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Topics to Cover

- ▶ Overview of Texas Manufacturing Exemptions
- ▶ Mining Industry vs. Manufacturing Industry
- ▶ Court Cases
 - ▶ Apache Corporation vs. Combs
 - ▶ Southwest Royalties Inc vs. Combs
 - ▶ Observations

Overview - Texas Manufacturing Exemptions

- ▶ Texas sales and use tax exemptions are available for taxpayers who manufacture, fabricate or process tangible personal property for sale. Exemptions related to manufacturing activities are found in Tex. Tax Code Ann. §151.318.
- ▶ Exempt items noted in §151.318 include items such as:
 - ▶ Tangible personal property that becomes an ingredient or component of an item manufactured for sale, as well as taxable services performed on a manufactured product to make it more marketable.
 - ▶ Equipment that directly causes a chemical or physical change to the product being manufactured.
 - ▶ Pollution control equipment

Overview - Texas Manufacturing Exemptions

- ▶ In 1997, §151.318 was amended by making changes that would limit the prospective effects of two sales tax refund court cases that were decided in the taxpayers' favor. Portions of the statute that were amended included subsections (a) and (c).
- ▶ The amendments were effective as of October 1, 1997.

Overview - Texas Manufacturing Exemptions

The 1997 revisions to §151.318 were in direct response to the *Chevron Chemical* and *Tyler Pipe* court decisions.

- ▶ In support of the Comptroller's one-step removed theory, subsection (a) (2) was revised to require exempt manufacturing equipment to “directly” cause a physical or chemical change to a product being manufactured. - *Tyler Pipe*
- ▶ In support of the Comptroller's exclusion of intraplant transportation equipment from the manufacturing equipment exemption, subsection (c) was amended to specifically identify “piping” and “conveyor belts” as taxable equipment. – *Chevron Chemical*

Mining vs. Manufacturing

Is Oil and Gas exploration and production considered a “mining” activity or a “manufacturing” activity?

- ▶ If it is considered a “mining” activity, are there instances in which a manufacturing exemption could be claimed?
- ▶ If it is considered a “manufacturing” activity, what items qualify for the exemption?

Mining vs. Manufacturing

- ▶ Texas has generally taken the position that mining activities, those activities required to extract minerals and other items from the earth, are not included in the intended definition of manufacturing.
- ▶ Based on this premise, Texas has asserted that equipment used in mining will always be subject to sales tax, unless the equipment directly causes a chemical or physical change to the product being mined or extracted.

Mining vs. Manufacturing - History

- ▶ The Comptroller has a 45 year history of recognizing the extraction of oil and gas part of the mining industry and not an act of manufacturing.
- ▶ However, the Comptroller ruled in 1982 (8209T0467C10) that *“Chemicals used in the production and refining of oil qualify for exemption so long as they are necessary or essential in the actual manufacturing, processing, or fabrication operations, or are used for the purpose of producing or inducing a chemical or physical change during such operations, or for removing impurities or otherwise placing the product in a more marketable condition, or if they become an ingredient or component part of the product produced for ultimate sale.”*

Mining vs. Manufacturing - History

- ▶ Oil soluble chemicals generally qualify for the manufacturing exemption because they become a component part of the oil produced.
- ▶ Chemicals which are not oil soluble may also qualify for the manufacturing exemption if they are used to treat the product stream to cause a chemical or physical change, or to make the product more marketable.

Mining vs. Manufacturing - History

- ▶ The Comptroller contends the “production” of oil and gas is not a processing activity, and as a result, the manufacturing exemptions found in §151.318 have no application to equipment, supplies or chemicals used for production purposes. However, they have conceded that some processing of the oil can occur downhole at the well site, and the exemption for chemicals used to produce or induce a chemical or physical change, to remove impurities, or to make the product more marketable is available.

Court Cases

- ▶ *Apache Corporation vs. Combs* – District Court Trial set for September 4, 2012
- ▶ *Southwest Royalties Inc vs. Combs* – District Court Trial held in April 2012 – A rehearing was held on April 26 that reversed an earlier decision that was decided in the favor of Southwest Royalties.

Court Cases –

Apache Corporation vs. Combs

- ▶ Apache is seeking a refund for sales and use taxes paid on purchases of casing and other tangible personal property used at its oil and gas production well sites.

Court Cases – *Apache Corporation vs. Combs*

Apache's Position

- ▶ Well casing is exempt under §151.318 (5) – pollution control equipment -
 - ▶ Well casings operate as a single, integrated, sealed unit to prevent the migration of fluids between underground zones and to prevent the escape of fluids onto the surface or into the air.
- ▶ Well casing is exempt under §151.318 (10) – public health purposes -
 - ▶ The Texas Railroad Commission requires well casing to protect the ground water from production activities.
 - ▶ Intermediate casing and surface casing do not transport hydrocarbons – they are physically separated from the hydrocarbons by the production casing.

Court Cases – *Apache Corporation vs. Combs*

Texas' Position

- ▶ Casing is not exempt because §151.318 specifically excludes piping from the manufacturing exemption.
 - ▶ Legislature has expressed intent to exclude casing from the manufacturing exemptions. Revisions to the statutory text in 1997 reverse two court decisions that ruled against the Comptroller.
- ▶ Texas Tax Code Ann. §151.324 (Equipment used elsewhere for Mineral Exploration or Production) supports the Comptroller's longstanding policy Texas did not intend to exempt casing, tubing or other items used in oil and gas exploration.
 - ▶ Since this section exempts drill pipe, casing, tubing and other pipe used in the production of oil and gas if their use is offshore and not in Texas, it would be meaningless if casing were intended to qualify for manufacturing equipment exemptions.

Court Cases – *Apache Corporation vs. Combs*

Texas' Position (contd)

- ▶ Primary Purpose - The well casing's overriding purpose is to prevent the well bore from collapsing on itself and to provide protection for tubing as the hydrocarbons rise to the surface. The Comptroller considers the movement of hydrocarbons to the surface through the tubing and casing to be transportation, and therefore the casing should be considered transportation items.

Court Cases –

Southwest Royalties vs. Combs

- ▶ Southwest Royalties is seeking a refund for sales and use taxes paid on purchases of casing, and downhole equipment such as pumps, valves, couplings, motors and separators (“below-ground equipment”) because the equipment is directly used in or during the actual processing of oil and gas, and directly causes a chemical or physical change to the oil and gas being produced, as well as separates the oil and gas mixture into its components of oil, gas, and water.

Court Cases – *Southwest Royalties vs. Combs*

Southwest Royalties' Position

- ▶ The use of downhole gas separators, emulsion breakers/demulsifier's, paraffin inhibitors, CO₂, and other chemicals assist in the separation process and cause a physical or chemical change to the oil and gas.
- ▶ Manufacturing process begins downhole not only at the wellhead.
- ▶ Well casings are a component part of a single item of manufacturing equipment that also includes certain above ground equipment.

Court Cases – *Southwest Royalties vs. Combs*

Texas' Position

- ▶ Casings and other equipment do not directly cause a chemical or physical change to the oil and gas, and primarily serve to move the oil and gas to the surface. As such, transporting oil and gas to the surface is not manufacturing.
- ▶ Historically, Texas has ruled that the extraction of oil from the ground is not “manufacturing” since at least 1966 (6608H0279E01).
- ▶ Texas ruled in 1982 that the purchase of chemicals that are injected into the oil while it is still in formation is subject to the manufacturing exemption so long as the chemicals are oil soluble or if they cause a chemical or physical change in the oil. The Comptroller also noted that *“production of oil and gas by extracting them from the earth is not a processing activity, and the manufacturing exemption has no application to the equipment, supplies, or chemicals used in the production purposes.”*

Court Cases – *Southwest Royalties vs. Combs*

Texas' Position (contd)

- ▶ Texas ruled in 1983 that the purchase of CO₂, pumped underground to thin the oil is subject to the manufacturing exemptions. In that ruling, the Comptroller noted that bringing oil to the surface was not manufacturing. (8307L0524E01)
- ▶ Texas has noted a distinction between “mining” and “manufacturing” in the tax code as least as far back as November 1962.
- ▶ Legislative Intent is clear in this case by the following evidence:
 - ▶ 1962 report to legislature recognizing the commonly understood distinction between manufacturing and mining. The report provided definitions for the different industry's which the legislature adopted.
 - ▶ Various legislative reports from 1998 through 2011 treating the mining industry separate from manufacturing industry in both biennium revenue estimates and revenue interim reports on public education.

Court Cases – *Southwest Royalties vs. Combs*

Most Recent Developments

- ▶ On April 11, District Court Judge John Dietz ruled from the bench in favor of Southwest Royalties' contention that well machinery and equipment used to extract oil and gas were exempt qualifying manufacturing equipment.
- ▶ On April 26, a rehearing was held to allow Judge Dietz to gain a better understanding of the underlying issues of the case, and to allow both sides to present additional clarifying evidence in the case.
- ▶ On April 30, Judge Dietz reversed his earlier ruling in favor of Southwest Royalties, and ruled in favor of Texas. It was ruled that Southwest Royalties failed to meet their burden of proof in proving that the downhole equipment directly caused a chemical of physical change in the oil and gas being produced.

Court Cases - Observations

Observations

- ▶ Texas will vigorously pursue the court challenges and appeals processes if necessary.
- ▶ The legislature has consistently relied on the significant sales tax revenue generated by the natural resource/mining industry to fund Texas government and public school activities of the state.
- ▶ In the event that the courts rule against Texas, it is anticipated that legislative changes will be made to the sales tax code to reduce the prospective effects of the court decisions.
- ▶ It is possible that exemptions associated with other taxes, such as severance taxes, could be adjusted by the legislature to help offset the budgetary impact of the potential sales tax refunds associated with similar claims from other E&P companies if the courts decide in favor of Apache and Southwest Royalties.

Questions



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- ▶ Robert serves as the Ernst & Young's state motor fuels excise tax leader, as well as Ernst & Young's Southwest Area's energy industry transactional tax leader assisting clients with a variety of motor fuels, oil and gas, sales, and related excise tax issues. Robert's experience includes assisting clients with state motor fuels excise tax matters and managing projects involving excise tax audits, excise tax compliance functions and taxability research. Additionally, Robert has experience with various sales tax activities such as conducting taxability studies, consulting and planning for future transactions and activities, assistance with tax software implementation and integration projects, managed sales tax audits, submission of private letter ruling requests, state audit representation, managed audit procedures, reverse audit procedures, due diligence reviews, exposure studies, negotiated settlements, presenting training classes, and general tax research.
- ▶ Prior to joining Ernst & Young, Robert was an auditor with the Texas Comptroller of Public Accounts for eight years. His responsibilities included performing complex sales/use tax, oil and gas tax, and motor fuels tax audits on both in-state and out-of-state companies in a variety of different industries. While at the Comptroller's office, Robert audited numerous large accounts including multi-national concerns.
- ▶ Robert joined Ernst & Young's Fort Worth office in 1997 and holds a B.B.A. in Accounting from the University of Texas at Arlington. He is a Certified Public Accountant and a member of the Texas Society of CPAs, the American Institute of CPAs, and the Institute for Professionals in Taxation.

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