Sales Tax Issues and Recovery Audits for Kansas Oil & Gas Producers

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The Oil & Gas Industry in Kansas

Kansas ranks in the top ten for oil production in the United States producing over 125,000 barrels of oil per day. It is the home to almost 90,000 producing wells and hosts a major natural gas supply hub. There is no denying Kansas is a key player in the country's energy landscape. In return, Kansas' energy sector repays the favor by playing an integral part in the State's economy.

Big production means big expenditures. Subsequently, as the stacks of invoices pile up, one line item is often overlooked. This is the sales tax amount that adds an additional 6.15% to 10% expense to charges in Kansas. The purchaser just assumes the amount is legitimate and pays the tax without thinking twice. "In this world nothing can be said to be certain except death and taxes", right?

Kansas' sales and complementary use tax, first enacted in 1937 at a rate of 2%, is levied on the retail sale, rental, or lease of tangible personal property. These taxes are also tacked onto labor services to install, repair, or maintain tangible personal property. The State's tax rate is currently set at 6.15%; however, local rates for county, city and special districts are included to arrive at an effective combined tax rate.

Fortunately, for those that operate wells in Kansas, there is some relief from this tax liability: many sales tax exemptions are available to producers. Many of the goods and services utilized by operators are specifically exempt or are considered a component of a manufacturing process, which makes them nontaxable. In addition, if sales tax is paid on an exempt item, a refund may be granted to the purchaser if requested within the statute of limitations. In Kansas, the statute of limitations is three years from the date the tax was due to the Kansas Department of Revenue (KDOR).

Examples of Exempt Property	Examples of Exempt Services
Dehydrators	Roustabout services
Heater treaters	Cementing new well
Separators	Swabbing new well
Gun barrels	Hydraulic fracturing
Customized software	Installing artificial lift

Operators are overpaying on sales tax

Multiple factors lead to operators overpaying millions of dollars in sales tax annually. One reason operators overpay is due to the simple fact that rates vary from city to city and county to county. An additional factor is that tax laws are continually changing. In fact, new tax rates have been rolled out in 2013 that have lowered the state rates to 6.15% from 6.3%.

Furthermore, consider the fact that tax laws are complicated and require a certain degree of tax acumen to understand. Take this excerpt from K.S.A. 79-3606:

> *Subsections (3) and (5) shall not be construed as exclusive listings of the machinery and equipment that qualify or do not qualify as an integral or essential part of an integrated production operation. When machinery or equipment is used as an integral or essential part of production operations part of the time and for nonproduction purpose at other times, the primary use of the machinery or equipment shall determine whether or not such machinery or equipment qualifies for exemption.*

From this example, it is easy to deduce that a certain level of sophistication is needed to interpret whether a piece of equipment or service may be exempt from tax. The bottom line: company employees who are reviewing invoices are not sales tax experts and most likely do not possess the requisite skills and experience in applying these complex tax statutes.

Likewise, vendors are not tax experts either. While vendors may have the oilfield skills to acidize a well or install a gun barrel, their barebones accounting department may not. Departments with the highest turnover and employees with the least experience are often the ones creating the invoices. Their lack of knowledge on sales tax can directly impact the bottom line of operators by not properly applying sales tax exemptions.

In Kansas, the vendor is a fiduciary of the state and is responsible for collecting and remitting all sales tax. This, mixed with their possible lack of knowledge, motivates vendors to charge the highest tax rate and include all items in the taxable amount to avoid any liability associated with underpayment, including fines and penalties. On the flip side, the KDOR does not punish a vendor for over-collecting and they do not alert taxpayers when they overpay.

The combined tax rate is determined based on where the customer takes delivery of the goods or makes first use of the services. This often leads to a misapplication of tax rates. For example, an operator buys a string of tubing from a supplier in Pratt where the sales tax rate is 8.65%. The supplier delivers the tubing to a well in Rooks County where the tax rate is 6.15%. The supplier mistakenly charges Pratt's rate, qualifying the operator for a 2.5% refund. There are over 750 different tax jurisdictions in Kansas making it a challenge to always apply the correct rate.

In addition to all these factors, tax laws and exemptions may change frequently due to new legislation or court interpretations. A piece of equipment that is taxable in one year may become exempt in a subsequent year. Vendors and operators must stay current on court cases and any changes applicable to their business.

Reverse audits, reverse costs

The best way to discover overpayments is to perform a reverse audit. This audit is similar to one conducted by the state, except recoverable overpayments are targeted rather than underpayments, resulting in a refund rather than a penalty.

Reverse audits involve a major review of most invoices, especially large expenditures that may contain large recoverable amounts. A plan may be developed to target single types of transactions, certain vendors, or certain regions may be helpful in certain situations. If these patterns can be recognized, more recoveries can be found with less effort.

Internal vs. external review

Internal

A reverse audit may be performed internally by developing an audit plan, collecting accounts payable data, and performing the review. A sampling technique can be helpful in identifying specific areas to examine rather than reviewing every single invoice. Some strategies may be more effective than others, such as reviewing:

- Vendors with known problems
- Large vouchers
- Specific time periods with large capital expenditures

During the audit, scrutinize the processes and controls surrounding sales tax, particularly the invoice review process. Weaknesses that result in overpayments should be identified and fixed to avoid future overpayments.

Internally, checklists should be created to help identify overpayments and assure all necessary information is gathered. A refund request in Kansas must give: invoice number, invoice date, vendor name, description of the item, invoice amount, tax paid, and the reason for exemption. Be ready to justify the position with the exact statute when the KDOR challenges the request. Most exemptions for the Oil & Gas industry will fall under K.S.A.79-3606(kk).

After all necessary information has been captured and all support documentation gathered, it must be sent to the KDOR. They will begin processing the request after all necessary documentation is received. Place extra emphasis on the “all”. Incomplete applications will not be accepted and must be completed to KDOR’s specifications within 60 days.

If this is not achieved in time, a new refund application must be filed and the statute of limitations continues to run until a complete request is submitted. However, an informal conference may be requested to review KDOR’s ruling the application incomplete.

After KDOR receives a complete and valid request they will issue a refund within 120 days. If the refund process exceeds 120 days, interest will be rewarded on the refund amount.

External

If time and resources are constraints, an alternative to conducting an audit internally may be to engage a firm specializing in sales tax recoveries. These firms usually work on a contingency basis where their fees are based on a percentage of what they recover, not on the hours they work. This results in a risk-free audit for the producer.

These auditors must know the industry and have experience handling sales tax recoveries to be most effective. They must have the ability to target susceptible areas of overpayment to uncover the areas of largest overpayment. Without the proper knowledge of state tax law, operators may forego larger refunds when handling the audit in-house.

Another benefit of bringing in a third-party is that they can focus 100% on the audit. They can sift through the large volume of invoices, take care of all the required paperwork, and monitor the refunds until they materialize, while staying within the 36 month statute of limitations.

Some auditors have also developed a line of communication with the KDOR and know the best-practices to swiftly recover overpayments. Additionally, they work as a buffer between the operator and the vendor to preserve any delicate or long standing working relationships that often exist in the industry.

So, while Franklin may have been spot on surmising that death is certain, he was definitely off the mark when it came to exemptions around sales taxes. Is the same true for your company?

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