OIL AND GAS SEVERANCE TAX DEDUCTION FOR TRANSPORTATION COSTS & OIL AND GAS SEVERANCE TAX DEDUCTION FOR MANUFACTURING AND PROCESSING COSTS

JULY 2020

EVALUATION SUMMARY

2020-TE16

THESE EVALUATIONS WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

	DEDUCTION FOR TRANSPORTATION COSTS	DEDUCTION FOR MANUFACTURING & PROCESSING COSTS
YEAR ENACTED	1985	1985
REPEAL/ EXPIRATION DATE	None	None
REVENUE IMPACT	Approximately $240.8 million (CALENDAR YEAR 2018)	
NUMBER OF TAXPAYERS	Unable to determine	Unable to determine
AVERAGE TAXPAYER BENEFIT	Unable to determine	Unable to determine
IS IT MEETING ITS PURPOSE?	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

The Deductions allow taxpayers to deduct transportation, manufacturing, and processing costs when computing gross income for oil and gas severance tax purposes.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not directly state the purpose of these Deductions. We inferred that the purpose of the Deductions is to ensure that the severance tax on oil and gas is based on its value at the point of extraction (i.e., at the wellhead), rather than at a later point of the sale.

WHAT DID THE EVALUATION FIND?

We found that the Deductions are generally meeting their purpose because many taxpayers and CPAs who work with oil and gas operators and interest owners are aware of them and use them to determine the value of oil or gas at the wellhead. However, we found that it is likely that not all eligible taxpayers are claiming the Deductions, particularly those who are non-operator interest owners (e.g., royalty interest owners).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

- Requiring the Deductions to be reported by the operators to interest owners or changing the structure of the severance tax so that operators file and remit severance taxes and report the Deductions as opposed to interest owners.
- Clarifying the intent, scope, and definitions of the Deductions in light of the Colorado Supreme Court's decision in *BP Am. Prod. Co. v. Colo. Dep't of Revenue*, which effectively expanded the Deductions to allow taxpayers to deduct additional costs associated with transporting, processing, and manufacturing oil and gas.

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EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two related oil and gas severance tax deductions: (1) Oil and Gas Severance Tax Deduction for Transportation Costs [Section 39-29-102(3)(a), C.R.S.] and (2) Oil and Gas Severance Tax Deduction for Manufacturing and Processing Costs [Section 39-29-102(3)(a), C.R.S.] (Deductions). The Deductions allow taxpayers to deduct transportation, manufacturing, and processing costs when calculating their gross income for oil and gas severance tax purposes. Although "gross" income is typically considered to be income before deductions for expenses, statute [Section 39-29-102(3)(a), C.R.S.] defines gross income for oil and severance tax purposes as being net of transportation, manufacturing, and processing costs.

According to statute, severance tax is imposed on "the gross income attributable to the sale of oil and gas severed from the earth" at the following rates, as shown in EXHIBIT 1.1:

EXHIBIT 1.1. SEVERANCE TAX RATES ON OIL AND GAS	
GROSS INCOME	RATE
$0– $24,999.99	2%
$25,000– $99,999.99	3%
$100,000– $299,999.99	4%
$300,000 and over	5%
SOURCE: Office of the State Auditor analysis of Section 39-29-105(1)(b), C.R.S.	

Under the Deductions, taxpayers can deduct “transportation, manufacturing, and processing costs” from the amount they received from the sale of oil and gas.

- Statute [Section 39-29-102(7), C.R.S.] defines transportation as “the cost of moving identifiable, measurable oil or gas, including gas that is not in need of initial separation, from the point at which it is first identifiable and measurable to the sales point or other point where value is established.”

- Department of Revenue (Department) regulations [1 CCR 201-10, Rule 39-29-102(3)(A)(2)(g)] define processing as “subjecting to a particular method, system, or treatment designed to effect a particular result. ‘Processing’ includes, but is not limited to, mechanical separation, heating and treating, cooling, compression, dehydration, absorption, adsorption, refrigeration, flashing, sweetening, contaminant removal, cryogenic processing, and fractionation.”

- Neither statute nor Department regulations define the term “manufacturing.” According to the Department, it has generally considered “manufacturing” for severance tax purposes to have the same meaning as it does for sales tax purposes under Section 39-26-709(1)(a)(IV)(c)(III), C.R.S., and stated that the activities of producers prior to the sale of oil or gas generally do not qualify as manufacturing but may qualify as processing.

The General Assembly created the Deductions in 1985 with House Bill 85-1196 to clarify the method taxpayers use to establish their gross income subject to state severance tax. Prior to 1985, for oil and gas severance tax purposes, statute [Section 39-29-102(3)(a), C.R.S.] defined gross income as “the market value at the wellhead as determined by the actual transaction price or the value of the severer’s income as computed for Colorado and federal income tax depletion purposes, whichever is higher.” According to testimony for House

Bill 85-1196, at the time the General Assembly created these deductions, many transactions were not conducted at the wellhead and federal law had changed so that the federal depletion allowance was allowed only for some taxpayers. Therefore, most taxpayers were unable to use either of the methods prescribed in statute for determining gross income. For this reason, the Department's practice, similar to the Deductions, had already been to allow taxpayers to use the selling price of oil and gas, less deductions for certain costs, to determine the gross income subject to severance tax when oil and gas were not sold at the wellhead. House Bill 85-1196 served to codify this practice and revise statute to reflect evolving industry practices and federal law.

Statutorily, the Deductions have not changed since their enactment. However, in 2016, in its ruling in *BP Am. Prod. Co. v. Colo. Dep't of Revenue* [2016 CO 23], the Colorado Supreme Court interpreted the eligible costs deductible under the Deductions more broadly than the Department, effectively allowing taxpayers to deduct additional costs associated with transporting, processing, and manufacturing oil and gas. Two of the more significant deductions that are now consistently allowed due to this ruling are capital costs, which is "the amount of money that an investor could have earned on a different investment of similar risk," and costs for disposal of saltwater, which is a byproduct of oil and gas production and must be disposed of in accordance with Colorado Oil and Gas Conservation Commission regulations [2 CCR 404-1, Rule 907(c)(2)].

Oil and gas severance tax is imposed on the interest owners of oil and gas that is produced in Colorado, who often must coordinate with well operators to determine the amount of tax they owe and claim the Deductions. Interest owners are individuals or companies that have a right to receive income from production of oil and gas from wells in which they own an interest. Well operators are companies that manage the oil and gas wells, including the transportation, processing, and sale of oil and gas produced. Although in some cases a well operator may be the only interest owner, operators must otherwise provide information to interest owners including an Oil and Gas Withholding Statement (Form DR 0021W). This form provides the interest owners with the amount of their share of the gross income from oil and gas from that operator for the tax year, which they use to complete their severance tax returns with the Department of Revenue.

Interest owners are required to file an Oil and Gas Severance Tax Return (Form DR 0021) and its accompanying schedule, the Oil and Gas Severance Tax Computation Schedule (Form DR 0021D), to calculate and pay their severance tax. Interest owners claim the Deductions by excluding their value from the gross income they report in Column B of the Oil and Gas Severance Tax Computation Schedule. Neither the Oil and Gas Withholding Statement nor the Oil and Gas Severance Tax Computation Schedule provide a line for reporting the Deductions and they are generally not required to be reported on any form filed with the Department.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

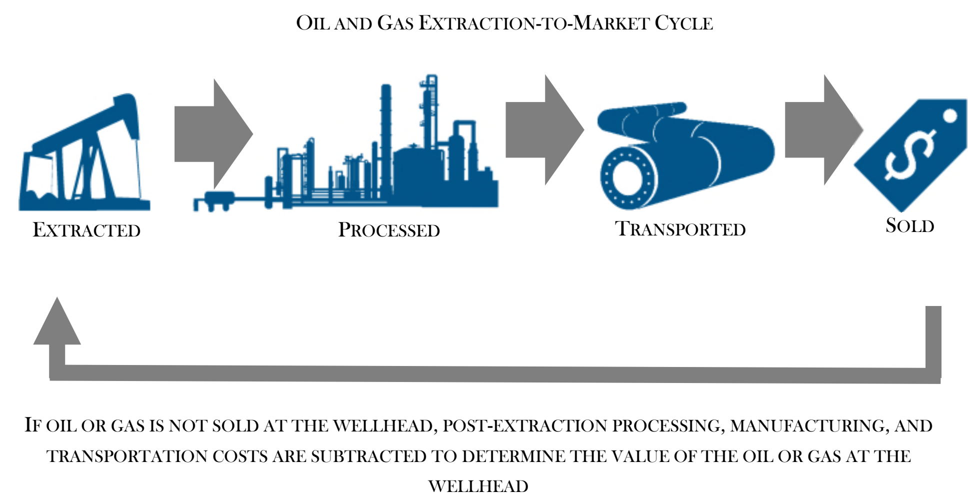
Statute does not explicitly state the intended beneficiaries of the Deductions. We inferred that interest owners are the intended beneficiaries because they are liable for the oil and gas severance tax and are eligible to take the Deductions when calculating their gross income for severance tax purposes. There are two main types of interest owners: (1) working interest owners, and (2) royalty interest owners. Working interest owners share in the costs of exploration, drilling, and production from oil and gas wells, whereas royalty interest owners do not share in these costs. However, depending on their contractual agreements, both working and royalty interest owners may share in the costs of manufacturing, processing, and transporting oil or gas once it is produced from a well and thus, be eligible to claim the Deductions.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Deductions. Based on the legislative history of the deductions, testimony for House Bill 85-1196, and the Colorado Supreme Court’s opinion in *BP Am. Prod. Co. v. Colo. Dep't of Revenue*, we inferred that the purpose of the Deductions is to ensure that the severance tax on oil and gas is based on the value at the point of extraction (i.e., at the wellhead), rather than at a later point of the sale. Because oil and gas are not always sold at the wellhead, but rather are sold after they have been processed and transported to market, if the severance tax was applied at the point of sale, it would be based on not just the value of the oil and gas severed, but also the value added to the oil and gas through processing and transportation.

Therefore, the Deductions allow taxpayers to deduct the costs incurred through processing, manufacturing, and transportation to get back to the value of the oil and gas at the wellhead. This method is referred to as "the netback approach" and is illustrated in EXHIBIT 1.2.

EXHIBIT 1.2. HOW THE DEDUCTIONS OPERATE[1]



SOURCE: Office of the State Auditor analysis of the operation of the Deductions.
[1] The order in which oil or gas is processed, manufactured, or transported may differ depending on the resource, where in the state it is extracted, and where the sale occurs. However, this diagram illustrates the general process of how the Deductions operate.

ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Deductions are generally meeting their purpose because many taxpayers and Certified Public Accountants (CPAs) who work with oil and gas operators and interest owners are aware of them and use them as intended. However, we found that it is likely that not all eligible taxpayers are claiming the Deductions, particularly royalty interest owners and interest owners who are not operators.

Statute does not provide quantifiable performance measures for these Deductions. Therefore, we created and applied the following performance measure to determine the extent to which the Deductions are meeting their purpose.

PERFORMANCE MEASURE: *To what extent are eligible taxpayers claiming the Deductions?*

RESULT: We found evidence that many taxpayers are likely using the Deductions, although we lacked information from the Department to quantify the extent to which they are used. Specifically, we consulted with several oil and gas operators in Colorado, a CPA that works with oil and gas operators and interest owners in Colorado, and an oil and gas trade organization, and they were all aware of the Deductions and claim them, or claim them on behalf of their clients, when they are eligible. We were unable to determine the number of taxpayers that claimed these Deductions because they are not required to report this information to the Department, and they subtract the value of the Deductions from their income prior to reporting gross income.

However, we found that some interest owners may not claim the Deductions when they are eligible due to a lack of information. As discussed, oil and gas well operators must use the Department's Oil and Gas Withholding Statement (DR 0021W) to provide interest owners with tax information based on their share of oil and gas production and sales, including their share of the gross income, from that operator for the tax year. There is no place on the form for operators to report the interest owners' share of costs eligible for the Deductions. In addition, the amount operators report to interest owners as gross income may or may not have the Deductions subtracted from it, but there is no requirement for the operator to do so. Because this line of the form (Line 6) is labeled as "gross income," some interest owners may assume that this is equivalent to the amount they must report on their Oil and Gas Severance Tax Computation Schedule (Form DR 0021D) in the column also labeled "gross income," which would result in them not claiming the Deductions unless the operator had already subtracted their share of the Deductions from the gross income amount it reported to them.

According to a CPA that works extensively with oil and gas operators and interest owners in Colorado, it is not typical for operators to subtract the Deductions from gross income on behalf of the interest owners when providing them with the Oil and Gas Withholding Statement. If interest owners want to claim the Deductions and the operator has not applied the Deductions, they must determine the amount they are eligible to deduct using information in other documents, such as their royalty statements, which are not standardized. They would then need to subtract this amount prior to reporting gross income to the Department on their return. However, it is likely that some interest owners who are not operators, particularly royalty interest owners, may not be aware that they would need to take these steps to claim the Deductions. For example, a farmer who receives royalty payments from oil produced from a well on their land may not know the shared costs that made them eligible for the Deductions or if the operator subtracted the value of their share of the Deductions from the amount it reported as gross income on the Oil and Gas Withholding Statement.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

We estimate that the Deductions resulted in approximately $240.8 million in forgone revenue to the State in Calendar Year 2018 based on limited data oil and gas operators reported to counties. Because no Department data is available for the Deductions for severance tax purposes, our estimate is based on manufacturing, processing, and transportation costs deducted for real property tax purposes in four counties, which accounted for about 96 percent of the total oil production in the state and 70 percent of the total gas production. Real property taxes are separate from severance tax and are paid to and administered by local governments. Similar to severance taxes, to determine the value of oil and gas for real property tax purposes, taxpayers are allowed to deduct processing, manufacturing, and transportation costs. Based on conversations with county assessors and Department staff, we determined that the manufacturing, processing, and transportation costs that can be deducted for real property tax purposes are similar enough to those eligible for the Deductions to provide an estimate that conveys the relative scale of the revenue impact of the Deductions. However, as discussed below, there were significant data limitations that likely have an impact on the accuracy and reliability of our estimate.

To calculate our estimate, we obtained data from four of the largest oil and/or gas producing counties in the state. Three of the four counties provided us with actual expense data showing the total deductions claimed in the county. The other county provided us with the average oil and gas processing and transportation costs as a percentage of gross income for all taxpayers in the county. For this county, we estimated the potential value of the costs deducted by multiplying the cost data provided by the county by the total value of the oil and gas produced in the county, which we obtained from the Division of Property Taxation, which is located within the Department of Local Affairs, 2018 Annual Report. We then multiplied the eligible deductions by an effective severance tax rate of 4.89 percent to estimate the revenue impact attributable to those four counties.

As discussed, there were substantial data limitations that affected the accuracy and reliability of our estimate. Specifically, the data we used had the following limitations:

- We did not have data from 32 of the 36 counties in which oil and/or gas production occurred in 2018 and these counties are not included in our estimate. These counties accounted for the minority of oil and gas production in the state that year (4 percent of oil and 30 percent of gas production) according to Division of Property Taxation data. We did not attempt to adjust our estimate to account for these counties because oil and gas processing and transportation costs can vary substantially by county and it is possible that interest owners with wells in these counties could have claimed the Deduction at proportionately higher or lower rates relative to the value of their production. Based on our conversations with stakeholders, processing, manufacturing, and transportation costs can vary dramatically by operator depending on their business model, the location of the well in relation to the point of sale, and how much processing has been done prior to the sale.

- Our estimate includes some deductions attributable to stripper wells that would not be allowed for severance tax purposes. Stripper wells, which are low-producing oil and/or gas wells, are exempt from severance tax, and therefore interest owners are not allowed to claim the Deductions for costs related to these wells. However, stripper wells are not exempt from real property tax so these deductions are allowed when calculating property tax and are included in the data we used; we lacked information necessary to calculate their value and remove it from our estimate.

- Our estimate includes deductions for gathering costs, which are not eligible for the Deductions, in two of the four counties we used for our calculation. Gathering costs are related to moving oil and gas through smaller pipelines in order to accumulate the oil and gas for the purpose of processing or storage. These costs are deductible for real property tax purposes and are included in the data we received from counties, but we only had sufficient data to remove these costs from our estimate for two counties.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Deductions were eliminated, it would result in the severance tax being imposed at the point of sale rather than the point of severance, since sales do not always occur at the wellhead. This could result in a substantial increase in taxpayers' severance tax liabilities. Overall, based on our revenue impact estimate, eliminating the Deductions would have increased severance tax liabilities in Calendar Year 2018 by approximately $240.8 million, which would be an increase of 153 percent based on the $157.3 million in oil and gas net severance tax liability reported by the Department for Tax Year 2018. Though taxpayers would potentially be able to offset this increase to some extent through increased use of other oil and gas severance tax expenditures, such as the Ad Valorem Credit, eliminating the Deductions would result in a substantial increase in the State's severance taxes.

Because the Deductions currently provide a larger benefit to taxpayers with higher transportation and processing costs prior to sale, these taxpayers would also pay a greater proportion of the increase in severance taxes if the Deductions were eliminated. This could put these taxpayers at a disadvantage relative to taxpayers with lower transportation and processing costs. Further, because some taxpayers sell oil and gas to other parties at a lower price prior to completing all of the necessary processing and transportation, while others may process and transport oil and gas themselves and sell at a higher price, eliminating the Deductions would result in a higher tax on the same oil and gas based on how much of the processing and transportation taxpayers take on prior to the initial sale.

Additionally, as discussed in more detail in the following section, other oil and gas producing western states allow deductions for processing and/or transportation costs. If Colorado eliminated these Deductions, it would result in Colorado being an outlier among these competitor states and could result in Colorado being less competitive in attracting or keeping oil and gas companies since they would pay severance tax on the selling price of oil and gas rather than the value at the point of severance.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the state tax laws and regulations of eight states that we identified as peer states to Colorado to determine whether they have similar processing, manufacturing, and transportation deductions for severance taxes. The eight states we identified as peer states are: (1) Kansas, (2) Montana, (3) New Mexico, (4) North Dakota, (5) Oklahoma, (6) Texas, (7) Utah, and (8) Wyoming. We identified these as peer states because they (1) produce the same types of mineral resources as Colorado, (2) are located in the western part of the United States, and (3) have been used in previous severance tax analyses conducted by other state agencies. We found that all eight of these states provide similar deductions, though two (Oklahoma and Texas) limit their deductions to gas production and do not exempt oil processing and transportation costs. Additionally, Montana limits its deduction to transportation costs and does not allow a deduction for processing costs. EXHIBIT 1.3 summarizes the similar deductions allowed in Colorado's peer states.

EXHIBIT 1.3. PEER STATES WITH SIMILAR DEDUCTIONS FOR OIL AND GAS SEVERANCE TAXES				
	DEDUCTION FOR OIL PROCESSING?	DEDUCTION FOR OIL TRANSPORTATION?	DEDUCTION FOR GAS PROCESSING?	DEDUCTION FOR GAS TRANSPORTATION?
Kansas	Yes	Yes	Yes	Yes
Montana	No	Yes	No	Yes
New Mexico	Yes	Yes	Yes	Yes
North Dakota	Yes	Yes	Yes	Yes
Oklahoma	No	No	Yes	Yes
Texas	No	No	Yes	Yes
Utah	Yes	Yes[1]	Yes	Yes[1]
Wyoming	Yes	Yes	Yes	Yes

SOURCE: Office of the State Auditor analysis of other states' statutes, regulations, and taxpayer guidance.
[1] In Utah, the transportation costs deducted may not exceed 50 percent of the value of the oil or gas.

Additionally, none of Colorado's peer states' statutes specifically allow a deduction for manufacturing costs. However, it is possible that other states have taken the position, similar to the Department's position, that manufacturing activities generally do not occur before the sale of oil and gas and, therefore, a deduction for manufacturing costs is not included in their statutes.

ARE THERE TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE IN THE STATE?

We did not identify other tax expenditures or programs with a similar purpose available in the State.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department was not able to provide us with data on the number of taxpayers that claimed the Deductions or the amount claimed. Therefore, we had to estimate the revenue impact of the tax expenditures using limited real property tax data we obtained from counties. As a result, our estimate may vary from the actual revenue impact of these Deductions and we could not determine how many taxpayers claimed the Deductions.

The Department was unable to provide this information because taxpayers are generally not required to report the value of the Deductions on the forms they file with the Department. Specifically, interest owners who claim the Deductions report gross income to the Department after subtracting costs that qualify for the Deductions and the Department's Oil and Gas Severance Tax Computation Schedule (Form DR 0021D) does not provide a line for reporting the value of the Deductions taxpayers claimed. Similarly, on the Oil and Gas Withholding Statement (Form DR 0021W), which provides interest owners with their gross income from that operator for the tax year, there is no line to report the costs eligible for the Deductions.

Some operators who are also interest owners are required to report the Deductions on a separate form, the Detail Information for Producers (Form DR 0021PD), which is an informational schedule on the wells that the operator both owns and operates. However, we could not use the information from this form for analysis due to several issues. First, although the Department's form instructions require that these taxpayers file the schedule and retain a copy, Department staff reported that it is not often filed and there is not currently a mechanism for the Department to reject a return missing this schedule. Because the Department does not consider this detail essential to processing the return and accompanying payment, it believes rejecting returns missing this information would not be prudent. Second, when the Detail Information for Producers forms are filed or are requested by the Department from the operator, the Department maintains scanned images of the forms, but the information on them is not digitally captured. Third, GenTax, the Department of Revenue's tax processing system, has not been configured to store the data even if it were captured from the form. If the Department required the Detail Information for Producers form to be filed and captured the data on the form, it would provide partial data for our analysis on taxpayers who use the Deductions. However, only operators who also own wells are required to file the form based on their percentage ownership in each well, and it is common for some operators to not entirely own the wells they operate, so we would still lack complete information on the use of the Deductions.

To address these limitations, the Department could create a new reporting line on the Oil and Gas Severance Tax Computation Schedule for interest owners to report the Deductions when calculating gross income. Alternatively, the Department could require all operators to file the Detail Information for Producers and report information on the costs eligible for the Deductions on all of the wells that they operate. However, this would only provide data on Deductions taxpayers are potentially eligible to claim and not actual Deductions claimed, since interest owners must ultimately claim the Deductions when calculating gross income on their Oil and Gas Severance Tax Computation Schedule.

These changes would create additional reporting requirements for operators and interest owners and could increase their administrative burden and compliance costs. Additionally, the Department would need to capture and house the data collected on the new lines in GenTax, which would also require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations). Moreover, according to the Department, in order to require all operators to file the Detail Information for Producers form, it would likely need authority to penalize taxpayers for not filing the required schedule.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE DEDUCTIONS MAY BE LESS EFFECTIVE AT MEETING THEIR PURPOSE BECAUSE SOME INTEREST OWNERS WHO ARE ELIGIBLE MAY NOT CLAIM THEM DUE TO A LACK OF INFORMATION. Specifically, when operators report gross income to interest owners on the Oil and Gas Withholding Statement (Form DR 0021W), it is not typical for operators to subtract the value of the Deductions from gross income on behalf of the interest owners. Additionally, the form does not include a line for operators to report interest owners' share of costs that are eligible for the Deductions. If interest owners want to claim the Deductions, they must determine the amount they are eligible to deduct using other documents, such as their royalty statements, which are not standardized. However, it is likely that some interest owners, particularly royalty interest owners who are not directly involved in the operation of wells, are not aware of severance tax laws, may not know they are eligible to claim the

Deductions, or how to obtain the information necessary to claim them. Consequently, some interest owners may be overpaying their severance taxes by not claiming Deductions for which they are eligible.

To address this issue the General Assembly could consider:

- **REQUIRING OPERATORS TO PROVIDE ALL INTEREST OWNERS WITH THEIR ELIGIBLE DEDUCTIBLE EXPENSES IN A CONSISTENT WRITTEN FORM, EITHER ON AN OFFICIAL DEPARTMENT FORM SUCH AS THE OIL AND GAS WITHHOLDING STATEMENT (FORM DR 0021W) OR IN A STANDARDIZED STATEMENT PROVIDED ANNUALLY TO INTEREST OWNERS.** This would more clearly allow interest owners to determine (1) whether they are eligible to deduct manufacturing, processing, and transportation expenses and (2) the amount of their eligible deductions. However, a CPA that works extensively with oil and gas operators reported that operators currently may not provide interest owners with their deductible expenses because by March 1, when the Oil and Gas Withholding Statement is required to be provided to the interest owners, they may not have complete information on the value of qualifying expenses for the prior year or they may not want to take a tax position on behalf of another taxpayer by telling them what they are eligible to deduct.

- **SHIFTING THE REPORTING OF SEVERANCE TAXES FROM THE INTEREST OWNERS TO THE OPERATORS.** Rather than having individual interest owners calculate their severance tax due, including determining whether and what amount of manufacturing, processing, and transportation deductions they are eligible to claim, and file a severance tax return, the General Assembly could require that operators handle all severance tax reporting and filing on behalf of the interest owners. We found that this type of structure is common in Colorado's peer states, including Kansas, Montana, Oklahoma, Texas, and Utah, which, in general, either require or allow operators or first purchasers to file and remit severance tax due on behalf of the interest owners. Requiring reporting and remitting of oil and gas severance tax to be handled at the operator level would have implications beyond the Deductions, such as changing the withholding system and placing responsibilities on operators to take tax positions on behalf of interest owners.

THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING THE INTENT, SCOPE, AND DEFINITIONS OF DEDUCTIONS ALLOWED AGAINST GROSS INCOME. In 2016, in its ruling in *BP Am. Prod. Co. v. Colo. Dep't of Revenue* [2016 CO 23], the Colorado Supreme Court effectively expanded the Deductions by interpreting the statute to allow taxpayers to deduct additional costs not previously allowed by the Department. Two of the more significant deductions that are now consistently allowed are capital costs, which is "the amount of money that an investor could have earned on a different investment of similar risk," and saltwater disposal activity costs. We lacked information to quantify the potential revenue impact of this ruling. One stakeholder, a CPA who works for oil and gas industry clients, reported that the ruling resulted in more uniform treatment among taxpayers rather than a significant expansion of the deductions since, prior to that ruling, some expenses, such as saltwater disposal activities, may have been inconsistently allowed by the Department. However, Department staff indicated that the ruling could result in some significant expansions of the Deductions. Because the ruling changed the application of the Deductions, the General Assembly may wish to consider whether the ruling is consistent with its intent.

Additionally, based on the ruling, it may still not be clear to taxpayers whether certain indirect costs related to oil and gas production are deductible. For example, it is unclear if maintenance costs for a road leading in and out of a site should be included in the transportation deduction. Clarifying the intent and scope of these deductions could provide more certainty for taxpayers and the Department by providing clear parameters for which expenses are deductible and which are not.