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DATE: December 20, 2005

TO: **REVENUE**

FROM: Dale Vettel, Director
Bureau of Tax and Economic Policy

SUBJECT: **INTERNAL POLICY DIRECTIVE 2005-5**
SEVERANCE TAX
TAXABILITY OF CRUDE OIL WHEN NATURAL GAS LIQUIDS ARE INJECTED INTO AN OIL WELL TO ASSIST IN PRODUCTION

Background

This Internal Policy Determination provides guidance as to the application of Michigan's severance tax when natural gas liquids are injected into an oil well to assist in the removal of crude oil from such well. In this process the natural gas liquids become commingled with the existing heavy crude oil in the oil well resulting in a new and thinner crude oil product being severed from the soil.

Legal Policy Issues

1. May a taxpayer receive a credit based upon purchased natural gas liquids that have been subsequently injected into an oil well to assist in the removal of crude oil?

2. If a taxpayer may receive a credit, how should that credit be calculated?

Legal Policy Determinations

1. Yes, the taxpayer may receive a limited credit.

2. A calculation based upon credit for Michigan severance tax paid should be used.

Discussion

1. Michigan's Severance Tax on Oil or Gas is set forth in MCL 205.301, et. seq. The statutory language states that there is a specific tax that is known as the severance tax that is "levied upon each producer engaged in the business of severing from the soil, oil or gas." MCL 205.301. "… the severance tax required to be paid by each producer at the time of rendering each monthly report, or by a pipeline company, common carrier, or common purchaser, for

and on behalf of a producer, shall be in the amount of 5% of the gross cash market value of the total production of gas or 6.6% of the gross cash market value of the total production of oil during the preceding monthly period, exclusive of the production or proceeds from the production attributable to the state, the government of the United States, or a political subdivision of the state or government of the United States." MCL 205.303(1). The statute provides a lower 4% rate on crude oil extracted from stripper wells and marginal properties as defined in statute. MCL 205.303(2). The statute goes on to state 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." MCL 205.303(1) and 205.303(2).

In addition, the portion of the Natural Resources and Environmental Protection Act, MCL 324.60101, et. seq. pertaining to regulation of oil and gas wells provides for a fee of up to 1% of the gross cash market value of oil and gas produced in this state. MCL 324.61524. The fee is collected by the Department of Treasury at the same time, in the same manner, and subject to the provisions of The Severance Tax Act. MCL 205.301, et. seq . This fee is commonly referred to as a surveillance fee.

When a taxpayer injects Michigan tax paid gas into a well in order to assist in the removal of heavy crude oil, the gas is commingled with the unsevered, untaxed, heavy crude oil. A new thinner crude oil product, that is neither a natural gas liquid nor the original heavy crude oil, is extracted from the oil well. The new extracted untaxed oil is subject to Michigan's severance tax and surveillance fee at applicable rates.

Michigan's severance tax has historically been imposed only once, at the first time oil or gas is severed from the soil in Michigan. While the thinner crude oil product extracted after injection of natural gas liquids is fully subject to both severance tax and the surveillance fee, the new product contains a portion representing the original natural gas liquids injected into the well. The injected natural gas liquids may have previously been subjected to Michigan severance tax and surveillance fees if it was severed from the soil in Michigan. Additional imposition of severance tax on the full value of the newly extracted crude oil product could be viewed as resulting in a higher effective rate of tax than the statute provides. The department wishes to avoid such a result, and will allow a credit against the severance tax and surveillance fee calculated on the newly severed commingled crude oil product for any Michigan severance tax and surveillance fees paid on the injected natural gas liquids.

2. The dollar value of the credit is an amount equal to the result of "a" multiplied by "b":
    a. the gross mcf (thousand cubic feet) of natural gas liquids injected, less the actual or industry average percentage of natural gas liquids that have migrated from the well;
    b. the gross cash market value of the natural gas liquids injected per thousand cubic foot at the time of their original extraction, multiplied by the severance tax rate of 5% plus the applicable surveillance fee percentage in effect at the time of original extraction.

The taxpayer is eligible for this credit each time it injects Michigan tax paid gas into a well that contains untaxed oil. The taxpayer shall claim the credit on the first monthly report following the date on which the taxpayer makes the first extraction of oil from the well after Michigan tax paid gas was injected into the well. In the event the calculated credit exceeds severance tax due in the month it is reported, such excess credit shall be used as a carry forward to subsequent months until used up. A credit is not valid unless the taxpayer attaches to the appropriate monthly report documentation to support the claimed credit. Documentation should include, without limitation, proof that Michigan severance tax was paid on the gas injected or that the gas injected was extracted by a producer in Michigan, the volume of gas injected, and the percent of migrated gas.