COLORADO
Department of Revenue
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September 20, 2016

To: Members of the Joint Budget Committee
From: Department of Revenue
RE: Response to Request for Severance Tax Status Updates

1. Update on Stakeholder Process

The Department conducted the first stakeholder meeting on the morning of August 23rd at 1881 Pierce in Lakewood, Colorado. The session lasted almost three hours. The session was well attended. The members of the stakeholder group are:

Name	Title	Organization
Barbara Brohl	Executive Director	Colorado Department of Revenue
John Vecchiarelli	Senior Director of Taxation	Colorado Department of Revenue
Philip Horwitz	Director of Tax Policy Analysis	Colorado Department of Revenue
Eric Meyer	Deputy Attorney General	State of Colorado Attorney General
Mark Bolton	Legal Counsel	Office of the Governor
Bill Levine	Budget Director	Colorado Department of Natural Resources
Scott Olene	Government Services Program Supervisor	Colorado Department of Local Affairs
Joe McGrath	Appraisal Standards Manager	Colorado Department of Local Affairs
Anthony Abeyta	County Commissioner	Las Animas County
Leeann Fabec	County Administrator	Las Animas County
Jimmy Walker	Owner	Petron Development Company
Stephen Bailey	Manager	BP America Production Company
L. Wade Hopper	Sr. Severance Tax Analyst	Chevron USA
Travis Holland	Accounting Advisor	Kerr-McGee/Anadarko
Lisa Call	Severance Tax Advisor	XTO Energy Inc/Exxon
John Nedelka	Director Revenue Accounting	Noble Energy
Martin Tschida	State and Local Manager	Hein & Associates LLP
Ashly Wolicki	Finance Manager	Black Hills Corp
Ken Wonstolen	Vice President & General Counsel	Bill Barrett Corp

In addition, there were a number of interested parties who attended and sat in the audience. The focus of the first meeting was to arrive at an agreed methodology for calculating the cost of capital/return on investment. The Department was hopeful that the stakeholders would agree to endorse and adopt the methodology prescribed by the state property tax administrator for calculating this deduction. However, after substantial discussion and debate, it was decided that we would form a subcommittee comprised of subject matter experts who would convene and make a recommendation about the methodology for calculating cost of capital. That subcommittee is scheduled to meet on September 26th.

The discussion then focused on the distinction between the property tax administrator statutes and the Department of Revenue statutes. It was interesting that the discussion revealed the fact that the Department of Revenue imposes a tax upon the minerals severed from the ground; however the property tax administrator has a different role. They serve more as a mediator or a referee between industry and local governments who impose a tax on the personal property, the real property, and the property severed from the ground. There was considerable discussion about why the severance tax statutes specifically exclude gathering (as defined in statute) as a deduction. No consensus was achieved. Therefore, the stakeholder committee agreed to again charge the subcommittee of subject matter experts with making recommendations about the deductibility of each of the NERF categories prescribed by the property tax administrator. Again, this meeting is scheduled for September 26th.

The Department believes the stakeholder meeting was highly beneficial inasmuch as it brought all parties to the table to discuss the matter. The subject matter is complicated, so it is in the best interest of all stakeholders to thoroughly vet the issues and come to consensus positions. If any of those recommendations require statutory revisions, the Department will present those recommendations to the JBC for consideration.

2. New information on regular severance tax refunds that will likely reduce General Fund revenues

The Department has not received any additional amended returns for tax years before 2015 since the August 1 JBC meeting, and, therefore, has not revised the estimated revenue reduction resulting from the BP decision. The results of the stakeholder process should be able to help the Department increase its confidence in these estimates, because that process is charged with clarifying all of the deductions that will now be available for severance tax.

FY 2016-17 **Severance Tax Activity** ***(Amounts rounded for reporting)***	**Accrual Beginning Balance**	**Period 1** **July 2016**	**Period 2** **August 2016**	**YTD Total**	**Accrual Ending Balance**
Severance Tax Collections		6,042,907	6,542,625	12,585,532	
Severance Tax Refunds		429,305	41,341,258	41,770,563	
Refund Cap (15% of Gross Collections)		906,436	981,394		
Refunds covered by Severance Tax		429,305	981,394	1,410,699	
Refunds covered by General Fund 2015-16	56,800,000		40,359,864	40,359,864	16,440,136
Refunds covered by General Fund 2016-17					
Amount to be distributed		5,613,602	5,561,231	11,174,833	
Legislative Transfers		1,500,000		1,500,000	
Amount distributed to DOLA Fund 1520		2,056,801	2,780,616	4,837,417	
Amount distributed to DNR Fund 7040		1,028,401	1,390,308	2,418,709	
Amount distributed to DNR Fund 7440		1,028,401	1,390,308	2,418,709	

Note: The approximately $41 million in refunds issued in August 2016 includes 5 current severance tax returns, as mentioned on slide 13 of the Department's August 1 presentation. These returns were not related to ROI or NERF deductions but rather to the ad valorem tax credit.

3. Has the Department increased its confidence in the estimated revenue reduction after the BP decision?

The Department has not received new material information since the last update provided to the JBC that would lead to a change in the current estimates. As discussed, the stakeholder process for determining the permissibility and method of calculation for certain deductions is in progress. Outcomes from the stakeholder process will provide information upon which the estimates may be revised. As shared in the last update, taxpayers seem hesitant to share their intentions until such time as they have guidance on deductions and calculations.

SEVERANCE TAX UPDATE

Presented to Joint Budget Committee
June 20, 2016
By Department of Revenue

CDOR COLORADO Department of Revenue

AGENDA

- Statutory Interpretation
- Deductions Allowed Under the Supreme Court Opinion
- Status of Refunds
  - ✓ Implementation of SB-218
  - ✓ Future Impact to Severance Tax Revenue
- Tax Policy Summary
- General Assembly Notification Process

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Statutory Interpretation

BARB BROHL, EXECUTIVE DIRECTOR DOR
ERIC MEYER, DEPUTY ATTORNEY GENERAL

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PRIOR TO THE SUPREME COURT OPINION IN THE BP CASE

- It was not clear that ROI – Return on Investment/Cost of Capital was an allowable deduction.
- Courts have consistently upheld that deductions and exemptions in taxation "are recorded as a matter of legislative grace . . . and they are not allowed unless clearly provided for…"in statute.

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LITIGATION HISTORY AND RULINGS

- The Department's interpretation was consistent with the analysis of two well-respected courts. Neither court defined the cost of capital as within the scope of transportation costs.
  - The 10th Circuit Court opinion on Atlantic Richfield (2000)
  - The CO Court of Appeals opinion on BP (2013)
- Until the Supreme Court issued its opinion in 2016, the Department had every indication it had interpreted statute correctly.

Deductions Addressed by the Supreme Court Opinion

BARB BROHL, EXECUTIVE DIRECTOR DOR
ERIC MEYER, DEPUTY ATTORNEY GENERAL

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ROI DEDUCTION

- **ROI – Return on Investment/Cost of Capital** is one type of NERF deductions and was defined by the Appellate Court as the, “opportunity cost of capital investment that an investor could have earned on a similar investment of similar risk”.
- Opportunity cost is not an expense that has been paid. It is the calculation of a perceived loss suffered by not choosing an alternate investment.

PRIMARY FOCUS OF THE SUPREME COURT CASE

- **ROI – Return on Investment/Cost of Capital** was the primary focus of the Supreme Court case.
- Additionally, the Supreme Court through dicta addressed all NERF deductions.

NERF DEDUCTIONS

NERF Deductions– Net-back Expense Report Form

- NERF deductions are currently allowed by the Property Tax Administrator (PTA) within the Department of Local Affairs.

TYPES OF NERF DEDUCTIONS

- Chemicals, Lubricants, Supplies Used on Site
- Cost incurred to sell product
- Direct G&A, Environmental
- Environmental Compliance Costs
- Field Labor (Pumper) Costs
- Fuel Expense
- Insurance, Liability and Equipment
- Lease Rentals
- Non-capitalized repairs
- **ROI – Return on Investment/Cost of Capital**
- Salt Water Disposal/Water Hauling
- Salaries, Wages, and Benefits
- Taxes: Personal Property and Improvements
- Utilities

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EVALUATION OF THE OPINION

- The Supreme Court Opinion was narrowly focused on ROI deductions.
- The court provided the allowance for ROI deductions but **NO** direction on the calculation methodology for the allowance.
- DOR will be promulgating rules to provide guidance on a consistent calculation methodology.

ADDITIONAL NERF DEDUCTIONS

- It is unclear how the NERF deductions relate to transportation, processing, and manufacturing costs borne by the taxpayer.
- The Department will conduct an extensive stakeholder and outreach process before we promulgate rules to address them.
- Because the Department did not have specific rules addressing NERF deductions, the Court took guidance from the Property Tax Administrator Guidelines.

Status of Refunds

BARB BROHL, EXECUTIVE DIRECTOR DOR
JOHN VECCHIARELLI, SR. DIRECTOR TAXATION DOR
ERIC JOHNSON, FIELD AUDIT TAXATION DOR

FISCAL IMPACT OF BP OPINION
TAX YEARS 2003-2014
(AMOUNTS IN MILLIONS)

	Actual Refunds	*Estimated Refunds*
ROI Deductions		
Stipulated Payout to BP	$2.4	N/A
Conferee Cases	$6.8	N/A
Future Amended Severance Tax Returns	N/A	$22.0
Subtotal by Type	**$9.2**	**$22.0**
Total Actual and Estimated ROI Refunds	**$31.2**	
Other NERF Deductions		
Conferee Cases	N/A	$31.5
Future Amended Severance Tax Returns	N/A	$45.0
Subtotal by Type	**$0.0**	**$76.5**
Total Estimated Other NERF Refunds	**$76.5**	
Total Actual and Estimated Refunds	**$107.7**	

TIMING OF REFUNDS

- The Department has no knowledge of potential claims until the taxpayers file a return.
- Therefore there is no way to *accurately* estimate the potential monetary impact or timing of refunds.
- Returns could be processed in FY 2016-17 and beyond as taxpayers submit returns.

SB-218 Implementation

BARB BROHL, EXECUTIVE DIRECTOR DOR
LORRI DUGAN, CHIEF FINANCIAL OFFICER DOR

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CURRENT MONTHLY SEVERANCE TAX ACTIVITY

- DOR collects Severance Tax revenue and processes normal refunds throughout the month.

1. Total Monthly Collections *(Gross Collections)*
2. minus Total Monthly Refunds

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3. Amount to be Distributed *(Gross Realized Collections)*

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CURRENT SEVERANCE TAX DISTRIBUTION PROCESS

Amount to be Distributed
(Gross Realized Collections)

↓

$1.5M Off-the-top annually to Colorado Energy Office

↓

Remaining Amount to be Distributed each Month

↙ ↘

50% DOLA | **50% DNR**

FY 2015-16 PROCESS UNDER SB-218 APRIL AND MAY

- April and May distributions were frozen pending outcomes from the legislative session related to Severance Tax.
- Now that SB-218 has become law, DOR has distributed April and May amounts per usual to DNR and DOLA pursuant to SB-218.
- Distributed amounts:

	April Distribution	May Distribution
DNR	$ 5.9M	$ 4M
DOLA	$ 5.9M	$ 4M

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FY 2015-16 PROCESS UNDER SB-218 JUNE

- The $2.4M stipulated to in the Supreme Court case will be processed in June as a refund.
- The remaining amount will be distributed following the current process.

FY 2016-17 PROCESS
BEGINNING JULY 1, 2016 THE PROCESS WILL CHANGE

- DOR collects Severance Tax revenue and processes normal refunds throughout the month.

1. Total Monthly Collections *(Gross Collections)*
2. minus Total Monthly Refunds
   (capped at 15% of Total Monthly Collections)
3. Amount to be Distributed *(Gross Realized Collections)*

- Any refunds in excess of 15% will be paid for by the General Fund

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Future Impact on Severance Tax Revenue

BARB BROHL, EXECUTIVE DIRECTOR DOR
ERIC JOHNSON, FIELD AUDIT TAXATION DOR

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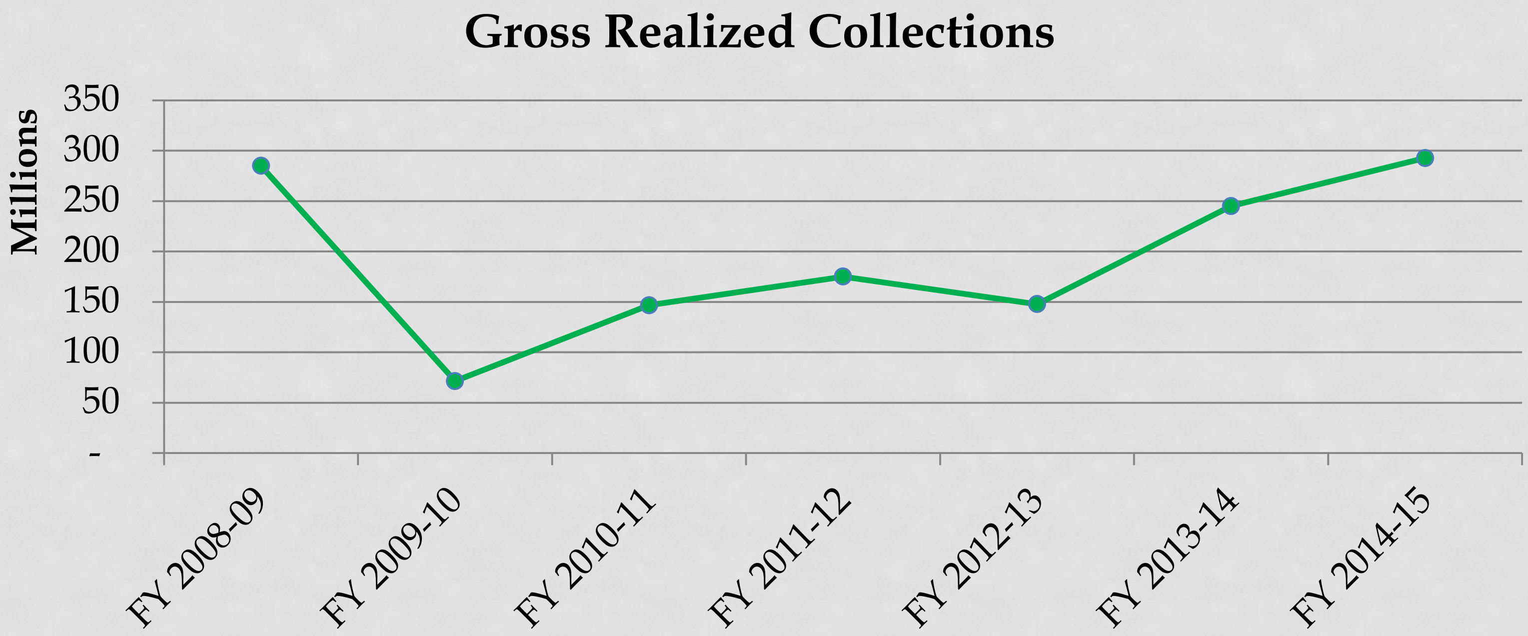
HISTORIC SEVERANCE TAX REVENUE



Annual revenue is highly volatile

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FUTURE REVENUE IMPACT

- Using an average percent of historic refunds over time will not yield a reliable amount because the total collections vary drastically from year to year based on the industry.

- However, there is a range; from *if ROI is deemed to be the only allowable deduction* to *if all deductions are deemed allowable.*
- The range could be a future annual revenue decrease (all things remaining constant such as industry activity and the price of oil) of 4% up to 12%.

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Tax Policy Summary

BARB BROHL, EXECUTIVE DIRECTOR DOR
JOHN VECCHIARELLI, SR. DIRECTOR TAXATION DOR

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ROLES

- DOR **does not** establish tax policy.
- DOR does **implement** policy by interpreting statute and case law set by the Legislature and the courts.
- DOR does **evaluate**, **audit**, and **enforce** policy set by the Legislature and the courts.

POLICY

- Since 2010 DOR has formally evaluated policy interpretation 425 times.
- There have been 7 instances when the Department has changed its interpretation of tax policy.

COMMUNICATION

- The number of changes has been small.
- However, the changes have been elevated to the level of the Legislature.
- More comprehensive outreach is needed to communicate when these types of changes occur.

GENERAL ASSEMBLY NOTIFICATION PROCESS

BARB BROHL, EXECUTIVE DIRECTOR DOR
JOHN VECCHIARELLI, SR. DIRECTOR TAXATION DOR

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CONFIDENTIALITY

- DOR is bound by statute to maintain strict taxpayer **confidentiality**.

  C.R.S. 39-21-113 (4) (a) ...*the executive director of the department of revenue and his agents, clerks, and employees shall not divulge or make known in any way any information obtained from any investigation conducted by the department or its agents or disclosed in any document, report, or return filed in connection with any of the taxes covered by this article.*

CURRENT OPTIONS FOR INFORMATION SHARING

1. Statewide Single Audit
   - Office of State Auditor (OSA) annually evaluates tax cases currently under protest and estimates collectability.
   - However, the OSA analysis does not consider the precedential impact the individual case could have on other affected taxpayers.
2. Attorney General (AG) evaluation of active litigation
   - The State AG analyzes and reports to the state controller cases with financial impact in excess of $5 million.
   - Again, the current approach does not consider a broader precedential impact, although DOR could work with the AG to conduct this type of analysis and incorporate it into this process.

NEW LEGISLATION COULD BE ENACTED

- Revisions to C.R.S. 39-21-113 could be made to grant the JBC access to specific tax information to be used for the purposes of planning and budgeting.
- DOR would be happy to work with the Attorney General's Office and Legislative staff to draft a bill that would allow the Department or the Attorney General's Office to provide the JBC with applicable information.