STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. MISC. 89-154
FMP OPERATING COMPANY 1615 Poydras Street New Orleans, Louisiana 70112,	§	
Taxpayer.	§	

FINAL ORDER
DENYING APPLICATION FOR REHEARING

A Final Order was entered in this case on May 4, 1995 dismissing the final assessment in issue. The Department timely applied for a rehearing on May 19, 1995. The application is denied and the Final Order is affirmed for the reasons stated below.

This case involves a straight-forward issue. What is the taxable value at the wellhead of the unprocessed gas sold by the associated owners.

"Value" is defined at Code of Ala. 1975, §40-20-1(3) as "the sale price or market value at the mouth of the well".

The associated owners, including the Taxpayer, sold their gas at the wellhead under the same casinghead contract terms and for the same fair market sales price as did the non-associated owners. The Department accepted the sales price paid to the non-associated owners as representing the true value of their gas. That same fair market sale price should also be accepted as the true market value for the identical gas sold by the associated owners.

The Department is authorized to determine "value" using the work-back method only if one of three "if" situations set out in

§40-20-1(3) is present. If none of the three "ifs" apply, the sale price actually received for the gas must govern. The Supreme Court stated as follows in State v. Phillips Petroleum Co., 638 So.2d 886 (Ala. 1992), at p. 889:

> "Under certain situations, §40-20-1(3) authorizes the Department to determine 'value.' That section states that the Department determines value in one of three situations: (1) '[i]f the oil or gas is exchanged for something other than cash.'; (2) 'if there is no sale at the time of severance'; or (3) 'if the relation between the buyer and the seller is such that the consideration paid, if any, is not indicative of the true value or market price.' *Id*. The Department may assess value only upon a showing of one of the specified situations." (emphasis added)

As previously discussed in the Final Order, at pages four through seven, none of the three "if" situations apply in this case.

First, it is undisputed that the gas in issue was sold for cash.

Second, the sale of the gas occurred at the wellhead. The sales were closed when title passed at the wellhead from the working interest owners to the Plant for a price. See, Code of Ala. 1975, §7-2-106(1). The price was established at the time of sale pursuant to the formula set out in the casinghead contracts. The fact that the actual dollar amount to be received by the seller was not determined until the gas was sold at the Plant tailgate does not alter the fact that the sales were completed upon delivery of the gas and passage of title at the wellhead.

Concerning the third "if" clause, the Department apparently rejects the idea that related parties can ever deal at arm's-length. I disagree. If the parties to a sale deal at arm's-length and the buyer pays fair market value to the seller, the sale is a valid arm's-length transaction regardless of the relationship of the parties.

In any case, the third "if" clause applies only if the consideration paid "is not indicative of the true value or market price" of the gas at the wellhead. The price received by the associated owners was the exact same sales price accepted by the Department as the true market value of the gas sold by the non-associated owners. The sales price received by the associated owners was thus indicative of the true value of their unprocessed gas at the wellhead.

Assuming for the sake of argument that one of the three "if" clauses does apply, the Department is then authorized to determine value, but only after "considering the sale price for cash of oil or gas of like-quality". "Considering" was defined by the Supreme Court as requiring the Department to "reasonably regard" like-kind sales. Phillips Petroleum Co., supra, at p. 889.

The Department claims that it considered the like-kind sales by the non-associated owners, but rejected them because (1) they were remote in time, and (2) the casinghead contracts allowed the Plant not to buy gas under certain circumstances. Those objections clearly do not constitute reasonable, valid reasons to reject the

like-kind sales by the non-associated owners. To the contrary, the sales by the non-associated owners were unquestionably arm's-length sales of like-kind gas made during the same time period in issue. The associated and non-associated owners should pay the same tax on the same gas.

"Value is a question of fact, and value may be shown by expert testimony or by evidence of other sales of like-quality gas." Phillips Petroleum Co., supra, at p. 889. The sales price received by the non-associated owners for their like-kind gas clearly establishes the fair market value of the identical gas sold by the associated owners. If those like-kind sales are not used to determine value in this case, then there would be no situation where like-kind sales could ever be used. In that case, the Legislature's mandate that value should be determined "considering the sale price for cash of oil or gas of like-quality" would be meaningless.

The Supreme Court approved use of the workback method in Phillips Petroleum Co. because Phillips failed to offer any like-kind sales as being determinative of the value of its gas. Rather, Phillips agreed that the work-back method could be used, and only disputed the amount that should be deducted for actual processing costs. Phillips Petroleum Co., at p. 895.

As previously discussed in the Final Order, at page eight, this case can be distinguished factually from Phillips Petroleum Co. because the Taxpayer in this case reported and paid tax based

on the sale price in the casinghead contracts. The Taxpayer also offered the casinghead contract sales by the non-associated owners as evidence of like-kind sales during the audit and at the hearing before the Administrative Law Division. Those like-kind sales offered by the Taxpayer are clearly indicative of the market value of the gas in issue and should be accepted by the Department.

Again, what the Department is attempting to do is not only tax the value of the unprocessed gas at the wellhead, which is the correct taxable measure for severance tax purposes, but also the profit derived by the associated owners from their ownership interest in the Plant. In the hypothetical set out on pages 16 and 17 of the Department's brief, the Department concludes "that the associated owner did not receive the same value for the same amount and same quality of gas as received by the non-associated owners." I disagree.

The associated owner and non-associated owner in the hypothetical both received the same $40.00 for their unprocessed gas at the wellhead, which is the taxable measure for severance tax purposes. It is irrelevant that the associated owner also received a profit (misleadingly included as "value" by the Department) for its pro-rata ownership interest in the Plant of the $60.00, less processing costs and taxes. That operating profit is not subject to severance tax.

Contrary to the Department's position, the gas sold by the associated and non-associated owners was co-mingled in the

gathering system, and it cost the Plant the same to process the identical gas. The Plant owners profited the same from processing and selling their own gas as they did from processing and selling the gas of the non-associated owners. But that profit is not subject to severance tax. Only the market value of the unprocessed gas at the wellhead is taxable, and that market value was the same for all like-kind gas purchased by the Plant.

The Department again argues that the Taxpayer's books and records are the best indicator of taxable value. However, the Taxpayer's books and records show that the Taxpayer was paid the same fair market sales price for its gas at the wellhead as were the non-associated owners. Only if the work-back method is appropriate would the Taxpayer's books and records showing actual processing costs be relevant and controlling in determining value. As stated above, the work-back method is not appropriate in this case.

Finally, I must rebut the Department's claim on page nine of its brief that the Department used the work-back method to determine the value of the gas sold by the non-associated owners.

The Department accepted the sale price paid to the non-associated owners under the casinghead contracts as the fair market value of that gas. The work-back method was not employed to determine value. The work-back method is calculated by taking the sale price of the processed gas at the tailgate and then backing out actual processing costs. Phillips Petroleum Co., at p. 888.

Obviously, actual processing costs had nothing to do with the sales price received by the non-associated owners under the pricing formula set out in the casinghead contracts. The non-associated owners received either 50% or 40% of the tailgate sales price, regardless of what it cost the Plant to process the gas.

In summary, the taxable "value" received by the associated owners for their gas at the wellhead was the actual sales price received under the casinghead contracts. That sale price represented the true market value of the unprocessed gas at the wellhead. The Department correctly accepted the casinghead contracts as the true value received by the non-associated owners. That same sale price should also be accepted for the associated owners.

But even if the sales price actually received by the associated owners is ignored, §40-20-1(3) requires that the Department must "consider" or "reasonably regard" like-kind sales in determining value. The Supreme Court has stated that "the prevalent view seems to be that the (work-back) method is to be used when there are no factually comparable sale contracts". Phillips Petroleum Co., footnote 2 at p. 890.

The sales by the non-associated owners are clearly "factually comparable" sales and are indicative of the true market value of the associated owners' gas at the wellhead. Those like-kind sales clearly establish and should be accepted as the taxable "value"

received by the associated owners for the gas in issue.

The above considered, the Final Order dismissing the final assessment in issue is affirmed. This Final Order Denying Application for Rehearing may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §§40-2A-9(f) and 40-2A-9(g).

Entered June 30, 1995.

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BILL THOMPSON
Chief Administrative Law Judge