

## **Taxability of Drilling Test Wells and Associated Services**

This memorandum addresses how the sales and compensating use taxes (sales tax) apply to receipts from the sale of the service of drilling test wells and other associated services. This memorandum does not address drilling services provided with respect to the production of gas or oil and related activities. Drilling services rendered directly with respect to real property, property, or land used or consumed directly and predominantly in the production for sale of gas or oil are exempt from sales tax.

### **Background**

Drilling services involving test wells are provided in various circumstances. Test wells are commonly required for environmental analysis projects, infrastructure or other construction projects, projects requiring exploratory drilling for geologic or hydrogeologic site characterization, and projects involving remediation services with respect to soil or groundwater contamination. The services provided usually include the collection of soil and groundwater samples. This can involve excavation and soil removal, along with backfilling the excavated area with clean soil. The drilling services associated with the collection of samples include core or soil test borings, drilling of test pits, installations of groundwater monitoring wells, installations of injection wells, and installations of piezometers. Well installations can be done on either a temporary or permanent basis. In addition, the analysis of water and soil samples is often subcontracted to an outside laboratory.

Section 1105(c)(5) of the Tax Law imposes sales tax on receipts from the services of maintaining, servicing or repairing real property, property, or land, as these terms are defined in the real property tax law. These services are taxable whether performed inside or outside of a building. Section 527.7(a)(1) of the Sales Tax Regulations states that *maintaining*, *servicing*, and *repairing* are terms that are used to cover all activities related to keeping real property in a condition of fitness, readiness, or safety, or restoring it to such condition. Section 1101(b)(9) of the Tax Law and section 527.7(a)(3)(i) of the Sales Tax Regulations define a capital improvement as an addition or alteration to real property which: (a) substantially adds to the value of the real property, or appreciably prolongs the useful life of the real property; and (b) becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and (c) is intended to become a permanent installation. The Sales Tax Regulations further provide under section 527.7(b)(4) that the imposition of tax on services performed on real property depends on the end result of the service. If the end result of the service is the repair or maintenance of real property, the service is taxable. If the end result of the same service is a capital improvement to the real property, the service is not taxable.

### **Tax treatment of drilling services**

Drilling services are generally taxable as repair or maintenance services to real property. However, drilling services performed as a constituent part of a capital improvement to real

property are not subject to tax. When drilling services are performed in conjunction with a remediation project or a construction project, the sales tax treatment of the drilling services will be determined by the overall nature of the project performed. If a project results in a capital improvement, the charge for the drilling services is not subject to tax. If a project is determined to be the service of maintaining, servicing, or repairing real property, the charge for the drilling services is subject to tax. A determination as to whether a remediation project or a construction project constitutes a capital improvement is a question of fact based on the circumstances in each particular instance. (**Note:** The drilling of a new water well or the deepening of an existing water well are considered capital improvements to real property and are not subject to sales tax. Therefore, where the service of a drilling company results in the installation of a new water well, or the deepening of an existing well, the service is not subject to sales tax.)

*Example 1: Company A is a construction contractor that specializes in remediation work as mandated by the New York State Department of Environmental Conservation (NYSDEC). Company A is involved in a remediation project requiring excavation and soil removal, collection of soil and water samples, installation of groundwater monitoring wells, backfilling the excavation with clean soil, and other remediation measures as may be mandated by NYSDEC. Company A was hired by the owner of a residential rental property that requires remediation procedures because of an oil leak. The purpose of the remediation is to remove as much of the contaminated soil as possible and replace it with clean soil. Company A hires Company B to collect the soil and water samples, in accordance with NYSDEC protocols, which includes the installation of monitoring wells. Once the collected samples show that all contaminated soil has been removed, the excavation site is backfilled with clean soil by Company A. Once all of the other measures are completed by Company A, the property is restored to a condition of fitness, efficiency, readiness, and safety.*

*Company A's project constitutes maintaining, servicing, or repairing real property. Company A can purchase Company B's otherwise taxable services for resale by issuing Company B a properly completed Form ST-120.1, Contractor Exempt Purchase Certificate. Company A must charge the property owner sales tax on the charge for its services.*

*Example 2: A property owner is in the process of revitalizing waterfront property by constructing a new building that will house both commercial and residential spaces. Before certain work can proceed, a remediation project must be completed to determine whether part of the site once occupied by an industrial printing facility is contaminated. If contaminated, that part of the site must be decontaminated and cleaned before construction there can continue. The property owner hires Company C, an environmental consulting firm that designs and installs remediation systems, to address possible leakage into soil and water beneath the surface of the property. Company C in turn hires Company D to drill and install filters, air venting apparatus, and test wells. As part of the remediation services, Company C monitors the test wells. Additionally, water and soil samples are collected by Company C personnel and are sent to an outside laboratory for analysis. Once this analysis is completed, the results are reviewed and interpreted by Company C's personnel.*

*Company C's remediation services are a constituent part of an overall capital improvement project. Since the capital improvement project cannot be accomplished without the installation of Company C's remediation system, the drilling services provided by Company D are also treated as a constituent part of the overall capital improvement project and are not subject to tax. Company C should give Company D a copy of Form ST-124, Certificate of Capital Improvement, that Company C received from the property owner. Company C's purchase of the laboratory analysis report from the outside laboratory is not subject to sales tax.*

### **Drilling services performed for engineering firms**

Engineering services are not taxable under section 1105(c) of the Tax Law. Drilling services are often provided to engineering firms in conjunction with their projects. Generally, an engineering firm will subcontract for drilling services as support services to the overall service that the firm is providing to its customer.

Charges for drilling services that are performed on real property, such as the drilling of test wells on the property of an engineering firm's client, are generally subject to sales tax, unless performed as a constituent part of a capital improvement project. While an engineering firm is not required to charge sales tax when billing its clients for engineering services, it must pay sales tax on its purchases of taxable property and services. Therefore, the fact that a drilling contractor's customer is an engineering firm is not relevant to determining the taxability of the drilling services provided. The taxability of drilling services is determined in accordance with the provisions of section 1105(c)(5) of the Tax Law and section 527.7 of the Sales Tax Regulations, as described above.

*Example 3: Company D is an engineering firm that has been retained by its customer to evaluate the feasibility of a commercial construction project at the customer's property. The property owner formerly leased the property to the operator of a now-abandoned steel mill. To complete its report to its customer, Company D needs an analysis of the land in order to determine whether the property contains any contaminants. Company E is hired by Company D to collect test bores of the soil at the site in question. Once all of the samples have been collected, they are sent by Company D to a third-party laboratory for analysis, and the results are incorporated by Company D into its report to its customer.*

*Since Company E's services to Company D constitute maintaining, servicing, or repairing real property, it is required to collect and remit sales tax on its services regardless of the fact that Company D is providing a nontaxable engineering service to its customer. Company D's purchase of the laboratory analysis report from the third-party laboratory is not subject to sales tax.*

### **Drilling services performed in conjunction with geological research and development services**

Certain companies primarily provide geologic site characterization reports. In these cases, a company will do its own drilling and sampling, rather than subcontract those tasks to a

third party, and furnish a written report to its customer. Geologic site characterization includes obtaining information pertaining to the depth of the water table from the land surface, the depth to the bedrock from the land surface, the direction of the flow of subsurface water, soil conditions, and underground water quality and quantity. The information obtained is used to define hydrogeologic conditions for geologic site characterization reports. These reports are similar to reports containing results of scientific laboratory analysis of environmental samples and are not subject to sales tax (see TSB-M-95(8)S, *Taxability of Certain Laboratory Reports*). If a company providing a geologic site report to its customer subcontracts for the necessary drilling services, these services are taxable unless performed as a constituent part of a capital improvement to real property.

*Example 4: Company F is an environmental company that performs services to determine the hydrogeologic conditions of a property. The company is engaged in investigating, evaluating, measuring, and plotting the subsurface characteristics of land, particularly with respect to subsurface water and its depth from the surface, its amount, its direction of flow, etc. Company F is hired by a real estate developer that is putting in a new housing development containing 300 houses. The developer needs to know if sufficient water is available on the site and where to obtain it. To provide its services, Company F installs monitoring wells on the property. The wells are used solely by Company F and are not used in any other services to the real property. The wells are not intended to be permanent and are removed once all the necessary information has been obtained.*

*Company F is the sole user of the monitoring wells in the performance of its services, and the installation of the wells is not considered to be maintaining, servicing, or repairing real property. Therefore, the installation of the monitoring wells by Company F is not subject to sales tax. Also, the confidential hydrogeologic site condition report prepared by Company F for the real estate developer is not taxable.*

NOTE: A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.