

Oil and Gas Severance Tax Deduction Memo

The Oil and Gas Severance Tax Deduction for Transportation, Manufacturing, and Processing Costs (Deduction) allows taxpayers to deduct these costs (i.e., transportation, manufacturing, and processing costs) when computing gross income for oil and gas severance tax purposes. Severance taxes are based on the “gross income attributed to the sale of oil and gas severed from the earth” [Section 39-29-105(1)(b), C.R.S.] and statute [Section 39-29-102(3)(a), C.R.S.] defines “gross income” for oil and gas severance tax purposes as the “net amount realized by the taxpayer for the sale of the oil or gas...at the wellhead, or after transportation, manufacturing, and processing of the product... less deductions for direct costs actually paid or accrued by the taxpayer for transportation, manufacturing, and processing...” Based on statute [Section 39-29-102, C.R.S.] and committee legislative testimony, we inferred that the purpose of the Deduction is to ensure that the severance tax on oil and gas is based on the value of oil and gas at the point of extraction (i.e., at the wellhead), rather than on the income realized at a later point of sale, since the sale price is typically higher than the value of the oil and gas at the point of extraction to cover the costs of transportation, manufacturing, and processing.

Oil and gas operators, which are companies that manage wells and also transport, process, and manufacture oil and gas, transmit the income from the sale of oil and gas to interest owners, which are companies and individuals who have an ownership interest in oil and gas wells. In some cases, operators are also interest owners for the wells they manage. Interest owners are responsible for applying the Deduction to compute “gross income”, calculating severance tax owed on their “gross income” from wells, and remitting severance taxes to the Department of Revenue (Department).

In our July 2020 evaluation of the Deduction, we found that it is generally meeting its purpose because many taxpayers and CPAs who work with oil and gas operators and interest owners are aware of and use it. We estimated that the Deduction had a revenue impact to the State of approximately \$240.8 million in reduced severance tax revenue. However, we found that it is likely that not all eligible taxpayers are claiming the Deduction, particularly interest owners that are not also operators, because operators do not always tell interest owners whether they applied the Deduction prior to transmitting their income or provide information that would allow interest owners to calculate the Deduction prior to paying their severance taxes. We included policy considerations that the General Assembly could consider:

- Clarifying the intent, scope, and definitions of the Deduction in light of the Colorado Supreme Court’s decision in *BP Am. Prod. Co. v. Colo. Dep’t of Revenue*, which effectively ruled that

statute allowed taxpayers to deduct indirect costs that Department rules had previously disallowed.

- Requiring that operators report the amount of the Deduction to interest owners who can then apply it when calculating their “gross income,” or changing the structure of the severance tax so that operators file and remit severance taxes and report the Deduction as opposed to transmitting income to interest owners who file and report their share of severance taxes (i.e., shifting the responsibility of paying the tax to operators).

The purpose of this memo is to provide an update on changes made to the Deduction since our last review and their impact.

The General Assembly clarified which costs are deductible. In 2021, the General Assembly enacted House Bill 21-1312, which scaled back allowable costs for the Deduction, restricting eligible costs to transportation, manufacturing, and processing costs that are “direct costs actually paid or accrued” by the taxpayer. This effectively disallowed the cost of capital, as defined by the Colorado Supreme Court, and other indirect costs, like the cost to dispose of saltwater used during drilling. Prior to House Bill 21-1312, the Colorado Supreme Court’s decision in *BP Am. Prod. Co. v. Colo. Dep’t of Revenue* [2016 CO 23] allowed taxpayers to claim capital costs, which, according to the ruling, is “the amount of money that an investor could have earned on a different investment of similar risk.” There is not a reliable method to determine how much this change affected the Deduction’s revenue impact.. As explained below, operators are not required to report the amount of the Deduction claimed, or the type of costs, so data is incomplete, and when operators do report the amount, it is done through paper filings, which makes gathering the information a manual process.

The Severance Tax Workgroup recommended changes to severance tax collection and how the Deduction is claimed. As of May 2025, the Department has not made any administrative changes, and there have been no legislative changes that have affected the way the Deduction is claimed since our 2020 evaluation. However, under Senate Bill 21-281 and House Bill 22-1391, a Severance Tax Workgroup (Workgroup), consisting of the director of the Office of State Planning and Budgeting and the Executive Directors of the Departments of Revenue, Natural Resources, Education, and Local Affairs, or their designees, was created to develop recommendations and an implementation plan to shift responsibility for remitting the state severance tax on oil and gas from interest owners to operators, require electronic filing of severance taxes, and require additional electronic data collection to ease administration and enforcement of oil and gas severance taxes. The Workgroup was required to submit its recommendations and implementation plan to the Joint Budget Committee by January 15, 2025. The Workgroup recommended that the General Assembly:

- Make operators responsible for remitting severance taxes beginning in Tax Year 2028. Interest owners would still be liable for severance taxes, but operators would be responsible for

computing taxes owed, withholding taxes, and remitting tax payments to the Department. The Workgroup anticipated this would significantly reduce the number of severance tax returns that are filed with the Department because there are far fewer operators than interest owners and would make it easier to collect information on the Deduction.

- Mandate electronic filing of severance taxes starting in Tax Year 2028, which is currently done through paper returns. Electronic filing would make it easier for the Department to require operators to report the amount of the Deduction claimed per well, which the Workgroup recommended the Department also start in Tax Year 2028. Currently, this information is part of an informational form (Detail Information for Producers Form DR 0021PD) that operators are required to complete, but are not required to submit to the Department. The Workgroup noted that requiring electronic filing and operators to report the amount of the Deduction they claim would allow the Department to more easily extract and use information on the Deduction for compliance and reporting purposes.

Legislation was not introduced during the 2025 Legislative Session to implement the Workgroup's proposed changes.

Current Audit

The Office of the State Auditor (OSA) is currently conducting a performance audit of oil and gas reporting, as required by Section 2-3-128, C.R.S. The legislative declaration from House Bill 22-1361, which created the audit requirement, states that the purpose of the audit is to “ensure proper reporting related to oil and gas extraction.” The audit statute requires the OSA to compare oil and gas related reporting from the Department of Revenue, Colorado Department of Public Health and Environment, and Energy and Carbon Management Commission within the Department of Natural Resources in order to find inconsistencies, and to describe missing, incomplete, or incorrect reports. Because operators are not required to report the Deduction to any of these state agencies, the audit will not be able to determine whether taxpayers are correctly claiming the Deduction or the amount deducted.

Office of the State Auditor

State Auditor	Kerri L. Hunter, CPA, CFE
Deputy State Auditor	Michelle Colin, JD
Evaluation Managers	Trey Standley, JD James Taurman, MPA
Evaluation Supervisor	Meghan Westmoreland, MBA
Evaluation Team	Jackson Brainerd



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