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Oil and Gas - Taxation of Mineral Interests - Legal Aspects of Severance Taxes on Petroleum Resources

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NOTES

Oil and Gas — Taxation of Mineral Interests — Legal Aspects of Severance Taxes on Petroleum Resources. — The major problem faced by a state in taxing oil and gas interests is that of determining whether an ad valorem property tax or a severance tax should be used. The former method involves valuation and assessment of the oil and gas lease itself.[1] Since this is difficult, no less than sixteen states [2] have severance tax statutes which levy on the working and royalty interests an impost on production measured by the gross value of the oil and gas produced.[3] This is alternatively called an excise, occupation, or gross production tax and is almost without exception classified as a privilege tax on the business of producing oil and gas rather than as a property tax.[4] Some states impose the tax in lieu of existing taxes while others superimpose it in addition to general ad valorem property taxes. The tax is borne ratably by the lessee and royalty owner in some states while the lessee alone bears the burden in others.[5] The North Dakota Legislature has recently enacted such a tax statute entitled "an act to provide a gross production tax on producing oil and gas properties in lieu of other taxes." [6] This note attempts to analyze

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1. Haglund, *Taxation of Oil & Gas Interests,* 20 Ky.L.J. 224,239 (1932).
2. 4 Summers, Oil & Gas §§801-814 (2nd ed. 1938).
3. Haglund, *supra,* note 1, at 239.
4. See discussions *infra,* on the gross production tax in Oklahoma and Wyoming; Gulf Refining Co. v. McFarland, 154 La. 251, 97 So. 433 (1923), *aff'd.,* 264 U.S. 573 (1924).
5. 4 Summers, *op.cit. supra* note 1, §801.
6. N.D. Sess. L. c. 339 (1953). The pertinent sections of this act are as follows:

Section 2.—"A tax of four-and-one quarter per centum of the gross value at the well is hereby levied upon all oil and gas produced within the state of North Dakota, less the value of any part thereof, the ownership or right to which is exempt from taxation. The tax hereby levied shall attach to and is hereby levied upon the whole production, including what is commonly known as the royalty interest."

Section 3.—"The payment of the taxes herein imposed shall be in full, and in lieu of all ad valorem taxes by the state, counties, cities, towns, townships, school districts and other municipalities, upon any property rights attached to or inherent in the right to producing oil and/or gas, upon producing oil and/or gas leases, upon machinery, appliances and equipment used in and around any well producing oil or gas and actually used in the operation of such well, and also upon oil and gas produced in the state upon which gross production taxes have been paid, and upon any investment in any property hereinbefore in this paragraph mentioned or described. Any interest in the land, other than that herein enumerated, shall be assessed and taxed as other property within the taxing district in which such property is situated. It is expressly provided that the gross production tax shall not be in lieu of income taxes nor excise taxes upon the sale of oil and gas products at retail."

Section 4—"No equipment, material or property shall be exempt from the payment of ad valorem tax by reason of the payment of the gross production tax as herein provided except such equipment, machinery, tools, material or property as is actually necessary and being used at the site of a producing well in the production of oil or gas; and it is expressly declared that no ice plants, hospitals, office buildings, garages, residences, gasoline extraction or absorption plants, water systems, fuel systems, rooming houses and other buildings, nor any equipment or material used in connection therewith shall be exempt from ad valorem tax, nor shall drilling rigs be exempt except as provided in the salient legal issues involved in the severance or gross production tax as they affect both the producer and lessor of petroleum resources.

It is generally held that a tax upon ". . . each corporation, association, or person engaged in the business of severing from the soil oil or gas . . ." [7] is a tax upon the lessee's occupation and thus a privilege tax.[8] The obvious intent has been to circumvent the inexactitudes

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section 57-0219. The real property shall not be exempt under this Act except to the extent of the mineral interests therein."

Section 5.—"The gross production tax on oil or gas, as herein provided, shall be paid on a quarterly basis. Said tax shall become due on the last day of the calendar month following the preceding quarterly period on all oil or gas produced in and saved during the preceding quarterly period, and if the tax is not paid on or before the end of the month succeeding the month in which the same becomes due the tax shall become delinquent and shall be collected as herein provided. On oil or gas sold at the time of production, the gross production tax therein shall be paid by the purchaser, and such purchaser shall and is hereby authorized to deduct in making settlement with the producer and/or royalty owner, the amount of tax so paid; provided, that in the event oil on which such gross production tax becomes due is not sold at the time of production but is retained by the producer, the tax on such oil not so sold shall be paid by the producer for himself including the tax due on royalty oil not sold; provided further, that in settlement with the royalty owner such producer shall have the right to deduct the amount of such tax so paid on royalty oil or to deduct therefrom royalty oil equivalent in value at the time such tax becomes due with the amount of the tax paid. Gas when produced and utilized in any manner, except when used for fuel or otherwise used in the operation of any lease or premises in the drilling for or production of oil or gas therefrom, or for repressuring thereon, shall be considered for the purpose of this Act, as to the amount utilized, as gas actually produced and saved. In case oil or gas is sold under circumstanes where the sale does not represent the cash price thereof prevailing for oil or gas of like kind, character or quality in the field from which such product is produced, the state tax commissioner may require the said tax to be paid upon the basis of the prevailing price then being paid at the time of production thereof in said field for oil, or gas of like kind, quality and character."

Section 6.—". . Reports from either purchaser and/or producer . . . shall be delinquent thirty days after the time fixed for filing the same, and every person required to file such report shall be subject to penalty of twenty five dollars per day for each property upon which such person shall fail or refuse to file such reports. The penalties . . . shall be in addition to the penalty imposed at the rate of seven per cent per annum for delinquent tax, and shall likewise constitute a lien against the assets of such person failing or refusing to file such reports . . ."

Section 8.—"The state board of equalization, upon its own initiative, may, and upon complaint of any person who claims that he is taxed too great a rate hereunder, shall, take testimony to determine whether the taxes herein imposed are greater than the general ad valorem tax for all purposes would be on the property of such producer subject to taxation in the district or districts where the same is situated and also the value of oil, gas, or mineral leases, or of the mineral rights, the machinery, equipment or appliances used in the actual operation of, in and around any such well, the value of the oil and/or gas produced and any other element of value in lieu of which the tax herein is levied. In determining the amount of tax payable under the general ad valorem tax, the average statewide mill levy of the state and its political subdivisions shall be applied. The said board shall have power and it shall be its duty to lower the rates herein imposed to conform thereto."

Section 11.—"The tax herein referred to shall, at all times, be and constitute a first and paramount lien against the purchaser's or producer's property as the case may be, both real and personal. . . ."

7. Mich. Comp. Laws, c. 205, §205.301 (1948).

8. *E.g.*, Swiss Oil Corp. v. Shank, 208 Ky. 64, 270 S.W. 478 (1925) *aff'd.*, 273 U.S. 407 (1927); Floyd v. Miller Lumber Co., 160 Ark. 17, 254 S.W. 450 (1923); Gulf Refining Co. v. McFarland, 154 La. 251, 97 So. 433, 434 (1923) ("A severance tax, even though it is measured by the value of the property severed, is not a property tax; it is an excise tax upon the privilege of severing; just as an inheritance tax, exen though measured by the value of the property inherited, is not a property tax, but an excise tax on the right of inheriting"); Mid-Northern Oil Co. v. Walker, 65 Mont. 414, 211 Pac.

of property valuation and the attendant constitutional strictures of a property tax, for many states have uniformity and equality prohibitions on levy and assessment in this respect.[9] The decisions of two states, Oklahoma and Wyoming, are unique in classifying the gross production taxes of those states as property taxes. Since the North Dakota statute is a near replica of Oklahoma's legislation, it seems desirable to analyze the arguments underlying the Oklahoma construction of the tax as one on property. Two overriding reasons present themselves in support of this incongruity. First, until 1949 it was difficult to impose an occupation or severance tax, in addition to existing property taxes, upon an oil producer who was a lessee of Indian lands for fear that the "federal instrumentality doctrine" would be invoked.[10] In the following instances the Supreme Court has held a state tax upon a lessee of federal Indian lands to be invalid because the lessee, being an agent or instrumentality of the Federal Government, was immune for taxation: a severance tax imposed on each barrel of oil produced; [11] a gross production tax; [12] a tax on the value of oil leases; [13] a tax upon the gross sales of a coal producer; [14] and a tax on the net income derived from the sale of oil under an Indian lease.[15] The doctrine had even gained approval respecting state school lands.[16] However, a long line of decisions has established that property belonging to an individual which is used in the performance of services for the

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353 (1922); Flynn, Welch & Yates, Inc. v. State Tax Commission, 38 N.M. 131, 28 P.2d 889 (1934) (A tax levied in proportion to minerals production is valid as an excise tax); Group No. 1 Oil Corp. v. Sheppard, 89 S.W.2d 1021 (Tex. Civ. App. 1935).

9. This pertains to a tax statute which attempts to include in the value of the lease the lessor and lessee's property interests, including the entire mineral value of the land. Valuations of property interests for this purpose are usually based upon the figure derived from a voluntary cash sale in the market place. To arrive at such a valuation is difficult indeed, especially concerning unsevered minerals. Phillips Petroleum Co. v. Townsend, 63 F.2d 293 (5th Cir. 1933) (Plaintiff sought to enjoin the collection of a property tax valued by multiplying the average daily production of each oil lease by $200 per barrel on the grounds that this method of assessment was discriminatory in contravening Article 8, section 1, Constitution of Texas, which demands equal, uniform taxation of property, proportionate to its reasonable cash market value. Assessment of plaintiff's oil properties at full market value, whereas banks in the county were assessed at seventy per cent, was the alleged discrimination. By dictum the court said: "Discrimination, intentional, systematic, and persistent, in valuation entitles the taxpayer to relief in state or federal courts, although his own property may not have been assessed above its full, fair value."

10. See *infra* note 11.

11. Oklahoma v. Barnesdall Refineries, 296 U.S. 521 (1936); Large Oil Co. v. Howard, 248 U.S. 549 (1919).

12. Howard v. Gypsy Oil Co., 247 U.S. 503 (1918).

13. Indian Oil Co. v. Oklahoma, 240 U.S. 522 (1916).

14. Choctaw & Gulf v. Harrison, 235 U.S. 292 (1914).

15. Gillespie v. Oklahoma, 257 U.S. 501 (1922).

16. Burnet v. Colorado Oil & Gas Co., 285 U.S. 393 (1932).

Federal Government is subject to state and local property taxes,[17] produced oil and gas being no exception where it is separated and withdrawn from restricted Indian lands.[18] In order to tax the lessee of Indian lands Oklahoma has thus consistently construed its gross production tax as a property tax.[19] The reciprocal immunity of state and federal instrumentalities from taxation was, however, steadily narrowed by federal decisions. The trend culminated in *Helvering v. Mountain Producers Corporation*,[20] in which it was held that a tax on the net income of a lessee of land belonging ot a state government was not unconstitutional as a tax upon an instrumentality of the state. The language used in the opinion clearly indicated that the Supreme Court had switched to the view that a tax was not unconstitutional if its effect upon a government —whether federal or state—was remote at best. The *Mountain Producers* case obviously indicated that the immunity of lessees of Indian land from state occupational or privilege taxes could not be expected to survive long. Supported by this decision, the Supreme Court upheld the constitutionality of such taxation in 1949,[21] thus overruling the cases which had supported the federal instrumentality doctrine.[22] It seems accurate to conclude that the rule that the privilege of extracting oil from Indian lands is untouchable by the state taxing authorities has given way to a rule that the constitu-

17. Choctaw, O. & G Ry. v. Mackey, 256 U.S. 531 (1921); Gromer v. Standard Dredging Co., 224 U.S. 362 (1912); Central Pacific Ry. v. California, 162 U.S. 91 (1896); Union Pacific Ry. v. Peniston, 18 Wall. 5 (U.S. 1873); Thomson v. Pacific Ry., 9 Wall 579 (U.S. 1869).

18. Indian Territory Illuminating Oil Co. v. Board of Equalization, 288 U.S. 325, 328 (1933) ("The holding of the oil . . . which had been segregated and withdrawn from the restricted lands as petitioner's exclusive property [after the Indian-lessors had been recompensed for royalty] was for its sole advantage and cannot be said to be so identified with its operations as a governmental instrumentality as to entitle it to exemption from the general property taxes").

19. Peteet v. Carmichael, 191 Okla. 593, 131 P.2d 767 (1942); State v. Indian Royalty Co., 177 Okla. 238, 58 P.2d 601 (1936); Meriwether v. Lovett, 166 Okla. 73, 26 P.2d 200 (1933); *In re* Protest of Bendelari, 82 Okla. 97, 198 Pac. 606 (1921); *In re* Indian Territory Illuminating Oil Co., 43 Okla. 307,142 Pac. 997 (1914) (reversed on other grounds).

20. 303 U.S. 376, 386 (1938) (". . . Immunity from non-discriminatory taxation sought by a private person for his property or gains because he is engaged in operations under a government contract or lease cannot be supported by merely theoretical conceptions of interference with the functions of government. Regard must be had to substance and direct effects. And where it merely appears that one operating under a government contract or lease is subjected to a tax with respect to his profits on the same basis as others who are engaged in similar businesses, there is no sufficient ground for holding that the effect upon the Government is other than indirect or remote").

21. Oklahoma Tax Comm'r v. Texas Oil Co., 336 U.S. 342, 365 (1949) (The court held that a lessee of mineral rights in allotted and restricted Indian lands was not immunized by the Constitution against payment of non-discriminatory state gross production and excise taxes on severed petroleum from such land. "But, so far as concerns private persons claiming immunity for their ordinary business operations (even though in connection with governmental activities), no implied constitutional immunity can rest on the merely hypothetical interferences with governmental functions . . ."

22. See *supra* notes 11-16.

tionality of such state taxes is determined by the manner in which the burden of the tax is placed; and that a severance tax upon a lessee of Indian lands is valid if it is non-discriminatory and imposes no direct and substantial burden on the federal government.[23] Wyoming imported Oklahoma's logic in construing its gross production tax on oil as a property tax on the basis of the same considerations which had moved the Oklahoma courts. Since much of Wyoming's oil was on federal and state tax-exempt lands, the severed mineral interest had to be considered taxable as personal property in order to be taxable at all.[24]

The second reason behind Oklahoma's unusual construction of the gross production impost as a property tax lies in the nature of the tax's operation. The following considerations have been determinative in establishing the severance tax as a property tax in that state: [25] (a) the fact that the rate of the tax depends upon the gross value of severed oil and gas less royalty interest; (b) the fact that the tax is a complete substitute and in lieu of all state and local taxes [26] upon property rights [27] in the minerals and other interests; (c) the fact that interests in land not enumerated or oil produced but stored on hand are taxed as other property; (d) the fact that a board of equalization is empowered to raise or lower the rates in conforming to the property tax rate;[28] and (e) the fact that the tax is not payable for engaging in the business of oil production but on the property injected into commerce in accordance

23. Note, 17 Geo.Wash.L.Rev. 570 (1949).

24. Board of Comm'r v. Bernardin, 74 F.2d 809 (10th Cir. 1934) (The gross products tax is a personal property tax measured by the gross mineral production and such a construction of the tax is more beneficial to the state); *see* Miller v. Buck Creek Oil Co., 38 Wyo. 505, 269 Pac. 43, 44 (1928) (A gross production tax is a property tax).

25. Large Oil Co. v. Howard, 63 Okla. 143, 163 Pac. 537 (1917).

26. Carpenter v. Shaw, 134 Okla. 29, 272 Pac. 393 (1928) (The clause was said to impose a property tax assessed on the production of minerals based on gross proceeds with everything incident to a lessee's production similarly taxed); *In re* Skelton Lead & Zinc Co., 81 Okla. 134, 197 Pac. 495, 497 (1921) (In construing the provision that the tax shall be in lieu of all state, county, city, township, and school district taxes upon property rights attached to or inherent in the right to oil and gas, upon oil leases, and upon machinery actually used in and around the well, the court said that the Legislature "had no other object than to levy a property tax upon mining property according to its fair cash value, using the measure therein adopted for ascertaining such value. . . . The tax . . . is not levied upon the mine products themselves, but . . . upon the entire property . . . as a going concern, the value of which . . . is to be ascertained by the gross value of the products").

27. Meriwether v. Lovett, 166 Okla. 72, 26 P.2d 200 (1933) (Minerals which are unproduced but conveyed to a lessee and the lessee's working interest are not subject to the ad valorem tax upon the surface owner's estate since severed oil upon the same land is already subject to the gross production tax).

28. *In re* Assessment of Champlin Refining Co., 186 Okla. 625, 99 P.2d 880 (1940) (An attempt to meet the' equality clause of state constitutions concerning property taxes); In re Protest of Bendelari, 82 Okla. 97, 198 Pac. 606 (1921) (Such a device in the tax statute is an attempt to adjust indiscriminate assessments in the same manner as a complainant obtains property tax equalization).

with its actual market value and which is a substitute for a property tax on all means by which oil and gas is produced.[29] Since our statute contains all of these factors [30] it would not be impossible to construe the tax as one on property; however, the probability is otherwise in light of the recent Supreme Court decision on Indian lands.[31]

Some jurisdictions agree that when the severance tax statute expressly provides that the lessor and lessee shall pay the severance tax according to their respective interests in the severed oil, the lessor must pay his share either personally or as a deduction from the royalty payment in case it is paid by the producer or purchaser of oil.[32] This rule obtains even though the producer has contracted to deliver the lessee's one-eighth royalty payment free of cost,[33] or expense of development and operation of the leasehold,[34] or to pay the full amount of the oil bonus,[35] or a contract to remit full royalty payment has been executed before passage of the gross production statute imposing liability on the lessor for his share.[36] The rationale supporting a tax on royalty interest, sanctioned by the Supreme Court,[37] is as follows: both the lessor and lessee are engaged in a common venture for the mutual benefit of each party; the lessee is concerned with exploration, drilling and pumping oil while the lessor is concerned with the right to explore and oil payments in the joint venture; both are devoted to the mutual purpose of producing oil and it is this production which is taxed according to the direct and beneficial interest of each royalty owner and producer.[38] In this respect the royalty owner is considered as engaging

29. Carpenter v. Shaw, 134 Okla. 29, 272 Pac. 393 (1920).

30. See *supra* note 6.

31. See *supra* note 21.

32. McLean v. Stanolind Oil & Gas Co., 238 S.W.2d 268 (Tex.Civ.App.1951)(a statute which provides that the purchaser of oil must pay the gross production tax, deducting the proportionate amounts from the royalty and producing interests, renders the royalty owner liable for his share).

33. McLean v. Stanolind Oil & Gas Co. *supra* note 32; Trustee of Cook's Estate v. Sheppard, 89 S.W.2d 1026, 1027 (Tex.Civ.App.1935) (A royalty of one-eighth of all oil produced and deliverable free of costs allows the deduction of the tax without impairment of the contract).

34. Cities Service Oil Co. v. McCrory, 191 S.W.2d 791, 792 (Tex.Civ.App.1945) (A contract providing that the producer shall pay costs of operation and development excludes the gross production tax since it is not an expense of operations and development).

35. Sheppard v. Stanolind Oil & Gas Co., 125 S.W.2d 643, 648 (Tex.Civ.App. 1939).

36. *Cf.* Barwise v. Sheppard, 299 U.S. 33 (1936) (A lessor cannot contract away the power of the state to impose a tax or prescribe who shall pay).

37. Barwise v. Sheppard, *supra* note 36.

38. Barwise v. Sheppard, *supra* note 36; Gulf Refining Co. v. Stone, 197 Miss. 713, 21 So.2d 19 (1945) (Since the lessor obtains his royalty payment by virtue of the lessee's activities in severing the oil he is thus essentially associated with production); Flynn, Welch & Yates, Inc., v. State Tax Comm'r., 38 N.M. 131, 28 P.2d 889 (1934) (The lessor and lessee participate in a joint venture and the tax is essentially occupational according

in the occupation of producing oil and is hence subject to the excise.

Other jurisdictions hold that a tax on the business of producing oil payable by each person in proportion to his interest in such production imposes no liability upon the royalty owner to pay a severance tax on his one-eighth payment,[39] but they generally agree, with the rest of the courts, that the lessee is liable for his share of the tax.[40] Since the royalty payment in these jurisdictions is held to be rent or in the nature of rent and therefore taxable as income, and since the taxation of income from the land is in effect a tax upon the land itself, the tax is actually one upon the property.[41] The royalty owner is thus not engaged in an occupation but is the recipient of income and an excise as to him would be invalid in states such as Illinois, which has a provision in its Constitution providing that a tax on property must be in proportion to its value, assessable by representatives of the General Assembly.[42] Moreover these jurisdictions hold that the royalty owner is not engaged in a common venture, and is not to be taxed as one habitually engaged in the occupation of producing oil since he merely receives income or rent in the same way a stockholder receives dividends from a corporation.[43] He is, furthermore, not a joint venturer because he cannot drill or take oil from the premises without the lessee's consent, and he cannot control operations.[44] Summarily, it seems that in the absence of a constitutional provision like Illinois' and in the absence of a construction of the royalty owner as the recipient of income and a non-participant in production, a severance tax upon the royalty payment is valid.

The Supreme Court has never invalidated a severance tax as being a burden on interstate commerce in violation of the commerce clause of the Federal Constitution.[45] The basic groundwork

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to their respective interests); Group No. 1 Oil Corp. v. Sheppard, 89 S.W.2d 1021 (Tex.Civ.App. 1935) (The producer is an agent of the state collecting from each interest holder the share of the tax owed).

39. Ohio Oil Co. v. Wright, 386 Ill. 206, 53 N.E.2d 966 (1944) (exhaustive review of the authorities on this proposition).

40. Swiss Oil Corp. v. Shanks, 208 Ky. 64, 270 S.W. 478 (1925), *aff'd,* 273 U.S. 407 (1927); Standard Oil Co. v. Police Jury, 140 La. 42, 72 So. 802 (1916); Mid-Northern Oil Co. v. Walker, 65 Mont. 414, 211 Pac. 353 (1922); Kanawha Valley Bank v. United Fuel Gas Co., 121 W.Va. 96, 1 S.E.2d 875 (1939); *cf.* Oliver Iron Mining Co. v. Lord, 262 U.S. 172 (1923).

41. Burnet v. Harmel, 287 U.S. 103 (1932); Von Baumbach v. Sargent Land Co., 232 U.S. 503 (1917); U.S. v. Noble, 237 U.S. 74 (1915); Callahan v. Martin, 33 Cal. 2d 110, 43 P.2d 788 (1935); Bachrach v. Nelson, 349 Ill. 579, 182 N.E. 909 (1932); Boeing v. Owsley, 122 Minn. 190, 142 N.W. 129 (1913).

42. Ill. Const. Art. IX, §1.

43. *Cf.* Dawson v. Kentucky Distilleries, 255 U.S. 288 (1921); McCoach v. Minehill & S. Ry., 228 U.S. 295 (1913)); Zonne v. Minn. Syndicate, 220 U.S. 187 (1911).

44. Ohio Oil Co. v. Wright, 386 Ill. 206, 53 N.E.2d 966 (1944).

45. U.S. Const., Art I, §8, cl. 3; See the discussion in Comment, *Natural Resource Taxation and the Commerce Clause,* 30 Texas L. Rev. 96 (1951).

for this proposition was laid in *Oliver Iron Mining Co. v. Lord,*[46] where the Supreme Court upheld a Minnesota occupation tax of six per cent of the value of severed iron ore, though ninety-eight per cent of the production entered interstate commerce. The court said that the tax was imposed upon mining before the ore entered the channels of commerce and affected interstate commerce only indirectly or incidentally at most. This rule has withstood the expansion of federal control via the lever of the commerce clause.[47] The validity of a severance tax, the value of which is measured at some point beyond immediate severance, is more uncertain because the chance it will affect interstate commerce is more direct The court in *Eastern Gulf Oil v. Kentucky,*[48] for example, held that a severance tax measured by the value of oil produced was violative of the commerce clause because the measurement attached, not while the oil was in the producer's possession, but while it was in the hands of the transporter while it had become an article of commerce. But this is a problem in itself.

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46. 262 U.S. 172 (1923).
47. National Labor Relations Board v. Jones & Laughlin, 301 U.S. 1 (1937) (Congress has power to regulate any and all activity which affects interstate commerce).
48. 17 F.2d 394 (E.D. Ky. 1926).