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REVENUE ADMINISTRATIVE BULLETIN 2019-23

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ALLOWABLE MARKETING COST DEDUCTIONS TO SEVERANCE TAX ON NATURAL GAS

(Replaces Revenue Administrative Bulletins 1989-19, 1989-20, 1992-5 and 1992-9)

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

RAB 2019-23.

This Revenue Administrative Bulletin ("RAB") replaces RABs 1989-19, 1989-20, 1992-5, and 1992-9 and updates the Department's guidance regarding allowable marketing cost deductions to the severance tax on natural gas under 1929 PA 48, MCL 205.301 *et seq.* ("Act").[1]

Background

The Michigan Severance Tax Act levies a tax on each producer[2] (or pipeline company, common carrier, or common purchaser, for and on behalf of a producer) engaged in the business of severing natural gas from the soil in Michigan.[3] The severance tax on natural gas is equal to 5% of the "gross cash market value of the total production of gas" (exclusive of production or proceeds from the production attributable to the state, federal, or local government).[4] The Act provides that the value of *all* production "shall be computed as of the time when and at the place where the production was severed or taken from the soil immediately after the severance."[5] This means that the taxable value of the production is to be computed at the wellhead.[6]

If the market is away from the wellhead, or when there are conditioning and/or plant facilities between the wellhead and the sales meter (because the gas is not salable at the point of severance), the purchase price may not be the proper basis for computing the severance tax. This is due to the

[1] This bulletin is limited to gas production since marketing costs for Michigan oil and condensate are inapplicable.
[2] The Act defines a "producer" as the "person who owns, or is entitled to delivery of a share in kind or a share of the monetary proceeds from the sale of, gas or oil as of the time of its production or severance." MCL 205.312(2).
[3] MCL 205.303(1).
[4] *Id*.
[5] *Id*.
[6] See *Schroeder v Terra Energy, Ltd*, 223 Mich App 176, 190-191 (1997).

fact that there may be marketing costs allowed as deductions from the selling price determined when title to the severed gas transfers to the purchaser of the gas. In general, "marketing costs" refers to certain costs incurred after production of the gas from the well in order to get the gas in a suitable condition to be sold and delivered to market. These marketing cost deductions may be taken to arrive at the taxable value at the wellhead.

General Rules Regarding Marketing Costs

- Marketing costs do not include any costs associated with producing gas or with the separation of natural gas from oil, condensate and water (i.e., lease separation).
- The cost must be necessary and essential to marketing the gas.
- The cost must be directly related to the physical handling of the gas.

Costs Not Deductible as Marketing Costs

A foundational principle surrounding the marketing cost deduction is that the deduction is related to gas that has already been severed from the ground and, if applicable, has undergone normal lease separation. Therefore, deductible marketing costs do not include any of the following:

- Cost incurred for wellhead and downhole equipment or operations.[7]
- Costs incurred in producing the gas, including the costs of (or relating to) production equipment.[8]
- Costs incurred in normal lease separation, including costs relating to required equipment up to and through lease separation.[9]

In addition, deductible marketing costs *exclude* certain capital and operating costs[10] and certain metering costs.[11] Other costs incurred after production that are not deductible as marketing costs include costs for certain lease equipment after the wellhead.[12]

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[7] Examples include: acidizing; casing; cementing; drill pipe; fishing/fishing tools; fracturing; hot oiling/hot oil treatment (unless used in flow lines); injecting baroid; logging; packers/setting packers; paraffin removal; paraffin inhibitors used downhole; perforating; swabbing; tubing; well service; methanol injected into well; wire line service.

[8] Examples include: Christmas tree; compressors (wellhead, suction, vacuum) used to create vacuum or suction pressure to aid production; corrosion inhibiting chemicals (unless used in pipelines that are part of marketing function); electricity and/or lease gas to run pumping unit; rods and pulling rods, submersible pumps; tanks and tank/vessel cleaning.

[9] The Department considers the normal lease separation of oil or condensate from the gas, and all functions prior to the separation, to be production costs and not allowable marketing cost deductions. Until such time that the normal lease separation occurs, the products are not yet defined as gas, oil, or condensate, so the production has not yet ceased. Accordingly, any and all severed gas that is used or consumed to operate the on-lease or off-lease normal lease separation functions is taxable for Michigan severance tax purposes.

[10] Examples of *capital* costs that are not deductible as marketing costs include: fencing; safety shut-in systems; water and lift lines; facility construction for (or related to) non-qualifying equipment; insulation and painting; buildings; noise suppression; environmental monitoring; and construction overhead related to non-qualifying equipment. Examples of *operating* costs that are not deductible as marketing costs include: liability and property insurance; snow removal and ground maintenance; water and lift line repair, materials, and labor; production-related first level

<u>Costs Generally Deductible as Marketing Costs</u>

All of the following are generally allowed as marketing costs, which may be deducted from the selling price to arrive at the wellhead value for severance tax purposes (unless noted as disallowed in this RAB):

- Plant investment, straight-line depreciation for each year of the statutory period in accordance with provisions of the Internal Revenue Code.[13]
- Operating costs for each year.[14]
- Amortization of a purchased capital asset (limited to qualifying equipment).[15]
- Return on investment, based on the average prime rate for the year of production applied against the average of yearly beginning and ending depreciated investment.
- Direct overhead (i.e., administrative costs directly allocated to the plant operation) and other overhead costs - limited to 6%.[16]
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- Other labor expenses (employee and contract)[17] such as pumper wages, salaries and benefits that are necessary to keep persons working on marketing equipment employed – variable percentage allowed to be deducted.[18]

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supervision; monitor/safety device operation; delivery costs of oil, methanol, and glycol; environmental protection and safety; and administrative overhead not otherwise allowable as described in this RAB.

[11] Examples include : check meters (used to verify sales volume); meter on test separator; and meter to measure lease use gas.

[12] Examples include: air compressors to start lease equipment; compressors for gas lift systems and/or to return gas to leases; breakout of heater and removal or set new heater and start hook-up (unless a qualifying line heater); line heater before first separator; compressors used in transmission line after sale has been made; concrete pad around compressor used to reduce environmental clean-up by collecting oil and drainage; demulsification chemicals; heater treater; hydrogen sulfide monitoring; Lease Automatic Custody Transfer (LACT) Units; oil/condensate storage tanks; painting separators; water/lift pipeline between wellhead and separator; and vapor recovery units (unless used to capture vapors that are subsequently metered and sold).

[13] Examples include: costs of facility construction for (or related to) qualifying equipment such as pipes, valves, fittings, concrete, cranes); inlet compressors; tailgate compressors (if handling sales gas before the sales meter); propane compressors (before the sales meter); trucks for intra-plant transportation (limited to 6% overhead rate); control room computers; and de-methanization expenses, water chilling expenses, and other similar compression, dehydrating, or sweeting equipment not otherwise described in this RAB.

[14] Examples include: hydrostatic testing for pressure and water in pipelines (after separation and if pipeline qualifies for marketing deduction); gas gathering line repair, sales line repair, material and labor; gas scrubbers and filters; H_2S and CO_2 removal; vapor recovery units used to capture vapors that are subsequently metered and sold; ad valorem taxes (on value of marketing facilities/equipment only); and chemical injection to protect qualifying equipment.

[15] If a capital asset that qualifies as a deductible marketing cost is sold, the purchaser of the asset may deduct as future marketing costs the amortized costs of that asset. The purchaser must be able to provide documentation of the purchase price of the equipment being amortized upon request of the Department subject to the applicable statute of limitations.

[16] Examples include: materials and supplies; field supervisor cost (salary and transportation); general administrative expenses and similar items such as cellular phone in pumper's truck, radios, and CBs; meals and food expenses for pumper/gauger; transportation expenses for pumpers/gaugers (trucks); safety clothing (required by OSHA or EPA); supervisors of company and contract labor; and training classes for pumpers.

- Certain metering costs.[19]
- Fees for rental of post-production equipment owned by a third-party to make gas salable, such as equipment for compressing, dehydrating, or sweetening the gas (except if disallowed as described in this RAB).[20]

Other costs incurred after production that are deductible as marketing costs include costs of (or relating to) certain lease equipment after the wellhead for gas gathering[21] and for compressing, dehydrating, or sweetening the gas.[22]

Notice to Common Purchaser of Marketing Cost Deductions

The Department will allow a producer to provide the common purchaser with the allowable deductions for marketing costs to be used in completing the common purchaser's severance tax report. Such notice may also inform the common purchaser of any exempt interest holders as provided in MCL 205.303. The purchaser shall not accept any deductions or exempt interest claims by the producer without prior approval by the Department. Such approval is to be obtained by submitting a separate letter (detailing the request for deductions or exemptions from the sales/purchase price per thousand cubic feet ("MCF") or per million British thermal units ("MMBTU").

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[17] Company labor costs are not allowed as deductions when the company has hired contractors to work on the marketing equipment, but the contract labor expenses can be claimed on the marketing equipment. If the contractors work only on specific equipment (e.g., the compressor), then an appropriate percentage of company labor costs can be allowed as deductions for time spent on other marketing equipment.

[18] The exact percentage of these expenses that is deductible depends on the employee's or contractor's overall duties and the types of equipment on which the employee or contractor works. The Department will allow a standard percentage of 50% of the labor expenses on gas wells (or in the case of oil wells for casing head gas, 25% of the labor expenses) without supporting documentation. If the taxpayer wants to claim a higher percentage, the taxpayer must provide a detailed analysis of how the employee or contractor spends his or her time and an analysis of the equipment on the various leases on which the employee or contractor works.

[19] Examples include: gas analysis expenses to ensure contract requirements are met; sales meters (i.e., meter on which payment is based); allocation meters (if one well or lease is paid from a single purchase meter); meter calibration services (for sales and allocation meters only).

[20] These fees are deductible as a monthly expense.

[21] Gas gathering lines between the mouth of the well and the central processing facility are deductible.

[22] Examples include: electrical material and installation for (or related to) qualifying equipment; cathodic protection; chrome/stainless steel piping for handling gas with high H_2S content (if piping qualifies as marketing deduction); clean contacts for coffing for compressors; compressors used to get gas up to required sales pressure; compressors at central facility; concrete slab for qualifying compressors; dehydrators; lease use gas used in a qualifying compressor or dehydrator; filters for qualifying equipment; flow lines from separator to purchaser's transmission line; glycol for use in dehydrators; fin fans; line heaters located after the separator; pigs and pigging equipment; methanol for gas line; pipeline between wellhead and sales line if no lease separation and separation prior to sale (marketing costs must be allocated between gas and condensate – deduct portion of line allocated to gas only); pipeline between wellhead and plant if there is no lease separation and gas is going full well stream to the plant for processing (marketing costs must be allocated between gas and condensate – deduct portion of line allocated to gas only); pipeline after first separator (between separator and sales line); shed/covers over sales compressor; skid mounting of sales compressor; and H_2S removal and sweetening processes including related chemicals not otherwise addressed in this RAB.

Computation of Allowable Marketing Costs

After the marketing costs are determined, they must be divided by the actual throughput volume of product for the plant equipment to arrive at the MCF or MMBTU allocation.

The allowable marketing cost deduction for future years is to be an estimate based upon any of the following, which the taxpayer may choose for any tax period being reported:

- The average MCF or MMBTU cost for the past four years,
- The MCF or MMBTU cost computed for the previous year,
- Any other reasonable method that is based on estimated future costs and/or throughput, subject to approval by the Department.

At the end of each subsequent year, the actual costs must be determined, and adjustments must be made for any difference between the actual marketing costs and the estimate computed under the options described above. Adjustments are to be reflected in the following year’s marketing cost deduction estimate.

Producer's Plant

When the gas conditioning equipment is owned and operated by the producer, the MCF unit marketing costs computation is to be based on the actual volume of product processed through the equipment. This includes such conditioning equipment as dehydrators, sweeteners, and compressors.

When a gas plant is owned and operated by the producer and the first sale of the gas is after the tailgate of such plant, the marketing costs per unit of product (MCF or MMBTU) are to be based on the actual throughput volume of product for that plant.

Fee Plants

When the producer is under an arm’s length agreement to pay a third-party fee plant operator for gas processed prior to the first sale, the fee is a marketing cost. The allowable deduction for this marketing cost is the actual fee paid (e.g., per MCF or MMBTU) to the plant operator.