STATE OF COLORADO

DEPARTMENT OF REVENUE

State Capitol Annex 1375 Sherman Street, Room 409 Denver, Colorado 80261 Phone (303) 866-3091 FAX (303) 866-2400



John W. Hickenlooper Governor

> Barbara J. Brohl Executive Director

GIL-13-027

November 13, 2013

Re: Drilling Equipment

Dear XXXXXXXXXXXX

You submitted on behalf of your client ("Company") a request for guidance to determine the applicability of Colorado sales and use tax on Company's specialized drilling equipment.

The Colorado Department of Revenue ("Department") issues general information letters and private letter rulings. A general information letter provides a general overview of the relevant tax issues and is not binding on the Department. A private letter ruling provides a specific determination for a specific set of facts, is binding on the Department but not on the taxpayer, and requires payment of a fee. For more information about general information letters and private letter rulings, please see Department regulation 24-35-103.5 at www.colorado.gov/revenue/tax > Tax Library > Rulings.

The Department initially treats your request as one of a general information letter. If you would like the Department to issue a private letter ruling on the issues you raise, you can resubmit a request and fee in compliance with regulation 24-35-103.5. It is important to remember that general information letters, such as this one, are general discussions of tax law and are not a determination of the tax consequence of any particular action or inaction.

Issue

Is Company liable for sales or use tax for fixtures built at drilling sites and for specialized drilling equipment?

Background

Company provides equipment and services necessary to drill and install conductor, rat, mouse and cellar holes at oil, gas, and geothermal well sites in order to facilitate well

production. More specifically, Company prepares the well site for occupation by a larger drilling rig and eventual production. These services include: transporting drilling tools and equipment to and from the well site, drilling of the conductor, rat, mouse, and cellar holes, providing and delivering pipe materials (steel casing and corrugated steel) to be installed within these holes to prevent cave-ins and create permanency, providing welding and cutting services to prepare the casing to specified lengths before installation, lowering and installing the casing into the drilled holes, providing and delivering cement to permanently affix the conductor, rat, mouse and cellar casings to the ground, providing and attaching (by welding) pressure caps and hole covers to the tops of the open holes to safely cover the casing, and providing skid steer services to move equipment while on location and to clean the location before departing the well site.

The preparatory work Company provides includes drilling several holes that are of a particular nature and purpose. The initial hole is called the cellar and is lined with corrugated pipe to prevent its collapse. The cellar captures drilling fluids and accommodates the blow-out process and the well head equipment which is used for production. In addition, Company also drills a conductor hole, which is drilled in the center of the cellar hole and is the guide hole used by the drilling rig to do its deeper drilling. The conductor hole is usually lined with heavy duty steel pipe which is lowered into the hole and lined with cement to prevent the hole from caving-in, conduct drilling mud from the bottom of the hole to the surface when drilling begins, and protect ground water from the drilling operations. Company may drill two other holes – the rat hole and the mouse hole. The rat hole is used to store the "Kelly" while the drill pipe is being hoisted out of the well hole, and the mouse hole is a similar hole used to store the next stem of drill pipe used during the drilling operation.

Company is incorporated outside of Colorado and uses specialized equipment purchased from a specialty manufacturer who is located outside of the state where Company is incorporated. Company uses a type of mobile drilling unit capable of moving between locations without breaking the equipment down and hauling the unit piece by piece. The drilling units are used in multiple states and locations as the work dictates. More specifically, a drilling unit may be purchased and used in a state for a single use and then moved to another state where more work is located. At times, a unit will be purchased to use in a particular state until the work load no longer requires its service and is then moved to another state where capacity is needed. Due to the mobile nature of the unit, it is rarely placed for permanent use in a single state.

Discussion

You ask for guidance regarding the applicability of sales and use taxes to structures built and used in oil and gas drilling. In addition, you ask about the tax treatment of machinery used in the company's operations. Our responses are presented in this order.

Colorado levies sales tax on retail sales of tangible personal property. A retail sale is defined as all sales except wholesale sales. A wholesale sale is a sale to a retailer for resale. In order to qualify as a wholesale sale, the purchaser cannot alter or use the property before resale. See, e.g., *Hirschfeld Press v. City and County of Denver*, 806 P2d 917 (Colo. 1991) ("We thus conclude that, for purposes of the Code, a purchase of an item of tangible personal property is a purchase for resale and therefore not a purchase at retail if the primary purpose of the transaction is the acquisition of the item for resale in an unaltered condition and basically unused by the purchaser.").

There are at least two transactions identified by you: Company's purchase of steel, cement, pipe, and other material from suppliers and Company's contract with drilling companies to build the structures constituting the cellar, rat, and mouse holes. Company's purchases from suppliers are not wholesale purchases because Company alters and uses the materials to build the structures. This is consistent with the holding in *Craftsman v. Carpenter*, 137 P.2d 414 (Colo. 1942), in which the Court held that a company that performed painting and electrical work on real property is the user and consumer of the paint, wiring, and other building materials used to perform under the contract, and, therefore, liable for sales or use tax.

With respect to the second transaction between Company and the drilling companies, the transaction is not subject to sales tax if Company uses a lump sum contract. The Department presumes that the true object of the transaction in such cases is the performance of services (construction) and that title and possession of the materials used to construct the structures pass to the drilling companies after the materials have become incorporated into the real property as fixtures.⁴ If the parties use a time and material contract, the Department assumes that the true object of the transaction is the sale of construction services and a separable sale of tangible personal property whose title or possession passes to the real property owner before the completed structure is incorporated into the real property as a fixture.⁵

The second issue raised in your request is how Colorado applies sales or use tax to drilling rigs when other states may also apply sales or use tax, either before or after Colorado levies its taxes. We assume that the sale and purchase of the equipment occurs outside Colorado, although it is not clear that this is the case in every instance. The rigs may have been used in other states before the equipment is used in Colorado. The machinery may be used in different state-administered local tax jurisdictions in Colorado. The machinery may also be moved from Colorado to another state.

Cf. Noble energy v. Department of Revenue, 232 P.3d 293 (Colo. 2010)

A sale generally takes place where either title or possession pass to the buyer.

¹ §39-26-104(1), C.R.S.

² §39-26-102(9), C.R.S.

³ §39-26-102(19), C.R.S.

See, generally, Department FYI Sales 6, Contractors and Retailer-Contractors – Definitions and Sales Tax Requirements.

Colorado levies sales and use tax on the sale or use of tangible personal property. Motor vehicles and special mobile machinery are tangible personal property. Special mobile machinery is defined to include drilling rigs. The owner of a motor vehicle or special mobile machinery used in Colorado must register the machinery in Colorado. Sales or use tax is paid on the motor vehicle and special mobile machinery at the time of registration with the county clerk where the motor vehicle or machinery is primarily used. The county clerk where the motor vehicle or machinery is primarily used.

If the sale occurs outside Colorado and Company pays sales or use tax to another state, and Company, thereafter, moves the machinery to Colorado for use in Colorado, then Company must pay Colorado state use tax and any state-administered local use tax applicable to the location where the machinery is registered. 11 Company is entitled to a credit against any such Colorado state and local use taxes equal to the amount of sales or use tax paid to the other state. 12 There is no credit for sales tax or value added taxes paid to a foreign country. 13 If, after Company registers the machinery in one Colorado location, Company then moves the machinery to another stateadministered local tax jurisdiction, Company will need to register the machinery in that new state-administered jurisdiction and pay any state-administered local use tax applicable to that new jurisdiction. Company is entitled to a credit against such new state-administered local use tax of an amount equal to the state (and any local sales tax applicable in the other state) sales tax paid to another state. For example, if the other state's combined (state and local) sales tax is 6% and the combined Colorado and state-administered local use taxes for the first drilling site is 5%, then no Colorado state or state-administered local use tax is due because the 6% credit exceeds the Colorado use tax rate. If the combined Colorado use tax rate at the second location is also 5%, then, again, no Colorado state or state-administered local use taxes are due. If, however, the combined state and local use tax rate at the second drilling location is 7%, then the company is liable for a 1% state-administered local use tax.1

Miscellaneous

This letter represents the good faith opinion of Department personnel who are knowledgeable on state taxes issues. However, the Department does not make a specific determination here on any of the issues raised and the Department is not bound by this general information letter.

^{§39-26-104(1),} C.R.S.

⁸ §42-1-102(93.5)(b), C.R.S.

⁹ §43-2-102(1)(b)(II), C.R.S. and §42-3-106, C.R.S.

¹⁰ §39-26-113(1), C.R.S.

See Department Form DR 1002, which can be viewed on the Department's website at www.colorado.gov/revenue/taxes > Forms > Sales Tax Forms.

See, 24-60-1301, Art. V, para. 1, C.R.S. (Credit applies only for sales taxes paid to another state, not use taxes paid to another state).

You state that the machinery is purchased from an international supplier. The supplier may have paid foreign taxes.

See, 24-60-1301, Art. V, para.1, C.R.S. (Credit first applied to state use tax and then to state subdivision use tax).

The Department administers state and state-administered local sales and use taxes. This letter does not address sales and use taxes administered by home-rule cities and home-rule counties. You may wish to consult with local governments which administer their own sales or use taxes about the applicability of those taxes. Visit our web site at www.colorado.gov/revenue/tax for more information about state and local sales taxes.

Enclosed is a redacted version of this letter. Pursuant to statute and regulation, this redacted letter will be made public within 60 days of the date of this letter. Please let me know in writing within that 60 day period whether you have any suggestions or concerns about this redacted letter.

Sincerely,

Neil L. Tillquist Colorado Department of Revenue

Tele: (303)866-5627

Email: neil.tillquist@state.co.us