Marcellus Shale Update – State Tax

I. Pennsylvania

A. Sales and Use Tax

1. Manufacturing/Mining Exemption is Broad

   a) What is exempt?

      (1) The rendition of services or the transfer of tangible personal property including, but not limited to, machinery and equipment and parts therefor and supplies to be used or consumed by the purchaser directly in the operations of the manufacture of tangible personal property. 72 P.S. §§ 7201(k)(8); 7201(o)(4).

         (a) Manufacturing includes refining, blasting, exploring, mining and quarrying for, or otherwise extracting from the earth or from waste or stock piles from pits or banks any natural resources, minerals and mineral aggregates including blast furnace slag. 72 P.S. §§ 7201(c); 7201(c)(3).

      (2) The purchase or use of tangible personal property or services performed thereon by a person engaged in the business of mining is exempt from tax if the property is predominantly used directly by the person in mining operations. 61 Pa. Code § 32.35(a)

         (a) Direct Use – 61 Pa. Code § 32.35(a)(1) – factors: (i) physical proximity, (ii) temporal proximity, and (iii) the existence of an active casual relationship between the use of the property and the mined product

         (b) Predominant Use – 61 Pa. Code § 32.35 – must make use of the property more than 50% of the time directly in mining operations. Look for use in actual mining process, to transport or convey the product or production personnel, or to handle or store the product during production.

2. Who must use the property for it to be exempt?


      (1) Pennsylvania Supreme Court held that the taxpayer, R.G. Johnson Company, a hard rock extractor, was engaged in
mining coal, and entitled to the manufacturing exemption on its purchases of machinery and equipment, even though it did not actually extract the coal, but rather assisted closely in the extraction of coal. The court found that it is not the identity of the party who performs the work, but the nature of the work performed that should control. The court determined that the coal extractor was dependent upon the equipment and capabilities of the taxpayer, and without the equipment and capabilities of the taxpayer, coal extraction was not possible.

(2) Reed Smith Comment – The “dependent upon” test employed by the Court should be interpreted broadly. Most importantly, this decision states explicitly that it is not the identity of the party who performs the work, but the nature of the work that controls taxability.

3. Department of Revenue is impermissibly limiting scope of mining exemption through Policy Statements and Rulings

   a) Sales and Use Tax Ruling SUT 10-003. September 15, 2010 – Applicability of the Mining Exemption to Fracturing Services

      (1) In R.G. Johnson v. Commonwealth, the court held that the mining exemption applied to purchases by a taxpayer who was in the business of sinking mine shafts and driving slopes, even though the taxpayer did not do the actual mining. The court determined that it was the nature of the work and not the identity of the individual who performed the work that controlled the applicability of the exemption. Relying on the court's decision in R.G. Johnson, the Department has opined that a subcontractor's activity fell "under the mining exclusion even though the subcontractor was not mining or extracting anything because the actual drilling for and extraction of oil or gas is dependent upon the machinery and equipment" the subcontractor employs. The Department derived this "dependent upon" standard directly from the Pennsylvania Supreme Court's language in the R.G. Johnson opinion.

      (2) Reed Smith Comment - Despite the fact that the "dependent upon" standard set forth in R.G. Johnson is the law in Pennsylvania, the Pennsylvania Department of Revenue recently published guidance in the form of a letter ruling that applies the mining exemption in a much more limited manner than allowed by R.G. Johnson. Many of the items the Department treats as taxable in the ruling clearly would not have been treated as taxable if the proper "dependent upon" standard had been applied. Consider the following examples:
(a) Frac Pump (exempt in letter ruling) vs. Hydration unit (taxable in the letter ruling)- The Frac Pump injects fluid into a shale formation and the Hydration unit mixes and retains the fluids on the surface at the well site. Both pieces of equipment are used at the well site to facilitate the extraction of natural gas. Thus, the extraction process is dependent upon both the Frac Pump and Hydration unit. In the letter ruling, the Department summarily opined that only the purchase of the Frac Pump is covered by the mining exemption.

(b) Twin Cement Unit (exempt in the letter ruling) vs. Sand Conveyor and Sand Storage Bins (taxable in the letter ruling) - The sand conveyor transports sand from the storage bins to the cement unit, and the cement unit mixes cement. This cement is then used to bond casing or piping to the wall of the bore hole. All of this equipment is located and used at the well site, and the success of the extraction process is dependent upon the proper operation of both the cement units and the conveyor. Nonetheless, in the letter ruling, the Department opined that only the cement unit qualifies for the mining exemption.

(c) Reed Smith Comment – The Department’s regulation on manufacturing equipment also states that testing equipment is subject to tax. However, the Department has not extended that treatment to testing equipment used in the fracking process such as equipment used to measure the amount of natural gas entering the drilling mud stream or meters that measure production at the well site.

b) Sales and Use Tax Bulletin 2012-01, April 16, 2012 – Mining Site Preparation

(1) The Department’s ruling states that “The foundation directly underneath the drilling rig is excluded from tax. Therefore, although equipment used to build rigging pads is taxable, any foundation material supporting the drilling rig, such as sand, stone or other similar material, would be excluded from tax as foundation material for exempt mining equipment.”

(a) Reed Smith Comment - This exceeds the scope of the statute and regulation. Taxable pre-mining activities are specifically defined as “property used to transport
personnel or to collect, convey or transport other property, and storage facilities or devices used to store the property, prior to the actual mining operation.”

(2) The construction of ponds or any other vessels for storage of fresh water or raw materials prior to their use in drilling or hydraulic fracturing is not a mining activity. Therefore, equipment used to construct these ponds and the actual materials used in the ponds, such as liners, are taxable pre-mining property. Ponds to be used to control or abate pollution generated in the mining operation, however, are excluded from tax. Therefore, although equipment used to build such ponds is taxable, any materials used in that construction, such as liners, sand and gravel, would be excluded from tax.

(a) Reed Smith Comment - These are artificial distinctions and not supported by case law or the regulation and statute. The equipment used to build the pollution control ponds should also be exempt. Also, presumably, the Department has determined that the mining operation starts some time between when fresh water and raw materials are placed in the storage ponds or vessels and when the fracking begins. See Union Paving v. Commonwealth 611 A.2d 360 (1992) for a discussion of the manufacturing process. Also, see below for further discussion of the Pollution Control Exemption.

c) Sales and Use Tax Update, January 2012 – Drilling Equipment and Sales Tax Exclusions Clarified

(1) “The purchase of otherwise sales-tax-exempt mining equipment is taxable if purchased by an entity that does not use or consume the equipment in a mining operations. For example, otherwise tax-exempt drilling equipment would be taxable if purchased by a party who then gives the equipment to a business engaged in the extractions of natural gas.

(2) Reed Smith Comment - This treatment is directly contrary to Commonwealth v. R.G. Johnson Company, 495 Pa. 256 (1981). The court found that it is not the identity of the party who performs the work, but the nature of the work performed that should control.

(3) Reed Smith Comment - Recent Board of Finance and Revenue determinations seem to have reversed the Department’s position on this issue.
4. Pollution Control and Research and Development Exemptions Refunds and Planning

a) Pollution Control

(1) Equipment, machinery, and supplies, designed and used to control, abate, or prevent air, water, or noise pollution generated in the mining operation are deemed to be directly used in mining and, therefore, is not subject to tax. In order for property to qualify as exempt pollution control devices, it is not necessary that the pollutants be recycled or used in any manner. 61 Pa. Code § 32.35(a)(2)(ii).

(2) Kelly Run Sanitation v. Commonwealth, 487 A.2d. 58 (1985) also held that any equipment used in the disposal of hazardous waste or pollutants is exempt as pollution control equipment.

(3) Reed Smith Comment - In addition to the above, because of the unique nature of the fracking process, that is, a mining process by which pressurized fluid is injected into a shale formation causing small fractures in the rock it stands to reason that, all of the specialized equipment and processes necessary to accomplish that process contain an element of pollution control and should be, at least to some extent, exempt from sales and use tax.

b) Research and Development

(1) Property which is used directly in research activities is exempt from tax, provided that the object of the research is the production of a new or improved product or method of producing a product. The exemption does not apply to property used in market research or in other research which is conducted with the objective of improving administrative efficiency. 61 Pa. Code § 32.35(a)(2)(vi).

c) Reed Smith Comment - Because of the unique nature of each well site, the nature of horizontal and vertical drilling, the exploration and construction of the well site should be, at least to some extent, exempt from sales and use tax.

B. Breaking Down the Unconventional Gas Well Fee

1. Who Does it Apply to?

a) Persons holding permits to sever natural gas for sale, profit or commercial use in the Commonwealth. 58 Pa. C.S. §§ 2302(b); 2301
b) Unconventional shale formations which require hydraulic fracture treatments or multilateral bore hole to produce gas at economic flow rates. 58 Pa. C.S. § 2301

c) Obligation begins when drilling begins, and lasts 15 years, generally.

2. Fee

a) Based on:

(1) the number of years after either the commencement of drilling for new wells or the year the fee is imposed for existing wells;
(2) the average annual price of natural gas as determined using the New York Mercantile Exchange average settled price for near-month contracts on the last trading day of each month;
(3) the Consumer Price Index for all urban consumers; and
(4) whether a well has a single vertical bore.

3. Compliance Burdens

a) Paid to the Public Utility Commission (“PUC”)

b) Drilling commenced prior to Jan 1, 2012, fee due Sept 1, 2012 and every year thereafter

c) Drilling commenced on or after Jan 1, 2012, fee due April 1, 2013 and every year thereafter.

d) Must file an extensive report with the PUC

4. Constitutionality

a) Tax v. Fee? – if the fee is really a tax, it is subject to uniformity clause of P.A. Constitution, and equal protection requirements of the 14th Amendment.

(1) When classifying the type of a particular tax, Pennsylvania courts have looked at the substance and nature of the tax, rather than merely its title.

(2) In determining whether an exaction is a fee or a tax, out-of-state courts have found that fees are:

(a) charged in exchange for a particular government service which benefits the party paying the fee in a manner not shared by others not paying the fee;

(b) paid by choice in that the party paying the fee has the option of not utilizing the government service, and thereby avoiding the charge; and
(c) collected not to raise revenues but to compensate the governmental body providing the services for its expenses. Legislation, the fees are to be used to pay for a broad range of

b) If a reclassified as a tax, there are Retroactivity Issues

(1) There are limitations on the scope of the retroactivity. Those limitations emanate from the Due Process Clause of the U.S. Constitution and the due process provisions of the Pennsylvania Constitution, and primarily concern the time limit of the retroactive change, and the overall fairness of the change.

(a) Commonwealth v. Budd Co, 379 Pa. 159, Supreme Court of Pennsylvania, June 28, 1954 – Pennsylvania Supreme Court held that the General Assembly may not retroactively apply a tax law change "beyond the year of the general legislative session immediately preceding that of its enactment; to provide otherwise constitutes a violation of due process."

(i) Thus, under Budd, the current General Assembly cannot retroactively tax activities that occurred in the Commonwealth prior to 2011.

(ii) Reed Smith Comment - In this case, however, the "catch-up" provision in the bill attempts to impose a fee on all wells drilled in the Commonwealth regardless of date of drilling by deeming wells currently operational as being drilled in 2011. This appears to go beyond the scope of Budd.

(2) Reed Smith Comment - There are also serious concerns regarding whether the fee is imposed on all well operators in a uniform manner. This is because some well operators are not subject to the fee based entirely on their level of gas production. While others who are subject to the fee with low levels of gas production are burdened disproportionately (by effectively paying more per unit of gas produced) compared to others with much greater levels of gas production.

5. Interpretation Issues

a) What is an unconventional formation?

b) How will the capped, stripper and plugged well exemptions apply?

c) How will the 80% discount for vertical wells apply?
6. Administrative Procedure

a) Are assessments and refunds to be made by/with the PUC or BF&R?

C. Keystone Opportunity Zone ("KOZ")

1. Sales and Use Tax

a) Effective September 9, 2008, no sales or use tax will be charged on retail sales of service or tangible personal property, other than motor vehicles, made to a qualified business, or a construction contractor based on a construction contract with a qualified business, for the exclusive use, consumption and utilization at the qualified business, landowner or lessee's facility located expansion subzone or improvement subzone. 73 P.S. § 820.511(a). Such sales are also exempt from local sales and use tax. 73 P.S. § 820.705(b).

2. Income Tax - Payroll and Property Apportionment of Income:

a) The income and value of a business is apportioned to a KOZ by multiplying the income or value by the average of two factors, a property and a payroll factor. 73 P.S. §§ 820.515(d); 820.516(c)(2).

   (1) The payroll factor “is a fraction, the numerator of which is the total amount paid in the [KOZ] during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid in this Commonwealth during the tax period.” 73 P.S. § 820.515(d)(2)(i).

      (a) Compensation is paid in the KOZ if the employees service is, 73 P.S. § 820.515(d)(2)(ii):

         (i) performed entirely within the KOZ;

         (ii) performed within and without the KOZ, but services performed without the KOZ is incidental to the employee’s services within the KOZ; or

         (iii) performed within and without the KOZ, and the employee’s base of operations is in the KOZ, and if there is no base of operations, the place from which the employee’s service is directed or controlled is in the KOZ.

   (2) Reed Smith Comment - The term “base of operations” is not defined in the KOZ Act or under Pennsylvania law; however, Model Multistate Tax Commission Regulation IV.14 defines “base of operations” as “the place of more or less permanent nature from which the employee starts his [her] work and to which he customarily returns in order to receive instructions.”
II. **West Virginia**

A. Sales and Use Tax

1. **Broad Exemption for Services and Tangible Personal Property Used in the Production of Natural Resources**

   a) Sales of services, machinery, supplies and materials *directly used or consumed* in the activities of ... production of natural resources are exempt from sales and use tax. W. Va. Code § 11-15-9(b)(2)

   (1) Production of Natural Resources - for the natural resources oil and gas, means the performance, by either the owner of the natural resources, a contractor or a subcontractor, of the act or process of exploring, developing, drilling, well-stimulation activities such as logging, perforating or fracturing, well-completion activities such as the installation of the casing, tubing and other machinery and equipment and any reclamation, waste disposal or environmental activities associated therewith, including the installation of the gathering system or other pipeline to transport the oil and gas produced or environmental activities associated therewith and any service work performed on the well or well site after production of the well has initially commenced. W. Va. Code § 11-15-2(b)(14)

   (a) Persons subject to the severance tax are exempt on all purchases made by them for use in severance activities, regardless of the “direct use or consumed” concept. W. Va. Code of St. Rules 110-15-123.4.3.4

   (i) This exemption includes purchases used either directly or indirectly in production of natural resources, but only in activities for which the gross receipts are subject to severance tax.

   (ii) If a person will be using the item both in an exempt manner and a taxable manner, it is possible that he may have to apportion the tax on purchases used in more than one activity.

B. **Research and Development Exemption Applies the Production of Natural Resources.**

1. Sales of tangible personal property and services after June 13, 2002, directly used or consumed in the activity of research and development are exempt from tax imposed by this article. W. Va. Code § 11-15-9b(a)
a) Reed Smith Comment - Regulations are improperly restrictive - W. Va. Code of St. Rules § 110-15-123.4.3.6.a.8 states that “research and development equipment used in developing new products or improving present products,” referring to natural resources, is taxable.

III. Ohio

A. Sales and Use Tax

1. Exemption for Property Used in Mining is Extensive

a) Sales where the purpose of the purchased is to use or consume the thing transferred directly in producing tangible personal property for sale by mining, including, without limitation… production of crude oil and natural gas. Ohio Rev. § 5739.02(B)(42)(a)

b) Who may use the property to be claimed?

(1) Persons engaged in rendering services in the exploration for, and production of, crude oil and natural gas, for others are deemed engaged directly in the exploration for, and production of, crude oil and natural gas.

c) What may be claimed?

(1) May claim exemption when purchasing machinery, equipment and personal property used… Ohio Admin. Code § 5703-9-22.

   (a) in the extraction from the earth of a substance classified geologically as a mineral
   (b) to transport the substance extracted
   (c) to make temporary private roads or such transportation (materials only)
   (d) to repair the machinery, equipment and personal property
   (e) to protect the substance during excavation or transportation

B. Additional Tax Implications

1. Commercial Activity Tax (“CAT”)

a) Ohio also imposes a commercial activities tax (CAT), which is levied upon persons who meet certain minimum thresholds.

   (1) If Ohio-sourced gross receipts are less than $1 million, only the minimum tax of $150 is imposed.
Any gross receipts sourced to Ohio greater than $1 million are taxed at a rate of 0.26%.

IV. Maryland:

A. Drilling not expected to commence until 2014 – or until MD Dept. of Environment Study Concludes

B. Bills floating around with proposals of anywhere from 2.5%, to a 15% severance tax.
   1. Allegany and Garret Counties already impose a 5.5% severance tax
   2. Del Maggie McIntosh (D-Baltimore) & Del. Sheila Hizson (D-Montgomery) – 15% tax proposed
   3. Sen. G. Edwards (R-Allegany & Garrett) – 2.5% tax proposed
   4. Del. Mizeur (D-Monomoy) – recommends at least 10% tax, and is open-minded to higher.

C. Exemption from sales and use tax for machinery and equipment used directly and prominently in a production activity, covering any stage of operation on a well site
   1. Md. Code Ann. Tax-Gen § 11-210(b)(1) – tangible personal property used directly and predominantly in a production activity at any stage of operation on the production activity site from the handling of raw material or components to the movement of the finished product; if the tangible personal property is not installed so that it becomes real property
      a) Md. Regs. Code § 03.06.01.32-2(B) (as per § 03.06.01.32-2(A), applies to sales and purchases on or after July 1, 2000) - Used directly and predominantly in a production activity – (2) – use of the property is integral and essential to the production activity, occurs where the production activity is carried on, and occurs during the production activity; and property used both in production activities and administrative, managerial, sales, or any other operational or non-operational activities is used more than 50% of the time directly in production activities.

V. New York:

A. Moratorium on drilling until June 1, 2012
   1. Executive Order No. 41 issued December 13, 2010, imposing an effective moratorium on drilling in the Marcellus Shale formation by banning any new
permits for “high volume, horizontal hydraulic fracturing” until studies confirm the practice’s environmental safety.

2. Moratorium then extended

3. Multiple bills presented in assembly and senate to further extend the moratorium
   a) Some pending bills include: S06772; S06097/A300-A; A07400A/S6261; A10234

4. Local moratoriums in City of Buffalo and Dryden

B. Continued discussions on the need of a severance tax on natural gas severed from the Marcellus or Utica shale formations by means of a horizontal well

C. Broad exemption from sales and use tax for purchases of machinery and equipment used directly and predominantly in mining or extracting activities

1. N.Y. Tax Law § 1105-B – Exemption – receipts from the retail sales of parts with a useful life of one year or less, tools and supplies for use or consumption directly and predominantly in the production of tangible personal property, gas, electricity, refrigeration or steam for sale by manufacturing, processing, generating, assembling, refining, mining or extracting shall be exempt from sales and use tax.

2. N.Y. Tax Law § 1115 - Exemptions:
   a) - (a)(12) – machinery or equipment for use or consumption directly and predominantly in the production of tangible personal property, gas, electricity, refrigeration or steam for sale, by manufacturing, processing, generating, assembling, refining, mining or extracting, but not including parts with a useful life of one year or less or tools or supplies used in connection with such machinery or equipment. Includes all pipe, pipeline, drilling rigs, service rigs, vehicles and associated equipment used in the drilling, production and operation of oil, gas, and solution mining activities to the point of sale to the first commercial purchaser.

   b) - (a)(36) – parts with a useful life of one year or less, tools and supplies for use or consumption directly and predominantly in the production for sale of gas or oil by manufacturing, processing, generating, assembling, refining, mining or extracting.

   c) - (c)(1) – fuel, gas, electricity, refrigeration and steam, and gas, electric, refrigeration and steam service of whatever nature for use or consumption directly and exclusively in the production of tangible
personal property, gas electricity, refrigeration or steam, for sale, by manufacturing, processing, assembling, generating, refining, mining or extracting shall be exempt from the taxes imposed under subdivisions (a) and (b) and use tax.

D. Additional exemptions specifically available for research and development, and underground gas storage facilities

1. N.Y. Tax Law § 1115:
   a) - (a)(10) – research and development
   b) - (w) – applies to underground gas storage facility

VI. Additional Relevant Recent Rulings:

A. Virginia

1. Ruling of the Tax Commissioner, 12-73, May 9, 2012
   a) Ruling - the use of trace wire and stone was not used "directly" in the mining process, and therefore did not qualify for an exemption from use Tax. However, pit liners, tanks and slit fence used for pollution control complied with the codes requirements, and therefore were exempt from use tax.
   b) Mining Exemption - exemption applies only when an item is indispensable to the actual production and is primarily used or consumed immediately in the actual production of products. In coming to this conclusion, the Commissioner looked to regulation, Title 23 of the Virginia Administrative Code § 10-210-960 A, which states that "[t]he fact that particular property may be considered essential to the conduct of the business of mining or mineral processing because its use is required either by law or practical necessity does not, of itself, mean that the property is used directly in mining or mineral processing operations." The trace wire was used, as required by the Virginia Department of Mines, Minerals and Energy ("DMME"), in order to trace pipelines at a later time. The stone was used to support the buried pipelines and prevent the settling of the ground above the pipelines. Stone was also used in the well site access areas and for road construction and maintenance. None of these were found to be used "directly" in the mining process.
   c) Pollution Control - the Commissioner allowed for the removal from the assessment of products purchased in order comply with the DMME's pollution control requirements, as provided by Virginia Code §§ 58.1-609.3 9 (ii), 58.1-3660 B.
B. Texas

1. Southwest Royalties, Inc. v. Susan Combs, Cause No. D-1-GN-09-004284

   a) Written judgment states that petitioner, Southwest Royalties, is not entitled to the manufacturing exemption because it is not the equipment at issue that "directly causes" the physical change to the extracted petroleum. Instead, it is the change in pressure that causes the physical change from oil to gas, and "plaintiff’s equipment that brings it to the surface is merely an indirect cause of the changes."

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