Removing Pumping Unit and Wellhead. Down hole repair and maintenance activities generally require the removal of the pumping unit and wellhead in order to access the well bore. A workover/service rig is typically used to do this. The steps are:

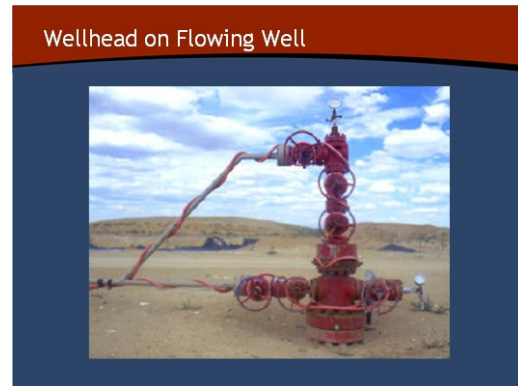


²²⁷ Comptroller Letter No. 8811L0913G08 (Nov. 16, 1988).

²²⁸ Tax Policy News (March 2012).

Removing the Horsehead (Pumping Unit Only). Typically, the horsehead of a pumping unit must be removed to gain access to the wellhead equipment.

Removing the Wellhead. To begin the process, the wellhead must be removed from the casing flange.



After the pumping unit and wellhead are removed, repairs and maintenance work may begin.

Downhole Services. Downhole services are services performed within or through the well bore.

Downhole services include all associated activities of the well service company on or above the surface, and those at or away from the well site. This

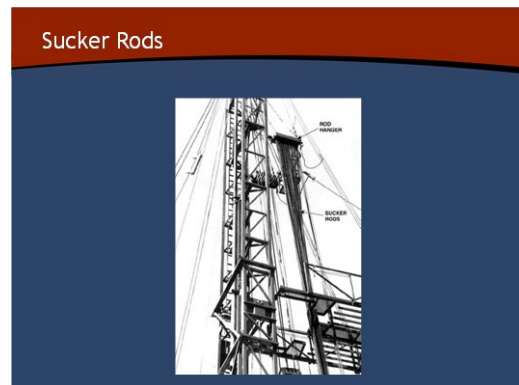
includes such services as preparation for the service or transportation of equipment and materials, which are a necessary part of the downhole service being performed. Certain downhole services are subject to the Texas sales & use tax.

Removing Production Tubing or Sucker Rods.

Often, it's necessary to remove the production tubing or sucker rods to perform downhole services. Common reasons for pulling tubing include replacing the tubing, replacing a packer, locating a tubing leak or plugged tubing. Pulling tubing refers to the process of removing tubing from the well. Running tubing refers to the process of replacing tubing in the well.

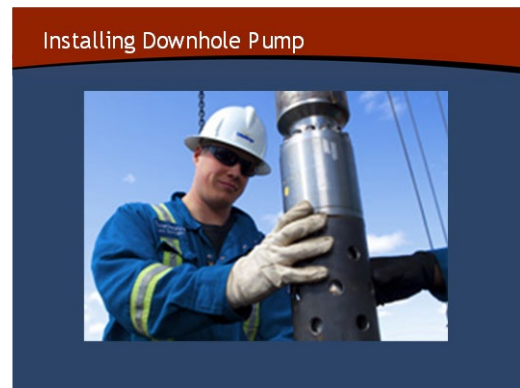
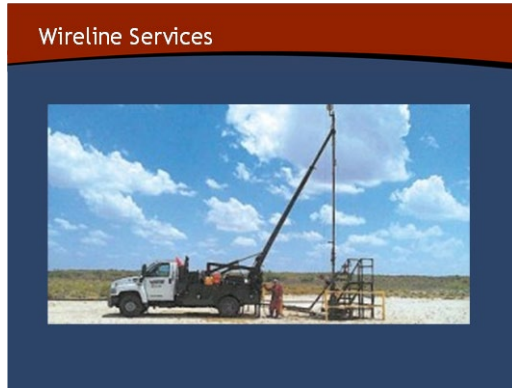
To service, repair, or replace the rods or pump, the sucker rod string must be pulled out of the hole.

The labor charge by the crews who remove the production tubing or sucker rods for servicing may or may not be subject to the Texas sales tax depending on the type of work actually done in the wellbore. For example, a crew removing rods so that the operator may repair a downhole pump would be performing a taxable service. However, a well service company may also perform a rod or tubing job in order to facilitate a nontaxable service. This



will render the service charge for pulling the rod or tubing nontaxable.²²⁹ In this instance, the labor charge for the crew to remove tubing so that the operator may workover the well is not taxable.²³⁰

Wireline Services. Wireline services are used in performing several types of downhole work. The wireline service company uses a wireline to raise and lower different types of tools in a wellbore. Generally, if the wireline service is not directly related to starting or stimulating production, then the charge for the service is treated as taxable service.²³¹



Taxable Downhole Services. These services are subject to the Texas sales & use tax on services. They are not subject to the Texas well servicing tax:

Changing a Downhole Pump. Oil wells with pump jacks use pumps located downhole to bring the oil to the surface. The downhole pumps are inserted in the tubing near the bottom of the well. The pump plunger is connected to surface by a long rod string, called sucker rods, and operated by a beam unit at surface. Each upstroke of the beam unit lifts the oil above the pump's plunger. When they become worn, they must be repaired or replaced. The total charge to remove and replace them or to remove, repair and re-install them is subject to sales tax.

Cleaning the Well. The well service company cleans sand out of the well bore and injects chemicals to prevent erosion. The charge for the service and chemicals is taxable.

²²⁹ Comptroller Rule §3.324(d)(4).

²³⁰ Comptroller Rule §3.324(e)(1).

²³¹ Comptroller Letter No. 9803236L (March 30, 1998).

Example

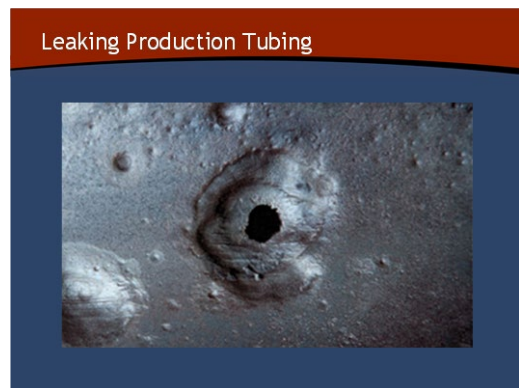
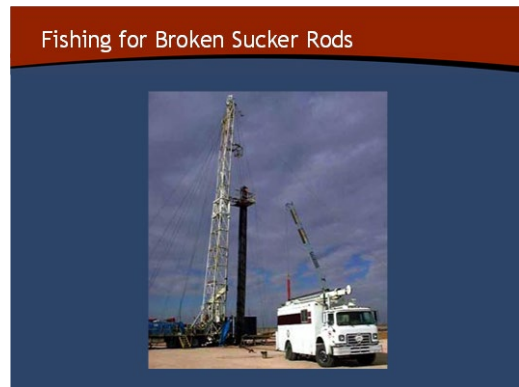
Well Service Co. owns a coil tubing unit (truck) which it uses to clean wells. The coiled tubing is inserted into existing wells. The unit pumps acid, nitrogen, mud-water, and other fluids down the coil tubing and into the well to wash it out the well. The fluids are circulated and flow back out of the well. This constitutes a service taxable under the sales tax laws. It is not taxable as a well servicing tax, even though the service provider pumps acid down the well. The purpose of the service is to clean the well, not to stimulate production.²³²

Fishing for Rods/Tubing. Sucker rods may break or part, or tubing may come apart fall to the bottom of the wellbore. When stray equipment falls into a well, fishing is required to remove it so that the well can function properly.

Well fishing services are subject to the sales tax when they are performed after the completion of the well. Removing stuck tubing or sucker rods is taxable because these activities are performed after the well is completed and during production.²³³

Repairing Tubing Leak. Tubing is the small diameter pipe placed in a well through which the oil & gas flows to the surface. It may become worn or develop a leak. When that occurs, the well service company pulls the tubing and replaces it and often the tubing collar.

Changing Packer or Anchor. A packer looks like a large donut that fills the space between the tubing and the next layer of casing. The packer creates a tight seal and prevents fluids (such as oil) from entering the well bore except through the tubing. Production packers may be retrievable or permanent. An anchor is a device that secures or fastens downhole equipment. It may be necessary for the well service company to pull the rods and/or tubing to change a packer or anchor.



²³² Comptroller Letter No. 9102T1095F04 (February 26, 1991).

²³³ Comptroller Letter No. 200002026L (February 4, 2000).

Packer

*Packer Sales and Rentals.*

The total charge for the sale and installation of a packer is taxable. If the packer is later replaced, the total charge is taxable unless work is also being performed on the formation or casing string.

Packers rented to operators and other service companies are bare rentals unless the packer company is also providing other well-services down-

hole. However, when the rods and/or tubing are pulled merely to install a rental packer and no other services are provided, they are not considered to be providing a well-service but providing a service that is part of the rental of tangible, personal property. The charges billed to pull the rods and/or tubing are taxable as a service connected with the rental of tangible personal property.²³⁴

Paraffin Clogging Production Tubing



Hot Oil or Water Treatment. This service treats a producing well with heated oil or water in order to melt the accumulated paraffin in the tubing, flow lines, or casing. Special truck-mounted hot oil units heat the oil or water and pump it down the well or through the flow lines where it flows down the casing and back up through the tubing to melt and remove the deposits from the well bore.

Treating a producing well with heated oil or water to melt accumulated paraffin in the annulus, tubing or surface piping (flow line) through which the oil travels from the well to storage is subject to the Texas sales & use tax.²³⁵

²³⁴ Comptroller Oil & Gas Well Servicing Audit Manual.

²³⁵ Comptroller Rule §3.324(d)(1)(F).

Injecting Chemicals. Chemicals. The oil & gas exploration and production process uses a wide variety of chemicals that accomplish specific oilfield-related tasks. Chemicals include corrosion inhibitors, bactericides, potassium chloride (KCL), CO₂ etc.

The initial inquiry concerns whether the taxpayer is purchasing the chemicals or whether an oilfield service provider is using them to provide a service. The Comptroller treats a service company as providing services if it injects the chemicals into the well. Merely delivering chemicals or other fluids into a frac tank or other storage unit constitutes a sale of the chemicals. Comptroller Rule 3.324(h)(1).

If it is unclear from the invoice whether a service was provided or whether chemicals were sold, the presumption is that if a high-pressure pump truck is used, a service has occurred. However, if a vacuum truck is used to deliver the fluids or CO₂, then the Comptroller treats the work as a sale of tangible personal property.

Since the maintenance of tangible personal property is taxable, the injection of maintenance-type chemicals such as corrosion inhibitors, bactericides, etc., into the wellbore to maintain the downhole equipment constitutes a taxable service. Since certain chemicals are oil soluble and remain in the product flow after injection, the well operator may purchase those chemicals separately from the service provider and issue a resale certificate in lieu of tax on the charge for the chemicals. Note that all charges associated with the injection of the chemical are taxable, including mileage, standby, pump truck, and labor. Comptroller Rule 3.324(h)(1).

The injection of chemicals to stimulate production or remove impurities from the product being removed such as acid, emulsifiers, or nitrogen constitutes the provision of a nontaxable service. The Comptroller, however, treats the service company as the consumer of all chemicals pumped down hole and requires it to pay sales tax at the time of purchase. Comptroller Rule 3.324(h)(2).

When CO₂ is used to stimulate production, the well operator may claim an exemption for its purchase, by the well operator for injection provided the well operator issues a properly completed exemption certificate in lieu of paying the tax. Comptroller Rule 3.324(h)(2).

Audit Procedures for Chemicals. Operators should be aware that the Comptroller has developed specific audit procedures for determining whether injected chemicals are taxable



or exempt. Presently, the Comptroller allows an exemption for oil-soluble chemicals since they will be produced with the oil.²³⁶

As a result, the exemption can only apply to a well that produces oil. Gas wells don't qualify. The following Comptroller audit procedures are designed to test whether the qualifying circumstances are present.

Oil or Gas Well? To begin, the Comptroller directs the auditor to determine if the well is an oil well or a gas well. The auditors are trained to make that determination by reviewing information on the Texas Railroad Commission website ("RRC"). The RRC issues permits to drill oil and gas wells. When a permit to drill is issued by the RRC, the RRC assigns a permit number and an API number.

- API numbers are a standardized system of numbering oil and gas wells in the United States where the first two numbers are the State (Texas is 42), followed by three representing the county.
- The county code is always an odd number. For example: 001 is Anderson County here in Texas. The next 5 numbers are the ID number for the well location within the County.
- An API number never changes and is permanently attached to each well bore (historic wells being the only exception).
- In Texas, when an oil well is completed and assigned to a field, it is given a 5 digit Lease number. Oil lease numbers are assigned sequentially within each RRC District. There are 12 Districts in Texas: 01, 02, 03, 04, 05, 06, 6E, 7B, 7C, 08, 8A, 09 and 10. A single lease can have hundreds of wells under one oil Lease number.
- A gas well, on the other hand, is assigned a 6 digit number linked to that well only, and is sequentially independent of the RRC District it is in. Well bores can have multiple

To begin, the auditor must trace the oil soluble chemicals to the well where they were used. This is done by examining the invoice or purchase order and noting the names of the lease/well name and the operator. There are two methods an auditor may use to determine whether the well produces oil:

Option 1: The auditor will obtain from the taxpayer a cross-reference between lease/well name and Railroad Commission (RRC) lease number. The RRC assigns a six-digit

²³⁶

Presently, the Comptroller is challenging the exemption for oil soluble chemicals in *Avalon Exploration and Production, LLC. v. Hegar et. al.*, Cause No. D-1-GN-22-006033 (Oct. 19, 2022).

identification number for each gas lease and a five-digit identification number for each oil lease. The number itself (5 v. 6 digits) immediately informs the auditor if the lease is an oil or gas lease.

The lease identification number reported to the Comptroller's office consists of three different fields including: 1) Lease Type - "1" for oil and "2" for gas; 2) County Code - three-digit county code designated by the Comptroller's office for each county in Texas; 3) Lease Number - the RRC lease number - six-digit gas lease or zero followed by five-digit oil lease.

Once the auditor verifies the lease and lease number on which the chemical was used, the auditor is directed to verify that the oil or gas lease is valid using the Comptroller's publicly-available database, the Crude Oil & Natural Gas system (CONG), which is available at: <https://mycpa.cpa.state.tx.us/cong/loginForward.do?phase=check>.

The CONG system requires the six-digit lease number (six-digit gas or zero followed by five-digit oil) and time period. The site does not require a Login.

Once the CONG system is accessed, the auditor will select the menu located on the left side of the screen and choose Lease Search: Lease Drop - Crude Oil or Lease Drop - Natural Gas depending on the type of lease. Once the lease number and time period are entered, the site will provide specific reported amounts for the lease. Using either method, if lease information is populated, you know the oil or gas lease you researched is valid. If reported data is not populated, inform the taxpayer the lease does not appear to be valid.

Option 2: Using the Railroad Commission website, the auditor can search by Completion using the Completions Query.

<http://webapps.rrc.texas.gov/CMPL/publicSearchAction.do?formData.methodHndlr.inputValue=init&formData.headerTabSelected=home&formData.pageForwardHndlr.inputValue=home>

Once here, the easiest way to search is by clicking the Search Operator button. This will allow the auditor to search by either name or number. The auditor can then narrow the results by county to get a list of all wells for a particular operator in that county. If you have other information, API, Lease No, etc. you may search by any of those criteria as well. If the return is too large, you will need to narrow the search until it returns a list of wells. You can then highlight the entire list and paste it into an Excel spreadsheet. The links will still be functional in the spreadsheet and you can use Excel to search more easily.

Clicking on the link for any well will allow you to access the GIS map and all forms associated with the well.

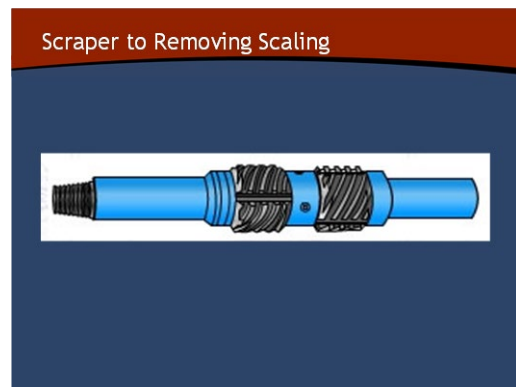
The auditor is directed to use the well classification used by the Texas Railroad Commission (RRC) if the taxpayer claims that a well produces both oil and gas. If a gas well also produces condensate (oil based), the audit instructions direct the auditor to contact one of one of the Audit specialists.

If the auditor determines that the well is a gas well and not an oil well, the exemption for resale that is available for oil soluble chemicals does not apply and the auditor will treat the chemicals as taxable.

Auditors are instructed to deny all claims of exemption for reasons other than oil solubility. If the claim pertains to fracking chemicals that allow for the reuse or recycle of wastewater, auditors are directed to contact the Audit Headquarters' Settlement Group for review. Auditors are advised the referral is solely to obtain direction on how to handle the issue and NOT for the purpose of obtaining a settlement.

If an auditor determines that the well involved in the claim is an oil well, the auditor must then determine if the taxpayer has records to show how the oil soluble chemical is used. If the taxpayer is an operator and does not own or operate equipment above ground, the auditor may conclude that the operator is using the chemical downhole. If the operator operates both the well and the equipment upstream, the auditor should request documentation from the operator showing where the chemicals were used - downhole or above ground. If the documentation shows that oil soluble chemicals were injected downhole, the auditor should allow the resale exemption for those chemicals. If the auditor determines the chemicals are not being injected downhole, oil solubility is no longer enough to support the resale exemption. For any claims of exemption for chemicals used above ground, the taxpayer must explain where and how the chemical is used.

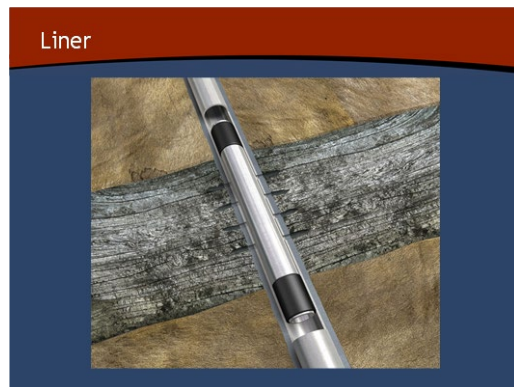
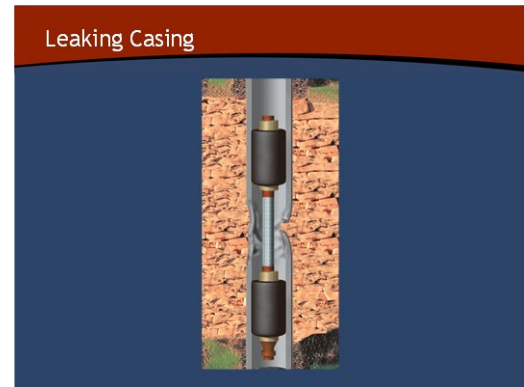
Scraping Casing or Tubing. A casing scraper removes rust, scale, cement, mud, bullets,



paraffin, perforation burrs, and other obstructions or foreign material from the inside walls of casing or tubing. The casing scraper may be attached to the drill string with a drill bit attached to the bottom connection. The well service company runs the scraper into the casing or tubing using rotation to clean the inside wall of the pipe.

Testing for Leaks. Stand alone charges for testing casing or production tubing for leaks is nontaxable.²³⁷

Squeezing Cement to Repair Casing. The well service company performs this service using cement trucks with high pressure pumps that force cement slurry to the damaged or leaking casing. The casing area to be repaired is sealed off with packers in order to force the cement into the damaged area and to prevent the migration of the cement into other areas.



Pulling or Resetting Casing Liner for Repairs. A liner is any string of casing whose top is located below the surface. Liners are set for the purpose of admitting production to the bottom of the well. Pulling or resetting a liner involves moving this casing up or down the hole or pulling it out of the well. When the purpose of pulling or resetting is to repair the liner, the entire charge is taxable.

Temporary Plugging and Abandoning. Sometimes the operator of a well needs to temporarily plug the well in order to stop corrosion while the well is not producing. Unlike the charge for permanent plugging and abandonment, the charge for temporary plugging a well is taxable.

Killing the Well. Kill charges will be taxable or nontaxable depending on the overall purpose. All kill charges will be presumed taxable until the contrary is established. The service company should bill tax if it is not known at the time of billing what the overall purpose was. The operator must then pay the tax or provide either a direct payment exemption certificate or a statement that the purpose was to facilitate a nontaxable service.²³⁸



²³⁷ Comptroller Letter No. 8806L0893F12 (June 23, 1988).

²³⁸ Comptroller Rule §3.324(h)(3).

Swabbing to Clean Casing. Swabbing is the act of pulling fluid from the well bore through the use of wire rope and cup assembly. Swabbing equipment includes a swabbing assembly, lubricator with an oil saver, and shut-off valve on the well, also called a swabbing valve.

Repairing Downhole Equipment. The charge to repair sucker rods, downhole pumps, production tubing and other similar downhole equipment is subject to sales tax. Note that any separately-stated charges for inspection are not taxable. Moreover, if the service provider also performs a small amount of cleaning (for example, dusting of the thread area), the charge will remain non-taxable. However, if the cleaning involves removing scales, removing rust or recoating the tool, the charge is taxable.²³⁹

*Changeover/conversion of an artificial lift.*²⁴⁰ While the labor charge associated with the new installation of equipment to perform artificial lift is not taxable, the sales tax laws treat the labor charge for the replacement or conversion of exiting artificial lift equipment as taxable.

Testing Casing or Tubing for Leaks. Standalone charges for testing the casing or tubing are not subject to the sales tax so long as the taxpayer does not also perform the repair work.²⁴¹

Nontaxable Downhole Services: The charges for downhole services that would otherwise be subject to the sales tax may be performed in order to facilitate a nontaxable service (e.g. pulling tubing to perform workover). This will render the otherwise taxable service nontaxable.²⁴² Charges for labor to start or stimulate production or for labor to work on formation outside the well are subject to the well servicing tax and not the sales tax.

*Squeeze Cement.*²⁴³ It is non-taxable when it is used to isolate a producing formation or seal off water. Well service companies perform the service using cement trucks with high pressure pumps that force cement slurry to specified points in the well to cause seals at the points of squeeze.

*Workover.*²⁴⁴ Well service companies perform workover services when the formation declines in production or ceases to produce. The purpose of workover is to restore or increase production. Workover operations may include deepening or plugging back.

²³⁹ Comptroller Letter No. 8802L0859E01 (February 5, 1988).

²⁴⁰ Comptroller Letter No. 9105L110C10 (1991).

²⁴¹ Comptroller Letter No. 8806L0893F12 (1988).

²⁴² Comptroller Rule §3.324.

²⁴³ Comptroller Rule §3.324(b)(2)(C).

²⁴⁴ Comptroller Rule §3.324(b)(2)(D).

*Drilling Deeper.*²⁴⁵ A workover operation where the well is deepened in either the existing or another producing formation.

*Plug Back.*²⁴⁶ A workover operation placing cement in the bottom of a well for the purpose of excluding bottom water, sidetracking or producing from a formation already drilled through. A mechanical plug can be set by wireline, tubing, or drill pipe.

*Plug and Abandon.*²⁴⁷ A welder cuts the casing and removes the wellhead. Cement plugs are installed to prevent formation fluids from migrating. The charge is non-taxable if the operator intends to permanently plug the well. Temporary plugging (e.g. performed to prevent corrosion) is taxable.

*Pulling and Resetting Casing Liner.*²⁴⁸ A liner is any string of casing whose top is located below the surface. Liners are set for the purpose of admitting production to the bottom of the well. Pulling or resetting a liner involves moving this casing up or down the hole or pulling it out of the well. Pulling and resetting the casing liner is taxable if repair are made to the casing string.

*New Installation of Casing Liner.*²⁴⁹ The labor charge to install casing liner either in a new well as part of well completion or in connection with workover services.

*Drilling Out a Plug.*²⁵⁰ The well service company drills out a cement plug in the wellbore.

*New Installation of Artificial Lift.*²⁵¹ This includes rod pumping, centrifugal pumping, gas lifting, hydraulic pumping, and other forms.

*Running a Bottom Hole Bomb.*²⁵² The pressure in a well at a point opposite the producing formation is recorded by a bottom hole pressure bomb, which is a steel container that houses a precision pressure gauge. The bomb is lowered on a wireline.

Secondary Recovery. The secondary recovery process injects water recovered from the primary production process into secondary recovery injection wells to move oil and gas towards the producing well. Primary production uses the reservoir's natural pressure to produce oil and gas. Often, salt water is produced along with the oil and gas. Oil, gas, and

²⁴⁵ Comptroller Rule §3.324(b)(2)(G).

²⁴⁶ Comptroller Rule §3.324(b)(2)(H).

²⁴⁷ Comptroller Rule §3.324(b)(2)(J).

²⁴⁸ Comptroller Rule §3.324(b)(2)(K).

²⁴⁹ Comptroller Rule §3.324(b)(2)(L).

²⁵⁰ Comptroller Rule §3.324(b)(2)(M).

²⁵¹ Comptroller Rule §3.324(b)(2)(N).

²⁵² Comptroller Rule §3.324(b)(2)(O).

water emulsify under the reservoir's high pressure and temperature. This emulsification must be broken down before the oil and gas can be sold.

Separators are used to separate the oil, gas, and water mixture. Separators directly touch the oil, gas, and water mixture and cause physical changes to it by separating it into its three components and by removing waste. As such, the process qualifies as manufacturing and the separators qualify as manufacturing equipment.²⁵³

In order to enhance production from the reservoir, operators may drill and equip secondary recovery injection wells to receive the produced and separated water from the well to "water flood" the reservoir. Doing so causes the oil and gas in the reservoir to move towards the producing well which enhances production from the well. In effect, the secondary recovery process recycles and reuses water arising from the separator's manufacturing process.

As a result, the tangible personal property purchases in connection with operation of the secondary recovery injection wells is arguably exempt from Texas sales and use taxes under Tex. Tax Code § 151.318(a)(11)(B), which exempts "tangible personal property specifically installed to . . . reuse and recycle wastewater streams generated within the manufacturing, processing, fabrication, or repair operation." This property may include casing, tubing, downhole equipment, drilling mud, electrical equipment, electronic submersible pumps, chemicals, valves and fittings, brine water, and blowout preventers.

Moreover, any services (such as repairs) performed on the exempt tangible personal property may qualify for exemption as well. Tex. Tax Code § 151.3111(a), exempts "a service that is performed on tangible personal property that, if sold, leased, or rented, at the time of the performance of the service, would be exempted under this chapter because to determine whether they should file refund claims. of the nature of the property, its use, or a combination of its nature and use.

☞ **Important Note.** We advise affected operators and service providers to consult with their advisors

*Swabbing to Stimulate Production.*²⁵⁴ The well service company performs this service by sending a cable down the hole with rubber cups attached. The cable is pulled back up to remove water in the wellbore. The wellbore may contain small amounts of sand and paraffin. The water that is brought out of the hole is normally held in a tank and then removed by a transport service. Swabbing done to start or restart a well is considered a nontaxable service. Even though small amounts of sand and paraffin will be removed with

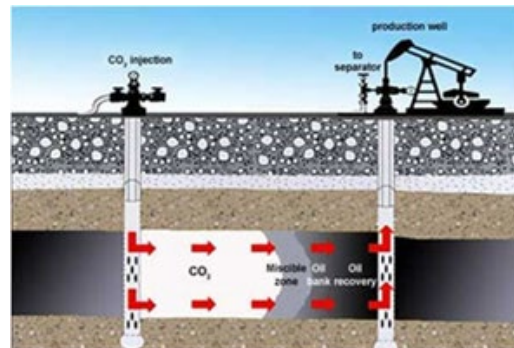
²⁵³ See Tex. Tax Code § 151.318(a)(2).

²⁵⁴ Comptroller Rule §3.324(b)(2)(P).

the fluids, this will not cause the service to become taxable.²⁵⁵ However, the charge for running bailers or cutters down hole to remove debris or to cut paraffin is considered a taxable service.

*Jetting to Enhance Production.*²⁵⁶ Jetting is the injection of fluids or inert gases into the wellbore to enhance production or recovery. Pumping (jetting) fluids downhole can have two purposes: either to stimulate production from the formation or to clean the downhole equipment. The type of fluid does not matter. It may be an acid, chemical, water, mud-water, nitrogen, or some other type. The taxability of the service is determined by the primary purpose for the service. Of course, after each service is performed a secondary benefit may result. If the well service company pumps nitrogen down the well hole to wash out the well, the charge is taxable. The reason is that the primary purpose of the service is to clean the corrosion, bottom sand, or other debris out of the production tubing or casing; increased production is a secondary benefit which occurs because the production tubing or casing are cleaned and allow more product to flow out of the well. Conversely, pumping nitrogen downhole and forcing it into the formation in order to move the oil to the surface in a more efficient manner is not taxed even though the production tubing and casing may be cleaned in the process.

Injecting CO₂. During the primary phase of producing oil, gravity, or the natural pressure of the reservoir combined with artificial lift techniques such as pumps, will drive the oil into the wellbore bringing it closer to the surface. However, only 10 percent of the original oil in the reservoir is produced during the primary recovery. More of the residual oil may be recovered from the reservoir by injecting CO₂. This process of one of the methods of enhanced oil recovery.



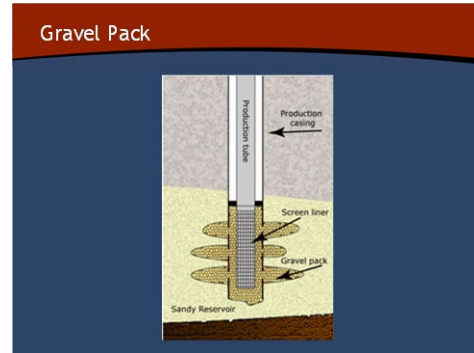
This process enhances the recovery of crude oil from the pores of a rock by injecting Carbon dioxide into the subsurface. The miscibility property of the oil (i.e. the extent to which it will mix with other liquids) determines the interaction of carbon dioxide and crude oil. During CO₂ enhanced oil recovery, carbon dioxide mixes with oil, helping it move through the rock pore spaces.

²⁵⁵ Comptroller Letter No. 200107379L (July 17, 2001).

²⁵⁶ Comptroller Rule §3.324(b)(2)(Q).

Taxability. The purchase of CO₂ injection services by a well operator to stimulate production is exempt from the sales tax. However, CO₂ purchased by nontaxable well service providers (e.g., a fracking service provider) to provide their nontaxable well services does NOT qualify for exemption. Comptroller Rule 3.324(h)(3).

*Gravel Packing.*²⁵⁷ Gravel packing is the term used to refer to the installation of a screen to prevent the intrusion of formation sand into the wellbore. Gravel packing is one of the forms of sand control. Sand control means preventing the sand from mixing with the oil being produced.



*Hot Oil Treatment of the Formation.*²⁵⁸ A hot oil unit is designed to circulate heated fluid into piping, tubing, casing, or tanks for a variety of



reasons, including the removal of paraffin and tar-based oils. If a hot oil unit is used to treat the formation, the charge is not subject to the sales tax; it is subject to the well servicing tax. The Comptroller's policy is that the invoice must clearly identify the purpose of the treatment or it will be considered to be a treatment on the wellbore and subject to the sales tax.²⁵⁹

Chemical Injection to Stimulate Production. The charge for injecting chemicals such as acid, emulsifiers, or nitrogen to stimulate production or remove impurities from the product being removed is a nontaxable service.²⁶⁰ The sales tax laws treat the well service company as the consumer of the chemicals pumped down hole and it must pay sales tax on them at the time of purchase.²⁶¹

Soap Sticks. In a well bore, high-pressure water or condensate can stop the flow of gas when the formation pressure is insufficient to push water or condensate out of the hole. To remedy this, soap sticks or acid sticks are injected into a well to decrease water pressure (e.g., by reducing the water to suds or bubbles) so that lower-pressure gas can escape from the formation. While a well operator may issue an exemption certificate for chemicals that

²⁵⁷ Comptroller Rule §3.324(b)(2)(R).

²⁵⁸ Comptroller Rule §3.324(b)(2)(S).

²⁵⁹ Comptroller Rule §3.324(b)(2)(S).

²⁶⁰ Comptroller Rule §3.324(h)(1).

²⁶¹ Comptroller Rule §3.324(h)(2).

become part of the product that is sold, since soap sticks or acid sticks dissolve in the water (or condensate) rather than the product that is sold, well operators must pay sales tax on charges for soap sticks and acid sticks.²⁶²

Facilitating Non-taxable Services. Taxable downhole services may be performed in order to facilitate a nontaxable service. For example, pulling tubing to perform a workover is normally taxable.

However, when the tubing is pulled in order to perform a workover, the otherwise taxable service becomes nontaxable. It is not unusual for two separate work crews to be used to maintain a well, e.g., one crew pulls the rods and another performs the workover. The charge for both crews' labor will be taxable or nontaxable depending upon what ultimate service is being done to the well. The act of replacing an item (supplied by the well owner) while performing a nontaxable service will not cause the labor to become taxable.

However, performing a nontaxable downhole service in connection with taxable above-ground services will not convert the above-ground services into nontaxable services.

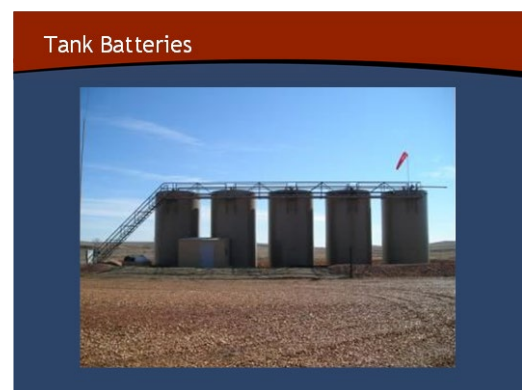
☞ Important Note: The well service company's work orders and invoices should describe the exact work being performed so that it can be established whether or not the labor is taxable. If the Comptroller's auditor cannot determine which ultimate service is actually being provided, he or she will tax the total charge including mileage, trip fees and standby time.

At the Wellsite Surface.

These types of services may be performed on the surface equipment or on the wellsite grounds.

Repairing and Maintaining Surface Equipment.

This includes the repair, maintenance, and installation of above-ground equipment. The charges for labor to repair, restore, remodel, or maintain tangible personal property, such as well equipment, are subject to the Texas sales & use tax.



²⁶² Comptroller Letter No. 9809836L (Sept. 15, 1998).

Repairing Flow Lines



As a result, the entire charge (materials & labor) for repairing, restoring, remodeling or maintaining any of the following oilfield equipment²⁶³ is taxable: Christmas trees, wellhead and well components, including line heaters; storage facilities (tanks or batteries) each with a storage capacity of five hundred (500) barrels or less; gathering lines and flow lines which are

above the ground; above-ground and underground flow lines are tangible personal property; gathering lines and flow lines which are buried;²⁶⁴ wellhead pumping equipment, pumpjacks and their power source; the rig or production package attached to offshore platforms; electric power systems which are easily removed; compressors which are easily moveable and located in the field (between the wellhead and booster stations); board roads and board turnaround areas; everything inside the casing of a well, including tubing, pipe, pumps, rods, gas-lift equipment, and packers inside the casing; temporary fences; and board roads.

Compressors



Board Roads



Temporary Fencing



Calibrating & Repairing Meters. Contractors integrate gas charts, calculate gas volumes, calibrate gas meters, and repair gas meters. Charges to repair meters are taxable regardless of whether the meters are considered real property or tangible personal property.²⁶⁵ Gaugers perform gas chart services and gas volume calculation services for audit purposes. These services by gaugers are generally nontaxable.²⁶⁶

²⁶³ The Comptroller's auditor's sales tax manual states that the Comptroller considers these items to be tangible personal property.

²⁶⁴ Or partially buried (as of July 1, 1985).

²⁶⁵ Comptroller Letter No. 8802L0862E06 (Feb. 19, 1988).

²⁶⁶ Comptroller Letter No. 8802L0862E06 (Feb. 19, 1988).

Charges to calibrate meters are considered maintenance. Whether these calibration charges are taxable depends upon whether the meters are considered real property or tangible personal property. Meters located at well sites or between lease sites and pipelines (meters on flow lines or gathering lines) are considered personal property and calibration of these meters is a taxable service. Meters located on pipelines or booster stations are considered real property and calibration of these meters is a nontaxable service.²⁶⁷

Monitoring Equipment & Services. While the charges for monitoring services are nontaxable, charges for renting the related equipment are taxable when separately stated on the customer's invoice. In a 2019 hearing, the Comptroller found that a taxpayer's sale of monitoring services and rentals of the monitoring equipment had to be analyzed separately. The taxpayer provided a monitoring service using monitoring equipment it installed at well sites in order to detect harmful sour-gas chemicals. The taxpayer offered a "protection package" that included equipment, installation, response packages, breathing air compressors, gas detection sensors, alarms, safety trailers, training, contingency plans, and rescue teams. The package sometimes also included monthly or annual testing and compliance inspections, certified technicians, and 24/7 service. The taxpayer separately listed its charges for the monitoring service from the rental of the equipment. The Comptroller found that there was "clear and ascertainable value" for both the monitoring service and the monitoring equipment. The Comptroller further found, without any explanation, that neither were incidental to the other. The Comptroller concluded that the charges for the rental of the monitoring equipment was taxable while the charges for the monitoring services were not.²⁶⁸

Environmental & Conservation Services. Texas law provides a sales tax exemption for the charges of certain type of labor performed as required by laws and rules in order to "protect the environment or to conserve energy." Specifically, Texas Tax Code § 151.338. ENVIRONMENT AND CONSERVATION SERVICES reads, in relevant part:

Sec. 151.338. ENVIRONMENT AND CONSERVATION SERVICES.

(a) Subject to Subsections (b) . . . , labor to repair, remodel, maintain, or restore tangible personal property is exempted from the taxes imposed by this chapter if:

- (1) the repair, remodeling, maintenance, or restoration is required by statute, ordinance, order, rule, or regulation of any commission,

²⁶⁷ Comptroller Letter No. 8802L0862E06 (Feb. 19, 1988).

²⁶⁸ Comptroller Hearing 115,873 (Aug. 29, 2019).

agency, court, or political, governmental, or quasi-governmental entity in order to protect the environment or to conserve energy; and

- (2) the charge for the labor is itemized separately from the charge for materials furnished.
- (b) The exemption provided by Subsection (a) does not apply to the charge for materials furnished by the service provider to the purchaser as part of the service.

When an operator or oilfield service provider claims the labor exemption under this provision, the Comptroller instructs his auditors to require that the operator or oilfield service provider specify the specific statutes or regulations that provide the environmental or conservation requirements set forth in the statute above and further identify the equipment to which their claim applies. Once the operator or oilfield service company provides sufficient information, the auditor is directed to send the information to one of the oilfield audit specialists who will determine if guidance is needed from Tax Policy.

The Comptroller appears to allow this exemption only when the labor work itself is required by regulations regarding the environment or energy conservation. In Comptroller Hearing no. 44,228 (Oct. 19, 2007), the Comptroller rejected the claim of the environmental exemption for replacing a leaking valve and cleaning an oil spill that resulted from the leaking valve.

In the absence of an exemption, the repair charge would be taxable as the repair of tangible personal property. The taxpayer sought, but the Comptroller denied the environmental exemption despite the taxpayer citing a Texas Railroad Commission rule that defines unpermitted discharges of oil and gas as hazards to public health and safety under 16 Tex. Admin. Code, Section 3.8. The Comptroller stated there is no evidence that the repair itself was required by regulations regarding environment or energy conservation, notwithstanding the Railroad Commission rules that prohibit unpermitted discharges of oil and gas wastes. The Comptroller further stated that taxpayers could not rely upon general legal requirements and had to point to a specific regulation requiring the repairs.

Repairing or Restoring Real Property. Charges for labor to repair, remodel, or restore improvements to real property at a lease site are taxable.²⁶⁹

²⁶⁹ These services became taxable on January 1, 1988.

The typical types of real property found at oil & gas well sites²⁷⁰ include:

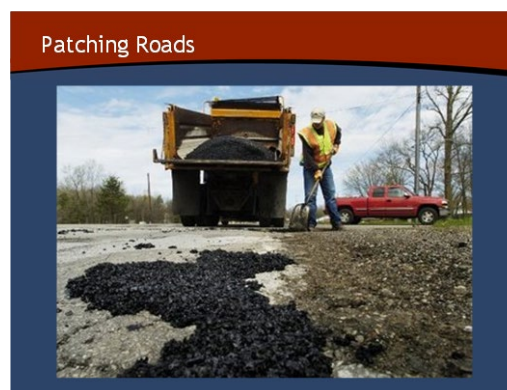
Pump stations, booster stations; casing in place; enhanced production-injection and recovery systems which cannot be moved intact; storage facilities (tanks or batteries) each with a storage capacity of more than 500 barrels; vapor recovery systems at service stations; compressors at compressor stations other than leased compressors; production platforms with their supports permanently embedded in the sea bed; water disposal systems - same guidelines as storage facilities; gathering lines and flow lines which are buried;²⁷¹ and gas processing plants not easily movable.



Well Site Grounds Services. Charges for certain real property services, such as patching roads, pest control are subject to the Texas sales & use tax. As they apply to the well servicing industry, the following real property services are taxable:

Digging Work Pits. Digging a new pit is classified as new construction; the labor charge is not taxed. Cleaning out or re-digging an existing pit is restoration of nonresidential realty; this is a taxable service and the total amount is taxed.²⁷²

Patching Lease Access Roads. The private roads to the oilfield site often need to be patched or leveled due to inclement weather conditions or heavy vehicles traveling on them. The charge for repairing or patching private roads is subject to the sales tax. Charges for caliche are taxable.²⁷³



However, if a road serves both as a driveway to a residence and to a lease site or for agricultural use, then the portion up to the residence is residential realty, past the residence to the lease site

²⁷⁰ These are the items listed as real property in the Comptroller Oil & Gas Well Servicing Audit Manual.

²⁷¹ Or partially buried (prior to July 1, 1985).

²⁷² Comptroller Letter No. 9410808L (October 6, 1994).

²⁷³ Comptroller Letter No. 9410808L (October 6, 1994): hauling caliche: the charge for hauling caliche may be part of sales price of the non-residential repair service and taxed. The charge for hauling alone (not connected with a taxable sale) is not taxed.

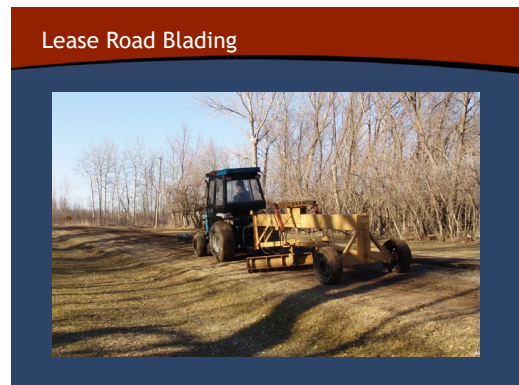
or for agricultural use is nonresidential realty. The labor to repair residential realty is not taxed.²⁷⁴

Repairing Cattle Guards. Cattle guards are used to keep cattle from entering the oilfield site. Like the lease access roads, they often become worn and in need of repair. The charge for repairing cattle guards is taxable.



Repairing Permanent Fences. Permanent fences may require repair, either due to age, trees and brushes growing through them, or other circumstances. The charge to repair permanent fences is taxable.

Lease Road Blading. Blading is need when lease access road develop ruts or holes that make traveling on them difficult. Also, blading the roads will cause rainwater to drain away rather than pool up in the middle of the road. The charge for road blading performed in order to bring the road back to a functioning condition is taxable.



Structural Pest Control Services. Pest and weed control services performed at the well site by a licensed exterminator are subject to the sales tax.



This includes the chemical spraying of weeds to kill them. If, however, the pest and weed control services are performed at a location where there are items of tangible personal property (e.g., pump jacks, flow lines, heater treaters, separators, Christmas trees, tanks of less than 500 barrel capacity, etc.), pest and weed control services performed in connection with this tangible personal property are not taxable. Charges for pest

and weed control services performed for real property should be separately stated from charges performed on tangible personal property. If an invoice fails to separately state the

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Comptroller Letter No. 9410808L (October 6, 1994).

real property-related and tangible personal property-related charges, the entire charge will be taxable if at least 5% of the charge relates to real property.

Pipeline Right-of-Way Surveying Charges. The charge for surveying to determine the boundaries of real property is taxable as a real property service. Accordingly, the charge to determine pipeline right of ways is subject to the sales tax.

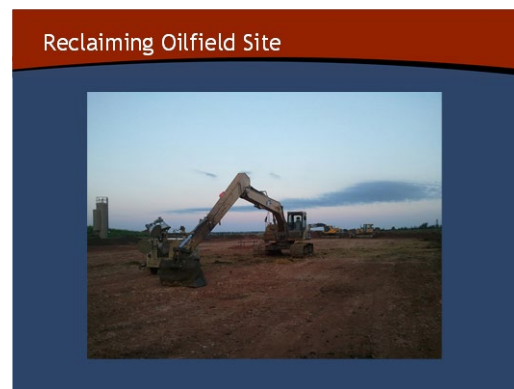
Non-Taxable Wellsite Ground Services. The following real property services are not subject to the Texas sales tax:

Pulling Trucks. The charge for pulling trucks out of the mud or for pulling trucks from one location to another is not subject to the sales tax.²⁷⁵

Building Dikes. Building dikes around tank battery pads. When a contractor builds a dike around the tank battery, positioning the mound of dirt for the first time into a new dike, the charge for the work qualifies as non-taxable new construction. However, if the contractor subsequently reconfigures or rebuilds the dike, say after a hard rain, the entire charge is taxable as commercial repair or remodeling.²⁷⁶

Reclamation Services. Most lease agreements require the oil company to restore the land upon which the drilling occurs back to its original condition. The charges for reclamation services performed to restore oil & gas lease properties to their original condition are not subject to the sales tax.²⁷⁷

Lease Road Blading Maintenance. If the lease road blading is scheduled, performed at stated intervals, and done without regard to the condition of the road, when scheduled and recurring;

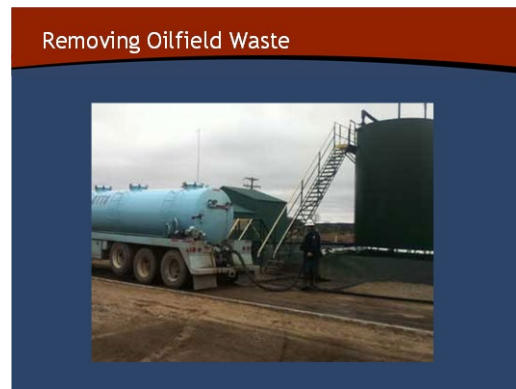


²⁷⁵ Comptroller Letter No. 9410808L (October 6, 1994).

²⁷⁶ Comptroller Letter No. 9410808L (October 6, 1994).

²⁷⁷ Comptroller Letter No. 9410808L (October 6, 1994).

Waste Removal. Removing waste materials from the lease site which result from activities

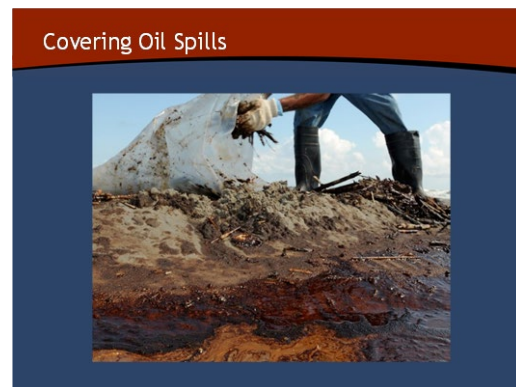


performed in the exploration and production process is non-taxable. While generally the charge for waste removal is taxable, the fees paid for the removal of industrial solid waste are exempt from sales tax. Industrial solid waste includes the solid waste resulting from or incidental to a process of industry, manufacturing, mining or agricultural operations.²⁷⁸ As a result, the collection and disposal of used and depleted drilling mud, drilling

fluids, saltwater, broken pipe or other waste directly coming from an oil or gas well is not a taxable service when provided during the exploration, development and production of an oil or gas well.²⁷⁹

The Comptroller does not require an exemption certificate in order to purchase the services tax-free as long as the invoice and contract between service provider and customer clearly state that the waste removal service is for waste created from the exploration, development and production of an oil or gas well or substances regulated by the TNRCC.

However, the charge for the collection and removal of any other waste that does not directly result from the exploration, development or production of an oil or gas well is taxable. As a result, the Comptroller treats as taxable the collection and disposal of items such as empty food and beverage containers, wrappers, bags and other unwanted personal disposal items. It doesn't matter that the waste was generated by the well service staff, roustabouts, roughnecks, operator or others.²⁸⁰



²⁷⁸ Texas Health and Safety Code, Ch. 361.

²⁷⁹ Tax Policy News (May 2012) and Texas Tax Code §151.0048(a)(3)(C).

²⁸⁰ Tax Policy News (May 2012).

Example

Cleaning up Oil Spills at Lease Sites. The charge to clean up oil spills regardless of the location is not taxed because it is exempt hazardous waste removal.²⁸¹

SWD Facilities: Waste water produced from oil and gas wells may be sent, by truck or pipeline, to Salt Water Well Disposal Well Facilities to extract skim oil for sale and to permanently treat and dispose of the remaining water.

The equipment used to extract the skim oil (e.g. gun barrels, separators, etc.) should qualify as exempt manufacturing equipment.²⁸²

There is a legal issue as to whether the equipment and chemicals used in the treatment and disposal of the remaining waste water qualifies as well.

☞ **Important Note.** Salt water disposal well companies should consult with their advisors on whether to file refund claims for sales tax paid on the equipment, supplies, chemicals, and electricity purchased for use in the treatment or disposal.

Vehicle Wash Out Services. A taxpayer's charges for washing and cleaning out the vehicles used to transport oilfield waste constitute nontaxable charges for the maintenance of motor vehicles.²⁸³

Mowing. While the tax laws treat as taxable the charges for cutting or mowing grass and weeds for aesthetic purposes, they are excluded from tax when performed at an oil or gas well site, water disposal or injection well.²⁸⁴ Mowing or trimming that is performed on private or commercial yards or lawns is a taxable service. However, mowing or cutting to clear land for buildings, power line rights-of-way, pipeline rights-of-way is not taxable. The charge for cutting weeds, mowing, or trimming weeds or grass at lease sites (oil or gas) is not taxable because the activities are not performed on private or commercial yards or lawns. However, the charges for mowing or trimming that is performed on the farmer's or rancher's yard or lawn are taxable. These tax consequences apply regardless of whether the farmer, rancher, or oil company pays for the service.²⁸⁵

Pest Control. Pest control services to kill insects or remove weeds at an oil field related location, such a well site, compressor or booster station, and similar areas classified as real

²⁸¹ Comptroller Letter No. 9410808L (October 6, 1994).

²⁸² See Tex. Tax Code §151.318(a)(2).

²⁸³ See Tex. Tax Code §151.0101(a)(5)(C).

²⁸⁴ Tax Policy News (May 2012).

²⁸⁵ Comptroller Letter No. 9410808L (October 6, 1994).

property, through the use of pesticides, herbicides or other similar chemicals are taxable as structural pest control services.

Pest control services provided at a location where there are only items of tangible personal property are not taxable structural pest control services. At some oil field related locations, some of the machinery and equipment is tangible personal property and not a structure or improvement to realty. For example, Texas law classifies pump jacks, flow lines, heater treaters, separators, and wellhead Christmas trees as tangible personal property.

Tanks that hold 500 barrels of liquid or less are treated as tangible personal property while tanks exceeding 500 barrels are real property. Since the charge for the first is non-taxable and the charge for the second is taxable, the total charge for the pest control service at the well site should be separately stated for the services related to the realty (taxable) from the tangible personal property (non-taxable). Otherwise, the mixed services rule imposes the sales tax on the total combined charge if the portion of the charge relating to the realty represents more than five percent (5%) of the total charge.

☞ **Caution.** The mixed services problem discussed in Chapter II often arises in oilfield service billings. Taxable services should be separately stated and identified from nontaxable services on the invoice or contract. If not, the total charge is presumed taxable when the charges for taxable services and nontaxable services are billed as one amount and the sum of the charges for taxable services is greater than five percent of the total charge.²⁸⁶

Examples

Straightening oilfield pipe – taxable repair/remodel/maintenance of tangible personal property²⁸⁷

Hydrostatic testing – non-taxable service if separately stated²⁸⁸

Drifting oilfield pipe – drifting is a form of examination of the inside of the pipe – nontaxable service²⁸⁹

Cleaning the inside or outside of oilfield pipe – taxable²⁹⁰

Pickup and delivery charges – taxable or nontaxable depending upon the taxability of the related product or service²⁹¹

²⁸⁶ Comptroller Rule §3.324.

²⁸⁷ Comptroller Letter No. 8505L0637D09 (May 9, 1985).

²⁸⁸ Comptroller Letter No. 8505L0637D09 (May 9, 1985).

²⁸⁹ Comptroller Letter No. 8505L0637D09 (May 9, 1985).

²⁹⁰ Comptroller Letter No. 8505L0637D09 (May 9, 1985).

²⁹¹ Comptroller Letter No. 8505L0637D09 (May 9, 1985). *Comptroller Rule 3.357; *Chevron Pipeline Co. v. Strayhorn*.

Away from the Well Site

In addition, repairs, remodeling, restoration of real property used in the oil & gas industry that's not typically located at the well site include: underground storage facilities; pipeline transmission lines; machinery, equipment, and fixtures which are attached components of processing or manufacturing facilities; and permanent lighting.

Pipeline Construction and Repair

Texas sales tax treatment of labor charges in connection with constructing, relocating, repairing, replacing, removing, or demolishing underground natural gas pipelines depends upon the circumstances.

Nontaxable New Construction. The Comptroller treats as nontaxable the charges for labor for: (1) placing a new pipeline in a new trench to the left or right of an existing pipeline; (2) constructing a new pipeline in a new trench that is "substantially" deeper than the trench of an existing pipeline (depth of new pipeline is at least one-third greater than the depth of existing pipeline); and (3) placing a new pipeline in a new trench that is substantially shallower than an existing pipeline.

Nontaxable Demolition. The Comptroller treats as nontaxable the following labor charges because the work constitutes the complete demolition of an existing pipeline: (1) removing the existing pipeline from a trench before constructing a new pipeline at a depth that is at least one-third greater than the depth of the existing pipeline; and (2) filling an existing pipeline with concrete in order to abandon the pipeline.

Taxable Nonresidential Real Property Repair. These labor charges are taxable as nonresidential real property repair or remodeling: (1) replacing an existing pipeline with a new pipeline at the same depth; (2) excavating and lifting out an existing pipeline from the trench in connection with replacing it; (3) inserting a new pipeline inside of an existing pipeline; (4) connecting a new pipeline to an existing pipeline; and (5) capping the ends of an existing pipeline in order to abandon the pipeline in place.

Cleaning & Drying Pipelines *Cleaning & Drying Pipelines.* Contractors clean and dry pipelines by using dryers and air compressors to propel pipeline pigs through sections of line. Contractors use chemicals to clean pipelines and remove residue. Charges for cleaning and drying pipeline are nontaxable. These charges remain nontaxable regardless of whether they are billed to the pipeline owner or another contractor and regardless of whether materials and labor charges are stated separately or billed lump sum. Service providers pay tax on the purchase of materials, supplies, and equipment used or consumed providing pipeline cleaning and drying, including cleaning chemicals.²⁹²

²⁹² Comptroller Letter No. 9212953L (Dec. 16, 1992).

Hydrostatic Testing & Leak Repair. Contractors perform hydrostatic testing to determine if pipelines have leaks. Charges for hydrostatic testing are nontaxable, regardless of whether they are billed to the pipeline owner or another contractor, and regardless of whether materials and labor charges are separately stated or billed lump sum. If a contractor repairs leaks, charges to repair leaks are taxable. If a contractor performs hydrostatic testing and leak repair, separate charges for hydrostatic testing are nontaxable, and separate charges for leak repair are taxable.

Miscellaneous Work. The charges for excavating and removing nonoperational pipe and moving it to the service yard or to a recycler are taxable as a real property service.

A contract involving both taxable tie-in labor and nontaxable new construction labor is presumed to be taxable if the tie-in labor represents more than 5% of the total charge, unless the charge for new construction labor is separately stated.²⁹³

Workover

Workover activities include one or more of a variety of remedial operations on a producing well to try to increase production.

Drilling Deeper

Work performed inside the wellbore for the purpose of starting initial production in a new deeper zone or increasing production in an existing zone by working on the formation is not subject to sales tax



Sand Cleanout

Sand cleanout operations are performed to remove buildup of sand in the wellbore. Wells are often cleaned by bailing sand with a wireline unit (and bailer) or sand washing with a coiled tubing unit. The charges for both are subject to sales tax as the taxable repair, maintenance, or restoration of tangible personal property when performed on the tubing string within the wellbore for the purpose of bringing the malfunctioning tubing back to its original working condition, keeping the tubing in good working order by preventing its decline, failure, or deterioration, or rehabilitating the tubing to its original, properly functioning condition.²⁹⁴

Sand bailing or sand washing the tubing in a well is not subject to sales tax when performed during the completion of a well (prior to certification by the Texas Railroad

²⁹³ Comptroller Letter No. 201706007L (June 26, 2017).

²⁹⁴ Comptroller Letter No. 200412932L (Dec. 14, 2004).

Commission that the well has been completed for production to begin) or in connection with other work being performed on the formation to start or stimulate production, such as acidizing, fracking or workover operations on the well's formation.²⁹⁵

Bailing or washing sand from the casing or pre-existing perforations in the casing of a producing oil or gas well is also subject to sales tax as the taxable repair or restoration of an improvement to real property (the casing string). Any labor to repair, remodel, or restore an improvement to real property is a taxable real property repair or remodeling service. If the work qualifies as periodic and scheduled maintenance of realty, the labor is not taxable.²⁹⁶ Bailing or washing sand from the casing or perforations in the casing of a well is not subject to sales tax when performed during the completion of a well or in connection with other work being performed on the formation to start or stimulate production, such as acidizing, fracking or workover operations on the well's formation.

Sand bailing or sand washing services performed exclusively below the end of the tubing string and/or casing string (and thereby ending up as work on the formation) is not subject to sales tax as a taxable repair or restoration service. However, pumping fluids into an oil or gas well to circulate out sand or bailing out sand with a wireline unit and thereby removing sand from the bottom of the well when the main purpose of the job was to remove sand from the tubing string and/or the casing string of the well is a taxable service subject to sales tax except when performed during the completion of a well or in connection with other work being performed on the formation to start or stimulate production, such as acidizing, fracking or workover operations performed on the well's formation.²⁹⁷

If a well service company is contracted to perform one type of job, such as sand control (subject to sales tax) but the customer determines that something else is necessary, such as acidizing (not subject to sales tax), the service company's labor will be taxable or not taxable depending on what is actually done. For example, if the work started out inside the wellbore but ended up as work on the formation, the service company's labor will not be subject to sales tax.²⁹⁸

Repairing Liners and Casing

Liners and casing are essentially the same and repair procedures are the same for both. Casing can be damaged by corrosion, abrasion, pressure, or other forces that create holes or splits. A packer is run down the well to locate the hole in the casing. Fluid is pumped

²⁹⁵ Comptroller Letter No. 200412932L (Dec. 14, 2004).

²⁹⁶ See Comptroller Rule §3.357(a)(7).

²⁹⁷ Comptroller Letter No. 200412932L (Dec. 14, 2004).

²⁹⁸ Comptroller Letter No. 200412932L (Dec. 14, 2004).

into the casing above the packer. A loss of pressure indicates a hole in the casing. Well service companies use the following methods to repair casing: squeeze cementing, patching a liner, replacing casing, adding a liner, and opening collapsed casing.

Sidetracking

Sidetracking is the workover term for drilling a directional hole to bypass an obstruction in the well that cannot be removed or damage to the well, such as collapsed casing that cannot be repaired. Sidetracking is also done to deepen a well or to relocate the bottom of the well in a more productive zone, which is horizontally removed from the original well.

To sidetrack, a hole (called a window) is made in the casing above the obstruction. The well is then plugged with cement below the window. Special drill tools, such as a whipstock, bent housing, or bent sub are used to drill off at an angle from the main well. This new hole is completed in the same manner as any well after a liner is set.

Plug-Back

Plug-back places a cement plug at one or more locations in a well to shut off flow from below the plug. Plug-back is also used before abandoning a well or before sidetracking is done. Plugging back operations performed inside the wellbore are not subject to sales tax, regardless of whether it's the placement of a mechanical plug, cement plug, sand plug, etc. in the bottom of a well for the purpose of excluding bottom water, sidetracking or producing from a formation already drilled through.²⁹⁹

Converting to Salt Water Disposal Well

The charge for labor to convert a producing well to a salt water disposal well is not subject to the well servicing tax, but is potentially subject to sales tax. Therefore, the removal and replacement of the wellhead and replacement with one that will allow the flow of salt water for disposal constitutes the taxable sale and installation of tangible, personal property.³⁰⁰

Other work to convert the well may be taxable is the repair of tangible, personal property or as the remodeling of commercial real property.³⁰¹

Taxability. Services performed as part of workover are generally not taxable. However, services performed during a routine repair are taxable. Services performed during the workover of a well that has stopped producing or reduced production are not taxable. Workover includes remedial operations when the formation has declined in production or

²⁹⁹ Comptroller Letter No. 200412932L (Dec. 14, 2004).

³⁰⁰ Comptroller Letter No. 9005L1020B10 (May 11, 1990).

³⁰¹ Comptroller Letter No. 9005L1020B10 (May 11, 1990).

ceased to produce, with the hope of restoring or increasing production: deepening a well or plugging back; clearing well of deposits; correcting problems; and cleaning.³⁰²

Plugging & Abandoning the Well

A well is abandoned when it reaches the end of its useful life or is a dry hole. A well service company performs the service by removing and salvaging the casing and other well equipment. The well service company places cement plugs in the wellbore to prevent fluids from migrating between the different formations. And finally, the surface is reclaimed.

Taxation. The labor charge for permanently plugging and abandoning a well is non-taxable. Charges to repair, restore, remodel, and maintain tangible personal property, and charges to repair, remodel, or restore improvements to real property are generally subject to tax. These charges, however, are nontaxable when the charges are directly related to plugging and abandoning a well.

For example, a welder's labor charge is nontaxable when the welder cuts casing at a drill site in order to remove the wellhead for a well to be plugged and abandoned. Although the Comptroller's rules create a presumption that all welding is presumed to be taxable, the presumption may be overcome with evidence that the specific work is directly related to nontaxable plugging and abandoning. In this instance, the welder's invoice must state that the purpose of the welding is to plug and abandon the specific well, identify the well by lease number, and show that the service is not part of the repair and remodeling of a well that will continue to produce. When a welder provides nontaxable services directly related with plugging and abandoning a well, the welder is responsible for paying tax on his material purchases.³⁰³

However, the labor charge for temporarily plugging the well, usually performed to prevent the well from deteriorating while it's not producing, constitutes a taxable service.

To prepare a well for plugging and abandoning, rods, tubing, and other downhole equipment must be removed. The charge for this removal service is nontaxable, regardless of whether the removal service is performed on the same day as plugging the well, because the removal service is directly related to plugging and abandoning the well. The Comptroller recommends that the company providing removal service obtain a statement



³⁰² Comptroller Letter No. 200412932L (December 14, 2004).

³⁰³ Comptroller's Letter No. 201106057L (June 8, 2011).

or other documents from the well operator to show that the removal service is directly related to plugging and abandoning the well.³⁰⁴

³⁰⁴ Comptroller Letter No. 9511671L (Nov. 10, 1995).

Chapter V. Sales & Use Tax Exemptions

Texas tax laws exempt various processes and equipment used in the oil & gas industry in order to promote its economic growth in our state.

An entity claiming an exemption may issue an exemption certificate in lieu of paying sales tax on an item. Courts have held that the purchaser bears the burden of proving the exemption. The Comptroller and the courts construe all doubts in favor of non-exemption or taxability.

A buyer provides an exemption certificate when the buyer or the item is exempt from the sales tax. A buyer provides a resale certificate when the buyer plans to resell the item. In the latter case, sales tax collection ultimately occurs when the buyer resells the item to a consumer.

Accepting an Exemption Certificate

All of a seller's gross receipts are presumed to be subject to the sales tax unless the buyer furnishes the seller with a properly completed exemption or resale certificate. The sale of a taxable item by a person for delivery in Texas is presumed to be a sale for storage, use or consumption in Texas unless the seller accepts an exemption or resale certificate. The purchaser has the burden to claim the exemption to which he or she may be entitled.

If the seller does not receive an actual exemption certificate from the purchaser but instead receives only the purchaser's sales tax number, the seller should charge the purchaser sales tax on the transaction. The Texas Sales & Use Tax Act does not allow an exemption number or a tax-exempt number to be issued or used as a substitute for an exemption certificate.

Good Faith Acceptance

A sale is exempt if the seller receives in good faith from a purchaser a properly completed exemption certificate, and the seller lacks actual knowledge that the exemption is invalid.³⁰⁵ A seller must look at the facts behind the exemption and reject an exemption certificate even if it appears to be valid if there is some reason to suspect that the exemption is being claimed in error. For example, if a buyer purchased a TV set which was to be delivered to his home and then claimed a sales tax exemption from a local Red Cross

³⁰⁵ The Comptroller's position is that resale and exemption certificates that aren't properly completed lose the good-faith presumption. Comptroller Hearing No. 41,214 (June 14, 2002).

shelter, the seller should further investigate the claim for exemption before accepting the certificate.³⁰⁶

After an audit, sellers have 60 days after notification by the Comptroller to gather and submit exemption certificates determined to be lacking. If the seller does not provide these certificates to the Comptroller within 60 days from the date the Comptroller gives written notice requiring possession of them, the Comptroller will disallow deductions claimed by the seller that require delivery of the certificates. This rule applies to all types of exemption certificates, including direct pay exemption certificates.³⁰⁷ The good faith presumption does not apply to the exemption certificates obtained during the audit and through the 60 day period. The auditor will probably scrutinize them carefully. Note that certificates are only required in order to claim exemptions. Exclusions and exceptions (such as government purchases) do not require the seller to obtain or the purchaser to produce an exemption certificate. However, sellers should keep invoices, receipts, etc. on file as verification of nontaxable sales.

Content of an Exemption Certificate

An exemption certificate must show all of the following or the Comptroller will disallow it: name and address of purchaser; description of the item to be purchased; reason the purchase is exempt from tax; signature of purchaser and the date; and the name and address of the seller.

Special Requirements for Exempt Gas and Electricity

In addition to the usual exemption certificate requirements, an entity claiming the gas and electricity exemption must include the following statement of exemption:

A valid and complete study has been performed which shows that (insert the actual exempt percentage) of the natural gas or electricity is for processing tangible personal property for sale in the regular course of business.

It must also bear the original seal of the registered engineer who performed the study or a signed statement including the original signatures of the business owner and engineer.

☞ **Caution:** Be sure to use the proper form of the Exemption Certificate, which is available on the Comptroller's website at:

<http://www.cpa.state.tx.us/taxinfo/taxforms/01-forms.html>

³⁰⁶ cf. Comptroller Letter No. 200209465L (2002), which determined that a taxpayer could purchase a vehicle tax-free to be leased to the American Red Cross. If the vehicle ceased to be leased to the Red Cross (i.e., a divergent use), motor vehicle sales tax would be due on the owner's book value of the vehicle.

³⁰⁷ Comptroller Hearing No. 103,803 (2012).

Taxable Use/Divergent Use

When an item purchased under a valid exemption certificate is used in a taxable manner, whether the use is in Texas or outside the state, the purchaser is liable for payment of sales tax based on the fair market rental value of the item for the period of time used. If the item has no fair market rental value, or if the exemption certificate is invalid at the time of issuance, the purchaser owes tax on the original purchase price.³⁰⁸

Example

Smitty Pipe & Supply sells equipment and supplies for performing downhole services. Smitty also performs nontaxable well services under lump-sum contracts. Smitty purchases supplies using a resale certificate and places them in inventory. One day, while servicing a well, Smitty needs to remove parts from inventory for use in the nontaxable service. This is a divergent use. Smitty must accrue and remit use tax on the price it paid for the parts when it takes them out of inventory and uses them in performing the nontaxable service.

Resale Exemption

A sale of a taxable item for resale is exempt from sales & use tax. A sale for resale is defined as a sale of a taxable item to any purchaser who is purchasing the item for the sole purpose of reselling, leasing or renting it within the geographical limits of the United States of America, its territories and possessions, in the normal course of business either in the form or condition in which it is purchased, or as an attachment to, or integral part of, other taxable items. A purchaser may give a properly completed resale certificate to a Texas seller if acquiring a taxable item for the purpose of selling, leasing or renting the item in Mexico in the normal course of business. The resale certificate must show the purchaser's Mexican federal identification number in addition to the other required information.

Proppants Used in Fracking. The Comptroller has held that proppants used during the hydraulic fracking process did not qualify for the sale-for-resale exemption.³⁰⁹

An oilfield service provider argued that its purchase of proppants and chemicals used during the fracking process qualified for the sale-for-resale exemption.³¹⁰ In order to qualify, the oilfield service provider had to prove that proppants and chemicals used during the fracking process constituted tangible personal property that was ultimately transferred to the well operators. The oilfield service provider argued that the fracking process did not change the physical properties of the proppants and chemicals, which remain in the well

³⁰⁸ There is a special rule for divergent uses of tangible personal property used in manufacturing, which is discussed later in these materials.

³⁰⁹ See Comptroller Hearing No. 110,819 (November 6, 2015).

³¹⁰ See Comptroller Hearing No. 110,819 (November 6, 2015).

formation after fracking is complete— propping open cracks in the formation through which oil and gas may flow. The oilfield service provider testified that it retained no rights to the proppants and chemicals once they become embedded in the well formation, so the well owner assumed care, custody, and control of the proppants once they were pumped downhole.

In opposition, the Comptroller’s attorney argued that a portion of the proppants and chemicals injected into the well formation were later removed from the wellbore and disposed as waste. This could occur through either the vacuuming of impediment from the wellbore, or through the release of pressure at the surface of the well. Because a portion of the proppants are disposed of as waste, the Comptroller’s attorney argued that care, custody, and control of these proppants never transferred to the well owner. As such, the Comptroller’s attorney argued that the oilfield service provider did not qualify for the sale for resale exemption because it failed to state the portion of proppants that remained in the formation and the portion removed and disposed of as waste.

The Comptroller’s analysis turned on the lack of evidence presented at the hearing, rather than a technical analysis of the physical property of different proppants. The Comptroller noted that the oilfield service provider had the burden to prove by clear and convincing evidence that care, custody, and control of the proppants was transferred to the well owner. The oilfield service provider presented several news articles, technical tables, and an unsworn affidavit attempting to explain the fracking process, generally, and the physical properties of proppants injected into the well. The Comptroller concluded that the oilfield service provider’s evidence failed to prove by clear and convincing evidence that proppants remained in the well formation and were not removed as waste or lost through the release of pressure at the surface. As a result, the Comptroller denied the oilfield service provider’s claims.

☞ **Comment:** The fact that some of the proppants and chemicals are disposed of after the fracking process seems irrelevant to the issue of whether they were transferred to the customer prior to injection downhole. As a result, the Comptroller’s analysis appears to leave ample room for the oilfield service provider to challenge the decision in district court.

The Comptroller has also denied the resale exemption for purchases of proppants on the basis that the proppants were not transferred in connection with the performance of a taxable service. The taxpayer, an oil and gas well service company, sought a refund of sales tax on proppants that it contended were resold in performing hydraulic fracturing services. The Comptroller acknowledged that a “sale for resale” includes the purchase of tangible personal property for the purpose of reselling it “in the form or condition in which it is

acquired or as an . . . integral part of other tangible personal property or taxable service.”³¹¹ However, the Comptroller noted, a sale for resale “does not include the sale of tangible personal property . . . to a purchaser who acquires the property . . . for the purpose of performing a service that is not taxed under Chapter 151,” the Tax Code Chapter which imposes the sales tax. The Comptroller rejected the taxpayer’s argument that “because oil and gas services are exempt from tax” under Chapter 151, “they must be taxable under 151.” Instead, the Comptroller found that fracking is a service “not taxed under Chapter 151” and, therefore, the taxpayer did not qualify for the resale exemption.³¹² Retroactive Legislation to Bolster Litigating Position. During 2019, the Comptroller convinced the Legislature to pass retroactive amendments to the Tax Code in order to bolster his litigating position in the courts. One of the retroactive amendments changes the definition of “resale” to expressly exclude “the sale of tangible personal property to a purchaser who acquires the property for the purpose of using, consuming, or expending it in, or incorporating it into, an oil or gas well in the performance of an oil well service taxable under Chapter 191.” The obvious purpose of this legislative change is to prevent the Comptroller from suffering a potential defeat in pending district court litigation in which a fracking company seeks a refund of sales taxes paid on proppants and chemicals used to provide oil well services, like fracking and acidizing on the basis of the resale exemption.

Materials Provided with Services

The definition of “sale for resale” includes sales of taxable services performed on tangible personal property held for sale by the purchaser of the taxable service and tangible personal property sold to a purchaser who acquires the property for the purpose of transferring it as an integral part of a taxable service. Tangible personal property used to perform a taxable service is not considered resold unless care, custody and control of the property is transferred to the purchaser of the service.³¹³

Example

Arturo’s Well Servicing performs taxable downhole well services under lump-sum contracts. Arturo may issue a resale certificate when he purchases chemicals for use in taxable downhole services as long as Arturo will transfer care, custody and control of the chemicals to the customer as part of the taxable service.

³¹¹ Tex. Tax Code § 151.006(a)(1).

³¹² Comptroller Hearing 115,910 (Aug. 28, 2019).

³¹³ Comptroller Letter No. 200209434L (Sept. 19, 2002), stated that sea salt purchased for use in an aquarium at a zoological facility was taxable, rather than being exempt as property transferred as part of a taxable amusement service.

Resale Certificates

A sale is exempt if the resale certificate is accepted in good faith and the seller lacks actual knowledge that the sale is not a sale for resale. It is the seller's responsibility to take notice of the type of business generally engaged in by the purchaser as shown on the resale certificate. The same documentation requirements that apply to exemption certificates also apply to resale certificates.

Requirements. A resale certificate must show the name and address of the purchaser; the number of the sales tax permit held by the purchaser or a statement showing that an application for a permit is pending, including the date the application was made. If the application is pending, the certificate is valid for 60 days, after which time the certificate must be renewed to show the permit number. Federal identification numbers or social security numbers are not acceptable evidence of resale; a description of the taxable items generally sold, leased or rented by the purchaser in the regular course of business and a description of the taxable items to be purchased tax free by use of the certificate; the signature of the purchaser and the date; and the name and address of the seller.

Retailers Outside of Texas

A seller in Texas may accept a resale certificate in lieu of tax from a bona fide retailer outside Texas who purchases taxable items for resale. The resale certificate must show the signature and address of the purchaser, the state to which the property is taken for resale and the sales tax permit number, if any, or the registration number assigned to the purchaser by the purchaser's home state. The resale certificate must also state the type of business engaged in by the purchaser and the type of items sold in the regular course of business. An invoice describing the taxable item purchased and showing the exact street address or office address from which the taxable item will be sold must be attached to the resale certificate.

The Manufacturing Exemption

The Texas Tax Code provides several exemptions from sales tax which are designed to promote industry and prevent the multiple taxation of manufactured products that are sold at retail. Generally, materials and equipment that are used or consumed in manufacturing, processing or fabricating products to be sold at retail are exempt from the sales & use tax.³¹⁴

³¹⁴ Comptroller Rule §3.300.

First Production Stage

The “first production stage” means the first act of production. It does not include acts in preparation for production.

Example

A recent Comptroller letter considered whether line heaters qualify for the manufacturing exemption.³¹⁵ Line heaters are used in the oil & gas industry to (1) reverse the temperature and pressure drop that occurs when natural gas is extracted from the earth, and (2) begin the process of breaking out gas and liquids during the separation process. The Comptroller’s position is that line heaters used for these purposes do not qualify for the manufacturing exemption because these are activities which are performed in preparation for production. The manufacturing exemption only applies to equipment used from the first production stage forward, and does not apply to pre-production activities.

Manufacturing Defined

A manufacturer is a person engaged in manufacturing and includes processors, fabricators and custom manufacturers.³¹⁶ Manufacturing includes each operation beginning with the first stage in the production of tangible personal property and ending with the completion of tangible personal property having the physical properties (including packaging, if any) that it has when transferred by the manufacturer to another.³¹⁷

Pre-Production Acts. Before determining whether equipment or supplies are exempt, the taxpayer must first determine whether the equipment or supplies will be used while manufacturing or processing is occurring. Bringing oil to the surface is not processing, fabrication, or manufacturing. Some confusion exists in this area because the term “production” is generally used in the oil & gas industry to refer to the activity of bringing oil to the surface of the earth. The term “production” is also used to describe the manufacturing of an item of tangible personal property. The statutory language applies the manufacturing exemption only to “manufacturing, processing, or fabrication,” which generally requires that a chemical or physical change occur in order to bring the product being manufactured closer to being ready to sell. The Comptroller has determined that the oilfield producers are not manufacturing or fabricating when they transport the oil from its subsurface location to the surface or when they move the oil.³¹⁸

³¹⁵ Comptroller Letter No. 200404645L (April 14, 2004).

³¹⁶ Comptroller Rule §3.300(a)(8).

³¹⁷ Comptroller Rule §3.300(a)(9)(A).

³¹⁸ Comptroller Letter No. 9612121L (December 11, 1996).

Processing. Processing occurs when the oil is being treated or changed in some way, processing is being done. Processing has been defined for sales tax purposes in terms of an act or series of acts which brings about a physical or chemical change in an item. Texas tax law exempts substances used for the purpose of creating a physical or chemical change in the oil.³¹⁹

Qualifying Items

The following categories of items are exempt from sales & use tax:³²⁰

Component Parts. Tangible personal property that will become an ingredient or component part of tangible personal property manufactured, processed or fabricated for ultimate sale;³²¹

Example

Oil soluble chemicals will be generally considered to be exempt because they become an ingredient or component part of the oil to which they are added, assuming that the oil is sold (e.g., glycol, methanol). Chemicals which are not oil soluble (e.g., water soluble chemicals) are generally taxable. However, if they're used to treat or cause a physical or chemical change in the oil they may be exempt. Chemicals which are not oil soluble and which are used for the purpose of protecting the pipes or other equipment are not entitled to an exemption, because they are not used in processing. This would generally include corrosion inhibitors which are intended to protect or coat pumps, pipes, etc.³²²

Direct Use Equipment. Tangible personal property directly used or consumed in manufacturing, processing or fabricating tangible personal property for ultimate sale. The use or consumption of the property must be "*necessary or essential*" to the manufacturing, processing or fabricating operation and the use must *directly* make or cause a chemical or physical change either to the preliminary, intermediate or final product being manufactured for ultimate sale.³²³

Dehydration Equipment. Dehydration is the loss of water from cement slurry or drilling fluid by the process of filtration. Dehydration results in the deposition of a filter cake and loss of the slurry's internal fluid into a porous matrix. The cement is not completely dehydrated because sufficient water remains to allow setting of the cement. Dehydration

³¹⁹ Comptroller Letter No. 9612121L (December 11, 1996).

³²⁰ Texas Tax Code §151.318.

³²¹ Beginning October 1, 1997, the property must be directly used or consumed in the manufacturing, processing or fabrication of the property. Tex. H.B. 1855, 75th Leg., R.S., (1997).

³²² Comptroller Letter No. 9612121L (December 11, 1996).

³²³ Texas Tax Code §151.318, "Property Used in Manufacturing".

equipment is used to create the proper moisture level for manufacturing. The equipment is therefore exempt from sales & use tax under the manufacturing exemption.

Heater Treaters. A heater treater transfers heat to the produced gas stream. Heater treaters are used to treat oil-water emulsions so the oil can be accepted by the pipeline or transport. Heaters are especially used when producing natural gas or condensate to avoid the formation of ice and gas hydrates. These solids can plug the wellhead, chokes and flowlines. Heaters may also be used to heat emulsions before further treating procedures or when producing crude oil in cold weather to prevent freezing of oil or formation of paraffin accumulations.³²⁴

Separators. A separator is a cylindrical or spherical vessel used to separate oil, gas and water from the total fluid stream produced by a well. Gravity segregation is the main force that accomplishes the separation, which means the heaviest fluid settles to the bottom and the lightest fluid rises to the top. Additionally, inside the vessel, the degree of separation between gas and liquid will depend on the separator operating pressure, the residence time of the fluid mixture and the type of flow of the fluid.

Generally, the Comptroller agrees that separators qualify for the manufacturing exemption, but may raise the issue of partial non-qualified (divergent) use. The Comptroller is presently challenging the claim of the exemption for separators in *Tetra Production Testing Services, LLC. v. Hegar*, D-1-GN-20-006888 (Travis County District Court, filed Nov. 13, 2020).

Gun Barrels. A gun barrel is a settling tank used for treating oil. Oil and brine are separated only by gravity segregation forces. The clean oil floats to the top and brine is removed from the bottom of the tank.³²⁵

Example

A recent Comptroller hearing considered whether booster pumps and recompressors qualify for the manufacturing exemption. A booster pump directly makes or causes a chemical or physical change in crude oil being processed. The booster pump separates carbon dioxide (CO₂) from gas steam. The ALJ determined that the booster pump that separates the CO₂ from the gas steam is making a chemical or physical change to the item being manufactured, so the booster pump qualifies for the manufacturing exemption.³²⁶

³²⁴ Comptroller Letter No. 9609L1435A12 (September 3, 1996), Comptroller Letter No. 9702256L (February 13, 1997) and Comptroller Letter No. 9910770L (October 13, 1999).

³²⁵ Comptroller Letter No. 9609L1435A12 (September 3, 1996).

³²⁶ Comptroller Hearing No. 40,528 (2002).

The compressed CO₂ is then transferred into a liquid pump located at the field booster pump where it is mixed with other CO₂ of approximately the same pressure, further compressed and re-injected into the oil formation to further encourage additional oil production. The recompressors repressurize the recycled CO₂ for reinjection into the well formation. The Comptroller's ALJ determined that the recompressors were also exempt because they were directly used during processing and were necessary and essential because the CO₂ will not enter the formation until it is pressurized. Moreover the compression physically changed the CO₂ itself, which is an intermediate product that becomes part of the recovered oil and natural gas.

Chemicals & Catalysts. The manufacturing exemption includes chemicals, catalysts and other materials used during a manufacturing, processing or fabrication operation to produce or induce a chemical or physical change, to remove impurities or to make the product more marketable.

Example

A compressor used by a gas operator is exempt if used to compress gas to a contractual target sales pressure or used to operate a gas dehydration unit to process or manufacture tangible personal property for sale. Lubricants and coolants used in these compressors qualify for the manufacturing exemption.³²⁷

Example

Lubricants and coolants (antifreeze) used in drivers for salt water disposal pumps are not exempt. The salt water disposal pump is not processing or manufacturing equipment. A compressor that is used to transport oil & gas or to power equipment or facilities not directly used in manufacturing tangible personal property for sale is not processing or manufacturing equipment. Lubricants and coolants used in this equipment do not qualify for the manufacturing exemption.³²⁸

Example

Chemicals and catalysts used to protect production equipment also do not qualify for the exemption. Sulfate reducing anaerobic bacteria exist and multiply without oxygen. They usually exist in the tubing-casing annulus of production wells. Therefore, producers must use Biocide and MicroBiocide to control or restrain the bacteria growth. The chemicals are used to keep equipment from

³²⁷ Comptroller Letter No. 9612121L (December 11, 1996).

³²⁸ Comptroller Letter No. 9612121L (December 11, 1996).

clogging or jamming or corroding. While these chemicals and catalysts beneficially affect the oil produced, these effects are the positive consequences of protecting the production equipment. Therefore, these chemicals and catalysts do not qualify for the manufacturing exemption.³²⁹

Listed Support Equipment. This equipment automatically qualifies for the exemption if it is used to power, supply, support or control equipment that qualifies for exemption or to generate electricity, chilled water or steam for ultimate sale. It includes actuators, steam production equipment and its fuel, in-process flow through tanks, cooling towers, generators, heat exchanges, electronic control room equipment, computerized control units, compressors, and hydraulic units,³³⁰ transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the transformers; pumps; and transformers located at an electric generating facility that increase the voltage of electricity generated for ultimate sale, the electrical cable that carries the electricity from the electric generating equipment to the step-up transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the step-up transformers; and transformers that decrease the voltage of electricity generated for ultimate sale and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the step-down transformers.

Lubricants. The Comptroller allows the manufacturing exemption for lubricants, chemicals, chemical compounds, gases or liquids used or consumed during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if their use or consumption is necessary and essential to prevent the decline, failure, lapse or deterioration of exempt manufacturing equipment.

Gases. The Comptroller allows the manufacturing exemption for gases used on the premises of a manufacturing plant to prevent contamination of raw materials or products, or to prevent a fire, explosion, or other hazardous or environmentally damaging situation at any stage in the manufacturing process or in loading or storage of the product or raw material on premises.

³²⁹ Comptroller Letter No. 9612121L (December 11, 1996).

³³⁰ Texas Tax Code §151.318, "Property Used in Manufacturing."

Example.

In the course of repairing oil refinery equipment, inert gas is piped in to displace oxygen in order to prevent fires or an explosion. The inert gas may be purchased tax-exempt.

Quality Control Process. The Comptroller allows the manufacturing exemption for tangible personal property used or consumed during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to a quality control process.

Example.

Spectrometers used to test the composition of chemicals produced for ultimate sale.

Safety Clothing. The Comptroller allows the manufacturing exemption for safety apparel or work clothing that is used during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the manufacturing process would not be possible without the use of the apparel or clothing and the apparel or clothing is not resold to the employee.

Examples.

Hardhats, earplugs, hairnets, safety shoes, mouth coverings, bunny suits.

Public Health. The Comptroller allows the manufacturing exemption for tangible personal property used or consumed in the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to comply with federal, state or local laws or rules that establish requirements related to public health.

☞ **Caution:** OSHA-required items only qualify for the manufacturing exemption if they're used in the actual manufacturing of the product for sale and they are necessary and essential to comply with regulations.³³¹

Water Conservation. The Comptroller allows the manufacturing exemption for tangible personal property specifically installed to reduce water use and wastewater flow volumes from the manufacturing, processing, fabrication or repair operation; reuse and recycle wastewater streams generated within the manufacturing, processing, fabrication or repair operation; or treat wastewater from another industrial or municipal source for the purpose

³³¹ See, e.g., Tax Policy News, November 2002 and Comptroller Hearing No. 38,348 (2002) (deciding that an OSHA-required eyewash system didn't qualify for the manufacturing exemption because it wasn't used or consumed in the manufacturing process).

of replacing existing freshwater sources in the manufacturing, processing, fabrication or repair operation.

Example.

The cost of redesigning and rebuilding a machine so that it will use less water.

☞ **Note:** The pollution control exemption already covers much of this equipment. This provision extends the exemption to cover equipment that treats wastewater from a source other than the taxpayer.

☞ **No Divergent Use:** The water conservation exemption applies only if the equipment or services are used solely for the exempt purpose.

Increased Capacity in a Petrochemical Refinery or Chemical Plant. Labor is exempt as new construction when the repair, restoration, remodeling or modification of an improvement to a manufacturing or processing production unit in a petrochemical refinery or chemical plant provides increased capacity in the production unit.³³²

Pollution Control Equipment. Machinery or equipment required by law or regulation to control pollution resulting from the manufacturing process also qualifies for the exemption.³³³

Example

Pollution control equipment required by regulatory authorities in connection with particular manufacturing processes, such as fuel blending operations, is exempt. The electricity used to power the equipment is also exempt.³³⁴

Non-Qualifying Items

By statute, many items will not qualify for the manufacturing exemption, even if they directly touch the product or cause a chemical or physical change to the product being manufactured for sale.

Downhole Equipment. The Texas Supreme Court has held that certain downhole equipment- such as tubing, casing, and pumps- does not qualify for the manufacturing exemption.³³⁵

- *Southwest Royalties v. Hegar.*³³⁶ In this case, Southwest Royalties argued that downhole equipment was directly used, necessary, and essential to the processing of oil and gas

³³² Comptroller Rule §3.362.

³³³ Texas Tax Code §151.338.

³³⁴ Taxability Ruling 1275 (John Sharp, October 18, 1991) (STAR No. 9110T1221D05.)

³³⁵ *Southwest Royalties v. Hegar*, No. 14-0743, 500 S.W.3d 400 (Tex. 2016).

³³⁶ No. 14-0743, 2016 Tex. LEXIS 508 (Tex. 2016).

because it separated the hydrocarbons into their component parts (oil, gas, and water). In contrast, the Comptroller argued that the extraction of oil and gas was not processing within the meaning of the exemption, and even if it were, the changes to the hydrocarbons during their movement to the surface were directly caused by natural pressure and temperature changes- not by Southwest Royalties' equipment.

The Texas Supreme Court first determined the meaning of "processing" for purposes of the manufacturing exemption, looking to the Comptroller's rule and defining processing to mean "the application of materials and labor necessary to modify or change characteristics of tangible personal property." Then, the Court turned to the question of whether the equipment for which Southwest Royalties sought the manufacturing exemption satisfied the definition of processing. In other words, was the equipment "used in the actual physical application of materials and labor to the hydrocarbons necessary to cause, and caused, a physical change to them?" Looking at the testimony provided by engineers for both Southwest Royalties and the Comptroller, the Court concluded that there was no evidence that Southwest Royalties' "equipment acted upon the hydrocarbons to cause a modification or change in them other than by being the vehicle through which they exited the underground formation and traveled to the surface." Rather, the changes were caused "by the natural pressure and temperature changes that occurred as the hydrocarbons traveled from the reservoir through the casing and tubing to the surface." As expressly noted by the Court, the decision did not turn on the fact that the alleged processing occurred underground as contrasted with above-ground.

Hegar v. Texas Westmoreland Coal Co. A 2021 decision by the Third Court of Appeals cast doubt upon the Comptroller's position that extraction could *per se* never constitute processing.³³⁷ In *Hegar v. Texas Westmoreland Coal Co.*, the Comptroller argued that excavators used in lignite coal mining could not qualify for the manufacturing exemption because the coal had not been severed from the earth at the time the excavators were used to process them. The Third Court of Appeals rejected this argument, finding that nothing in the manufacturing exemption statute requires that inputs into the manufacturing process be severed from the earth at the time the equipment in question causes a chemical or physical change.

☞ **Note:** The *Southwest Royalties* opinion does not entirely foreclose manufacturing exemption refunds for the oil and gas industry. A case-by-case analysis is necessary. Purchases of other types of equipment may satisfy either the court's definition of processing or other statutory language outlined in the manufacturing exemption.

³³⁷ *Hegar v. Texas Westmoreland Coal Co.*, No. 03-20-00406-CV (Tex. SC, Sept. 30, 2022, review denied).

Indirect Equipment. The manufacturing sales tax exemption applies only to equipment that is directly used or consumed in manufacturing, processing or fabricating tangible personal property for ultimate sale.³³⁸ The equipment must directly make or cause a chemical or physical change to the preliminary, intermediate or final product being manufactured for ultimate sale.

Intraplant Transportation Equipment. This equipment is used to move, without change, products in process in the manufacturing plant. This equipment and machinery, by statute, does not qualify as manufacturing equipment.³³⁹ This includes equipment such as conveyor belts, pipelines, forklifts, etc.³⁴⁰

Example

Compressors used to compress processed gas to a customer's contractual target sales pressure prior to entering a sales line will qualify for the manufacturing exemption.³⁴¹ In addition, compressors necessary for the operation of field dehydrators, heater treaters, separators and scrubbers may qualify for the manufacturing exemption as processing equipment.³⁴²

In contrast, compressors used at the well head to extract (i.e. lift or produce) oil and gas from below the ground do not qualify for the manufacturing exemption.³⁴³

³³⁸ October 1, 1997. cf. *Sharp v. Tyler Pipe Indus., Inc.*, 919 S.W.2d 157 (Tex. App. – Austin 1996).

³³⁹ Texas Tax Code §151.318(c)(1).

³⁴⁰ Prior to October 1, 1997, equipment purchased for intraplant transportation of products may qualify for the manufacturing exemption if some physical or chemical change occurs during the transportation. See Comptroller Letter No. 9709429L (September 29, 1997). cf. *Chevron Chemical v. Sharp*, 924 S.W. 2d 429 (Tex. App.—Austin 1996, writ denied).

³⁴¹ See Comptroller Letter No. 201509491L (September 30, 2015).

³⁴² See Comptroller Letter No. 201509491L (September 30, 2015); Tex. Tax Code §151.318(a)(4).

³⁴³ See Comptroller Letter No. 201509491L (September 30, 2015).

Example

A company builds a liquefied natural gas plant in Texas. The company purchases pipeline quality natural gas that is delivered to the plant by pipeline. The company converts this gas into liquefied natural gas, which it sells to other companies. Compressing the gas to a pressure required to convert the gas into liquid while it is within the plant is considered a manufacturing process and will qualify for the manufacturing exemption.³⁴⁴

Example

Electricity used to transport product (e.g., propylene and butadiene) within a plant facility is taxable intraplant transportation. Transporting blended product from tanks and loading it into rolling stock, barges or tankers is also transportation. Equipment and electricity used to transport and load the product is taxable.³⁴⁵

☞ **Caution:** Depending upon how they're used, compressors may or may not qualify for the manufacturing exemption. If they're used for transportation, they're generally taxable.

Exception for Recirculation. Piping qualifies if it is piping through which the product (or an intermediate or preliminary product that will become an ingredient or component part of the product) is recycled or circulated in a loop between the single item of manufacturing equipment and the ancillary equipment that supports only that single item of manufacturing equipment, if the single item of manufacturing equipment and the ancillary equipment operate together to perform a specific step in the manufacturing process.

Property Repairs. Manufacturing includes repairing or rebuilding tangible personal property for the purpose of being sold, but does not include the repair or rebuilding of property belonging to another.³⁴⁶

Maintenance Excluded. The manufacturing process does not include maintaining the life of tangible personal property after the completion of manufacturing.³⁴⁷

Opportunities and Pitfalls

Manufacturers should be alert to these issues dealing with the manufacturing exemption:

³⁴⁴ See Comptroller Letter No. 201501032L (January 27, 2015).

³⁴⁵ Comptroller Letter No. 9110T1221D05 (October 18, 1991).

³⁴⁶ Comptroller Rule §3.300(a)(9).

³⁴⁷ Comptroller Rule §3.300(a)(9).

Equipment Repairs and Overhauls. Repairs, overhauls and other taxable services performed on manufacturing equipment are exempt from sales tax.

☞ **Note:** This includes manufacturing equipment which was purchased before the manufacturing exemption became law. For example, repairs to manufacturing machinery purchased in 1975 are nonetheless exempt, even though there was no manufacturing exemption in 1975.

Product Services. Taxable services performed directly on the product being manufactured prior to its distribution for sale and for the purpose of making the product more marketable are exempt from sales & use tax.

Leased Equipment. Any manufacturing equipment leased or rented for more than one year is entitled to the exemption. The one-year period is taken literally. Therefore, the Comptroller believes that a lease for a term of one year, even if it has month-to-month renewals after that term, will not be entitled to the exemption.

Compressor Rentals. A recent Comptroller letter considered whether compressors rented for use in processing oil & gas qualified for the manufacturing exemption.³⁴⁸ Rental equipment, including compressors, qualifies for the manufacturing exemption only if it is rented for one year or longer. If the compressor breaks down prior to the end of the one-year rental contract, it still qualifies for the exemption. However, the exemption is lost if there is no written contract. Similarly, if the rental contract is not renewed in writing for a term of one year or longer, subsequent rental payments will subject to tax. Entering into a subsequent agreement to extend the lease will not retroactively exempt month-to-month lease payments that have already occurred prior to the renewal.

Lump-Sum Construction Contracts. The manufacturer must be the purchaser of the equipment. Recall that contractors who purchase materials under a lump-sum construction contract are considered the consumer of all materials purchased for the job. Therefore, if a contractor is constructing a manufacturing complex under a lump-sum contract, the contractor, and not the manufacturer, is the purchaser of the manufacturing equipment. The manufacturing exemption is lost simply because the contract did not separately state the charge for materials and labor. Once it is lost, it can never be regained.

Real Property. The exemption is only available for *personal property*. It is not available for *real property*. While this is rarely an issue when the equipment is initially purchased, it can affect whether or not repairs of the equipment will be exempt after installation. If the equipment is so affixed to the real estate that it loses its character as personal property and becomes a fixture to the real property, the exemption is lost and all subsequent repairs will

³⁴⁸ Comptroller Letter No. 200102379L.

be considered taxable repair and remodeling of commercial real property. To avoid this, a manufacturer should ensure that the equipment is carried on its books as personalty and not realty. Furthermore, the manufacturer should be able to show how the equipment could be moved to a new site if needed. The mobility of the property can affect its status as personalty.

Manufacturers Who Install. Contractors who consume tangible personal property while improving real estate aren't eligible for the manufacturing exemption.³⁴⁹

The Comptroller treats manufacturers who install items of tangible personal property or real property as contractors for sales & use tax purposes.³⁵⁰ The Comptroller requires the manufacturer/installer to pay sales tax on its purchases. If the manufacturer previously purchased equipment under a manufacturing exemption, the Comptroller requires the manufacturer to treat as a divergent use, the use of the equipment for jobs including installation.³⁵¹ The Comptroller's position is that it makes no difference whether the manufacturer performs the work as part of a lump-sum contract or a separated contract.

Divergent Use. Taxpayers are required to accrue use tax on the fair value of non-qualified use of manufacturing equipment. Prior to October 1, 2001, taxpayers could not claim a partial manufacturing exemption. The item was either exempt or it was not exempt.³⁵²

Once the divergent use occurred, the taxpayer owed sales & use tax on the fair rental value of the equipment. After October 1, 2001, Texas taxes the amount of divergent use during the first four years of owning the equipment.³⁵³ However, no tax is due on divergent use if the first divergent use occurs after the first four years or doesn't exceed 5% of the total use of the item.

Example

Matrix Mud Company manufactures custom chemical blends of oil-based mud. When it purchases or builds new mixing plants and storage tanks for finished goods, Matrix selects designs that allow for independent mixing in each tank. All of Matrix's large storage tanks are fitted with jets, suctions and discharges to allow

³⁴⁹ Texas Tax Code §151.056.

³⁵⁰ Comptroller Hearing No. 41,339 (2002) (stating that a manufacturer of signs lost its manufacturing exemption when it began providing installation services).

³⁵¹ In Comptroller Hearing No. 41,339 (2002), the Comptroller refused to allow a credit for taxes that the taxpayer had "erroneously" collected from its customers. Instead, the Comptroller stated that Tax Code §111.016 requires the manufacturer/installer to remit all tax it collected in error, plus the additional tax assessed on the purchase of materials and the divergent use of equipment. The Comptroller will refund or credit the "erroneously" collected tax only after the taxpayer reimburses the tax to its customers.

³⁵² Texas Tax Code §151.3181. (effective Sept. 1, 2001).

³⁵³ Texas Tax Code §151.3181 (effective Oct. 1, 2001).

mixing action. To expedite manufacturing, Matrix mixes basic blends and stores these unfinished products in the storage tanks. When it receives an order from a customer for specific chemical properties, Matrix adds materials to the basic blends in the storage tanks and the tanks are used to finish blending. These tanks vary in size, and can be less than 500 barrels or greater than 500 barrels.³⁵⁴

The Comptroller generally treats aboveground storage tanks with a capacity of more than 500 barrels as improvements to real property unless there is other evidence, such as a contract or an agreement, that the tanks are tangible personal property. Aboveground tanks that have the capacity of 500 barrels or less are treated as tangible personal property.

Matrix's tanks are used for both storage (divergent use) and mixing (exempt use). Matrix may claim an exemption on the tanks that remain tangible personal property, but must accrue tax on the divergent use.³⁵⁵

Storage tanks that are in excess of 500 barrels are improvements to realty. A manufacturer, who purchases tanks that would qualify for the manufacturing exemption (i.e., directly makes or causes chemical or physical change to product for ultimate sale) but are incorporated to become improvements to realty, may issue an exemption certificate for the separately-stated charges for parts that actually process the product (i.e., jets, suction and discharges) and that are sold under a separated contract.³⁵⁶ The manufacturer may claim an exemption on the other materials, but must accrue tax based on divergent use of those materials.

If the stairs and railings are added to tanks that have capacity in excess of 500 barrels when the tanks are first installed to put into service, then the work is new construction finish-out and the terms of the contract will determine the party responsible for tax on the materials.

Once the storage tanks become improvements to realty, modifications (i.e., adding stairs and rails) to nonresidential improvements to real property are taxable. Maintenance performed on nonresidential improvements to real property is taxable unless it qualifies as scheduled and periodic maintenance under Rule 3.357.

Storage tanks that are in excess of 500 barrels that are solely used to store raw materials or finished products do not qualify for the manufacturing exemption.

³⁵⁴ See Comptroller Letter No. 200301709T (January 30, 2003).

³⁵⁵ See Rule 3.300. Divergent use of the equipment that occurs prior to October 1, 2001 is taxable based on the fair market rental value of the equipment for the period of taxable use. Divergent use of manufacturing equipment used on or after October 1, 2001 is taxed in the manner set out under Section 151.3181 of the Texas Tax Code. See Rule 3.300(k).

³⁵⁶ See Rule 3.300(i).

Gas and Electricity Exemption

The purchase of gas or electricity may be exempt from sales tax, depending upon whether the use is qualified.

Qualified Uses Applying to the Oil & Gas Industry.

Taxpayers may exempt gas and electricity if it is used:

Manufacturing. Processing tangible personal property for sale as tangible personal property;³⁵⁷

Mining. Exploring for, or producing and transporting a material extracted from the earth. This includes materials such as coal, oil, natural gas or coal slurry. However, sales or use tax is due on natural gas or electricity used to transport a product which was manufactured from a material extracted from the earth;

Electrical Processes. This includes electroplating, electrolysis and cathodic protection.

³⁵⁷ Electricity may be exempt if a restaurant uses it predominately in manufacturing or processing the food. However, further cooling or freezing of products isn't exempt. Comptroller Hearing No. 39,093 and 39,8707 (2001).

Example

Petrochemical storage and distribution facilities may claim an exemption for electricity used in pumping product into a blending tank if the product being pumped into the tank is a material or its component extracted from the earth. Blending various products for the production of special types of fuel is considered nontaxable processing. However, the electricity would be taxable if the product contained substances which did not exist in nature or were not components of the material extracted from the earth.³⁵⁸ Electricity to transport a blended or processed product is taxable, while electricity used to transport a material extracted, prior to processing, blending, etc., from the earth (oil, gas, sulfur, water, etc.) is an exempt use.

Example

Mixing feed stock of various petroleum products and blending them with additives to manufacture specific products requested by a customer is also considered processing. The electricity used to power blending pumps, which directly blend the products is exempt.³⁵⁹

Example

The electricity used in the initial refrigeration to “chill” petroleum products, such as propylene and butadiene, is exempt. However, subsequent refrigeration of the “chilled” products is taxable (e.g., keeping the product chilled in the holding tank).³⁶⁰

Example

Natural gas used in blending and refrigeration operations to burn recovered vapors (as part of pollution control) resulting from the blending process and from the initial refrigeration to “chill” the products is exempt. Natural gas used to burn recovered vapors resulting from storage refrigeration and any other nonprocessing operations is not exempt.³⁶¹

³⁵⁸ Comptroller Letter No. 9110T1221D05 (October 18, 1991).

³⁵⁹ Comptroller Letter No. 9110T1221D05 (October 18, 1991).

³⁶⁰ Comptroller Letter No. 9110T1221D05 (October 18, 1991).

³⁶¹ Comptroller Letter No. 9110T1221D05 (October 18, 1991).

Non-Qualifying Uses

Non-qualifying use means the use of gas and electricity by a person engaged in selling, warehousing or distributing a commodity or performing a professional or personal service. This includes electricity or gas used in the wholesale and retail trades, hotels, office buildings, in preparing or storing food for immediate consumption and for use by persons providing taxable services.

Taxable v. Exempt Uses

When determining the predominant use of natural gas or electricity, utilities used to operate production machinery and for lighting, cooling and heating in the manufacturing area are considered exempt uses. Gas and electricity used to operate, lighting, cooling and heating in manufacturing support areas are considered taxable uses. Manufacturing support areas include, but are not limited to, storage, engineering, office and accounting areas, research and development and break room, eating and restroom facilities. Utilities used in an area open to the public for purposes of marketing a product ready for sale are considered taxable uses. Utilities used to operate other nonproduction machinery or equipment are taxable.

Single Meters and Predominant Use. Natural gas or electricity used for both exempt and taxable purposes under a single meter is totally exempt or totally taxable based upon the “predominant use” of the gas or electricity measured by that meter. Predominant use of gas and/or electricity for exempt purposes is required to obtain an exemption.

Utility Study Required. If the utilities are not separately metered, the Comptroller requires the taxpayer to have an engineer perform a utility study to establish the qualified, predominant use of the utilities. The study must list all exempt and nonexempt uses of the utilities, as well as other technical specifications. The business owner must certify that all items using natural gas or electricity are listed and the hours of use for each item are correct. The electricity or natural gas computations must be performed by a registered engineer or a person with an engineering degree from an accredited engineering college. The taxpayer must complete the utility study and have it on file at the time the taxpayer submits the exemption certificate to the utility company. Without the study, the Comptroller presumes the exemption is invalid.

Comptroller Rule §3.295 requires a predominant use study to include all items on a particular meter and all utility uses for each item. If the taxpayer limits the analysis to a portion of the use (e.g., refrigeration), it will result in an incomplete study. A taxpayer claiming exemption must present evidence that clearly brings him within the exemption.³⁶²

³⁶² Comptroller Letter No. 9110T1221D05 (October 18, 1991).

No Study. Persons obtaining a sales tax refund without a valid study will be assessed tax, penalty and interest on the full amount of the refund, if the exemption is not proved. The Comptroller may request a copy of the study for review before or after the sales tax exemption is granted. Review of the study by the Comptroller does not confirm the study's accuracy.

What if Qualifying Use is 50% or Less? If 50% or less of the electricity or gas flowing through a single meter constitutes a qualified (exempt use), none of the electricity or gas is exempt. However, the taxpayer may add another meter through which the qualifying use electricity or gas may flow which will then allow the exemption for the gas or electricity flowing through the second meter (assuming more than 50% of the use flowing through the second meter is qualified.) According to the Comptroller's office, this strategy is allowed.

Non-Qualifying Property. The following items³⁶³ don't qualify for the manufacturing exemption: Property used in the transmission or distribution of electricity; transformers, cable, switched, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are not otherwise exempted; and lines, conduit towers and poles.

☞ **Caution:** The Comptroller requires a business with more than one location to have a valid utility study for each location, even if the gas and electricity use at the various locations are comparable.³⁶⁴

Common Property Ownership Transfers

This is the drill pipe rule. It was created during the oil boom when commonly-owned limited partnerships were transferring oil & gas drilling equipment among themselves for credits on the joint interest billings. Sales of tangible personal property are not subject to sales tax if the purchaser owns a joint or undivided interest in the property with the seller, either before or after the sale.³⁶⁵

☞ **Pitfalls and Opportunities:** Closely-held companies often organize one entity to own and maintain the equipment. The affiliates make periodic equipment rental payments to the equipment-holding entity for use of the equipment. Generally, the rental payments

³⁶³ Tax Code §151.318 (c)(5).

³⁶⁴ Comptroller Hearing No. 39,602 (2002).

³⁶⁵ Comptroller Rule §3.331 and Texas Tax Code §151.306. See also Texas Tax Code §151.348 (exempting certain transactions between members of cooperative research and development joint ventures) and Comptroller Decision No. 38,891 (June 14, 2002) (determining that a sale of software to a participant of a joint venture that developed the software was not subject to sales & use tax).

would be taxable as the rental of tangible personal property. The closely-held companies may be able to use this rule to solve this dilemma.

In order to show that the transfers of tangible personal property (e.g., belts and fittings) are exempt under the “drill pipe” rule, a taxpayer must be able to provide documents showing common ownership of the property after the sale (e.g. a copy of the contract for the well listed on the invoice). The taxpayer must also be able to show that the purchaser paid tax when it purchased the item (e.g. a copy of the original purchase invoice, or printouts from the accounting or inventory system showing that tax was paid).

Offshore Use Exemption

The U.S. Constitution limits the state’s ability to tax outside its borders. Therefore, Texas law exempts from sales & use tax certain drilling equipment and component parts used for offshore exploration or production of oil, gas, sulfur or other minerals. The exemption applies to drill pipe, casing, tubing and other pipe used for exploration for or production of oil, gas sulfur or other minerals offshore not in this state; and tangible personal property exclusively used for the exploration for or production of oil, gas sulfur or other minerals offshore not in this state.

The exemption also applies to certain drilling equipment for offshore use. The drilling equipment may be delivered to Texas or built in Texas and still qualify for exemption, as long as certain conditions apply as discussed below.

Drilling Equipment Built for Exclusive Use Outside Texas.

The drilling equipment may be built in Texas for use in offshore exploration for or production of oil, gas sulfur, or other minerals. In order to qualify for the exemption, the drilling equipment must be built for exclusive use outside this state and, on completion of the equipment, it must be removed “forthwith” from this state. Drilling equipment generally includes the materials and equipment needed to make the hole. Production equipment includes the materials and equipment needed to bring the minerals to the surface.³⁶⁶

Delivery May Be in Texas. A taxpayer may take delivery of exempt items in Texas. Delivery in Texas will not disqualify the purchaser or lessee from the exemption as long as the property is removed from the state. The removal may be by any means, including by the use of the purchaser’s or lessee’s own truck, barge or other facilities.

Delivery in Texas for Further Assembly. Shipping exempt drilling equipment to Texas for further assembly or fabrication won’t disqualify the equipment for the exemption.

³⁶⁶ Comptroller Letter No. 8510L0679D12 (October 16, 1985).

However, on completion of the further assembly or fabrication, the equipment must be removed “forthwith” from this state.

Offshore. “Offshore” means outside Texas territorial waters, which means three marine leagues or more from the Texas coastline.³⁶⁷

Removal Forthwith. Removal “forthwith” is removal from the state within a *reasonable* period. In order to qualify for exemption there must be no consumption or use of the property in Texas. Assembly or fabrication is not considered “use” as long as the property is removed forthwith beyond the territorial limits of Texas upon completion of the fabrication or assembly.³⁶⁸

☞ **Caution:** Intent to remove forthwith is not the same as removing forthwith. If, at the time of purchase, a customer plans to store the rig for several months and is uncertain where it will place the rig, the exemption doesn’t apply.³⁶⁹

☞ **Note:** There is no requirement that pipe and casing be removed “forthwith.” The requirement that equipment be removed forthwith applies only to certain equipment built, assembled or fabricated in this state and does not include drill pipe or casing.³⁷⁰

Temporary Storage. Items purchased for purposes of offshore use but then used in a divergent manner are taxable. “Use” is the “exercise of a right or power over or the keeping or retaining of, tangible personal property for the purpose of transporting the property outside the state” In order to show that no divergent use has occurred, the Comptroller may require taxpayers to show, on a case-by-case basis, that exempt items stored in Texas are stored here temporarily.³⁷¹ For example, items transferred to the offshore wellsite as soon as feasibly possible, under the circumstances, maintain their exemption. Items first transferred to a Texas wellsite for use before being shipped offshore lose their exemption.³⁷²

Caution: If a taxpayer purchases component parts, stores them temporarily in Texas, assembles a machine using the component parts, and then ships the machine out of state, the taxpayer must be sure to maintain careful records of the use of the equipment. In an administrative hearing, the Comptroller held that a taxpayer in this situation could not prove that the temporary storage exemption applied, because it only tracked the use of the

³⁶⁷ Comptroller Letter No. 8703L0800B04 (March 19, 1987). A marine league equals three nautical miles.

³⁶⁸ Comptroller Letter No. 200006379L (June 5, 2000).

³⁶⁹ Comptroller Letter No. 9712138L (December 23, 1997).

³⁷⁰ See Comptroller Hearing No. 19,873 (1987).

³⁷¹ See Comptroller Hearing No. 19,873 (1987).

³⁷² See Comptroller Hearing No. 19,873 (1987).

final assembled tools, and not the use of the component parts that it purchased and stored.³⁷³

Repairs. Repairs to exempt offshore rigs are also exempt.³⁷⁴ Therefore an oil & gas producer may provide an exemption certificate in lieu of tax on purchases of labor and materials to repair or maintain offshore rigs.

Specific Identification Required for Drilling Equipment Exemption. In order to claim the drilling equipment exemption, the taxpayer must be able to specifically identify the drilling equipment that is used exclusively outside of Texas. In *Nabors Drilling Technologies USA, Inc. v. Hegar*,³⁷⁵ the court rejected Nabors' claim for exemptions for drilling equipment exclusively used outside of Texas.

Nabors purchased component parts that it ultimately incorporated into oil and gas drilling equipment for use to provide directional drilling services to its customers, who were located both inside and outside of Texas. The court found that, at the time Nabors purchased the component parts, it did not document the intended place of use of each item, the parts were not incorporated into drilling equipment until needed for a specific job at a specific location. Nabors failed to present evidence concerning how long the component parts stayed in inventory prior to being shipped to a customer drill site, and that after Nabors incorporated component parts into drilling equipment, that equipment was used on customer jobsites both in Texas and out of Texas. The court also determined that Nabors stored the component parts in its Houston-based warehouse in between use on customer job sites.

The court also held that Nabors was not eligible to claim the temporary-storage exemption for use tax assessed on the storage of component parts in its Houston warehouse because the parts were stored temporarily on multiple occasions—both after Nabors' initial purchase of the parts, and then again in between use at customer job sites. The court reasoned that the temporary storage exemption contemplates only one initial period of temporary storage before an item is permanently removed from the state.

³⁷³ See Comptroller Hearing No. 107,598 (December 4, 2014).

³⁷⁴ See Texas Tax Code §151.3111 – Services on Certain Exempted Personal Property.

³⁷⁵ See *Nabors Drilling Technologies USA, Inc. v. Hegar*, 03-17-00284-CV, 2018 WL 2709201 (Tex. App.—Austin June 6, 2018, no pet. h.).

Exemption for Drilling Rigs as Commercial Vessels

Texas law exempts from sales & use tax the original builder's sale of a vessel eight tons of displacement or greater which will be used exclusively for commercial purposes.³⁷⁶ Various types of drilling rigs may qualify as exempt vessels:

Jack-Up Rigs

These are barges or floating drilling platforms with legs. The rigs may have some self-propulsion, but are usually towed from place to place. Once the rigs are in place, the legs are lowered to the ocean floor and the platform is jacked up above the water.³⁷⁷

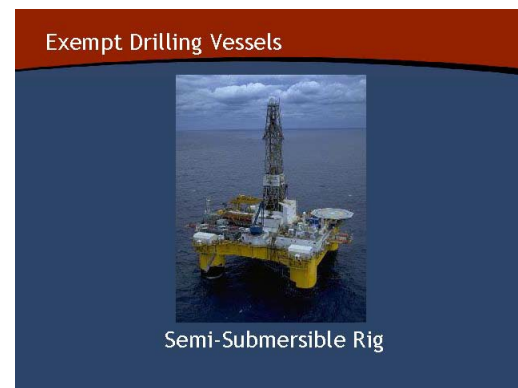


Drilling Barges

These are modified barges which contain all the drilling equipment necessary for a drilling a well. They are generally not self-propelled but must be towed from one place to another.³⁷⁸

Semi-Submersible Rigs

These are rigs that float on a type of "pontoon" in route to an off-shore drilling site. The pontoons are submersed to stabilize the rig during drilling. These units usually require some towing.³⁷⁹



Drillships

These are ships which have been modified to facilitate drilling down through the center of the ship. These units are almost always self-propelled and generally drill in deep water.³⁸⁰

³⁷⁶ Comptroller Rule §3.297(b)(1).

³⁷⁷ Comptroller Letter No. 8306T0515A13 (June 16, 1983).

³⁷⁸ Comptroller Letter No. 8306T0515A13 (June 16, 1983).

³⁷⁹ Comptroller Letter No. 8306T0515A13 (June 16, 1983).

³⁸⁰ Comptroller Letter No. 8306T0515A13 (June 16, 1983).

Equipment on Drilling Vessels

The equipment on drilling vessels is also exempt if it is either a component part of the vessel or if it is used exclusively for offshore drilling.³⁸¹ Component parts are those which are integral to the drilling rig.

Component Parts

The Comptroller generally deems the following items to be component parts of drilling rigs:³⁸² drill pipe; tongs – gripping and lifting tools; life boat; draw work chain; life preservers; kelly; swivels; adapters; wire rope; slips and liners; sand line; elevators; weight indicator gauge; swivel joints; bushings, collars (chicsane); intercom; fire extinguishers; rotary hose; safety or personnel net; automatic driller; cementing unit; logging units; mud monitor logging units; masts; power units; hoisting equipment attached to the rig and mud pumps; drawworks; derricks; drill pipe; ropes; bits; chains; and blowout preventers (exempt unless left at the well site).

Sometimes Component Parts

The Comptroller deems the following items³⁸³ to be component parts of drilling vessels when bolted or otherwise firmly attached to the vessel: washer/dryer; lights for hood; beds/mattresses; compressors; trash compactor; ice machine; writing table; dishwasher; refrigerator; milk dispenser; range; and lockers.

Not Component Parts

The Comptroller does not consider the following items³⁸⁴ to be component parts of drilling vessels: unattached kitchen equipment; unattached furniture and appliances; clothing; safety belts; lubricants; wash pipe packing; fuel; linen; consumable supplies; tableware; casing; hand tools; and food.

Repairs

Repairs to exempt vessels are also exempt.³⁸⁵ Therefore, rig owners may issue an exemption certificate in lieu of paying tax on purchases of labor and materials to repair or maintain drilling rigs that qualify as exempt vessels.

³⁸¹ Comptroller Letter No. 8306T0515A13 (June 16, 1983).

³⁸² Comptroller Letter No. 8306T0515A13 (June 16, 1983).

³⁸³ Comptroller Letter No. 8306T0515A13 (June 16, 1983).

³⁸⁴ Comptroller Letter No. 8306T0515A13 (June 16, 1983).

³⁸⁵ See Texas Tax Code §151.3111 – Services on Certain Exempted Personal Property.

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