SEVERANCE TAX ADMINISTRATION IN LOUISIANA: AN OVERVIEW

Presentation to the

COUNCIL OF PETROLEUM ACCOUNTANTS SOCIETIES

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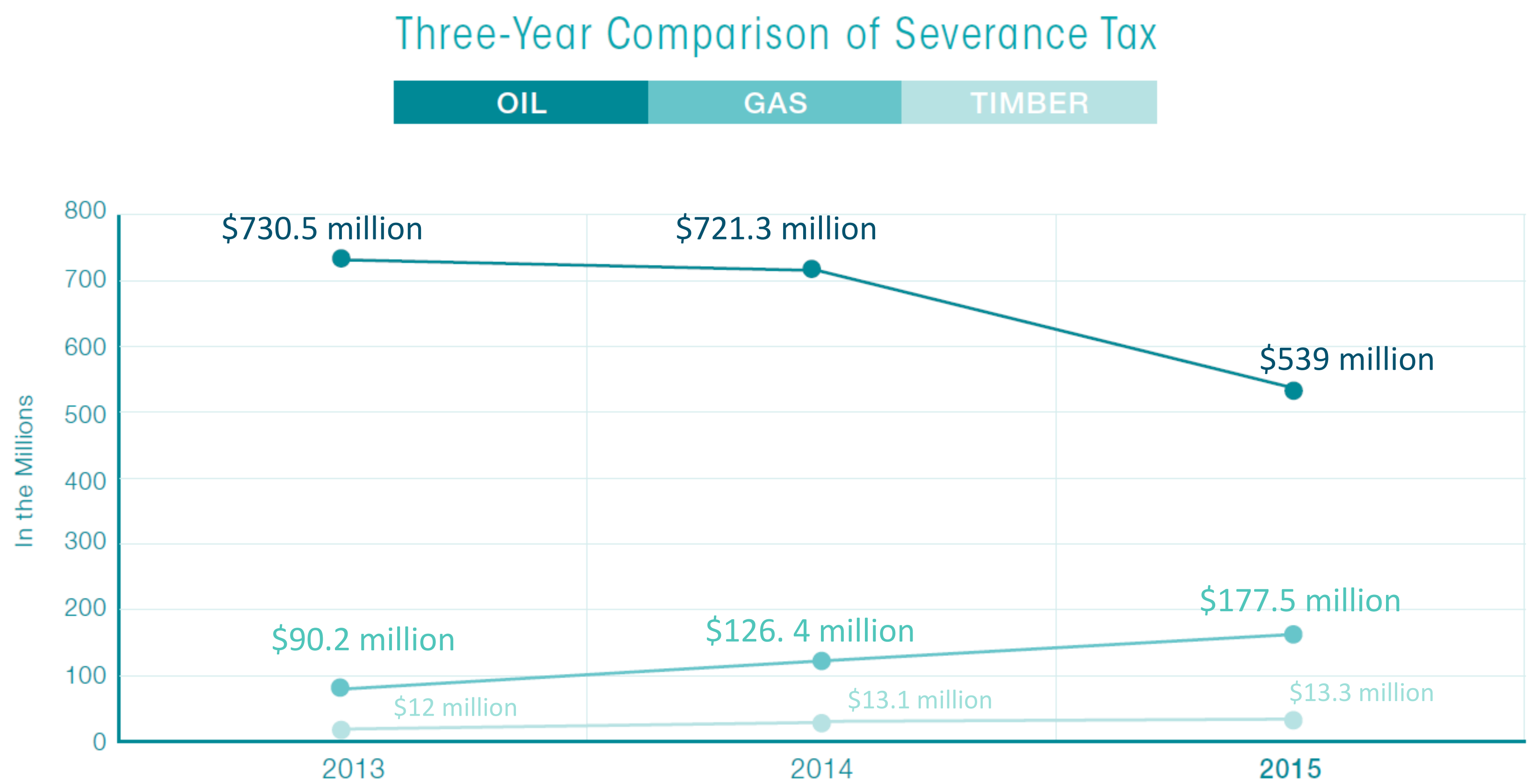
HISTORY

- The first tax imposed upon the severance of oil and gas by the state of Louisiana was an occupational license tax
  - Created in 1910
  - Levied at a rate of 1/5 cent per 10,000 cubic feet or 10 MCF for gas
  - Levied at a rate of 2/5 cent per barrel of oil
- Act 140 of 1922 created the constitutional authority for a state severance tax, **LA Const. Art. 7, Section 4**


Three-Year Comparison of Severance Tax
OIL
GAS
TIMBER
In the Millions
800
700
600
500
400
300
200
100
0
2013
2014
2015
$730.5 million
$721.3 million
$539 million
$90.2 million
$126. 4 million
$177.5 million
$12 million
$13.1 million
$13.3 million

OIL

RATE

- LA R.S. 47:633(7) & (8) levy a severance tax on oil at the following rates:
  - **Capable** rate: **12.5%** of value at the time and place of severance
  - **Incapable** rate: **6.25%** of value at the time and place of severance
  - **Stripper** rate: **3.125%** of value at the time and place of severance
  - **Condensate**, distillate: **12.5%** of value at the time and place of severance
- Production from oil wells is **exempt*** from severance tax for a period of 5 years when:
  1. returned to service after being **inactive** for 2 or more years; or
  2. having 30 days or less of production during the past 2 years.

To qualify for inactive well status, it is necessary to apply to the Department of Natural Resources, Office of Conservation

"VALUE"

- Louisiana Revised Statute 47:633(7)(a) defines "value" as:
  - "the higher of (1) the gross receipts received from the first purchaser, less charges for trucking, barging and pipeline fees; or (2) the posted field price."
- It is important for producers to understand how a purchaser arrives at "value" in a contract.
- **The taxpayer will be required to provide the documentation necessary to support the contract price** and any deductions (such as transportation and fees).

“VALUE”

- Gross receipts includes “all things of value received directly or indirectly by the producer”
- If the producer transports the oil by his own facilities, deduction is $0.25 per barrel.
- If a third party transports the oil, the deduction is the actual amount charged.

HORIZONTAL WELLS

- Louisiana Revised Statute 47:633(7)(c)(iii) suspends or exempts severance tax on production from horizontally drilled wells, depending on the year in which the well commenced production.
- **All severance tax is suspended for a period of 24 months or until payout** for horizontally drilled wells that **commenced production between July 31, 1994, and June 30, 2015**.
- Representative Major Thibaut's Act 120 of the 2015 Regular Session modified the suspension of severance tax **for horizontally wells that commenced production on or after July 1, 2015**.
  - These wells are allowed an **exemption from severance tax for a period of 24 months or until payout** of the well is achieved.
  - LA R.S. 47:633(7)(d)(i) requires the LDR secretary to determine the oil price upon which the exemption is based according to the average New York Mercantile Exchange (NYMEX) price per barrel of crude oil per month, for the past 12 months, at the close of business on June 30th.
  - **The value of the exemption for a horizontal well is based on the NYMEX price per barrel of oil.**

HORIZONTAL WELLS

- The amount of the exemption for a horizontal well that produces oil shall be as follows:
  - 100% if the price of oil is **at or below seventy dollars** per barrel
  - 80% if the price of oil is **$70-$80** per barrel
  - 60% if the price of oil is above **$80** and at or below **$90** per barrel
  - 40% if the price of oil is above **$90** and at or below **$100** per barrel
  - 20% if the price of oil is above **$100** and at or below **$110** per barrel
- There shall be no exemption in effect for horizontally drilled wells if the price of oil exceeds $110 per barrel.

HORIZONTAL WELLS

- "Payout" occurs when gross revenue from the well, less royalties and operating costs directly attributable to the well, equals the cost of completing the well to the commencement of production, as determined by the Department of Natural Resources (DNR).
  - Operating costs are limited to those costs **directly attributable** to the operation of the exempt well, such as: direct materials, supplies, fuel, direct labor, contract labor or services, repairs, maintenance, property taxes, insurance, depreciation, and any other costs that can be directly attributed to the operation of the well.
  - Operating costs **do not include any costs that were included** in the well cost approved by the Office of Conservation.
  - **Costs** which should have been reported as initial well costs, but **which were omitted from the Application for Well Status Determination report filed with DNR's Office of Conservation cannot be included later** as an operating cost in the payout calculation.

HORIZONTAL WELLS

- The following items are **not** considered to be costs that are directly attributable to the operation of the exempt well:
  - Communication costs, including but not limited to phone & internet services
  - Lawn service, chemical weed and grass control, yard clean-up
  - Entertainment and catering costs
  - Transportation charges
  - General liabilities
  - Workers' Compensation
  - Office supplies
  - Fees charged by the LA Dept. of Conservation and DEQ permits
  - Safety training and safety class fees
  - Janitorial services
  - Appliances and appliance repairs
  - Monthly storage fees
  - Padlocks and gate locks
  - Signs
  - Rent
  - Location work on sinkholes and roads
  - Production fees
  - Expenses listed as "other"

REDUCED RATE WELLS

- In order to qualify as an **incapable** well, an oil well must:
  1. Be **classified** by DNR's Office of Conservation as an oil well which is incapable of producing an average of more than **25 barrels of oil per producing day** during a taxable month;
  2. Be **certified by LDR** as incapable on or before the 25^{th} day of the second month following the month of production; and
  3. Produce **at least 57% salt water** per day.

REDUCED RATE WELLS

- In order to qualify as a **stripper** well, an oil well must:
  1. Be **classified** by DNR's Office of Conversation as an oil well which is incapable of producing an average of more than **10 barrels of oil per producing day** during a taxable month, and
  2. Be **certified by LDR** as incapable of producing an average of more than 10 barrels of oil per producing day on or before the 25th day of the second month following the month of production.

REDUCED RATE WELLS

- After a well has been certified for a reduced severance tax rate**, it is necessary to file continuing certification forms** on or before the 25th day of the 2nd month following the months of production.
  - It is not necessary to include stripper wells that are certified with a “B” prefix code on the continuing certification form.
  - Failure to file, or delinquent filing of, the continuation certification forms may result in certification denial for the month’s production.
  - Wells cannot be certified as both a stripper and an incapable oil well.
  - Recertification is required in any of the following circumstances:
    - the well operator changes
    - the well overproduces in the month of production
    - the well changes from one tax rate status to another tax rate status
  - All wells are subject to redetermination of their reduced rate status, based upon reports filed with LDR and DNR’s Office of Conservation.

COMMON CAUSES FOR AUDIT ADJUSTMENTS

- **Discrepancies** in volumes reported to LDR vs. DNR
- Unreported barrels
- Bonuses, premiums and transportation reimbursements that are not reflected in the reported value
- Non-arms-length transactions
- **Excessive claims**:
  - Transportation deductions
  - Federal government royalties

GAS

RATE

- LA R.S. 47:633(9)(a)(ii) and (d) requires the LDR secretary to annually adjust the severance tax rate on natural gas produced from capable wells.
  - The rate equals 7 cents per thousand cubic feet (MCF), **multiplied by** the gas base rate adjustment for the fiscal year, as determined by the DNR secretary.
  - The natural **gas severance tax rate for the current fiscal year** has been set at **9.8 cents per MCF**.
  - The natural **gas severance tax rate for the 2017-2018 fiscal year** has been set at **11.1 cents per MCF**.
- Rate for low pressure wells—3 cents per MCF
- Rate for incapable wells—1.3 cents per MCF

HORIZONTAL WELLS

- Louisiana Revised Statute 47:633(7)(c)(iii) suspends or exempts severance tax on production from horizontally drilled wells, depending on the year in which the well commenced production.
- For horizontally drilled wells that **commenced production between July 31, 1994, and June 30, 2015**:
  - **All severance tax is suspended for a period of 24 months or until payout**
- For horizontally drilled wells that **commenced production on or after July 1, 2015:**
  - The well is allowed an **exemption from severance tax for a period of 24 months or until payout** of the well is achieved.
  - LA R.S. 47:633(7)(d)(ii) requires the LDR secretary to determine the natural gas price upon which the exemption is based according to the average New York Mercantile Exchange (NYMEX) price per million BTU per month on the close of business June 30th for the prior 12 months.
  - **The value of the exemption for a horizontal gas well is based on the NYMEX price per million BTU.**

HORIZONTAL WELLS

- The amount of the exemption for a horizontal well that produces natural gas shall be as follows:
  - 100% if the price of natural gas is at or below $4.50 per million BTU
  - 80% if the price of natural gas is above $4.50 and at or below $5.50 per million BTU
  - 60% if the price of natural gas is above $5.50 and at or below $6.00 per million BTU
  - 40% if the price of natural gas is above $6.00 and at or below $6.50 per million BTU
  - 20% if the price of natural gas is above $6.50 and at or below $7.00 per million BTU
- There shall be no exemption in effect for horizontally drilled wells if the price of gas exceeds $7.00 per million BTU.

REDUCED RATE WELLS

- In order to qualify as an **incapable** gas well, the well must be **classified** by DNR’s Office of Conservation as a gas well which is incapable of producing more than **250,000 cubic feet of gas per day** during a taxable month.

REDUCED RATE WELLS

- In the case of gas produced from an oil well:
  - in order to qualify as a **low pressure well**, the well must be designated by DNR's Office of Conservation to have a **wellhead pressure of 50 pounds per square inch gauge or less** under operating conditions; or
  - In the case of gas rising in a vaporous state through the annular space between the casing and tubing of the oil well and released through lines connected with the casinghead gas, DNR's Office of Conservation must have determined that the well has **a casinghead of 50 pounds per square inch gauge or less** under operating conditions.

REDUCED RATE WELLS

- To receive the reduced severance tax rate on natural gas or casinghead gas production, an application must be filed with LDR **on or before the 25th day** of the second month following the month in which the production occurs.
- After a well has been certified for the reduced tax rate, it is necessary to file **continuing certification forms** on or before the 25th day of the second month following the month of production.
- It is not necessary to include incapable gas wells that are certified with an “F” prefix code on the continuing certification forms.
- **Failure to file or delinquent filing** of the continuing certification forms **may result in certification denial for the month’s production**.

REDUCED RATE WELLS

- A well cannot be certified as both an incapable oil well and an incapable gas well.
- If the well changes from one tax rate status to another tax rate status, a new certification is required.
- **Recertification is required in any of the following circumstances**:
  - the well operator changes
  - the well overproduces in the month of production
  - the well changes from one tax rate status to another tax rate status

COMMON CAUSES FOR AUDIT ADJUSTMENTS

- **Underreporting** of taxable MCF's
- **Misunderstanding** amongst partners regarding the method of payment (ex: operator pays his own share and partners think he is paying for them, etc.)
- Plant fuel, shrinkage, and residue not reported as part of taxable volume
- Allocation procedure not correctly followed or followed in error
- Severance tax paid after processing, when sale occurred in the field
- Severance tax nonpayment on the production of natural gas liquids
- On the exclusion from severance tax for field use gas: plant use gas does not apply to the exclusion.
- Reporting wells at a reduced rate on returns for uncertified wells.

Audit Considerations

AUDIT CONSIDERATIONS

- Please retain the following records, which are requested when audit appointments are scheduled:
- **OIL**
  - Oil sale contracts and/or marketing agreements
  - Invoices to purchasers
  - Transportation contracts
  - Purchaser oil run statements and/or accounting records of oil sales
  - Working interest ownership percentage(s) of Take in Kind volumes
  - Well division orders for any properties with a U.S. government royalty interest
  - Records related to payout computation on deep and horizontal wells, if applicable
  - **You may be asked for additional documentation such as production and sales allocation and inventory receipt statements.**

AUDIT CONSIDERATIONS

- Please retain the following records, which are requested when audit appointments are scheduled:
- **<u>GAS</u>**
  - Purchaser gas settlement statements-purchaser meter statements or transporter meter statements
  - Louisiana Department of Natural Resources plant reports (R-6), if applicable
  - Plant Gas Processing Statements, if applicable
  - Working interest ownership percentage(s) of Take In Kind volumes
  - Well division order for any properties with a U.S. government royalty interest
  - Records related to payout computation on deep and horizontal wells, if applicable
  - **You may be asked for additional documentation such as gas delivered, meter readings, field and or plant sketches, gas allocation statements, and gas plant gas allocation statements.**

AUDIT CONSIDERATIONS

- LDR auditors and agents strive to make the audit process as efficient as possible. In order to attain the least burdensome assessment, we ask that taxpayers observe the following requests:
  - **Please include the field/lease/well numbers in your records, in addition to well names**. This allows us to recognize the correlation between your records and LDR returns.
  - Please reference exempt wells (inactive or horizontally drilled) by well number, instead of lease number, on the LDR return.
  - Please have records and a contact person readily available.

AUDIT PROGRAMS AT LDR

- Taxpayer Compliance
- Field Audit Excise
  - Revenue Tax Specialists -production and reduced rate well compliance reviews as limited scope audits.
  - Auditors -full scope audits
  - Tax Specialists and Revenue Tax Auditors work together to ensure no duplication of assessments

2017 Proposed* Legislation

**The following slide summarizes proposed legislation relative to severance tax; these proposals were pre-filed independently from the LDR legislative package. More information about the proposals may be obtained from the proposing author.*

2017 Regular Session Legislative Proposals

- HB 54, Representative Robby Carter
  - Proposed constitutional amendment that would ask voters to approve the creation of a **Hydrocarbon Processing Facilities Use Tax**
  - The tax would be levied at a rate not to exceed 3 percent of the value of hydrocarbons
  - If the constitutional amendment passes and the hydrocarbon processing tax is subsequently determined to be valid by a final, non-appealable judgment, the law would prohibit a severance tax on oil and gas
  - If passed by the Legislature, the proposed constitutional amendment will be presented to voters on the October 14, 2017, ballot

2017 Regular Session Legislative Proposals

- HB 170, Representative Robby Carter
  - Would repeal the severance tax exemption for horizontally drilled wells
  - Proposed effective date: August 1, 2017
- HB 364, Representative Barry Ivey
  - Would reduce the severance tax on oil from 12.5 percent to 8 percent
  - Would extend the exemption for horizontal wells from 24 months (or until payout) to 60 months (or until payout); would eliminate the formula that bases the exemption value on the NYMEX price of oil and would, instead, create an exemption value of 4%
  - Proposed effective date: August 1, 2017

2017 Regular Session Legislative Proposals

- HB 461, Representative Stuart Bishop
  - Would eliminate the 5 year severance tax exemption on production from **inactive wells** returned to service and, instead provide for an exemption equal to **50 percent of the severance tax rate for a 10 year** period.
  - Would create a 10 year severance tax exemption for production from **orphan wells** that is equal to **75 percent of the tax rate**.
  - Proposed effective date: August 1, 2017

2017 Regular Session Legislative Proposals

- HB 516, Representative Chris Broadwater
  - Would eliminate the requirement that LDR certify the status of a reduced rate oil well in order for the oil production to be taxable at a reduced rate.
  - Would require the severer of production from reduced rate wells to provide production reports to DNR's Office of Conservation.
  - **Would create a new reduced rate for gas produced from gas wells** that are designated by DNR's Office of Conservation as **incapable of producing an average of 5,000 cubic feet of gas per day** during a taxable month.
  - Proposed effective date: January 1, 2018

Questions?

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