HR 3919 : The crude oil windfall profit tax act of 1980 - An explanation

Touche Ross & Co.
HR 3919: THE CRUDE OIL
WINDFALL PROFIT
TAX ACT OF 1980

an explanation

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TOUCHE ROSS
ACKNOWLEDGEMENTS

This booklet was prepared under the direction of Thomas C. Latter, national services director—energy, taxation, and a tax partner in the Houston office. Substantial assistance was provided by Michael Saks, also of the Houston tax department.

This booklet focuses upon the excise tax provisions in the Crude Oil Windfall Profit Tax Act. The reader should be aware that the Act also contains other provisions such as residential and business energy credits, alcohol fuel credits, the repeal of carryover basis, and partial exclusion from income for certain interest received by individuals.

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EXECUTIVE SUMMARY

The introduction of price control regulation in the early seventies resulted in domestic crude oil prices falling substantially behind world market prices. In 1979, the President elected to phase out price controls, but at the cost of what many have described as the largest tax ever imposed on a single industry. The President's Windfall Profit Tax is a significant excise tax on all domestic production. Based on revenues rather than profits, it gives the federal government a quasi royalty interest in all domestic oil production, including that from reserves yet to be discovered.

The tax imposes costly financial and administrative burdens on the oil industry. The financial burdens may affect capital formation necessary for new exploration and development. Over a ten-year projected life, the tax is expected to net $227.3 billion in new revenue to the federal government, and may well generate amounts in excess of that target. Only 15 percent of the expected revenue is earmarked to develop new energy programs, a matter of great concern to many.

The administrative burden—collecting, accounting, and reporting—is the responsibility of the first purchaser of crude oil, who must withhold and pay the tax based on information he has received from the operator of the property. To a certain extent, the information will involve data already required to be reported by established Department of Energy (DOE) pricing regulations; however, new items of information are required and may not have previously been compiled by operators. Both first purchasers and operators will need to cooperate to handle the detailed recordkeeping that will be necessary in all cases. The tax combines many of the complexities of DOE pricing regulations with old and new provisions of the Internal Revenue Code, resulting in a number of ambiguities that must be resolved. Whoever collects the tax must: (1) integrate revenue and royalty accounting with DOE pricing procedures; (2) incorporate the new tax definitions and calculations into his accounting system; and (3) develop new collection and reporting systems. The complexity of this task will depend on the capacity of existing systems, the nature of the properties, and the status of the property owners.

In addition to financial and administrative burdens, there are other potential problems.

Reduced cash flow could be a problem for some of those charged with withholding the tax. The withholding agent must make prompt deposits of the tax withheld, possibly before the settlement date of some transactions. Producers who are entitled to certain exemptions and reduced rates will find that such relief is
not automatic; it will require action on their part to avoid significant over-withholding.

Finally, most producers will want to consider the net income limitation to determine if there has been an overwithholding of tax. The new law limits the revenues which are taxable to 90 percent of the "net income" from the oil. Calculation of net income will require going back to prior years' records to compute a hypothetical depletion cost, a calculation which could be difficult to derive as well as different for each interest owner.

It will take substantial cooperation and communication between operators and interest owners to determine when the net income test may apply and, further, to identify opportunities to maximize the limitation by timing discretionary expenditures.

The tax is now law, and the industry must act to minimize its burdens. Each taxpayer and affected party should examine every opportunity to reduce the impact of the tax. Operators and first purchasers must: (1) review their administrative obligations and options; (2) establish a strategy and approach for responding to those obligations; and (3) place into operation the policies, procedures, systems and organization needed to comply. These actions, if not underway, should be undertaken immediately.

Richard M. Pollard
Executive National
Services Director—Energy
BACKGROUND OF PRICE REGULATION

Since August 1971, the sale of domestic crude oil has been subject to price control regulation. As a result, the current price of controlled, domestic crude oil is far below the world market price.

In May 1979, mandatory price controls ended. The President, however, had discretionary authority to extend controls through September 1981. In April, the President announced that he would continue controls under a new program involving a “phased” decontrol which would allow the price of domestic crude oil to gradually reach the level of world market prices. The new regulatory scheme, set forth in June 1979, provided the framework for the President’s proposal.

Pre-June 1979 Price Controls. Prior to June 1979, there were six major classifications of oil, divided between the categories of controlled and uncontrolled oil.

Controlled oil included old, new, and Alaskan oil. Old oil sold at a ceiling price of about $6 a barrel and was defined as oil from wells in production prior to 1973. New oil was priced at $13 a barrel and represented oil from wells brought into production after 1972. Both old and new oil could be produced from a single property; therefore, a base production control level (BPCL) was established to delineate the classes of oil from a property. A BPCL was defined in terms of the average daily production from a property during the year 1972. Production below a BPCL was old oil while the production above a BPCL was regarded as new oil. Thus, by its definition, properties placed into production after 1972 did not have a BPCL.

Adjustments to a BPCL were allowed in subsequent years, including a complete recalculation of the BPCL where one could use production from either 1975 or 1979. After determining an adjusted BPCL, any shortfalls in production below the BPCL resulted in “cumulative deficiencies.” If later production rose above the adjusted BPCL, the excess was, first, classified as old oil rather than new oil until the deficiencies were eliminated.

Alaskan oil was primarily oil produced from the Sadlerochit Reservoir. The ceiling price of the oil was controlled; however, because significant costs were associated with the transportation of the oil, no wellhead price was set. Wellhead costs and transportation costs of Alaskan crude oil were estimated in the range of $7.50 and $6.25, respectively.

Uncontrolled oil included three classifications: stripper, incremental tertiary, and Naval Petroleum Reserve. Stripper oil was defined as production of ten barrels or less per day from a well operating at maximum efficiency. Incremental tertiary oil was the excess production attributable to the use of a qualified
enhanced recovery method. Naval Petroleum Reserve oil was oil production from certain federally owned leases.

June 1979 Price Controls. Under the President's new program of phased decontrol, three tiers of oil are established: lower, upper, and uncontrolled. The lower tier is composed of old oil as denoted from the previous regulations. The upper tier is mainly new oil. These two tiers retain the ceiling prices for their respective classifications of oil. The third, or uncontrolled, tier has no ceiling price. Oil in this tier can be sold at world market prices.

The new regulations call for a shift of oil from the lower tier price to the upper tier price and from the upper tier to the uncontrolled tier. The shift from lower to upper tier was at the rate of 1.5 percent per month for 1979 and is now at the rate of 3 percent per month until controls expire at the end of September 1981. The upper tier shift to uncontrolled is at the rate of 4.6 percent per month.

Several new categories of oil are also established: newly discovered, heavy, "front-end" tertiary and marginal. All except marginal are classified in the uncontrolled tier.

Newly discovered oil is production from a property which had no production during 1978 and, in the case of an offshore property, the property cannot have been leased before 1979. Marginal oil is defined as a low amount of production from a property, determined by a formula which utilizes average production per average well depth in 1978. "Front-end" tertiary oil is old oil which is released to the uncontrolled tier so that the additional revenue may be used to finance costly tertiary recovery projects. Finally, heavy oil is defined as oil with a specific gravity of 20 degrees API or less.
STRUCTURE OF THE WINDFALL PROFIT TAX

The windfall profit tax is an excise, or severance, tax levied upon the first sale of domestic crude oil. The tax is levied not on excess profits, but rather on excess revenue from the sale of domestic crude oil at a price above a statutory base price. Producers, defined as holders of the economic interest in the oil, are the taxpayers under the law. The tax will be withheld from gross receipts by either the first purchaser of the oil or the operator of the property. The total amount of windfall profit from a barrel of oil which is subject to tax cannot exceed 90 percent of the net income attributable to the barrel of oil.

The tax is structured to place into the Federal treasury most of the increased revenues from the decontrol of existing production while attempting a balance which leaves some incentives to producers to maintain or increase future production. To accomplish this objective, the tax is correlated with the price control program, from which it borrows many of its concepts and definitions. For example, the tier system and the classifications of oil are related to those used in the price control program. There are, however, some significant differences which may create new administrative headaches. The definition of “property” is one example. Certain aspects of administering the tax require treating property in the DOE sense, but other aspects follow the definition set forth in the Internal Revenue Code. This leads to unique calculations, and new recordkeeping and reporting requirements for a number of “properties.”

Additionally, the law provides a full exemption from tax or a partial reduction in tax for certain producers. Implementing these exemptions or reductions at the withholding stage may be imprecise and complicated. The result will be an over- or under-withholding of the tax which will require adjustments to future tax payments.

Sales on or after March 1, 1980 are subject to the tax. The tax is scheduled to phase out over a 33-month period beginning the later of January 1988 or after $227.3 billion in revenue has been collected from the tax. In any event, the tax will begin to phase-out January 1991, even if the revenue goal of $227.3 billion is not achieved.

Tier Structure

Essentially, the windfall profit tax provides for a three-tier system of taxable oil and a fourth category of exempt oil. The tax rate varies for each tier and, within some tiers, according to the status of the oil production as determined by the law. The following charts illustrate the structure of the tax:
WINDFALL PROFIT TAX
TIER STRUCTURE

Tier 1
Tax rate — 70% for all producers, including royalty owners
— 50% for independent producer oil on first 1,000* barrels of production per day
Base price — $12.81,** adjusted for inflation
Scope — most classifications of oil from fields in production before 1979

Tier 2
Tax rate — 60% for all producers, including royalty owners
— 30% for independent producer oil on the first 1,000* barrels of production per day
Base price — $15.20,** adjusted for inflation
Scope — stripper oil and National Petroleum Reserve Oil

Tier 3
Tax rate — 30% for all producers, including royalty owners
Base price — $16.55,** adjusted for inflation and a 2% "kicker"
Scope — newly discovered, incremental tertiary, and heavy oils

Exempt
North Alaskan Slope oil
"Front-end" tertiary oil

*The lower rates apply to the first 1,000 barrels per day of production prorated between Tier 1 and Tier 2 oil. Within a tier the reduced rate will be applied first to the highest priced oil.

**These are estimates of typical base prices and are not meant to reflect actual figures. A base price may vary depending upon grade, quality, and location.
**WINDFALL PROFIT TAX**  
**CRUDE OIL CLASSES**  
**RELATIONSHIP OF DOE CRUDE CLASSES TO IRS CLASSES**

<table>
<thead>
<tr>
<th>DOE Classes</th>
<th>IRS Classes</th>
<th>Tier 1</th>
<th>Tier 2</th>
<th>Tier 3</th>
<th>Exempt</th>
</tr>
</thead>
<tbody>
<tr>
<td>LOWER TIER:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Old Oil (Pre 1973)</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Heavy (Between 16° &amp; 20°)</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marginal (20%)*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>UPPER TIER:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New Oil (Pre 1979)</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Released Lower Tier</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marginal (80%)</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alaskan (Sadlerochit)</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNCONTROLLED:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Released Upper Tier</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stripper</td>
<td></td>
<td></td>
<td>X</td>
<td></td>
<td></td>
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<tr>
<td>National Petroleum Reserve</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Newly Discovered</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Incremental Tertiary</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Front-End Tertiary</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>North Slope Alaskan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Heavy (20°)</td>
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<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Heavy (16°)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

*This oil is expected to be released to the upper tier soon after passage of the Act.*
# WINDFALL PROFIT TAX
## TAX RATE* BY PRODUCER (OWNER)

<table>
<thead>
<tr>
<th>Producer (Owner)</th>
<th>Tier 1</th>
<th>Tier 2</th>
<th>Tier 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Working Interest:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Integrated Producer</td>
<td>70%</td>
<td>60%</td>
<td>30%</td>
</tr>
<tr>
<td>Independent Producer</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Normal Rate</td>
<td>70%</td>
<td>60%</td>
<td>30%</td>
</tr>
<tr>
<td>• Reduced Rate</td>
<td>50%</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td>Royalty Owner:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exempt:</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>• Indian Tribes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Charitable Institutions</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>(interests owned before</td>
<td>January 22, 1980)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• State &amp; Local Government</td>
<td>-0-</td>
<td>-0-</td>
<td>-0-</td>
</tr>
<tr>
<td>Normal:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Royalty</td>
<td>70%</td>
<td>60%</td>
<td>30%</td>
</tr>
<tr>
<td>• Net Profits</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Overriding</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Certain Production Payments**</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**MEMO: TYPICAL BASE PRICE**

(MARCH, 1980) $12.81 $15.20 $16.55

*Tax = Tax Rate × (Removal Price − Severance Tax − Base Price)
Base Price Escalated at Beginning of Each Quarter by GNP Inflator
**Includes only those production payments qualifying as an economic interest in the property within the meaning of Section 636.

## Tier 1

The first two tiers under the price control program have been merged into one tier for purposes of the windfall profit tax. The decision to combine the two tiers was based upon a desire to simplify the tax structure. The combined tier encompasses most domestic production from fields discovered before 1979.

The tax is imposed on the "windfall profit," which is defined as the excess of the removal, or sales, price over an adjusted base price. A deduction from the windfall profit is allowed for the portion of severance taxes paid on the windfall profit element. On intercompany transactions, a reconstructed removal price will be used. The removal price cannot be less than the constructive sales price used for purposes of determining gross income from a prop-
erty under the depletion sections of the Internal Revenue Code. In addition, the Secretary of the Treasury has authority to restructure removal prices to prevent tax avoidance. The occurrence of removal will follow those guidelines used to determine removal for depletion computations. Usually, removal will have occurred when the crude oil is transferred from the property or subjected to manufacturing or conversion processes on the property. Oil which is reinjected or consumed on the property ("powerhouse fuel") will not be considered removed.

The base price for Tier 1 oil is equal to the ceiling price of upper tier oil in May 1979 reduced by 21 cents. This is roughly equivalent to $12.81 per barrel for most oil, adjusted for grade, quality, and location. The price does not coincide with the current ceiling price for upper tier oil under the price control program due to Congress having juggled the base price to achieve its revenue goals. The inflation adjustments will be similar, but not identical, to those used under the price control program; therefore, the gap between base prices and ceiling prices will remain fairly small while price controls are in effect.

As a result of the correlation between Tier 1 and the price control program, little or no tax will be imposed on oil subject to price controls. Producers will not pay a windfall profit tax on old oil which is subject to price control and which has not been released from the lower tier to the upper tier. Since the lower tier ceiling price is below the adjusted base price for the windfall profit tax, there is no excess revenue on this oil.

Those who produce oil subject to the upper tier price will pay relatively little windfall profit tax on this oil since the ceiling price will exceed the adjusted base price by a small amount. It is only after the oil is released to the uncontrolled or world market price that the windfall profit tax on Tier 1 oil will become significant.

The tax rate for all producers, including royalty owners, is 70 percent. Independent producer oil is taxed at the reduced rate of 50 percent on the first 1,000 barrels of production a day. If an independent producer has the qualified production in Tier 2, as well as in Tier 1, he must allocate the 1,000 barrels on a pro rata basis between the two tiers. An overriding royalty interest, a net profits interest, certain production payments, or any other non-operating interest is a royalty interest subject to the higher tax rate. If an independent producer holds a nonoperating interest, he will not be entitled to the reduced rate on revenue from that production even though it is within his 1,000 barrel a day limitation.

An independent producer is defined in terms of one who is eligible for percentage depletion under Section 613A of the Internal Revenue Code. However, because the qualification is
based on a quarter by quarter determination, the definition is modified somewhat. Generally, it refers to a person (1) who is not a retailer, or is not related to a retailer, of oil or oil products with sales of $1.25 million or more per taxable quarter, or (2) who is not a refiner, or is not related to a refiner, with runs of 50,000 barrels or more on any day in a taxable quarter. The term “related to” is discussed at length in the proposed regulations under Section 613A of the Internal Revenue Code.

**Tier 2**

The second tier includes only two categories of oil: National Petroleum Reserve oil and stripper oil. National Petroleum Reserve oil is production owned by the Federal government. The government as producer and, therefore, taxpayer will merely be transferring funds from one revenue fund to another. Stripper oil is defined as oil from a well which has an average daily production of ten barrels or less for the preceding 12-month period while operating at maximum efficiency. Once a property is classified as a stripper property, it will always be a stripper property even though production from the property may increase in subsequent periods.

The tax rate for this tier is 60 percent for all producers and royalty owners, and 30 percent for independent producer oil on the first 1,000 barrels a day of production. The base price for the interim period of March 1, 1980, through September 30, 1980, will be the highest posted field price for uncontrolled oil on December 31, 1979 multiplied by the fraction of $15.20 over $35.00. A minimum interim price, equivalent to the May 1979 price for the class of oil plus $1 per barrel, has been established to insure that no producers are penalized should their December 31, 1979 field price be low. The formula is gauged to result in a typical Tier 2 base price of $15.20 per barrel.

The permanent base price for Tier 2 oil will be prescribed in regulations to be set forth by the Secretary of the Treasury. Guidelines in the statute direct the Secretary to design his method to approximate the December 1979 price of Tier 2 oil if (a) all domestic crude oil were decontrolled, and (b) the average sales price for Tier 2 oil were $15.20 a barrel. All base prices are subject to adjustment for inflation.

**Tier 3**

The third tier of the windfall profit tax includes only three classes of oil: newly discovered, tertiary, and heavy oil.

Newly discovered oil consists of oil from an “onshore” or an
"offshore" field which did not produce oil in commercial quantities during 1978; in addition, the "offshore" field must not have been leased prior to 1979. The definition is identical to the one used for the price control program. The definition includes oil from properties which produced oil in commercial quantities before 1978, and oil to be produced from certain reservoirs penetrated before 1979 but from which there was no commercial production during 1978. The latter class of oil is more commonly referred to as "behind the pipe."

Incremental tertiary oil, perhaps the most complicated of all classes of oil, consists only of the enhanced production which results from a qualified tertiary recovery project. The classification applies only to new projects begun after May 1979 or to the significant expansion of existing projects.

The producer has to be cognizant of several requirements before oil may be classified in this tier. First, the producer must determine a base level of production from the property before the project begins so that he may determine the excess production due to the use of the tertiary recovery method. The base level is equivalent to the amount of production from the property for the six-month period ending March 31, 1979. The base level is reduced each month by one percent until the project begins and 2.5 percent thereafter. Second, the producer must use one or more of several specified chemical, fluid, or gaseous techniques which are recognized as tertiary methods. Third, the producer must seek certification of the project. The Department of Energy, the U.S. Geological Survey, or a state government agency may certify the project. Also, self-certification will be permitted if performed by a petroleum engineer. If a regulatory certification for a project is revoked, the project will be treated as if it were self-certified.

A tertiary project will not be certified for purposes of the windfall profit tax unless it is shown to be in accordance with sound engineering principles and is expected to result in more than an insignificant increase in production. All certified projects will be subject to review by the Internal Revenue Service. Self-certified projects will probably be subject to closer scrutiny than projects certified by a regulatory agency.

Once the project is qualified, the production from a property will be prorated between incremental tertiary oil and the classes of oil previously produced from the property. The classification as incremental tertiary oil will continue only as long as the qualified project is in operation. The termination date of the project will be determined on a case-by-case basis. Thus, a halt in the injection process will not necessarily be equivalent to the termination of the project.

Heavy oil was placed in the third tier because its low viscosity
has made this type of oil difficult and expensive to produce. Under the windfall profit tax, oil with a gravity of 16 degrees API or less will qualify for Tier 3 treatment. The definition of heavy oil for the price control program is 20 degrees API or less. This discrepancy may be adjusted in a technical amendment to the act. Until that time, certain amounts of decontrolled heavy oil will be subject to Tier 1 or 2 of the windfall profit tax if it would otherwise be classified as Tier 1 or 2 oil.

The tax rate for production in the third tier will be 30 percent for all producers. Unlike the first two tiers, there will be no preferential rate for independent producer oil. The base price for Tier 3 oil will be calculated in a manner similar to that for Tier 2 oil. The interim base price will be the highest posted field price for uncontrolled oil on December 31, 1979, multiplied by the fraction of 15.65 over 35.00. The minimum interim price will be equivalent to the May 1979 price for the class of oil plus $2 per barrel. Finally, the permanent base price is designed to approximate the December 1979 price of Tier 3 oil if (a) all domestic crude oil were decontrolled, and (b) the average sales price for Tier 3 oil is $16.55 per barrel. The base prices are subject to a quarterly adjustment for inflation plus a "kicker" of 0.5 percent per quarter.

**Exempt Oil**

North Slope Alaskan oil and "front-end" tertiary oil have been exempted from the windfall profit tax. The exemption for North Slope Alaskan oil initially was limited to oil produced from reservoirs penetrated by a well located north of the Arctic Circle. The present statutory language has been expanded to encompass any well located north of the Aleutian Mountain ranges and at least 75 miles distance from the Trans Alaskan Pipeline. This will not include oil presently being produced from the Sadlerochit Reservoir which is taxed in Tier 1.

The second class of exempt oil is "front-end" tertiary oil. In August 1979, pricing regulations allowed lower tier oil to be released from price controls and sold at world prices provided that the additional revenue which was generated was used to finance tertiary recovery projects. The pricing regulations limit the amount of oil which is decontrolled to the lower of 75 percent of actual expenses (excluding the cost of any hydrocarbons used in the project) or $20 million. The limitation applies on a project-by-project basis, but there are no restrictions on the number of projects a producer may undertake.

"Front-end" tertiary oil deregulated under the pricing regulations will be exempt from tax where the tertiary project is controlled by an independent producer. There are two exceptions.
First, if the oil could be decontrolled under any other pricing regulation, it is not eligible for exemptions from tax. Second, the oil cannot be used to finance prepaid expenses (those expenses attributable to the period after September 30, 1981).

Tertiary projects controlled by an integrated oil company will not be exempt from tax even though the oil is released to the uncontrolled tier under the pricing regulations. Instead, all producers (including independent producers) will be eligible for a refund of windfall profit tax to the extent qualified expenditures for the project exceed the amount recouped from the additional revenue generated by the released "front-end" tertiary oil. An integrated oil company is considered to have control of the project where it owns, directly or indirectly, 50 percent or more of the working interest in the property on January 1, 1980.

The exemption or refund for "front-end" tertiary oil cannot be used to finance expenditures incurred after September 30, 1981. Income tax regulations will be used to determine what expenditures are allocable to the qualifying period whenever there is uncertainty about a particular expense, such as purchases of depreciable property or injectants.

**Taxable Persons**

*General*—under the new law, the taxpayer is the producer or holder of the economic interest in the oil. The term includes not only those who own working interests, but also those who own nonoperating interests such as royalty interests, overriding royalty interests, net-profits interests, and certain production payments. In the case of a partnership, each partner will be the producer and, thus, liable for tax on the amount of revenue attributed to his share of production.

*State and local governments*—economic interests owned by state or local governments and their agencies are not subject to tax if the revenue received from the interest is dedicated to a public purpose, e.g., education. The act does not restrict the type of public purpose which may qualify.

*Charitable, educational and medical institutions*—various charitable institutions, which owned an economic interest in oil production on January 21, 1980 may be exempt from tax on those interests. To qualify, the institution must be one that is considered a charitable organization within the meaning of Section 170 of the Internal Revenue Code. An educational institution must meet the further requirement that it maintain a regular faculty and curriculum, and that it have students in regular attendance. Churches may also receive this exemption if the pro-
ceeds from their oil interests were dedicated to use in qualified educational or medical institutions on January 21, 1980.

**Indian tribes**—oil produced from interests owned by Indian tribes, individuals, or organizations and held in Trust by the United States will be exempt from tax. Also, interests owned by the Alaskan Native Regional Corporations, from lands they received under the Alaskan Native Claims Settlement Act, will be exempt from tax. The exemption, however, does not extend to non-Indian lessees of tribal interests.

**Administration of the Tax**

Although the tax is imposed on the producer, the first purchaser is generally charged with the responsibility for collecting and depositing the tax. In addition, the first purchaser must file quarterly returns within two months after the close of a quarter. The final quarterly return should contain an annual summary of information.

The tax is collected by withholding the requisite amount from payments to producers. The frequency with which a tax deposit must be made depends on the status of the first purchaser. An integrated oil company who is a first purchaser is required to make tax deposits on a semimonthly basis. A nonintegrated company who is a first purchaser has 45 days from the end of the month in which the oil is removed from the premises to deposit the tax. Where a nonintegrated company purchases for an independent refiner and has entered into a contract under which the refiner is not obligated to pay for the oil until at least 45 days from the date of purchase (deferred payment), the nonintegrated company may deposit the tax 60 days after the end of the month of removal. The term "independent refiner" is defined in the pricing regulations as one who does not secure more than 70 percent of its oil from a producer who is controlled by the refiner and one who does not distribute a substantial amount of its refined products to a "branded" marketer. The varying deposit dates are designed to alleviate the cash flow problems some purchasers may have.

Where a producer does not sell the oil but instead refines and markets the oil himself, he must calculate the tax and make deposits. The timing of payments follows the status of the producer. An integrated producer must file semimonthly, and a nonintegrated producer must file within 45 days after the month of removal.

The act requires the operator of a property to supply the first purchaser with the data necessary to compute the tax and to complete the quarterly returns. This would include such information as the classifications of oil, property, and taxpayer, and the ad-
justed base prices. Also, the operator must supply the purchaser with certifications relating to reductions in tax withholding or exempt taxpayers.

In lieu of providing such information, the operator and the first purchaser may elect to have the operator withhold and collect the tax. In this instance, the operator must make deposits on the same date the first purchaser would have. The only benefit to derive from such an election is that, administratively, only one person will be required to collect data and make calculations. In the absence of the election, two sets of data will be required to be kept, one by the operator and one by the first purchaser. The election should be made only after a careful study of the cash flow between the parties.

Where the first purchaser collects the tax, his liability extends to insuring that the tax is properly calculated, withheld, and paid to the government. The failure to make timely deposits can result in stiff penalties. Additionally, the first purchaser may be liable if he is negligent in determining the tax, or if there is collusion with the producer to misrepresent the amount of tax due. Adjustments with respect to over- or under-withholding are required to be made in later periods if there continues to be transactions between the same producers and purchasers. A producer may voluntarily request first purchasers to withhold only additional not lesser amounts in any quarter. These amounts will be treated as any other amount withheld and required to be deposited by the first purchaser.

Primary liability for deficiencies in tax, which are not the result of negligence or misrepresentation by the first purchaser, lies with the producer. If the producer is fully satisfied with the amount withheld, he need not file a return. If not, he must file a return either to pay the additional tax or to secure a refund. A producer that is exempt from tax or entitled to reduced rates must certify that status to the operator. Otherwise, the operator cannot relate the certification to the first purchaser and withholding will be at the maximum rate.

Purchaser's responsibilities:

• collect information pertinent to calculation of tax
• calculate tax
• withhold and pay tax on a timely basis
  • semimonthly deposits if integrated purchaser
  • deposits within 45 or 60 days if nonintegrated purchaser
• file quarterly returns; fourth quarter should contain annual summary
• report amounts withheld to operator and producer
Producer’s responsibilities:
• supply certifications to operator
• pay any deficiencies due to withholding
• calculate net income limitations and file for refund at year-end

Operator’s responsibilities:
• supply first purchaser with the data necessary to calculate the tax
• collect certifications from producers
• elect to withhold and pay tax, and to file quarterly returns
• keep records as required by regulations

Administrative and Judicial Enforcement

The administration of the tax will be by the Internal Revenue Service and not the Department of Energy. The act provides the Secretary of the Treasury with the general authority to promulgate regulations and to take all action necessary to insure compliance with the windfall profit tax. One of the more significant administrative powers granted to the Secretary is the authority to restructure removal prices in transactions between related or unrelated parties to insure that fair values are placed on the oil which is sold. The Secretary’s power will be triggered when, in his judgment, it is necessary to prevent tax avoidance.

In addition, the failure to pay the tax or to comply with the other requirements of the windfall profit tax will result in the imposition of civil and criminal sanctions which are applicable to other taxes imposed by the Internal Revenue Code. The Tax Court has been granted concurrent jurisdiction, along with the district courts and Court of Claims, to hear cases involving the windfall profit tax. As with income taxes, Tax Court jurisdiction is based on challenging an unpaid assessment; District Court and Court of Claims jurisdiction requires payment of tax and suit for refund.

Burden of Proof

The taxpayer has the burden of proof in establishing his tax liability. Thus, a taxpayer alleging that he is entitled to preferential tax treatment must be able to support the classifications of oil or property which he asserts, as well as the other factors which enter into the calculation of the tax. This burden makes it imperative that producers require the operator of a property to keep accurate records.

In connection with tertiary recovery projects the burden of proof has been modified where an authorized regulatory agency has certified the project. Here, the certification will stand unless
the Internal Revenue Service can demonstrate by "substantial evidence" that there is no support for the certification.

Though the tax is closely tied to the Department of Energy price control program, the burden of proof is governed by standards applied to tax cases rather than those applied to DOE cases. Some courts have required the government to prove "flagrant violations" in DOE cases involving pricing regulations. This standard will not apply to windfall profit tax cases. The calculation of tax by the Internal Revenue Service carries a presumption of correctness which must be overcome by the taxpayer.

Statute of Limitations

Several modifications have been made to the statute of limitations under applicable sections of the Internal Revenue Code. First, the statute begins to run when the producer files his annual income tax return for the taxable year in which the calendar year of the oil's removal ends for all production subject to withholding. For example, if a corporate producer's year-end were March 31, 1981, the statute of limitations with respect to the tax paid for oil removed in calendar year-end 1980 would not begin to run until the producer filed his income tax return on June 15, 1981. Extending the time to file the income tax return correspondingly extends the excise tax statute.

Second, the statute will be held open, at least for one year, where a property or oil is reclassified. This will allow sufficient time for a possible audit of the property and allow additional time for filing a tax refund claim due to the reclassification. The statute will be held open, however, only with respect to the items adjusted by the reclassification.
SPECIAL RULES AND DEFINITIONS

Property
The term “property” has two meanings with respect to the windfall profit tax. When the term is used in the context of classifications for pricing and tax calculations, it carries the definition given in the DOE pricing regulations. The regulations define property as a right to produce which arises from a leasehold or fee interest. Also, the regulations allow a producer to treat as separate properties each separate and distinct reservoir subject to the same right to produce, provided that the reservoirs are recognized as separate by a government agency.

The other definition of property is derived from Section 614 of the Internal Revenue Code. Often, a tax Code property may contain several DOE properties. The tax Code definition of property is applicable for purposes of determining the net income limitation and the percentage depletion calculation under Section 613A of the Code.

Where several properties are unitized, the effect is to make one single property out of the unit. A producer will continue to receive the classification for his oil which it received prior to the unitization. Thus, if it was stripper oil prior to unitization, it should continue to be stripper after unitization. Unitization may have some adverse effects on certain classifications, such as newly discovered oil, depending on when the unit was formed. Guidelines for determining the effect of unitization are to be set forth in regulations.

Property Transfers
To prevent tax avoidance, the act provides that oil from a property transferred after 1978 will retain the same classification it had prior to the transfer. Thus, a producer cannot create a preferred class of oil or property merely by transferring the property to another. In addition, if a property is divided and a portion is transferred, the BPCL for the property must be allocated between the transferred property and the property retained. Property transferred to charitable, organizations after January 21, 1980 will not be eligible for the special exemption provided to churches which dedicate the proceeds to use in charitable, educational or medical institutions.

As a general rule, property which has been transferred will not be eligible for the reduced rates provided to independent producers. The rule is similar to the transfer rule used for depletion purposes under Section 613A of the Code. There are, however,
two exceptions. First, a transfer between an individual and a con­
trolled corporation will not disqualify the property for the re­
duced rate. Second, where the transferor is a small independent
producer with less than 1,000 barrels a day of production, he may
transfer the property to another independent producer without
disqualifying the property for the reduced rates. This last excep­
tion carries the additional qualification that the transferred prop­
erty cannot at any time in the past have been owned by an in­
tegrated producer or a large, independent producer with over
1,000 barrels a day of production.

Severance Taxes
In calculating the amount of windfall profit derived from a barrel
of oil, a deduction is allowed for payment of the severance taxes
attributable to the windfall profit element. The deduction equals
the excess severance taxes paid over what would have been the
tax had the oil sold at the adjusted base price. Although severance
taxes may be imposed either on a fixed fee per barrel or a percent­
age of gross value basis, the deduction only encompasses those
taxes imposed as a percentage of gross value. Further, the deduc­
tion only applies to the extent that the total severance tax does
not exceed 15 percent of the total sales price of the barrel. Any
portion of the deduction attributable to severance taxes which
are increased after March 31, 1979 will only be allowed if the in­
crease is applicable to the entire price of the barrel of oil.

County, city, and other local taxes imposed on oil production
do not qualify as severance taxes eligible for the deduction. Also,
Indian severance taxes do not qualify. At this point, it is uncer­
tain whether state ad valorem taxes will qualify.

Inflation Adjustment
The base price for the three tiers of oil will be adjusted each
quarter to account for inflation. The adjustment factor uses the
GNP deflator for the second quarter preceding the quarter for
which the adjustment is made to the extent it exceeds the GNP
deflator for the quarter ending June 30, 1979. The two-quarter lag
is necessary because of the time required to generate the data for
the deflator. For the first quarter of 1980, the base prices may be
adjusted using the GNP deflator for the third quarter of 1979. The
"first revision" of the deflator will be the version used for the
calculations. In addition, the Tier 3 base price will be adjusted
upward 0.5 percent each quarter.
Net Income Limitation

The net income limitation can have a significant impact on the amount of tax paid on certain properties. Those properties likely to utilize the limitation are (a) properties with a low gross revenue due to either a large amount of controlled oil or relatively high expenses, (b) proven properties recently purchased before 1979 with a high depletable basis, or (c) properties that are nearing the end of their useful lives.

The act provides that the windfall profit on a barrel of oil cannot exceed 90 percent of the net income attributable to the barrel. The net income from a barrel of oil is determined by dividing the taxable income from a property (the tax Code definition of property is used) by the number of taxable barrels produced from the property.

Taxable income, in turn, is determined in accordance with Section 613(a) of the Code. The income from a property will include production used to discharge production payments.

In general, the expenses allowed to be deducted are the same as those used in the 50 percent net income limitation for depletion purposes. This will include lease operating expenses, certain work-over expenses, and portions of the administrative expenses. Where a lease produces both oil and gas, the expenses must be allocated between the two products on the basis of gross receipts.

No deductions from income will be allowed for percentage depletion, intangible drilling costs (except those with respect to dry holes), and the windfall profit tax. However, a deduction will be allowed for cost depletion by those who ordinarily use this method of depletion. In cases where the taxpayer has been using percentage depletion, he will be allowed a deduction for a hypothetical cost depletion based on what would be the figure if he had capitalized and amortized intangible drilling costs (except those with respect to dry holes) and costs of tertiary injectants.

Where a proven property has been transferred after 1978, the amount of hypothetical cost depletion which is allowed for purposes of the net income limitation is restricted to the amount which could have been taken prior to the transfer. This restriction was added to prevent transfers of property for the sole purpose of creating additional cost basis in the property.

Additional Definitions

Crude Oil—the term is the same as that used in the June 1979 energy pricing regulations. It includes condensate such as natural gas liquids, but does not entail synthetic petroleum, such as oil
from shale or tar sands. It is uncertain at this time whether con-
densate from gas wells will be subject to tax.

BPCL—the base production control level serves to establish
the amount of old oil produced on a property.

Producer—the term "producer" means the holder of the
economic interest in the crude oil produced on the property. Generally, a leasehold or fee interest will be considered the holder of the economic interest. (This includes all royalty owners.) An owner of a production payment may also be considered a holder of an economic interest in crude oil and, therefore, be a producer. In the case of a partnership, the partner is the holder of the economic interest.

Operator—the term "operator" means the one who is charged with the management of the well. The operator may also be a "producer" where he owns, or is one of the owners, of the economic interest in the property.
INTERACTION WITH THE INCOME TAX

The windfall profit tax will interact with the federal income tax in two significant ways. First, a deduction from gross income for all tax paid or accrued will be allowed. This will prevent the imposition of a double tax which would arise from paying an excise tax and then an income tax on the same revenues. Second, percentage depletion will be calculated with respect to the gross revenue from oil production, including the windfall profit portion. The depletion deduction extends to all those who are currently eligible for the deduction, such as independent producers and royalty owners.
CALCULATION OF THE TAX

Each property is unique with respect to the calculation of tax because there are so many variables to consider. Changing any variable will result in a new tax calculation.

Several sets of data must be maintained to calculate the tax. First, classifications under the price control program must be determined. Second, owners of the economic interest must be identified and their status determined. As an example, old oil which is controlled is sold at a removal price which is less than the adjusted base price for the oil; therefore, there is no windfall to be taxed. Old oil which has been released from control may be taxed at the rate of 50% or 70%.

Below is a list of the data which must be considered in calculating a tax.

Classes of oil:
- old oil
- new oil
- newly discovered oil
- incremental tertiary oil
- heavy oil
- stripper oil
- exempt oil
- marginal oil

Status of producer:
- independents
- royalty owners and integrated companies
- exempt

Removal prices:
- lower tier (relevant only through September 1981)
- upper tier (relevant only through September 1981)
- world price

Adjusted base price (adjusted for inflation):
- tier one
- tier two
- tier three (also adjusted for 2% "kicker")

Severance taxes
Net Income Limitation
BPCLs

A hypothetical example shown in Schedule 1 helps to illustrate both the impact and the calculation of the tax in future periods. This example assumes:
- A producing property selling a constant 200 barrels per day of oil.
- Prior to June 1979 all the oil was classified as old and the
unadjusted BPCL was 200 barrels per day, based on the six-month period ending March 31, 1979.

- The working interest is owned by integrated producers so that all working and royalty interests are subject to the 70%, Tier 1 rate.
- The unadjusted base price for the oil is $12.81 per barrel.

To isolate the joint effect of price decontrol and the windfall profit tax, the example assumes that (1) the price of uncontrolled oil holds constant at $35 per barrel, and (2) there is no inflation. In actual practice, the price of uncontrolled oil will follow the world market and there will be quarterly inflation adjustments to the ceiling prices of controlled oil and to the IRS base prices.

Exhibit 1 illustrates graphically the increase in total gross revenues and the increasing tax bite in three periods:

- March 1980 (first month of the tax)
- December 1980
- October 1981 (first month after price controls are completely phased out)

In this example, gross revenues increase from $55,000 in March 1980 to $210,000 in October 1981. At the same time, windfall profit taxes increase from just over $4,000 to almost $89,000—from 8% to 42% of gross revenues. By October 1981, the tax amounts to $14.76 per barrel, which is greater than either the upper tier oil ceiling price or the IRS base price, uninflated.
### SCHEDULE 1
CALCULATION OF WINDFALL PROFIT TAX FOR HYPOTHETICAL PROPERTY
(INTEGRATED PRODUCERS and Royalty Owners, 200 Bbl/day sales and 200 Bbl/day BPCL—unadjusted)

#### PART 1—CALCULATION OF EXCESS REVENUES

<table>
<thead>
<tr>
<th>DOE Oil Classification</th>
<th>Sales (1) Volume, Bbl</th>
<th>Removal Price, Per Bbl</th>
<th>Gross Revenue</th>
<th>Base Price (2) Per Bbl</th>
<th>Base Price x Volume</th>
<th>&quot;Excess&quot; Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lower Tier</td>
<td>4,380</td>
<td>$ 6.30</td>
<td>$ 27,594</td>
<td>$12.81</td>
<td>$56,108</td>
<td>$ -0-</td>
</tr>
<tr>
<td>Upper Tier</td>
<td>1,396</td>
<td>13.75</td>
<td>19,195</td>
<td>12.81</td>
<td>17,883</td>
<td>1,312</td>
</tr>
<tr>
<td>Uncontrolled</td>
<td>224</td>
<td>35.00</td>
<td>7,840</td>
<td>12.81</td>
<td>2,869</td>
<td>4,971</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>6,000</strong></td>
<td><strong>$ 54,629</strong></td>
<td><strong>$6,283</strong></td>
<td><strong>$41,041</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Lower Tier             | 2,760                 | $ 6.30                 | $ 17,388      | $12.81                 | $35,356             | $ -0-             |
| Upper Tier             | 1,452                 | 13.75                  | 19,965        | 12.81                  | 18,600              | 1,365             |
| Uncontrolled           | 1,788                 | 35.00                  | 62,580        | 12.81                  | 22,904              | 39,676            |
| **Total**              | **6,000**             | **$ 99,993**           | **$41,041**   |                       |                     |                   |

| Lower Tier             | -0-                   | $ —                    | $ -0-         | —                      | —                   | $ -0-             |
| Upper Tier             | -0-                   | —                      | -0-           | —                      | —                   | -0-               |
| Uncontrolled           | 6,000                 | 35.00                  | 210,000       | 12.81                  | 76,860              | 133,140           |
| **Total**              | **6,000**             | **$210,000**           | **$133,140**  |                       |                     |                   |

#### Part 2—CALCULATION OF TAX

<table>
<thead>
<tr>
<th>Period</th>
<th>&quot;Excess&quot; Revenues (Part 1)</th>
<th>Less Severance Tax (5% of Revenues)</th>
<th>Taxable Revenues</th>
<th>Times Tax Rate</th>
<th>&quot;Windfall Profit&quot; Tax</th>
<th>Memo: Tax as % of Gross Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Period 1</td>
<td>$6,283</td>
<td>(314)</td>
<td>$5,969</td>
<td>× 70%</td>
<td>$4,178</td>
<td>7.7%</td>
</tr>
<tr>
<td>Period 2</td>
<td>$41,041</td>
<td>(2,052)</td>
<td>$38,989</td>
<td>× 70%</td>
<td>$27,292</td>
<td>27.3%</td>
</tr>
<tr>
<td>Period 3</td>
<td>$133,140</td>
<td>(6,657)</td>
<td>$126,483</td>
<td>× 70%</td>
<td>$88,538</td>
<td>42.2%</td>
</tr>
</tbody>
</table>

(1) Assumes all 30-day months for comparison  (2) Assumes no inflation
Exhibit 1

WINDFALL PROFITS TAX RELATIVE TO PRICE DECONTROL, HYPOTHETICAL EXAMPLE

<table>
<thead>
<tr>
<th>Date</th>
<th>Windfall Profits Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>March, 1980</td>
<td>$54,629</td>
</tr>
<tr>
<td>December, 1980</td>
<td>$4,178</td>
</tr>
<tr>
<td>October, 1981</td>
<td>$121,462</td>
</tr>
</tbody>
</table>

WINDFALL PROFITS TAX

$ in thousands

250
200
150
100
50
0

March, 1980
December, 1980
October, 1981

$210,000
$88,538
$121,462
EFFECTIVE DATE AND PHASEOUT

The Crude Oil Windfall Profit Tax Act is effective as of March 1, 1980. The tax will be phased out over a period of 33 months to begin the later of January 1988 or one month after $227.3 billion in revenue is collected from the windfall profit tax. Thus, revenues in excess of $227.3 billion may be collected for the tax. In any event, the tax will begin to phase out no later than January 1991.
USE OF FUNDS

Rather than establish separate trust funds for the revenue generated by the windfall profit tax, Congress has placed the amounts in the general revenue fund. Congress also designated three areas to receive the revenues:

• 25 percent will be used for programs to aid lower income households
• 15 percent will be spent on energy and transportation projects
• 60 percent has been set aside for prospective tax cuts for individuals and corporations

The act requires the President to recommend each year specific programs for use of the revenues in each of the designated areas. Failure by Congress to enact any specific programs will result in use of the funds to reduce the federal deficit.