STATE OF NEW MEXICO
ADMINISTRATIVE HEARINGS OFFICE
TAX ADMINISTRATION ACT

IN THE MATTER OF THE PROTEST OF
HALLIBURTON ENERGY SERVICES, INC.
TO THE DENIALS OF REFUND ISSUED UNDER
LETTER ID NOS. L0037204528, L0708364848, and L1630542128

v. **D&O No. 19-05**

NEW MEXICO TAXATION AND REVENUE DEPARTMENT

DECISION AND ORDER

On October 22, 2018, October 23, 2018, October 24, 2018, October 25, 2018, and January 4, 2019, Chief Hearing Officer Brian VanDenzen, Esq., conducted a merits administrative hearing in the matter of the tax protest of Halliburton Energy Services, Inc. (Taxpayer) pursuant to the Tax Administration Act and the Administrative Hearings Office Act. At the hearing, Attorneys Adam Feinberg and Nicholas Metcalf of Miller & Chevalier and Suzanne Bruckner of Sutin, Thayer, & Browne appeared, representing Taxpayer. Attorneys Lauren Keefe and Matthew Jackson of Peifer, Hanson & Mullins, P.A. appeared, representing the Taxation and Revenue Department (Department), along with staff attorney Marek Grabowski. Over the course of the hearing, Taxpayer witnesses David Harless, Thomas Lee Martin, Amanda Hamm, Denise Tuck (expert witness in Chemistry), Josh Cohen, and Robert Wilson testified. Department witnesses James Francis, CPA, (an expert witness in oil and gas accounting), Dr. Cory Leclerc (expert witness in the field of chemical engineering), and Department employee Mark Wachter testified. The record of this hearing closed on January 4, 2019, beginning the 30-day window in which to issue a decision. In compliance with NMSA 1978, Section 7-1B-8 (C) (2015), this decision was timely filed within 30-days. *See* NMSA 1978, § 7-1-77 (1965); *see also* Regulation 22.600.3.15(G) NMAC.

These consolidated protests generally involve Taxpayer's claims for refund for gross receipts taxes previously paid on sales related to hydraulic fracturing of oil wells in the Permian Basin, refunds premised on the chemical and reagents deduction under NMSA 1978, Section 7-9-65. In this bifurcated proceeding, the first phase of hearing focused on three disputed issues (the parties mutually identified these three issues in their joint prehearing statement). The first issue is whether "[f]or products, other than proppants, for which Taxpayer seeks a refund, did Taxpayer sell the products or did the Taxpayer use those products during the performance of a service?" The second issue, as framed by the parties in the joint prehearing statement, is "[h]ow is a 'lot' [under Section 7-9-65] measured?" The final issue jointly identified by the parties in the joint prehearing statement "[i]s curable resin coated proppant a chemical [for the purposes of Section 7-9-65]?

After considering the evidence presented at hearing, the arguments of the parties, and the proposed findings of fact and conclusions of law submitted by the parties, and for the reasons stated herein, the hearing officer rules for the Department on issue one and three. The hearing officer adopts and incorporates all of the Department's proposed findings of fact and conclusions of law addressing issues one and three into this decision and order with only slight modifications as noted. The hearing officer also partially rules for the Department on issue two, but with an alternative modification adopting Taxpayer's proposed single day's worth of delivery standard in the event that on appeal it is determined that a continuous flow of goods can constitute a lot. In any case, since resolution of issue one is dispositive of these combined protests, ruling is reserved on any of the other bifurcated issues that were to be addressed in the second bifurcated proceeding, as such further proceeding is unnecessary. Because issue one is dispositive of the protests, this order represents the final decision and order in these consolidated protests, subject to Taxpayer's right for appeal to the New Mexico Court of Appeals pursuant to NMSA 1978,

Section 7-1-25 (2015).

FINDINGS OF FACT[1]

General Factual, Jurisdictional, and Procedural Findings

1. Taxpayer is engaged in the business of hydraulic fracturing. [Joint Stipulated Fact #1, Joint Prehearing Statement].

2. Hydraulic fracturing, or fracking[2], is a method used in the oil and gas industry to create fractures in oil or gas bearing formations. [Joint Stipulated Fact #2, Joint Prehearing Statement; Joint Stipulated Fact #2, Supplemental Joint Prehearing Statement].

3. The purpose of fracking is to maximize production from a well. [Joint Stipulated Fact #3, Supplemental Joint Prehearing Statement].

4. The process of fracking involves mixing multiple products together and pumping the resulting mixture into the well. [Joint Stipulated Fact #4, Supplemental Joint Prehearing Statement].

5. Taxpayer is seeking a refund in connection with transactions involving three customers – Devon Energy Corporation, Concho Resources, Inc. and Apache Corporation – that drill wells in New Mexico's Permian Basin. [Joint Stipulated Fact #5, Supplemental Joint Prehearing Statement].

6. The protest hearing focused on ten sample wells from Taxpayer's three customers located in New Mexico's Permian Basin. For ease of access to the exhibits and the transcript of the hearing, the sample wells and associated customers are[3]:

	Well Name:	Customer:	Citations:

[1] With exception of findings #1-32 and #201-203, all other findings were adopted from the Department's proposed findings of fact, with citations updated where appropriate or where the proposed citation was incorrect.
[2] Fracking is the colloquial term for hydraulic fracturing. Those terms were used interchangeably by the parties throughout the protest process and are used interchangeably throughout this decision and order.
[3] This finding is partially modified from Taxpayer's proposed finding of fact #2.

1	Crypt 30 State 2H ("Crypt")	Concho	Exs. #3, #6-#8
2	Tiger 11 Federal 1H ("Tiger")	Concho	Exs. #11-#15, #27-#28
3	Caswell 23 Federal 1H ("Caswell")	Devon	Exs. #31, #34, #36
4	Lusk 34 Federal 1H ("Lusk")	Apache	Exs. #39, #42-#44
5	Chicken Dinner 36 State 1H ("Chicken Dinner")	Concho	Exs. #47, #50, #52-#53
6	Harroun Trust 31 4H ("Harroun")	Devon	Exs. #57, #59-#60
7	Salvador Fee 1H ("Salvador")	Concho	Exs. #63, #66, #68-#69
8	Windward Federal 4H ("Windward")	Concho	Exs. #72, #75, #77-#78
9	Arcturus 18 Federal Com 8H ("Arcturus")	Devon	Exs. #81, #84, #86-#87
10	Bradley 8 Fee 6H ("Bradley")	Concho	Exs. #90, #93, #95-#96

7. Taxpayer is seeking a refund under NMSA 1978, Section 7-9-65 (1969). [Joint Stipulated Fact #6, Supplemental Joint Prehearing Statement].

8. Taxpayer is seeking a refund based on the contention that it sold chemicals in lots in excess of 18 tons during the course of the transactions at issue. [Joint Stipulated Fact #7, Supplemental Joint Prehearing Statement].

9. On December 8, 2015, Taxpayer filed an application for refund with the Department (first claim for refund), claiming a refund of $44,454,836.00 in gross receipt tax from the reporting periods between December 1, 2011 and April 30, 2015. [Administrative File; Protest Letter Exhibit I; Taxpayer. Ex. #111].

10. On February 11, 2016, by letter id. No. L0037204528, the Department denied Taxpayer's first claim for refund for $44,454,836.00 for the period ending on April 30, 2015. [Administrative File; Attachment to Request for Hearing].

11. On March 29, 2016, Taxpayer protested the Department's denial of the first claim for refund under letter id. No. L0037204528. [Administrative File; Protest Letter].

12. On April 1, 2016, the Department acknowledged receipt of Taxpayer's protest of the denial of the first claim for refund under letter id. No. L0037204528. [Administrative File; attachment to Hearing Request].

13. On May 9, 2016, the Department requested a hearing before the Administrative Hearings Office regarding the denial of the first claim for refund under letter id. No. L0037204528. [Administrative Record; Hearing Request].

14. A scheduling hearing on the protest of the denial of the first claim for refund under letter id. No. L0037204528 occurred on June 17, 2016. At that hearing, because the parties needed additional time to prepare discovery and motions as required under NMSA 1978, Section 7-1B-6 (D) (2015), the parties did not object that conducting the scheduling hearing satisfied the 90-day hearing requirement under NMSA 1978, Section 7-1B-8 (A) (2015).

15. On December 28, 2015, Taxpayer filed an application for refund with the Department (second claim for refund), claiming a refund of $3,462,261.00 in gross receipt tax from the reporting periods between March 1, 2012 and December 31, 2014. [Administrative Record; Taxpayer. Ex. #110].

16. On March 11, 2016, by letter id. No. L0708364848, the Department denied Taxpayer's second claim for refund for $3,462,261.00 for the period ending on December 31, 2014.

17. On June 6, 2016, Taxpayer protested the Department's denial of the second claim for refund under letter id. No. L0708364848. [Administrative Record].

18. On June 21, 2016, the Department acknowledged receipt of Taxpayer's protest of the denial of the second claim for refund under letter id. No. L0708364848. [Administrative Record].

19. On June 30, 2016, the Department requested a hearing before the Administrative Hearings Office regarding the denial of the second claim for refund under letter id. No. L0708364848. [Administrative Record].

20. A scheduling hearing on the protest of the denial of the second claim for refund

under letter id. No. L0708364848 occurred on August 19, 2016. At that hearing, because the parties needed additional time to prepare discovery and motions as required under NMSA 1978, Section 7-1B-6 (D) (2015), the parties did not object that conducting the scheduling hearing satisfied the 90-day hearing requirement under NMSA 1978, Section 7-1B-8 (A) (2015).

21. On August 19, 2016, Taxpayer's protests of the denial of the first and second claims for refund under letter id. no.'s L0037204528 and L0708364848, upon agreement of the parties, were consolidated by order of the Administrative Hearings Office.

22. On December 21, 2016, Taxpayer filed an application for refund with the Department (third claim for refund), claiming a refund of $36,436,330.00 in gross receipt tax from the reporting periods between December 1, 2012 and October 31, 2014. [Administrative Record].

23. On March 6, 2017, by letter id. No. L1630542128, the Department denied Taxpayer's third claim for refund for $36,436,330.00 for the period ending on October 31, 2014.

24. On May 15, 2017, Taxpayer protested the Department's denial of the third claim for refund under letter id. No. L1630542128. [Administrative Record].

25. On June 7, 2017, the Department acknowledged receipt of Taxpayer's protest of the denial of the third claim for refund under letter id. No. L1630542128. [Administrative Record].

26. On July 21, 2017, the Department requested a hearing before the Administrative Hearings Office regarding the denial of the third claim for refund under letter id. No. L1630542128. [Administrative Record].

27. On August 3, 2017, the Administrative Hearings Office adopted the Modified Protective Order in this matter, protecting trade secrets, proprietary information, and other confidential material from disclosure.

28. A scheduling hearing on the protest of the denial of the third claim for refund under letter id. No. L1630542128 occurred on August 18, 2017. At that hearing, because the parties needed additional time to prepare discovery and motions as required under NMSA 1978, Section 7-1B-6 (D) (2015), the parties did not object that conducting the scheduling hearing satisfied the 90-day hearing requirement under NMSA 1978, Section 7-1B-8 (A) (2015).

29. After various requests for extension of time, requests for continuance, substitutions of counsel, and reassignments[4], a summary judgment hearing in this matter occurred on June 26, 2018. After that hearing, for reasons detailed further during the hearing, additional written briefing from Taxpayer was permitted until July 10, 2018.

30. On July 10, 2018, Taxpayer in fact filed its final briefing, making the summary judgment motion ripe for ruling on that date.

31. On July 13, 2018, the Administrative Hearings Office issued an order denying summary judgment and making threshold 18-ton lot legal determination. Although that order denied the Department's request for summary judgment because of an insufficiently developed factual record, the order did note that some of the Department's legal arguments were strong.

32. On October 5, 2018, with the filing of the Supplemental Joint Prehearing Statement, the parties agreed to consolidate the legal issues in Taxpayer's protest of the denial of the claim for refund issued under letter id. no. L1630542128 with the first and second claims for refund. The parties did not present any factual evidence related to the third claim for refund, but did agree that the legal determinations will apply to the third claim for refund.

Issue One:

33. Fracking is done to optimize oil and gas production. [Tr. 384:18-386:5].

[4] In the interest of brevity, many other non-essential hearing dates, motions, continuances, pleadings, and orders will not be identified in these findings of fact, but all such pleadings remain part of the administrative record.

34. The various products used in fracking are mixed together before they are pumped into the well. [Tr. 133:4-24; 156:21-157:19; 376:15-19].

35. When Taxpayer performs a fracking job, it does not deliver products to the site for the customer's use; it pumps the products into the well. [Tr. 293:2-11[5]].

36. The products are pumped into the well using Taxpayer's equipment. [Tr. 133:4- 24; 156:21-157:19; 340:10-13; 375:24-376:1].

37. The products are mixed by Taxpayer's crew. [Tr. 528:5-6; Tr. 529:7-11; 376:15-19; 377:8-10].

38. The products are pumped into the well by Taxpayer's crew. [Tr. 133:4-24; 156:21-157:19; Tr. 528:7-8; 340:14-21; 344:9-11].

39. The products are not merely poured into the well: they are pumped at varying pressures by a trained crew. [Tr. 394:21-395-25].

40. Most jobs take several days. [Tr. 379:23-24].

41. Taxpayer's crew is sometimes paid a bonus for its work. [Tr. 380:22-381:16].

42. The customer will have one to three representatives on site during a fracking job. [Tr. 527:8-12].

43. Taxpayer continuously monitors the progress of the job. [Tr. 541:19-542:16; 340:2-4; 377:25-3787].

44. Taxpayer will typically have 12-16 crew members on site at any time. [Tr. 322:24-323-4]. Taxpayer has a crew on site 24 hours a day. [Tr. 322:24-3234].

45. Those representatives are on site to monitor and oversee the job. [Tr. 527:8-17].

46. The customers' employees do not perform the fracking job. [Tr. 527:18-19].

[5] The Department's citation is not correct in that no such transcript page exists. However, the record of the proceeding at numerous points and the exhibits overwhelmingly support the finding that delivery of products did not occur until product was pumped into wellhead.

47. The customer hires Taxpayer to perform the fracking job. [Tr. 527:20-21].

48. The customer does not bring equipment out for use in fracking. [Tr. 527:23-528:1].

49. The customer does not do any of the mixing necessary to perform the fracking job. [Tr. 528:5-6].

50. Unless it is exercising its right to test the products, the customer does not handle the products used in fracking. [Tr. 528:11-14].

51. The customer's personnel do not have the training to handle the products used in fracking. [Tr. 528:21-23].

52. The customer expects Taxpayer to handle the products used in fracking. [Tr. 528:15-17].

53. If the customer feels that there needs to be a change to the way the fracking job is being performed, it will ask Taxpayer to make that change. [Tr. 529:13:-530:19]. In that scenario, it will still be Taxpayer who performs the work. [Tr. 529:13:-530:19].

54. The customer expects Taxpayer to follow its directions. [Tr. 531:6-532:15].

55. The products cannot be retrieved after they have been pumped into the well. [Tr. 533:2-13].

56. The products cannot be reused after they have been pumped into the well. [Tr. 533:14-17; Tr. 550:7-12].

57. The customer does not take possession of the products for its own use. [Tr. 533:18-20].

58. The customer cannot move the products to a different location or use

them at a different well. [Tr. 533:18-22].

59. The only possible way to manipulate products is to pump additional materials into the well in hopes of pushing the other products into a different location. That is the only control that the customer has over the products after they have been pumped into the well. Even in that scenario, it would be Taxpayer, not Concho, that would pump the additional materials. [Tr. 533:23-534:8].

60. The products are "nontraceable" after they have been pumped into the well, meaning there is no way to identify the individual products that were mixed into the fracking fluid. [Tr. 534:7-13].

61. Many of the products dissipate into the formation after they have been pumped into the well. [Tr. 535:16-25]. In essence, those products no longer exist after they have been pumped into the well. [Tr. 536:1-5].

62. Many of the products flow back out of the well and are disposed of with the waste water. [Tr. 534:10-13].

63. Many of the products are left behind as waste products in the well. [Tr. 536:10-14].

64. The products have no value to the well operator once they have been used in the fracking job. [Tr. 534:10-24].

65. The customer will sometimes separately purchase materials that could be used in fracking. When it does so, the materials are delivered directly to the customer and the customer is free to use them as it sees fit. [Tr. 536:24-537:4; 537:5-538:4].

66. Taxpayer will sometimes sell products used in fracking even when it is not providing fracking services. When it does, it will deliver the product to the buyer for the buyer's use. [Tr. 422:21-423:12].

67. Taxpayer presented evidence of 168 instances of separate sales of chemicals independent to fracturing job, but only five of those sales occurred in New Mexico. The five New Mexico sales were for a total of $42,981.00. These five separate sales in New Mexico are only a tiny fraction of Taxpayer's total sales during the refund period, as shown just by the sales documented in the New Mexico refund claims. [Taxpayer Ex. #123].

68. The branded fluid systems are not sold separately. [Tr. 538:10-12].

69. The customer has never purchased a branded fluid system separately from fracking services. [Tr. 538:15].

70. Fracking companies do not sell their branded fluid systems. [Tr. 538:20-539:9].

71. The customers consider a company's safety record when deciding whether to hire them to perform a fracking job. [Tr. 539:10-16].

72. The customers consider a company's management when deciding whether to hire them to perform a fracking job. [Tr. 539:17-24]. They generally do not hire people they do not know. [Tr. 539:17-24]. They need to be sure that they can trust the provider. [Tr. 539:17-540:2].

73. Concho has never asked for a refund of the amount paid for products that have been pumped into the well. [Tr. 540:3-23].

74. Concho's testifying representative[6] [, Thomas Lee Martin,] does not routinely rely on the Master Service Agreement for any purpose. [Tr. 540:20-541:2].

75. [Concho's testifying representative] does not "get into the weeds" regarding the meaning of the Master Service Agreement. [Tr. 541:4-10].

[6] The parties stipulated at hearing that Daniel Wood of Devon would have testified identically or substantively identically to Lee Martin of Concho. [Tr. 551:24-552:13].

76. [Concho's testifying representative] has not routinely been asked to determine the meaning of provisions of the Master Service Agreement. [Tr. 541:11-14].

77. Concho considers Taxpayer's employees to be professionals. [Tr. 543:10-11].

78. Taxpayer's crew is experienced. [Tr. 543:12-13].

79. Taxpayer has a longstanding working relationship with Concho. [Tr. 543:14-20].

80. The deduction for chemicals and reagents in lots in excess of 18 tons was first enacted in 1964, as part of the Compensating Tax Act. The following year, the Legislature incorporated a corresponding deduction in the Emergency School Tax Act, which established a tax on the gross receipts of certain products. The deduction was later incorporated into the combined Gross Receipts and Compensating Tax Act. *See* N.M. Ag. Op. 65-148 (discussing the history of the deduction).

81. It is not possible to frack a well without the products used in fracking. [Tr. 138:17-20].

82. Taxpayer, on its website, advertises its branded fluid systems as services. [Department Ex. A.001-A.005].

83. It specifically advertises Delta Frac, Hybor, Silverstim and Aquastim – products for which it seeks a refund – as services. [Department Ex. A.001-A.005].

84. Taxpayer explains on its website that the fluid systems "are designed to implement a treatment according to design in order to help increase production and improve the Operator's return on investment." [Department Ex. A.001].

85. Taxpayer states on its website that it "uses" fracturing fluid systems as part of

these services. [Department Ex. A.001, A.004[7] (describing Taxpayer's CleanStim and EZ-Stim services)].

86. Taxpayer acknowledges on its website that the fluid system services "include" a fluid system. [Department's Ex A.004 (describing the "Silverstim Service")]. It explains that AquaStim involves "treatments using friction-reduced water" and new service technology. [Department Ex. A.005].

87. In its own internal documents, Taxpayer describes Hybor as "Fracturing and Stimulation Services." [Department Ex. D.001].

88. In those documents, Taxpayer describes the fluid sold as part of the Hybor package as the "Hybor service fluid." [Department Ex. D.006].

89. Taxpayer's internal documents provide instructions that acknowledge that Hybor must be "prepared" and tested before use, with detailed instructions for the mixing procedure. [Department Ex.'s D.006, D.021].

90. The internal documents regarding Delta Frac also set forth detailed instructions for mixing the Delta Frac ingredients – which can vary from job to job – at the job site. [Department Ex. E.016].

91. The branded fluid systems represent a "marketing, branding scheme" for components that Taxpayer mixes together. [Tr. 134:1-8]. The branded fluid system is a "marketing package" or a "marketing construct." [Tr. 301:22-24; 318:24-319:5].

92. There is not a set group of components that make up Taxpayer's branded fluid system. [Tr. 330:8-331:2].

93. Taxpayer will sometimes include ingredients in the cost of its branded

[7] Also Department Ex. A.003

fluid systems and will sometimes charge separately. [Tr. 330:25-331:2; 332:12-21; 335:2-18.]

94. Taxpayer's representative could not say which products were billed as part of its branded fluid systems and which were not. [Tr. 344:25-350:19].

95. The documents also show that Taxpayer must follow testing procedures before pumping the fluid systems into the well, including break tests to determine the concentration of breaker necessary to reduce the viscosity of the fluid. [Department Ex.'s D.012-D.014, D.017, E.030].

96. Taxpayer's internal documents likewise acknowledge that Hybor is applied in the field, not delivered to the customer. [Department Ex. D.006].

97. Taxpayer described both Silverstim and Delta Frac as services when applying for trademarks. [Department Ex.'s B and C].

98. Records from the Trademark Electronic Search System reveal that Taxpayer described SilverStim to the United States Patent and Trade Office ("PTO") as "[o]il and gas stimulation ***services***, namely fracturing ***using*** a stabilized fluid system." [Department Ex. B.001].

99. These same descriptions are included in the Trademark Drawings and Applications for Silverstim and Delta Frac. [Department Ex's. B.007-B.008 and C.002, C.005].

100. These documents likewise reveal that Taxpayer described Delta Frac as "oil well and gas well fracturing services using borate fluids for low to moderate temperature wells." [Department Ex. C.001].

101. Taxpayer applied for a Service Mark, not a mark for goods, when seeking trademarks for Silverstim and Delta Frac. [Department Ex. B.002 and

C.001].

102. In the "Statement of Use Filing" and "Trademark/Service Mark Statement of Use" submitted to the PTO for Silverstim, Taxpayer indicated that it had attached to its application a "[c]opy of advertisement of the services." [Department Ex. B.004-B.005].

103. The applications were submitted by a trademark attorney. [Department Ex.'s B.004-B.005, B.007-B.008, C.004, C.005, C.007, C.008].

104. Taxpayer's branded systems are not a single product; their components can vary from job to job. [Tr. 133:17-24; 360:25-361:15].

105. Taxpayer has performed fracking in the Permian Basin for several decades. [Tr. 662:13-19].

106. Taxpayer has not previously sought a deduction under Section 7-9-65, even though it has been available since 1964. [Tr. 660:9-15].

107. The Department has previously advised people in the industry that products used in fracking are used in the performance of a service and are not sold to the well operator. [Tr. 771:14- 772:17; 774:8-776:24].

108. In 2015, the Department issued a revenue ruling advising that products used in fracking, other than proppant, are used in the performance of a service and are not sold to the well operator[8]. *See* Revenue Ruling 420-15-1.

109. James Francis, who has performed oil and gas accounting in the Permian Basin for 40 years, has throughout that time advised clients that products used in fracking are used in the performance of a service and are not sold to the well operator. [Tr. 765:18-766:3; 770:3-14].

[8] No citation provided in proposed finding of fact, but supported by Tr. 772:11-17 as well a revenue ruling itself.

110. Mr. Francis has been providing that advice since 1975. [Tr. 770:15-20].

111. Fracking companies have typically paid gross receipts tax on the full amount of their invoices. [Tr. 777:10-25].

112. Taxpayer uses friction reducers to reduce friction of the fluid as it is pumped into the well, so that it flows into the well more easily. [Tr. 387:5-20].

113. Taxpayer uses breakers so that the viscous material later breaks apart, makingit easier to flow the fluid system back out of the well when the fracking job is complete and the operator is ready to begin production. [Tr. 387:21-388:6].

114. Taxpayer uses surfactants to modify the surface tension of the fluid system of the fluid. [Tr. 387:21-388:6].

115. Taxpayer uses biocides to kill bacteria that may develop in the other products used in fracking. [Tr. 389:6-11].

116. Taxpayer uses clay stabilizers to prevent clay within the formation from swelling. [Tr. 389:14-24].

117. Taxpayer adds cross-linkers, which makes it "better for carrying the proppant," to the fluid system. [Tr. 389:3-16[9]].

118. Taxpayer uses defoamers to eliminate bubbles, which can impede the production of oil or gas, from the fluid system. [Tr. 390:17-391:8].

119. Taxpayer uses scale inhibitors to prevent the creation or build up of scale, which could also impede the production of oil or gas. [Tr. 391:9-392:2].

120. These additives "help optimize the various parameters of the fracturing fluid systems." [Department Ex. A.003].

[9] The correct citation, rather than one provided by the proposed findings of fact, is Tr. 389:25-390:16.

121. Taxpayer entered a "Master Service Agreement" with COG Operating LLC ("Concho"). [Taxpayer Ex. # 106.1].

122. The contract was not entered until February 4, 2015. [Taxpayer Ex. # 106.1].

123. The refund period in this case runs from December 1, 2011 to October 30, 2016. [Administrative File, claim for refund].

124. Taxpayer has not produced a written agreement with Concho that was in effect from December 1, 2011 to February 3, 2015. [Tr. 398:10-16].

125. The Master Service Agreement was entered into in recognition of the fact that Concho "may desire to engage [Taxpayer] to provide services" and Taxpayer has the "expertise, facilities, equipment in good working order and fully trained personnel capable of safely and efficiently operating such equipment and performing services for [Concho]." [Taxpayer Ex. ##106.1].

126. The Master Service Agreement provides that Taxpayer "retains the authority and right to direct and control all the details of the Work, [Concho] **being interested only in the results obtained**." [Taxpayer Ex. ##106.7 (emphasis added)].

127. The Master Service Agreement establishes that Taxpayer is an independent contractor "free and clear of any dominion or control by [Concho] in the manner in which said services are to be performed … ." [Taxpayer Ex. ##106.7].

128. In the Master Service Agreement, Taxpayer warranted that it had "fully trained personnel capable of efficiently and safely operating equipment and performing Work for [Concho]," that it would perform its work in accordance with all applicable safety regulations." [Taxpayer Ex. #106.4].

129. In the Master Service Agreement, Concho reserved the right to suspend or

terminate any work being done or to change the scope of the work. [Taxpayer Ex. ##106.9].

130. In the Master Service Agreement, Taxpayer warranted that it would comply with all applicable laws. [Taxpayer Ex. #106.4].

131. In the Master Service Agreement, Taxpayer warranted that its equipment would be in good working order. [Taxpayer Ex. #106.4].

132. In the Master Service Agreement, Taxpayer warranted that it would complywith labor laws. [Taxpayer Ex. #106.4].

133. In the Master Service Agreement, Taxpayer warranted that it would obtain all permits necessary to perform its work. [Taxpayer Ex. #106.4-106.5].

134. In the Master Service Agreement, Taxpayer warranted that it would perform its services in "good and workmanlike manner." [Taxpayer Ex. #106.5].

135. In the Master Service Agreement, Taxpayer agreed that it would provide the services and labor needed to complete any work. [Taxpayer Ex. #106.5].

136. In the Master Service Agreement, Taxpayer agreed that it would be responsible for providing materials and equipment. [Taxpayer Ex. #106.8].

137. In the Master Service Agreement, Taxpayer agreed that it would supply all "machinery, equipment, tools, materials, expendable construction items, supplies, transportation and whatever else is necessary in the performance and completion of the Work." [Taxpayer Ex. #106.5].

138. In the Master Service Agreement, Taxpayer agreed that it would provide a work schedule when requested. [Taxpayer Ex. #106.5]. It agreed that it would report any accidents to Concho and permit Concho to conduct a post-accident investigation. [Taxpayer

Ex. #106.6-106.7[10]].

139. The Master Service Agreement recognizes that Taxpayer will use "goods" and "materials" in the course of providing its services and that the term "Services," as used in the contract, includes "those Goods which are provided incidental to the provision of any oilfield services and/or any discreet oilfield services which are requested by [Concho] and which are provided by Contractor during the term of this Agreement." [Taxpayer Ex. #106.3].

140. The Master Service Agreement does not identify which goods are sold and which goods are used in the performance of a service and does not provide any means to distinguish between the two. [Taxpayer Ex. #106].

141. The Master Service Agreement also does not specify that any tangible personal property used in fracking is considered to be sold rather than used in the performance of a service. [Taxpayer Ex. #106].

142. The Master Service Agreement is a global agreement that applies to all work that Taxpayer performs for Concho, not just fracking. [TR. 397:21-398:9].

143. The Master Service Agreement warrants that any goods will be new and warrants that the goods will be free from defect for 18 months after delivery. [Taxpayer Ex. #106.4].

144. The Master Service Agreement contains a clause providing that Taxpayer shall be responsible for pollution that occurs above the surface and that Concho shall be responsible for downhole losses. [Taxpayer Ex. #106.16-106.17].

145. The downhole loss clause provides that Concho shall reimburse Taxpayer

[10] Citation corrected from proposed finding of fact.

for any losses to Taxpayer's materials if those losses occur downhole. [Taxpayer Ex. #106.16- 106.17].

146. In the Master Service Agreement, Concho agreed to be responsible for all injuries to its personnel, and included no limit that would make Taxpayer liable from injuries resulting from the products before they are pumped into the wellhead. [Taxpayer Ex. #106.14].

147. Taxpayer agreed to be responsible for all damage to its own property, and included no limit that would make Concho responsible for damage to property that occurs below ground. [Taxpayer Ex. #106.14].

148. Concho, in turn, agreed that it would be responsible for all damage to its own property, and included no limit that would make Taxpayer responsible for damage to property that occurs above ground. [Taxpayer Ex. #106.14-106.15].

149. Taxpayer entered a Master Service and Supply Agreement with Devon Energy Services. [Taxpayer Ex. #107.1].

150. The Master Service and Supply Agreement provides that Devon "desires to employ the services of [Taxpayer]" from time to time. [Taxpayer Ex. #107.1].

151. While the Master Service and Supply Agreement contains an agreement that Taxpayer will provide goods to Devon, Taxpayer has not produced the document showing what goods will be provided under that agreement.

152. Taxpayer represented in the Master Service and Supply Agreement that it "has adequate equipment in good working order and fully trained personnel capable of safely operating such equipment and performing the services described in Schedule A attached or in any addendum or work orders." [Taxpayer Ex. #107.2].

153. Taxpayer agreed in the Master Service and Supply Agreement that its work

"shall be done with due diligence, in a good and workmanlike manner, using skilled, competent and experienced workmen and supervisors and in accordance with good oilfield servicing practices." [Taxpayer Ex. #107.2].

154. The Master Service and Supply Agreement specifies that Devon is interested only in the results obtained and has only the general right of inspection and supervision in order to secure the satisfactory completion of any such services. [Taxpayer Ex. #107.3[11]].

155. There is no provision in the Master Service and Supply Agreement providing for the transfer of title of any product at any point in time. [Taxpayer Ex. #107].

Issue Two

156. A revenue ruling made in 1973 described deliveries that were made by truck or other vehicles – not in a continuous flow where title transfers as a product is pumped into a well. *See* Revenue Ruling 73-195-4.

157. Taxpayer's representative confirmed that it is Taxpayer's position that title transfers when the products are pumped into the wellhead. [Tr. 326:11-21].

158. In Taxpayer's view, in the moment before the products are pumped, they belong to Taxpayer. In the moment after the products are pumped, they belong to the well operator. [Tr. 325:15-21; 326:11-21].

159. In Taxpayer's view, once any amount of any product crosses the wellhead, it belongs to the customer. Thus, if during a one-minute interval 0.1 gallons of one product has been pumped into the well, that amount now belongs to the customer. If, at that point, the well would shut down, Taxpayer would invoice the customer for 0.1 gallons of that product. If no other products have been pumped into the well at that time, then in Taxpayer's view no other products have been sold. [Tr.

[11] Corrected citation.

326:2-21; 362:5-363:24].

160. Taxpayer's representative confirmed that it does not pump more than 18 tons into a well at one time. [Tr. 468:6-15].

161. Even if it were theoretically possible to pump more than 18 tons into a well at one time, the vast majority of what would be pumped into the well would be water. [Tr. 467:8-21].

162. Taxpayer would not be able to pump more than 18 tons of acid at one time. [Tr. 468:16-25].

163. Taxpayer produced, for two of the sample wells, reports showing the amounts pumped into the well each minute. [Tr. 324:9-22; Taxpayer Ex.'s #8, 44]. Taxpayer could have produced those same reports for the other wells. [Tr. 325:3-14; 740:7-10; Tr. 338:8-24].

164. Taxpayer could have produced reports showing the amounts pumped into the well each second. [Tr. 324:24-325:2].

165. Taxpayer could have produced reports showing the amounts pumped into [nine of the ten sample wells[12]] at each step within a stage. [Tr. 740:11-19].

166. Taxpayer could calculate the weight of the products pumped into the well during each step within a stage. [Tr. 741:6-743:4; 355:25-357:23].

167. Taxpayer conceded that it cannot rely on the weight of water – which is not a chemical under the Department's definition and is supplied by the customer, not Taxpayer – in order to meet the 18-ton threshold. [Tr. 52:8-9].

168. It would be difficult to determine the amount of the ingredients of the branded fluid systems, excluding customer provided water, particularly if Taxpayer used more than one branded fluid system during a fracking job. [Tr. 344:25-351:5; 358:5-24].

[12] The Department's proposed finding of fact has been adopted with modification, since the cited testimony clearly states that the data was unavailable for one of the ten sample wells. [Tr. 740:13-19].

169. Fracking is performed in stages or intervals. [Tr. 158:22-159:16].

170. The well operator will decide in advance the length of each stage. [Tr. 143:7-15].

171. Before starting the fracking job, a separate contractor will perforate the first stage of the well, which is the stage furthest from the wellhead. [Tr. 137:10-138:11].

172. Taxpayer will then pump the fracking fluids into the first stage of the well. When it has finished that process, it will cease operations to permit the wireline contractor to perforate the next stage. [Tr. 162:20-165:1].

173. Each stage is divided into steps (sometimes referenced as stages, or substages). [Tr. 159:19-160:20].

174. These steps will follow a defined sequence. [Tr. 165:2-6].

175. Taxpayer will first pump acid into the well to dissolve cement around the pipe and dissolve any acid soluble parts of the formation. [Tr. 160:2-5; 298:11-15; 312:18-20; 355:12-17].

176. Taxpayer will next introduce water to push the acid down to the perforations. [Tr. 298:17-19; 312:21-314:25].

177. Taxpayer will sometimes pump acid a second time. [Tr. 315:25-316:2; 339:9-10; 341:3-21; 342:3-12].

178. When Taxpayer pumps acid a second time, it does so after a step where it pumps treated water into the well. [Tr. 316:3-317:14; 342:3- 12; Taxpayer's Ex. 7.37, 27.13].

179. When Taxpayer pumps acid a second time, it then again pumps treated water into the well. [Tr. 317:15-18; 339:15-17].

180. Taxpayer will then run a pad, which is a fluid system with no proppant. [Tr. 160:6-10; 317:19-23; 342:13-15; 355:19-20].

181. Taxpayer will then run several steps in which it pumps proppant-laden fluid into the well, although sometimes the pumping of proppant will be interrupted. Taxpayer will sometimes switch

from one branded fluid system to another during this phase. [Tr. 160:11-14; 298:23-299:3; 317:24-318:12; 342:16-18; 355:21-22; 342:19-343:19].

182. At each new step, Taxpayer will pump a similar mixture with a higher concentration of proppants and other products. [Tr. 161:10-22; 300:15-301:9].

183. There may be intermittent steps where Taxpayer pumps a fluid system without proppant. [Tr. 299:4-7; 317:24-318:12; 343:20-344:11].

184. Each increase in concentration is considered a different step. [Tr. 161:19-22].

185. In most cases, it will only introduce CRC proppant during the final step in which proppant-laden fluid is pumped into the well. [Tr. 301:10-12; 302:7-9; 318:13-15; 366:9-12].

186. When that step is complete, Taxpayer will then flush out the well, sometimes using a different branded fluid system, but without proppant. This is done to make sure all the proppant has been installed in the fractures and is not left behind in the pipe. Tr. 160:15-20; 301:13-14; 318:16-20; 355:23-24].

187. Taxpayer does not pump acid at the same time as its branded fluid system. [Tr. 301:25-302:3; 318:21-23].

188. If Taxpayer uses two different branded fluid systems, it does not pump them at the same time. [Tr. 302:4-6; 318:24-319:5].

189. The various components of the slurry are not pumped into the well at the same time. [Tr. 302:12-308:16; Tr. 319:10-322:21].

Issue Three

190. Fracking companies, including Taxpayer, use various types of proppant in fracking. [Tr. 544:6-12].

191. Proppant is used to hold open the fractures. [Tr.365:2-11].

192. CRC proppant is used to perform this same function. [Tr. 365:2-11; 578:6-11 ("Curable resin-coated proppant is the proppant that's sent down hole to keep the fracture open …"); Tr. 543:22-544:5].

193. CRC proppant is made up of three substances: silica, resin, and the curing agent. [Tr. 603:16-22: 578:15-579:2; 585:14-23].

194. The resin and curing agent are not a natural part of the silica: they are sprayed on and make a coating on the outside of the silica. [Tr. 578:20-23].

195. Taxpayer is not seeking a refund for other types of proppant. It concedes that proppants that are not sprayed with resin and a curing agent are not properly classified as chemicals.

196. The resin and the curing agent require some outside action before they react. It is either the heat of the well or an activator that produces any reaction. [Tr. 923:25-924:3; 932:7-19].

197. "Sand-PRC Premium," another proppant, is pre-cured, i.e., the curing reaction has already taken place prior to being sent down the well. The pre-cured proppant serves the same purpose – to hold open the fractures. [Tr. 600:4-18; 367:23-368:10[13]].

198. The resin and the curing agent comprise at most **[REDACTED]** of the CRC proppant by weight. [Tr. 604:10-605:21].

199. The remaining **[REDACTED]** of the CRC proppant is silica. [Tr. 604:10-605:21].

200. The silica does not participate in any reaction. [Tr. 603:20-24].

201. Dr. Cory Leclerc is currently a professor of chemical engineering at New Mexico Tech. During his 11 years at New Mexico Tech, Dr. Leclerc has served as department chair of the

[13] Although not cited in the Department's proposed finding, Tr. 607:9-17 also is pertinent.

chemical & petroleum engineering department. Dr. Leclerc previously served as professor of chemical engineering at McGill University in Montreal, Canada. Dr. Leclerc has an undergraduate bachelor's of science degree, summa cum laude, in chemical engineering from the University of Maine and a PhD in chemical engineering from the University of Minnesota. [Department Ex. CCCC; Tr. 904:8-905:21].

202. Dr, Leclerc was recognized as an expert witness in the field of chemical engineering. [Tr. 908:16-25].

203. In Dr. Leclerc's highly credible, competent, and persuasive expert opinion, the resin in CRC proppant is not used for producing a chemical reaction. [Tr. 929:18-931:8; 931:24-935:7].

DISCUSSION

As stated in the introduction, the main issue in this protest is whether Taxpayer is entitled to its claims for refunds for receipts related to hydraulic fracturing. Taxpayer claims that chemicals sold during hydraulic fracturing are deductible as the sale of a chemical and reagents in lots greater than 18-tons under NMSA 1978, Section 7-9-65. The parties agreed to bifurcate the hearing, with the first hearing addressing three issues. The first issue is whether "[f]or products, other than proppants, for which Taxpayer seeks a refund, did Taxpayer sell the products or did the Taxpayer use those products during the performance of a service?" The second issue is what constitutes a lot for the purposes of Section 7-9-65. The third issue is whether CRC proppant is a chemical for the purposes of Section 7-9-65.

Burden of Proof at Protest.

Taxpayer has the burden to establish its entitlement to the claims for refund. *See*

Regulation 22.600.3.23 (B) NMAC. When claiming refunds, the issue must be analyzed through the "lens of presumption of correctness." *Corr. Corp. of Am. of Tenn. v. State*, 2007-NMCA-148, ¶17, 142 N.M. 779 (Court of Appeals reviewed a refund denial through "lens of presumption of correctness"). Under NMSA 1978, Section 7-9-5, there is a presumption that all receipts of a person engaging in business are subject to the gross receipts tax. *See Rauscher, Pierce, Refsnes, Inc. v. Taxation & Revenue Dep't*, 2002-NMSC-013, ¶ 11, 132 N.M. 226, 46 P.3d 687.

"Where an exemption or deduction from tax is claimed, the statute must be construed strictly in favor of the taxing authority, the right to the exemption or deduction must be clearly and unambiguously expressed in the statute, and the right must be clearly established by the taxpayer." *Wing Pawn Shop v. Taxation and Revenue Department*, 1991-NMCA-024, ¶16, 111 N.M. 735 (internal citation omitted); *See also TPL, Inc. v. N.M. Taxation & Revenue Dep't*, 2003-NMSC-7, ¶9, 133 N.M. 447 (any deductions are construed strictly against the taxpayer).

Principals of Statutory Construction.

This case involves competing interpretations of the chemical and reagents deduction codified under NMSA 1978, Section 7-9-65. Questions of statutory construction begin with the plain meaning rule. *See Wood v. State Educ. Ret. Bd.*, 2011-NMCA-20, ¶12. In *Wood*, ¶12 (internal quotations and citations omitted), the Court of Appeals stated "that the guiding principle in statutory construction requires that we look to the wording of the statute and attempt to apply the plain meaning rule, recognizing that when a statute contains language which is clear and unambiguous, we must give effect to that language and refrain from further statutory interpretation." A statutory construction analysis begins by examining the words chosen by the Legislature and the plain meaning of those words. *State v. Hubble*, 2009-NMSC-014, ¶13, 206 P.3d 579, 584. Extra words should not be read into a statute if the statute is plain on its face,

especially if it makes sense as written. *See, Johnson v. N.M. Oil Conservation Comm'n*, 1999-NMSC-21, ¶ 27, 127 N.M. 120, 126, 978 P.2d 327, 333.

"Tax statutes, like any other statutes, are to be interpreted in accordance with the legislative intent and in a manner that will not render the statutes' application absurd, unreasonable, or unjust." *City of Eunice v. State Taxation & Revenue Dep't*, 2014-NMCA-085, ¶8 (internal citations and quotations emitted). It is a canon of statutory construction in New Mexico to adhere to the plain wording of a statute except if there is ambiguity, error, an absurdity, or a conflict among statutory provisions. *See Regents of the Univ. of New Mexico v. New Mexico Fed'n of Teachers*, 1998-NMSC-20, ¶28, 125 N.M. 401. Only if the plain language interpretation would lead to an absurd result not in accord with the legislative intent and purpose is it necessary to look beyond the plain meaning of the statute. *See Bishop v. Evangelical Good Samaritan Soc'y*, 2009-NMSC-036, ¶11, 146 N.M. 473. When applying the plain meaning rule, the statutes should be read in harmony with the provisions of the remaining statute or statutes dealing with the same subject matter. *See State v. Trujillo*, 2009-NMSC-012, ¶22, 146 NM 14. *See also Hayes v. Hagemeier*, 1963-NMSC-095, ¶9, 75 N.M. 70 ("All legislation is to be construed in connection with the general body of law.").

ISSUE ONE: Did Taxpayer sell the products or did the Taxpayer use those products during the performance of a service?

As the parties stipulated in the joint prehearing statement, the first issue in dispute is whether "[f]or products, other than proppants, for which Taxpayer seeks a refund, did Taxpayer sell the products or did the Taxpayer use those products during the performance of a service?" The Department argues that hydraulic fracturing is the performance of a service where the tangible chemicals are consumed as part of the performance of the service rather than sold. Taxpayer argues that under the predominant ingredient test, because the relative input costs to

Taxpayer of the chemicals exceeds the inputs cost of the services provided by Taxpayer, hydraulic fracturing qualifies for the sale of chemicals deductible under Section 7-9-65. Although both parties make some interesting, and at times potentially persuasive arguments, the analysis of issue one must begin with a close and careful reading of the statute itself.

A. Review of the plain language of Section 7-9-65 shows distinctions between chemicals and the performance of an associated service with those chemicals.

A careful reading of all the provisions of Section 7-9-65 shows that the Legislature intended to distinguish between the sale of chemicals, potentially subject to the deduction therein, and the sale of the service, which is not deductible under that section.

Section 7-9-65 reads:

> Receipts from selling chemicals or reagents to any mining, milling or oil company for use in processing ores or oil in a mill, smelter or refinery or in acidizing oil wells, and receipts from selling chemicals or reagents in lots in excess of eighteen tons may be deducted from gross receipts. Receipts from selling explosives, blasting powder or dynamite may not be deducted from gross receipts.

While the parties focused almost exclusively on the second clause of the deduction, which is the subject of the refund claims, under principles of statutory construction the entire statutory language of the deduction is relevant in determining the plain meaning of the statute and the legislative intent. In other words, although the refund claims may be premised entirely on the second clause of 7-9-65, the terms of the first clause of 7-9-65 are still relevant in determining the meaning of the deduction under that entire section.

In the first clause, the Legislature modified chemical and reagents with the words "for use in processing ores or oil in a mill, smelter or refinery or in acidizing oil wells." This phrase contains three verbs (or nominalizations of verbs): to use, to process, and to acidize. The three verbs or nominalizations of verbs are indicative of performances of services rather than sale of

tangible property. To "use" involves some level of consumption/application of the tangible property. *See* NMSA 1978, § 7-9-3 (N) (2007) (defining "use" under the Gross Receipts and Compensating Tax Act). To "process" indicates, at least in this context, beginning with one tangible and ending with a modified form of the tangible or a new tangible. *See* Merriam Webster's Collegiate Dictionary (11th edition, 2014) (defining process as "a series of actions or operations conducing to an end; *esp*: a continuous operation or treatment esp. in manufacture"). To "acidize" a well suggests, in this context, using chemical acids to change the chemical or physical attributes of the well[14]. By separating the chemicals and reagents portion of the section from the three modifying verbs indicative of services rendered using those chemicals, it is clear that the Legislature was attempting to distinguish between the chemicals themselves and the user of the chemicals for the related service. Based on this distinction in the statutory language, the deduction under Section 7-9-65 applies only to the sale of the chemicals or reagents themselves rather than the use or user of those chemicals and reagents in the related services. This reading of Section 7-9-65 is also consistent with the required narrow application of a claimed deduction. *See Reed v. Jones*, 1970-NMCA-050, ¶ 9, 81 N.M. 481; *see also TPL, Inc.*, 2003-NMSC-007, ¶9, 133 N.M. 447.

B. The Predominant Ingredient Test does not apply under Section 7-9-65.

Taxpayer claims that the predominant ingredient test applies to Section 7-9-65. The predominant ingredient test stems from the 1976 Legislative action amending the definition of "services" under the Gross Receipts and Compensating Tax Act, replacing the word "primarily" with "predominately" and adding the additional clause that "[i]n determining what is a service,

[14] *See* Merriam Webster https://www.merriam-webster.com/dictionary/acidize ("to treat with acid; *specifically*, to charge (an oil or gas well) with hydrochloric acid, sometimes with hydrofluoric acid added, for dissolving the lime out of the sand in order to facilitate and increase production")

the intended use, principal objective or ultimate objective of the contracting parties shall not be controlling the performance of service as distinguished from selling or leasing property." *See EG & G, Inc. v. Dir., Revenue Div., Taxation & Revenue Dep't,* 1979-NMCA-139, ¶7-8, 94 N.M. 143, 607 P.2d 1161. By making these changes to NMSA 1978, Section7-9-3(M), the Legislature overruled the New Mexico Court of Appeals decision in *EVCO v. Jones*, 1970-NMCA-076, 81 N.M. 724, 472 P.2d 987. *See EG & G, Inc.*, 1979-NMCA-139, ¶7-8, 94 N.M. 143. *EVCO* had previously focused on the end product of the transaction to determine whether a mix sale of tangibles and services constituted the sale of a good or the sale of a service. The Court of Appeals later determined in *EG&G* that the Legislature had adopted the predominant ingredient test, which requires comparing the relative inputs of services and tangible property to determine whether the sale involved a service or property. *See id*., ¶12.

Taxpayer's reliance on the predominant ingredient test under Section 7-9-65 is misplaced for two related reasons. First, in light of this Legislative distinction in the statutory deduction language between the tangible chemicals or reagents and the use of the chemicals in a related a service, as well as the presumed narrow application of a deduction, application of the predominant ingredient test is contrary to the plain language and intent of the deduction under Section 7-9-65. When the Legislature passed Section 7-9-65 in 1966, New Mexico did not use or apply the predominant ingredient test. Indeed, as *EVCO* shows, at that time the end product transferred test controlled. Given the absence of the predominant ingredient test at the time of the passage of the deduction and the clear distinction made by the Legislature in the language of the statute between the chemicals and the use of those chemicals for the related services, the Legislature did not intend that the predominant ingredient test be used to determine what might qualify for the Section 7-9-65 deduction. Instead, it is clear that the Legislature only intended the deduction under Section 7-9-65 to apply to the sale of tangible chemicals or reagents rather than

to the performance of service using those chemicals or reagents. While the predominant ingredient test is now clearly the default rule in determining the question of the performance of a service versus the sale of a tangible in transactions that involve both the sale of a service and of tangible personal property, the predominant ingredient test cannot be used to rewrite or to eliminate clear Legislative restrictions on the application of a specific deduction like Section 7-9-65. *See Rauscher, Pierce, Refsnes, Inc. v. Taxation & Revenue Dep't*, 2002-NMSC-013, ¶ 39, 132 N.M. 226, 46 P.3d 687 (The predominant ingredient test cannot be applied in a manner that would render another statutory provision a nullity, particularly if its application under a specific statutory provision would "surely" lead to sales exceeding the service component). *See also TPL, Inc.*, 2003-NMSC-007, ¶9, 133 N.M. 447 (deductions are to be interpreted and construed narrowly).

The second reason why the predominant ingredient test is incompatible with Section 7-9-65 relates to the practical application of the 18-ton lot requirement contained in the deduction. Because of the 18-ton lot requirement, applying the predominant ingredient test under Section 7-9-65 would surely result in treating virtually every transaction in dispute under that section as the sale of tangible chemicals. The value of the tangible chemicals in an 18-ton lot quantity almost always would exceed the value of any service component related to the sale of that quantity of chemicals. Indeed, it is difficult to imagine a circumstance where the mathematical value of any service input associated with chemicals would ever outweigh the value associated with the sale of a quantity of chemicals exceeding 18-tons. The statute's weight standard specification of a minimum sale in excess of 18-ton lots sets such a heavy bar in favor of the tangible component that the objective comparison between the tangible and service input required under the predominant ingredient analysis is meaningless and fundamentally incompatible with the deduction expressed by Section 7-9-65. Given how much the 18-ton lot requirement literally tips

the scales in favor of the tangible chemicals, applying the predominant ingredient test would be akin to running a hundred meter dash with one runner beginning from the usual starting line while the other runner starts 10 meters short of the finish line: everyone would know who would usually win such a race but no one would ever really know which runner was objectively faster.

In *Rauscher*, 2002-NMSC-013, ¶ 39, 132 N.M. 226, the New Mexico Supreme Court rejected an application of the predominant ingredient test to a specific provision when the nature of the transaction itself at issue would "surely" result in the sales component exceeding the service component, thus rendering a specific statutory provision a nullity. Applying the predominant ingredient test to Section 7-9-65 would be contrary to this principle articulated in *Rauscher* and contrary to the requirement that a deduction must be construed narrowly and that the right to a deduction must be clearly established by Taxpayer. *See Wing Pawn Shop*, 1991-NMCA-024, ¶16. Consequently, the hearing officer finds that the predominant ingredient test is not the appropriate standard for determining deductibility under Section 7-9-65.

C. Hydraulic Fracturing Fundamentally Involves Performing Services.

Conceptually, hydraulic fracturing is equivalent to the service activities made distinct from the chemicals in the first clause under Section 7-9-65. As the Department points out, the Legislature defines "use" or "using" to include "use, consumption, or storage other than storage for subsequent sale in the ordinary course of business or for use solely outside this state." NMSA 1978, § 7-9-3 (N) (2007). Just like an oil company would use chemicals in acidizing a well, Taxpayer is using the chemicals to fracture rocks within the well. Like the acid that is consumed in performing the well acidizing service, the chemicals used in hydraulic fracturing are consumed as part of the hydraulic fracturing service. The deduction under Section 7-9-65 allows the deduction for the separate sale of the chemicals, like the acid used for acidizing the well. However, based on the statutory distinction discussed in the first clause, the deduction does not

allow the person or entity using the chemical for the performance of the associated service to claim the deduction. Just as the acidizing the well is fundamentally a service not subject to the deduction under Section 7-9-65, hydraulic fracturing of a well is also a service not subject to the deduction under Section 7-9-65.

As the Department persuasively cited in its arguments, numerous other states (including three[15] of New Mexico's neighboring states that also have a large oil and gas industry presence), have held that hydraulic fracturing amounts to a service rather than the sale of goods. Taxpayer's main criticism of these cases is that they all employ an analysis other than the predominant ingredient test used in New Mexico. It is true that none of these cases analyze the issue under the predominant ingredient test. However, as discussed above, the predominant ingredient test is not compatible with the deduction under Section 7-9-65. The absence of a predominant ingredient test in these cases does not fundamentally alter the persuasive value of the cited cases when considering a deduction where the predominant ingredient analysis also does not apply. While New Mexico's gross receipts tax scheme is certainly unique compared to other states like Colorado, Utah, Texas, Illinois, and Kentucky, hydraulic fracturing is not unique to New Mexico, making those other states' treatment of hydraulic fracturing still pertinent to the analysis in this case in spite of the different statutory schemes. As the Department argued in response to Taxpayer's attempt to distinguish these cases from New Mexico law, all of the cases reached some variation of the conclusion that the chemicals and other products are consumed in the process of hydraulic fracturing of the oil well, the purpose of which is to improve oil well

[15]As the Department cited in its summary judgment motion, the Texas Comptroller found that a hydraulic fracturing taxpayer was not entitled to a refund when it failed to show that it transferred the care, custody, and control over the proppants and other chemicals used in the fracturing process to its customer well operators. *See Taxpayer No.**** *v. Texas Comptroller of Public Accounts*, 2015 Tex. Tax LEXIS 174 (non-precedential). The case will not be addressed further because of its limited analysis.

production to the well owner rather than to sell them chemicals.

In *Noble Energy, Inc. v. Colo. Dep't of Revenue*, 232 P.3d 293 (Colo. App. 2010), the Colorado Court of Appeals considered the question of a claim for refund of Colorado sales tax stemming from that Taxpayer's hydraulic fracturing activities in Colorado. Noble Energy sought a refund of paid sales tax on the materials provided to it by hydraulic fracturing companies, arguing that it made no purchase of tangible materials from the hydraulic fracturing companies. *See id*., 295. The District Court in that case had granted the refund, finding in pertinent part that the goods and services components of hydraulic fracturing were inseparable, that the true object of the transaction was for Nobel Energy to obtain the hydraulic fracturing service to improve oil-well productivity rather than to obtain the materials, and that any tangible property transferred was incidental to the performance of the fracturing service. *See id*. On these pertinent issues, the Colorado Court of Appeals in *Nobel Energy* ultimately upheld the District Court's ruling.

There are some important notable differences between New Mexico and Colorado law: unlike New Mexico's hybrid gross receipts system, Colorado generally only imposes a sales tax on the sale of tangible personal property and not on the provisioning of services. In determining whether a sale involves tangible personal property or the performance of a service, Colorado uses the true object test rather than the predominant ingredient test that controls in New Mexico. As discussed above, since the predominant ingredient test cannot apply under Section 7-9-65, this distinction is not as critical as Taxpayer argues. In analyzing the issue before it, the Colorado Court of Appeals persuasively described the nature of the hydraulic fracturing transaction:

> The fracturing fluids have no value to the taxpayer after the services are performed and, as discussed below, the sands become an integral and inseparable part of the realty that taxpayer does not own. The fracturing company, not taxpayer, uses the fracturing materials, even though taxpayer must dispose of the waste. The tangible personal property once consumed is disposed of, not retained. The fractures, not the materials, are the finished product sought by taxpayer. The skill and expertise used to create

the fracturing materials are not transferred, or even disclosed, to taxpayer.

Noble Energy, Inc., 232 P.3d 293, 298.

The Colorado Court of Appeals also quoted favorably the Illinois Supreme Court, which had considered the tax implications of stimulation treatments on oil and gas wells (hydraulic fracturing has a similar purpose to enhance production): “[i]t also seems clear that the treatments involve the utilization of special skill, knowledge and experience to accomplish the end result desired by the customer, and that the chemicals utilized are incidental to the rendition of the service." *Noble Energy, Inc. v. Colo. Dep't of Revenue*, 232 P.3d 293, 298-99 (Colo. App. 2010), citing *Dow Chemical Co. v. Department of Revenue*, 26 Ill. 2d 283, 186 N.E.2d 333, 335 (Ill. 1962). In Colorado, hydraulic fracturing is considered the performance of a service (which is not taxable in Colorado), and the materials are inseparable from the performance of that fracturing service.

Similarly, in a case cited in *Noble Energy, Inc.*, the Kentucky Court of Appeals also found that when a well service company engaged in cementing, acidizing, and fracturing oil wells totally consumes the materials in the process of stimulating well production, that company is not selling tangible personal property. *See Nowsco Well Serv. v. Revenue Cabinet Commonwealth*, 804 S.W.2d 10 (Ky. Ct. App. 1990).

The Utah Supreme Court reached a similar conclusion about the nature of hydraulic fracturing in the case *BJ-Titan Servs. v. State Tax Comm'n*, 842 P.2d 822, 183 Utah Adv. Rep. 20 (1992). Like the later Colorado case, the taxpayer challenged the imposition of a sales tax—which under Utah applies only to tangible personal property rather than services—on hydraulic fracturing and acidizing of oil wells in Utah. *See id*. While again Utah does not use the predominant ingredient test, the analysis about the nature of hydraulic fracturing is still pertinent to the specific deduction under Section 7-9-65 at issue. In finding that no Utah sales tax applied,

the Utah Supreme Court stated that

> …fracturing and acidizing produce no finished tangible product. Chemicals are injected into the well to stimulate well flow and returned as part of production when oil and other fluids are taken from the well. The well operator is not concerned with retrieving the chemicals, or the use of any particular chemical. **The value to the customer lies purely in the service, not in the chemicals, and there is no real transfer of possession or ownership of the chemicals**. Therefore, the essence of BJ-Titan's fracturing and acidizing services is providing services, not tangible personal property, and **the chemicals consumed in providing those services are merely incidental** and thus not taxable.

BJ-Titan Servs. v. State Tax Comm'n, 842 P.2d 822, 828-29, 183 Utah Adv. Rep. 20 (1992) (emphasis added).

The common denominator in these out-of-state cases is that the courts all found that the tangible chemicals and other products were consumed in performance of the hydraulic fracturing service. Although the out of state cases applied different legal standards from the respective states at issue, that common observation still is relevant under New Mexico law. In fact, as the next few sections discuss, the hearing officer finds the case law quite compelling: chemicals used and consumed in the performance of hydraulic fracturing are incidental to the performance of the fracturing.

D. Chemicals used in hydraulic fracturing are consumed in performance of that service and are incidental to the performance of that service.

Regulation 3.2.205.10 NMAC states that "[w]hen a taxpayer uses tangible personal property in the performance of a service, the tangible personal property is acquired for use and not for sale in the ordinary course of business." Department regulations are to be given substantial weight and are presumed to be proper implementations of the statutes. *See Chevron U.S.A., Inc. v. State ex rel. Dep't of Taxation & Revenue*, 2006-NMCA-50, ¶16, 139 N.M. 498,

503; *see also* NMSA 1978, § 9-11-6.2 (G) (2015). Taxpayer argues[16] that this regulation only applies to the specific deduction under NMSA 1978, Section 7-9-47 or the nontaxable transaction certificate (NTTC) required by that statute. While the regulation references the NTTC and regular course of business requirements of Section 7-9-47, there is nothing in the regulation that expressly limits its application solely or exclusively to Section 7-9-47. The scope of part 205 of the regulations is to all persons engaging in business in New Mexico, not just those persons seeking the deduction under Section 7-9-47. *See* Regulation 3.2.205.2 NMAC. The objective of part 205 of the regulations is to "interpret, exemplify, implement and enforce the provisions of the Gross Receipts and Compensating Tax Act." Regulation 3.2.205.6 NMAC. As such, in addition to its specific application to Section 7-9-47, the regulation also has relevance to other questions under the Gross Receipts and Compensating Tax Act, including the disputed deduction at issue in this protest.

Taxpayer was performing a service for its customers when it used the chemicals at issue for hydraulic fracturing of oil wells. Taxpayer presented much evidence as part of the predominant ingredient test that the costs of goods sold during the fracking job exceeded the costs of labor and administrative costs. But, as the predominant ingredient test does not apply under Section 7-9-65, that evidence was ultimately unpersuasive in light of the real object of the work to the customer: to increase oil well production. *See BJ-Titan Servs.*, 842 P.2d 822, 828-29. The fact that Taxpayer used various billing strategies or separately billed goods from labor and administrative costs does not fundamentally alter the analysis. Taxpayer itself seemed to recognize the true value of the work in its marketing materials, its internal documents, and its trademark applications. Taxpayer's marketing materials and its own internal technical materials

[16] *Taxpayer Written Closing Argument*, p. 21.

described its branded fluid products as part of a fracturing service system. Taxpayer's trademark applications for its branded fluids described those branded fluids as services. Taxpayer's witnesses readily conceded that the branded fluid systems composition changed depending on the needs of the job, which is highly indicative of the exercise of technical expertise and judgment consistent with the rendering of a service rather than the sale of a tangible chemical. Taxpayer used the branded fluid systems and chemicals to perform the service of hydraulic fracturing. To that extent, Regulation 3.2.205.10 NMAC establishes the Taxpayer acquired the chemicals for use in a service rather than for resale to the well operators.

Regulation 3.2.205.10 NMAC also contains numerous examples, with example 4 being particularly pertinent to the use of chemicals and other materials in hydraulic fracturing:

> O & G Service Company uses swabbing cups and other rubber goods in the course of its **servicing an oil well**. In fact, **this tangible personal property loses its separate identity in the course of the service**. As is customary in the industry, O & G Service Company separately states the value of the swabbing cups and other rubber goods in its billing to the person who contracted for the servicing of the well. O & G may not execute nontaxable transaction certificates under Section 7-9-47 NMSA 1978 to acquire the swabbing cups and other rubber goods because **O & G is using those goods in the performance of its service**. In this case, it is immaterial whether O & G Service Company separately states the value of such tangibles or whether it is the industry practice to do so.

Regulation 3.2.205.10(7) NMAC (emphasis added).

While this example expressly states that the oil and gas service company cannot issue a NTTC needed to meet the deduction under Section 7-9-47, it also makes clear that when the tangible personal property loses it separate identity in the course of servicing the oil well, the goods are being used in the performance of a service rather than being sold as tangibles. Even beyond Section 7-9-47, that concept has a direct application to hydraulic fracturing: because the chemicals are consumed upon entry into the wellhead, those chemicals are being used solely for the performance of the hydraulic fracturing service rather than being sold to Taxpayer's

customers as tangible chemicals. The evidence clearly established in this case that once the chemicals passed into the wellhead, they were essentially consumed in that they were either absorbed permanently and not retrievable into the subsurface formations, or they returned out of the wellhead as waste products that could not be reused or repurposed in a manner consistent with their original purpose.

Moreover, under Revenue Ruling 420-15-1, the performance of a service does not include the sale of tangible property when the tangible property either is consumed within the performance of a service or is the product of a service. Department rulings are presumed to be proper implementations of provisions of the law. *See* NMSA 1978, Section 9-11-6.2 (G) (2015). Revenue Ruling 420-15-1, synthesizing numerous regulations and their accompanying examples, carefully distinguished between when a tangible property is consumed (in which case the service does not also involve the sale of tangible property) versus when the tangible is installed (in which case the transaction involves both the sale of a service and sale of tangibles):

> Regulations 3.2.1.29 and 3.2.205.10 NMAC address when the performance of a service involves the sale of tangible property as well. Essentially, based on the different paragraphs and examples set forth in these regulations, the performance of a service does not include the sale of tangible property when the tangible property is either consumed within the performance of the service or is the product of the service. (See, e.g., Regulations 3.2.1.29(D)(5), (7), (8) and 3.2.205.10(A)(4), (6), (7) NMAC). However, when the tangible property is permanently placed or installed in conjunction with the performance of the service and separately stated on the taxpayer's invoicing, the transaction includes both the performance of a service and the sale of tangible personal property. (See, e.g., Regulations 3.2.1.29(D)(12) and (E)(2) and 3.2.205.10(D), (E), (H) NMAC).

Revenue Ruling 420-15-1.

Under Revenue Ruling 420-15-1, because proppant is not consumed and instead becomes permanently installed in the subsurface rock formation in order to hold open the fractures in the formation from which the oil will flow through to the wellhead, the sale of proppant (if separately

billed) as part of the hydraulic fracturing process does amount to the sale of tangible property in addition to the sale of a service. *See id*. In contrast, and in pertinent part to the resolution of this protest, since chemicals used in hydraulic fracturing are consumed during the performance of the hydraulic fracturing service, Revenue Ruling 420-15-1 concludes that those chemicals used in hydraulic fracturing transaction do not amount to the sale of tangible property:

> the chemicals X uses as part of its fracturing services are consumed during the performance of the fracturing services. Because these chemicals are consumed during the performance of the fracturing services, X is not selling tangible property to the purchaser of its fracturing services, regardless of the fact that X separately states the amount and price of the chemicals on its invoices.

Id.

In other words, under Revenue Rule 420-15-1, which is the presumed proper implementation of the applicable law, the sale of chemicals as part of hydraulic fracturing service may not be treated as the sale of tangible products because those chemicals are consumed during the fracturing of the well. This conclusion is independent of the billing method employed by the parties. *See id.*

This conclusion of the relevant ruling is consistent with Regulation 3.2.205.10 NMAC, with the out of state case law finding that the tangible chemical property consumed during hydraulic fracturing is incidental to the performance of the fracturing service, and with numerous other areas of the Gross Receipts and Compensating Tax Act, and accompanying regulatory examples, cited by the Department in its written closing argument. Without fully restating all of the Department's contentions in its written closing argument, a few bear highlighting as supportive of the Department's proposition that under the Gross Receipts and Compensating Tax Act the Legislature "did not intend to permit a taxpayer who uses tangible personal property in the performance of a service to claim that it was selling that property." [17]

[17] *Department Written Closing Argument*, p. 4.

The Department cites[18] the definition of "consumable" under NMSA 1978, § 7-9-46 (F) (2013), which means "tangible personal property that is incorporated into, destroyed, depleted, or transformed the during the process of manufacturing a product," to argue that by analogy this concept of consumption of tangible personal property in the manufacturing process should also apply to consumption of the tangible personal property in the hydraulic fracturing process. The Department also cites[19] the deduction under NMSA 1978, Section 7-9-54 (2015), which does not permit receipts from performing a service that reflects the value of tangible personal property utilized or produced in the performance of that service from being included in the deduction for selling tangible personal property to governmental agencies. *See also* NMSA 1978, Section 7-9-78 (1991) (Department highlighted[20] that the deduction does not apply if the use of tangible personal property was incidental to the performance of a service). The Department contrasts[21] the examples under Regulation 3.2.2015.10(C) NMAC (landscaper does not sell fertilizer, insecticides, or the herbicides used in lawn maintenance) with Regulation 3.2.2015.10(D) NMAC (landscaper does sell plants, shrubs, trees, rock, seeds, sod, and ornaments) to distinguish between when the seller is merely using the items to perform the service or whether the items are being transferred to the buyer for the buyer's use. Again, these examples support the Department's contention that the Legislature "did not intend to permit a taxpayer who uses tangible personal property in the performance of a service to claim that it was selling that property."

E. Even if the Predominant Ingredient Test applies, Taxpayer's arguments do not persuade, as the transfer of the chemicals was incidental to the performance of the hydraulic fracturing service.

[18] *Department Written Closing Argument*, p. 12.
[19] *Department Written Closing Argument*, p. 3-4.
[20] *Department Written Closing Argument*, p. 3-4.
[21] *Department Written Closing Argument*, p. 8-9.

While the hearing officer does not find that the predominant ingredient test is compatible with the specific statutory requirements of the deduction under Section 7-9-65, even arguably if it was, Taxpayer's argument would not prevail in light of the regulations addressing the predominant ingredient test. Regulation 3.2.1.29(A) NMAC addresses when a transaction is predominately a service:

> (1) **A transaction involving both the transfer of tangible personal property to the buyer and the performance of a service** other than a construction or research and development **service is predominantly a service when**:
>
> (a) the seller is **not regularly engaged in selling** or leasing the same or similar tangible personal property other than in conjunction with the sale of a service; and
>
> (b) **at least one of the following** conditions applies:
>
> (i) the **transaction is primarily the performance of work** and the transfer of any property through the transaction is incidental to the performance of the required work; or
>
> (ii) the transaction requires the performance of work which is substantially greater in value than the value of the tangible personal property involved in the transaction; or
>
> (iii) **the performer of the service has the power to influence significantly the degree of involvement of the tangible personal property** in the transaction.
>
> (2) **When the transaction is predominantly a service** other than construction, **any tangible personal property transferred in conjunction with the service is incidental to the service and the value of the property becomes an element of and is incorporated into the value of the service sold**. Type 2 nontaxable transaction certificates (NTTCs) may not be executed to acquire the property so incorporated.

3.2.1.29 NMAC (Emphasis added)

Contrary to Taxpayer's assertion in its closing argument that none of the conditions under Regulation 3.2.1.29(A)(1) NMAC are true[22], the hearing officer finds based on the preponderance of evidence that conditions (1)(a), (1)(b)(i) and (1)(b)(iii) were met, making the transaction predominantly a service and the transfer of the tangible chemicals as part of the hydraulic

[22] *Taxpayer Written Closing Argument*, p. 11.

fracturing service incidental to the service. In an answer to the Department's interrogatories [Department Ex. I.060], Taxpayer admitted it did not regularly engage in selling the chemicals and other hydraulic fracturing products outside of the sale of the hydraulic fracturing service. While Halliburton did present some evidence at hearing [Taxpayer Ex. #123] that it occasionally sells the chemicals separate from the performance of hydraulic fracturing services, only five of those sales for a nominal amount occurred in New Mexico during the refund claims period. This evidence simply does not support that separate sales are a frequent or regular occurrence despite the argument otherwise. Given the size of Taxpayer as a large multinational corporation and Taxpayer's sales volume of hydraulic fracturing just in New Mexico as shown by the refund claims, 168 examples of total separate sales, only five of which occurred in New Mexico, are isolated and occasional sales not indicative of regularly engaging in the separate sales of chemicals. Therefore, the hearing officer finds that under Regulation 3.2.1.29(A)(1)(a) NMAC, Taxpayer was not regularly engaged in the separate sales of chemicals other than in conjunction with the performance of hydraulic fracturing.

Further, consistent with the findings of the Utah Supreme Court, the Colorado Court of Appeals, and the Illinois Supreme Court as discussed above, the hearing officer finds under Regulation 3.2.1.29(A)(1)(b)(i) NMAC that the hydraulic fracturing transaction is primarily the performance of a service, with the transfer of the chemicals being incidental to the performance of the service. *See BJ-Titan Servs.*, 842 P.2d 822, 828-829; s*ee also Noble Energy, Inc.*, 232 P.3d 293, 298; s*ee also Noble Energy, Inc.*, 232 P.3d 293, 298. Taxpayer's expertise in hydraulic fracturing, Taxpayer's experienced employees, Taxpayer's equipment for the job, Taxpayer's engineering and chemistry knowledge, and Taxpayer's development through testing and laboratory work of intellectual property and proprietary branded fluid systems all appear to be critical to increasing efficiency in well production. *See Dow Chemical Co.,* 186 N.E.2d 333, 335

("the treatments involve the utilization of special skill, knowledge and experience to accomplish the end result desired by the customer, and that the chemicals utilized are incidental to the rendition of the service."). Despite Taxpayer's attempts to minimize the importance of the service component of the hydraulic fracturing service by separate billing and its predominant ingredient analysis, like the Utah Supreme Court and Colorado Court of Appeals, the hearing officer is convinced based on the evidence presented and the case law that the essence of hydraulic fracturing is Taxpayer's "specialized skill and knowledge, laboratory data and tests and information regarding a particular well to be fractured," the things necessary to create fractures in the subsurface formation for increasing well production. *Noble Energy, Inc.*, 232 P.3d 293, 299.

Taxpayer's customers are all sophisticated oil and well companies with knowledge of their own well, knowledge of their own needs to maximize oil production from their own well, their own employees, their own infrastructure, and their own equipment in place at each well location. Instead of simply purchasing chemicals necessary to fracture the well on their own using their own resources, Taxpayer's customers still hire Taxpayer to fracture the well. While a physical transfer of the chemicals may in fact occur at the wellbore, Taxpayer's customers never meaningfully use, possess, or control the injected chemicals, as they are essentially fully consumed during the performance of the hydraulic fracturing service. Surely, what Taxpayer's customers seek is Taxpayer's specialized knowledge and skills in fracturing, which leads to increased well production through fracturing the subsurface geology.

The hearing officer also finds that Regulation 3.2.1.29(A)(1)(b)(iii) NMAC has been satisfied in this case. As to this condition, Taxpayer argues that the customers dictated the degree of involvement of the tangible personal property in the transaction[23]. The evidence established

[23] *Taxpayer Written Closing Argument*, p. 12.

that Taxpayer had the power to influence to a significant degree the involvement of tangible chemicals in the transaction. It is certainly true that Taxpayer's customers sent out the detailed job requests, always had employees at the job site, and as owners of the wells, Taxpayer's customers could stop the service at any point. But it is also true that Taxpayer had the specific expertise, knowledge, experience, equipment, and employees at the wellsite to perform the hydraulic fracturing service, meaning that Taxpayer had a great deal of power in developing the fracking plan, including the chemicals to be used, and implementing or changing that plan as conditions dictated at the job site. Taxpayer's branded fluid systems' composition changed depending on the specific jobsite and formation at the wellhead. The fact that Taxpayer could use its own branded and trademarked fluid systems, and could change the composition of those fluids systems as necessary to meet its customer's needs, shows exactly that Taxpayer had the power to influence what chemicals were involved in the transaction under Regulation 3.2.1.29(A)(1)(b)(iii) NMAC. Because the hearing officer finds that conditions (1)(a), (1)(b)(i) and (1)(b)(iii) under Regulation 3.2.1.29(A)(1) NMAC were met, Regulation 3.2.1.29(A)(2) NMAC dictates that even if the predominant ingredient test applied under Section 7-9-65, the transfer of the chemicals in conjunction with the hydraulic fracturing service was incidental to that service and value of those chemicals is incorporated into the value of the services sold.

The hearing officer does not find compelling Taxpayer's argument[24] that two regulatory examples under Regulation 3.2.205.14 NMAC dealing with the administering of drugs by an oncologist and a veterinarian support its claim for refund. Under Regulation 3.2.205.14 (D) NMAC, cancer drugs administered by an oncologist may be deducted if separately billed and if the oncologist delivers a type 2 NTTC to the seller. Similarly, under that regulation, veterinarians

[24] *Taxpayer Written Closing Argument*, p. 14-16.

who administer drugs to animals in the course of treatment may be deductible with a type 2 NTTC. Despite Taxpayer's criticism[25] of the Department's reliance on Regulation 3.2.205 NMAC because that rule's references to NTTCs suggested it only applied to the deduction under Section 7-9-47, Taxpayer cites two examples from the very same regulation, both examples also referencing NTTCs. Taxpayer's argument attempts to analogize the injection of drugs into a patient like the injection of chemicals into the oil well, and as such, argues that the hydraulic fracturing chemicals should be equally deductible.

Perhaps on a superficial level, these examples may seem comparable to hydraulic fracturing, but given the fundamentally different nature of the transactions at issue and more importantly the different treatment of those transactions under the tax scheme, there is little persuasive value in the comparison. The Gross Receipts and Compensating Tax Act's treatment of medical services involves a complex web of overlapping, piecemeal, and at times potentially contradictory treatment of medical receipts, depending on both source of payment and the type of medical provider involved in the transaction. As such, the hearing officer finds little persuasive value in attempting to analogize receipts related to performance of hydraulic fracturing with the mosaic web of treatment of medical receipts. This is especially true in this case, where there are numerous other more pertinent regulatory examples in the same related field of servicing of oil wells as hydraulic fracturing. *See* Regulation 3.2.205.10(7) NMAC; *see also* Regulation 3.2.1.29 (A)(5) NMAC (addressing an oil well service company's use of products that are consumed in the course of servicing the well and finding that those products are incidental to the performance of the service).

In summary of issue one, based on the record, the persuasive legal arguments of the

[25] *Taxpayer Written Closing Argument*, p. 20-21.

Department, and the analysis contained in this section, the hearing officer finds and holds that the chemicals used as part of the hydraulic fracturing process are consumed in the performance of the service making them incidental to the performance of that service and not subject to the deduction under Section 7-9-65. As such, Taxpayer's claims for refund, and this protest, must be denied regardless of the remaining disputed issues. Nevertheless, because of the likelihood of appeal the remaining two issues will still be addressed in turn.

ISSUE TWO: Determining how a "lot" is measured under Section 7-9-65.

The second issue that the parties identified in their joint prehearing statement is, for the purposes of the deduction under Section 7-9-65, how is a "lot" measured? To reiterate, the pertinent portion of the deduction under Section 7-9-65, reads "…receipts from selling chemicals or reagents in lots in excess of eighteen tons may be deducted from gross receipts." The question at issue is what constitutes a lot and how is a lot measured. This was also at issue in *In the Matter of the Protest of Tucson Electric*, Administrative Hearings Office Decision and Order #16-29 (non-precedential, currently under appeal, Court of Appeals No. A-1-CA-35781), a case currently under appeal before the New Mexico Court of Appeals. The resolution of the *Tucson Electric* appeal may well be dispositive of this issue. Because issue one is dispositive of this protest and the appeal in *Tucson Electric* will bring further clarity on issue two, the discussion of issue two will be relatively concise.

A. Multiple Chemicals may constitute an 18-ton lot under Section 7-9-65.

Taxpayer argued[26] that a lot can consist of different chemicals and the hearing officer

[26] *Taxpayer Written Closing Argument*, p. 22-23.

agrees. Section 7-9-65 uses the plural "chemicals" rather than the singular "chemical." A plain reading of this statutory language suggests that the Legislature contemplated that a lot could be composed of multiple chemicals. As Taxpayer persuasively cited in support, Department Regulation 3.2.223.7(A)(2) NMAC and Revenue Ruling 73-195-4 support that multiple types of chemicals can constitute an 18-ton lot for the purposes of Section 7-9-65.

B. Lots under Section 7-9-65 Do Not Include Delivery by a Continuous Flow.

The Department's argument that under Section 7-9-65, a "lot" was never intended to apply to products delivered by continuous flow of goods is persuasive. Regulation 3.2.223.7 (A) NMAC (emphasis added) defines "lots" for the purposes of Section 7-9-65 to mean "a parcel or single article which is the subject matter of **a separate sale or delivery**, whether or not it is sufficient to perform the contract." This regulatory definition of "lots" mirrors the Uniform Commercial Code's definition of "lots" at U.C.C. §2-105(5) as adopted in New Mexico at NMSA 1978, Section 55-2-105(5). A continuous flow of goods is inconsistent with the regulation's single article standard. While a parcel of goods certainly could involve volumes of fluid within a greater volume of the same fluid[27], that definition still implies some fixed quantities of fluid rather than a continuous flow of fluids through a pipeline. A continuous flow of goods through a pipe is not consistent with the regulatory requirement of "a separate sale or delivery." Nor is it consistent with the basic historical intent of the 18-ton lot requirement: 18-tons is the quantity needed to fill a carload of acid. *See* 65 Op. Att'y Gen. 148, 252 (1965).

Although Taxpayer makes some good counterarguments—which is part of the reason why this decision adopts an alternative approach on issue two in addition to the pending appeal in *Tucson Electric*—the hearing officer ultimately finds that the regulatory language defining lots,

[27] See Merriam Webster, https://www.merriam-webster.com/dictionary/parcel

the carload historical basis for the 18-ton lot requirement that was understood at the time of the passage of Section 7-9-65, and the general requirement that deductions be construed narrowly, *see Wing Pawn Shop*, 1991-NMCA-024, ¶16, 111 N.M. 735, supports the Department's contention that the term lots means a discrete and identifiable set of goods rather than a continuous flow. The fact that each party presented competing points to define the single sale or delivery in the circumstance of a continuous flow of chemicals into a wellhead illustrates that the statute and interpreting regulations were never intended to apply to the continuous flow delivery mechanism at issue in this case. Taxpayer's position on how to define and measure a lot requires an expansive reading of the deduction and regulations, an approach not permitted for interpretation of a deduction. *See id*.

C. In the alternative, a day's worth of deliveries is the appropriate measurement period.

Alternatively, in the event that upon appeal a continuous flow of delivery is permitted under Section 7-9-65, the hearing officer finds that the most logical measuring time period consistent with the statute, the regulation, and *Runco* is a calendar's day worth of deliveries.

Taxpayer originally argued that all chemical transfers shown on the invoices in this case could be aggregated for the purposes of calculating an 18-ton lot. However, the hearing officer rejected that approach with the July 13, 2018 order a making threshold legal determination but denying summary judgment (threshold order). Taxpayer renewed[28] that argument in its closing argument, but the hearing officer remains unconvinced. Taxpayer's preferred approach simply is not consistent with the statutory language, Regulation 3.2.223.7 (A) NMAC, and to a lesser extent, *Runco Acidizing and Fracturing Co., Inc. v. Bureau of Revenue*, 1974-NMCA-145, 87 NM 146.

[28] *Taxpayer Written Closing Argument*, p. 26-27.

Taxpayer's original argument for an aggregation of chemicals on an invoice approach was inconsistent with the example under Regulation 3.2.223.7 (A)(2) NMAC:

> H sells P fifteen tons of hydrochloric acid on March 1, 1978. On April 15, 1978, H sells P another ten tons of chemicals. P does not use the chemicals for exempt purposes. H wants to deduct the gross receipts from these sales since the total amount of chemicals sold exceeded eighteen tons. In this case one lot amounted to fifteen tons, the other to ten tons. The sales may not be added for the purpose of this deduction. The deduction will be disallowed.

Under this regulatory example, aggregating quantities of chemicals delivered at distinct times is not permitted. This is consistent with the separate sale or delivery requirement under the same regulation.

Moreover, the approach also appeared inconsistent with *Runco,* the only case that has addressed the deduction under Section 7-9-65. In *Runco,* the New Mexico Court of Appeals noted that under the facts of that case, since each single delivery (or daily delivery) of chemicals or reagents pursuant to a purchase order individually fell below the 18-ton lot threshold, the only way that taxpayer might still qualify for the chemicals or reagents deduction was if the entire purchase order qualified as a sale. *See Runco,* 1974-NMCA-145, ¶5. In other words, if all single deliveries under the umbrella of the same purchase order could constitute one separate sale under that purchase order, then in affect the single deliveries noted on the purchase order of less than 18-ton lots could be aggregated to above 18-ton lots and the *Runco* taxpayer could still be entitled to the deduction. The Court of Appeals assumption built into this framing of the issue is that a taxpayer cannot aggregate multiple deliveries of chemicals in discrete amounts less than 18-tons into more than 18-ton lots unless the multiple deliveries can be considered as one sale. This framing of the issue is also perhaps represents the clearest legal holding in the case. In considering the competing evidence of when the sale occurred, the Court of Appeals noted that

> [t]he wording of the purchase orders and contract, together with evidence

> that Runco invoiced only for chemicals and reagents delivered to a well and retained payment only for what was used, supports the inference that the purchase order was not a transfer for consideration and therefore not a sale.
>
> More than one inference can be drawn from the evidence. Accordingly, the Commissioner's decision that the sale occurred when the chemicals and reagents were delivered to the well is binding.

Runco, 1974-NMCA-145, ¶ 7-8. Because *Runco* found competing inferences and accordingly upheld the decision on those grounds, it ultimately does not provide a definitive statement of law about what period of time might be applied to determine whether the lot exceeded 18-tons under Section 7-9-65.

In closing argument, Taxpayer renewed its argument for aggregation of all chemicals used in a hydraulic fracturing job under one work order contract by asserting that the facts of this case distinguish it from the critical fact of *Runco*: Taxpayer points to the fact that there is no contractual provision in this case that each "customer instruction"—the way the customer ordered products—is a separate contract and transaction. Again, because of the competing inferences that led the *Runco* court to affirm the underlying decision, the ruling in that case does not provide a definitive statement of law and to the extent Taxpayer's extrapolation from that one distinguishable fact appears somewhat overstated. Moreover, the implication of this argument is that the form of a contract could be used to control the 18-lot determination as opposed to what legally constitutes a separate sale or delivery, as required under Regulation 3.2.223.7 (A) NMAC. This elevation of form over substance is disfavored. *See Escrow Corp. v. State Taxation & Rev. Dep't,* 1988- NMCA-068, ¶ 21, 107 N.M. 540 (rejecting contention that wording in a basic real estate contract transformed the agreement into a loan for purposes of statute providing a deduction for receipts from charges made in connection with a loan).

Ultimately, it is the assumption built into the court's framing of the issue that has the most

value: *Runco* does rule out the possibility of aggregating multiple sales or deliveries into lots of 18-tons. And this principle, along with the regulatory example under Regulation 3.2.223.7 (A)(2) NMAC and the requirement of narrow interpretation of a deduction, means that Taxpayer's initial approach was inconsistent with Section 7-9-65, as discussed further in the threshold order. The hearing officer ruled in the threshold order that Taxpayer must show delivery of discrete separate sale or delivery of 18 ton lots in order to qualify for the deduction under Section 7-9-65.

There remains the question of what period of time constitutes a discrete separate sale or delivery. While the Taxpayer's preferred approach to define that period was not persuasive, neither is the Department's preferred alternative approach of a moment-by-moment measurement to test the 18-ton lot requirement. The Department argues that because it is Taxpayer's position that title to the fluids transfers the instant that the fluids passes through the wellhead, it is that exact instant in time that the 18-ton lot requirement must be measured. That is, the Department would require Taxpayer to show that literally in that instant of time 18-tons of chemicals passed through the wellhead, a near impossibility. A statute should not be interpreted in a manner that would require a nearly impossible event to occur, which would lead to the absurd result disfavored in the cannons of statutory construction. *See Regents of the Univ. of New Mexico*, 1998-NMSC-20, ¶28.

On a broader level, the Department's alternative argument is supportive of its main position that a continuous flow was never meant to constitute a lot for the purposes of Section 7-9-65. The nature of the continuous flow leads to potential philosophical and scientific arguments about what constitutes an instant of time (is it a millisecond, a second, a minute?) that no rational legislature could have ever intended to be at the core of a statutory deduction from taxation. Such debates would create a nightmare for fair, consistent, and even-handed application of the tax code

and tax administration. But on a practical level, the Department's preferred alternative approach is not workable or consistent with the reality of even a traditional delivery of a lot. The delivery of a train carload (18-tons) of hydrochloric acid, which the Department asserted was the historical basis for the deduction under Section 7-9-65 (a position supported by 65 Op. Att'y Gen. 148, 252 (1965)), would take more than an instant. Similarly, the unloading of a delivery truck containing 18 tons would surely involve more than a moment to unload. A rule of reason application of the statutory and regulatory language requires a single sale or delivery window larger than a mere moment or instant that the Department advocates for if a continuous flow lot is permitted.

But that still leaves the question about what is a workable time period in which to determine whether the 18-ton lot requirement was met. On this question, the only authority is *Runco*. In *Runco*, the Court of Appeals did make reference to a potential period of time to determine the 18-ton lot requirement: "[n]o single delivery nor **any single day's delivery** amounted to eighteen tons or more." *Runco*, 1974-NMCA-145, ¶ 5 (emphasis added). It is true, as the Department argues that this is merely a passing reference to using a day's period. Nevertheless, *Runco* is still good law and it is the only remaining valid authority that even remotely addresses this issue. A single day's worth of delivery also would set a clear, bright line rule amenable to effective and consistent tax administration. Indeed, although the revenue ruling was repealed in 1993, for 20-years the Department had in place Revenue Ruling 73-195-4 in which the Department concluded that shipments made to the same well on the same day constituted a single delivery. Given the current absence of any other statutory, regulatory, or case law authority, the *Runco* reference to a single day's delivery supports the hearing officer's alternative finding that should a continuous flow lot be permitted upon appeal, then a single calendar's day worth of shipments counts towards the 18-ton lot requirement.

ISSUE THREE: Is CRC Proppant a chemical for purposes of Section 7-9-65?

The final issue in dispute, as the parties agreed in the joint prehearing statement "[i]s [whether] curable resin coated proppant a chemical" for the purposes of Section 7-9-65. Proppant is a substance used to hold the fracture in the subsurface formation open so that oil can subsequently be pumped out of the formation. By composition, proppant is made up primarily of sand. In some circumstances, other compounds are added to the sand that can be cured for hardening the opening in the subsurface formation. The substance specifically in dispute here is Taxpayer's curable resin coated proppant, also known as CRC proppant, used in 9 out of the 10 sample wells. In the CRC proppant, the curable resin coating and a curing agent are added to the sand so that when the proppant is sent into the well, it can be hardened into the fracture using a curing agent. As the record evidence shows, both the curing agent and the curable resin coating have specific chemical formulations. However, there is no need to detail those specific chemical formulations in order to resolve this issue, and those formulations will be left out of this decision in order to respect the trade secrets privilege.

The Department argued that the CRC proppant was not a chemical for the purposes of the deduction for three reasons. First, the Department argues that that CRC proppant is not a chemical for purposes of the deduction because it is not used to produce a chemical reaction. Second, and somewhat relatedly, the Department argued that not only is CRC proppant not used for the purpose of producing a chemical reaction, but that Taxpayer failed to prove that it could produce a chemical reaction even if it was used for that purpose. Thirdly, the Department argued that since the weight of the resin and curing agent was so small in comparison to the sand, Taxpayer should not be able to claim the full weight of the sand in the composition of the CRC proppant. Taxpayer counters that the weight of the curable resin coating is irrelevant under the

analysis of a chemical, that the curable resin coating and curing agent are chemicals deductible under the language of Section 7-1-65. In considering the evidence and the arguments of the parties on issue three, the Department's argument are more persuasive.

For the purposes of Section 7-9-65, Regulation 3.2.223.7(B) NMAC (emphasis added) defines "chemicals" to mean "means a substance **used for producing** a chemical reaction." In light of this definition, the fact that curable resin coating may have a specific chemical composition by itself does not satisfy the regulatory definition of chemical for the purposes of Section 7-9-5. In other words, it is not enough under the applicable regulation to show that the substance in question was a chemical or that a chemical reaction occurred involving the substance, as those words/phrases are understood in common or even scientific parlance. Much of Taxpayer's evidence (such as the testimony of Taxpayer's expert chemist Denise Tuck) focused on establishing that the components of CRC proppant were chemicals as that term is commonly understood by chemists and that in fact chemical reactions occurred involving the components of CRC proppant. However, Regulation 3.2.223.7(B) NMAC requires more: it must be a substance that **is used for producing** a chemical reaction. *See In the Matter of the Protest of Peabody Coalsales*, Administrative Hearings Office Decision and Order No. 17-34 (non-precedential, currently under appeal, Court of Appeals No. A-1-CA-36632)[29].

As the Department persuasively argued, the curable resin coating is not used for the purpose of producing a chemical reaction. Instead, the CRC proppant is used for the physical purpose of holding open the fractures in the subsurface formation. It is the activator chemical that is later introduced into the wellhead that is used to produce the chemical reaction.

The credible, chemical engineering expert testimony of Dr. Leclerc, Professor of

[29] Part of the reason for the discussion of issue three, despite issue one being dispositive, is because the issue relates closely to the appeal in *Peabody Coalsales*.

Chemical Engineering at New Mexico Tech, was particularly helpful in this context. Dr. Leclerc indicated that the phrase "used for producing" is not terminology employed in the field of chemistry. [Tr. 930:2-4]. While Taxpayer attempts to reject Dr. Leclerc's testimony on these grounds, the hearing officer found that this acknowledgment was simply Dr. Leclerc's recognition that the standard for the purposes of the deduction is a legal standard rather than a term of art in the field of chemistry. In light of the absence of meaning in the specific field of chemistry, "producing" should be given its ordinary meaning under the regulation. As the Department cited in argument, Webster's defines "produce" as "to cause to have existence or to happen: bring about; ORIGINATE." Webster's 3d New Int'l Dictionary at 1810 (1993). And, as the department cites in its closing argument, this "producing" concept related to a chemical is not foreign in the law even if it is not a phrase or language regularly used by chemists. *See, e.g.*, *Millennium Pharms., Inc. v. Sandoz Inc.*, 862 F.3d 1356, 1364 (Fed. Cir. 2017) ("However, the prior art does not teach or suggest that lyophilization of bortezomib in the presence of mannitol would produce a chemical reaction and form a new chemical compound"); *Application of Samtko*, 393 F.2d 998, 1000 (C.C.P.A. 1968) ("When radiation such as alpha, beta, gamma, neutrons and X-rays passes through matter, the heavier particles tend to produce nuclear changes and chemical reactions."); *McCants v. Hallenback*, 2014 WL 4638836, at *3 (E.D.N.Y. Sept. 16, 2014) ("A reagent is a liquid substance added to another substance that produces a chemical reaction, which itself produces a color change that would indicate (in this case) whether the questioned sample is consistent with cocaine."); *May v. Colvin*, 2013 WL 1702544, at *5 n.4 (W.D. Mo. Apr. 19, 2013) ("Visudyne is activated by the laser light, which produces a chemical reaction that destroys abnormal blood vessels."); *Nichols v. Strike King Lure Co.*, 2000 WL 1593616, at *7 (N.D. Tex. Oct. 25, 2000) ("The preferred embodiment describes how the coating is produced: 'To produce such coating, a liquid epoxy resin and a hardener for such resin are mixed to produce a chemical reaction resulting in converting the liquid mixture into a

solid by passing through a highly viscous liquid stage.'"); I.R.S. PLR 200746011 (IRS PLR Nov. 16, 2007) ("A proprietary chemical reagent, which is designed to produce a chemical reaction as part of the synthetic fuel production process is then applied to the feed stock coal and thoroughly combined in the mixer."); *B.F. Goodrich Co. v. Oldmans Twp.*, 17 N.J. Tax 114, 128-30 (1997) ("The tanks are then heated with steam then cooled with chilled water to produce the chemical reaction"), *aff'd*, 733 A.2d 1204 (N.J. App. Div. 1999); *Walsworth Pub. Co. v. Dir. of Revenue*, No. 98-2404 RV at 3 (Mo. Admin. Hr'g Comm'n July 28, 2000) ("When taking a photograph, the light that strikes the film produces a chemical reaction within the silver halide emulsion and creates a negative latent image on the film."), *available at* https://ahc.mo.gov/cases/historical/79000; *compare Cambria Cogen Co v. Commonwealth of Pennsylvania, Dep't of Env. Res.*, 1995 EHB 191, 197 (Pa. Env. Hr'g Bd. Feb. 10, 1995), *available at h*ttp://ehb.courtapps.com/content/adjudications/Adjudications&Opinions-1995- Vol%201%20(pp.1-435).pdf ("The furnace heat calcines the limestone to form calcium oxide. This calcium oxide ***reacts*** with sulfur dioxide to form calcium sulfate.") *with id.* at 223-24 ("A treatment plant is no less beneficial to the general public because in its operation chemicals are added which, as a result thereof in treatment, **produces** a chemical reaction forming a sludge.") (emphasis added).

Dr. Leclerc credibly testified that the curable resin coating in CRC proppant is not used for producing a chemical reaction. [Tr. 929:18-931:8; 931:24-935:7]. Using his knowledge of chemistry to apply the regulatory legal standard, Dr. Leclerc credibly opined that the curable resin coating merely participated in the chemical reaction but was not used to produce the chemical reaction. Instead, Dr. Leclerc opined that the producer and the catalyst for that reaction was either heat or the two types of separate activator chemicals later sent down the wellhead. [Tr. 929:18-931:8; 931:24-935:7]. Since the curable resin coating did not produce the chemical reaction, that compound does not meet the regulatory definition for a chemical subject to the deduction under Section 7-9-65, making CRC proppant ineligible for the deduction under that

section.

As to Taxpayer's counterargument about the weight of the curable resin coating compared to the sand in CRC proppant, Taxpayer appears to significantly overstate the rationale of the hearing officer *In the Matter of the Protest of Tucson Electric,* Administrative Hearings Office Decision and Order #16-29 (non-precedential, currently under appeal, Court of Appeals No. A-1-CA-35781). Taxpayer claims[30] that there was no need for the hearing officer to determine how much methane was in natural gas because it made no difference whether a chemical had active or inactive ingredients so long as it is used to produce a chemical reaction. However, despite quoting the language, Taxpayer overlooks that fact that the hearing officer specifically found that methane was "a **major** component of natural gas." *Id*., p. 3, FOF #13 (emphasis added). A substance that has such a minor weight of CRC proppant does not appear to be a major component of CRC proppant. Nor does the fact the curable resin coating has far more monetary value necessarily establish that it is a major component of CRC proppant, especially because, as the Department counters, Section 7-9-65 establishes a weight standard not a value standard for the deductible chemicals.

In summary of issue three, because CRC proppant is not used to produce a chemical reaction, and instead just participates in a chemical reaction produced by heat or an activator chemical, it does not meet the regulatory definition of a "chemical" under Regulation 3.2.223.7(B) NMAC for the purposes of Section 7-9-65.

CONCLUSIONS OF LAW[31]

1. Taxpayer filed timely, written protests of the Department's denial of the claims for refund and jurisdiction lies over the parties and the subject matter of this protest.

[30] *Taxpayer Written Closing Argument*, p. 32-33.
[31] Except for Conclusions of Law #1, #111-114, and #122, all conclusions of law were adopted from the Department's proposed conclusions of law and the Department proposed Governing Principles of Law.

Issue One: **Taxpayer's use and consumption of chemicals is incidental to the performance of hydraulic fracturing services and not deductible under Section 7-9-65.**

2. "[I]t is presumed that all receipts of a person engaging in business are subject to the gross receipts tax." NMSA 1978, § 7-9-5 (1966, as amended through 2002).

3. "[T]axation is the rule and the claimant must show that his demand is within the letter as well as the spirit of the law." *Rauscher, Pierce, Refsnes, Inc. v. Tax. & Rev. Dep't*, 2002-NMSC-013, ¶ 11, 132 N.M. 226 (quoting *Kewanee Indus., Inc., v. Reese*, 1993-NMSC-006, 114 N.M. 784 (1993)).

4. "Since the avowed purpose of the act is to provide revenue, any deductions must receive strict construction in favor of the taxing authority." *Reed v. Jones*, 1970-NMCA-050, ¶ 9, 81 N.M. 481.

5. "For that reason, **deductions are construed strictly against the taxpayer**." *TPL, Inc. v. New Mexico Taxation & Revenue Dep't*, 2003-NMSC-007, ¶ 9, 133 N.M. 447 (emphasis added).

6. "[T]he statute must clearly and unambiguously express the right to the exemption or deduction … ." *New Mexico Taxation & Revenue Dep't v. Dean Baldwin Painting, Inc.*, 2007-NMCA-153, ¶ 12, 143 N.M. 189; *see also Samosa v. Lopez*, 1914-NMSC-061, ¶ 13, 19 N.M. 312 ("It is a well-established rule of construction that a statute of exemption from taxation must receive a strict construction, and no claim of exemption should be sustained, unless within the express letter or the necessary scope of the exemption clause.").

7. "Tangible personal property is often used in the process of making other property and in rendering services." *BJ-Titan Services v. State Tax Comm'n*, 842 P.2d 822, 825 (Utah 1992).

8. The Department's longstanding regulations provide "when a taxpayer uses tangible personal property in the performance of a service, the tangible personal property is

acquired for use and not for sale in the ordinary course of business." Regulation 3.2.205.10 NMAC.

9. "[A] statutory subsection may not be considered in a vacuum, but must be considered in reference to the statute as a whole and in reference to statutes dealing with the same general subject matter." 2A Norman J. Singer, *Statutes and Statutory Construction* § 46:05, at 165 (6th ed., rev. 2000).

10. "When attempting to unravel a statutory meaning we begin with the presumption that the statutory scheme is comprehensive." *Sims v. Sims*, 1996-NMSC-078, ¶ 21, 122 N.M. 618.

11. "We will construe the entire statute as a whole so that all the provisions will be considered in relation to one another." *N.M. Bd. of Veterinary Med. v. Riegger*, 2007-NMSC-044, ¶ 11, 142 N.M. 248, 164 P.3d 947 (internal quotation marks and citation omitted).

12. The goal "is to, so far as practicable, reconcile different provisions so as to make them consistent, harmonious and sensible." *State ex rel. Clinton Realty Co. v. Scarborough*, 1967-NMSC-152, ¶ 9, 78 N.M. 132.

13. In particular, it should be presumed that "the Legislature intended to adopt a consistent statutory scheme" when enacting tax statutes. *See Blackwood & Nichols Co. v. New Mexico Taxation & Revenue Dep't*, 1998-NMCA-113, ¶ 12, 125 N.M. 576.

14. Where terms are not defined, it is appropriate to look at other statutes to determine their meaning. *See Kreutzer v. Aldo Leopold High School*, 2018-NMCA-005, ¶¶ 35-42, 409 P.3d 930 (concluding that charter schools are government entities for the purposes of the Tort Claims Act because they are defined as public schools in several other statutes); *Hernandez v. Grando's LLC*, No. A-1-CA-35677, 2018 WL 4233790, at *4 (N.M. Ct. App. Aug. 30, 2018) (applying definition from the Motor Carrier Act to the New Mexico Motor Carrier Safety Act).

15. Other statutes draw a distinction between the use and sale of tangible personal property and establish that tangible personal property used in the performance of a service is not sold. For example, NMSA 1978, § 7-9-54(A) provides that:

> Receipts from selling tangible personal property to the United States or New Mexico or a governmental unit, subdivision, agency, department or instrumentality thereof may be deducted from gross receipts or from governmental gross receipts.

The deduction, however, does not apply to "that portion of the receipts from performing a 'service' that reflects the value of tangible personal property utilized or produced in performance of such service." Section 7-9-54(A)(4).

16. Similarly, NMSA 1978, § 7-9-78 (1969, as amended through 1991) creates a deduction from the compensating tax for tangible personal property that is used in New Mexico if the taxpayer "is engaged in a business which derives a substantial portion of its receipts from leasing or selling tangible personal property" and merely holds the property for sale. The deduction, however, does not apply if the taxpayer "use[s] the tangible personal property in a manner incidental to the performance of a service."

17. New Mexico courts have also applied this same distinction when applying other statutes, not just Section 7-9-47. *See Leaco Rural Tel. Co-op., Inc. v. Bureau of Revenue*, 1974-NMCA-076, ¶ 3, 86 N.M. 629 (drawing distinction between the use and sale of tangible personal property for the purposes of NMSA 1978, § 7-9-60, which provides that "receipts from selling tangible personal property to 501(c)(3) organizations may be deducted from gross receipts or from governmental gross receipts if the sale is made to an organization that delivers a nontaxable transaction certificate to the seller.").

18. New Mexico has also drawn a distinction between use and sale in the construction

context. *See* NMSA 1978, Section 7-9-3(M) (1978, as amended through 2018) provides that the term "'[s]ervice' includes construction activities and all tangible personal property that will become an ingredient or component part of a construction project." New Mexico also permits a deduction for ingredients or components used in construction. *See* NMSA 1978, § 7-9-51 (1969 as amended through 2001).

19. Similarly, NMSA 1978, § 7-9-46 (1969, as amended through 2013) permits a deduction for ingredients or components used in manufacturing, recognizing that such items are not sold during the manufacturing process.

20. Other jurisdictions agree that a taxpayer who is using tangible personal property in the performance of a service is not selling that property. *See, e.g.*, *Modern Paint & Body Supply, Inc. v. State Bd. of Equalization*, 87 Cal. App 4th 703, 709 (2001) (noting that California's regulations "distinguish[] between property furnished and property consumed. In order for a sale to occur, property must be furnished."). As one example, courts have concluded that dentists do not sell prothesis or other appliances to patients. *See City of Shreveport v. Kleowdis*, 408 So. 2d 956 (La. Ct. App. 1981); *see also Hamm v. Proctor*, 198 So. 2d 782, 785 (Ala. 1967). Similarly, an Alabama court concluded that hospitals are not selling medicine that are administered to patients on site. *See State v. Tri-State Pharmacuetical*, 371 So. 2d 910, 914 (Ala Ct. App. 1979). A California court concluded that a company that was in the business of shipping vegetables did not sell ice to its customers, even though it separately billed the customers for the ice and the customer kept the ice that remained when the vegetables were delivered. *See People v. Puritan Ice Co.*, 24 Cal.2d 645, 651 (1944); *White Oak Corp. v. Dept. of Revenue Services*, 503 A.2d 582, 587 (Conn. 1986) (road construction company was not re-leasing equipment to the state); *Fusco-Amatruda Co. v. Tax Comm'r*, 362 A.2d 847, 850 (Conn. 1975) ("it is generally held that a general contractor who purchases material from a retailer for use in the construction of a building for his customer is the 'consumer' of those

materials … ."); *Hotels Statler Co. v. District of Columbia*, 199 F.2d 172, 174 (D.C. Cir. 1952) (items in a hotel room are not sold to customers, but are used by the hotel to provide services); *Boise Bowling Center v. Idaho*, 461 P.2d 262, 264 (Idaho 1969) (bowling alley did not re-lease pinsetting devices to customers); *Craig-Tourial Leather Co. v. Reynolds*, 73 S.E.2d 749, (Ga. 1952) (shoe repairman was not selling the leather used to repair shoes); *A.B. Hirshfeld Press, Inc. v. City and County of Denver*, 806 P.2d 917, 923-24 (Colo. 1991) (printer was not selling pre-press materials to its customers, even though it transferred the material to the customer when the job was completed).

21. Section 7-9-3 does not prohibit the consideration of the purpose for which tangible personal property is used in evaluating whether that property is used or sold. Section 7-9-3(M) merely provides that "in determining what is a service, the intended use, principal objective or ultimate objective of the contracting parties shall not be **controlling**." (emphasis added). Our courts, after the enactment of Section 7-9-3(M), have continued to consider the ultimate purpose as a factor when determining whether a transaction, as a whole, should be characterized as a sale of a service. *See Phillips Mercantile Co. v. New Mexico Dept. of Taxation & Revenue*, 1990-NMCA-006, ¶ 16, 109 N.M. 487 (holding that a transaction was the sale of tangible personal property because "there were no services provided that were not related to the ultimate purpose of creating catalogs or inserts that were sold to retailers.").

22. When products are determined to be used in the performance of a service, there is no basis to apply a general test to determine whether the transaction as a whole should be characterized as the sale of services or the sale of tangible personal property. *See Modern Paint & Body Supply, Inc. v. State Bd. of Equalization*, 87 Cal. App 4th 703, 710 (2001); *cf. Rauscher, Pierce, Refsnes, Inc. v. Taxation and Revenue Department of the State of New Mexico*, 2002-NMSC-013, 132 N.M. 226 (once payment was determined to be a commission, and thus taxable, taxpayer could not rely on the predominant ingredient test to characterize the payment as part of the sale of

securities).

23. For the purposes of the Gross Receipts and Compensating Act, the Legislature has defined "'use' or 'using' to include use, consumption or storage other than storage for subsequent sale in the ordinary course of business or for use solely outside the state." NMSA 1978, § 7-9-3(N) (1978 as amended through 2007).

24. This statute "is quote broad" and should be interpreted "consistent with the statutory presumption in favor of taxation." *Dell Catalog Sales LP v. NM Taxation and Revenue Dept.*, 2009-NMCA-001, ¶ 62, 145 N.M. 419.

25. Regulation 3.2.205.10 provides numerous examples of transactions that involve either the use of tangible personal property during the performance of a service or, in contract, the sale of tangible personal property. Among them, Regulation 3.2.205.10(C) provides that:

> Receipts from selling fertilizer, insecticides, herbicides and similar items of tangible personal property to a person engaged in the business of providing lawn maintenance services may not be deducted from gross receipts pursuant to Section 7-9-47 NMSA 1978. Such receipts are not receipts from selling tangible personal property for resale since the property is being used by the person in the course of providing lawn maintenance services.

26. Regulation 3.2.205.10(C) also provides that:

> Receipts from selling landscape items such as plants, shrubs, trees, rocks, seed, sod and ornaments to a person engaged in the business of designing landscapes and selling and installing landscape items are receipts from selling tangible personal property for resale since it is the trade practice of persons engaged in the landscape business to bill landscape items separately from the design and installation services involved.

27. Regulation 3.2.205.10(A)(7) also provides that:

> O & G Service Company uses swabbing cups and other rubber goods in the course of its servicing an oil well. In fact, this tangible personal property loses its separate identity in the course of the service. As is customary in the industry, O & G Service Company separately states the value of the

> swabbing cups and other rubber goods in its billing to the person who contracted for the servicing of the well. O & G may not execute nontaxable transaction certificates under Section 7- 9-47 NMSA 1978 to acquire the swabbing cups and other rubber goods because O & G is using those goods in the performance of its service. In this case, it is immaterial whether O & G Service Company separately states the value of such tangibles or whether it is the industry practice to do so.

28. For a transfer to occur, "the buyer must perform some identifiable activity within the state that constitutes initial use or acceptance of delivery." *TPL*, 2003-NMSC-007, ¶ 23; *see also Dean Baldwin Painting*, 2007-NMCA-153, ¶ 25 (transfer occurred when buyer took possession of repaired airplane).

29. Tangible personal property is not considered sold because the seller has chosen to separately invoice that property. Although some examples in the regulation cite the custom of separate invoicing as a basis to conclude that tangible personal property is sold, not used, other provisions make clear that invoicing will not be determinative if the tangible personal property is used in the performance of a service. *See* Regulation 3.2.302.10(A)(7) (because swabbing cups and other rubber goods are consumed during the performance of well servicing, they are used in the performance of a service, and "it is immaterial whether [a well servicing company] separately states the value of such tangibles or whether it is the industry practice to do so."); *see also In re Mountain States Contracting, Inc.*, Decision and Order No. 96-04 at 6 ("The fact that the materials are separately reflected in Taxpayer's invoices does not alter the fact that what it is providing to Chino is the service of constructing the railway roadbed."); *Puritan Ice*, 24 Cal.2d at 651 ("the separate billing of ice" is "not controlling"); *Tri-State Pharmaceutical*, 371 So. 2d at 914 (pharmaceuticals administered by hospital were used in the performance of a service even were billed separately).

30. Moreover, although Regulation 3.2.205.10(A)(8) NMAC states that tangible personal property will be deemed to be acquired for resale when it is the custom of the industry and the business to separately state the value of the service and the value of the tangible personal

property, that is only true if the tangible personal property is transferred to the buyer and "is not used by the business in the course of the performance of a service." *Id*.

31. A buyer's control over a seller's services is immaterial to the question of whether tangible personal property is used in the performance of a service. *See American Totalisator Co., Inc. v. Dubno*, 555 A.2d 414, 417 (Conn. 1989) ("The presence of [a buyer's] control … does not convert contracts for the establishment and operation of wagering systems into contracts for the sale or lease of the personal property used in operating those systems."); *White Oak Corp.*, 503 A.2d at 586 ("[C]ontrol … is not the major factor in the determination of whether there was a resale to the state. The fact that the DOT exercised control over the manner in which certain services and rentals were to be used by the plaintiff in the execution of its construction contracts does not make the state a purchaser of those services and rentals.").

32. The Department has concluded, based on its review of its regulations, that "the performance of a service does not include the sale of tangible property when the tangible property is either consumed within the performance of a service or is the product of the service." Revenue Ruling 420-15-1. *See* NMSA 1978, Section 9-11-6.2 (G) (2015) (Department rulings are presumed to be proper implementations of provisions of the law).

33. Elsewhere in the Gross Receipts and Compensating Tax Act, "consumable" is defined to mean "tangible personal property that is incorporated into, destroyed, depleted or transformed during the process of manufacturing a product." NMSA 1978, § 7-9-46(F) (1969, as amended through 2013).

34. Other jurisdictions have concluded the products used in fracking are consumed during the fracking process. *See Noble Energy*, 232 P.3d at 298 ("the fracturing company, not taxpayer, uses the fracturing materials, even though the taxpayer must dispose of the waste. The tangible property once consumed is disposed of, not retained."); *BJ-Titan*, 842 P.2d at 828 ("there is

no real transfer of possession or ownership of the chemicals."); *Nowsco Well Service v. Revenue Cabinet Com. of Ky.*, 804 S.W.2d 10, 12 (Ky. Ct. App. 1990) (affirming conclusion that "the raw materials and industrial supplies are consumed as part of Nowsco's services[.]"); *see Taxpayer No.**** *v. Texas Comptroller of Public Accounts*, 2015 Tex. Tax LEXIS 174 (non-precedential) (products used in fracking are not transferred to the well operators).

35. Tangible personal property are used in the performance of a service if the service cannot be completed without the products. *See A.B. Hirshfeld*, 806 P.2d at 923 (materials were used in the performance of a service where seller "could not perform the services it was contractually obligated to perform for its customers without making extensive use" of them); *White Oak*, 503 A.2d at 587 (tangible personal property is used in the performance of a service if it is a "necessary part" of that service); *Nashville Mobilphone Co., Inc. v. Woods*, 655 S.W.2d 934, 937 (Tenn. 1983) ("when the primary function and purpose of the taxpayer is to provide services, the ownership, use and maintenance of certain types of property and equipment are necessary in order to enable it to furnish the services, so that the taxpayer, not the customer, is the ultimate user or consumer within the meaning of sales and use tax statutes."); *S&R Hotels v. Fitch*, 634 So. 2d 922, 927 (La. Ct. App. 1994) (tangible personal property is used in the performance of a service if it is an "integral part" of the services provided); *Bridges v. Cepolk Corp.*, 153 So.3d 1137 (La. Ct. App. 2014) (tangible personal property is used in the performance of a service when "the work and the materials are inextricable from each other[.]").

36. Tangible personal property is used in the performance of a service if it loses its separate identity while the services are performed. *See Hardy v. State Tax Comm'n*, 561 P.2d 1064, 1070 (Utah 1977).

37. Tangible personal property is used in the performance of a service if it ceases to have any potential use for which it was purchased. *See Hardy v. State Tax Comm'n*, 561 P.2d at

1070.

38. In determining whether a transaction is subject to taxation, "the manner in which the parties designate a relationship is not controlling." *Chevron Oil Co. v. Sutton*, 1973-NMSC-111, ¶ 3, 85 N.M. 679.

39. More particularly, "[a]n agreement between a buyer and seller on a place for title to pass need not be conclusive for the purposes of laws extrinsic to the contract." *Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225, 232 (5th Cir. 1984) (clause in contract providing that transfer of title for natural gas occurred "at the well" did not control determination as to place of sale for purposes of determining amount of royalty owed).

40. "[T]axation is not so much concerned with the refinements of title as it is with actual command over the property taxed-the actual benefit for which the tax is paid." *Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

41. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U.S. 252, 255 (1939).

42. "In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed." *Frank Lyon Co. v. United States*, 435 U.S. 561, 573 (1978).

43. The appropriate approach is to "place substance before form and must examine in detail the nature of the transaction." *N.M. Life Ins. Guar. Ass'n v. Quinn & Co., Inc.*, 1991-NMSC-036, ¶ 15, 111 N.M. 750.

44. Any other approach would encourage parties "to adopt certain contractual language" even though "the sole purpose of such manipulative wording would be to improperly permit a deduction from gross receipts … ." *See Escrow Corp. v. State Taxation & Rev. Dep't*, 1988-

NMCA-068, ¶ 21, 107 N.M. 540 (rejecting contention that wording in a basic real estate contract transformed the agreement into a loan for purposes of statute providing a deduction for receipts from charges made in connection with a loan).

45. The New Mexico Supreme Court has rejected the contention that the transfer of title alone is the controlling factor for determining the application of the Gross Receipts and Compensating Tax Act. *See Dell Catalog Sales v. NM Taxation & Revenue Dep't*, 2009-NMCA-001, 145 N.M. 419.

46. A party's claim regarding the transfer of title does not determine whether tangible personal property will be considered used or sold for tax purposes. For example, some courts concluded that the eventual transfer of title is immaterial if the property was first used in the performance of a service. *See A.B. Hirshfeld*, 806 P.2d at 923 (transfer of title was immaterial where "customers acquired title to the items only after Hischfeld had used and in most cases altered the pre-press materials."); *Bridges v. Ceplok Corp.*, 153 So.3d 1137, 1150 (La. Ct. App. 2014) (parties' agreement that title transferred upon completion was immaterial because the transfer occurred after the property was used in the performance of a service); *Regional Transp. Dist. v. Martin Marietta*, 805 P.2d 1102, 1105 (Colo. 1991) (concluding that property was used in the performance of a service even though title was eventually transferred to the buyer); *Sta-Ru Corp. v. Mahin*, 356 N.E. 67, 70 (Ill. 1976) (taxpayer's claim regarding transfer of ownership would not control result when the products at issue could not be reused by the customers).

47. Taxpayer has the burden to establish that it was selling the products at issue.

48. Regulation 3.2.205.10 provides the governing standard for determining whether tangible personal property is sold or is used in the performance of a service.

49. The same standard that governs whether a product is sold for purposes of Section 7- 9-47 should govern whether a product is sold for the purposes of Section 7-9-65.

50. If Taxpayer would not be selling the products that it uses in fracking for the purposes of Section 7-9-47, then it is not selling those products for the purposes of Section 7-9-65.

51. The fact that Section 7-9-47 incudes the additional requirement that tangible personal property be sold in the ordinary course of business does not prevent the application of Regulation 3.2.205.10 to determine whether a taxpayer is selling chemicals for the purposes of Section 7-9-65.

52. New Mexico's statutes, read together, show that the Legislature intended to distinguish between the sale and use of tangible personal property and did not intend to permit a taxpayer who uses tangible personal property in the performance of a service to claim that it was selling that property.

53. Regulation 3.2.205.10 is consistent with New Mexico's overall statutory scheme and should be applied in any circumstance in which it is necessary to determine whether a taxpayer is selling any type of tangible personal property.

54. There is no language within Section 7-9-65 that indicates it would be properly applied to transactions involving the use of chemicals by a buyer.

55. Section 7-9-65 through its plain language applies only when a taxpayer is selling chemicals and not when a taxpayer is using chemicals in the performance of a service.

56. The Department appropriately interpreted the statute as applying only when chemicals are sold, and can look to Regulation 3.2.302.10 to make that determination.

57. The Department reasonably applied this standard when determining whether a taxpayer is selling chemicals for the purposes of Section 7-9-65.

58. Section 7-9-3 does not prohibit the consideration of the purpose for which tangible personal property is used in evaluating whether that property is used or sold.

59. The first step in determining whether a taxpayer is selling tangible personal property is to determine whether the tangible personal property was transferred to the buyer or used in the performance of a service. If the tangible personal property was used in the performance of a service, it is part of a service, and no further analysis is necessary. The predominant ingredient test is applied only after this determination is made. A taxpayer cannot transform the use of tangible personal property into the sale of tangible personal property through application of the predominant ingredient test.

60. The predominant ingredient test is not applicable in this case because it would render Section 7-9-65 a nullity, particularly in that the application of the 18-ton lot requirement under the deduction would lead to sales exceeding the service inputs under the predominant ingredient test. *See Rauscher, Pierce, Refsnes, Inc. v. Taxation & Revenue Dep't,* 2002-NMSC-013, ¶ 39, 132 N.M. 226, 46 P.3d 687.

61. The predominant ingredient test is only applied after it is determined whether the components of a transaction constitute the sale of tangible personal property or the sale of services.

62. For the purposes of the predominant ingredient test, when tangible personal property is used in the performance of a service, the cost of that tangible personal property is included in the cost of services.

63. The deduction for selling chemicals in lots in excess of 18 tons has been available for more than 50 years and has not, historically, been applied to transactions that involve the use of chemicals rather than the transfer of chemicals to a buyer for the buyer's use.

64. The Department's prior interpretation of Section 7-9-65 showed that it interpreted the statute to apply when chemicals were transferred to a buyer for the buyer's use.

65. A taxpayer is not selling chemicals if it is using chemicals in the performance of a service.

66. Taxpayer has the burden to show that it was selling tangible personal property rather than using it in the performance of a service.

67. Taxpayer is not selling chemicals when it provides fracking services.

68. The products used in fracking are used in the performance of a service.

69. Tangible personal property is only sold if it is transferred to the buyer for the buyer's use.

70. The products used in fracking are not transferred to the buyer for the buyer's use.

71. Tangible personal property is not only sold if it is transferred to the care, custody and control of the buyer.

72. The products used in fracking are not transferred to the care, custody and control of the buyer.

73. The products used in fracking are controlled by the seller during the performance of the fracking job.

74. Any control over the products after they have been pumped into the well is de minimis.

75. Taxpayer's ability to move some of the products after they have been pumped into the well does not establish that the products have been transferred to the buyer.

76. The customer does not take care, custody or control over the products

used in fracking at any point.

77. Tangible personal property is used in the performance of a service, and is not sold, if it is consumed during that service.

78. Tangible personal property is consumed during a service if it is depleted, destroyed or otherwise has no use after the service is performed.

79. The products used in fracking are depleted, destroyed and otherwise have no use after the service is performed.

80. Tangible personal property is used in the performance of a service, and not sold, if it loses its separate identity during the performance of a service.

81. The products used in fracking lose their separate identity during the fracking service.

82. Tangible personal property is used in the performance of a service, and is not sold, if it has no value to the buyer after the services are performed.

83. The products used in fracking have no value to the buyer after the services are performed.

84. Tangible personal property is used in the performance of a service, and not sold, if the service cannot be performed with the property.

85. Fracking cannot be performed without the products at issue.

86. Tangible personal property is used in the performance of a service if it ceases to have any potential use for which it was purchased.

87. The products used in fracking cease to have any potential use for which they are purchased after the fracking is performed.

88. When tangible personal property is used during the performance of a service, it is immaterial whether the seller separately states the value of such tangibles on

its invoice.

89. The provisions in the Master Service Agreement and Master Service and Supply Agreement show that both Taxpayer and its customers understood that Taxpayer, in essence, provides services to its customers.

90. The Master Service Agreement and the Master Service and Supply Agreements do not answer the question of whether the products used in fracking were sold or were used in the performance of the fracking services.

91. There is no indication that these contracts were intended to establish that there had been any transfer of title to products that are used in the performance of a service, cannot be retrieved once they are underground, have no further use, and have either dissipated into the formation or must be removed as waste.

92. The provision in the Concho Master Service Agreement providing an 18-month warranty for products that are sold to Concho supports the conclusion that the terms of the agreement providing for transfer of title do not apply to products used in fracking, which lose their identity when they are mixed together before they are pumped into the well and are nothing more than waste products after they are pumped into the well.

93. The fact that the Concho Master Service Agreement includes clauses on pollution and downhole losses in the agreement undermines the claim that there was any agreement between Concho and Taxpayer regarding the transfer of title. Such provisions would not be necessary if there was an actual agreement regarding the transfer of title, as the shift in title would also shift such responsibility.

94. The downhole loss clause in the Concho Master Service Agreement is inconsistent with the notion that Concho holds title to any products that have been pumped into the well. A clause providing that Concho will indemnify Taxpayer for any losses to any

materials that have been pumped downhole is inconsistent with the contention that all materials belong to Concho once they have been pumped into the well.

95. Other provisions in the agreements are also inconsistent with the claim that title transferred at the wellhead.

96. Taxpayer's claim that title to the products transfers to the customer is insufficient, without more, to establish that the products at issue were sold to the customer and not used in the performance of a service.

97. Taxpayer uses the products in question in the performance of a service and does not sell them to its customers.

98. Taxpayer is not entitled to a deduction under Section 7-9-65 for the products that it uses in the performance of a service.

***Issue Two*: Continuance flow is not a lot under Section 7-9-65; In the alternative, a single day's worth of deliveries constitutes a lot for purposes of Section 7-9-65**.

99. A lot is "a parcel or single article which is the subject matter of a separate sale or delivery, whether or not it is sufficient to perform the contract." Regulation 3.2.22.7 NMAC.

100. Provisions within the UCC, and cases interpreting those provisions, establish that the term "lot" refers to a defined amount that is purchased at one time or a discrete set of goods that are delivered at one time.

101. The UCC provides that, at an auction, all items that the auctioneer designated to be sold at one time constitutes a single "lot." *See* NMSA 1978, § 55-2-328 (1961).

102. The UCC provides that when a seller delivers a buyer "may revoke his acceptance of **a lot** or commercial unit whose nonconformity substantially impairs its value … ." NMSA 1978, § 55-2-608(1) (1961) (emphasis added).

103. The amount of the lot defines the amount that the buyer can reject based on nonconformity. *See S&R Metals, Inc. v. C. Itoh & Co.*, 859 F.2d 814, 817(9th Cir. 1988) ("If goods are shipped in a single lot, as here, then the right of revocation extends to the entirety.").

104. The UCC provides that, if the parties to a contract arrange for multiple deliveries, each delivery constitutes a separate "lot." *See* NMSA 1978, § 55-2-612 (1961).

105. The term "lot," in the context of a commercial sale, describes "the measure of goods that the contract states will be delivered together in one installment." *Midwest Mobile Diagnostic Imaging, LLC v. Dynamics Corp. of America*, 965 F. Supp. 1003, 1011 (W.D. Mich. 1997) (each mobile MRI unit to be delivered to the buyer constitutes a separate lot); *see also Edwards Co., Inc. v. Hammond Box Co.*, 17 So. 2d 53, 55 (La. Ct. App. 1944) (each separate delivery of strawberry crates constituted a lot); *A.K. Young & Conant Mfg. v. Wakefield*, 121 Mass. 91, 92-93 (Mass. 1876) (order of cloaks delivered at one time constituted a single lot).

106. Provisions of the UCC show that the term "lot" is used to describe a discrete and identifiable set of goods and contemplate that there will be a discrete delivery of those goods.

107. The term "lot" does not apply to goods that are delivered in a continuous flow.

108. It would have been nearly impossible, at the time the deduction for chemicals sold in lots in excess of 18 tons was enacted to determine the amount pumped into a well at one time.

109. NMSA 1978, Section 7-9-65 does not appear to contemplate delivery by continues flow but instead requires discrete deliveries.

110. The products in question were not delivered in lots, as that term is used in the UCC.

111. Alternatively, to the extent that a lot may be delivered through continuous flow, a rule of reason requires some defined period of delivery beyond the moment-by-moment account

advocated for by the Department: even a traditional delivery may not occur instantaneously, as there may be unloading of the delivery in multiple stages over a period of time.

112. In the alternative, in the event that a continuous flow delivery method is permitted, the most logical and reasonable discrete delivery period for a fracking job is a single day. the steps within the stags of a fracturing job.

113. "[A]ny single day's delivery" constitutes a single lot. *Runco*, 1974-NMCA-145, ¶ 5. See also Ruling 73-195-4; Ruling 430-97-4 ("lot is [buyer's] daily contract quantity")[32].

114. If continuous flow delivery is permitted as a lot, to meet its burden of proof, Taxpayer must show that it pumped more than 18 tons of products that are properly classified as chemicals, under the Department's regulations, during a single calendar day.

115. Taxpayer cannot include the weight of water when attempting to present proof that it can meet Section 7-9-65's 18-ton threshold.

Issue Three: **CRC Proppant does not produce a chemical reaction and thus is not a chemical subject to the deduction under 7-9-65.**

116. "As used in Section 7-9-65 NMSA 1978 the term 'chemical' means a substance used for producing a chemical reaction." Regulation 3.2.223.7(B) NMAC.

117. The fact that a chemical reaction may take place does not establish that a substance is used to produce a chemical reaction. *See In re Peabody Coalsales*, Decision and Order No. 17-34, at 15.

118. Instead, "what the [substance] is used for is dispositive." *See In re Peabody Coalsales*, Decision and Order No. 17-34, at 15.

119. A taxpayer must prove that a buyer is using a substance for the express purpose of

[32] Adopted from Taxpayer's Proposed Conclusion of Law #25.

producing a chemical reaction in order to qualify for the deduction under Section 7-9-65. *See id.* As an example, a taxpayer who sold high-calcium-carbonate rock, which was ground up and sprayed into power plant in order to produce chemical reaction that removed sulfur was likely selling a substance that was used to produce a chemical reaction. *See* Revenue Ruling 412-98-1 (Mar. 9, 1998).

120. "Produce" connotes origination or initiation. *See* Webster's 3d New Int'l Dictionary at 1810 (1993) (defining produce, in part, as "to cause to have existence or to happen : bring about : ORIGINATE").

121. "Produce" is used this way in the context of chemical reactions. *See, e.g.*, *Millennium Pharms., Inc. v. Sandoz Inc.*, 862 F.3d 1356, 1364 (Fed. Cir. 2017) ("However, the prior art does not teach or suggest that lyophilization of bortezomib in the presence of mannitol would produce a chemical reaction and form a new chemical compound"); *Application of Samtko*, 393 F.2d 998, 1000 (C.C.P.A. 1968) ("When radiation such as alpha, beta, gamma, neutrons and X-rays passes through matter, the heavier particles tend to produce nuclear changes and chemical reactions."); *McCants v. Hallenback*, 2014 WL 4638836, at *3 (E.D.N.Y. Sept. 16, 2014) ("A reagent is a liquid substance added to another substance that produces a chemical reaction, which itself produces a color change that would indicate (in this case) whether the questioned sample is consistent with cocaine."); *May v. Colvin*, 2013 WL 1702544, at *5 n.4 (W.D. Mo. Apr. 19, 2013) ("Visudyne is activated by the laser light, which produces a chemical reaction that destroys abnormal blood vessels."); *Nichols v. Strike King Lure Co.*, 2000 WL 1593616, at *7 (N.D. Tex. Oct. 25, 2000) ("The preferred embodiment describes how the coating is produced: 'To produce such coating, a liquid epoxy resin and a hardener for such resin are mixed to produce a chemical reaction resulting in converting the liquid mixture into a solid by passing through a highly viscous liquid stage.'"); I.R.S. PLR 200746011 (IRS PLR Nov. 16, 2007) ("A proprietary chemical reagent, which is designed to produce a chemical reaction as part of the

synthetic fuel production process is then applied to the feed stock coal and thoroughly combined in the mixer."); *B.F. Goodrich Co. v. Oldmans Twp.*, 17 N.J. Tax 114, 128-30 (1997) ("The tanks are then heated with steam then cooled with chilled water to produce the chemical reaction"), *aff'd*, 733 A.2d 1204 (N.J. App. Div. 1999); *Walsworth Pub. Co. v. Dir. of Revenue*, No. 98-2404 RV at 3 (Mo. Admin. Hr'g Comm'n July 28, 2000) ("When taking a photograph, the light that strikes the film produces a chemical reaction within the silver halide emulsion and creates a negative latent image on the film."), *available at* https://ahc.mo.gov/cases/historical/79000; *compare Cambria Cogen Co v. Commonwealth of Pennsylvania, Dep't of Env. Res.*, 1995 EHB 191, 197 (Pa. Env. Hr'g Bd. Feb. 10, 1995), *available at h*ttp://ehb.courtapps.com/content/adjudications/Adjudications&Opinions-1995- Vol%201%20(pp.1-435).pdf ("The furnace heat calcines the limestone to form calcium oxide. This calcium oxide ***reacts*** with sulfur dioxide to form calcium sulfate.") *with id.* at 223-24 ("A treatment plant is no less beneficial to the general public because in its operation chemicals are added which, as a result thereof in treatment, **produces** a chemical reaction forming a sludge.") (emphasis added).

122. Since, as Dr. Leclerc's credible expert opinion established, resin in CRC proppant is not used for producing a chemical reaction, CRC proppant does satisfy the regulatory definition of a chemical pursuant to Regulation 3.2.223.7(B) NMAC and thus CRC proppant is not deductible under Section 7-9-65[33].

123. The well operators do not use CRC proppant in order to produce a chemical reaction.

124. Taxpayer was clear that the proppant is used to perform a physical function – to hold open the fractures.

125. The well operators do not purchase CRC proppant in order to produce a chemical reaction; they purchase CRC proppant to hold open the fractures.

[33] This was not a proposed Department Conclusion of Law but it is a conclusion of the law of the hearing officer.

126. The CRC proppant did not produce a chemical reaction.

127. Taxpayer cannot rely on the weight of silica to establish that it met the 18-ton threshold when that substance did not participate in a chemical reaction.

128. Taxpayer is also not entitled to a refund on the taxes paid on the value of CRC proppant.

For the foregoing reasons, Taxpayer's protest **IS DENIED**. Taxpayer is not entitled to its claims for refund under NMSA 1978, Section 7-9-65 because Taxpayer's use of chemicals that are consumed as part of the hydraulic fracturing process are incidental to the performance of the hydraulic fracturing service.

DATED: February 4, 2019

Brian VanDenzen, Esq.
Chief Hearing Officer
Administrative Hearings Office
P.O. Box 6400
Santa Fe, NM 87502

NOTICE OF RIGHT TO APPEAL

Pursuant to NMSA 1978, Section 7-1-25 (2015), the parties have the right to appeal this decision by filing a notice of appeal with the New Mexico Court of Appeals within 30 days of the date shown above. If an appeal is not timely filed with the Court of Appeals within 30 days, this Decision and Order will become final. Rule of Appellate Procedure 12-601 NMRA articulates the

requirements of perfecting an appeal of an administrative decision with the Court of Appeals. Either party filing an appeal shall file a courtesy copy of the appeal with the Administrative Hearings Office contemporaneous with the Court of Appeals filing so that the Administrative Hearings Office may being preparing the record proper. The parties will each be provided with a copy of the record proper at the time of the filing of the record proper with the Court of Appeals, which occurs within 14 days of the Administrative Hearings Office receipt of the docketing statement from the appealing party. *See* Rule 12-209 NMRA.

CERTIFICATE OF SERVICE

On February 4, 2019, a copy of the foregoing Decision and Order was mailed to the parties listed below in the following manner:

INTENTIONALLY BLANK

John D. Griego
Legal Assistant

Administrative Hearings Office
Post Office Box 6400
Santa Fe, NM 87502
PH: (505)827-0466, FX: (505)827-9732
Tax.pleadings@state.nm.us