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Beware of Louisiana Severance Tax Assessments on Crude Oil

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The Louisiana Department of Revenue's Field Audit Division has recently embarked on an effort to pursue Louisiana oil producers for additional severance tax. The Field Audit Division is now interpreting long-standing oil purchase contracts to include a disallowable "transportation deduction," and thus to assert that the severance tax paid on crude oil sold during the contract term was not properly calculated. Oil producers are being asked to pony up hundreds of thousands of dollars in additional severance tax.

Gordon Arata's Martin Landrieu is the lead attorney at the firm assisting several oil producers in connection with these severance tax disputes, and he has led a collaborated effort to meet with the legal representatives and policy makers at the Louisiana Department of Revenue to address the issue on an industry-wide basis.

Here's a scenario illustrating the problem:

Oil Producer owns leasehold interests in Louisiana and has a well producing oil in paying quantities. Oil Producer sells its oil production to Oil Purchaser pursuant to an industry standard Crude Oil Purchase Contract negotiated as an arm's length transaction between unaffiliated parties. This Oil Purchase Contract provides for the sale and delivery by Oil Producer, and the purchase and receipt by Oil Purchaser, of Light Louisiana Sweet crude oil at a designated price, with delivery to be made "at the well tankage into Oil Purchaser's designated transportation facilities" on the lease site.

The negotiated contract price for the purchase and sale of crude oil is defined in the Oil Purchase Contract and is calculated using three or four adjustable pricing components and one fixed pricing component. A typical contract may define the price to be received by the Oil Producer something similar to the following:

Price*: For the crude oil sold and delivered hereunder, Purchaser agrees to pay price per barrel which shall be calculated as follows:*

a. ConocoPhillips' West Texas Intermediate crude oil posting deemed at 40° API gravity based on equal daily quantities during the calendar month in which deliveries occur.

b. To the number determined in the foregoing paragraph (a), add the average of the daily quotes from Argus Weighted Daily Average Posting Plus for the month of delivery in Petroleum Argus "America Crude Assessments" based on pricing assessed for the days the U.S. Crude Oil Market is open….

c. To the number determined in the foregoing paragraph (b), add the weighted average quote for LLS for the month of delivery in ARGUS (Petroleum) "America's Crude Oil Assessments" based on pricing assessed for the days the U.S. Crude Oil Market is open…. The number determined pursuant to subparagraphs (a), (b) and (c) shall be the base price per barrel of crude oil.

d. To the base price determined in (c) above, subtract $2.00.

Typically, the first few price components are calculated in relation to variable industry benchmarks and are defined collectively as the "Base Price." An additional fixed price component particular to each well or field covered by the contract is also included in the calculation. This final component of the price, sometimes called a "lease premium or deduct," has been described as a "fixed market differential" set by the parties from field to field. It is this pricing component (item (d) in the example above) that the Louisiana Department of Revenue is calling an improper "deduction."

As noted above, we are engaged in ongoing "policy" discussions with the Department of Revenue concerning the purpose and effect of this pricing component. As it stands, the Department's "official position" is stated as follows:

> The Department of Revenue's position regarding any costs other than transportation costs that are incurred by the producers are not deductible from the selling price of the crude oil. All other costs taken as a deduction from the gross selling price are deductions that are not in accordance with the state of Louisiana severance tax laws and are not allowed. The auditor is correct in adding the costs back into the selling price and assessing the producer the additional severance tax due on the recalculated selling price because under the severance tax laws the producer is held to be ultimately responsible for the payment of the severance tax.
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> In regards to the Oil Severance Tax Audit, the Department of Revenue's official position on this issue is as outlined in Revenue Information Bulletin 08-015.

> Basically the only transportation costs allowed as a deduction are transportation costs that are incurred by the producer. Therefore if the purchaser assumes responsibility for transporting the oil from the field to the refinery then the transportation costs are costs of the purchaser and not the producer; therefore, the cost is not deductible from the selling price.

More often than not, the Oil Purchaser assumes the administrative responsibility for calculating, reporting and remitting to the State all severance tax due on the purchase of the crude oil based on the price yielded by the contract. Nevertheless, the Department of Revenue looks to the producer for accurate payment. This usually comes in the form of an Oil Severance Tax Audit covering multiple years, followed by a preliminary audit report and corresponding schedules showing an alleged “delinquent tax.” The Audit Report purports to disallow and completely disregard the premium/deduct component of the Contract Price specifically identified in the Oil Purchase Contract and adds a corresponding value to the agreed-upon Contract Price of crude oil purchased under the Oil Purchase Contract. In other words, by virtue of these audits, the State is attempting to unilaterally increase the Contract Price stated in Oil Purchase Contract for purposes of severance tax calculations and, hence, the amount of severance tax due the State. This practice is in conflict with rules and regulations directing producers to calculate and pay severance taxes based on the value of oil at the time and place of severance, which value “shall be 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.”

The Department usually allows the producer 30 days to respond to the Audit Report, then issues a Notice of Proposed Tax Due, followed by a formal Tax Assessment. The assessment includes a demand for payment of the additional severance tax, together with interest, delinquent payment penalties, negligence penalties and other miscellaneous charges.

Oil producers have several options to respond to an audit or an assessment, including payment under protest with a suit for recovery, or a claim for redetermination of the assessment filed with the Louisiana Board of Tax Appeals. Failure to timely respond can be costly. Feel free to call us if you have any questions.