REDACTED DECISION – DOCKET NUMBERS 15-040 CU, 15-041 CU, CONS # 15-0006

BY: A.M. "FENWAY" POLLACK, CHIEF ADMINISTRATIVE LAW JUDGE
SUBMITTED FOR DECISION ON OCTOBER 17, 2016
ISSUED ON APRIL 3, 2018

BEFORE THE WEST VIRGINIA OFFICE OF TAX APPEALS

FINAL DECISION

On December 19, 2014, the Auditing Division of the West Virginia State Tax Commissioner's Office (Tax Commissioner or Respondent) issued two Notices of Assessment, one against Petitioner for Company A and another Company B.[1] These assessments were issued pursuant to the authority of the State Tax Commissioner, granted to him by the provisions of Chapter 11, Article 10 *et seq*, of the West Virginia Code. The assessment against Company A was for combined sales and use tax for the period January 1, 2011, through December 31, 2013, for tax in the amount of $_____ and interest in the amount of $_____ for a total assessed liability of $_____. The assessment against Company B was for combined sales and use tax for the period, January 1, 2011, through December 31, 2013, for tax in the amount of $_____ and interest in the amount of $_____, for a total assessed liability of $_____. Thereafter, February 11, 2015, the Petitioners timely filed with this Tribunal, two petitions for reassessment, one for Company A and one for Company B. An evidentiary hearing was held in this matter on May 5, 2016, at the conclusion of which, the parties filed legal briefs.[2] The matter became ripe for a decision at the conclusion of the briefing schedule.

[1] Between the issuance of the assessments in this matter and the evidentiary hearing, Company B was merged with Company A. This Tribunal consolidated the two matters by an Order entered on May 18, 2015.
[2] The evidentiary hearing in this matter was conducted by Chief Administrative Law Judge Heather Harlan. Since the date of the hearing, Judge Harlan has resigned her position, and this decision was written by Chief Administrative Law Judge A.M. "Fenway" Pollack.

FINDINGS OF FACT

1. The Petitioner is a C corporation with its corporate offices in another State. TR P9 at 17-18.
2. The Petitioner's business consists of what it characterizes as "drilling for minerals". It conducts these drilling operations in numerous states, including West Virginia.
3. A typical drilling site of Petitioner's will consist of the "drilling rig" and various pieces of supporting equipment. Included among this equipment are machines to generate electricity, provide potable water, provide sanitation, and treat sewage. A typical site also contains what Petitioner calls "skid houses", or crew quarters, which are modular buildings to provide temporary housing and office space.
4. In a typical drilling operation of Petitioner's, it will not own any of the equipment on site, but rather will rent it all. TR P27 at 6-22.
5. The actual drilling takes place on what Petitioner calls a "pad". A pad can contain anywhere from two (2) to eight (8) wells (a well being the actual hole drilled into the ground) TR P11 at 6-7. These wells can be as close as ten feet apart. TR P18 at 8.
6. Petitioner's Exhibit 19 is a photograph of a typical drilling site operated by Petitioner.
7. A typical well pad will have thirty (30) to forty (40) people working at any one time. TR P19 at 5-6. Virtually all of those people will be employed by the company from which Petitioner rents the drilling rig. TR P33 at 3-5. The drilling rig rental company will have a person in charge at the pad site, and that person's job title is "tool pusher". TR P34-35 at 18-5.
8. The Petitioner will typically have one person on the pad site who is their direct representative, and their job title is "company man". TR P20 at 6-12. However, even the

company man is a subcontracted employee of a specialized consulting firm, and is not employed by Petitioner. TR P50 at 1-5.

9. Due to the close proximity between the well holes, it is imperative to Petitioner that each well travel in a straight line, to ensure that the drill bit does not stray and break a pipe in a nearby well hole. TR P37 at 1-6. To that end, Petitioner subcontracts with specialists called "directional drillers", whose main job function is to prevent that scenario from happening.
10. There are two directional drillers on the well pad at all times. Typically, each works a twelve (12) hour shift while the other is off. However, at certain times, both directional drillers have to independently, but contemporaneously, program coordinates into a computer regarding the current and future location of the drill bit. At those times, the directional driller who is "off duty" will be summoned, even if he or she is asleep, to perform this function. TR P35-37, P48 at 11-22. Both the company man and the tool pusher are also required to participate in the drill bit location programming. TR P37 at 4-12.
11. The company man works on the well pad site for twelve hours and then is housed in a hotel when he or she is not at the well site. TR P47 at 14-19.
12. The tool pusher is on the well pad 24 hours a day, 7 days a week, for 2 weeks at a time. TR P50 at 6-17. When he or she is not working they stay in a trailer that is part of the drilling rig rental package. TR P35 at 1-5.
13. The Petitioner is contractually bound to provide housing on the well pad for the directional drillers. TR P38 at 11-15.
14. During the audit in this matter the auditor found some of the rentals utilized by Petitioner to be subject to use tax, some to be partially subject to use tax and some to be exempt from

use tax. All of these calculations were based upon whether the rented items were directly or indirectly used in the mineral extraction process.

15. Specifically, the auditor found that a percentage of the skid house/crew quarters were directly used in extraction, because a portion of them had "office space" that housed the computers that controlled the drilling. Conversely, the auditor found that the parts of the quarters that were used for "living" ie; the bedrooms, restrooms, kitchen and living area were subject to use taxes. TR P61 at 8-11.
16. The auditor also found that a portion of the equipment that supports the crew quarters, equipment such as generators was subject to use tax, because a percentage of those rentals was used to support the living quarters. TR P72 at 6-8.
17. The auditor found certain rentals to be entirely subject to use tax, those items being porta-potties, all equipment for portable sewage/sanitation systems, and all trash/waste dumpsters/bins.

DISCUSSION

The dispute in this matter centers on whether certain items rented by Petitioner are directly or indirectly used in its drilling operations.

Generally, if a business in West Virginia were to buy a case of glass cleaner from ABC Cleaning Supplies in Anytown, U.S.A., one of two things would happen. Either ABC would charge the business West Virginia sales tax or the business would later remit use tax to the Tax Commissioner pursuant to West Virginia Code Section 11-15A-2, which states:

> An excise tax is hereby levied and imposed on the use in this state of tangible personal property, custom software or taxable services, to be collected and paid as provided in this article or article fifteen-b of this chapter, at the rate of six percent of the purchase price of

> the property or taxable services, except as otherwise provided in this article.

W. Va. Code Ann. §11-15A-2(a) (West 2010). However, there are exemptions from the use tax, and one of those exemptions is if the property or service is exempt from sales tax, pursuant to Article 15 of Chapter 11. *See* W. Va. Code Ann. § 11-15A-3 (West 2013). Section 9 of Article 15, Chapter 11 contains the sales tax exemptions and subsection (b)(2) of Section 9 provides an exemption for:

> The following sales of tangible personal property and services are exempt from tax as provided in this subsection: . . . (2) Sales of services, machinery, supplies and materials directly used or consumed in the activities of manufacturing, transportation, transmission, communication, production of natural resources, gas storage, generation or production or selling electric power, provision of a public utility service or the operation of a utility service or the operation of a utility business, in the businesses or organizations named in this subdivision and does not apply to purchases of gasoline or special fuel;

W. Va. Code Ann. § 11-15-9(b)(2) (West 2018)

Additional guidance regarding what the phrase "directly used" means is contained in West Virginia Code Section 11-15-2 which states:

> "Directly used or consumed" in the activities of manufacturing, transportation, transmission, communication or the production of natural resources means used or consumed in those activities or operations which constitute an integral and essential part of the activities, as contrasted with and distinguished from those activities or operations which are simply incidental, convenient or remote to the activities.

W. Va. Code Ann. §11-15-2(b)(4) (West 2018).[3]

[3] We find the remainder of subdivision 4 to be somewhat confusing. Paragraph A of Subdivision 4 offers a list of fourteen (14) uses of property or services that purports to be the entire list of uses that are direct. "(A) Uses of property or consumption of services which constitute direct use or consumption in the activities of manufacturing, transportation, transmission, communication or the production of natural resources include **only**: . . . ." *Id* at (b)(4)(A) (emphasis added). Interestingly, subparagraph xiv of paragraph A then has a catchall that mirrors the same language as subdivision 4. "Otherwise using as an integral and essential part of transportation, communication, transmission,

Based upon the language in both subdivision 4 and subparagraph xiv, we find the question to be answered in this case to be: were the items rented by Petitioner "integral and essential" or "incidental, convenient or remote", as those terms are used in Section 2(b)(4), to the drilling operations. Neither party argues that any of the statutory provisions at issue are ambiguous. Petitioner argues that we must give the terms "integral and essential" and "incidental, convenient or remote" their plain and ordinary meaning and we are in agreement.

The rentals at issue in this matter are:

1. The skid houses/crew quarters.
2. Generators, transformers, and related water and electrical equipment and connectors to service the skid houses/crew quarters.
3. Porta-a-Potties.
4. Portable water and sewage systems, including specialized boxes to protect the same from the elements.
5. Trash trailers and bins.

We will address each category of rental in turn, starting with the skid houses because they, and much of the equipment supporting them, form the bulk of the assessment at issue.

We should state at the outset that the record in this case regarding the skid houses and the various personnel on the well pad site is a bit muddled. Petitioner presented exhibits and testimony regarding three groups of employees, "company men", "tool pushers" and "directional drillers". A close reading of the testimony shows that the skid houses are at the well site for only one of these groups, the directional drillers. The company men stay in a hotel when they are not on site. The tool pushers stay in housing that is part of the daily rental package that includes the drilling rig itself and virtually all of the equipment on the pad site. It is the directional drillers who stay in the skid houses and they, (the skid houses) are there because Petitioner is contractually bound to provide them.

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manufacturing production or production of natural resources." *Id* at (b)(4)(A)(xiv). As such, subparagraph xiv seems to render the specificity in the subparagraphs above it moot.

> **ATTORNEY GRIFFITH**: And you mentioned that they're there 24/7. Do they use Petitioner-rented crew quarters or ---?
>
> **MR. A**: We do rent crew quarters for them. As part of their bill is they ---. Basically, we have a day rate, and then we're required to provide them crew quarters for their people to be at.

See Transcript P38 at 11-15. Petitioner's witness testified that two directional drillers are on site at all times. Their primary job seems to be to ensure that everyone knows where the drill bit is, and more importantly, where it is going. As testified to, in a situation with up to eight wells on a pad, each separated by only ten feet, it is obviously critical to make sure that the drill bit does not stray into a nearby already dug well hole. Therefore, while only one directional driller is "working" at any given time, the other directional driller needs to be constantly available for consultation and concurrence regarding computer programing of where the drill bit may be going next. To underscore the importance of these calculations, both the company man and the tool pusher are also involved in this computer programing.

> **MR. A.** But we have this halo of safety that says --- if we think we know where our bit is, and we have a ten-percent margin of error to where we think it is, then that means the bit could be anywhere in this circle.
>
> And so, what happens is that if anytime this circle, which is an imaginary circle around where we really think it is, is within X number of feet --- comes within X number of feet or our existing wellbore or another wellbore, everything stops, because you never want that thing to hit. So what we have to do is they have to go get the other directional driller and the company man and the tool pusher. The tool pusher's invested because his people are going to die if they screw up.
>
> And they all have to get together and they have to independently ---. Because they all decide, okay, which way do we go, if we go the wrong way, we hit a well, if we go ---. And so everybody has to agree on the orientation that the motor has to go, and they have to put in the codes that make it go that way, and the two directional drillers have to enter that independently of each

> other to make sure that it got in there right; right? You do not want a mistake at that point.
>
> And so the directional driller will go get the guy that's asleep. It doesn't matter what time of day or night it is. Go get the guy that's asleep. And they have to go independently. Everybody has to sign off. The company man, the tool pusher and both directional drillers have to sign off on that orientation of where that mud motor's going to go and how it's going to direct the rig.
>
> And they basically do that through the whole drilling process. They're onsite 7 by 24, 365 days, as long as that drilling process is going on, because you also have --- you don't want to wander onto the other guy's minerals.

See Transcript P35-37. For his part, the Tax Commissioner's auditor testified that while she understood the necessity of the directional drillers being on site at all times, nonetheless, a portion of the skid houses were not essential because those portions, (those for sleeping and eating, etc.) were not used directly in the drilling process.

> **ATTORNEY GRIFFITH**: And so if they're essential employees and best industry practice is to keep them onsite for two weeks on and two weeks off, why would that living space not be considered directly used in the production process?
>
> **MS. B**: Well, we would have considered that it wasn't a direct part of the drilling process, that it was --- you know, that the additional space was used for other things like sleeping, eating, breaks, things along that line that we wouldn't consider --- even though they were required to be there, we didn't consider that to be directly involved in the drilling process.

See Transcript P73 at 7-14.

While the auditor testified that her considerations and analysis involved what was "directly" used in the natural gas extraction, she makes no mention of the more nuanced part of the question before us, to wit, are the skid houses an integral and essential part of the drilling, or merely incidental, convenient or remote? To be fair, we believe that the Tax Commissioner's argument can be fairly characterized as standing for the proposition that the sleeping quarters, kitchen, living room and bathrooms are not necessary to drill for natural gas. Rather, they are there

to make life cushier for the workers; a warm place to hang out and watch TV or get a snack when time allows. In other words, they are there for the convenience of the workers. We believe that the evidence in this matter does not bear this out. The record is clear and unrebutted that every minute of every day while there is drilling going on, there is a directional driller who, while not technically "on the clock", is required to be there. Petitioner has, as part of contracting for these directional drillers services, agreed to provide housing for them during these periods of required availability. Obviously, Petitioner thinks having two directional drillers on site at all times is essential, otherwise they would not be spending the money required to make that happen. We agree with the Tax Commissioner, to the extent that if we were talking about a typical factory or manufacturing facility that had a killer break room with a cappuccino machine, foosball table and comfy sofas, our conclusion would be different. However, the situation before us is quite different. In fact, Petitioner's witness testified as to the spartan nature of the skid houses.

> **MR. A.** And what these are, these are offices for the most part, sleeping quarters for some part for some of these people. But the reason that they're on there full-time in these areas ---. Even your worst hotel is --- this is worse than your worst hotel. This is a very loud operation. This is not a hotel setup. It's a singlewide trailer that has sleeping quarters, a small kitchenette and an office space in it, and they're there for safety reasons.

See Transcript P17 at 1-5. As a result, we rule that the rental of skid houses/crew quarters by Petitioner is critical and essential to its production of natural resources. To be clear, we rule as such because the evidence shows that the directional drillers are on site for safety reasons. We do not mean to quantify what is too cushy versus what would be spartan enough to not be considered for convenience. That is an argument for another day.

Our ruling involving the skid houses implicates other portions of the assessment, because the auditor found that the rental of certain other services associated with the skid houses also needed to be apportioned, to the extent that a portion of these services went to support the living

areas of the skid houses, versus the small portion the auditor found to be utilized for drilling. These rentals are for the items to provide water and electricity to the skid houses, such as generators, transformers, and water hook up hardware. For the reasons stated above, we rule that these items are also critical and essential to Petitioner's drilling operations.

Next is Petitioner's rental of various sized trash receptacles, which the auditor found to be entirely taxable, because the waste on site was not directly from the drilling operations. The auditor testified that in discussions with employees of Petitioner, she learned that no waste from the actual well hole was put into the various dumpsters and rollouts located on the well pad. In his post hearing brief, the Tax Commissioner continues this theme, that in order to qualify for the direct use exemption, the trash receptacles must contain waste that is the direct result of the drilling. The Tax Commissioner relies on Section 123.3.1.12 of Title 110, Series 15 of the West Virginia Code of State Rules, which states:

> 123.3.1. Uses of Property or Services Constituting Direct Use. - Uses of property or services which will constitute direct use when used by a person engaged in the business of manufacturing, transportation, transmission, communication or the production of natural resources, thereby making its purchase exempt from sales and use tax shall include only the following:
>
> 123.3.1.12. Tangible personal property or services used in the storage, removal or transportation of economic waste directly resulting from the activities of transportation, communication, transmission, manufacturing production, production of natural resources, or in contracting activity during the period July 1, 1987 to February 28, 1989. For example, trash bins used to store waste directly resulting from manufacturing are directly used in manufacturing.

W. Va. Code R. §110-15-123.3.1 (1993). The problem with the Tax Commissioner's reliance on Section 123.3.1.12 is that it impermissibly expands West Virginia Code Section 11-15-2. As discussed above, Section 2 contains subdivision 4, which contains a list of fourteen uses that are

considered direct. Included in subdivision 4 is subparagraph xii, which states that direct use includes: "Storing, removal or transportation of economic waste resulting from the activities of manufacturing, transportation, communication, transmission or the production of natural resources". W. Va. Code Ann. § 11-15 2(b)(4)(A)(xii) (West 2018). Section 123.3.1.12 states that in order to be considered directly used, the waste must be the **direct** result of the activity in question, but subparagraph xii contains no such directive. In fact, the language of the two provisions is virtually identical, except for the usage of the word direct in Section 123.3.1.12. It is the inclusion of this one word that causes the section to run afoul of West Virginia law.

The primer on the relationship between statutes and rules in West Virginia is the case of Appalachian Power Co. v. State Tax Dep't of W. Virginia, 195 W. Va. 573, 466 S.E.2d 424 (1995). In Appalachian Power, the Court clearly states, more than once, that despite the fact that a legislative rule may have been properly promulgated, through legislative rule making, it is still impermissible for a rule to expand or contract the statute that gave it life. "'Rules and Regulations of ... [an agency] must faithfully reflect the intention of the legislature . . ." Appalachian Power at 587, 438. "As authorized by legislation, a legislative rule should be ignored only if the agency has exceeded its constitutional or statutory authority or it is arbitrary or capricious." *Id*. at 585, 436. Here, Section 123.3.1.12 clearly exceeds its statutory authority and it is precisely this excess that the Tax Commissioner is seeking to utilize, by his insistence that the only waste that is subject to the exemption is waste from the well hole. However, if the word "directly" is removed, as in subparagraph xii, then all the waste from the well pad would be considered subject to the exemption, because it all obviously is the result of the activity going on there, namely drilling for natural gas.

Additionally, our analysis must include a discussion of the general direct use exemption language contained in Section 2. Again, the list of fourteen (14) uses of property or services

contained in subdivision 4 contains a catchall that mirrors the general language and reiterates that any service that is an integral and essential part of drilling for natural gas is considered direct use. It is hard to argue that the activity of collecting and removing the trash from the well pad is not integral and essential, particularly when the contrasting statutory language is "incidental, convenient or remote". Obviously removing the trash is essential, and, as Petitioner points out in its post hearing briefs, not doing so would cause it to run afoul of the environmental laws and potentially subject it to federal and state fines for pollution.

Finally, we come to the rentals that the auditor found to be entirely taxable pursuant to the general statutory language regarding direct use. These are the Port-a-potties, and the water and sewage systems for the skid houses. During the hearing in this matter the auditor, when asked how Port-a-potties were not an absolute necessity at a well site, stated:

> **ATTORNEY GRIFFITH**: How would it be possible to operate one of these well sites without porta potties onsite?
>
> **MS. B**: Again, we would look ---. I think they would be required, but I think that things would be required for other similar type of indirect/direct use businesses, which we would still normally not consider this to be a direct use of those facilities, even though they're required to be there.

Transcript P76 at 10-15. In his post hearing briefs, the Tax Commissioner switched tacks, arguing that the water and sewage was associated with the skid houses, and therefore was not exempt because it was impossible to apportion usage between the workers in them for "office" use versus sleeping, and eating etc. As for the Port-a-potties, the Tax Commissioner again argued that it is impossible to apportion their usage between the employees who are actually working and those on a break or spending time in the skid houses. Petitioner argues that OSHA regulations require it to provide bathrooms for the workers.[4]

[4] The record is not entirely clear regarding what type of bathroom facilities are in the skid houses or why there is a need for Port-a-potties at all. We presume that the skid houses have bathrooms to satisfy OSHA requirements and

We find the Tax Commissioner's arguments regarding these rentals to be unpersuasive, and rule that it would be critical and essential to have proper sanitation facilities for an outdoor workplace such as Petitioner's.

CONCLUSIONS OF LAW

1. It is the duty of the Tax Commissioner to see that the laws concerning the assessment and collection of all taxes and levies are faithfully enforced. *See* W. Va. Code Ann. §11-1-2 (West 2010).

2. "The Tax Commissioner shall collect the taxes, additions to tax, penalties and interest imposed by this article or any of the other articles of this chapter to which this article is applicable." W. Va. Code Ann. §11-10-11(a) (West 2010).

3. "An excise tax is hereby levied and imposed on the use in this state of tangible personal property, custom software or taxable services, to be collected and paid as provided in this article or article fifteen-b of this chapter, at the rate of six percent of the purchase price of the property or taxable services, except as otherwise provided in this article." W. Va. Code Ann. §11-15A-2(a) (West 2010).

4. The use in this state of the following tangible personal property, custom software and services is hereby specifically exempted from the tax imposed by this article to the extent specified: (2) Tangible personal property, custom software or services, the gross receipts from the sale of which are exempt from the sales tax by the terms of article fifteen, chapter eleven of the code of West Virginia, one thousand nine hundred thirty-one, as amended, and the property or

that the Port-a-potties are there because the well pad site is so large that for certain workers traveling to the skid house to use the bathroom is not practical. Whatever the case, this omission does not affect our ruling.

services are being used for the purpose for which it was exempted." W. Va. Code Ann. §11-15A-3(a)(2) (West 2013).

5. West Virginia Code Section 11-15-9(b)(2) provides an exemption from the consumers sales and service tax for sales of services, machinery, supplies and materials directly used or consumed in the activities of manufacturing, transportation, transmission, communication, production of natural resources.

6. Directly used or consumed is defined as "used or consumed in those activities or operations which constitute an integral and essential part of the activities, as contrasted with and distinguished from those activities or operations which are simply incidental, convenient or remote to the activities." W. Va. Code Ann. §11-15-2(b)(4) (West 2018).

7. The Petitioner's rental of the following services is integral and essential to its natural gas drilling operations, as those terms are used in West Virginia Code Section 11-15-2(b)(4):

a. Skid houses/crew quarters

b. Generators and other equipment to supply electricity to the skid houses

c. The equipment to supply potable water to the skid houses

d. All equipment to provide sanitation and sewage to the well pad site

8. It is impermissible for a properly promulgated legislative rule to expand or contract the statute that gave it life and the rules and regulations of an agency must faithfully reflect the intention of the legislature. *See* Appalachian Power Co. v. State Tax Dep't of W. Virginia, 195 W. Va. 573, 466 S.E.2d 424 (1995).

9. Section 123.3.1.12 of Title 110, Series 15 of the West Virginia Code of State Rules impermissibly expands West Virginia Code Section 11-15 2(b)(4)(A)(xii), by its requirement that

only the storage and removal of waste that is the **direct** result of Petitioner's activities is direct use, as opposed to merely being the result of its activities.

10. Petitioner's rental of equipment and services to remove all waste from the well pad site is direct use, and thus exempt from use tax because such rentals are to remove economic waste that is the result of its activities at the site, and these rentals are integral and essential to its operations. *See* W. Va. Code Ann. § 11-15A-2(b)(4)(A)(xii) and (xiv) (West 2018)

FINAL DECISION

Based upon the above, it is the **FINAL DECISION** of the West Virginia Office of Tax Appeals that the two assessments issued against the Petitioner on December 19, 2014, are hereby **MODIFIED** in a manner consistent with this decision and now reflect the amounts due as follows:

The combined sales and use tax assessment for the period January 1, 2011 through December 31, 2013 for tax of $_____, and interest of $_____ for a total liability of $_____. Additionally, interest on the Petitioner's overpayment will continue to run, pursuant to West Virginia Code Section 11-10-17(d).

WEST VIRGINIA OFFICE OF TAX APPEALS

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A.M. "Fenway" Pollack
Chief Administrative Law Judge

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Entered