Ohio | Department of Taxation

Senate Ways & Means
April 18, 2018
Tax Commissioner Joseph W. Testa
HB 430 Opposition Testimony

Chairman Eklund, Vice Chairman Terhar, Ranking Member Williams and members of the Senate Ways and Means Committee, thank you for the opportunity to offer opposition testimony to House Bill 430. My name Joe Testa and I am the Ohio Tax Commissioner for the Ohio Department of Taxation.

H.B. 430 expands the current exemption of the sales and use tax on tangible personal property (TPP) directly used in the exploration and production of oil and gas. This legislation would allow TPP used indirectly in the exploration and production of oil and gas to now be exempt from Ohio's sales and use tax. Such expansion provides for an estimated revenue loss of $50.5 million in state and local revenue for the retroactivity as well as a future loss of $5.2 million each fiscal year. Further, "directly" used in an identified activity is a common standard for exemptions in R.C. 5739.02. The expansion of this exemption as accomplished by this bill would likely invite those who mine other minerals as well as other industries to request similar treatment, which could lead to revenue losses in the hundreds of millions of dollars for state and local governments.

Any argument ODT is mis-interpreting and re-interpreting Ohio law is belied by decisions of the Ohio Supreme Court and Board of Tax Appeals during the last 70 years. Courts have consistently ruled that sales and use tax exemptions are to be applied narrowly. "[S]tatutes relating to exemption or exception from taxation are to be strictly construed, and one claiming

such exemption or exception must affirmatively establish his right thereto." As such, the mining exemption has been narrowly construed by the Supreme Court of Ohio. In 1948, the court held that items used or consumed directly in the production of TPP for sale by mining include "only those items which are indispensable for mining and does not include items that are merely convenient or facilitative." The court opined the word "directly" was previously inserted into the statute to narrow the field and change it from an "industry-wide" exemption to an exemption only for those items used or consumed directly in the production of TPP for sale. In 1953, the court further clarified that "direct use" refers to use that is part of the activity or occurs between essential steps of the activity. Necessity is not a basis for the exemption and an item does not become exempt simply because production would stop without it. To be entitled to the exemption, the item must be used directly in the mining activity.

In 1988, the Supreme Court of Ohio had the opportunity to apply the mining exemption to oil and gas production. The court held that "actual drilling" is the appropriate place for beginning of the mining activity for oil and gas production. The Supreme Court reiterated that the exemption from taxation is "provided for items as to which the principal use is directly a part of the drilling activity." Drilling commences "when the drilling of a hole starts and terminates when the hole has been drilled to its total depth."

Since the court limited the exempt activity to actual drilling, the exemption from taxation is correspondingly limited to the equipment that performs actual drilling functions. Accordingly, in another 1988 case, the Supreme Court held that "frac tanks" (tanks at the well site that store large volumes of water used in hydraulic fracturing process) are not exempt from taxation because the use of these tanks is preliminary and preparatory to production.

The method of oil and gas drilling known as "fracking" is not new to Ohio and its courts. The Board of Tax Appeals (BTA) is an independent, quasi-judicial tax court and an administrative agency in the state of Ohio. In 1991, the BTA denied the exemption for blending units, which are the blenders at the well site that are used to mix the fracturing material before it is pumped into the well. In January of this year, the BTA issued a decision where the taxpayer argued the exemption applied to items not directly used in the drilling process. Relying on the Ohio Supreme Court's directives in previous cases, the BTA stated that the "equipment at issue in these matters are adjuncts to the drilling process" and not entitled to exemption.

Finally, the Department of Taxation has denied applications for sales tax exemptions applied to items used for brine injection wells being claimed as industrial water pollution control facilities. The taxpayer claimed that an exemption for "industrial water pollution control facilities" applies to these brine injection wells because ODNR has general regulatory authority over them. However, per R.C. 5709.211, the opinion of the Director of the Ohio Environmental Protection Agency is required before the Tax Commissioner issues an exempt facility certificate for "industrial water pollution control facility." Here, the OEPA Director has recommended denial; only OEPA has the authority to approve the installation of industrial water pollution control facilities within Ohio. The determination of whether a brine injection well amounts to a "industrial water pollution control facilities" should not be made under the auspices of a tax department ruling, but rather by the proper regulatory agency.

The definition of "industrial water pollution control facility" found in R.C. 5709.20(L) designates "any property designed, constructed, or installed for the primary purpose of collecting or conducting industrial waste to a point of disposal or treatment; reducing, controlling, or eliminating water pollution caused by industrial waste; or reducing, controlling, or eliminating

the discharge into a disposal system of industrial waste or what would be industrial waste if discharged into the waters of this state. **This division applies only to property related to an industrial water pollution control facility placed into operation or initially capable of operation after December 31, 1965 and installed pursuant to the approval of the environmental protection agency or any other governmental agency having authority to approve the installation of industrial water pollution control facilities."** (Emphasis added).

As was conveyed in a final determination of the Tax Commissioner: "The plain meaning of this sentence [emphasized above] is that only property installed pursuant to the approval of the OEPA, or property installed pursuant to the approval of a government agency that has the authority to approve the installation of industrial water pollution control facilities is eligible for exemption under R.C. 5709.20(L). In the case at hand, ODNR is a 'governmental agency', but it does not have the authority to approve the installation of water pollution control facilities, as only the OEPA has authority to approve the installation of water pollution control facilities within Ohio. Therefore, ODNR does not qualify under R.C. 5709.20(L), and R.C. 5709.20(L) does not apply to the property at issue."

Thank you for your time today. Please feel free to ask any questions you may have.