

**INFORMATION NOTICE
SALES AND USE TAX 2014-02**

Natural Gas Mining

Issued: September 22, 2014

General Overview

The Department of Revenue (the "Department") provides this Sales and Use Tax Information Notice to taxpayers in the natural gas mining industry and related activities. Pennsylvania law exempts the purchase of taxable tangible personal property and services from tax when such property and services are predominantly used directly in mining activities (the "mining exemption") 72 P.S. §§ 7201(k)(8) and (o)(4). The Department's Mining Regulation set forth at 61 Pa. Code § 32.35 governs the scope of the mining exemption. This Information Notice applies the law, the Mining Regulation and other applicable regulations specifically to the natural gas industry and related activities.

Mining activities are defined in the law and regulations as including exploring, extracting, blasting, mining, or drilling for purposes of removing natural resources from the earth or refining natural resources removed from the earth. For natural gas mining, these activities would include cementing (pumping of cement slurry to bond casing or piping to the wall of the bore hole), fracturing (using fluids, a mixture of water and chemicals, to crack the rock formation and the injection of proppants such as sand and ceramic materials into cracks in the formation to open channels through which the gas flows) and acidizing (injecting acid below rock fractures to create flow channels within the rock formation). In this Information Notice these activities will be collectively known as "gas mining".

The mining exemption applies to the purchase or use of tangible personal property or services predominantly used directly in gas mining. Additionally, if a miner is entitled to purchase otherwise taxable property that is predominantly used directly in a gas mining activity exempt from tax, then a third-party vendor performing the same mining activity for the miner is also entitled to the exemption on the purchase of property predominantly used directly in that mining activity. *Commonwealth v. R.G. Johnson Co.*, 433 A.2d 465 (Pa. 1981).

However, the mining exemption does not extend to all property or services used in gas mining. The taxability determination of any property or services used in gas mining is fact-specific and depends on the use of the property or service as it relates to the mining process. The factors that determine whether property or services are directly used and thereby exempt are: (1) physical proximity to the mining operation, (2) temporal proximity to the mining operation, and (3) the existence of an active causal relationship between the use of the property and the mined product. 61 Pa. Code § 32.35(a)(1).

It is important to note that 61 Pa. Code § 32.35(a)(1)(iii) specifically states, in considering the existence of an active causal relationship, "[t]he fact that particular property may be considered essential to the conduct of the business of mining because its use is required either by law or practical necessity does not, of itself, mean that the property is used directly in mining operations". Furthermore, when property is used in two different



activities, one of which is direct-use and the other is not, the property is not considered exempt property unless it is used more than 50% of the time in direct-use activities. 61 Pa. Code § 32.35(a)(2).

The mining exemption only applies to “[m]achinery, equipment, parts and foundations therefor, and supplies which are used in the actual mining production, to transport or convey the product ... [other than vehicles required to be registered under the Vehicle Code], or to handle or store the product during the production.” 61 Pa. Code § 32.35(a)(2)(i) (emphasis added).

Consequently, property used prior or subsequent to the actual mining operation, to collect, convey or transport property to a mining activity or to remove the mined product after the final mining operation, and storage facilities or devices used to store property prior or subsequent to actual mining operation are subject to tax. 61 Pa. Code §§ 32.35(a)(3)(iii)(G) and (I). Similarly, property used in non-mining activities is subject to tax even if it is used during the mining operation. 61 Pa. Code § 32.35(a)(3)(iii)(H). For example, monitoring equipment that merely tracks and records drilling data is not exempt property even though it may be used during drilling operations.

A common issue in determining taxability is whether a transaction should be classified as a service or sale at retail of property. The answer often turns on the wording of contracts and invoices. Generally, if a transaction is determined to be a sale at retail of services that are predominantly used directly in exempt activities, then the service fees and any separately-stated charges incurred in conjunction with providing the services (*e.g.*, set-up fees, standby fees, travel costs or additional materials or labor fees, etc.) are also exempt.

If a transaction involves the sale at retail of property (which includes a rental or lease) and the property, such as equipment is furnished with the services of an operator with the charges for each billed separately, it is presumed that the transaction involves a transfer of the right to direct the use of the equipment. 61 Pa. Code § 31.4(a)(1). As such, the transaction is treated as equipment rental and provision of help supply services respectively. Assuming the leased property is taxable because it is not used predominantly and directly in mining, the rental charges are taxable. Furthermore, any additional charges incurred in conjunction with renting the taxable property such as those for set up time, standby time, additional pumping time, travel costs or additional labor or materials are also taxable. On the other hand, if the leased property is nontaxable, any separately stated charges incurred in conjunction with the exempt property (*e.g.*, set-up fees, standby fees, travel costs or additional materials or labor fees, etc.) are also exempt. However, the mining exemption is inapplicable to taxable help supply services. Thus, the separately-stated operator charges remain taxable regardless of the taxability of the rental property.

Also, no exemption is to be given to maintenance facilities or for materials or supplies to be used or consumed in construction, reconstruction, or remodeling of real estate other than exempt machinery, equipment and parts therefor that may be affixed to real estate. 72 P.S. §§ 7201(k)(8) and (o)(4); Pa. Code 61 § 32.35(a). Finally, vehicles required to be registered under 75 Pa. C.S. §§ 101-9909 (the “Vehicle Code”).

Based on information currently available to the Department, the taxability of property and services commonly used in or in conjunction with gas mining is as follows:

A. Exploration

“Mining” as defined by law includes exploration for natural gas so otherwise taxable tangible personal property and services are exempt from tax when they are predominantly used directly in exploration. Examples of exempt exploration property and services include:

1. Seismic exploration services.
2. Exploratory well drilling services.
3. Seismic imaging services.
4. Seismic data.

B. Site Preparation & Pre-Production Construction

Generally, the mining exemption does not apply to property or services used in the construction, reconstruction, alteration, remodeling, servicing, repairing, maintenance or improvement of real estate. The mining regulation further states that property used in the removal of trees and clearing of land in preparation for extraction activities is not directly used and therefore taxable.

1. Equipment, parts and materials used in site preparation including, but not limited to, removal of timber, building of access roads and removal of dirt and rocks from the land are taxable, including, but not limited to the following:
 - a. Bulldozer.
 - b. Backhoe/front loader.
 - c. Stone for roads.
 - d. Road fabric.
 - e. Sluice pipe.
 - f. Security fencing.
 - g. Bridges and bridge construction materials.
2. Equipment, parts and materials used in 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 such as liners are taxable.
3. Geosynthetic materials used to store clean water used in the drilling operations are taxable.
4. Equipment, parts and materials used in the construction, reconstruction, alteration, remodeling, servicing, repairing, maintenance or improvement of real estate even if the structure may house or otherwise contain equipment or other facilities used directly in mining are taxable.
5. Equipment, parts and materials used to construct an electrical system used to deliver electricity to exempt property from the point the electricity leaves the local distribution company transmission line to the point immediately prior to the last transformer prior to the exempt equipment are taxable. All property used to deliver electricity from this point to the exempt equipment, including the last transformer, is exempt from tax. If the equipment to which the electricity is delivered is taxable, the materials incorporated into an electrical system, even the last transformer and property between that transformer and the taxable equipment are taxable.

If the equipment the electricity powers is both taxable and nontaxable, predominant use determines the taxability of the materials incorporated into the electrical system. The building of the electrical system is a construction contract. Whatever the use of the equipment to which the electricity is delivered, equipment used to construct the electrical system is taxable if it is not incorporated into the electrical system.

C. Extraction and Production

For purposes of the mining exemption, the actual gas mining process begins with the drilling of the wellbore and ends with the last physical change of the gas prior to it being sold and transferred by the miner to another. Therefore, property and services predominantly used directly during this process are exempt.

1. Exempt

- a. The well pad and the foundation directly under the well pad including, but not limited to materials such as sand, stone, gravel or other similar material directly supporting the well pad and any materials used in the well pad itself such as liners and mats are exempt as pollution control property if the well pad was constructed after April 16, 2012 in accordance with 58 P.S. § 3218.2 (relating to containment for unconventional wells).
- b. Materials, such as liners, sand, gravel, etc. used in the construction of storage ponds or vessels from which fracturing fluids (a mixture of water and chemicals) are pumped into fracturing well holes. The exemption also applies to holding ponds, tanks and other containment vessels for fluids that are pumped from the well hole and reused in fracturing multiple wells.
- c. Digging and extracting equipment, machinery, and tools directly used in gas mining:
 - i. Drilling rig unit.
 - ii. Drilling head.
 - iii. Drilling bits.
 - iv. Drilling extensions.
 - v. Drill string and downhole equipment.
 - vi. Drilling mud.
 - vii. Casing.
 - viii. Cement to encase the casing.
 - ix. Twin cement unit (a system located at the well site that mixes cement to be added to the batch mixer).
 - x. A frack unit (affixed to the back of a truck chassis) and all repair parts and fuel used in running the fracturing unit, not including the licensed chassis.
 - xi. Frack pumps (equipment that injects fluids into a rock formation).
 - xii. Gases, sand and cement used in fracturing.
 - xiii. Pumps used to extract gas from the ground.
 - xiv. Pump down acid equipment (pumping equipment used to perform fracturing, which includes a positive placement pump to expand a

- cavity and a boost pump for increasing system pressure of the operation).
- xv. Pump rod (connected to the pump).
 - xvi. Acid pumper (equipment used to pump specially blended acid into the wellbore).
 - xvii. Bath mixer (equipment used at the well site to mix cement slurry).
 - xviii. Sucker pipe (pipe that allows oil to flow to the surface).
 - xix. Cap affixed to the top of the wellhead.
 - xx. Pump jack (provides upward and downward movement to the pump rod directly resulting in the operation of the pump).
 - xxi. Manifold trailer (equipment that attaches piping lines to the well head to facilitate the pumping operation).
 - xxii. Fishing or extracting tools used predominantly to retrieve and remove objects from a drilled hole during the drilling operation.
 - xxiii. Electricity or fuel used to run direct-use equipment.
 - xxiv. Frack tanks predominantly used to hold in-process materials, including flow-back water.
- d. Remote control and accompanying monitoring equipment used to control and operate frack pumps, blenders and liquid additive units during fracturing only if the equipment makes automatic adjustments to the pumps, blenders, etc. during fracturing.
 - e. Lighting equipment and supplies used to light production activities. Protective devices worn by production personnel in their work. Communication devices such as handheld radios used predominantly in mining activities such as work coordination among production employees of equal authority.
 - f. Compression machinery and equipment used up to the last physical change of the gas prior to its being sold and transferred by the miner to another.
 - g. Refining machinery and equipment used to remove water, vapors or hydrocarbons from gas.
 - h. Waste extraction, removal, handling, disposal equipment and machinery used in the course of production operations.
 - i. Half tanks – large open tanks hold drill cuttings during the course of drilling operation.
 - ii. Geotechnical products such as liners used to hold contaminated fracturing water during the course of drilling operation.
 - iii. Pit liner used in the sludge holding ponds to hold sludge during the course of drilling operation.
 - i. Pollution Control Devices
 - i. Equipment, machinery and supplies designed and used to control, abate, or prevent air, water or noise pollution generated in the mining operation, including but not limited to flare stacks.

- ii. Materials such as liners, sand and gravel used in constructing a pond used predominantly in controlling, abating, or preventing pollution generated in the mining operation.
 - iii. Geosynthetic materials used to prevent contamination generated in the mining operation.
 - iv. Back-up containment systems.
 - v. Erosion control property, such as silt fences, stakes or hay bales, is exempt, only if used to control, abate or prevent air, water or noise pollution generated in the mining operation.
- j. Property to test and inspect the product up to the last physical change of the gas prior to its being sold and transferred by the miner to another party.
 - k. Reclamation machinery, equipment and materials such as bulldozers, graders, fill, seedlings, grass seed, shrubs, stone, concrete and soil nutrients used in backfilling and reclamation of directly used mining facilities only when the backfilling and reclamation is required by law.
 - l. Gyroscopes and the wireline with which a gyroscope is hoisted and lowered into the wellbore when the gyroscopic data is used by the miner to guide and direct equipment used during drilling production.
 - m. Any otherwise taxable property purchased by a nonresident outside of and brought into Pennsylvania for use in the Commonwealth for a period of not more than seven days.

2. Taxable

- a. Equipment used to construct well pads.
- b. Equipment used to construct ponds or other vessels for storage of fresh water, raw materials or in-process fluids.
- c. Property, including liners, used in constructing ponds for storage of water prior to its use in drilling.
- d. Property used in water transportation system that pumps water from a body of water to the water storage pond.
- e. Property used in construction, reconstruction, alteration, remodeling, servicing, repairing, maintenance or improvement of real estate even if the structure may house or otherwise contain equipment or other facilities used directly in mining.
- f. Erosion control property, such as silt fence, stakes, hay bales, is taxable if such property is not used to control, abate or prevent air, water or noise pollution generated in the mining operation.
- g. Pipe racks/pipe boats for pipe storage.
- h. Fuel storage unit.
- i. Sand or gravel storage unit.
- j. Tanks predominantly used to store raw materials prior to use in a mining operation.

- k. Mine management and administration.
 - i. Office furniture, supplies and equipment, textbooks and other educational materials, books and records and other property used in mining recordkeeping and other administrative and managerial work.
 - ii. Property, including but not limited to supplies used to record the quality and quantity of work in production or goods in storage, the flow of work, the results of inspection, or to instruct workers in routing work or other production activities.
 - iii. Property used to record the volume and pressure of gas coming from the wellhead.
 - iv. Communication devices used for managerial direction and supervision.

D. Transport

Machinery, equipment, parts and foundations therefor, and supplies used to transport or convey extracted product during production are directly-used in mining and therefore exempt.

1. Exempt

- a. Transportation devices and equipment such as gathering lines used to transport gas from the wellhead to the miner's compression or refinery operations up to the last physical change of the gas prior to its being sold and transferred by the miner to another.
- b. Pump and power for pump used to move the gas through a pipeline prior to the last change.
- c. Pipes and any foundation materials directly under the pipes, such as sand, stone or other similar materials.

2. Taxable

- a. Vehicles required to be registered under 72 Pa. C.S. §§ 101-9909 (the "Vehicle Code"), supplies, repair parts and repair services for the vehicles.
 - i. Truck chassis to which a drilling unit, frack unit, or service rig is affixed.
 - ii. Acid transport (a tractor trailer used to move raw or blended acid to well sites).
 - iii. Bulk truck (a truck that transport dry products to the batch mixer).
 - iv. Vehicles and trailers registered under the International Registration Plan ("IRP") as they are required to be registered under the Vehicle Code.
 - v. Cargo trailer such as an enclosed utility trailer that transports testing equipment.
 - vi. Chemical liquid additive tractor trailer that transports chemicals to be used at well sites. The unit maintains the temperature of the chemicals in transit.
 - vii. Chemical transfer tractor trailer used to transport the chemical liquid additive unit to well sites.

- viii. Mechanic service truck.
- ix. Crew bus.
- x. Data van (a van used to house remote control equipment).
- xi. Frack iron float (a tractor trailer that transports piping to the well site to connect the manifold and wellhead).
- xii. Hydration unit (a tractor trailer hydration unit that mixes and retains fluids on the surface for polymers to hydrate).
- xiii. Mobile food trailers.
- xiv. Pick-up trucks.
- xv. Sand conveyor (a trailer-mounted belt used at well site to transport sand from sand storage bins to the blender).
- xvi. Sand storage bins (a mobile trailer storage bin with multiple compartments that delivers sand to the sand belt or directly to the containers for sand).
- xvii. Sand transport (a tractor trailer used to transport sand from the bulk plant to the well site).
- xviii. Equipment used to build the pipelines such as bulldozers, front loaders, or road fabric, except for equipment used in reclamation.

E. Vehicles and Special Mobile Equipment (“SME”)

The mining exemption does not apply to any vehicles required to be registered under The Vehicle Code. Under the Vehicle Code, non-self-propelled SME are exempt from registration. Thus, such SME is eligible for the mining exemption if it is predominantly used directly in mining.

1. Exempt

- 1. Non-self-propelled equipment with an SME-plate issued by the Pennsylvania Department of Transportation (“PennDOT”) if used predominately and directly in gas mining.
- 2. Non-self-propelled equipment without a SME-plate only if it is:
 - i. Not designed for or used in transportation of property other than tools or parts for the equipment,
 - ii. Primarily for off-highway use and only operates incidentally on the highway, and
 - iii. Used predominantly and directly in gas mining.

NOTE: The burden of proof is on the person who claims that equipment is an SME not required to be registered under the Vehicle Code. This burden will be met if the person obtains a written PennDOT determination that the equipment qualifies as a non-self-propelled SME, *e.g.*, frack tank trailers.

2. Taxable

- 1. All self-propelled SME.
- 2. Mobile dormitories and offices.

F. Gas Storage

The definition of “mining” includes the extraction of natural resources from stockpile. As such, the withdrawal of gas from gas storage is considered an exempt mining activity. Consequently, equipment predominantly used directly in withdrawing natural gas from a storage facility is exempt. On the other hand, equipment used to inject gas into storage, storage equipment and facilities for finished product are taxable.

G. Distribution

Meters used to measure gas usage of the property owner are taxable unless used by a public utility.

H. Research

Property used directly in research activities with the objective of producing a new or improved product or method of producing a product is exempt whereas property used in market research or in other research that is conducted with the objective of improving administrative efficiency is taxable.

I. Services

1. Maintenance, repair and cleaning services on exempt property are exempt, as are repair or replacement parts for exempt machinery and equipment. Operational supplies such as fuel, lubricants, paint, etc. are exempt if actively and continuously used in the operation of exempt machinery and equipment.
2. Maintenance, repair and cleaning services on taxable property are taxable. Also taxable are repair or replacement parts for taxable machinery and equipment.
3. The purchase or rental of property used to perform maintenance, repair and cleaning services are taxable regardless of the taxability of the property on which the services are performed. Equipment and supplies used in general cleaning and maintenance of mining property such as soaps, cleaning compounds, brushes, brooms, mops and similar items are also taxable.
4. Services, other than cleaning services, which do not alter the property on which the service is performed, such as calibration, inspection or testing, are exempt.
5. The other enumerated taxable services in the statute, including lobbying, adjustment services, collection services, credit reporting services, secretarial or editing services, disinfecting or pest control services, building maintenance or cleaning services, employment agency or help supply services, lawn care services or self-storage services are taxable even if directly used in a mining activity.