TORCH OPERATING COMPANY 1221 Lamar Suite 1600 Houston, TX 77010,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. MISC. 02-590
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER DENYING DEPARTMENT'S APPLICATION FOR REHEARING

This case involves the Taxpayer's Alabama oil and gas privilege and production (severance) tax liability for January 1999 through November 2001. An Opinion and Preliminary Order was entered on July 31, 2003 directing the parties to recompute the Taxpayer's liability for the subject period. A Final Order was subsequently entered on September 8, 2003, which voided the final assessment in issue and directed the Department to issue the Taxpayer a refund of $5,220.69, plus applicable interest. The Department applied for a rehearing.

This case concerns the workback method for determining the taxable value of the Taxpayer's raw gas at the wellhead. As discussed in the Opinion and Preliminary Order at 1, "the workback method is used when there is no sale of the product at the wellhead. 'Value' is computed under the workback method by taking the sale price of the refined product, and then 'working back' to the taxable value of the raw product at the wellhead by deducting the various post-production transportation, processing, and other costs incurred in refining the product into marketable form." Three issues are involved:

(1) What percentage of the Taxpayer's field labor costs was processing-related, and thus should be allowed under the workback method;

(2) What percentage of the Taxpayer's overhead costs should be allowed; and,

(3) Should the Taxpayer be allowed to include a return on investment in computing the actual cost of producing its fuel gas during the audit period.

Issue (1). The Field Labor.

The Taxpayer employed 23 field employees during the audit period. The employees performed both processing-related and production-related work. The Department agrees that the Taxpayer's processing-related labor costs can be allowed under the workback method.

The Department allowed the Taxpayer to deduct 40 percent of total field labor in one prior audit in the 1990's, and 100 percent in another prior audit.[1] The Taxpayer had not maintained records during the prior audit periods showing what portion of total field labor constituted deductible processing-related labor versus nondeductible production-related labor. The Department also never requested such records from the Taxpayer, and never instructed the Taxpayer that such records should be maintained for future audits.

The Taxpayer deducted 70 percent of total field labor during the audit period in issue based on its understanding that it had an ongoing agreement with the Department that 70 percent would be allowed. The Department rejected the 70 percent amount, and instead estimated deductible field labor using a formula suggested by one of its auditors, as follows – "The Department determined that the Taxpayer operated 7 compressor stations, and that all work at the compressor stations was deductible. It multiplied the number of compressor stations by 10 on the assumption that work at the compressor stations was 10 times more

[1] The amount allowed in a third prior audit was not submitted into evidence, although the Taxpayer claims that 100 percent of field labor was also allowed in that audit.

labor intensive then at the well sites. It also assumed that all work at the wells was nondeductible. By comparing deductible work at the compressors to nondeductible work at the wells, the Department computed deductible field labor to be 15.0862 percent of total field labor . . ." Opinion and Preliminary Order at 4.

The Administrative Law Division rejected the Department's formula because it was contrary to the evidence and did not accurately reflect the Taxpayer's processing-related field labor. Instead, the Administrative Law Division computed deductible field labor based on the testimony of the Taxpayer's field supervisor, which was the only evidence submitted by either party on the issue. Based on that evidence, the Administrative Law Division determined that the Taxpayer should be allowed 65.564 percent of total field labor as a deduction under the workback method. Opinion and Preliminary Order at 6-11.

The Department argues on rehearing that the Taxpayer was required to maintain adequate records distinguishing deductible versus nondeductible field labor, and that because the Taxpayer failed to maintain such records, the Department's computation of deductible field labor must be affirmed. I disagree.

All taxpayers, including the Taxpayer in this case, are generally required to maintain adequate tax records. However, in three prior audits involving the workback method, the Department never requested or required the Taxpayer to keep specific records identifying processing-related field labor. Rather, it allowed an estimated amount in each audit. Under those circumstances, it is understandable that the Taxpayer did not maintain records identifying deductible field labor during the period in issue.

It is also unclear what form or type of records the Department is claiming that the Taxpayer should have maintained. The Taxpayer's field employees perform both deductible and nondeductible jobs during a typical day. For example, work at the wells involves both processing and production-related functions, which vary in time from well to well, depending on the circumstances. Because some jobs take less than one minute to perform, it necessarily follows that the only way the Taxpayer could accurately document deductible field labor would be for each field employee to keep detailed records showing the time spent on each activity.

The Department strenuously argues, however, that it has never required such records – "There is nothing in the record that ever indicated that the Department was seeking to require meticulous minute by minute recordkeeping." Dept. App. for Rehearing at 6. "There is absolutely no such reference in the entire record now under consideration which indicates the Department was demanding or seeking 'meticulous minute-by-minute recordkeeping.' The Department strenuously objects to this attribution by the Administrative Law Division." Dept. App. for Rehearing at 10, 11. But if the Department is not requiring such detailed records, what type of records did it expect the Taxpayer to maintain?

The amount of deductible field labor performed by the Taxpayer's employees cannot be automatically recorded by machine, as can, for example, sales on a cash register or nontaxable utility services on a separate meter, see, *Shellcast Corp. v. White*, 477 So.2d 422 (Ala. 1985). If the Department did not expect the Taxpayer's field employees to keep detailed records of their daily activities, the only other written "record" the Taxpayer could

have maintained would have been a general job description that estimated the amount of processing-related labor performed by the employees. I doubt, however, if the Department would have accepted such an estimate. In any case, any written estimate provided by the Taxpayer would have shown the same information provided by the testimony of the Taxpayer's field supervisor, which, as stated in the Opinion and Preliminary Order at 7, "is better evidence because (the field supervisor) was subject to cross-examination by the Department."

The gist of the Department's argument is that deductions under the workback method are like income tax deductions, and that if a taxpayer fails to keep records proving the amount of the deduction, the deduction must be disallowed, or at the least, the taxpayer cannot dispute the Department's estimate of the amount that should be allowed. Again, I disagree.

Income tax deductions are matters of legislative grace. If a taxpayer fails to keep records verifying an income tax deduction, the deduction must be disallowed.[2] But concerning workback method deductions, the Department is under an affirmative duty to accurately determine and allow all processing-related expenses in computing taxable wellhead value. Consequently, even though the Taxpayer did not maintain records distinguishing deductible and nondeductible field labor, the Department was still required to

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[2] Even for income tax purposes, if a taxpayer has proved that he is entitled to a deduction but does not have records establishing the amount, The *Cohan* rule will in most cases allow the taxpayer to reasonably estimate the amount. *Cohan v. Commissioner*, 39 F.2d 540 (1930).

estimate deductible labor using the best information available.[3] The Department recognized this affirmative duty when it estimated deductible field labor using the formula discussed above, at page 2. The issue is not whether the Taxpayer maintained good records. Rather, it is whether the Department's estimate accurately reflects the amount of the Taxpayer's deductible field labor.

The Department's formula, however well-intended, is flawed and does not accurately reflect the Taxpayer's processing-related field labor. First, the formula incorrectly assumes that the Taxpayer had seven compressor stations instead of eight. It also ignores the fact that some stations had more compressors than others. Most importantly, the Department's formula assumes that all work at the well sites was production-related, and thus nondeductible. The evidence clearly shows otherwise.

The Alabama Supreme Court held in *State of Alabama v. Phillips Petroleum Co.*, 638 So.2d 886 (Ala. 1992), that if the Department estimates value under the workback method, its determination of value "may be challenged by the taxpayer on the ground that the assessment overestimates, or underestimates, the 'value' or 'market value.' Value is a question of fact, and value may be shown by expert testimony or by evidence of other sales of like-quality gas. Also, when the Department resorts to the work-back method, which is disfavored as a method of calculating value, the assessment can be attacked by showing that the calculations improperly included or excluded items in such a manner that the end

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[3] This is consistent with Code of Ala. 1975, §40-2A-7(b)(1)a., which provides that "if the department . . . is required to determine value, the department may calculate the correct . . . value based on the most accurate and complete information reasonably obtainable by the department."

result does not fairly indicated value." *Phillips Petroleum*, 638 So.2d at 889, 890.

The Department estimated a component of the workback method, i.e. deductible field labor, using a flawed formula. The Taxpayer challenged the Department's calculations through the testimony of its field supervisor. As indicated in the Opinion and Preliminary Order at 10, "his testimony was credible, and is the best evidence available." The Department still has not offered any evidence contradicting the field supervisor's testimony, nor has it disputed any substantive aspect of his testimony. Rather, it only argues that because the Taxpayer failed to keep some type of records identifying deductible field labor, the Taxpayer should not be allowed to dispute its calculations. I disagree for the reasons explained above and in the Opinion and Preliminary Order.

The Department may, of course, require or specify by regulation that the Taxpayer and all other oil and gas producers must maintain a specific type or form of record that identifies processing-related field labor, and also other allowed costs under the workback method. Such a recordkeeping requirement would be affirmed if reasonable under the circumstances. See, *Shellcast*, *supra*.

The Department may also prescribe by regulation a fixed percentage of total field labor that will be allowed, as it has done concerning deductible overhead, which is discussed in Issue (2) below. But again, the amount must be reasonable, and could be challenged by expert testimony or other evidence showing that the amount allowed did not accurately reflect deductible field labor under the circumstances.

The finding in the Opinion and Preliminary Order that the Taxpayer should be allowed 65.564 of total field labor as a deduction under the workback method is supported

by the evidence, and is affirmed.

Issue (2). Overhead.

The workback method allows the Taxpayer to deduct that portion of its administrative and other overhead costs that relate to the processing of the Taxpayer's gas. However, like deductible field labor, the amount of deductible overhead cannot be precisely measured because some administrative employees perform both processing-related and production-related functions. Consequently, deductible overhead must be estimated.

Before the Department promulgated Reg. 810-8-6-.01 in 1997, it agreed that the Taxpayer could deduct 10 percent of its total overhead. The Taxpayer's monthly computer printouts consequently showed total overhead in one column and the deductible 10 percent of total overhead in another column.

The Taxpayer began complying with Reg. 810-8-6-.01 after it was promulgated. It continued showing total overhead on its monthly printout, and also the 10 percent of total overhead that it had previously deducted before the regulation was promulgated.[4] It then hand calculated the 10 percent maximum allowed by the regulation, which generally amounted to from 10 to 15 percent of total overhead. See, Opinion and Preliminary Order at n. 5. The Taxpayer consequently deducted the 10 percent maximum allowed by the regulation.

[4] The Taxpayer's printout continued to include the 10 percent of total overhead column only because the Taxpayer did not want to spend the money to delete the column from its computer program.

The Department rejected the amounts claimed by the Taxpayer, and instead allowed the Taxpayer the 10 percent of total overhead amounts that continued to be shown on the Taxpayer's computer printouts. The Department claims that the 10 percent amount must be used because it represents the Taxpayer's actual processing-related overhead. That is clearly wrong. The 10 percent of total overhead amounts shown on the Taxpayer's computer printouts have nothing to do with the Taxpayer's actual processing-related overhead. Rather, as discussed, they are only arbitrary amounts that the Department allowed the Taxpayer to deduct before Reg. 810-8-6-.01 was promulgated.

This issue turns on the correct interpretation of Reg. 810-8-6-.01(6)(b)7., which reads as follows:

> 7. ADMINISTRATIVE AND OVERHEAD COSTS. Administrative and overhead costs related to the supervision of facility operations, expense accounting, secretarial expense and the expense of marketing a product, shall be limited to ten percent of allowed depreciation, direct labor, contract services, materials, supplies, equipment rentals, fuel and power costs.

Although the regulation could have been better worded, its intent is clear – an overhead deduction shall be allowed up to 10 percent of the allowed depreciation, direct labor, and the other costs listed in the regulation. That is exactly what the Taxpayer deducted during the period in issue.[5]

The Department claims, however, that the regulation allows an overhead deduction for either actual processing-related overhead or the 10 percent maximum allowed by the

[5] The Taxpayer actually claimed less of an overhead deduction than allowed by the regulation, see Opinion and Preliminary Order at n. 3.

regulation, whichever is less. And as discussed, the Department continues to insist that the 10 percent of total overhead amounts shown on the computer printouts represented the Taxpayer's actual processing-related overhead during the audit period.

I am perplexed by the Department's position on this issue. Processing-related overhead cannot be accurately measured or recorded. If it could be, there would be no need for a regulation that specifies the amount that should be allowed. Yet the Department continues to argue that the 10 percent of total overhead amounts shown on the Taxpayer's computer printout constitutes the Taxpayer's actual processing-related overhead. Clearly it does not. How would the Department have computed deductible overhead if the Taxpayer had not continued to include the 10 percent of total overhead column in its monthly printouts? It could only have done so by allowing the Taxpayer the 10 percent maximum allowed by the regulation, which is what the Taxpayer attempted to claim, and which in all months was considerably less than the Taxpayer's total overhead costs.

The Department states in its application for rehearing, at page 12, that "the language of the Revenue Rule does not allow a deduction for all 'overhead costs' as concluded by the Taxpayer and the Administrative Law Division." That statement is wrong. The Taxpayer never argued, and the Administrative Law Division never concluded, that the Taxpayer should be allowed to deduct all overhead costs. Rather, the Taxpayer correctly argued for, and the Administrative Law Division allowed, only the 10 percent amount fixed by the regulation. Only if total overhead was less than the 10 percent maximum allowed by the regulation could it plausibly be argued that total overhead could be deducted under the language of the regulation. But that never occurred during the audit period. Rather, as

discussed, the amounts claimed by the Taxpayer and allowed by the Administrative Law Division were usually between 10 and 15 percent of total overhead.

The Department makes several other incorrect claims concerning this issue in its application for rehearing. For example, it states in the first paragraph on page 14 that "[w]here a taxpayer's overhead costs are less than the 10 percent maximum allowed under the regulation, as they were under the undisputed facts of this case, . . ." That statement is wrong because in all months the Taxpayer's overhead costs greatly exceeded the 10 percent maximum. There is no need to discuss the other incorrect assertions in the Department's application because to do so would serve no useful purpose.

The rationale of the Opinion and Preliminary Order as its relates to the overhead issue is affirmed.

Issue (3). Fuel Gas.

Fuel gas is gas produced and processed by the Taxpayer that the Taxpayer subsequently uses to operate its compressors, dehydration units, and other processing-related equipment and facilities. The Department concedes that the actual cost of producing the fuel gas can be allowed under the workback method. See, Reg. 810-8-6.01(6)(b)5.(iii). The issue is whether a return on investment (ROI) should be an allowed cost in computing the Taxpayer's cost of producing the fuel gas.[6]

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[6] The regulation allows a deduction for only the cost of producing the gas, i.e. bringing the raw gas to the wellhead. I initially assumed that fuel gas was unrefined gas. Opinion and Preliminary Order at n. 7. The Taxpayer has indicated in its reply to the Department's application for rehearing, at page 11, n. 9, that fuel gas is refined product. The Taxpayer certainly incurred some processing costs when it refined the fuel gas into usable form. Consequently, I do not understand why the fuel gas deduction should not also include the

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The Department conceded that ROI is a deductible cost under the workback method. It also allowed the Taxpayer to claim ROI as a cost of producing its fuel gas in prior audits. The Department initially argued in this case, however, that ROI cannot be considered because while it is an allowed cost under the workback method, it is not an actual cost. That rationale was rejected in the Opinion and Preliminary Order at 14-15.

On rehearing, the Department now argues that ROI should not be considered in determining the cost of producing the fuel gas because "[n]o funds are actually expended by a taxpayer for Return on Investment (ROI)." Dept. App. for Rehearing at 15. But clearly a refinery owner must invest, i.e. expend funds, before it can claim an ROI deduction. In any case, as discussed, the Department concedes that ROI is a cost under the workback method, despite its contradictory claim, at page 15 of its application for rehearing, that "(ROI) would clearly not be a cost."

The basis for the Taxpayer's general ROI deduction relating to the processing of the gas is the cost of its processing-related equipment and facilities, as depreciated. That is not disputed by the Department. The Taxpayer also expended or invested considerable sums in its production-related equipment. That equipment was used to produce the Taxpayer's raw gas, including the gas that was subsequently used as fuel gas. Consequently, one of the costs incurred by the Taxpayer in producing the fuel gas was the ROI on the production-related equipment, as depreciated. That actual cost should be

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actual costs incurred by the Taxpayer in processing the raw gas into usable fuel gas. The Taxpayer has not, however, made that argument in this case, but instead is only claiming that ROI should be included as a cost of producing the fuel gas, i.e. bring the raw gas to the wellhead.

allowed.

The allowance of ROI as a cost of producing the Taxpayer's fuel gas is affirmed.

The Department's application for rehearing is denied. The Final Order is affirmed. This Final Order Denying Department's Application for Rehearing may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered December 19, 2003.