Texas origin-based sales tax sourcing and the effect on local governments located in oil and gas formations: *Origin-based sales tax sourcing maximizes urban local government revenues.*

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INTRODUCTION

Texas county governments located where oil and gas exploration and production occur struggle to maintain the health, safety, and welfare of the county because of the high cost of road maintenance, emergency services and other county public safety services.

In 2012 Phil Wilson Executive Director of the Texas Department of Transportation notes that "every time you drill a well, it takes about 1,200 trucks, and to maintain that well on an annual basis, about 300 [trucks] most of these roads were built in the '50s or '60s."[1]

In May 2014 Karnes County Sheriff Dwayne Villanueva said "We are just so swamped" in response to the surge in serious accidents.[2]

Fracking requires twice or three times as many truck trips per well as older oil and gas extraction techniques. That could be reason for drilling areas in Texas witnessing a significant spike in traffic fatalities, new analysis suggests.[3]

In 2016, LaSalle County Judge Joel Rodriquez, Jr. worries that vacant buildings could turn into hazards, eating up the resources of his busy fire crew.[4] Even "with the help of oil money, the [LaSalle]county recently beefed up its emergency response capabilities, but the department still can't afford a ladder truck that would reach the top of the taller hotels."[5]

Economic activity during the oil and gas business cycle creates burdens for Texas local governments that last long after the business cycle declines. Oil and gas exploration and production increase the demand on courthouse staff to handle increased.

legal disputes related to real estate, pipeline right-of-way condemnations and family mineral disputes. The local sheriff's departments contend with increased traffic accidents, road fatalities and traffic control.

Inadequate road budgets

The largest part of a local governments budget is road spending. Trucks that weigh 125,000-150,000 lb. gradually crush the gravel into dust. In Dewitt County Road spending accounted for 57% of the county's 2014 budget.[6]

DeWitt County commissioned an engineering study of road maintenance needs. The DeWitt County Road Damage Cost Allocation Study issued in 2012 found that the county road system was designed to handle light, local traffic. The study found that upgrading the country road system to meet the needs of the energy industry would cost $432 million, which was higher than Dewitt's entire record high budget for fiscal year 2014.[7]

Permian Strategic Partnership

In November 2018, the Permian Strategic Partnership pledged $100 million to address labor, housing, overtaxed healthcare, and traffic congestion caused in part by companies producing in the Permian Basin including Texas and New Mexico. The Permian Strategic Partnership is an alliance of 17 energy companies.[8]

WHY DO TEXAS COUNTIES STRUGGLE TO PROVIDE BASIC SERVICES EVEN WITH THE "HELP OF OIL MONEY"?

Why do counties like Karnes and LaSalle counties struggle even with the "help of oil money" to provide basic county services such as repair and maintenance of roads and bridges, emergency and fire services, crime prevention and control and other infrastructure needs? Even though there are several tax types derived from oil and gas exploration and production within a local government those taxes are either (1) statewide and deposited into the State's general fund; (2) property tax that is limited in appraisal value and (3) sales of taxable goods and services not sourced to the local government where the activity occurs.

Sources of tax revenue from oil and gas exploration and production

- ***Property Tax - lag time between completion date and appraisal date***

Texas appraises oil and gas property by calculating the present value of the discounted future income. There is lag time between well completion and the property tax appraisal. Also, Texas law restricts a county from collecting a proportionality higher amount in property taxes-its primary source of funding. Texas property tax law caps growth in county property tax revenue to 8% per year. If the appraised property tax value exceeds the 8% cap, then the tax rate must be reduced to stay below the 8% revenue growth limit.

- ***Oil & gas production related taxes - statewide rate***

Another source of revenue from oil and gas production within a county is the State's production taxes. Texas production tax is assessed statewide. Texas collects production tax at a rate of 4.6% on crude oil market value and 7.5% on natural gas market value. In 2013 Texas collected $244.2 million in production tax on DeWitt County production. Production tax collected is allocated to the state's Permanent School Fund and the Economic Stabilization Fund. DeWitt County Judge Daryl Fowler described the current production tax collection as a "free lunch" for the state at the expense of the county.[9]

- ***Texas Gross Receipts tax on well services - statewide rate***

Texas well services tax is imposed on certain well services such as cementing the casing seat, shooting the formation, fracturing the formation, acidizing the formation, and surveying or testing the formation. The statewide rate is 2.42% on taxable receipts. The well service tax (Tax Code Ch. 191) is deposited into the State's General Fund. In 2013, the Texas Legislature appropriated $225 million in extra funding for the repair and maintenance of county road and bridges affected by the shale energy boom and another $225 million for other county transportation projects.[10]

A Texas county or city can impose a local sales tax provided the combined rate of all local sales taxes do not exceed 2 percent at any location with its territorial limits.

- ***Sales tax options for counties***

Texas counties have a variety of local option sales taxes that may be imposed at any location within the county's territorial limits. [11]

Texas counties may impose a county sales tax for property tax relief tax to help reduce county property tax rate (**Tax Code Chap. 323.103.**) Counties may impose a sales tax to support a crime control and prevention district in a county with a population of more than 130,000 (**Loc. Govt. Code, Chap. 363 and Tax Code, Sec. 323.15.**) County assistance districts may be imposed on all or part of a county to undertake a variety of projects including roads or highways, law enforcement and detention services, library improvements, parks, and museums (**Loc. Govt. Code Chap. 387.**) Counties may hold elections in all or part of a county to create an emergency service district. (**Health and Safety Code, Chapters 775.**)

- ***Sales tax options for cities***

Texas cities like counties have a variety of local option sales taxes that may be imposed at any location within the city's territorial limits. [12] Texas cities may impose a city sales tax for economic development (**Loc. Govt. Code, Chap. 505-5050.**) Cities may impose a sales tax to support a street maintenance (**Tax Code, Chap. 327.**) Municipal development corporations can undertake projects for job training, early childhood education, and other projects (**Loc. Govt. Code, 379A.**) Cities may elect to adopt a Municipal development district sales tax (**Loc. Govt. Code, Chap 377.**) **Chap. 387.**)

Cities may create an EMS district in all or part of a city to create an emergency service district. (**Loc. Govt. Code, Chap 344 and Tax Code, Sect. 321.106.**) Cities can enact a sales tax for property tax relief (**Tax Code, Chap. 321.**)

TEXAS IS AN ORIGIN-BASED SOURCING STATE FOR SALES TAX

A state's sales tax sourcing provisions aid a seller by identifying which State taxes should be applied to a sale. There two main sourcing rules in the United States are origin-based and destination-based. Origin-based sources the sale to the location of the seller. Destination-based sources to the sale where the goods or services are delivered or used. Texas enacted an origin-based approach to sales tax sourcing. Most states have enacted destination-based sales tax sourcing. There are 36 destination-based states and 10 origin-based sales tax sourcing.

The origin-based approach is based on the location of the seller's place of business. In Texas, sales orders for taxable oil and gas goods and services are generally sourced where the order was received or fulfilled. Most sales are consummated at the seller's place of business in Texas. A sales order for tubulars to be used in Pecos County might be sourced for sales tax to a location outside of Pecos County. This means that the sales tax collected for an order for tubulars going to Pecos County that was taken or fulfilled in Harris County Texas would be allocated to Harris County. This is the basis of an origin-based sales tax approach.

Note: *There are exceptions to this rule. For example, nonresidential real property repair and maintenance services are sourced where the service is delivered.*

A destination-based sourcing approach sources sales tax to the location where the goods or services are used or consumed without regard to where the order was taken or fulfilled. Destination-based sales tax is a "use" tax approach. A destination-based approach shifts the emphasis of local sales tax from the seller's location to buyer's location and affects those who ship or deliver products to customers. For example, an order for tubulars to be *used* in Karnes County but taken in Harris County is sourced to Karnes County. Destination-based sourcing does not apply when a customer buys something in a store and leaves with it. In-store sales are sourced to the seller's location.

Why did the Texas legislature adopt the origin-based sales tax sourcing approach?

A report by the Texas House of Representatives sheds some light on the adoption of origin-based sourcing. The Texas House of Representatives, Committee on Ways, and Means, Interim Reports, 66th Legislative Session, October 2, 1980 deals with the problem of determination of place of business for the local sales and use tax. [13] Senate Bill 582 was enacted to reduce the ambiguity in determining where a sale is consummated. The report noted that *U.S. Steel v. Bullock* (citation omitted) and *Bullock v. Dunigan Tool Supply Co, Inc. 588 S. W. 2d 633(1979)* presented legal challenges for out-of-state vendors.

The Committee Report explains the pros and cons of four sales tax options to abate any legal challenges. One of the Committee findings with destination-based sourcing is the loss of city revenues. One of the Committee's arguments in favor of origin-based sourcing is that cities provide services to sales outlets, so cities do have an argument for receiving the revenue. Another Committee argument opposing the origin-based approach is that purchasers are forced to pay for city and special purpose districts taxes when the business location is not in that city or special purpose district.

The Committee Report finds that "defining a 'place of business' to be a retail outlet and consummating the sales at that location, it is easier for the retailer to determine if local tax is due." [14] The Committee also found that the "major reason for rewriting the Local Tax Act last session was to prevent disruption to city revenue."[15]

In 1985, a sales tax dispute that was bought by an oil and gas service provider that gives further insight into the legislative intent. In a sales tax redetermination hearing a Texas service provider claimed that sales orders from customers were taken at well sites were outside the city limits and thus no city tax was due. This was an intrastate sales tax dispute in that the service provider's permitted outlet was inside the city limits and the well site was located outside the city limits. The Judge found that those orders taken at the well site relate back to the outlet inside the city limits.[16] The State Administrative Law Judge Fred Conder noted that:

> It also seems fairly clear that the Legislature did not want "destination sales," but some "origination" of sales approach. This, of course, would tend to maximize city revenues while not affecting state revenues."[17]

Since 1980 (the Committee Report year) drilling for oil and gas has changed to include hydraulic fracturing. George Mitchell and his team are credited for the Texas shale boom in the Barnett Shale and the development of hydraulic fracturing. The upside of hydraulic fracturing in the Barnett Shale was the exponential production increase from 1982 to 2001.[18] The downside was the wear and tear on the infrastructure from pump, fluid storage and trucks.

Since 1980 sales orders for oil and gas goods and services are processed much different today. Technology has changed the way oil and gas upstream segments process business information. Tax technology, electronic commerce and digital platforms have transformed the industry so that sales orders are taken, processed, and delivered electronically.

Purpose of the research

The purpose of this paper is to analyze Texas sales tax data and oil and gas production data to see if metropolitan local governments' sales tax revenues are maximized under Texas origin-based sales approach. Counties were selected over cities because the available data is more reliable at the county level. It can be assumed that comparing rural cities with metropolitan cities would result in similar outcomes.

ORIGIN-BASED SALES TAX SOURCING MAXIMIZES METROPOLITAN COUNTY REVENUES

This paper's objective is to examine, analyze and validate the intent of the Texas Legislature and the comments of Texas Administrative Laws Judge Fred Condor. Does Texas origination-based sales tax sourcing approach "intend to maximize local revenues for the state's cities"? The assumption is that state's cities have more places of business that receive or fulfill orders for oil and gas goods and services than rural oil and gas producing local governments. Another assumption is that large metropolitan areas (MSA) are not major oil or gas producers. So, let us look at the period from 2005 to 2014 to see what how oil and gas taxable goods and services are sourced by county. The period 2005 through 2014 fairly approximates the last oil boom.

Data for four counties were analyzed: Harris County (1% metro transit tax), Karnes County (.5% county tax), Martin County (.0% county tax) and Midland County (.5% county tax). Harris County was selected because it is in a metropolitan statistical area and includes the city of Houston within its territorial boundaries. Karnes County was selected because of its location in the Eagle Ford Shale Play. Martin County was selected because of its proximity to Midland County and is in the Permian Basin. Midland County was selected because of its inclusion in a metropolitan statistical area, includes the city of Midland and is in the Permian Basin.

SOURCES AND ACCURACY

The data presented in this report are based on the ten-year period beginning 2005 and ended 2014. Sales and use tax permit information and production data were provided by the Texas State Comptroller's Office and Texas Railroad Commission pursuant to a Texas Open Records requests.

TERMS AND PHRASES

"Averages" means for the 10-year period 2005-2014.

"Local government" means a city, county, or special purpose district.

"Metropolitan Statistical Area" **(MSA)** means free-standing metropolitan areas composed of one or more counties. Texas Comptroller Metropolitan Statistical Area Information and Definitions

"Net Taxable Value of Volume" is the taxable value as reported to the Texas Comptroller on a purchaser or producer report for production tax.

"Oil and gas taxable goods and services" means oil and gas sales of services and tangible personal property subject to the Texas Limited Sales, Excise and Use Tax Chapter 151(b) and the Texas Tax Code Rule 3.324, Oil, Gas and Related Well Service.

"Permitted Outlet" is a place of business for 2012 NAICS Codes for crude oil petroleum and natural gas extraction, natural gas liquid extraction, drilling oil and gas wells, support activities for oil and gas operations, oil and gas field machinery and equipment machinery and equipment rental and leasing.

"Production Market Value" means the actual market value of oil, gas and condensate produced within the boundary of a county as reported to the Texas State Comptroller.

"Place of business" is.

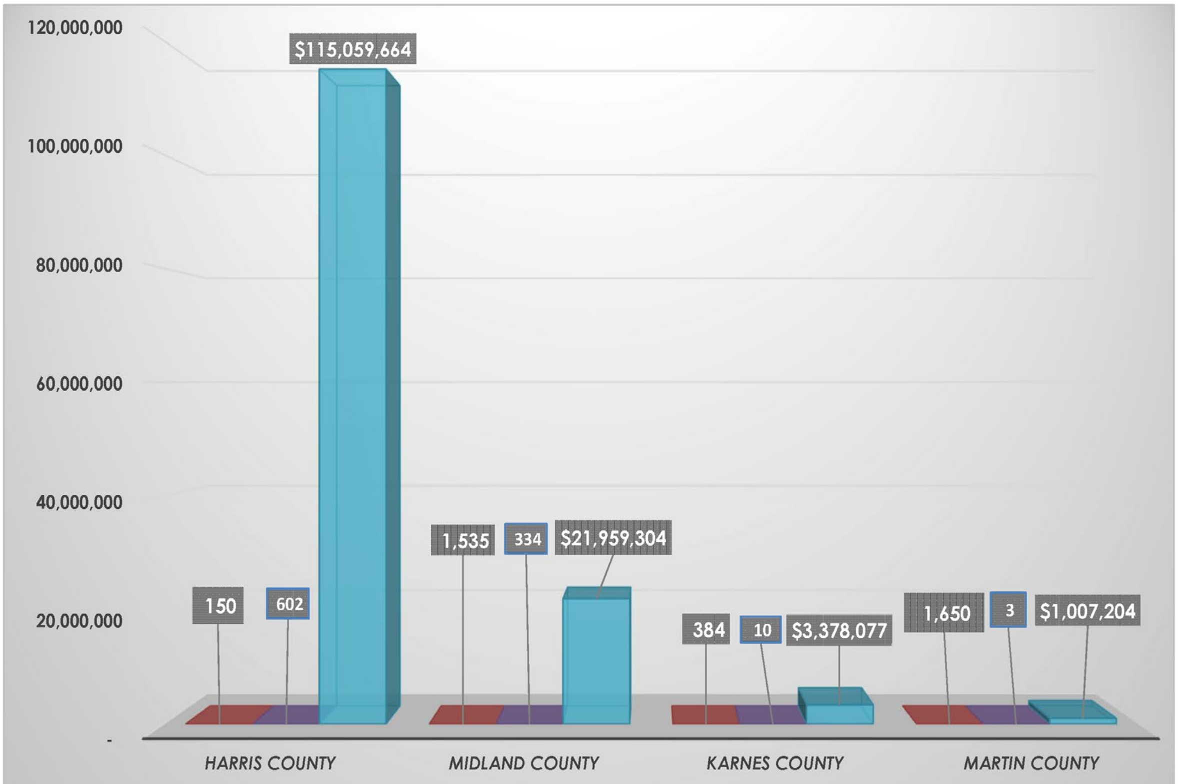
> Place of business of the retailer mean an established outlet, office, or location operated by the retailer or the retailer's agent or employee for the purpose of receiving orders for taxable items and includes any location at which three or more orders are received by the retailer during a calendar year.[19]

"Taxable sales" means oil and gas sales of services and tangible personal property subject to the Texas Limited Sales, Excise and Use Tax Chapter 151(b) and the Texas Tax Code Rule 3.324, Oil, Gas and Related Well Service.

"Warehouse, Storage Yard, Manufacturing Plant" is a warehouse, storage yard, or manufacturing plant is not a "place of business of the seller" for tax permit requirement purposes unless the seller receives three or more orders in a calendar year at the warehouse, storage yard or manufacturing plant.[20]

COMPARING PERMITTED OUTLETS,
PRODUCING LEASES AND TAXABLE SALES PER OUTLET

Figure 1 shows the 10-Year average total producing leases, permitted outlets and average taxable sales per permitted outlet using data obtained from the Texas Comptroller's Office and the Texas Railroad Commission. Four counties were selected: Harris County, midland County, Karnes County and Martin County. Harris County yielded the highest taxable sales per outlet with 602 permitted oil and gas vendor outlets, 150 producing leases with an average $115 million taxable sales per outlet. Martin County yielded the lowest taxable sales per outlet with $1 million in taxable sales per outlet for three permitted oil and gas vendor outlets and 1,650 producing leases. The reason for the taxable sales per outlet disproportion is that most of the taxable sales were sourced to metropolitan counties like Harris County. This is the lopsided economic effect of origin-based sales tax sourcing for local governments where oil and gas are produced.



	Harris County	Midland County	Karnes County	Martin County
Producing Leases	150	1,535	384	1,650
Permitted Outlets	602	334	10	3
Taxable sales per outlet	$115,059,664	$21,959,304	$3,378,077	$1,007,204

Figure 2 - 2005-2014 Comparison of Producing Leases to Taxable Goods & Services of producing leases, permitted outlets, and taxable sales per outlet.

COMPARING PRODUCING LEASES TO TAXABLE GOODS AND SERVICES

Another example the of sourcing disproportion effect is the comparison of producing leases to actual oil and gas taxable goods and services. **Figure 2** shows the amount of oil and gas taxable sales that was sourced by county and the total average producing leases for the 10-year period. For example, Harris County sourced $74 billion in taxable goods and services with only 150 producing leases. Martin County sourced only $4.8 million in taxable goods and services for 1,650 producing leases. Karnes County with 384 average producing leases is low because the increase in Eagle Ford Shale permitting activity started around 2010. This disparity is due to the origin-based sourcing of sales tax. If Texas were a destination-based state, the data would be show sales tax sourced in parity to the number of producing leases.

	Oil & Gas Taxable Goods & Services	Producing Leases
Martin County	$4,811,186	1,650
Karnes County	$56,258,084	384
Midland County	$8,648,151,346	1,535
Harris County	$74,876,009,200	150

Figure 2 - 2005-2014 Comparison of Producing Leases to Taxable Goods & Services

VALUE RECIEVED AND VALUE GIVEN

A comparison is made of the amount of county sales tax allocated to the county to the market value of oil and gas sold. This comparison *is value received to value given*. The *value received* is the actual sales tax sourced to the county for oil and gas taxable goods and services. (Texas Administrative Code Rule §3.324 Oil, Gas, and Related Well Services). The *value given* is the actual market value as reported on Texas oil or gas production tax reports by county and operator (wellhead gas and casinghead gas were converted to barrels of oil equivalent (BOE)). The value given is the market value of the extracted oil and gas from the formation within the county territorial limits. Oil and gas formations are a depleting, non-renewable resource.

Map 1 shows the distribution of permitted outlets and oil and gas lease for Harris, Midland, Martin, and Karnes County. These distributions are demonstrated by the predominant black oil symbols (producing leases) in Karnes, Martin and Midland County and the predominant blue telephone (permitted outlets) symbols in Harris County. The table overlay is Table 2 discussed below.

State Oil and Gas Regulatory Preemption

In November 2014, the city of Denton voted to ban hydraulic fracturing within its city limits. In April 2015, the Texas Legislature passed House Bill 40 (Darby, R-San Angelo; Fraser, R-Horseshoe Bay) which preempts the regulation of oil and gas activity within any municipality or other political subdivision. In May 2015, Governor Gregg Abbott signed HB 40 into law.

Denton currently imposes a sales tax (1.5%) and is located within the Denton County Transit Authority (.5%). Under a destination-based sales tax sourcing method, taxable sales would be sourced to the well located within the city of Denton. Under the current origin-based system it can be assumed that some of the taxable sales associated with hydraulic fracturing within the city of Denton will be sourced to a location other than Denton.

Local jurisdictions like the city of Denton are preempted from regulating oil and gas exploration and simultaneously disadvantaged by origination sales tax sourcing.

Destination sourcing is a matching concept that allows local governments to impose taxes that match the effects of the sale.

Map 1-Permitted well services outlets and oil and gas leases.

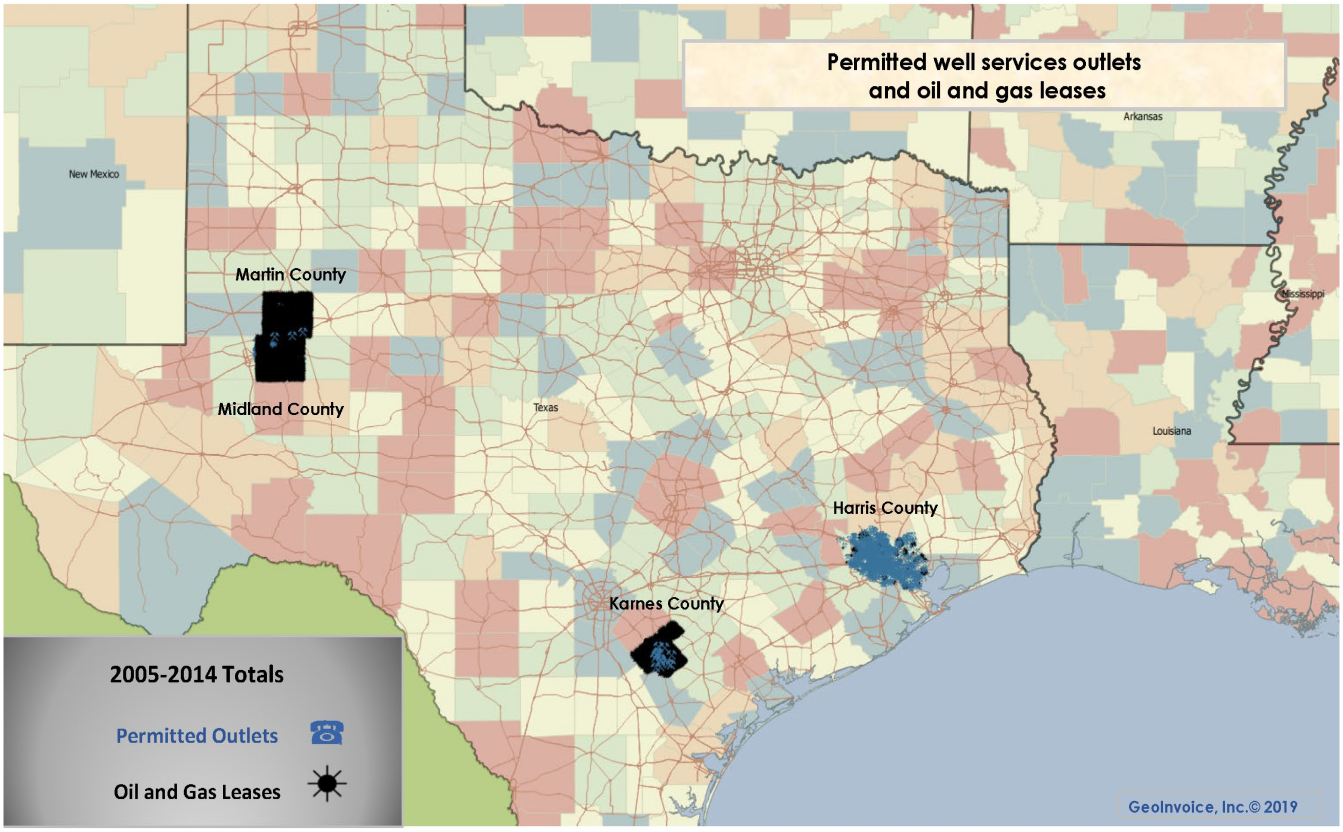


Table 2 shows a ratio that compares the amount of sales tax received to the market value of oil and gas extracted. Harris County was sourced $74 billion is sales tax revenue derived from the sale of oil and gas services and goods for approximately 150 producing leases whose severance tax to the state was only $994 million. Each outlet is a location that takes orders for oil and gas well services and tangible personal property like wellheads, flow lines, well components, compressors, tubulars, etc.

In contrast Martin County sourced only $4.8 million in sales tax revenue while sending to the State $11.9 billion in severance tax for 1,650 producing leases.

County	Oil & Gas Taxable Goods & Services	Net Taxable Value of Volume Sold-Crude Oil and Natural Gas	Value Received/Value Given
Harris	**$74,876,009,200**	**$994,303,793**	**75.30**
Midland	**$8,648,151,346**	**$14,380,794,602**	**0.60**
Karnes	**$56,258,084**	**$30,306,239,652**	**0.00**
Martin	**$4,811,186**	**$11,999,096,336**	**0.00**

TABLE 2 – Value Received to Value Given

CONCLUSION

The data in this report confirms that the origin-based sales tax approach does maximize urban and metropolitan city sales tax revenues derived from taxable oil and gas exploration and production goods and services. This research on sales tax data confirms Administrative Law Judge Condor's comment that the Texas legislature adopted the origin-based sales tax approach to maximize city revenues. Most of the oil and gas well service permitted outlets are in urban metropolitan statistical areas like Harris and Midland County.

A rural local city and county government located within producing oil and gas basins can enact a local sales tax option to provide for the health, safety, and welfare. However, most of the sales tax collected will not be allocated to rural city and county governments unless a destination-based sales sourcing is adopted by the Texas Legislature.

DISCLOSURE

Susette M. McNeel, CPA, CGMA is the president and founder of GeoInvoice, Inc. GeoInvoice develops mobile sales tax applications and services. GeoInvoice Streamline Sales Tax app is a geospatial sales tax application that gets sales tax rates anywhere using GPS.

Field Service Sales Tax is a GeoInvoice service for the oil and gas upstream segment. Field Services Sales tax is an end-to-end and do-it-yourself sales tax compliance service for the oil and gas upstream segment. Field Service Sales Tax is a sales tax determination service that includes over 15,000 oil and gas services, equipment materials and supplies in all the major oil and gas producing states. Now vendors and suppliers can bill customers sooner with accurate sales tax rates and tax determinations.

CONTACT

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SUGGESTED CITATION

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ENDNOTES

[1] Phil Wilson: The TT Interview, (*Aman Batheja, August 23, 2012, The Texas Tribune*) https://www.texastribune.org/2012/08/23/phil-wilson-tt-interview/

[2] Fracking's unexpected side-effect: Traffic deaths on the rise, (*RT, May 10, 2014*), https://on.rt.com/hvbavg

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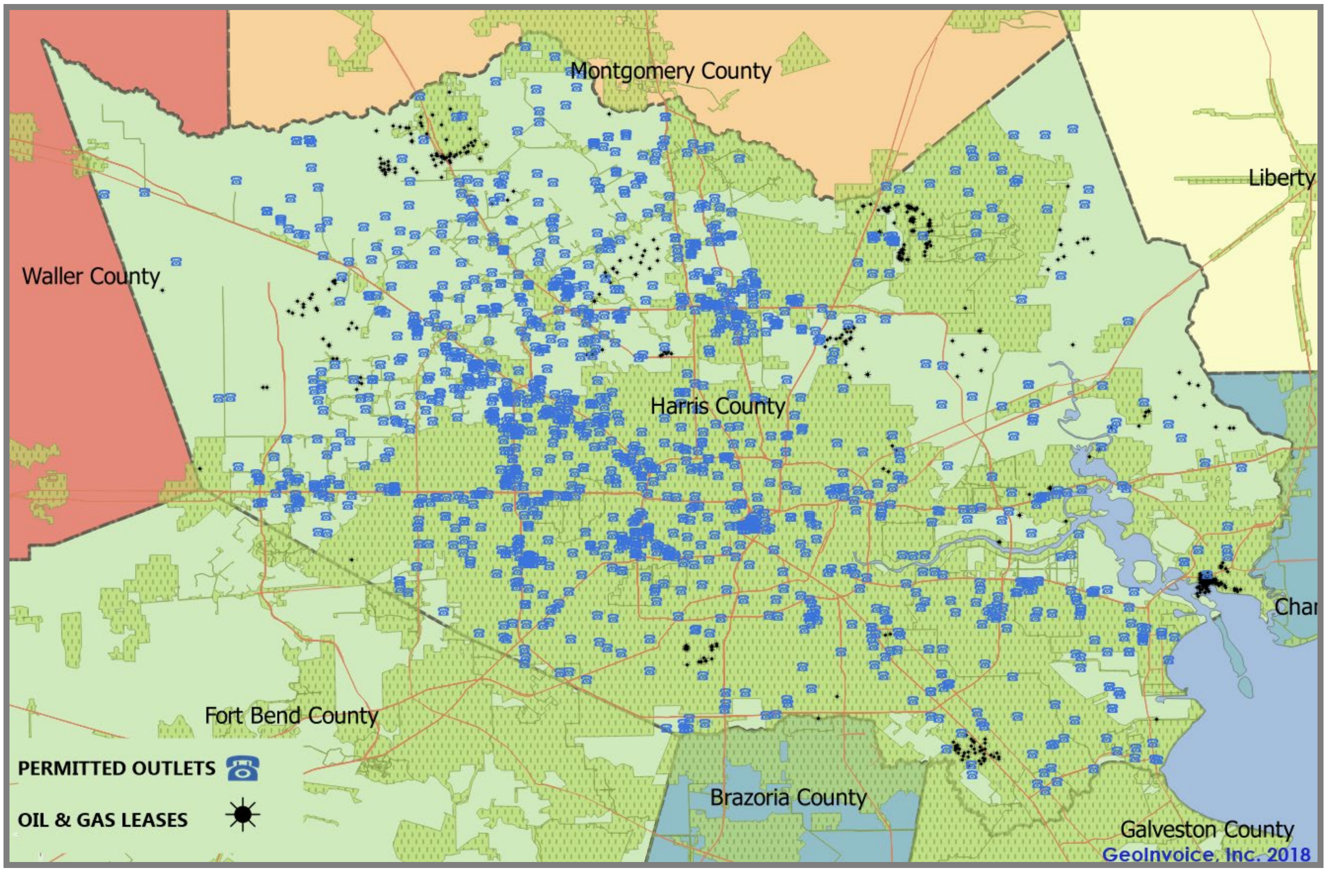
[17] Ibid

[18] Energy Central, August 7, 2013, https://www.energycentral.com/c/ec/george-p-mitchell-how-he-founded-shale-gas

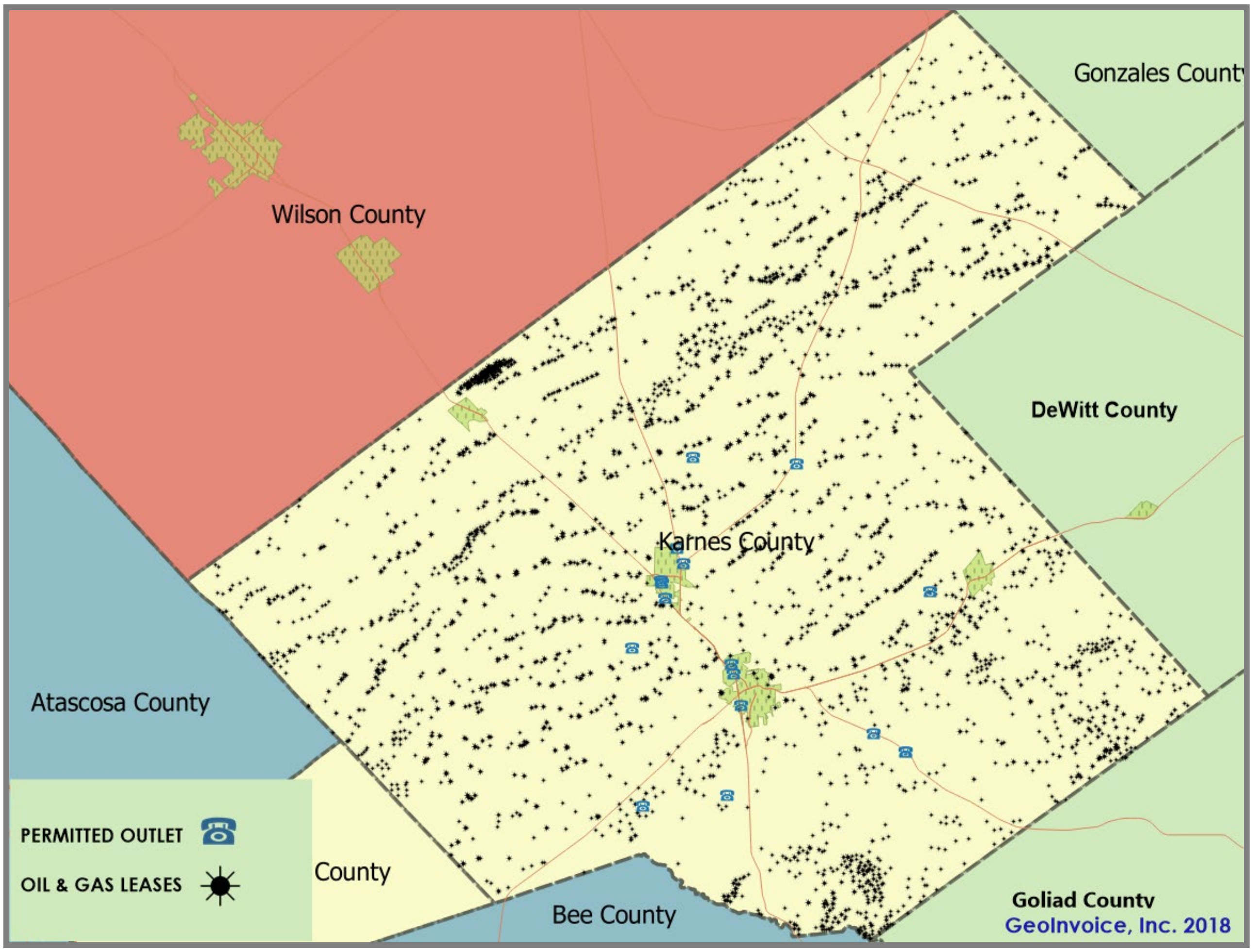
[19] Section 321.002(a)(3)(A) Texas Municipal Sales and Use Tax Act.

[20] Section 323.002 Texas County Sales and Use Tax Act.

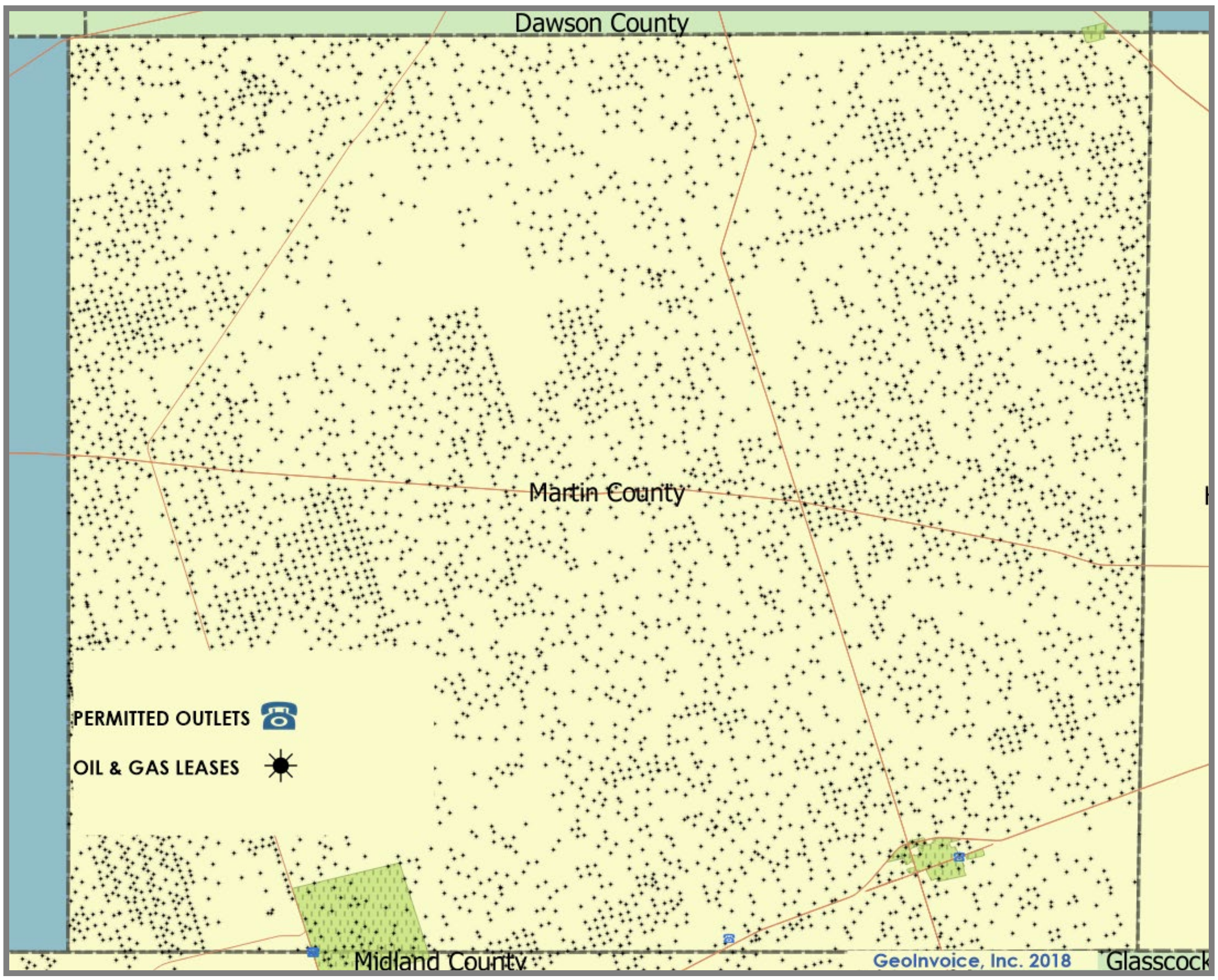
Harris, Karnes, Martin, and Midland County maps of oil & gas permitted outlets and producing leases.



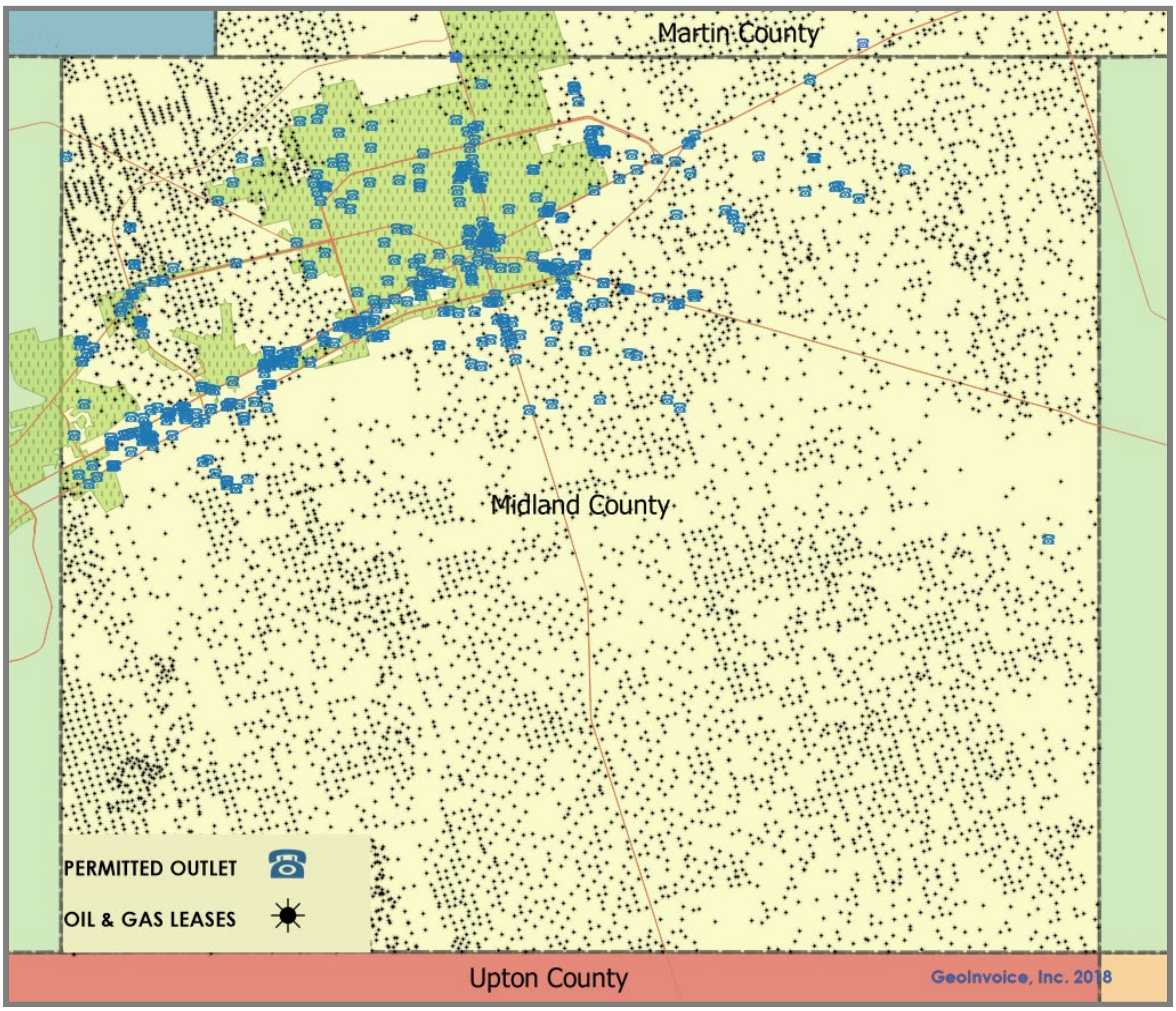
MAP 2 – Harris County Permitted Outlets and Producing Leases



MAP 3 -Karnes County Permitted Outlets and Producing Leases



MAP 4-Martin County Permitted Outlets and Producing Leases



MAP 5-Midland County Permitted Outlets and Producing Leases