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Memorandum

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TO: Interested Persons

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SUBJECT: Impact of 2016 BP America Decision on Severance Tax Liability and Refunds

Summary

On April 25, 2016, in *BP America v. Colorado Department of Revenue* (the BP case), the Colorado Supreme Court ruled that oil and gas producers were allowed to take a larger deduction for transportation and marketing costs on their severance tax return than what had previously been allowed. Following the ruling, the state anticipated oil and gas severance taxpayers would file amended returns claiming the expanded deduction, resulting in significant severance tax refunds. Reports prepared by the Department of Revenue for gross and net tax liabilities from before and after the ruling suggest that the amended returns claiming the expanded deduction allowed under the BP decision has not been a significant driver of refund activity.

While the decision did not generate large refunds, the expanded deductions may have reduced severance tax collections. Taxpayers may have already been claiming the expanded deduction upheld by the Supreme Court, suppressing collections in the years prior to the court ruling. Taxpayers do not report the deduction on tax forms. Therefore, audits of taxpayers' supporting documentation would be required to determine the full impact of the BP decision on severance tax collections.

Supreme Court Ruling

The Supreme Court decision in the BP case allows oil and gas producers to deduct a broad array of costs, including those listed on the netback expense report forms (NERF) submitted by oil and gas producers to county assessors.[1] These include direct costs and foregone returns on investment as a result of expenditures for the transportation, manufacturing, and processing of oil and gas. The decision allows producers to claim significantly larger deductions than had been allowed previously. Additionally, the decision results in an increased state liability for severance tax refunds to the extent that taxpayers file amended returns claiming the larger deduction.

[1]A copy of the NERF form can be found here: https://www.colorado.gov/pacific/dola/property-taxation-forms

Expectations for Amended Returns

Taxpayers may file amended returns and claim a tax refund for up to three years after the original tax was paid.[2] Amended returns generate a refund liability for the state equal to the overpayment of taxes for previous years. The Department of Revenue processes amended returns when they are received.

After the BP ruling, oil and gas severance taxpayers were expected to file amended returns for tax years 2013 through 2015, reflecting the expanded deduction allowed under the BP ruling. However, available data to date suggests that the impact of amended returns and refunds has been fairly limited. These findings suggest that oil and gas severance taxpayers were likely already claiming the expanded deduction and/or the impact of the BP decision will have a smaller impact on severance tax collections than previously expected.

Data limitations. Notably, data available to quantify the impact of the BP ruling are limited. The Department of Revenue has not published data on the number of amended returns filed following the BP decision, and the amount of refunds issued due exclusively to the expanded deduction is not available. The deduction impacted by the BP decision is not required to be reported on tax forms and is only available in supporting taxpayer documentation. The Department of Revenue would need to audit a significant share of tax returns and report on the deductions allowed to be claimed before and after the BP decision to determine the actual impact of the decision.

Comparing Oil and Gas Severance Tax Reports Before and After the Ruling

The Department of Revenue provides data on oil and gas severance taxes to the Legislative Council Staff with summary information from the oil and gas severance tax form by tax year each quarter. These data provide a snapshot of information reported on oil and gas severance taxes in GenTax, the state's tax administration software, as of the date the report was generated.

Data reflected in these reports change over time with amended returns, late filings, and audit activity. Therefore, comparing reports from before and after the BP ruling captures activity from amended returns filed in response to the BP decision. The last oil and gas severance tax report prepared before the BP decision was prepared on February 22, 2016. The most recent report was generated on February 16, 2018. These reports allow for a comparison of reported oil and gas severance tax liabilities for tax years 2010 through 2014. The BP decision would be expected to impact returns for tax years 2013 and 2014. Other years are included to provide the most complete data and context on the extent of changes due to the BP decision and other factors.

The following compares reported gross and net severance tax liabilities between the February 2016 and February 2018 GenTax reports. Respectively, these reports reflect changes in reported tax liabilities for taxes before and after the ad valorem tax credit.

[2] Section 39-21-108, C.R.S.

Gross Severance Tax Liability

Gross severance tax liability, reported on Line 2 on the Colorado Oil and Gas Severance Tax Schedule, is the severance tax due after accounting for deductions but prior to claiming the ad valorem credit. Table 1 provides a comparison of reported gross severance tax liabilities as of February 22, 2016, and February 16, 2018.

Table 1
Gross Severance Tax Liability

Tax Year	2018 Report	2016 Report	Change in Gross Tax Liability Amount	Change in Gross Tax Liability Percent
2017*	$4,749	NA	NA	NA
2016*	$245,316,599	NA	NA	NA
2015*	$323,277,480	$88,490	NA	NA
2014	$546,844,108	$538,602,649	$8,241,459	1.5%
2013	$387,545,715	$387,940,364	-$394,649	-0.1%
2012	$272,678,243	$272,470,340	$207,903	0.1%
2011	$307,758,796	$308,625,058	-$866,262	-0.3%
2010	$278,418,846	$278,207,803	$211,043	0.1%

Source: Colorado Department of Revenue.
** A comparison for tax years after 2014 is not possible because the 2016 report was prepared prior to the due date for 2015 severance tax returns.*
NA = Not available.

These reports reflect relatively minor changes in the gross severance tax liability for 2010 through 2013. These changes are likely due to a number of factors, including amended returns following the ruling, late returns filed by taxpayers, and audit activity. The change in reported liabilities for the 2014 tax year were more substantial, differing by 1.5 percent, or $8.2 million. This difference is likely explained by the processing of late returns.

The positive change in the liability for tax year 2014 runs counter to the expectations that the BP ruling would reduce severance tax liabilities by causing large refunds with amended returns. Further, the relatively minimal change in liabilities for tax year 2013 suggest that taxpayers did not claim larger deductions for oil and gas development activity that occurred in 2013.

Net Severance Tax Liability

Net severance tax liability is the severance tax due after claiming the ad valorem credit and is reported on Line 5 of the Colorado oil and gas severance tax form. Table 2 provides a comparison of net severance tax data as of February 22, 2016, and February 16, 2018.

Table 2
Net Severance Tax Liability

Tax Year	2018 Report	2016 Report	Change Net Tax Liability Amount	Percent
2017*	$1,808	NA	NA	NA
2016*	$47,399,927	NA	NA	NA
2015*	$23,774,156	$67,117	NA	NA
2014	$262,969,019	$267,641,883	-$4,672,864	-1.7%
2013	$196,925,469	$196,578,928	$346,541	0.2%
2012	$108,945,127	$108,857,278	$87,849	0.1%
2011	$153,112,212	$154,127,216	-$1,015,004	-0.7%
2010	$144,839,008	$144,783,853	$55,155	0.0%

Source: Colorado Department of Revenue.
** A comparison for tax years after 2014 is not possible because the 2016 report was prepared prior to the due date for 2015 severance tax returns.*
NA = Not available.

Similar to gross severance taxes, there were relatively minor changes for tax liabilities reported for tax years 2010 through 2013, while the change for tax year 2014 was more significant. For 2014, gross severance tax collections *increased* 1.5 percent between the 2016 and 2018 reports, while net severance tax liability *decreased* 1.7 percent. This difference is explained by the ad valorem credit. The value of the ad valorem credit claimed by taxpayers increased by $12.8 million between the 2016 and 2018 reports. The opposite happened in 2013, where gross liability decreased by 0.1 percent and net severance tax liability increased by 0.1 percent, a swing of $741,190. The 2013 tax liability increase is consistent with audit activity by the department that disallowed the ad valorem credit for property taxes paid on stripper wells.

Taken together, reports for gross and net tax liabilities suggest that the amended returns claiming the expanded deduction allowed under the BP decisions have not been a significant driver of refund activity.

Expectations for Future Refunds

In February 2018, the Department of Revenue estimated that there was a potential $66.5 million in refunds that may be claimed before June 2019 due to the Supreme Court ruling. This estimate includes $14.5 million in refunds currently in the Conferee Office, an additional $20.0 million in refunds that are currently being audited, and $32.0 million from yet-to-be-filed amended returns for 2013 through 2016. The department has received the returns in the Conferee Office and under audit, increasing the certainty that the first $34.5 millions in refunds will be eventually be issued.

The department has no advance notice of taxpayer intent to file an amended return, making the $32.0 million in refunds from amended returns less certain. Given that amended returns have not resulted in significant refunds to date for tax years 2013 and 2014, the Legislative Council Staff March 2018 economic and revenue forecast assumed that amended returns will have only a small impact on severance tax collections.[3] Further, due to rising oil prices and production activity, the oil and gas industry is currently in a more favorable financial position than in 2016 when the BP decision was issued. Taxpayers entitled to a refund for the over payment of severance taxes in 2013 and 2014 were more likely to file amended returns and claim refunds because of the financial conditions of the industry in 2016 than they are to wait and file amended returns with current prices.

[3]The March 2018 forecast can be found at: http://leg.colorado.gov/node/1305376/.