

M e m o r a n d u m**190.0538**

To: Bakersfield (DHA)
Branch Office Supervisor
J. Wayne Lazenby

February 6, 1989

Memo note – See letter dated 2/6/89 from Stipes to C---

From: Headquarters – Legal
Robert J. Stipe

Subject: M--- C--- C---, Inc.
SR -- XX-XXXXXX

This is in reply to your memorandum of October 19, 1988. You request an opinion concerning the correct application of tax to certain charges for cementing new and/or abandoned oil wells.

As I understand the facts, cementing abandoned oil wells requires a series of cement plugs at varying levels in the well. Taxpayer delivers the wet cement (ready-mix) to the jobsite in its own trucks and injects the cement into the well. The injection into the well is often through a chute attached to the truck but sometimes requires pumping. When a required level has been plugged, other fluids are injected to fill the void between the plug and the next level at which a plug is required.

New oil well cementing occurs when new wells are drilled and unwanted fluids, at various levels in the well, must be blocked. Taxpayer delivers dry cement mix to the well site and blows the dry mix out of its container where it is hit by a jet stream of water, thereby mixing the cement into a “buttermilk” consistency. This mixture is pumped into the well.

Taxpayer bills his customers on a time and material basis. Taxpayer purchases the cement ex tax and collects sales tax reimbursement on the cement material, delivery and handling charges. Additionally, if the cement is ready-mix, taxpayer imposes a “transit mix charge” which is computed on the basis of an hourly rate. If the cement must be installed below ground, taxpayer imposes a “hook-up charge” which is a flat fee and a “pumping charge” which is computed on an hourly rate. You inquire whether the transit mix, hook up and pumping charges are taxable.

As a result of a previous audit of taxpayer’s business operations, a hearing officer in a 1979 hearing report determined that taxpayer was a construction contractor furnishing and installing cement under a time and material contract as provided in Sales and Use Tax Regulation 1521(b)(2)(A)2. Based on the information you provided us, it would appear tha the

Bakersfield (DHA)
Branch Office Supervisor
J. Wayne Lazenby

-2-

February 6, 1989
190.0538

taxpayer's contracts in the current audit are similar and should be treated in the same fashion. In our view, taxpayer's charges for mixing dry cement into a wet mixture and the hook up and pumping of this cement mixture into the well are all steps in the process of installing the cement and therefore are not includable in the taxable measure. Accordingly, it is our opinion that the taxpayer's charge for mixing the cement (called "transit mix charge" by taxpayer) and the hook up and pumping charges are not taxable.

RJS:sr

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February 6, 1989

Mr. P--- C. C---, Attorney
B---, B--- & K---
XXXX XXth Street
---, CA XXXXX

SR -- XX-XXXXXX

Dear Mr. C---:

Your October 27, 1988 letter requesting a written opinion as to whether the proposed activities and transactions of a cement contractor are subject to tax has been referred to me for a reply.

Specifically, you write that you represent M--- C--- C---, Inc. (M---). M--- is a specialty contractor whose main line of business is oil well cementing. In general, M--- does cementing work on abandoned and new oil wells.

As I understand the facts, cementing abandoned oil wells requires a series of cement plugs at varying levels in the well. M--- delivers wet cement (ready-mix) to the jobsite in its own trucks and injects the cement into the well. The injection into the well is often through a chute attached to the truck, but sometimes requires pumping. When a required level has been plugged, other fluids are injected to fill the void between the plug and the next level at which a plug is required.

New oil well cementing occurs when new wells are drilled and unwanted fluids, at various levels in the well, must be blocked. M--- delivers dry cement mix to the well site and blows the dry mix out of its container where it is hit by a jet stream of water, thereby mixing the cement into a buttermilk consistency. This mixture is pumped into the well.

M--- bills its customers on a time and material basis. M--- purchases the cement ex tax by issuing its vendor a resale certificate and therefore collects sales tax reimbursement on the cement material, delivery and handling charges. Additionally, if the cement is ready-mix, M--- also imposes a "transit mix charge" which is computed on the basis of an hourly rate. If the cement must be installed below ground, M--- imposes a "hook-up charge" which is a flat fee and a "pumping charge" which is computed on an hourly rate.

M--- proposes to alter its business practice and purchase the cement tax paid so that tax does not apply to any of M---' charges to its customers. You request our opinion.

In general, a construction contract is a contract for the improvement of realty (Sales and Use Tax Reg. 1521(a)(1)(A)1). In our view, a contract to pour cement into oil wells is a contract for the improvement of realty and therefore it is a construction contract (see also BTLG Annot. 190.0540). In addition, for purposes of the Sales and Use Tax Law, M--- would be classified as a construction contractor since M--- enters into agreements to perform the above described construction contracts (Reg. 1521(a)(2)).

Sales and Use Tax Regulation 1521(a)(8) defines a lump sum construction contract as a contract "under which the contractor for a stated lump sum agrees to furnish and install materials...." A construction contractor is a consumer of materials furnished and installed in the performance of a lump sum construction contract and generally tax applies to the gross receipts from the sale of the materials to the construction contractor (Reg. 1521(b)(2)(A)1). Thereafter, a construction contractor's lump sum charge to its customers to furnish and install materials to the realty are not taxable. Finally, we note that cement is classified as a material pursuant to Regulation 1521(a)(4) and Appendix A.

Applying the above criteria, M--- may purchase cement tax paid, assuming it has a lump sum contract to furnish and install cement into its customers' oil wells. Thereafter, M---' lump sum charge to its customer is not taxable. We note that a time and material contract is "a contract under which the contractor agrees to furnish and install materials...and which sets forth separately a charge for the materials...and a charge for their installation or fabrication" (Reg. 1521(a)(7)). A lump sum contract does not become a time and material contract when the amounts attributable to materials or labor are separately stated on the bill to the customer (Reg. 1521(a)(8)).

Accordingly, even though M--- separately states charges on its bill to its customers for items such as transit mix, pumping or hook ups, these charges do not become taxable, assuming M--- has a lump sum contract to furnish and install the cement for its customers. .

Additionally, you write that the cement for oil well cementing is highly specialized and cannot be reused for a different well or job. If a customer cancels an order and does not receive the cement, M--- bills the customer for the marked up cost of the cement. You inquire whether M--- may take a "tax-paid purchases resold" deduction for these transactions.

Sales and Use Tax Regulation 1701(a), in pertinent part, provides as follows:

"A retailer who resells tangible personal property before making any use thereof (other than retention, demonstration or display while holding it for sale in the regular course of business) may take a deduction of the purchase price of the property if, with respect to its purchase, he has reimbursed his vendor for the sales tax or has paid the use tax...." (Emphasis added.)

Since M--- pays sales tax reimbursement on the cement it uses for oil well cementing, we assume M--- has entered into a lump sum construction contract to furnish and install the cement. As such, M--- is the consumer, and not the retailer of the cement. Further, when M--- (a consumer of the cement) blends the cement for the construction job, it is making a use of the cement other than a retention, demonstration or display of the cement while holding the cement for sale in the regular course of business. Therefore, M---, as a consumer making a use of the cement purchased tax paid, is not entitled to a "tax-paid purchases resold" deduction for the described cement.

Finally, you inquire about the meaning of Regulation 1701(c) which provides as follows:

“(c) PARTICULAR APPLICATION. ‘STANDBY SERVICE’. Property purchased ‘tax-paid’ by a retailer and placed in ‘Standby Service’, located at the place of intended use and committed to that use, is considered used sufficiently to preclude a tax-paid purchase deduction when sold, even though never physically used there and ultimately removed and sold.”

As noted in Regulation 1701(a), a tax-paid purchases resold deduction is not allowed on property purchased tax paid by a retailer and used by that retailer prior to the retailer reselling that property. Regulation 1701(c) provides that if the retailer purchased the property tax paid and places the property purchased in standby service at the location where the retailer intends to use the property, and commits that property to that use, then the property is used sufficiently to preclude a tax-paid purchases resold deduction even though the retailer resells the property prior to the property's actual physical use.

I hope the above information is helpful. If you have any further questions concerning this topic, please do not hesitate to contact this office..

Very truly yours,

Robert J. Stipe
Tax Counsel

RJS:sr

cc: J. W. Lazenby
Bakersfield (CHA)