The Impact Of State Taxes On The Oil & Gas Industry

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When the term "taxes" is used in referring to the oil and gas industry we are inclined to direct our thoughts toward federal income taxes. This inclination is probably true when referring to most industries, for the income tax is so much a part of our lives today that we seem to tie it in with all of our business activities. However, in so doing, we as a rule, overlook the importance and impact of state taxes which are applicable to our business operations. Most of the papers and talks which have been presented on taxes in recent years have been directed toward federal taxes, and more especially toward the federal income tax.

This paper here will not be concerned with income taxes, but will be limited to state taxes applicable to the oil and gas industry. Furthermore, the discussion will be further restricted to include only Texas and surrounding states.

An understanding of the taxes borne by the oil and gas industry is very important to management in planning and carrying out its operations. Management includes managers, operators, engineers, and, in fact, just about everyone and the amount of taxes paid is too important to be overlooked by anyone. In fact, it is so important in Texas that under present conditions, the state would have a difficult time operating without that source of revenue. One may have seen the little looklet, 61 Facts, which is published by the Texas Mid-Continent Oil & Gas Association of Dallas and which gives information about the oil and gas industry in Texas. The following facts as given are important, will emphasize the importance of state taxes, and will tie in with later discussion of taxes in Texas. These statements were, that (1) Texas petroleum industry taxes account for 27 per cent of all state taxes and licenses, that (2) Texas petroleum industry's 1960 tax payment to state government were $210.5 million, that (3) Texas production taxes on oil raised $123 million in 1960 and $52 million on gas, and that (4) Texas petroleum industry pays 30 per cent of state franchise tax and 37 per cent of state property tax.

There are many kinds of taxes: some are hidden, and some very clearly describe who is liable for payment and when and how the tax is to be paid. It is the latter type of tax that will be considered in this discussion.

COMMON TAXES

In addition to the general taxes to which all businesses are subject, there are state taxes peculiar only to the "oil and gas industry," a term which includes oil producers, oil operators, and others in the industry upon which the taxes may fall.

Franchise Tax

A general business tax common to the corporate form of organization is the franchise tax. In his paper to the Eleventh Annual Institute on Oil and Gas Law, Mr. A. E. Collier pointed out the importance of the corporate franchise tax in Texas and surrounding states. That the oil and gas industry pays 30 per cent of the revenue from the franchise tax indicates its importance, both to the industry and, as a source of revenue, to the state. Furthermore, the rate of this tax has been increased several times during the past ten years; in fact, it increased from $1 per $1000 of capital, surplus and long term debt in 1950 to $2.75 in 1959, or a total increase of 175 per cent. Too, there was an additional temporary tax of 75 cents per $1,000 to be effective from September 1, 1959, to April 31, 1962.

States surrounding Texas also have the franchise tax. Louisiana has a franchise tax of $1.50 per $1,000 of capital stock, surplus, and borrowed capital. New Mexico has a corporate franchise tax imposed at the rate of $1 per $1,000 of capital stock issued. Surplus and long term debt are not included. The corporate franchise tax in Oklahoma is imposed on capital, surplus, and long term debt at a rate of $1.25 per $1,000, and industry is subject to $20,000 maximum tax per year. Arkansas imposes a franchise tax at the rate of $1.10 per $1,000 of outstanding capital stock. These various states all have certain formulas for allocating stock, surplus and long term debt to the state for taxing purposes.

The two principal taxes borne by the oil and gas industry are (1) the tax upon oil and gas in place and (2) the tax upon the production of oil and gas, or, in other words, the removal of the mineral from the land or water. These two taxes are described in various ways and are given different names in the various states. This difference in nomenclature is partly because of the purpose of the state in establishing the tax, and partly because of the court decisions which have been handed down in the different states. But, regardless of the variations in describing the taxes, one is essentially an advalorem tax and the other is a production tax.

Advalorem or State Property Tax

For advalorem tax purposes, minerals in and under land are a part of the value of the land and are considered as such until removed.[1] One of the big problems is that of placing a value on the minerals and then determining who is liable for the tax on the minerals. Until minerals are severed from the land, they are taxable to the owner of the land. Courts have handed down various decisions, approving, in many cases, certain schemes for assessing, or placing a value on the minerals in place, or still in the land. But once the mineral is removed from the land, it then becomes subject to a tax on units produced. Very seldom does the landowner pay an advalorem tax on all the minerals since the owner seldom produces the mineral. This situation results in the lessee and producers being taxed if an interest in the mineral has been transferred. Advalorem taxes paid on undeveloped property are usually charged to current operating expenses, while in a few cases they are capitalized as a part of the undeveloped property.[3]

TAXES ON OIL AND GAS PRODUCTION

State taxes on the production of minerals are not new, but are peculiar to certain businesses. For more than half a century, Texas has imposed a tax on the persons operating in the oil and gas business, while during the past half century other states have enacted similar taxes: severance taxes, production taxes, occupation taxes, gas gathering taxes, and in some cases excise taxes.[3] However, under any name, the taxes are based on the severing of the mineral from the land, and the production of oil and gas. They are not property taxes. In some states the tax is in lieu of the property tax; in other states it is in addition to the property tax. In some states the tax is borne by the lessee and royalty owner proportionally; in other states it is borne by the lessee or producer alone.

The previous discussion points out that most of the taxes borne by those involved in the oil and gas industry can be grouped into three main classifications: (1) the state corporate franchise tax, or the tax for right to do business, (2) the advalorem, or state property tax, and (3) the production tax, or the tax upon revenue derived from the removal of oil and gas from the land. The general discussion indicates the importance of these taxes in bringing in state revenue. Indicated also are the various means used by the states to determine a basis for the tax, and to determine rates applicable to both property in place and units produced. Further discussion will attempt to show specifically the workings of the franchise tax, the property tax and the production tax in Texas, Oklahoma, New Mexico, Louisiana, and Arkansas. These are heavy oil and gas producing states and are of greatest concern to all persons in this area.

Arkansas

For the sake of establishing a plan for discussion, first to be considered are those taxes applicable in Arkansas. In addition to the franchise tax which is imposed at the rate of $1.10 per $1,000 of outstanding capital stock, Arkansas also imposes a severance tax on both oil and gas. However, this state does not have a general property tax.[2]

In 1923 Arkansas passed a "severance tax," a privilege or license tax placed upon persons who were engaged in the business of removing minerals from land or water for commercial purposes. The tax was challenged in the "Floyd vs. Miller Lumber" case, but the courts held it to be a privilege tax and not a property tax. At the time the tax was enacted the rate was 2 1/2 per cent of the gross cash market value of oil and gas severed or removed from the land. Today, however, Arkansas has in force a tax of 5 per cent of gross market value of oil at point where it is removed from land, and a tax of .3 cent per MCF on gas. In addition Arkansas has a regulatory tax of 5 mills per barrel on oil and 1/2 mill per MCF on bas. Furthermore, the state has been very careful to close loopholes and to prevent evasion of the tax payment. The tax burden is borne by the producer and royalty owner in proportion to their interests, and the producer has to withhold the tax from the royalty owner's share. Too, heavy fines and penalties may be invoked if the producer fails to make reports and pay the tax as required. The tax is a lien on the oil or gas, the well, and machinery and equipment of the producer, and two thirds of the tax collected goes into a common school fund, while one third goes to the counties from which the oil and gas is produced.[1]

Louisiana

Louisiana hits the oil and gas industry with taxes from many angles. The state imposes three taxes common to all business: the franchise tax, the general property tax, and the income tax and has a heavy severance tax on the production of oil and gas. If, in Louisiana, one does business as a corporate member of the gas and oil industry, he pays a franchise tax of $1.50 per $1,000 of capital stocks, surplus and borrowed capital. There is a property tax rate of 57 1/2 cents per $100 of assessed value, but the constitution exempts oil and gas leases from property taxation because of the severance tax on production. However, lease and well equipment used in production is subject to the property tax.

Too, Louisiana is one of the states imposing corporate and personal income taxes on income derived from oil and gas operations, but the state tax law, like that of the federal government, allows a deduction of 27 1/2 per cent of gross income for oil and gas and allows for current drilling and development cost.

The corporate income tax rate is 4 per cent, whereas the personal income tax rate goes from 2 per cent up to a maximum of 6 per cent on net income above $50,000.

The above taxes are common to business in general, not just to the oil and gas industry. However, Louisiana has tried several taxes peculiar to the oil and gas industry, and some have been upheld. For instance, from 1942 to 1958, Louisiana imposed a so-called "gas gathering tax," but the 2 cent MCF tax was suspended in 1958 and has now been declared unconstitutional.

The important tax in Louisiana is the severance tax, a tax placed on oil and gas produced; but the rate is graduated on the basis of gravity. Thus, low producing wells are paying a much lower rate than do high producing wells. The state also applies different rates to gas severed and the product extracted from gas.[3]

Louisiana also imposed a "royalty gas excise tax," the effect of which is to eliminate the advantage of some producers over others and to keep producers from becoming unjustly rich at the expense of royalty owners. The tax, in effect, is the difference between what producer paid royalty owner for his interest and what the producer sold it for. This tax discourages the producer from taking advantage of the royalty owner and tends to encourage fair competition. If the producer uses the gas himself, the fair market value is the value that he is considered as having received.

Too, Louisiana goes further and places two separate special taxes on the transportation of oil by pipe lines, and a 1 per cent of gross receipts tax on the transportation of natural gas by pipe lines.

Producers and purchasers are both required to make quarterly verified reports to the supervisor of public accounts. If the producer fails to make these reports, the supervisor examines the books, determines the production, then computes and collects the tax. This tax becomes a first lien on the oil and follows even into the hands of the third party. Oil and gas leases and royalty interests are subject to seizure and sale for payment of tax in preference to other claims and liens.

New Mexico

The oil and gas industry in New Mexico is subject to three state taxes common to business in general. In addition to the corporate franchise tax imposed at the rate of $1 per $1,000 of capital stock allocated to the state, there are also the property tax and the state income tax.

The property tax, or advalorem tax, was set at the rate of 61.7 cents per $100 assessed value of lease and well equipment used in producing operations and not on the value of oil and gas in place. In lieu of a tax on oil and gas in place, New Mexico has an advalorem production tax. The State Tax Commission appraises the value of productive mineral properties, determines 50 per cent of each year's production, and applies to that value the state, county, and local tax rates.[1]

Furthermore, New Mexico has imposed a corporate and personal income tax upon the net income derived from oil and gas operations. The corporate tax is 2 per cent of net income, and the personal state income tax ranges from 1 per cent to a maximum of 4 per cent on net income over $100,000. "A reasonable allowance for depletion" may be deducted in computing net income from gas and oil in New Mexico. The allowance is 27 1/2 per cent of gross income and cannot exceed 50 per cent of net income.

In addition to the taxes named as being common to business in general, New Mexico has also evolved other heavy taxes peculiar to the oil and gas industry. Included in this group are the advalorem production tax, the oil and gas severance tax, the oil and gas conservation tax, and the oil and gas emergency school tax. A recent move on the part of New Mexico has brought all of these taxes together for reporting purposes.

The oil and gas severance tax is the most important of the group and is imposed at the rate of 2 1/2 per cent of value at time of production. One can call this an excise tax upon natural resources severed from the land of the state.

There is also another oil and gas production tax known as the "oil and gas emergency school tax" which is levied at the rate of 2 per cent of value at time of production. It is known as the conservation tax and is imposed at the rate of .14 of 1 per cent of market value at time of production.[2]

Pipe lines of oil and gas companies in New Mexico also come in for a license tax based on the aggregate installed rate of horsepower of compression facilities located in New Mexico. This tax rate is graduated up to 100,000 hp and is $75 per 10,000 hp in excess of 100,000. In addition, pipe lines pay $1 per mile for 8 in. and smaller pipe in excess of 100 miles, and $2 per mile for larger pipe in excess of 100 miles.[2]

The large number of taxes placed on the oil and gas industry in New Mexico provides a good source of state revenue. It also requires excessive record keeping and reporting by those upon whom the tax is imposed.

Oklahoma

The oil and gas industry in Oklahoma is subject to two taxes common to business in general. These are the corporate franchise tax and the state income tax, but there is no general property tax imposed by the state.

The state franchise tax is much like the one in Texas, for it is imposed on capital, surplus, and long term debt. The rate is $1.75 per $1,000, compared to $2.75 in Texas.[2]

Oklahoma is similar to New Mexico is that it also imposes a corporate and personal income tax upon net income from oil and gas operations. The corporate rate is 4 per cent, and the personal rate ranges from 1 per cent to a maximum of 6 per cent on net income above $7500. An allowance for percentage depletion is at the rate of 20 per cent.

Oklahoma was the second state in the country to impose a production tax on the oil and gas industry. In 1908 Oklahoma set a tax rate of 1/2 of 1 per cent of the gross receipts from the total production of petroleum or other mineral oil or natural gas.[1] This was to be a production tax and was to be in addition to any advalorem tax which might be collected. However, the state courts held it to be an occupation tax and not a property tax; and after this court decision, the statute pertaining to the tax was amended in 1915 to increase the rate of the tax to 2 per cent and to make the base of the tax specifically the value of the production of petroleum. In 1916, the statute was further amended to raise the rate to 3 per cent. Today, Oklahoma has a gross production tax of 5 per cent on oil and gas, a rate that was established in 1935. Too, the Oklahoma tax rate has always been the same on oil as on gas.

Texas

In Texas, the largest natural gas producing state in the nation, about one-fourth of all tax and license revenue received by Texas in 1959 came from petroleum taxes, and more than one-half of the state's total receipts from land sales, rentals and royalties were from oil and gas royalties. And this total does not include the pipeline gross receipts taxes and gasoline taxes.[4] Various studies have been made in an effort to see just how much of the revenue in the state of Texas comes from the oil and gas industry. Some of these estimates will be pointed out as the different taxes are discussed. The following taxes, all of which are important sources of state revenue, are imposed upon the oil and gas industry in Texas:

1. General property tax
2. Corporation franchise tax
3. Oil production tax (occupation tax)
4. Gas production tax (occupation tax)
5. Crude oil tax
6. Natural gas pipeline tax
7. Severance beneficiary tax
8. Occupation tax on certain service, in connection with oil wells
9. Excise tax of 5 cents per gallon on motor fuel sold

The corporate franchise tax is a general business tax and is common to not only the gas and oil industry, but also to all corporate organizations operating in the state. This tax is imposed at the rate of $2.75 per $1,000 of capital, surplus, and long term debt.[2]

Like all other businesses and individuals in Texas, members of the gas and oil industry are subject to a general property tax, the rate of which is 42 cents per $100 of assessed value.[2] Some hold that because of the $3,000 homestead exemption, the major part of this tax comes from business. In fact, the Texas State Tax Study Commission has said that 77 per cent of the revenue from this general property tax is paid by business property owners.[2] Other estimates have shown that, without a doubt, the property tax is very important to the oil and gas industry in Texas.

Texas also seems to have, in effect, all the taxes peculiar to the oil and gas industry, and motions are continually before the legislature to change, increase and add taxes in this area. For example, Texas was the first state in the nation to enact, or impose a tax upon the production of oil and gas. This tax was enacted, in 1905, and was a tax of 1 per cent placed on the average market value of oil produced.[1] As in most situations, the tax was challenged, but was held by the courts to be a proper tax. Later, in 1931, the Texas Legislature passed companion taxes on the production of oil and gas.

First, an occupation tax on oil produced is imposed on the market value of oil produced and is at the rate of 4.6 cents per barrel of forty-two standard gallons. The payment of this tax is the primary liability of the producer and the purchaser must collect the tax from the producer. The tax will be paid by the first purchaser from the producer, but if oil is not sold during the month, the producer will pay the tax as if the oil had been sold.

The tax is paid monthly on the 25th of each month, and the producer must keep complete records of all oil produced.

Next, the gas production tax, at the rate of 7 per cent on market value, is regulated and controlled similarly to the oil production tax. Reports and records are required by the state and the tax is to be paid by the producer and is deducted from the amount to be paid to the producer.

Also, there is a special crude oil tax imposed for the purpose of providing funds to be used by the Texas Railroad Commission in carrying out the state's conservation laws. This is a regulatory tax of 3/16 of 1 cent per barrel of crude oil produced.

Too, sales from natural gas pipe lines within the state of Texas are taxed at 1/4 of 1 per cent of gross receipts.

Furthermore, gas production in Texas is subject to a recently enacted tax, known as the "Severance Beneficiary Tax,"[5] of 1 1/2 per cent of market value when gas is produced. With a few exceptions, this tax is imposed on market value of the gas at the mouth of the well. It is an occupation tax and is a liability of the producer of gas. The first purchaser shall pay the tax on gas purchased, and this tax is payable monthly to the state through the comptroller's office.

Moreover, there is now an occupation tax that was set at the rate of 2.42 per cent of gross receipts and imposed upon every person who, within the state, is engaged in the business of furnishing any service or performing any duty for others for a consideration or compensation and with the use of tools, instruments of equipment, whether electrical or mechanical, etc., if that service is performed in connection with the drilling or operations of oil or gas wells.[6] Proper records and reports must be kept for these services and penalties up to $500 for each day's violation may be imposed by the state of Texas.

Finally a big source of revenue for the state of Texas is the 5 cents per gallon excise tax levied upon the first sale, distribution, or use of motor fuel in the state of Texas. Once the 5 cents per gallon has been collected, the tax will be added to the selling price so that the ultimate consumer will pay the tax.[7]

Summary

The purpose of this paper is not to decide that state taxes applicable to the oil and gas industry in Texas and surrounding states are too high or that they are too low, but the purpose is to report that they are important to everyone in the oil and gas industry. It is evident that the oil and gas industry has been, and is now, a good source of state revenue. The various types of taxes imposed indicates that the taxing powers have considered the value of this source to be a fact. At the time of this writing, consideration is being given by the legislature for an increase in the franchise tax in Texas. The Texas Mid-Continent Oil & Gas Association is very concerned about this move and considers that an increase will present a major problem at this time.

The state taxes are so important in the operations of oil and gas enterprises that it is of great value to management for all concerned to be familiar with the tax impact. The number of reports required by the states is of no little significance and accounting records and files are necessary to back up the required reports. Furthermore, penalties may be very heavy where violations are involved.

This discussion has been concerned mainly with state taxes imposed on the oil and gas industry which are applicable in Texas, Oklahoma, Louisiana, New Mexico, and Arkansas, but they are by no means the only states wherein common and peculiar taxes are applicable to oil and gas. If one operates in California, in Montana, or in any of the other states where oil and gas is produced, he will need to concern himself with the taxes peculiar to that state. Familiarity with these taxes is mandatory for all members in the oil and gas industry today.

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