

BEFORE THE STATE TAX APPEAL BOARD  
OF THE STATE OF MONTANA

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COMANCHE DRILLING COMPANY, )	
Appellant, )	DOCKET NO.: MT-1998-2
-vs- )	
THE DEPARTMENT OF REVENUE )	FACTUAL BACKGROUND,
OF THE STATE OF MONTANA, )	CONCLUSIONS OF LAW,
Respondent. )	ORDER and OPPORTUNITY
	<u>FOR JUDICIAL REVIEW</u>

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The above-entitled appeal came on regularly for hearing on the 8th day of March, 2000, in the City of Helena, Montana, pursuant to the order of the State Tax Appeal Board of the State of Montana (the Board). The notice of said hearing was duly given as required by law setting the cause for hearing. The taxpayers, represented by Dan Mitchell, owner; Elaine Mitchell, accountant; and Patrick Montalban, president and CEO of Mogul Petroleum Corporation, an independent oil and gas company in Cut Bank, Montana, presented testimony in support of the appeal. The Department of Revenue (DOR), represented by Van Charlton, tax specialist with the Natural Resource and Corporation License Tax Division, presented testimony in opposition thereto. At this time and place, testimony was

presented, and exhibits were received. The Board allowed the record to remain open for a period of time for the purpose of receiving a post-hearing submission from the Department of Revenue. Having received the post-hearing submission, the Board then took the cause under advisement; and the Board having fully considered the testimony, exhibits, post-hearing submission, and all things and matters presented to it for its consideration by all parties in the Docket, and being well and fully advised in the premises, concludes as follows:

FACTUAL BACKGROUND

1. Due, proper and sufficient notice was given of this matter, the hearing hereon, and of the time and place of said hearing. All parties were afforded opportunity to present evidence, oral and documentary.

2. The issue under appeal is an audit assessment for tax years 1992, 1993, 1994 and 1995.

3. Comanche Drilling (hereafter "Comanche"), owned by Dan Mitchell, is an operator for oil and gas leases in Glacier County.

4. Comanche receives twenty-five cents per barrel of oil from the purchasers (CENEX and Montana Refining) as a bookkeeping fee. Comanche issues royalty checks to the royalty owners (land owner or mineral rights

owner) in return for this payment to save the purchaser from having to perform this task.

STATEMENT OF THE ISSUE

Comanche disputes the DOR determination that the bookkeeping fee is part of the gross value, or the posted price, of a barrel of oil.

TAXPAYERS' CONTENTIONS

By way of background, before an oil and gas operator drills a crude oil well, he must talk to the land (mineral) owner, and enter into an agreement for an oil and gas lease. Once signed by the mineral owner, that lease gives the operator the right to drill an oil and gas well on the landowner's property. When oil or natural gas is found, a well is drilled and revenue is generated in the form of crude oil or natural gas. When a barrel of oil is produced, the operator has the responsibility to distribute the ownership of that barrel of oil to his partners, if any, and the royalty owners (the land or mineral owners). For illustrative purposes, if the contract price for a barrel of oil is one dollar, the operator will receive 87½ cents from the purchaser. The other 12½ cents will go to the mineral, or royalty, owners. Comanche Drilling has entered into an agreement with its purchasers to assume responsibility for paying the royalty owners. In return

for performing this task, the purchaser pays Comanche Drilling 25 cents per barrel of crude oil as a bookkeeping fee. This payment is made separately from payment for the crude oil itself. In essence, the twenty-five cents per barrel bookkeeping fee is paid to the operator by the crude purchaser to cover the costs of royalty and tax accounting distributions. As such, it amounts to an administrative fee only.

Ms. Mitchell, accountant for Comanche Drilling, outlined the chronology of the appeal: In August of 1996, the DOR performed a selective audit of Comanche Drilling.

The remaining issue resulting from that audit is Comanche's omission of a bookkeeping fee as part of the gross value in the production tax. Comanche's position is that the bookkeeping fee is not part of the gross value of a barrel of oil. Prior to this audit, Comanche had never included the bookkeeping fee as part of the gross value for production tax purposes.

Approximately one year later, Comanche received a notice of tax deficiency and interest for the years 1992 through 1995, as a result of the 1996 audit. This notice claimed that Comanche had underpaid Montana production taxes for those years, specifically, oil severance, oil privilege and license, oil resource indemnity trust tax,

oil local government severance tax and quarterly net proceeds.

Pursuant to Section 15-1-211, MCA, Comanche timely filed an objection to this assessment on September 17, 1997. Additional information regarding the subject bookkeeping fee was submitted on October 25, 1997.

By letter dated December 22, 1997, the administrator of the Natural Resource Bureau, Don Hoffman, upheld the DOR position that additional tax was due and owing for the amount received by Comanche for the twenty-five cent per barrel bookkeeping fee.

In trying to reach a settlement on this issue, Comanche was instrumental in passing legislation during the 1999 session which eliminated the twenty-five cent bookkeeping fee from consideration of the gross value of a barrel of oil. Comanche worked closely with the Department of Revenue in drafting the language for this legislation.

Comanche further argued that a taxation inequity exists because only those operators who are audited by the Department of Revenue are assessed additional tax due to the bookkeeping fee. Other operators either voluntarily include the bookkeeping fee, or exclude it due to their belief that it does not constitute gross value of production. Therefore, vast inconsistency exists in

Montana as to the amount of production tax paid by oil producers. Ms. Mitchell testified that, in her experience as an accountant with other clients, "the Department of Revenue has not even been consistent in applying the tax. In some audit cases, they include this bookkeeping fee as value. In other cases, they don't."

Mr. Montalban, a petroleum engineer and 1999 lobbyist for the Northern Montana Oil and Gas Association, spoke on the subject of the successful 1999 legislation authored by Elaine Mitchell. He stated that this legislation was pursued for two reasons: 1) it created jobs and, 2) inclusion of the bookkeeping fee in the gross value of production amounted to double taxation because the bookkeeping fee was reported as income and taxed accordingly. In addition, a production tax is paid on the actual barrel of oil itself.

Senate Bill 430, authored by Elaine Mitchell in conjunction with the Department of Revenue, was pursued in the belief that the twenty-five cents per barrel of oil bookkeeping fee paid by the purchasers had absolutely nothing to do with the price of oil. The legislation was ultimately successful and was codified under Section 15-36-305 (2), MCA, with retroactive applicability to tax years beginning after December 31, 1998:

For the purposes of determining average value at the mouth of a well, a fee of up to 25 cents a barrel paid to the operator or producer to administer royalty payments, whether or not the fee is payable on a per barrel basis, may not be considered a part of the value of the oil. (Emphasis supplied.)

DEPARTMENT OF REVENUE'S CONTENTIONS

Mr. Charlton offered DOR Exhibit A, a copy of the December 22, 1997 letter from the division administrator which contained the final agency decision in this matter. Mr. Charlton testified that the language contained in this letter constitutes the best statement of the DOR's position in this appeal:

The industry standard for fair market value is no longer merely the posted price. It is in fact the posted price plus a premium or bonus. Oil producers negotiate with purchasers to receive the best price possible. Depending upon a company's negotiation skills, the amount of bonus or premium can vary drastically. Therefore, companies are currently receiving different values for oil. In the same regard, if a company chooses to perform the royalty disbursement, it is exercising a negotiation tool in order to receive additional revenue, i.e., bookkeeping fees.

It is irrelevant to the state what label is attached to the additional payment. Our position is based on the fact that the additional revenue is directly tied to production. (Emphasis supplied.) The more the operator produces, the more revenue they

receive, even though their expenses to distribute the revenue do not increase accordingly.

Other operators distribute revenue to the interest owners and receive no reimbursement from their crude purchasers. There are also other operators who have contracted with Cenex or Montana Refining as a purchaser, receive the \$.25 per barrel "bookkeeping fee", and currently include that revenue in taxable value for tax purposes.

Based on the above reasoning, it is determined that the original assessment is correct. . .

Because the payment of the twenty-five cents per barrel bookkeeping fee was written into the contracts with the crude purchasers for the tax years at issue, the DOR's position is that this revenue is directly related to production revenue. DOR Exhibit D is a copy of a contract between Montana Refining and Comanche, dated January 28, 1987, which contains the language that ". . . Seller wishes to receive 100% of the working interest, state taxes, and royalties and to make distribution of interest and for this service Montana Refining Company will pay seller \$0.25 per barrel. . . ." DOR Exhibit C is a copy of a contract between Cenex and Danco (Dan Mitchell), dated April 19, 1994, which contains the language, "In lieu of CENEX making individual payment distribution to the Royalty and Working Interest

Owners, CENEX will pay Danco on a 100% Payment Oil Division Order Basis. Danco will distribute payment funds to the appropriate Royal and Working Interest Owners. CENEX will pay Danco twenty-five cents per net barrel by separate check for this service."

The DOR argued that the bookkeeping fee must be considered part of the gross production revenue since the agreement to pay this additional revenue is specifically stated in contract language.

DOR Exhibit B is a list of operators with which Cenex Harvest States and Montana Refining has a contract containing a twenty-five cents per barrel bookkeeping fee. This document shows that Comanche Drilling's contracts with both companies contain this fee. Exhibit B also contains two pages of references to oil and gas operators entitled "companies receiving \$.25 bookkeeping." However, Mr. Charlton testified that these are companies that "we show actually, we know from our dealings, it could have been audit, I can't swear to that fact at this point in time how we know that they paid on the twenty-five cent bookkeeping. You'll see by looking at this list, though, a lot of the companies aren't filled in. We don't have a great idea of everybody that - we didn't contact all these companies to find out because . . . there's no way we would know, based

on the information that was sent in, that the taxes were paid on that additional value or not."

Mr. Charlton corroborated the taxpayer's testimony that the DOR did work closely with the Mitchells, Mr. Montalban and other industry members on Senate Bill 430, the 1999 legislation which resulted in the elimination of the twenty-five cents per barrel bookkeeping fee from inclusion as part of the value of oil for production tax purposes.

In response to questioning by the Board, Mr. Charlton acknowledged that nothing exists "in writing" in terms of statutory authority, administrative rule, or even a Department of Revenue internal policy statement regarding the Department's authority to include the bookkeeping fee in gross revenue for production tax purposes.

#### BOARD DISCUSSION

The Board finds that the taxpayer has satisfactorily demonstrated that the DOR's inclusion of the bookkeeping fee in its additional assessment resulting from the 1992-1995 Montana production tax audit was inappropriate and will order its removal.

The DOR could provide no support in the form of statutory authority or administrative rule for consideration of this bookkeeping fee as part of the value

of oil. The Board concludes that this bookkeeping fee is just that and has no relationship with the posted price (value) of oil specified in the contractual language presented at hearing. The Department of Revenue has taken a position, as discussed in its December 27, 1997 letter containing the administrator's final decision, which is not founded in statutory or administrative rule, or even by DOR policy.

The value of a barrel of oil is paid directly from the posted price in the contract with the purchaser. The twenty-five cents per barrel bookkeeping fee is simply a payment by the purchaser to the operator for performing accounting services.

The Board concludes that, since the DOR worked closely with the oil and gas industry in seeking to provide statutory clarification regarding this issue, it (the DOR) agrees with industry's contention that the posted price of oil as found in contractual language is the pivotal element in revenue generation for production tax purposes.

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The Board asked the DOR to provide a breakdown of the subject assessment, as it pertained to the bookkeeping issue herein, for the audit years in question. This document was received in our office on March 28, 2000:

<b>Year</b>	<b>Tax</b>	<b>Interest</b>	<b>Total Due</b>
1992	\$513	\$433	\$946
1993	\$438	\$314	\$752
1994	\$524	\$313	\$837
1995	\$437	\$145	\$535
<b>Totals</b>	<b>\$1,912</b>	<b>\$1,205</b>	<b>\$3,070</b>

CONCLUSIONS OF LAW

1. The Board has jurisdiction in this matter pursuant to Section 15-2-302, MCA.

2. The appeal of the taxpayer is hereby granted and the decision of the Department of Revenue is hereby reversed.

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ORDER

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the Department of Revenue shall remove the assessment and interest charges (\$3,070 through March 2000) relating to the 25 cent per barrel bookkeeping fee for the tax years in question.

Dated this 4<sup>th</sup> day of April, 2000.

BY ORDER OF THE  
STATE TAX APPEAL BOARD

( S E A L )

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GREGORY A. THORNQUIST, Chairman

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JAN BROWN, Member

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JERE ANN NELSON, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 4th day of April, 2000, a true and correct copy of the foregoing has been served on the parties hereto by depositing a copy thereof in the U.S. Mails, postage prepaid, addressed to the parties as follows:

Attn: Elaine Mitchell  
Comanche Drilling Company  
P.O. Box 636  
Cut Bank, Montana 59427

Don Hoffman  
Bureau Chief  
Natural Resource and Corporation License Tax Division  
Department of Revenue  
Sam Mitchell Building  
Helena, Montana 59620

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Donna Eubank  
Paralegal