COLORADO
Department of Revenue
Taxation Division
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PLR-16-002

March 8, 2016

XXXXXXXXXXXXXXXX
Attn: XXXXXXXXXXXXX
XXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXX

Re: Oil and Gas Well Cementing Products and Services

Dear XXXXXXXXXXXXXXX,

You submitted on behalf of XXXXXXXXXXXXXXXXXXXX ("Company") a request for a private letter ruling to the Colorado Department of Revenue ("Department") pursuant to Department Rule 24-35-103.5. This letter is the Department's private letter ruling. This ruling is binding on the Department to the extent set forth in Department Regulation 24-35-103.5. It cannot be relied upon by any taxpayer other than the taxpayer to whom the ruling is made.

Issues

1. Are the service and tangible personal property components of Company's contracts for cementing wellbores meaningfully separable such that Company must collect sales tax on the price charged for the tangible personal property and exclude the price for services?

2. If the service and tangible personal property components of Company's contracts for cementing wellbores are not meaningfully separable, is the "true object" of the contract the taxable sale of tangible personal property or the nontaxable performance of a service in which Company is the consumer of the tangible personal property and for which it must pay sales or use tax?

Conclusion

1. The separability of services and tangible personal property components of the contracts fall into two distinct sets of activities; 1) the manufacture and 2) the installation. With the manufacture, the services and tangible personal property are not meaningfully separable and, thus, tax is levied on all services and tangible personal property associated with the manufacture of the tangible personal property. With the installation, the installation services and the manufactured tangible personal property are meaningfully separable and, thus, tax is not levied on the installation services if separately stated.

2. The true object of the contract is the sale of the tangible personal property and tax is levied as discussed above. This situation differs from *Noble Energy* because in *Noble Energy*, the tangible personal property was considered incidental to the installation services. In this situation, the tangible personal property is not considered incidental to the installation services as the true object is the manufactured tangible personal property.

Background

Company provides an array of products and services to the oil and gas industry. Company's primary line of business in Colorado is oil and gas well cementing which helps to prevent the undesirable movement of fluids from one zone of the wellbore to another. Well cementing also helps prevent the loss of well production, protects the water supply, and prevents migration of gases and fluids.

Typically, after a wellbore is drilled and casing is inserted, a well service provider, such as Company, provides cement to hold the casing in place in order to stabilize and protect it within the wellbore. Well cement consists of raw Portland cement blended with water and assorted other solid and liquid additives that creates a "cement slurry." The design of the slurry varies based on each individual well, while taking into account well depth, pressure, and temperature. Each cement slurry solution is carefully engineered to meet specific well needs and comply with relevant regulatory requirements. When the final cement slurry specifications are determined, materials are blended at Company's facility. Company then deploys personnel and equipment with the materials to the well site in order to perform the job. Company's equipment is used to pump materials down-hole through the casing and ultimately into the space between the casing and wellbore, the "annulus." Once the cement sets, it bonds the casing to the wellbore.

All of Company's oil and gas well cementing contracts are negotiated to identify tangible personal property sales and services on a separate basis. Company's invoices show separate line item charges for materials, equipment, personnel, and other charges. The separate line item billing practice is standard in all of Company's proposals, work orders, and invoices to the customer. Currently, materials account for sixty to seventy percent of the total amount invoiced to customers. Company collects Colorado sales tax from its customers on materials and other charges directly related to the sale of materials, such as material transportation to the well site and material handling charges. Company does not collect sales tax on the portion of the transaction that constitutes the performance of services.

Discussion

Colorado levies sales tax on the retail sale of tangible personal property, but, with certain exceptions, does not generally tax services.[1] One such exception occurs when tangible personal property is manufactured or custom made to order. The statute requires that "sales tax is imposed on the full purchase price of articles sold after manufacture or after having been made to order and includes the full purchase price for the material used and the service performed in connection therewith."[2]

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[1] See generally, § 39-26-104, C.R.S.

[2] § 39-26-102(12), C.R.S.

The cement slurry placed into the wellbore is tangible personal property made to order. All services performed "in connection" with the cement slurry are taxable. It is our understanding that the cement slurry must be continuously agitated in order to prevent hardening before delivery and customers have no option but to use Company's delivery service to obtain the cement slurry. Therefore, the delivery of the cement slurry differs from other delivery services in that it is a continuation of the manufacturing process of the cement slurry. In addition, any analysis service in which Company analyzes the well to determine the depth, pressure, temperature, or any other analysis that directly influences the cement slurry mixture are performed "in connection" with the creation of the cement slurry. Thus, any charges for delivery[3] or analysis are part of the labor performed "in connection" with the creation of the cement slurry and are included in the taxable base.

However, not all services are included in the tax base as a result of the application of section 39-26-102(12), C.R.S. - only those labor costs that are performed "in connection" with the creation of the cement slurry are included. For example, installation of the cement slurry is not included in the tax base because the service is not performed "in connection" with the manufacture of the cement slurry. The cement slurry is already manufactured when it is being installed.[4]

Mixed Transaction and the True Object Test
We next turn to the separability test and true object test in light of *Noble Energy, Inc. v. Colorado Department of Revenue* 232 P.3d 293, 04/15/2010.

There is no question that cement is tangible personal property. However, the installation of the cement slurry is a mixed transaction involving the sale of property and services which raises the question of whether the price for these can be meaningfully separated. Second, the placement of the cement into the ground raises the question of whether the price for the cement is for tangible personal property or real property.

A transaction that involves both the delivery of a service and the sale of tangible personal property may require us to examine whether the service and the tangible personal property can be meaningfully separated.[5] When a mixed transaction cannot be meaningfully separated into tangible and other-than-tangible components, its taxable nature must be determined according to the transaction's "true object."[6]

In reviewing both the separability test and the requirements of section 39-26-102(12), C.R.S., we conclude that the separability test is only applied after the manufacture of the tangible personal property is complete because the nature and structure of section 39-26-102(12) determines that services performed in connection with the manufacture of the cement slurry are not meaningfully separable. In this case, many of the services that are

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[3] This is consistent with Department Regulation 1 CCR 201-5: SR 37 (Ready–mix concrete is taxable on the delivery price. This includes minimum load and transportation charges. Standby charges applied after arrival at the destination are not taxable if separately stated on the customer's invoice.)

[4] See discussion below as to whether installation services are separable from the cement slurry.

[5] In *A.D. Store Co. v. Exec. Dir. of Dep't of Revenue*, 19 P.3d 680, 684 (Colo.2001). The Colorado Supreme Court adopted the following test to determine the taxable nature of the transaction: "The test inquires whether the services and product are separable. If they are separable, then the service is not taxable."

[6] See *City of Boulder v. Leanin' Tree, Inc.*, 72 P.3d 361, 363 (Colo.2003).

described in the request occur prior to and "in connection" with the manufacture of the cement slurry. For example, Company might analyze a particular well to determine its depth, pressure, and temperature. If this is done pursuant to a stand-alone contract, the service is not subject to tax. By contrast, if this is done in connection with a contract to make cement slurry "to order", section 39-26-102(12) necessitates that the "service" is not meaningfully separable and is subject to tax as part of the manufacture of tangible personal property. The fact that this service may be separable is of no consequence to its taxability because of the operation of section 39-26-102(12), C.R.S.

The service of installation, however, is subsequent to the manufacture of the cement slurry. We conclude that the installation is meaningfully separable.[7]

Having determined that the analysis and delivery services are not meaningfully separable, we now turn to the true object test. In *Leanin' Tree,* the Colorado Supreme Court identified several factors relevant to determining the "true object" of a mixed transaction: (1) the value of the tangible property compared to that of the service; (2) whether there was an alternative method of transfer; (3) the length of time the intangible property provided retains its value; (4) constraints on the buyer's ability to use the tangible property; (5) what is actually done with the tangible property after it has yielded its intangible component; (6) whether the tangible property represents the finished product sought by the buyer; and (7) the skill and expertise used to create the tangible property.[8]

To the extent these factors can be applied to a well cementing job, we note that the value of the tangible personal property used to create the cement slurry accounts for sixty to seventy-five percent of the cost of the entire contract compared to the value of the service component.[9] When, as here, the price for the property portion of a mixed transaction makes up more than fifty percent of the total price, it cannot be merely "incidental" to the transaction. The installation service does not retain its value after completion, and the customer could, if it desired, purchase the cement slurry from one company and hire another company to install the cement slurry. But more importantly, the cemented well casing is the "purpose" or the "object" sought by the customer; the delivery and installation are simply the means to the end product. The cemented wellbore represents the finished product sought by the customer because the customer wants to prevent undesirable movement of fluids within the wellbore and to stabilize the wellbore. The final product has value to the customer only after the materials and services together have been provided. While the manufacture and installation of the cement slurry involve some level of expertise, we think, on balance, that the predominant factor in this case is the buyer's desire to acquire a cemented well casing. Lastly, unlike in *Leanin' Tree* where *Leanin' Tree* retained no tangible personal property from the transactions because no tangible personal property had been purchased,[10] the customers in this transaction do keep and

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[7] The focus of the analysis is the cement slurry rather than the completed well casing because the well casing is a fixture that is or becomes real property. The cement slurry is the last phase in which the product remains tangible personal property and subject to taxation.

[8] *City of Boulder v. Leanin' Tree, Inc.*, 72 P.3d at 365-66 (Colo. 2003).

[9] We assume that this percentage was calculated using only the costs of the materials in the cement slurry. However, any services performed "in connection" with the manufacture of the cement slurry should be included in the value of the slurry and compared to the value of the services performed not "in connection" with the manufacture of the cement slurry. Presumably this would make the percentage even higher.

[10] Id. at 366-367.

purchase tangible personal property in the form of the cement slurry which becomes the final cemented wellbore.[11]

Taking all of these factors into consideration, the "true object" of the customer is the cemented wellbore and not the installation service. As such, this case is dissimilar to *Noble Energy, Inc. v. Colorado Department of Revenue,* 232 P.3d 293, 04/15/2010. In *Noble Energy*, the Colorado Court of Appeals considered whether a contract for fracking was a sale of tangible personal property or a service. Fracking is the process of injecting water, chemicals, and sand into a well at high temperatures to fracture and maintain factures in the rock formation. The Court concluded that the acquisition of the water, chemicals, and sand were not the true object of the transaction but rather the means by which rock formations are fractured, and that the process of fracturing is a service. This strikes us as markedly different from a contract to construct a cemented wellbore. The customer seeks a cemented wellbore to prevent movement of fluids within the wellbore. The process of installation is simply the incidental means to that end. This is in stark contrast to *Noble Energy* where the Court emphasized the fact that fracturing is a service because the tangible personal property used in the service is disposed of and is not retained by the customer. In the case before us, the cemented wellbore is not disposed of, but remains in place.[12]

Cemented Well Casing a Fixture

The Court's principal conclusion in *Noble Energy* was that the "true object" of the transaction was the sale of a service and not the sale of tangible property. Having resolved the case, the Court went on to discuss whether the sale of sand was the sale of tangible or real property and concluded that the sale was of real property because the sand was incorporated into real property and cited *Raynor Door, Inc. v. Charnes*, 765 P.2d 650, 650 (Colo.App.1988) as precedent. Although the Court concluded that sand in this case is real property and not tangible personal property, it made clear that its conclusion was limited to the facts before it. It noted "...the sand, *as it is used in the transactions at issue here*, is excluded from the definition of 'tangible personal property'."[13] We acknowledge that the sand, and the cement casing, become real property once affixed to the realty. We do not read the Court's conclusion to suggest that the sand, or the cement slurry in this case, are real property before the product becomes affixed. In this case, the tangible personal property is transferred at the moment before it becomes affixed to the realty. At that moment, it is still tangible personal property and subject to taxation.

The treatment of tangible personal property that is incorporated into real property is a difficult area of taxation. We think the better approach is to treat the transfer of tangible personal property as the sale of tangible personal property. Whether it is later installed into real property (by either the owner or seller) should be of no consequence as to the taxability of the sale.

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[11] It is irrelevant that the tangible personal property becomes real property for purposes of the true object test. The customer wants the property, regardless of its character as real or tangible personal property.

[12] Although the customer retained the sand, the Court concluded that the sand was incidental to the service being performed.

[13] *Noble Energy, Inc. v. Colorado Department of Revenue*, 232 P.3d 300, 04/15/2010. (*emphasis added*)

The analysis in *BJ-Titan Services v. State Tax Commission,* 842 P.2d 822 (Utah, 1992) is the proper analysis of the circumstance described in this request. In *BJ Titan*, the Utah Supreme Court ruled that well cementing is the sale of tangible personal property and not the sale of real property.

> The different treatment applied to real property contractors is based on the proposition that building materials lose their identity as such when they become part of a building or facility. In other words, they are converted from tangible personal property into real property. The issue is not, as BJ-Titan urges, which party to the transaction converted the cement into real property, but rather, who is the ultimate user or consumer of the cement. Because the essence of the transaction between BJ-Titan and a well operator is tangible personal property, BJ-Titan purchased the raw materials used in producing its cement not for consumption, but for resale, and the labor expended in producing the final product merely increased the sales value of that product. The ultimate consumer is the well operator. In this respect, BJ-Titan is like a concrete mixing company hired to arrive at a site and pour concrete into a hole dug by and between forms erected by the general contractor, who is the consumer of the cement. The contractor purchases delivered and poured concrete and leaves the formulation of the blend of ingredients to the concrete provider, as conditions require. The labor expended in producing and pouring the concrete and the cost of delivery are all included in the price.[14]

Therefore, the Department concludes that the cement slurry and services, such as the delivery or analysis, that are performed in connection with the manufacture of the cement slurry are included in the purchase price of the cement slurry and subject to tax. Services that occur subsequent to the delivery of the cement slurry are exempt from the purchase price if separately stated and are not subject to tax.

Miscellaneous

This ruling is premised on the assumption that Company has completely and accurately disclosed all material facts. The Department reserves the right, among others, to independently evaluate Company's representations. This ruling is null and void if any such representation is incorrect and has a material bearing on the conclusions reached in this ruling. This ruling is subject to modification or revocation in accordance to Department Regulation 24-35-103.5.

This ruling is binding on the Department to the extent set forth in Department Regulation 24-35-103.5. It cannot be relied upon by any taxpayer other than the taxpayer to whom the ruling is made.

This ruling applies only to sales and use taxes administered by the Department. Please note that the Department administers state and state-collected city and county sales taxes and special district sales and use taxes, but does not administer sales and use taxes for self-collected home rule cities and 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/tax for more information about state

[14] *BJ-Titan Services v. State Tax Commission,* 842 P.2d 829 (Utah, 1992).

and local sales taxes.

Enclosed is a redacted version of this ruling. Pursuant to statute and regulation, this redacted version of the ruling 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 version of the ruling.

Sincerely,

Neil L. Tillquist
Colorado Department of Revenue
Office of Tax Policy Analysis

This ruling cannot be relied upon by any other taxpayer other than the taxpayer to whom the ruling is made.