



Latitude & Longitude Technology Solution for the Oil Field Tax Situs Challenge

A tax automation breakthrough addresses unique tax compliance challenges within upstream, midstream, and downstream segments



Because generating value in the oil and gas industry depends on pinpointing the location of precious natural resources in vast expanses, tax professionals must continually find their bearings amid a sea of complex rules, definitions, determinations, tax categories, overlapping jurisdictions (including home-rule cities and counties), and fluctuating legal interpretations and precedents. Tax professionals must clear these hurdles while also contending with resource limitations and, in many instances, data management challenges associated with legacy technology systems. Plus, these complications continually evolve and vary depending on which industry segment – upstream, midstream, downstream – a company occupies.

A recent innovation in tax automation can help tax teams thrive in their ongoing showdown against complexity, while also bolstering tax compliance. This type of streamlining results in process and efficiency improvements, and financial benefits via tax minimization, tax recovery, and cashflow enhancements.

Overcoming complexity is a tall task. Consider the difficulty tax professionals in the upstream or midstream segment face when determining the tax rates on purchases related to a pipeline project stretching across three counties and just as many, if not more, tax jurisdictions.

“You need to calculate sales tax and/or assess use tax based on where and how those transactions are sourced,” explains DMA Managing Director Nicole Stephens, who notes that the supporting tax automation needs to be able to accurately determine which portions of certain purchases are subject to which local tax jurisdictions’ rules and rates. Determining which jurisdictions possess the legal authority to tax a transaction (situs) is often complicated by the lack of traditional addresses attached to rural pipeline sites. “Rather than having a standard address, locations tend to take the form of: Take Exit 85 off I-35, turn left on County Road 12 for 15 miles and then turn southwest onto the next gravel road, and there you are. That’s one reason why many upstream and midstream companies can benefit from tax automation that accepts the latitude and longitude coordinates for a specific site.”

The previous example is just one of several common yet uniquely complex tax compliance scenarios that tax professionals within various oil & gas industry segments need to address. One of the most effective tools for mitigating this complexity is a tax engine containing sales and use tax content, along with supporting functionality, tailored to address the unique determination challenges in each of the three oil & gas industry segments.



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Managing Director, DMA



Commonly Complex Scenarios

It is important to recognize that each of the following oil & gas segments poses complex and novel tax determination and compliance scenarios:

- **The upstream segment**, which includes companies involved in the exploration, drilling, and extraction of crude oil and natural gas;
- **The midstream segment**, which includes companies that process, store, transport, and market oil, natural gas, and natural gas liquids (including ethane, propane, and butane); and
- **The downstream segment**, which includes companies that convert crude oil into finished products (e.g., gasoline, diesel, lubricants, plastics, detergents, fertilizers) and perform related marketing.

While there are numerous unique tax determination challenges within each segment, some of the most common issues include accurately categorizing rental services (depending on operator vs. supervisor determinations), treatments of compressor station equipment, and accurately determining field locations where products and services are purchased for use (“situs” in tax jargon).

Rental with Operator vs. Rental with Supervisor

Most states consider rental with mandatory operator to be a professional service, which renders the purchase exempt from sales tax. That said, the seller of the equipment may incur a use tax liability, depending on several factors. “It really comes down to how a state defines ‘operator,’” reports DMA Vice President James Edington, “and how a taxpayer proves it conformed to that definition under audit.” Invoice language is crucial, and often the first piece of information tax professionals use in these determinations. In addition, contract language qualifies as important evidence in many states. “There should also be a common understanding between the vendor and the customer as to what ‘rental with operator’ means,” Edington notes. “You can have a rental with operator situation, but unless the invoice or contract language specifies that, it can be extremely difficult to prove to an auditor that a transaction was not taxable.”

On the other hand, rental with mandatory supervisor is considered by most states to be a bare rental with an accompanying labor service (e.g., a service technician). As such, the sale is typically taxable in most states, while allowing the equipment purchased by the seller to be tax-exempt. Additionally, many states define mandatory supervisor and operator differently. For example, North Dakota's definition of an operator is someone who does more than set up, inspect, or maintain equipment. As such, Edington emphasizes that it is essential to determine if use tax is due up front. If that determination is not made early, hefty use tax audit assessments, along with penalties and interest, can be rendered on the seller of the equipment.

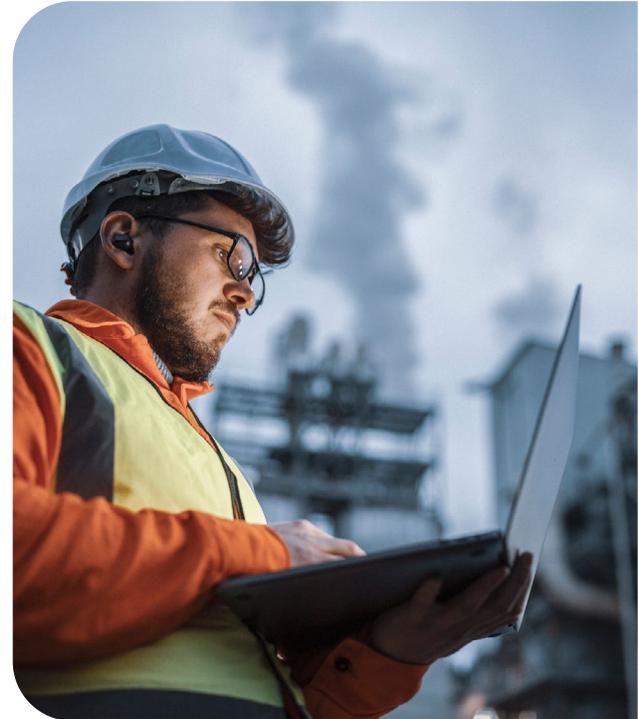
"You can argue that a lot of supervisors are operators," he continues. "However, North Dakota and other states can be challenging to work with in that regard, and they've assessed large liabilities along with penalties and interest to many oil & gas companies."

Compressor Station Equipment

Many states treat equipment used in the gathering process as taxable, given that it is not considered manufacturing equipment, notes DMA Vice President Lissa McFarlin. The determination depends on which equipment is being used, and how jurisdictions treat each piece of compressor station equipment from a tax perspective.

McFarlin points out that it is especially important to distinguish among the various pieces of equipment used in the gathering system in Texas, which deems slug catchers, dehydrators, separators, scrubbers, and heater treaters as tax-exempt. On the other hand, the Lone Star State treats condensers, glycol contactors, other glycol regeneration equipment, and flare/vapor recovery unit/pollution control equipment as taxable.

In recent years, the Texas Comptroller has taken the position that compressors in a gathering system are taxable because they are performing a transportation function. While the state has provided settlements in recognition of prior policy, it remains unknown how long those settlements will continue, as a related legal proceeding is progressing toward District Court. While that issue is specific to Texas, it illustrates the importance of accurately collecting and storing all relevant transaction and tax data.



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Location Challenges

As Stephens points out, it is an imperative that tax professionals make accurate situs determinations, an activity routinely complicated because many plant sites and production locations elude classification by a standard mailing address.

This gap may result in upstream and midstream companies paying unnecessary taxes over long periods of time. Without the ability to provide precise location data, it can be very challenging to get tax refund claims approved.

“Getting that money back requires significant effort, especially if you’re dealing with a home-rule city,” Edington notes. “Yet, a company never has to wage that battle when the tax department has the ability to pin down the exact location of the transaction and jurisdiction by leveraging a latitude and longitude data cleansing technology.”

A Tailored Tax Engine

The premise of the tax automation mentioned earlier is straightforward: different segments of the global oil & gas industry confront different tax determination and compliance issues, and therefore require tax content, within supporting automation solutions, that is tailored to address these unique challenges.

Tax professionals grappling with the operator vs. supervisor determination in rental equipment transactions need tax automation content that helps them make this distinction accurately. From a technology standpoint, that requires a tax engine to perform several discrete and related steps, including but not limited to:

- Accepting a description of the line-item transaction;
- Providing a tax assist rule to find key words in that description to set indicators and then map the transaction to the appropriate taxability category;
- Providing a descriptive master data element (ex. material group/item category) that distinguishes between a rental equipment transaction with an operator vs. without an operator;
- Passing the value into a purchase class field and map it to a taxability category.

Other steps are often involved, including actions required to map generic equipment rental materials to appropriate tax categories. “There are multiple ways to configure ERP systems and tax engines to handle difficult tax determination scenarios,” Stephens notes. “The most important thing to keep in mind when setting up an ERP system and a tax engine is that granular master data and data captured from vendor invoices is critical to driving accurate tax calculations.”

When it comes to equipment rentals, the tax engine should determine if the operator is included with the equipment rental instead of merely inspecting the equipment (a critical distinction in North Dakota, for example). A tax engine, via its integration with the ERP system and related accounting and purchasing applications, should be able to leverage any data captured by those systems from the invoice and/or contract to make these types of jurisdiction-specific and segment-specific distinctions.

A tax engine should also provide segment-specific content and capabilities to oil & gas companies that need to nail down situs. This means the technology should be able to accept and process latitude and longitude coordinates and use that data to accurately identify relevant jurisdictions even if projects are located in multiple counties and taxing jurisdictions. In these situations, Edington notes, the tax engine should support the creation of allocation tables to apply each jurisdiction’s tax rules after accessing all of the project’s relevant details from the ERP system.

Conclusion

A Tax Automation Test

The right automation tool will empower tax professionals in the oil & gas industry to proactively manage the tax determination complexities inherent in their operations. To make that technology determination, Katherine Moore, Vertex Global Account Executive for Oil & Gas, suggests that tax leaders should ask whether their existing tax automation:

- Provides differentiated content tailored to address the unique sales and use tax determination challenges of the upstream, midstream, and downstream segments of the oil & gas industry;
- Leverages location (latitude and longitude) coordinates to generate an accurate tax area identification;
- Integrates with ERP and other finance and accounting applications to pull and process all transaction-level data needed to make the correct tax determination and calculation;
- Enables and supports leading practices and process improvements in the tax department.

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