

202009002L [Tax Type: Sales] [Document Type: Letter/Memo]

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Texas Comptroller of Public Accounts STAR System

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NOTE: This memo supersedes STAR Accession Nos. 200208347L (Aug. 12, 2002), 200811221L (Nov. 20, 2008), 200804075H – Comptroller Decision 44,588 (2008), and 9705464H – Comptroller Decision 33,749 (1997) as they relate to equipment provided to control flowback and to the application of manufacturing exemptions for that equipment .

Memorandum

DATE: September 21, 2020

TO: Emma Fuentes, Audit Division

FROM: Teresa Bostick, Tax Policy Division

SUBJECT: Taxability of "Flowback Services"

Issue :

This memo clarifies guidance on the taxability of equipment provided at a well site to manage flowback and transition an oil or gas well to production after a frac job. It applies to all periods open within the statute of limitations.

Background :

After a frac job, certain companies may provide various items of equipment for what industry calls "flowback services." Despite the name, these companies generally only provide equipment and employees who install and remove the equipment, and while the equipment is in use, supervise and adjust the equipment under the direction of the well operator.

A "frac job" is described in Rule 3.324(b)(2)(A) (Oil, Gas, and Related Well Service) [ENDNOTE 1] as:

Work done on a well using pressure pumps 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.

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 more freely flow 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:

- 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 (e.g., exploratory wells with no pipelines in place to connect with transmission lines);
- Various safety systems and emergency shutdowns; and
- A logging cabin to run the data acquisition system.

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

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

Flowback services do not fit neatly within the taxable or nontaxable services in Rule 3.324. Rule 3.324(a)(1) defines oil well services as: “[a]n activity performed for others for a consideration or compensation at any well site including an oil, gas, water disposal, or injection well.” For purposes of this rule, “nontaxable services” are defined as labor to start or stimulate production or the labor to work on the formation outside the well. Rule 3.324(a)(3). Pumping the product is not considered to be stimulating production. *Id.* Labor to perform those services subject to the 2.42 percent oil well service tax imposed under Chapter 191 also is not subject to sales or use tax. Rule 3.324(b)(1). Rule 3.324(b)(2) provides a list of additional activities that are not taxable.

Rule 3.324(c)(1) states that a company that merely provides equipment and a supervisor is presumed not to be providing services but rather selling or renting equipment. The charge for the supervisor's time is part of the tax base as an expense connected with the sale or rental. Mileage charges are also taxable. Rule 3.324(b)(5) further states that “[a]ny machinery or equipment transferred to the customer will be taxable to the customer if sold or rented without an operator.” Rule 3.294(a)(3) (Rental and Lease of Tangible Personal Property) defines “operator” as “[a] person who actively guides, drives, pilots, or steers tangible personal property.”

Statement of Policy :

“Flowback services” are not included among the nontaxable services subject to the 2.42 percent oil well servicing tax imposed under Chapter 191 unless the flowback is provided by the frac service provider. Also, flowback is not one of the nontaxable services listed in Rule 3.324(b)(2) (A)–(S).

Charges for “flowback services” are taxed as the rental of equipment. Companies that provide “flowback services” are renting equipment to manage flowback pressure and manage the removal of frac fluids and proppants from the wellbore prior to transitioning the well into production status after a frac job. Sales or use tax is due on the total charge for the rental of equipment, including charges for transportation, installation, removal, and accompanying personnel. See Section 151.007 (“Sales Price” or “Receipts”) and Rule 3.324 (c)(1). This treatment applies regardless of whether the charges for equipment and personnel are billed as a lump-sum amount, separated amounts, or using two separate invoices.

With regards to the rental transaction, the customer obtains operational control of the equipment. They determine the location of the equipment and the rate at which the equipment operates. Once installed, the equipment works automatically and only needs minor adjustments made by the flowback personnel to meet the customer’s needs. The customer may use the equipment to perform testing after the flowback personnel are no longer onsite. The flowback personnel do not “actively guide, drive, pilot, or steer the equipment” while it is in use. See Rule 3.294(a)(3). Therefore, any flowback personnel, even supervisors, that accompany the equipment are not “operators” of the equipment for sales and use tax purposes.

General resale principles apply to the purchase of flowback equipment. The flowback company may purchase flowback equipment tax free for resale and collect tax on the total rental charge for the equipment. Tax will be due on any divergent use of the equipment by the flowback company other than renting the equipment. See Rules 3.285(e)(1) (Resale Certificate; Sales for Resale) and 3.324(c)(1).

Neither the companies providing flowback equipment nor the customers renting the equipment from the flowback company can claim the manufacturing exemption because the flowback process occurs prior to completion of the well and put into production. See Rule 3.300(a)(9) (Manufacturing; Custom Manufacturing; Fabricating; Processing (Tax Code, §§151.005, 151.007, 151.318, and 151.3181)). Note, that some items of equipment (e.g., separators) mentioned in this memo may qualify for the manufacturing exemption when used in other contexts outside of the flowback process. This memo does not address the applicability of the manufacturing exemption to any equipment when used in other contexts.

If the company providing the “flowback services” is also the provider of the fracking service at the wellsite, then the “flowback services” are subject to the 2.42 percent oil well service tax imposed under Chapter 191 instead of sales or use tax. The fracking service provider owes

sales tax on the purchase of the flowback service equipment and materials used in the flowback service at the time of purchase. See Rule 3.324(b)(3).

This memo is a policy clarification rather than a prospective change of policy and applies to all periods open within the statute of limitations. Tax Policy will supersede the following documents as they relate to equipment provided to control flowback and to the application of manufacturing exemptions for that equipment:

STAR Accession No. 200208347L (Aug. 12, 2002)

STAR Accession No. 200811221L (Nov. 20, 2008)

STAR Accession No. 9705464H – Comptroller Decision 33,749 (1997)

STAR Accession No. 200804075H – Comptroller Decision 44,588 (2008)

ENDNOTE:

1. Unless otherwise indicated, all references herein to "Chapter" and "Section" are to the Texas Tax Code, and all references to "Rule" are to Title 34 of the Texas Administrative Code.

ACCESSION NUMBER: 202009002L

SUPERSEDED: N

DOCUMENT TYPE: L

DATE: 2020-09-21

TAX TYPE: SALES