Before the

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The Ohio House of Representatives

Government Accountability and Oversight Committee

The Honorable Louis W. Blessing III

Chair

testimony regarding

House Bill 430
(Sales and Use Tax Clarification)

<u>Presented By</u>:

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Chairman Blessing, Vice Chairman Reineke, Ranking Member Clyde and members of the House Government Accountability and Oversight Committee, thank you for the opportunity to offer proponent testimony in support of House Bill 430. My name is Tom Stewart. While I have been retired for some time after leading the Ohio Oil & Gas Association since 1991; I have returned to the Association on an interim basis and welcome the opportunity to testify before you today on this particular legislation.

The issue before you today certainly confirms the need for this committee's good work. We bring before you a clear-cut case of a tax department's lack of transparency, flout of law and disrespect for legislative intent regarding tax application. Today, this hearing focuses on my members. But this is not the first in recent times that this Assembly has had to confront and correct taxpayer abuse levied by the current Administration that has plagued other industries and Ohio taxpayers.

I also note that the title to this bill is not precise since the legislation does NOT – IN ANY WAY - expand the sales tax exemption currently provided to the oil and gas exploration process. Rather, this bill explicitly defines oil and gas exploration and production using thus placing the sales tax exemption within clear parameters using guardrail language already approved by the General Assembly and now applied by other agencies. The purpose of this bill is to reaffirm the industry's traditional sales tax treatment and to provide taxpayers sorely needed clarity and certainty.

The Ohio Sales Tax and Use Tax:

The Ohio General Assembly enacted a sales tax in 1934 and a companion use tax in 1935 (O.R.C. Section 5739). The sales tax is an excise tax imposed on the transfer (purchase or transaction) of tangible personal property, and some services, within the state. [1]

Over time the General Assembly has amended O.R.C. Section 5709 in response to the evolution of economic activities, the complexity and application of products or social concerns. For example, early on, the purchase of food consumed outside of restaurants was exempted from sales tax. Over time, administrations have promulgated and updated rules to clarify the application of exemptions.

Manufacturing Exemption: A good example for this is the "manufacturing" exemption found in O.R.C. Section 5739.02 (B)(42)(g). The purpose of the exemption is to exempt from sales tax the "thing" that is transferred if it is:

1) used directly in a manufacturing operation to produce tangible personal property for sale, or

2) to incorporate the thing transferred as a material or part into tangible personal property to be produced for sale by manufacturing or refining.

[1] Similarly, the use tax is applied where a "buyer" of tangible personal property or taxable service was not charged sales tax on the transaction by the seller, but even so the buyer retains liability for payment of the sales tax. Tangible Personal Property (TPP) is personal property that can be seen, weighed, measured, felt, touched, or is perceptible to the senses. The sales and use tax is not imposed on real property. Real property (real estate) is land itself and all things permanently attached to the land such as buildings, structures and improvements. Ohio applies complex sales tax "timing rules" for tangible property that becomes part of real estate.

The overall idea here is that sales tax should be charged on a product <u>only once</u> with the point of taxation as the last sale to the end user.

Manufacturing is a process in which materials are changed, converted, or transformed into a different state, form (or phase) from which they previously existed. The process includes refining materials, assembling parts or preparing raw materials by mixing, measuring and blending with the primary goal to create a final product for eventual sale.

In 1977, the Ohio Department of Taxation promulgated O.A.C. Section 5703-9-21 to clarify and regulate the process.

Exploration and Production Exemption (E&P): A close cousin to manufacturing is the "production" exemption from sales tax found in O.R.C. Section 5739.02(B)(42)(a). This exemption applies to all minerals extracted from the earth, including crude oil and natural gas, and it exempts from taxation a sale where the buyer's purpose is to:

1) Incorporate the thing transferred as a material or part into tangible personal property to be produced for sale by <u>manufacturing,</u> assembling, <u>processing, or refining</u>.

2) Use or consume the thing transferred <u>directly</u> in:
    a. Producing tangible property for sale by mining, including, without limitation, the extraction from the earth of all substances that are classified geologically as minerals…..,, or
    b. <u>Production of crude oil and natural gas,</u> farming,…. (etc.)

Furthermore, the statute includes language regarding related contractors stating that persons engaged in rendering…. services in the exploration and production of crude oil and natural gas for others are deemed engaged directly in that process.

That section also makes clear the sale of tangible personal property that is incorporated into a structure or improvement to real property is not exempt. This would apply if that item were not specifically listed in the exemption.

Several observations: There are glaring similarities between the manufacturing and production exemptions as it relates to purpose, application and intent of the law. Much of the processes that take place in the modern oil and gas exploration and production industry are closely related to the manufacturing process, including the concept of effecting change and transformation to arrive at a marketable product for sale to someone else while using industry-specific equipment to bring about that transformation.

<u>Ohio statute and rules define manufacturing</u>. As recent as 1977, rules have been promulgated to appropriately apply the exemption that align with the obvious purpose of the process. The statute has been amended for the same reasons. It works for manufacturers.

<u>However, there is NO definition in the sales and use tax code for exploration and production of crude oil and natural gas.</u> And, even though the exemption has been part of the code since inception in 1935, there is no definition by statute, case law or other process that would reflect the clarity that exists for say the manufacturing status. This leaves a gap of potential confusion for application of the exemption.

Today, that gap is being exploited by the Ohio Department of Taxation, who is rewriting history, usurping legislative intent, and ignoring the authority law – all to harass taxpayers.

The administrative code does, in part, itemize what is real property and what is tangible personal property for tax proposes. (OAC 5703-3-02). It was created in 1939 and updated in 1949 and 2008. Unfortunately, tax auditors have ignored it.

The process of exploration and production has remained consistent over time. However, progression of the industry since 1935 and the corresponding expansion of expected standards have changed the scope and breadth of the industry and the requirements under which industry must operate.

For example:

- Today, oil and gas prospect generation, exploration, drilling, completion and production practices are highly sophisticated, utilizing very complex equipment and procedures to maximize deliverability and reserve values.

- Standards have changed. Where once a producer delivered raw product with few obligations to the buyer, today the producer has obligations to buyers, often corresponding to both state and federal laws, to treat and deliver production in a form acceptable to pipelines and end users. Crude oil on the well site must be treated for volatility, water content and volatile emissions. The producer must manage natural gas quality and interchangeability issues, water vapor content, hydrocarbon dew point content at a point in the production process and before final separation and delivery to pipelines or refineries. Otherwise, the producer will not move his product and it will not be sold.

- For the better (but unlike in 1935), the producer must comply with waste products such as produced water, tank bottoms, cuttings, soil erosion and abandonment procedures so as to comply with state and federal law. Absent compliance, the producer will not be allowed to produce the well. The manufacturer has similar issues.

There is a clear and compelling reason for the General Assembly to update the Revised Code to clearly define what is exploration and production (E&P) for purposes of fairly applying taxation.

The Ohio Department of Taxation is currently conducting many audits of oil and gas producers and adjunct service providers to the industry. Taxpayers report confusing signals from the Tax Department as to what is exempt and what is not exempt. Despite existing tax rules that identify real property classifications for the industry, clarity on tax status remains obtuse.

The Ohio Supreme Court clearly identified the problem in 1988. In *Lyons v. Limbach* (40 Ohio St. 3d 92 (1988)), a case regarding the sales tax status of certain purchases made for oil and gas purposes, the Court held that certain assessed items were not used directly in the E&P process.

In part, the Court noted the use of "frac tanks", while similar to the manufacturing process, still could not be considered adjunct to oil and gas since, "*there is no statutory definition of exploration for, or production of crude oil and natural gas; consequently, there is no language declaring an adjunct to exploration for, or production of crude oil and natural gas to be included in the operation and thus excepted.*"

Essentially, the Court held that, despite the similarities between manufacturing and mineral extraction, the lack of a clear definition of what is E&P provokes a gap that frustrates equal treatment between it and other processes such as manufacturing (for whom the General Assembly had provided ample clarity).

Examples:

Because the law lacks clarity, tax collectors are emboldened and that invites abuse. In this particular case, for example:

For all sales taxpayers, the Tax Commissioner treats private roads, culverts, bridges, fencing, drain ditches and artificial reservoirs as nontaxable under real property improvements and real property transactions. This is applied to everybody, except a producer of oil and gas who must build a road into the lease site to access the well location. Taxation has decided that the oil and gas industry should pay sales tax - even though the bulldozer owner that made the road has already paid sales tax on the dozer. Even golf cart paths and sand bunkers are exempt from this tax treatment.

Equipment used to refine and separate the natural gas from other liquids are exempt either as items used in oil and gas production or in the refining of a product necessary for sale. (To clarify, these are two different exemption classifications!) That's always been the case. A 1960 letter from the Ohio Department of Taxation written to clarify these issues confirms this to be the case. Industry has operated under this understanding for almost 60 years. Even so, today the Tax Department has changed their minds and are unilaterally disallowing these necessary items as exempt and assessing sales tax on producers.

Tanks to store material are not tax exempt. Tanks designed to heat product, separate and treat crude oil and its derivatives are another thing. Nearly all tanks used in the oilfield have heating and treating elements. The Tax Department unilaterally has changed their minds here as well, and are disallowing the exemption of these necessary items.

My personal favorite: The treatment of Class II UIC wells. By way of background, UIC Class II wells are necessary to properly and safely dispose of oilfield produced water for the sole purpose of protecting human health, safety and the environment. These wells are constructed and operated pursuant to the landmark federal law known as the Safe Drinking Water Act (SDWA).

Since the early 1980's, the United States Environmental Protection Agency has delegated authority to the ODNR Division of Oil and Gas Mineral Resources to regulate these facilities. Current Ohio statute directly refers to the SDWA as the standard of their authority. In 1985, the Ohio General Assembly enacted House Bill 501, which required that all produced water must be disposed of using a Class II UIC well – in order to protect the environment and prevent potential pollution. Ohio oil and gas producers, by both state and federal law, must comply.

A longstanding point of Ohio law is that equipment and devices used to safely hold, treat, dispose or convey to a point of treatment or disposal of the byproduct of drilling and producing known as brine are exempt as pollution control devices. Under current law, a prerequisite for such a designation is that the facility must have been installed pursuant to a permit issued by the "environmental protection agency **or any other governmental agency** * * *." O.R.C. 5709.20(L). **Historically, the Ohio Department of Taxation and Ohio EPA have granted the designation to UIC Class II facilities permitted by ODNR**.

Recently, and without any change in the statute, Taxation and Ohio EPA reversed course and rejected this designation for underground brine injection facilities. The only reason was because the Class II UIC wells were permitted by ODNR and not the Ohio EPA. Thus, these agencies unilaterally changed their minds, ignoring the plain reading of the law that doesn't suit their purposes, and are now disallowing these necessary items as required by both state and federal law as exempt – snubbing history, their own past practices and the clear intent of law.

The General Assembly can resolve the problem using existing statute found in O.R.C. Section1509.01 (AA). There the Ohio General Assembly defined a "production operation", to wit:

"Production operation" means all operations and activities and all related equipment, facilities, and other structures that may be used in or associated with <u>the exploration and production of oil, gas</u>, or other mineral resources that are regulated under this chapter, including operations and activities associated with site preparation, site construction, access road construction, well drilling, well completion, well stimulation, well site activities, reclamation, and plugging. (The section then goes on to more specifics.)

The General Assembly can provide tax clarity to both the industry and the Tax Department by making it clear that transactions made in compliance with the production exemption found in O.R.C. Section 5739.02(B)(42)(a) are those that are made for facilities defined by existing Ohio Revised Code language ,found in O.R.C. Section 1509.01 (AA), which is referenced and utilized similarly in other sections of Ohio law.[2]

To do so will provide much needed guidance on the issue and help resolve future disputes between taxpayers and the administration.

The Veto: What is interesting is that the General Assembly has already approved this legislation. Last year it was included in Senate Bill 235 and approved by the General Assembly by overwhelming vote. The Governor questionably line-item vetoed the provision, stating that the oil and gas sales tax provision will cost Ohio hundreds of millions dollars. Specifically, Taxation stated that over $264 million in revenue would be lost, including $201 million in costs because the measure exempted "gathering lines" from sales tax and even more because it expands the oil and gas provision by including waste disposal equipment and/or including ODNR as an expressed part of "industrial water pollution control facility" in ORC 5709.20(L).

Both allegations are deceitful and ignore the facts.

Gathering lines are not found in ORC 1509.01. Federal Rule, adopted by reference in Ohio, specifically provides a bright line demarcation between the end of production facilities and the beginning of gathering. State law specifically assigns regulatory

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[2] When this language was made part of Substitute Senate Bill 165 (128th G.A.), it was drafted based on existing federal regulatory language that defined production facilities for purposes of establishing federal jurisdictional boundaries pursuant to the Pipeline Safety Act. Additionally, production operation is referenced in O.R.C. Section 3737.832, fire and safety law and in O.R.C. Section 4906.01, Power Siting definitions. <u>Both citations utilize the O.R.C. Section1509.01 definition</u>.

jurisdiction over production facilities to the ODNR/DOGRM and, separately, authority over gathering lines to the Public Utilities Commission of Ohio (PUCO).[3]

Furthermore, in 2012, the Ohio General Assembly approved Senate Bill 315, a bill, introduced at Governor Kasich's request and entitled the "Energy MBR" bill, which, in part, enacted expanded PUCO authority to regulate gathering lines. The bill recognized and left undisturbed the bright line demarcation between those facilities and lines that were regulated by the PUCO (gathering) and those regulated by the ODNR (production).

Since the Senate Bill 235 amendment (and now House Bill 430) utilize a regulatory definition in Ohio oil and gas law (or ODNR regulation) and does not touch utilities law, one can plainly see that $201 million of the $264 million figure drawn up by Taxation was simply smoke and mirrors utilized to set the stage for a line-item veto. The much-publicized veto message that defined the oil and gas sales tax using the existing definition of oil and gas exploration and production is a deflection of truth and nothing less than absurd.

The preceding discussion exposes the veto message regarding pollution control devices as also a deflection of truth as deceitful. The Tax Department's long-established practice of granting UIC Class II injection under the pollution control exemption only demonstrates that the current administration is willing to close its eyes to its own history and change on a whim taxpayers' reliance on the rule of law.

The Fiscal Note: LSC began talking with ODT in an effort to produce an independent analysis following a series of meetings with the Ohio Department of Taxation. Here, the OOGA produced data and information that reflected the current and historical treatment of sales tax exemptions and also showed how the legislation mirrors past precedence. LSC had the same information from the industry, but needed additional data from ODT in order for them produce a fiscal note. LSC made several attempts to work with Taxation and, when even their efforts were rebuffed, conducted their own research to produce an accurate and independent analysis.

After exhausting all options, and realizing Taxation wasn't going to produce the information that LSC requested, LSC produced a fiscal note that reflected Taxation's estimated fiscal impact. It is worth noting that, at the end of the fiscal note, LSC clearly states that, due to Taxation not being forthcoming with the requested information, they could not produce an independent analysis of HB 430. The numbers you see in the fiscal note were not developed in a transparent way with the legislature, LSC, or the industry. In our view, if Taxation had a difference of opinion, backed by indisputable

[3] These federal and state law distinctions, being part of the jurisprudence of O.R.C. 1509.01, will impose similar limitations on any attempt to expand the sales tax exemptions beyond production lines. Additionally, production lines currently are not subject to sales tax under O.R.C. 5739.02(B)(42)(a) and (g) because they serve as in-process production material handling devices. The product already has gone through liquid gas separation and is under continuous gas liquid separation within and at the end of the production lines. This already qualifies as a tax exempt refining operation. O.R.C. 5739.01 (Q), 5739.011 and 5739.02(B)(42)(a) and (g).

facts, they should produce both those facts and information to make their case to the legislature.

H.B. 430 imposes clarity and intent under law using a definitional standard that has existed in law since 2010 and now is being utilized by several governmental agencies. Furthermore, it clarifies the type of facility that qualifies as an "industrial water pollution control facility" as one that the permit for which is regulated by the ODNR. It does not expand the exemption, but merely allows a permit by the ODNR to now be acceptable for the exemption (as has been the case multiple times in the past, thus addressing Ohio EPA's recent reluctance on the permit issuance).

The lack of a clear definition of exploration and production as it applies to the long-standing exemption from sales tax is a problem begging repair as has been noted by the Courts. It now presents a clear danger to taxpayers who are being targeted by an over-zealous Tax Department. The confusion has caused serious concerns among operators who have been using traditional exemptions as allowed to them in the past, but are now facing large tax liabilities because of the current administration's singular reinterpretation of the law. What was honored in the past and designated by the Ohio legislature, must be honored today.

Thank you once again, Chairman Blessing and members of the Committee, for allowing me to speak to you today on this vitally important issue for Ohio oil and gas industry. I strongly request that this Committee favorably report H.B. 430 to the House Floor as soon as possible, so that reason and clarity be provided to a situation that is currently lacking in both.

Respectfully submitted,

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