JURISDICTION: **OKLAHOMA TAX COMMISSION - DECISION**
CITE: **2001-12-19-002 / PRECEDENTIAL**
ID: **CR00009 / CR00011 / CR00015**
DATE: **12-19-01**
DISPOSITION: **DENIED**
TAX TYPE: **SALES / USE**
APPEAL: **OK SUP CT 97,264 / AFFIRMED**

FINDINGS OF FACT AND CONCLUSIONS OF LAW

1. PROTESTANT is an oil and gas exploration company which operates entirely within the continental United States and principally within the Mid-Continent Region, with its primary focus being Oklahoma, Texas, New Mexico, Arkansas and Kansas.

2. PROTESTANT operates approximately 1,192 wells in Oklahoma.

3. PROTESTANT does produce oil but is primarily a gas producer.

4. As the operator under a joint-operating agreement for a particular well, PROTESTANT is responsible for placing the equipment at the well-site. PROTESTANT'S average working interest in wells in Oklahoma is 68 PERCENT. PROTESTANT pays for the equipment and then bills the other working-interest owners their pro-rata percentage of the amount spent.

5. THE Manager of Operation Accounting FOR PROTESTANT testified that he attended a tax conference in October, 1998, and immediately thereafter contacted the Oklahoma Tax Commission for advice regarding obtaining a Manufacturer's Limited Exemption Certificate ("MLEC").

6. Pursuant to an application dated October 22, 1998, prepared by THE MANAGER OF OPERATION ACCOUNTING and signed by THE Controller, PROTESTANT applied for a sales tax permit.

7. Two weeks after applying for the permit, PROTESTANT received a probationary sales tax permit in the mail.

8. THE MANAGER OF OPERATION ACCOUNTING testified that because the business registration form was completed and PROTESTANT had received the probationary permit, PROTESTANT had completed the necessary requirements to be considered for a MLEC. He further stated that PROTESTANT commenced filing claims for refund.

9. Around the end of January or beginning of February, 1999, THE MANAGER OF OPERATION ACCOUNTING was contacted by a representative of the Audit Division, requesting access for inspection of the manufacturing site. THE MANAGER advised that PROTESTANT has thousands of wells in Oklahoma and that PROTESTANT was seeking exemption for different processes associated with oil and gas leases. Upon notification of the type of business involved, the auditor advised that PROTESTANT would not qualify for a MLEC.

10. At the point the probationary sales tax permit was about to expire, PROTESTANT contacted the Tax Commission, and was thereafter advised that it would need to supply additional information in the form of a listing of all the wells in which it had an interest in Oklahoma and the location of the wells.

11. PROTESTANT submitted a listing containing the locations of wells in which it had an interest in Oklahoma.

12. Approximately three weeks thereafter, PROTESTANT received a sales tax permit, expiration date November 2, 2001.

13. THE MANAGER OF OPERATION ACCOUNTING stated that the equipment typically found at a PROTESTANT-operated well in Oklahoma consists of a Christmas tree, separators, line heaters, compression, dehydration facilities, gas units, chemical injection facilities, tanks, flow lines, a heater-treater and a sales meter.

14. Initially, the fluids are brought up from the reservoir of the wellhead. The fluids flow into the first-stage separator at a certain pressure and through the principle of thermodynamic equilibrium and gravity, the fluids separate. Reaching equilibrium in the separator, the vapor by gravity rises to the top and the liquid goes to the bottom and out of the first-stage separator. The gas is taken off the top and the liquids, a combination of oil, water and entrained gas, are taken off the bottom. The gas leaves the first-stage separator and enters the compressor at the inlet end at a certain pressure. The compressor takes the vapor and compresses it, causing an increase in both pressure and temperature. Once it leaves the compressor, it enters into another separator. The purpose, as before, is to take the fluid and separate it into vapor and liquid. Again the pressure is changed and the vapor rises to the top and the liquids that separate go to the bottom and are sent to the stock tank. The hydrocarbon vapors still contain a significant amount of water entrained in the gas. The hydrocarbon vapor is sent to the dehydrator. In the dehydrator, the gas is brought in contact with triethylene glycol, which absorbs the water. As the gas rises through the falling liquid, the glycol absorbs the water. The glycol with the absorbed water is sent to a regenerator. The glycol is heated to the boiling point of water and the water is boiled off. Then the glycol can be recirculated into the system.

After the first stage of separation, the hydrocarbon liquid goes through another separator, which separates the oil and water and by equilibrium releases additional gas. In some cases, PROTESTANT takes the hydrocarbon liquid and sends it to an inlet tank where gravity separates the oil and water. After separation, the water is transferred to the disposal tank.

15. In the instances where a well is predominately an oil well, the fluid enters a stage of separation, where vapor is separated from liquid. For purposes of maximizing liquid recovery, there are additional stages of separation. If the amount of gas coming from the separators is sufficient, it is compressed for sale. The liquid usually goes through a heater-treater to separate water from the liquid hydrocarbon. The liquids are transferred to a gun barrel or stock tank for additional gravity settling. The oil is transferred to an oil tank and water to a water tank for additional processing before disposal.

The fluids which are brought to the surface are under significant pressure, and a choke is used to control the pressure. As the pressure drops, the fluids expand and cool. The cooling effect creates hydrates, which buck the line and stop the flow. An indirect water bath heater commonly called a line heater, found between the wellhead and separator, is used to preheat the fluids to prevent the creation of these hydrates.

Chemical additives are used, such as corrosion inhibitors and emulsion breakers, which pass through the equipment for protection against corrosion. Methanol is also used to help reduce the temperature to prevent hydrates from forming in the system.

AN Associate Professor of Petroleum Engineering, University of Oklahoma, testified that the fluid at the wellhead is not in a condition to be sent to market. He stated that the described pieces of equipment are necessary to make a marketable product both from a vapor phase and a liquid phase. At the beginning there is one fluid at the wellhead and through the described processes the fluid becomes three component fluids, gas, oil and water.

STIPULATION OF FACTS

The parties stipulate to the following facts:

1. The consolidated cases involve claims made by PROTESTANT for refund of sales and use taxes on certain items purchased by PROTESTANT during, respectively, the following time periods:

(i) October, 1995 - December, 1996;
(ii) January, 1997 - March, 1999; and
(iii) April, 1999 - June, 1999.

2. The Division has duly denied each of the claims for refund (Exhibits A, B and C to *Stipulation* filed August 7, 2000). PROTESTANT has timely protested each of the denials (Exhibits D, E and F to *Stipulation* filed August 7, 2000).

3. As corrected by the Division pursuant to its audit of the data submitted by PROTESTANT and in which corrections PROTESTANT concurs, the total amount of PROTESTANT's claim for refund in the above-referenced consolidated cases is $189,345.95.

4. Of said $189,345.95 total amount, $175,201.69 is attributable to purchases made by PROTESTANT prior to November 1, 1998, and $14,144.26 is attributable to purchases made by PROTESTANT after November 1, 1998.

5. Exhibit A to the *Stipulation* filed October 17, 2000, is a true copy of the "recap" portion (i.e., the summary portion) of the supplemental claims information that PROTESTANT submitted to the Division on August 25, 2000, as the same was corrected by the Division pursuant to its audit of the supplemental information and in which corrections PROTESTANT concurs.

ISSUES

The issue presented for decision is whether the machinery and equipment utilized by Claimant in its gas treatment operation at the well-sites, which are the subject of the refund request, qualify for exemption under Section 1359 of the Oklahoma Statutes.[1]

CONTENTIONS

Claimant contends that the items purchased prior to November 1, 1998, qualify for the sales and use tax exemption because the surface operations at its oil and gas well-sites constitute processing operations and are generally recognized as such. Claimant also asserts that these operations satisfy the requirement for exemption and therefore items purchased after November 1, 1998, are exempt from sales and use tax.

Specifically, Claimant states that these operations constitute the processing of articles for sale as tangible personal property; are commonly regarded as being processing; and change the form, composition, quality and character of the material brought to the surface at the wellhead into material having a different form or use following these surface operations performed at the wellhead.

[1] If a determination is made that the machinery and equipment utilized by Claimant in its operations qualifies for exemption, then it must be determined whether the provisions of Section 1359.2 of Title 68, which require an Oklahoma resident manufacturer to obtain proof of exemption eligibility, have been met.

Further, Claimant argues that Precedential Order No. 97-05-08-15, although only addressing the "generally recognized" language of Section 1359(C), calls for the rejection of the Division's argument that Claimant's operations must be regarded by the general public as being manufacturing. Claimant points to its expert witness' testimony that Claimant's well-site surface operations are generally recognized and commonly regarded in the oil and gas industry as field processing, as satisfying both the "generally recognized" requirement of Section 1359(C) of Title 68 and the "commonly regarded" requirement of Section 1352(9) of Title 68.

The Division contends that Claimant's well-site operations, i.e., the extraction of gas from oil, the removal of water from oil, or the extraction of water and sediment from gas, are not generally recognized or commonly regarded by the average man or the general public as manufacturing. Further, the Division contends that these activities have not been characterized by the industry or the Oklahoma Courts as manufacturing or processing. The Division contends that PROTESTANT'S EXPERT WITNESS admitted that he had no book or other authority to support his opinion that Claimant's activities at the well-site are generally recognized or commonly regarded as processing.

CONCLUSIONS OF LAW

1. Jurisdiction over the parties and subject matter of this proceeding is vested in the Tax Commission. 68 O.S. 1991, Section 207.

2. The Oklahoma Sales Tax Code levies an excise tax of four and one-half percent (4.5 percent) of the gross receipts of each sale of tangible personal property. 68 O.S. 1991, Section 1354(1)(A).

3. In addition, the Oklahoma Use Tax Code levies an excise tax of four and one-half percent (4.5%) on the purchase price of any tangible personal property which is purchased and brought into this state for storage, use, or other consumption. 68 O.S. 1991, Section 1402.

4. The Oklahoma Sales and Use Tax Codes specifically exempt manufacturers from the payment of sales and use tax on certain purchases. Prior to November 1, 1998, the sales tax exemption afforded manufacturers provided as follows:

> There are hereby specifically exempted from the tax levied by this article:
>
> (C) Sales of machinery and equipment purchased and used by persons establishing new manufacturing plants in Oklahoma, and machinery and equipment purchased or equipment built on site and used by persons in the operation of manufacturing plants already established in Oklahoma.

> This exemption shall not apply unless such machinery and equipment is incorporated into, and is directly used in, the process of manufacturing property for sale or resale. The term manufacturing plants shall mean those establishments primarily engaged in manufacturing or processing operations, and generally recognized as such;
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> * * *
>
> 68 O.S. 1991, Section 1359(C).

A corresponding exemption from the imposition of use tax is provided by 68 O.S. 1991, Section 1404(d).

5. "Manufacturing" was defined to mean and include "every operation commencing with the first production stage of any article of tangible personal property and ending with the completion of tangible personal property having the physical properties which it has when transferred by the manufacturer to another." 68 O.S. 1991, Section 1352(H). *Oklahoma Administrative Code 710:65-13-150*[2] citing *Century Dictionary* defined manufacture as "the production of articles for use from raw or prepared materials by giving these materials new forms, qualities, properties or combinations, whether by hand labor or machine." The process of manufacturing has taken place whenever labor is bestowed upon an article which results in its assuming a new form, possessing new qualities or new combinations. *Id.*

In order for the items purchased to qualify for exemption, three conditions must be met:
(1) The machinery and equipment must be incorporated into a manufacturing or processing operation, and must be directly used in that operation;
(2) the machinery and equipment must be part of, or be, a manufacturing plant; and
(3) the manufacturing plant must be an establishment that is primarily engaged in manufacturing or processing operations and also must be generally recognized as a manufacturing plant.

The manufacturing exemption "should receive a practical construction - one that would not allow a manufacturing operation that is in fact but one continuous and integrated production process to be chopped up into distinct and discrete segments." *Schulte Oil Co., Inc. v. Oklahoma Tax Commission*, 882 P.2d 65, 74 (Okl. 1994). See, *United Design Corp. v. Oklahoma Tax Commission*, 942 P.2d 725, 727 (Okl. 1997).

[2] *Oklahoma Administrative Code 710:65-13-150* was revoked at 15 Ok. Reg. 4315, eff. 9-16-98.

Although the *Schulte* decision expanded the manufacturing exemption, it did not declare that the exemption be afforded operations which are not generally recognized as manufacturing. Furthermore, *Schulte* did not overrule *Tulsa Machinery Co. v. Oklahoma Tax Commission*, 253 P.2d 1067 (Okl. 1953), or *Curry Materials Company v. Oklahoma Tax Commission*, 319 P.2d 292 (Okl. 1957). In those cases, the Court said that machinery and equipment used in extracting raw materials from the ground and the screening, washing and transporting the materials to a plant where the materials were processed for sale, was not used in the manufacturing process. The Court in *Curry* noted that the "washing and scouring wool does not make the resulting wool a manufacture of wool" nor does the "cleaning and ginning cotton make the resulting cotton a manufacture of cotton." *Curry* at Paragraph 8, *quoting Hartranft v. Wiegmann*, 121 U.S. 609, 7 S.Ct. 1240.

The Commission in Precedential Order No. 2000-05-03-016, considered the issue of whether machinery and equipment were purchased and used in the operation of a manufacturing or processing plant as defined by the statutes in effect prior to November 1, 1998. In that case, the Claimant sought a refund of sales and use taxes paid in 1991 and 1992 on purchases of the initial separators, which separate the natural gas from the oil, separators, and heater-treater, which remove water and other substances from the oil, and the compressors, parts, pipes, valves, separators and dehydrators, which comprised the Claimant's gas gathering system. The Commission concluded that well-site separation and treatment of oil, extraction of gas, and the gathering and transporting of gas to a processing plant or pipeline, including the field processes normally attendant thereon, do not constitute manufacturing, are not generally recognized as such, and go beyond the boundary of the manufacturing exemption intended by the Legislature.

The Commission, in rendering its decision, found the second and third conditions of Section 1359 to be of particular relevance in the case, citing *McDonald=s Corp. v. Oklahoma Tax Commission*, 563 P.2d 635 (Okl. 1977), wherein the Oklahoma Supreme Court found that any manufacturing plant must be one which is "generally recognized as such" and declared that this phrase "modifies the whole" statute. The Commission determined that neither the average person, nor the oil and gas industry itself,[3] considered the activities performed at the well-site to be processing. Rather, the Commission found that the activities and equipment at the lease sites, for which the Claimant sought a tax exemption as machinery and equipment used in manufacturing, are "in actuality and generally recognized as employed in the production (mining) of oil and gas, not its manufacture." Oklahoma Tax Commission

[3] The Commission in Order No. 2000-05-03-016, relying on Williams and Meyers, Oil and Gas Law, Office of Management and Budget, North American Industry Classification System - United States and related gross production tax cases, examined industry standards as to these wellhead processes and determined that the industry does not consider them to be processing.

Order No. 2000-05-03-016. For the period prior to November, 1998, none of the facts presented in the instant case would render a result different from the one reached in the precedent set out in the referenced precedential order.[4] Accordingly, Claimant's claim for refund which accrued prior to November, 1998, is denied.

6. Effective November 1, 1998, the exemption given manufacturers was amended and codified at 68 O.S. Supp. 1999, Section 1359(1), which provides as follows:

> There are hereby specifically exempted from the tax levied by Section 1350 et seq. of this title:
>
> 1. Sales of goods, wares, merchandise, tangible personal property, machinery and equipment to a manufacturer for use in a manufacturing operation;
>
> * * *

7. "Manufacturing" and "manufacturing operation" are defined in 68 O.S. Supp. 1999, Section 1352. The applicable portion reads as follows:

> 9. "Manufacturing" means and includes the activity of converting or conditioning tangible personal property by changing the form, composition, or quality of character of some existing material or materials, by procedures commonly regarded as manufacturing, compounding, processing or assembling, into a material or materials with a different form or use. "Manufacturing" does not include extractive industrial activities such as mining, quarrying, logging, and drilling for oil, gas and water, but may include processes subsequent to extraction if such processes result in a change of the form or use of the material extracted;
>
> 10. "Manufacturing operation," means the designing, manufacturing, compounding, processing, assembling, warehousing, or preparing of articles for sale as tangible personal property. A manufacturing operation begins at the point where the materials enter the manufacturing site and ends at the point where a finished product leaves the manufacturing site. "Manufacturing operation" does not include administration, sales, distribution, transportation, site construction, or site maintenance;

Although, Precedential Order No. 2000-05-03-016 addressed the pre-November 1, 1998, manufacturing exemption, focusing on the "generally recognized" condition of that statute, the post-November 1, 1998, exemption statute and corresponding definitions require that the activities in question must be "commonly regarded" as manufacturing, compounding, processing or assembling, to qualify for exemption. As there is not a

[4] Oklahoma Tax Commission Order No. 2000-05-03-016.

discernable distinction between the "generally recognized" and the "commonly regarded" conditions, the authority set forth in Precedential Order No. 2000-05-13-016 is dispositive of the outcome of Claimant's remaining refund.[5] Accordingly, the refund request which accrued after November 1, 1998, is denied.

Additionally, the Division asserts that Claimant did not comply with Section 1359.2, which requires a resident manufacturer to obtain proof of eligibility of the exemption by securing a manufacturer exemption permit.[6] Specifically, Division asserts that Claimant did not apply for a sales tax permit or recognition as a manufacturer until April 27, 1999. Therefore, Division argues that even if a determination was made that Claimant was a manufacturer subsequent to November 1, 1998, the claim from November 1, 1998, through April 27, 1999, should be denied based on Claimant's failure to comply with the requirements of Section 1359.2. This contention will not be considered.[7]

The fact that Claimant commenced the application process to obtain a manufacturer's exemption certificate in a timely manner as suggested by evidence and testimony introduced at hearing is immaterial, since the determination has been made that Claimant's operations do not qualify for exemption under any of the relevant statutory provisions.

DISPOSITION

It is the DETERMINATION of the OKLAHOMA TAX COMMISSION, based upon the specific facts and circumstances of this case, that the sales tax and use tax claim for refund of PROTESTANT CORPORATION be denied.

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[5] Statutory words and phrases are to be understood in their ordinary and usual sense where not otherwise defined or a contrary intention does not plainly appear. 25 O.S. 1991, § 1. *Loffland Bros. Equipment v. White*, 689 P.2d 311 (Okl. 1984). Reference to *Webster's New Collegiate Dictionary*, (1979) demonstrates that the two terms "generally recognized" and "commonly regarded" are synonymous.

[6] B. Each resident manufacturer wishing to claim the exemption authorized in paragraph 1 of Section 1359 of Title 68 of the Oklahoma Statutes shall be required to secure from the Oklahoma Tax Commission a manufacturer exemption permit, the size and design of which shall be prescribed by the Tax Commission. This permit shall constitute proof of eligibility for the exemption provided in paragraph 1 of Section 1359 of Title 68 of the Oklahoma Statutes. Each such manufacturer shall file with the Tax Commission an application for an exemption permit, setting forth such information as the Tax Commission may require. The application shall be signed by the owner of the business or representative of the business entity and as a natural person, and, in the case of a corporation, as a legally constituted officer thereof. 68 O.S. § 1359.2(B)

[7] However, the records of the Oklahoma Tax Commission indicate that on October 23, 1998, Claimant filed a Business Registration form signed by CLAIMANT'S Controller. On the face of the form, Claimant indicated its reason for filing same was to "file for Manufacturer's Exemption Cert." Claimant further indicated that it began manufacturing in Oklahoma on October 1, 1979, and described its manufacturing operation as "dehydration, chemical treating and compression of natural gas changing it from produced form to salable state."