

Texas Sales Tax Oilfield Services Industry 2022 Update

This teaching manual/outline provides information on general tax issues and is not intended to provide advice on any specific legal matter or factual situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.

Instructor



JIMMY MARTENS

Attorney, CPA | Martens, Todd & Leonard

Jimmy Martens, trial and appellate attorney, is the founding partner of Martens, Todd & Leonard, a boutique tax litigation law firm located in downtown Austin, Texas. Mr. Martens has handled the trial of tax cases and related appeals all the way through both the Texas Supreme Court and the U.S. Supreme Court.

His recent Texas Supreme Court cases include: *Hegar v. Gulf Copper & Manufacturing Corp.*, No. 17-0894, slip op. (Tex. Apr. 3, 2020), 601 S.W.3d 668 (Tex. 2020); *Combs v. Roark Amusement & Vending, L.P.*, 422 S.W.3d 632 (Tex. 2013); *In re AllCat Claims Serv., L.P.*, 356 S.W.3d 455 (Tex. 2011); and *Titan Transp., LP v. Combs*, 433 S.W.3d 625 (Tex. App.—Austin 2014, pet. denied).

His recent appellate cases include: *Combs v. Newpark Res., Inc.*, 422 S.W.3d 46 (Tex. App.—Austin 2013, no pet.); *Hegar v. CGG Veritas Servs. (U.S.), Inc.*, No. 03-14-00713-CV, 2016 WL 1039054 (Tex. App.—Austin Mar. 9, 2016, no pet.) (mem. op.); *Graphic Packaging Corp. v. Hegar*, 471 S.W.3d 138, 140 (Tex. App.—Austin 2015), aff'd, 538 S.W.3d 89 (Tex. 2017); *Hegar v. Gulf Copper and Manufacturing Corporation*, 535 S.W.3d 1 (Tex. App.—Austin 2017, pet. granted); and *OGCI Training, Inc. v. Hegar*, No. 03-16-00704-CV (Tex. App.—Austin Oct. 27, 2017, no pet.).

He focuses his law practice on challenging Texas franchise and sales tax assessments in administrative hearings, state district court, the related courts of appeal and Texas Supreme Court. He is board certified by the Texas Board of Legal Specialization in Tax Law.

Mr. Martens is vice-chair of the Texas State Bar Tax Controversies Committee, a former council member of the Tax Section for the State Bar of Texas and the former chair of the CLE Committee. He is the statewide course instructor for the Texas Society of CPAs. He teaches his Texas Franchise Tax and Texas Sales Tax courses for them annually in the major Texas cities.

Mr. Martens received his B.B.A. and J.D. from The University of Texas at Austin, both with honors.

Mr. Martens may be reached by email at jmartens@textaxlaw.com or by telephone at (512) 542-9898.

Table of Contents

I. COMPTROLLER AUDIT POLICY CHANGES	1
A. Flowback Services	1
B. Chemicals	4
C. Injected CO2	7
D. Water Transfer Service	7
E. Vapor Recovery Units (VRUs)	8
F. Mud Lost in Hole.....	9
G. Lease Automatic Custody Transfer (LACT) Units.....	10
H. Environmental and Conservation Services	16
I. Drilling Motors and Stators Damaged Beyond Repair.....	17
II. OIL & GAS MANUFACTURING EXEMPTION	17

Texas Sales Tax for Oilfield Services 2022 Update

The Texas Comptroller recently made sweeping, taxpayer-adverse changes to his policies and procedures for auditing oilfield service companies. He's said more changes are coming.

These changes affect many aspects of oilfield services, especially when determining whether services or rentals are being provided. The changes affect many areas, including the taxability of flowback services, chemicals, injected CO₂, water transfer services, vapor recovery units, LACT units, and claims for exemption under the Environmental and Energy Conservation exemption. This update as includes developments in other areas, including sand mines (for proppants) and chemicals to reduce corrosive H₂S in pipelines.

The most prominent, categorical change concerns the Comptroller's new rules for determining whether a transaction constitutes a rental or a service. This policy change affects numerous oilfield services, particularly those involving stationary equipment as contrasted with equipment that's driven. While the Comptroller labels his changes as a "clarification" of existing policies. That labeling is belied by the numerous policy letters he had to supersede to implement his changes.

I. COMPTROLLER AUDIT POLICY CHANGES

A. Flowback Services

Fracking a Well. In the fracking process, it can take up to 4 million gallons of water to frack a horizontally-drilled shale well. Chemical additives generally make up less than one-half of 1 percent of the water used. The chemicals benefit the wellbore by preventing corrosion and reducing friction.

A well is fractured using high pressure pumps which to stimulate production by increasing the permeability of the producing formation. Under extremely high hydraulic pressure a fluid (water, oil, alcohol, hydrochloric acid, liquefied petroleum gas, foam [and proppants]) is pumped down through the tubing and forced into perforations in the casing. The fluid enters the producing formation and parts or fractures it. Sand, aluminum pellets, glass beads, or similar [proppant] materials are carried in suspension into the fractures. These proppant materials are used to hold open the cracks in the formation caused by the high-pressure pumping. When the cracks are held open, oil flows more easily through them and into the well bore.

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

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 views the provision of flowback services as occurring under these circumstances:

1. The well operator determines the temporary location of the equipment and the rate at which the equipment will flow the well.
2. After installation, the equipment works automatically and only needs minor adjustments.

3. The flowback period typically lasts between 30 and 120 days. Most of the sand from fracking is removed from the well within two weeks. After this point, the flowback personnel usually leave the wellsite. However, the equipment may remain at the wellsite afterwards for use to conduct additional testing to determine the economic potential of the well.

4. Once the well pressure has normalized and the frac fluids and proppants are no longer impeding production, the well can be put into production.

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

If the service provider merely rented the flowback equipment without an operator, the Comptroller treated as the taxable rental of equipment. A person that 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.¹ It’s important to note that much of the rental equipment is 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.²

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.³ 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.

Revised Policy. The Comptroller now taxes the full charge for providing flowback services as equipment rentals. Not only does he minimize the operational control aspects of the work performed by the operators of the flowback equipment, *he taxes the charges for their otherwise non-taxable labor as well.*

In order to overcome the Comptroller’s taxable rental treatment, the flowback services provider will need to differentiate the nature of its services from circumstances described in 1. Through 4. above.

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

² Texas Tax Code §151.355(7); Tax Policy News (June 2011).

³ See Comptroller Hearing No. 44,155 (Mar. 26, 2004).

Auditing a flowback vendor (seller)

The Comptroller directs his auditors to follow these rules when auditing flowback transactions:

First, the agency says the auditor should first determine if the seller has been charging tax on its sales of the flowback. If the seller has been charging tax, the auditor should not make any adjustments. The auditor should disallow refunds claimed by sellers for taxes charged to the customer.

If a seller has not been charging tax, the auditor should determine if the seller paid or accrued tax on its purchases of equipment used in the flowback. If the seller paid tax on the purchase of equipment AND it agrees to collect tax on its sales going forward, the auditor is directed to contact the Audit Headquarters' Settlement Group for possible settlement. If the taxpayer hasn't been charging taxes OR it refuses to collect tax on sales going forward, the auditor should treat the flowback transactions as the taxable rentals of equipment without an operator.

Auditing a purchaser

Auditors should determine if the purchaser paid or accrued tax on the purchase of flowback services. If it did not, the auditor should assess tax on the untaxed purchases. Auditors are directed to deny all refunds claimed by purchasers on purchases of flowback. The basis for the denial is that these transactions constitute taxable equipment rental without an operator.

If taxpayers continue to claim their facts are different and should qualify for exemption, auditors should forward the taxpayers' documentation and contentions to the Comptroller's oilfield services specialists who will review the information and possibly seek guidance from the Tax Policy Division.

B. 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. The Comptroller allows an exemption for oil-soluble chemicals since they will be produced with the oil.

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"). 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 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 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.

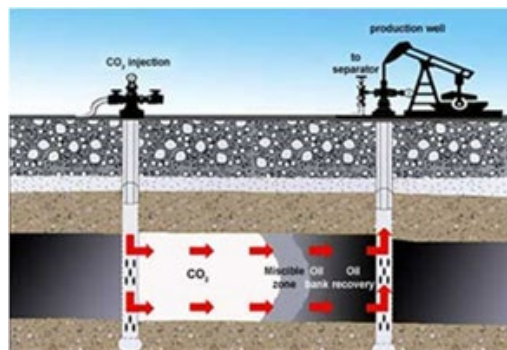
Auditors are instructed to deny all claims of exemption for reasons other than oil solubility. If the claim pertains to fracking chemicals that allow for the reuse or recycle of wastewater, auditors are directed to contact the Audit Headquarters' Settlement Group for review. Auditors are

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.

C. Injected 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.

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).

D. Water Transfer Service

Water transfer services are provided directly at the well site. The water transfer services company typically does not own the water sources. They are either owned by the operator or others. Moreover, water transfer services providers do not own the land from where the water is derived. A water transfer service company operates equipment to ensure that the correct amount of water is supplied at a constant rate, without interruption, during the fracking process. Water

transfer service company either rent their equipment bare to operators or provide personnel to operate the equipment. When provided, the operators to operate the pumping equipment typically in twelve-hour shifts. These operators are solely responsible for all aspects of operating and fueling the equipment. For example, operators will, as necessary, back flush and clear clogs from the equipment during the process.

The water transfer service company provides trucks, trailers, and crews to deliver and temporarily install the equipment at the wellsite. Charges for delivery are usually either separately stated on the customer's bill or included in a charge for "Mobilization" or "Demobilization." Charges for installation are generally included in the charge for "Mobilization." After the work is completed, the water transfer service company provides trucks and crews to disassemble and remove the equipment from the jobsite. Charges for disassembly and removal are generally included in the charge for "Demobilization."

Taxability. 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.

E. 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.

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.

F. Mud Lost in Hole

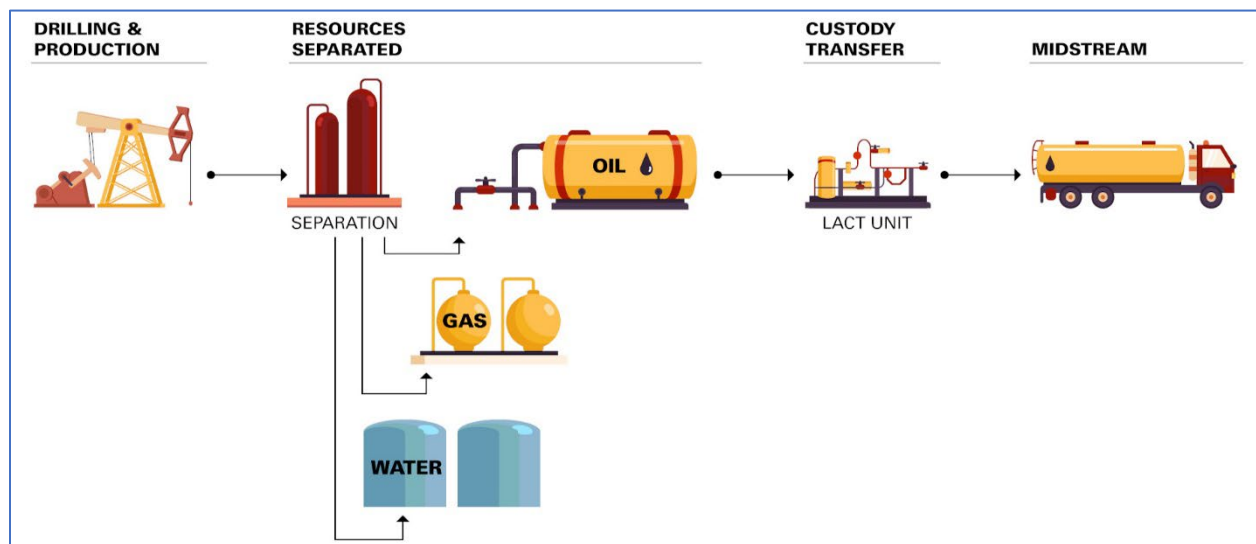
Some well operators have taken the position that drilling mud lost down-hole should be treated as equipment lost, which the Comptroller treats as non-taxable because “losing equipment” does not constitute the “sale” of equipment.

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).

G. 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

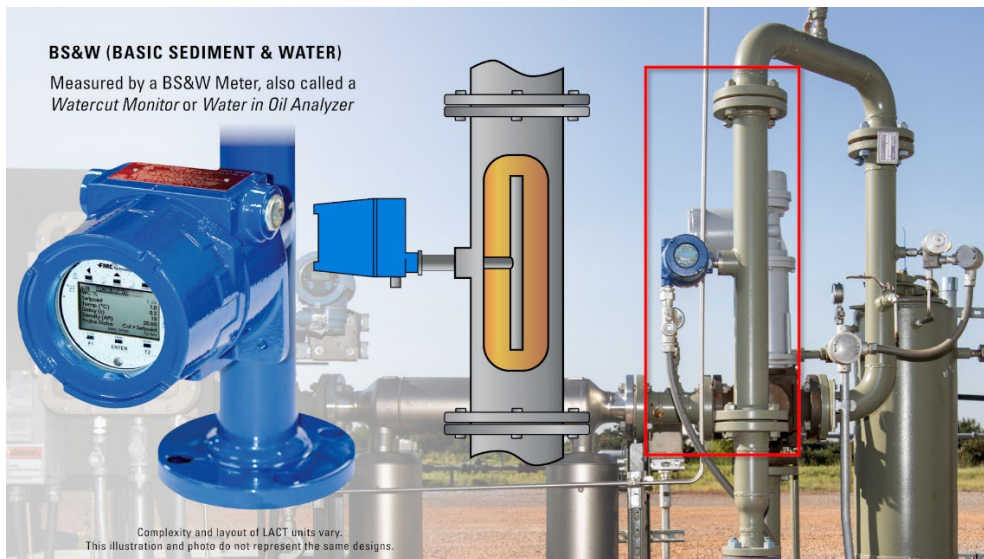
The pump draws oil from a storage tank into the unit.



BS&W

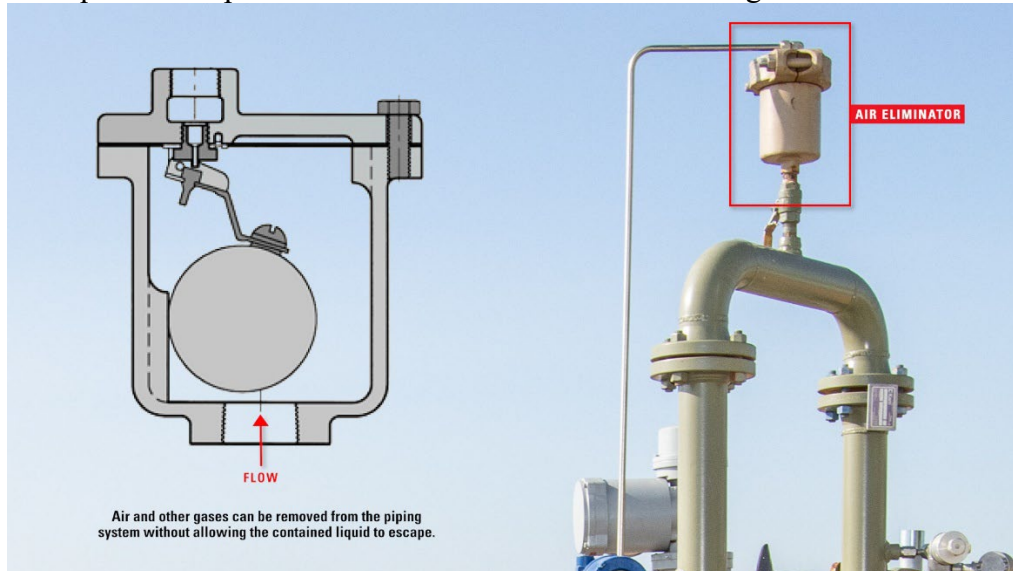
The levels of BS&W - Basic Sediment and Water - is read by a sensor and probe in the flow stream which is then communicated to a control panel. The BS&W Monitor records representative samples of the oil and the percentage of water.

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



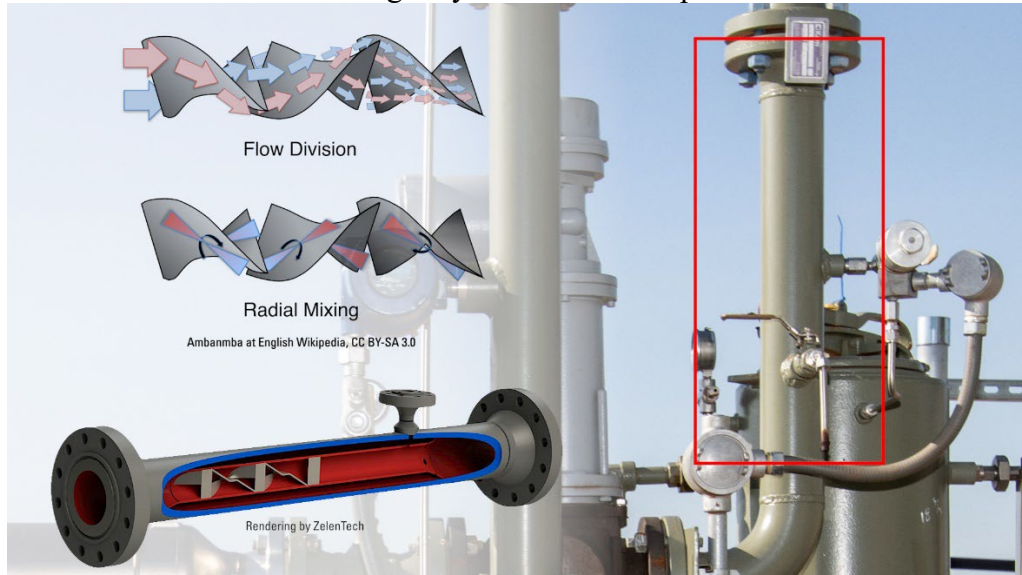
Air Eliminator

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.

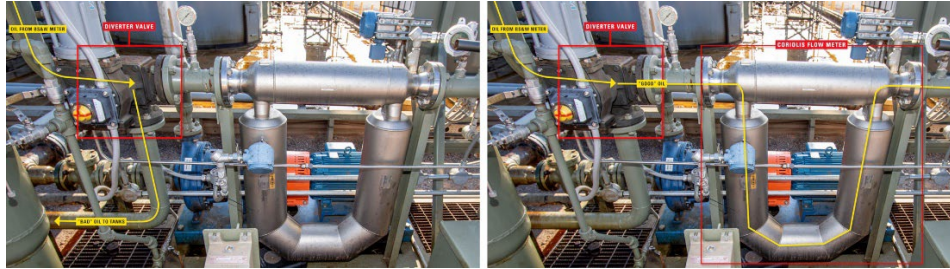


3-Way Diverter Valve

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.

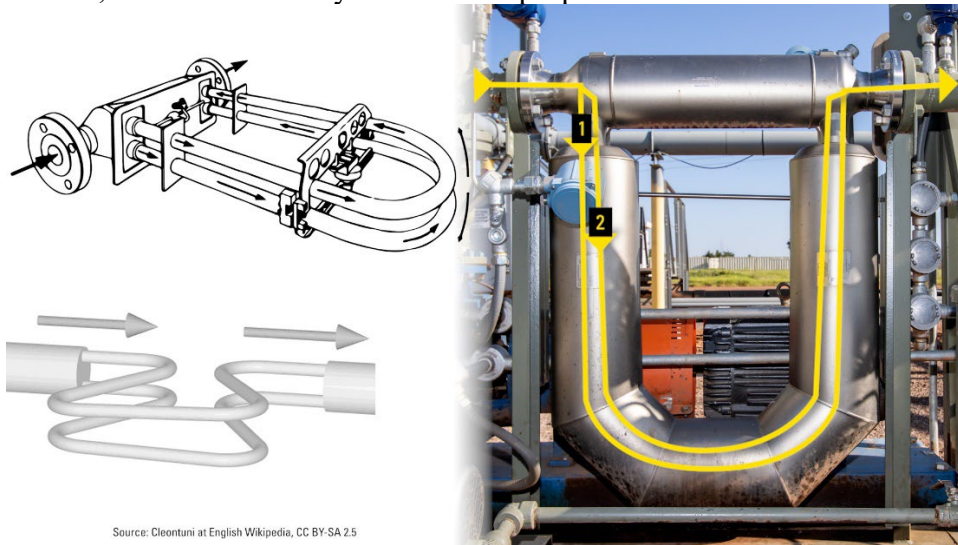
Bypass lines can direct the oil to the beginning of the separation process or a stand-alone heated vessel to remove high levels of BS&W.

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.



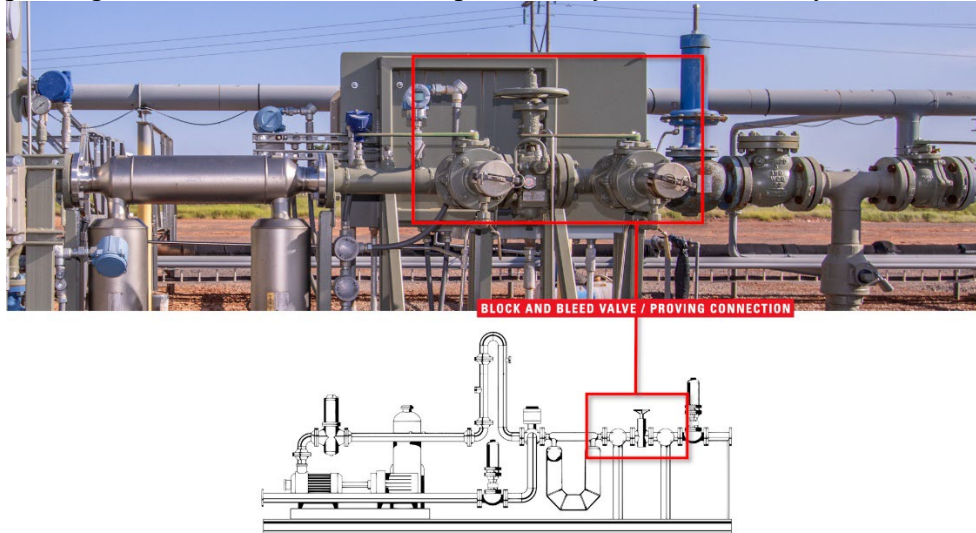
Coriolis Flow Meter

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.



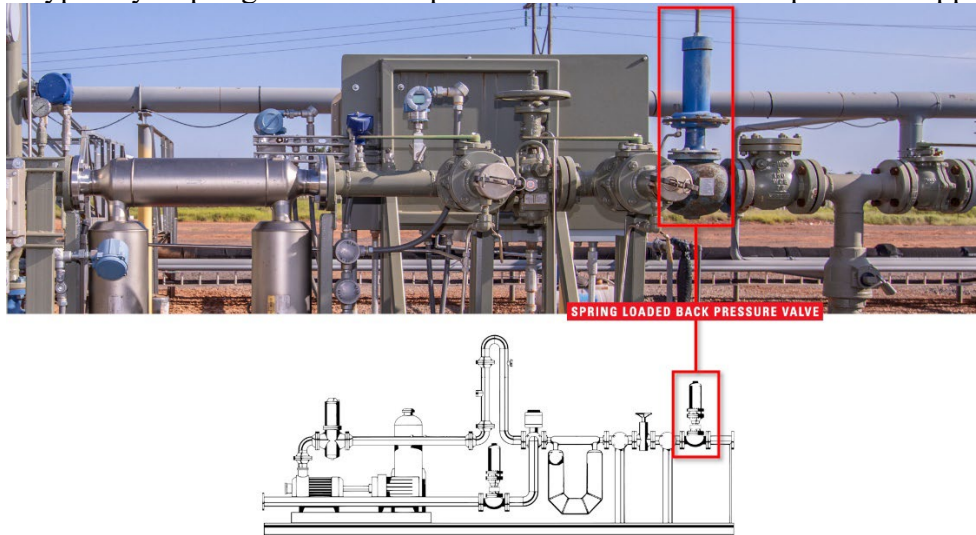
Block & Bleed Valves / Proving Connections

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.

H. Environmental and 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, 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.

I. Drilling Motors and Stators 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.

II. OIL & GAS MANUFACTURING EXEMPTION

A recent case handed down by the Court of Appeals has, once again, potentially resurfaced the issue of whether downhole activities may qualify for the manufacturing exemption. In 2016, the Texas Supreme Court handed down the *Hegar v. Southwest Royalties*⁴ decision where the Court held that Southwest Royalties had not presented sufficient proof that its downhole equipment qualified as manufacturing equipment because it caused the separation of oil from the gas as it flowed into the wellbore. Southwest had argued that upon entering the wellbore, hydrocarbons from the reserves were separated into oil & gas by the downhole equipment. The oil flowed up to the surface inside the production tubing. The gas flowed up to the surface outside the

⁴ 500 S.W.3d 402 (Tex. 2016).

production tubing and inside the casing. Southwest argued that its downhole equipment caused the separation. Southwest also argued that the hydrocarbons were converted from real property into tangible personal property once they entered the wellbore.

The Comptroller argued that the term “manufacturing” did not include “extraction and that the hydrocarbons weren’t transformed from real property to tangible, personal property until they reached the surface.

The Court rejected the Comptroller’s argument that the term “manufacturing” didn’t include “extraction” as well as Southwest Royalties’ argument that the downhole equipment caused the hydrocarbons to separate into the two different products. Ultimately, the Court held that the manufacturing exemption did not apply stating that the proof at trial indicated that natural temperature and pressure differentials caused the separation. The Court never reached the issue of whether hydrocarbons were converted from real property to tangible, personal property upon entering the wellbore or at the surface.

In late 2021, the Court of Appeals in Austin rendered the *Westmoreland Coal Company*⁵ case which allowed the manufacturing exemption for excavators that tore apart the coal bed seams by dragging their teeth across the top of the coal formations. The teeth broke the coal into smaller pieces so that it could be sold to customers who required it to be furnished in certain size ranges.

The Comptroller had argued that the manufacturing exemption didn’t apply because the raw material inputs were real property, not tangible personal property. The court rejected the Comptroller’s argument stating that it wouldn’t engraft extra-statutory requirements onto the manufacturing statute.

The Comptroller filed a Petition for Review with the Texas Supreme Court arguing that the term “manufacturing” must apply only to raw materials that constitute tangible, personal property and not to real property. The Comptroller further argues that the coal formation constitutes real property until it is broken up from the formation into smaller pieces.

The Texas Supreme Court has ordered full briefing on the merits.

Hegar v. Westmoreland. The Court of Appeals has found that a taxpayer who extracts and processes coal for ultimate sale is entitled to the manufacturing exemption from Texas’ sales and use tax.⁶ During the period at issue, Texas Westmoreland Coal Company owned and operated a lignite coal mine in Texas, using different types of heavy equipment to produce lignite coal that it sold to NRG Energy Corporation. After removing the dirt over the coal formation, Texas Westmoreland used excavators to break apart and reduce the size of the lignite coal.

⁵ *Hegar v. Texas Westmoreland Coal Co.*, No. 03-20-00406-CV (Tex. App.—Austin Oct. 7, 2021, pet. filed).

⁶ *Hegar v. Texas Westmoreland Coal Co.*, No. 03-20-00406-CV (Tex. App.—Austin Oct. 7, 2021, pet. filed).

In “one seamless process,” its excavators dragged large buckets with teeth through the exposed lignite coal formation to crack, break and rip apart the coal formation and dumped the pieces of lignite coal into trucks, causing them to further break. NRG required that Texas Westmoreland provide the coal in appropriately sized chunks no larger than a soccer ball so that NRG’s equipment could handle it.⁷

Texas Westmoreland sought a Texas sales tax refund under the manufacturing exemption for the excavators, asserting that the excavators were directly used in processing of tangible personal property for ultimate sale. Texas’ manufacturing exemption statute provides:

(a) The following items are exempted from the taxes imposed by this chapter if sold, leased, or rented to, or stored, used, or consumed by a manufacturer:

...

(2) 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 or causes a chemical or physical change to:

(A) the product being manufactured, processed, or fabricated for ultimate sale . .

.⁸

The Third Court of Appeals noted that Texas Westmoreland satisfied each of the statutory requirements:

- (1) the Product that Westmoreland sold to NRG was tangible personal property,
- (2) the excavators directly used to process the Product (and for which Westmoreland paid sales and use taxes) were tangible personal property, and
- (3) the excavators caused physical changes to the lignite coal during the production process.⁹

The Comptroller argued that, to qualify for the exemption, a taxpayer’s manufacturing or processing process must relate to property which constitutes tangible personal property when the process begins. Under Texas law, minerals such as lignite coal, oil and gas constitute real property until they are severed or extracted from the earth.¹⁰

⁷ *Texas Westmoreland*, slip op. at 2.

⁸ Tex. Tax Code § 151.318(a)(2)(A).

⁹ *Texas Westmoreland*, slip op. at 4–5.

¹⁰ *Cage Bros. v. Whiteman*, 163 S.W.2d 638, 641 (Tex. 1942); *In re Estate of Ethridge*, 594 S.W.3d 611, 616 (Tex. App.—Eastland 2019, no pet.).

The Third Court of Appeals “observ[ed] that the statute imposes no express requirement concerning the legal character of inputs or raw materials and, in fact, does not mention inputs or raw materials at all.”¹¹ The court noted that the statute’s language “manufacturing, processing, or fabrication of tangible personal property” used the preposition “of” only in reference to the state of the property at the end of the process, not the beginning. The court found that the exemption “expressly applies to the manufacturing of, the processing of, or the fabrication of a particular product for ultimate sale, and the essence of those three related processes is that the output at the end of the process is different from the one or more inputs along the way.”¹² As a result, the court refused to adopt an extra-statutory requirement that the inputs also constitute tangible personal property.

On November 22, 2021, the Comptroller filed a Petition for Review with the Texas Supreme Court.¹³ After the filing of the taxpayer’s Response and the Comptroller’s Reply, the Texas Supreme Court requested briefing on the merits on March 11, 2022.

Southwest Royalties v. Hegar. Southwest Royalties argued that downhole equipment was directly used, necessary, and essential to the processing of oil and gas because it separated the hydrocarbons into their component parts (oil, gas, and water).¹⁴ 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

¹¹ *Texas Westmoreland*, slip op. at 6.

¹² *Texas Westmoreland*, slip op. at 7.

¹³ *Hegar v. Texas Westmoreland Coal Co.*, No. 21-1007 (Tex. ____).

¹⁴ 500 S.W.3d 402 (Tex. 2016).

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.

☞ 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.

Index

Case, 22
Casing, 21
Chemical, 2
Component Part, 21
Fracturing, 2, 4
Maintenance, 4
Manufacturing Exemption, 21, 22
Materials, 21
Pits, 2

Processing, 21, 22
Refunds, 22
Returns, 2
Sand, 3, 4
Southwest Royalties v. Hegar, 21, 22
Supervision, 4
Supplies, 4
Tangible Personal Property, 4, 21
Tanks, 2
Tubing, 21