

DEPARTMENT OF REVENUE

Taxpayer Service Division – Tax Group

SEVERANCE TAX

1 CCR 201-10

RULE 39-29-102(3)(A) DEFINITION OF “GROSS INCOME” FOR SEVERANCE TAX ON OIL AND GAS [~~Emergency rule expired 05/23/2017~~]

Basis and Purpose

The basis for this rule is §§ 39-21-112(1), 39-29-102(3)(a), and 39-29-102(7), C.R.S. The purpose of this rule is to provide, consistent with the Colorado Supreme Court’s ruling in BP Am. v. Colo. Dep’t of Revenue, clarification regarding gross lease revenues and the costs deductible therefrom in the calculation of gross income subject to severance tax on oil and gas.

- (1) **General rule.** For the purpose of severance tax imposed on oil and gas under article 29 of title 39, C.R.S., “Gross Income” is determined by deducting from Gross Lease Revenues any costs incurred by the Taxpayer for the Transportation, manufacturing, and Processing of Product between the Point of Taxable Valuation and the Point of Sale. Pursuant to § 39-29-114(1), C.R.S., persons who are members of the same controlled group of corporations shall be treated as one Taxpayer and the Gross Income therefor will be determined collectively. Use of the term “Taxpayer” in this rule refers collectively to all members of the same controlled group.
- (2) **Definitions.** As used in this rule, unless context otherwise requires:
 - (a) “Department” means the Department of Revenue
 - (b) “Entity” includes, but is not limited to, any corporation, limited liability company, partnership, estate, or trust.
 - (c) “Gross Lease Revenues” means all revenues from an oil and gas leasehold or freehold from the sale of any Product produced. “Gross Lease Revenues” includes the fair market value of any property acquired in exchange for Product. “Gross Lease Revenues” also includes the fair market value of any hydrocarbon gases used by the Taxpayer and includible in Gross Lease Revenues pursuant to paragraph (6)(a)(I) or (6)(b) of this rule.
 - (d) “Party” means any entity or individual.
 - (e) “Point of Sale” means the sales point or other point where the fair market value is established.
 - (f) “Point of Taxable Valuation” means the point at which the process to separate a bulk production stream into identifiable and measurable oil, gas, or free water begins or, in the case of gas that is not in need of initial separation, the point at which the gas is first identifiable and measurable. Oil, gas, or free water are identifiable and measurable if their respective volumes can be actually and separately identified and measured, whether or not the oil, gas, or free water, at such point, undergo actual identification and measurement. Oil, gas, and free water within a bulk production stream with respect to

which separation has not yet begun are not identifiable and measurable, any estimation of their respective volumes notwithstanding.

- (g) “Processing” means subjecting to a particular method, system, or treatment designed to effect a particular result. “Processing” includes, but is not limited to, mechanical separation, heating and treating, cooling, compression, dehydration, absorption, adsorption, refrigeration, flashing, sweetening, contaminant removal, cryogenic processing, and fractionation. “Processing” includes the separation of water from Product in a bulk production stream and the disposal thereof.
- (h) “Product” means crude oil, condensate, coalbed methane, carbon dioxide, and natural gas, including hydrocarbon and nonhydrocarbon gases; except that Product does not include any oil, gas, or other commodity exempt from taxation under § 39-29-105(1)(b), C.R.S.
- (i) “Related Parties” include:
 - (I) individuals related to one another as a spouse, parent, child, sibling, grandparent, grandchild, aunt, uncle, niece, nephew, or cousin, regardless of whether the relationship is by blood, marriage, adoption, or other means;
 - (II) two Parties, one holding an ownership interest in the other, either directly or indirectly, or an ownership interest of at least five percent in each being held by a third Party;
 - (III) in the case of a trust, the trust, its trustee, and its beneficiaries’;
 - (IV) in the case of an estate, the estate, its personal representative (or equivalent), its beneficiary/heir, and its executor/administrator.
- (j) “Transportation” has the same meaning as in § 39-29-102(7), C.R.S.
- (k) “Unrelated Party” is a Party that is not a Related Party.

(3) Determination of Gross Lease Revenues.

- (a) Except as provided in paragraph (3)(b) of this rule, in the case of Product sold, the revenue from the sale is included in Gross Lease Revenues.
- (b) If the Parties to a sale are Related Parties and the sales price is lower than the price for which the Product could have otherwise been sold to a ready, willing, and able buyer and where the Taxpayer was legally able to sell the Product to such a buyer, Gross Lease Revenues shall include the fair market value of the Product as determined by reference to comparable arm’s-length sales of like kind, quality, and quantity in the same field or area. The Department bears the burden of proof for demonstrating that the sales price for any sale of Product is lower than the price for which the Product could have otherwise been sold to a ready, willing, and able buyer and where the Taxpayer was legally able to sell the Product to such a buyer.
- (c) In the case of hydrocarbon gases used by the Taxpayer pursuant to paragraphs (6)(a)(I) or (6)(b) of this rule, Gross Lease Revenues shall include the fair market value of the hydrocarbon gases as determined by reference to comparable arm’s-length sales of like kind, quality, and quantity in the same field or area.

- (4) **Deductions for Transportation, Manufacturing, and Processing Costs.** In determining Gross Income, deduction from Gross Lease Revenues is allowed, as prescribed in this paragraph (4), for costs borne by the Taxpayer for Transportation, manufacturing, and Processing of Product between the Point of Taxable Valuation and the Point of Sale.
- (a) **Direct Operating Costs.** Deduction is allowed, as prescribed in this paragraph (4)(a), for direct operating costs borne by the Taxpayer for the Transportation, manufacturing, or Processing of Product.
- (I) **Equipment, Machinery, and Real Property Improvements.** Deduction is allowed for the cost of equipment, machinery, and real property improvements used for Transportation, manufacturing, or Processing of Product. Deductible costs include, but are not limited to, the following costs to the extent that such costs are incurred for Transportation, manufacturing, or Processing:
- (A) acquisition costs for equipment and machinery not eligible for the depreciation and cost of capital deductions allowed under paragraph (4)(b) of this rule;
 - (B) depreciation and cost of capital, determined under paragraph (4)(b) of this rule, for depreciable equipment, machinery, and real property improvements, including any capitalized maintenance and repair costs;
 - (C) non-capitalized costs of maintenance and repair for equipment, machinery, and real property improvements;
 - (D) rental payments for leased equipment, machinery, and real property improvements;
 - (E) insurance costs for equipment, machinery, and real property improvements;
 - (F) property taxes on equipment, machinery, and real property improvements; and
 - (G) environmental compliance costs and the cost of any required environmental impact statement for the operation of equipment, machinery, and real property improvements.
- (II) **Materials and Supplies Costs.** Deduction is allowed for the cost of materials and supplies used for Transportation, manufacturing, or Processing of Product. Deductible costs include, but are not limited to, the following costs to the extent that such costs are incurred for Transportation, manufacturing, or Processing:
- (A) chemicals;
 - (B) lubricants for equipment and machinery;
 - (C) fuel and utilities used to operate equipment, machinery, and real property improvements, except that no deduction is allowed for the use of any hydrocarbon gases which are not included in Gross Lease Revenues reporting pursuant to paragraph (6)(a)(I) of this rule.
- (III) **Labor Costs.** Deduction is allowed for the cost of labor performed in the Transportation, manufacturing, or Processing of Product, including, but not

limited to, salaries, wages, payroll taxes, worker's compensation insurance, and benefits. Labor costs eligible for deduction include operating, monitoring, servicing, or repairing facilities, equipment, and machinery used for the Transportation, manufacturing, or Processing of Product. If an employee's duties include both work in the Transportation, Manufacturing, or Processing of Product and in non-deductible activities such as those enumerated in paragraph (4)(d) of this rule, deduction is allowed only for that part of the employee's labor that is in the Transportation, manufacturing, or Processing of Product.

- (IV) **General and Administrative Overhead Costs.** Deduction is allowed for general and administrative overhead costs that are directly and unambiguously attributable to Transportation, manufacturing, or Processing of Product.
- (V) **General and Public Liability Insurance.** Deduction is allowed for the cost of general and public liability insurance for Transportation, manufacturing, or Processing of Product.
- (b) **Depreciation and Cost of Capital.** Deduction is allowed, as prescribed in this paragraph (4)(b), for depreciation and cost of capital for any investment the Taxpayer makes in capital assets used for Transportation, manufacturing, or Processing of Product. The depreciation and cost of capital deductions shall be calculated in the same manner as prescribed for Return of Investment (Rofl) and Return on Investment (ROI), respectively, by the Property Tax Administrator for the valuation of lands and leaseholds producing oil and gas; except that no depreciation or cost of capital deduction is allowed for an investment in a capital asset not used in Transportation, manufacturing, or Processing as those terms are defined in this rule. The prescription by the Property Tax Administrator referenced in this paragraph (4)(b) is made in Assessor's Reference Library, Volume 3, Chapter 6 or any successor publication.
 - (I) If a Taxpayer makes a capital investment eligible for deduction under paragraph (4)(b) of this rule and also uses such capital asset to transport, manufacture, or process oil and gas for other Parties in exchange for compensation, the deduction allowed under paragraph (4)(b) of this rule shall be reduced in proportion to the amount of oil and gas transported, manufactured, or processed using the capital asset for which the Taxpayer receives compensation divided by the total amount of oil and gas transported, manufactured, or processed using the capital asset.
 - (A) *Example.* The Taxpayer uses a capital asset to transport 1,000 barrels of produced crude oil during the tax year. Three hundred of such barrels are transported on behalf of another Party from which the Taxpayer received compensation. The depreciation and cost of capital deductions otherwise allowable under this paragraph (4)(b) must be reduced by 30%.
 - (II) Assets partially depreciated as of the effective date of this rule shall be subject to the provisions of this rule and this paragraph (4)(b)(II).
 - (A) With respect to depreciation claimed for tax years prior to the effective date of this rule, no adjustment to such prior year claim shall be required as a result of this rule, except as prescribed by paragraph (4)(b)(III) of this rule.
 - (B) If a Taxpayer claims a deduction under paragraph (4)(b) of this rule for a partially depreciated capital asset, the amount of the deduction shall be calculated by dividing the remaining undepreciated investment balance

for the asset by the remaining years of the asset life, determined pursuant to Property Tax Administrator guidance published in Assessor's Reference Library, Volume 5, Chapter 4 or any successor publication and with respect to the year the asset was originally placed into service.

- (III) If a Taxpayer sells, transfers, or otherwise disposes of any asset for which the Taxpayer claimed a depreciation deduction in any prior tax year, the Taxpayer must make a depreciation adjustment as prescribed in this paragraph (4)(b)(III).
 - (A) If the remaining undepreciated balance of the asset exceeds the amount realized from the sale or transfer or, in the case of any other disposition, the fair market value of the asset, the difference shall be additional depreciation allocated to the year of the sale, transfer, or disposition for which the Taxpayer may claim a deduction, subject to the limitation in paragraph (5) of this rule.
 - (B) If the amount realized from the sale or transfer or, in the case of any other disposition, the fair market value of the asset, exceeds the remaining undepreciated balance, the difference shall be a reduction of the previously claimed depreciation; except that the reduction in depreciation is limited to the aggregate depreciation deduction previously claimed for the asset. The reduction shall be allocated first to the tax year immediately preceding the year of the sale, transfer, or disposition and, if the amount of the reduction exceeds the amount of depreciation claimed for the asset for that immediately preceding year, the excess will be allocated to the next immediately preceding tax year and, in the same manner, to each additional preceding tax year until the reduction has been fully exhausted. The Taxpayer must file an amended return for each year to which a reduction in depreciation has been allocated pursuant to this paragraph (4)(b)(III)(B); except that no amended return is required for any tax year for which the period permitted for assessment under § 39-29-107(1), C.R.S. has expired.
 - (C) In lieu of filing amended returns pursuant to paragraph (4)(b)(III)(B) of this rule, a Taxpayer may elect to report the entire reduction in depreciation as an addition to Gross Income for the year of the sale, transfer, or disposition.
- (c) **Fees and Charges – Related and Unrelated Parties.** Except as provided in paragraphs (4)(c)(I) and (II) of this rule, deduction is allowed for any fee, charge, or other amount the Taxpayer pays to a Related or Unrelated Party for the Transportation, manufacturing, or Processing of Product.
 - (I) If a Party pays any fee, charge, or other amount to a Related Party and the two Parties are treated as one Taxpayer pursuant to § 39-29-114(1), C.R.S., the fee, charge, or other amount shall be considered an intra-company transfer and, as a result, no deduction shall be allowed therefor. The Taxpayer may instead claim any deductions allowable under paragraphs (4)(a) and (4)(b) of this rule for costs incurred in the Transportation, manufacturing, and Processing of the Taxpayer's Product.
 - (II) If the Taxpayer pays any fee, charge, or other amount to a Related Party that is not treated as one with the Taxpayer under § 39-29-114(1), C.R.S., for Transportation, manufacturing, or Processing, and the fee, charge, or other amount exceeds the fair market value for the Transportation, manufacturing, or Processing performed, the deduction allowed to the Taxpayer is the fair market

value of the Transportation, manufacturing, or Processing performed as determined by reference to comparable, arm's length transactions. In determining the fair market value of the Transportation, manufacturing, or Processing performed, the quantity and quality of the Product, the field or area in which the service was performed, and the terms and conditions of the contractual agreement must be considered in determining the comparability of transactions. The Department bears the burden of proof for demonstrating that the fee, charge, or other amount paid exceeds the fair market value of the Transportation, manufacturing, or Processing performed.

- (d) **Non-deductible Costs.** No deduction is allowed for costs that are not for the Transportation, manufacturing, or Processing of Product. No deduction is allowed for any cost incurred in relation to any oil, gas, or other commodity exempt from taxation under § 39-29-105(1)(b), C.R.S. Non-deductible costs include, but are not limited to:
- (I) down-hole production and operating costs incurred to extract or move Product from the reservoir to the Point of Taxable Valuation, including:
 - (A) the cost of repairs and maintenance of the pumping unit, tubing, casing, liners, or down-hole equipment, parts or supplies; and
 - (B) the cost of injection of gas, water and/or CO₂ for secondary recovery;
 - (II) costs for any activities performed in relation to a bulk production stream prior to the Point of Taxable Valuation;
 - (III) legal costs, title opinions, and any other pre-drilling or pre-production costs;
 - (IV) work over, well-pulling, or well re-completion costs;
 - (V) theoretical or actual line losses or “shrinkage”;
 - (VI) property taxes on oil and gas leaseholds and lands;
 - (VII) oil and gas depletion allowances;
 - (VIII) general and administrative overhead costs that are not directly and unambiguously attributable to Transportation, manufacturing, or Processing of Product, such as headquarters personnel, telephone service, vehicle expenses, and office supplies;
 - (IX) marketing costs and costs incurred to sell Product;
 - (X) environmental compliance costs, including the cost of any environmental impact statement, related to oil and gas production prior to the Point of Taxable Valuation; and
 - (XI) any costs for Transportation, manufacturing, or Processing Product not included in Gross Lease Revenues.
 - (XII) any costs incurred by the Taxpayer to perform Transportation, manufacturing, or Processing of Product for another Party that compensates the Taxpayer for such Transportation, manufacturing, or Processing.

- (5) **Limitation on deductions.**

- (a) Transportation, manufacturing, and Processing costs must be determined and deducted on a well-by-well basis. If Product from multiple wells is collectively transported, manufactured, and processed, the costs of Transportation, manufacturing, and Processing must be allocated based upon pro rata sales from each well.
 - (I) If a Taxpayer performs Transportation, manufacturing, or Processing for another Party, no deduction is allowed for the cost of any Transportation, manufacturing, or Processing for which the Taxpayer receives compensation from the other Party.
 - (b) Deductions for Transportation, manufacturing, and Processing costs allocated and attributed to a well cannot exceed the Gross Lease Revenues derived from the well. No deduction is allowed for any cost incurred in relation to any oil, gas, or other commodity exempt from taxation under § 39-29-105(1)(b), C.R.S.
 - (c) Deduction is only allowed for costs substantiated by appropriate documentation. A Taxpayer must maintain records, made at the time any deductible cost was incurred, to demonstrate that the cost was for Transportation, manufacturing, or Processing of Product.
- (6) **Used Product.**
- (a) If a Taxpayer uses hydrocarbon gases it produces for Transportation, manufacturing, or Processing, the Taxpayer may elect to either:
 - (I) include in Gross Lease Revenues the fair market value of such hydrocarbon gases, as determined under paragraph (3)(c) of this rule, and claim deduction for such Product under paragraph (4) of this rule; or
 - (II) exclude from Gross Lease Revenues the fair market value of such hydrocarbon gases, as determined under paragraph (3)(c) of this rule, and claim no deduction for such Product under paragraph (4) of this rule.
 - (b) If a Taxpayer uses hydrocarbon gases it produces for any purpose other than reinjection, Transportation, manufacturing, or Processing the Taxpayer shall include in Gross Lease Revenues the fair market value of such hydrocarbon gases, as determined under paragraph (3)(c) of this rule, and claim no deduction for such Product.
 - (I) If the Taxpayer does not, within the Taxpayer's regular course of business, measure the volume of hydrocarbon gases used for nondeductible purposes and includible in Gross Lease Revenues pursuant to paragraph (3)(c) of this rule, the Taxpayer may use a reasonable method to estimate such volume. The Taxpayer must document the basis for such estimate and make such documentation available to the Department upon request.